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Does Insider Trading Pay? An Analysis of Trading and Tipping Activities in Insider Trading Litigation

Aneta Spaic

Claire Nolasco

Lily Chi-Fang Tsai

Michael S. Vaughn

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**DOES INSIDER TRADING PAY? AN ANALYSIS OF TRADING
AND TIPPING ACTIVITIES IN INSIDER TRADING
LITIGATION**

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DOES INSIDER TRADING PAY? AN ANALYSIS OF TRADING AND TIPPING

ACTIVITIES IN INSIDER TRADING LITIGATION

INTRODUCTION

The Concept of Insider Trading

Insider trading is prohibited under Section 10(b) of the Securities and Exchange Act (2012), and its implementing rule, Rule 10b-5 (Code of Federal Regulations, 2014). The law provides that,

(i)t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement [1] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. (Securities and Exchange Act, 2012)

Although not explicitly defined in current statutes, various federal and state courts, including the United States Securities and Exchange Commission (“SEC”) have developed and expanded on the forms, legal standards, defenses, and boundaries of insider trading (Anderson, 2014; Kim, 2014; Murdock, 2014; Yeager, Wood, Nagel, & Mccarrick, Jr., 2014; Tsepelman, 2015).

Breach of Duty

For insider trading to occur, the corporate insider must have breached a fiduciary duty to the corporation by trading on material, nonpublic information (Acoba, 1999; *Chiarella v. United*

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3 *States, 1980; Dirks v. SEC, 1983; Malone, 2003; Silver, 1985*). In one case, the Supreme Court
4 described what has become known as the majority rule, stating that a director owed a fiduciary
5 relationship solely to the corporation and not to the corporate shareholders (*Goodwin v. Agassiz,*
6 1933). Special facts, however, sometimes create a fiduciary relationship between a director and
7 shareholders, legally obliging the director to disclose material facts before trading on the
8 information (*Strong v. Repide, 1909*). Special facts existed in *Strong v. Repide* (1909) when the
9 director and controlling shareholder of the company used deceit by hiring an agent to personally
10 approach and purchase the shares from another stockholder, concealing his identity from the
11 latter. Other courts espouse the minority rule, holding that directors owed a fiduciary duty not
12 only to the corporation but also to the shareholders and hence, cannot profit by trading on inside
13 information at the expense of shareholders (*Dawson v. National Life Ins. Co. of America, 1916;*
14 *Hotchkiss v. Fischer, 1930; Oliver v. Oliver, 1903; Smith, 1921; Stewart v. Harris, 1904*).

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31 The law on insider trading was expanded to cover not only corporate insiders and tippees
32 but also misappropriators who employ deceit in obtaining material nonpublic information (i.e.,
33 external lawyers hired to assist corporate acquisitions and takeovers) (*United States v. O'Hagan,*
34 1997) and fiduciaries who trade on material nonpublic information confided to them by family
35 members (*Securities and Exchange Commission v. Rocklage, 2006; United States v. Evans,*
36 2007). The Second Circuit Court of Appeals in *Securities and Exchange Commission v.*
37 *Dorozhko* (2009) further created a category of fraud by affirmative misrepresentation, holding
38 that breach of fiduciary duty is a necessary element of insider trading only when deception is
39 based on silence or nondisclosure but not when deceit is based on active misrepresentation, such
40 as computer hacking. The Second Circuit remanded the case, saying that computer hacking could
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3 be considered a deceptive device prohibited by Section 10(b) of the Securities Exchange Act of
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5 1934 and Rule 10b-5 (*Securities and Exchange Commission v. Dorozhko*, 2009).
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8 The case of *United States v. Newman* (2014) clarified the nature of the tipper's breach of
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10 duty, the level of proof required to show such breach, and the standard of criminal intent or *mens*
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12 *rea* for the tippee liability (Malone, 2003; Silver, 1985; Strader, 2015). The insider or
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14 misappropriator must knowingly act with the intent of depriving the owner of the information for
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16 his or her personal gain (Beeson, 1996; Dessent, 1998; Strader, 2015). A tippee or individual
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18 who trades based on material nonpublic information received from an insider-tipper is also liable
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20 under Section 10-b (Yeager et al., 2014). Within the context of tipper-tippee liability, the tipper
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22 must disclose material, nonpublic confidential information for his or her personal benefit,
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24 "broadly defined to include not only pecuniary gain, but also, *inter alia*, any reputational benefit
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26 that will translate into future earnings and the benefit one would obtain from simply making a
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28 gift of confidential information to a trading relative or friend" (*United States v. Newman*, 2014,
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30 p. 452). For the tippee to be liable, he or she knows or should have known that: (1) the tipper
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32 breached a duty of confidentiality to the owner of the information for personal benefit; and (2)
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34 the tipper intended the tippee to trade on the information (*United States v. Newman*, 2014;
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36 Strader, 2015).
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42 **Forms of Insider Trading**

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45 There are two categories of insider trading involving deceit by omission or nondisclosure:
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47 (1) "traditional or classical" insider trading involving a corporate insider who uses or discloses
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49 material nonpublic information and trades on securities for personal gain (Anderson, 2014, p. 18;
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51 Strader, 2015, p. 1428); and, (2) the "misappropriation theory" of insider trading involving a
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53 non-corporate actor who appropriates information from the owner (e.g., lawyer whose firm was
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3 hired to assist the corporation planning to acquire another company) and trades on such
4 information (Anderson, 2014, p. 20; Strader, 2015, p. 1429). Both classical and misappropriation
5 forms of insider trading require that the actor must have breached a duty to the source of
6 information by deriving monetary, professional, or other valuable benefits (Anderson, 2014;
7 Strader, 2015). A third category of insider trading based on deceit involves affirmative
8 misrepresentation, as in the case of computer hackers who hack into a computer system of a
9 company to steal and trade on such information (*SEC v. Dorozhko*, 2009). Insider trading based
10 on deceit through active misrepresentation does not require breach of any duty to the owner or
11 source of information (Strader, 2015).
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23 **Legal Remedies against Insider Trading**

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26 Several legal remedies are available against individuals or corporations suspected of
27 insider trading: (1) government prosecution by the Department of Justice (“DOJ”) under the
28 criminal provisions of the Securities and Exchange Act of 1934 (2012); (2) civil enforcement
29 action by the SEC under the same securities laws; and, (3) private shareholder’s derivative class
30 action under Title IV, Rule 23 of the Federal Rules of Civil Procedure (2014). Civil liabilities
31 under the Securities Exchange Act of 1934 include, among others, disgorgement to the federal
32 government of the amount of profits or losses avoided and penalties not exceeding three times
33 the profit gained or loss avoided as a result of the unlawful insider trading (Securities and
34 Exchange Act of 1934, 2012). Criminal sanctions under Section 32(a) of the Securities Exchange
35 Act of 1934 involve fines not more than \$5,000,000 or imprisonment not more than 20 years, or
36 both, except when the defendant is legal entity such as a corporation, a fine not exceeding
37 \$25,000,000 may be imposed.
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SURVEY OF RELATED LITERATURE

Theories of Insider Trading

Various theories are tested in the literature on insider trading, including anomie theory (Passas, 1990), control theory (Makkai & Braithwaite, 1991), opportunity theory (Makkai & Braithwaite, 1991), organization theory (Ermann & Lundman, 1978; Braithwaite, 1989), and neutralization theory (Bensen, 1985). Some scholars advocate using the rational choice theory to test the assumption that insider traders are rational actors who weigh the potential benefits against the costs of committing white collar crime (Becker, 1968; Coffee, Jr., 1980; Oberg, 2014; Posner, 1980). Several studies analyze corporate crime within a deterrence/rational choice framework, based on the assumption that corporate offenders would be deterred by the threats of sanctions (Braithwaite & Geis, 1982; Chambliss, 1967; Oberg, 2014; Paternoster, 1989). However, some empirical studies have found no or weak support for the deterrence theory of corporate crime (Block, Nold, & Sidak, 1981; Simpson & Koper, 1992).

Paternoster and Simpson (1996) counter that the lack of support for rational choice theory in prior literature is due to the focus on formal sanctions instead of other informal sanctions (e.g. public censure). Paternoster and Simpson (1996, p. 553) explain that their choice model is a “subjective expected utility theory,” where the individual balances perceived costs of offending and subjective expectations of rewards and benefits. Individuals are also affected by the context within which they are employed, such as the characteristics and environment of their corporate workplace. Individual decisions to commit corporate crimes are thus influenced by perceived risks and benefits for themselves, for their firm or company (Paternoster & Simpson, 1996). Their study involving 98 graduate students in M.B.A. programs and corporate executives attending a business school confirmed that decisions to commit corporate crime are significantly

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3 affected by the “perceived incentives and disincentives of the act, the organizational context, and
4 the moral climate of the firm” (Paternoster & Simpson, 1996, p. 568). Respondents in their
5 study were significantly more likely to report that they would commit an illegal act (corporate
6 offending) if the act resulted in “direct financial benefits for the company,” such as higher
7 revenues or if it “enhanced a sense of organizational pride or esteem” (Paternoster & Simpson,
8 1996, p. 568).

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10 Szockyj and Geis (2002, p. 274) tested “inferentially” Gottfredson and Hirschi’s (1990)
11 self-control theory in their analysis of insider trading cases, both civil and criminal, from 1980 to
12 1989. According to self-control theory, offenders, including white collar criminals, have low
13 self-control (Gottfredson & Hirschi, 1990). People with low self-control are “risk seeking, short-
14 sighted, insensitive to others, and desire immediate gratification” (Szockyj & Geis, 2002, p.
15 274). They predicted, among others, that insider traders are: (1) more prominent in lower-level
16 employment than in higher level management, since advancement in position requires higher
17 level of self-control; (2) repeat offenders, engaging in insider trading more than once since they
18 are risk-seeking; and (3) more likely to tip others since they are risk-seeking (Szockyj & Geis,
19 2002) . Their analysis found that 63.4% of temporary insiders tipped others (chi-square was
20 significant at $p<.001$) and that defendants in the securities industry were more likely to be
21 charged with multiple illegal trades (chi-square was significant at $p<.001$). They also found that
22 compared to civil defendants, criminal defendants were more likely to have engaged in multiple
23 insider trading violations ($p<.001$). Being in business or in some other occupation than the
24 securities industry also decreased the odds of being charged criminally ($p<.05$). They also found
25 that criminal defendants were more likely to have obtained profits in excess of US\$25,800
26 compared to civil defendants (chi-square was significant at $p<.01$).

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3 McNamara (2015) analyzed insider trading law through the lens of evolutionary
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5 psychology. The author discusses Robert Trivers' (1971) theory of evolutionary psychology,
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7 explaining that human evolution favors individuals who have a "propensity for altruistic
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9 behavior" or behavior benefiting a non-affiliated recipient despite being "apparently detrimental"
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11 to the performer of the altruistic behavior (McNamara, 2015, p. 276). McNamara (2015, p. 278)
12
13 posits that human psychology is "finely tuned" to detect subtle forms of cheating, or situations
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15 where a partner "attempts to reciprocate less than the value of the act originally performed."
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17 Because of difficulties in detecting subtle cheating, humans evolved a "complex psychological
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19 system," wherein each individual regulates both "his own altruistic and cheating tendencies and
20
21 his responses to these tendencies in others" (McNamara, 2015, p. 278). McNamara (2015)
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23 explains that there is strong condemnation of insider trading because of perceptions that it
24
25 violates fundamental notions of fairness and involves cheating of other traders in the financial
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27 markets.
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33 Fehr and Gächter (2002) conducted an experiment that verified the existence of altruistic
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35 punishment. Their sample involved 240 students from the University of Zurich who were
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37 randomly assigned to groups of four and given a capital of 20 "money units" ("MUs") each (Fehr
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39 & Gächter, 2002, p. 137). They found that 84% of the participants punished a co-participant for
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41 insufficient cooperation at least once, and that 74% of the punishments were imposed by
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43 participants who made above-average contributions on those who made below-average
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45 contributions. They also found that the punishment conditions increased investments in
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47 subsequent rounds of the experiment. Thus, 94.2% of participants made higher investments in
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49 rounds with the punishment condition than in those without. The experiment verified the
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51 existence and effects of altruistic punishment— group cooperation remained stable in groups
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3 where punishment was imposed compared to those where it was not (Fehr & Gächter, 2002).
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5 Green and Kugler (2012) also found that respondents in case scenario surveys assigned more
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7 blame to tippees who traded on inside information than to the tipper who relayed the
8
9 information, regardless of the tipper's motives.
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11 12 **Enforcement of Insider Trading Laws** 13

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15 Extant literature analyzes the effectiveness of various methods of enforcement against
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17 insider trading (Dooley, 1980; Fried, 2014; Haddock & Macey, 1987; Henderson, Jagolinzer, &
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19 Muller, III, 2015; Heyman, 2015; Lei & Ramsay, 2014; Meulbroek, 1992; Reichman, 1993;
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21 Tomasic, 1991; Yadav, 2015). Heller (2015) cautions that criminal indictment of financial and
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23 accounting firms have substantial and far reaching consequences on the business sector and
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25 economy. He cites as examples, the corporate indictments of Arthur Andersen LLP in 2002 for
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27 obstruction of justice (due to its shredding of documents related to accounting services for Enron
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29 Corporation) and S.A.C. Capital Advisors LP ("SAC Capital") and three related entities in 2013
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31 for insider trading from 1999 to 2010. The author argues that prosecutors should consider the
32
33 inherent vulnerabilities of financial and accounting firms, which often rely on reputational
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35 goodwill when deciding whether to file corporate criminal charges. A mere indictment can have
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37 adverse consequences on these firms, resulting in massive layoffs, capital flight, decrease in
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39 revenues, and in certain cases closure of business. The author concludes that in certain cases,
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41 prosecutors should consider the appropriateness of alternative means, such as deferred
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43 prosecution agreements, non-prosecution agreements, and other pre-trial settlement agreements
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45 to settle corporate criminal liability (Heller, 2015). When considering collateral consequences of
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47 an indictment, prosecutors must consider the impact "on all affected parties and the economy as
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49 a whole" (Heller, 2015, p. 795).
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3 Oberg (2014) posits that criminal remedies and sanctions, including imprisonment and
4 fines, are more effective than civil remedies. Criminal sanctions are effective because they have
5 a deterrent effect on inside traders who are both profit driven and risk averse (Becker, 2012;
6 Kadir & Muhamad, 2012; Moohr, 2003; Oberg, 2014; O'Connor, 1989; Silver, 1985; Szockyj &
7 Geis, 2002). Criminal punishment is also more effective than civil remedies because it
8 effectively conveys public censure through the shaming function (Eads, 1991; Kahan, 1996;
9 Levi, 2001). Since insider traders have higher social standing than property or violent offenders,
10 imprisonment has a greater deterrent effect "because humiliation brought about by prison
11 punishment is felt more by middle- and upper-class offenders than lower-class ones" (Oberg,
12 2014, p. 120).

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Contrary studies claim that criminal sanctions have no deterrent effect because the
rational actor model of insider trading lacks empirical support (Langenvoort, 2007; Seyhun,
1992). Seyhun (1992), for example, analyzed trading activities and enforcement actions against
insider trading in the United States in the 1980s. He noted that despite the increase of criminal
fines to a maximum of US\$1 million and prison sentences to 10 years, there was an increased
frequency of large volumes of insider trading (Seyhun, 1992). Oberg (2014, p. 124) concedes
that criminal sanctions may lack deterrent effect due to "ineffective enforcement of insider
trading laws," "low probabilities of detection," difficulty of prosecution due to problems with
evidence gathering, and the "high burden of proof in criminal trials."

Other scholars espouse the effectiveness of alternative remedies such as civil litigation,
resulting in penalties up to three times the amount of profit or loss obtained as a result of insider
trading, individual fines, and disqualification orders, such as barring the offender from further
employment in the position that gave rise to his or her insider trading activities (Posner, 1980;

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3 Spitz, 1989). Civil litigation may be more effective due to lower procedural costs of
4 enforcement and lower burden of proof in civil cases (e.g., preponderance of evidence) (Atkins,
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6 2013; Brown, 2004; La Porta, Lopez-De-Silanes, & Shleifer, 2006).
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10 Pro-criminal litigation scholars of corporate crime assert, however, that civil litigation is
11 not as effective as criminal litigation because civil defendants are often individuals who lack
12 financial resources (Kahan, 1998; Robinson, 1996). Since civil damages and penalties are often
13 directed against the corporate firm instead of the individual, the “deterrent effect of individual
14 civil penalties is diluted” (Ober, 2014, p.129). In addition, “excessive litigation” and “weak
15 social stigma” of civil penalties further “dilute the deterrent effect” of civil litigation (Ober,
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17 2014, p.129).
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26 There has been no recent study on insider traders and their trading and tipping activities
27 within insider trading litigation. The seminal work of Szockyj and Geis (2002) on insider
28 litigation analyzed cases civilly filed by the SEC and criminally litigated by the DOJ from 1980
29 to 1989. This article further expounds on current research by analyzing civil cases and
30 enforcement proceedings filed by the SEC and criminally prosecuted by the DOJ from 2012 to
31 2014. The analysis aims to explore the motivations for trading and patterns for tipping by
32 corporate insiders and misappropriators. Civil and criminal proceedings are compared to
33 determine differences or similar among parties to the proceedings and outcomes of litigation.
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44 **DATA AND METHODS**

45 Two databases were used in this article to consolidate data on civil enforcement
46 proceedings and criminal litigation filed against individuals suspected of insider trading. The
47 Securities and Exchange Commission (SEC) maintains a public database, containing all records
48 of federal court actions, administrative proceedings, decisions of administrative law judges, SEC
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3 opinions, trading suspensions, and all corporate filings and information regarding different forms
4 of securities violation, including insider trading. A keyword search on “insider trading” yielded a
5 listing of all enforcement proceedings litigated and settled by the SEC. The authors limited their
6 analysis to insider trading enforcement proceedings litigated from January 1, 2012 to December
7 31, 2014 (N=69). The WESTLAW database contains electronic copies of all published and
8 unpublished court decisions. For this, a keyword search was used to gather criminal cases on
9 insider trading decided by federal courts (the U.S. Supreme Court, U.S. Circuit Courts of
10 Appeals, and U.S. District Courts). The search parameters required that the terms “insider
11 trading” AND “criminal” appeared in the “main body” of the case and that only reported
12 criminal cases filed and decided between January 1, 2012 until December 31, 2014 be searched
13 for relevant cases (N=58). The authors then read each case individually and determined that not
14 all cases were relevant to the study, either because the case only discussed insider trading in
15 passing and covered a different type of securities or financial fraud, the case did not contain
16 sufficient facts to enable full analysis, or contained a decision that either affirmed or repealed a
17 lower court’s decision, without discussing the facts. Also, some of the cases were repeated
18 because of the appeal process through the federal courts. The sample of criminal cases deleted
19 these, yielding a total of 14 cases. The authors conducted a preliminary inductive doctrinal
20 analysis (Nolasco, Vaughn, & del Carmen, 2010) to extract variables from these civil
21 enforcement proceedings and criminal cases to determine variables to be coded for quantitative
22 analysis (N=83). After conducting an in-depth doctrinal inductive analysis of the variables that
23 were relevant for this article, the cases were then analyzed and coded for further quantitative
24 analysis.

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54 The unit of analysis in this study was the insider trading case. Following jurisprudence on
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insider trading:

Type of case and type of defendants or tippers

The cases were classified according to whether they were civil or criminal. Defendants were classified according to whether they were: (1) corporate insiders (e.g., employee, officer, director) (*Chiarella v. United States*, 1980); (2) outsider who misappropriates (e.g., attorney) (*United States v. O'Hagan*, 1997); or, (3) outsider who makes an affirmative misrepresentation (e.g., hacker) (*Securities and Exchange Commission v. Dorozhko*, 2009).

Industry of insider

The occupations of the corporate insiders were classified according to whether they worked in the: (1) health and pharmaceutical industry; (2) securities and brokerage industry; (3) engineering, oil, and chemical industry; (4) technology, media, or investor relations industry; (5) retail industry; or, (6) legal, finance, and banking industry.

Breach of duty

The cases were analyzed to determine whether defendants breached a known duty to their corporations or source of information. Breach of duty was coded as 1 (no) and 2 (yes).

Entity to who defendant breached duty

Entity harmed by the breach was coded as 1 (corporation whose shares were traded) and 2 (source of inside information).

Trading activity of defendant or tipper

Not all instance of insider trading involved a defendant who traded on the material, nonpublic information. In some instances, the defendant(s) or tipper(s) tipped others who traded on the information. Since the authors wanted to examine the trading patterns not only of the tippees but the defendant(s) or tipper(s), the trading activity of the defendants/tippers was coded

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3 as 1 (no) and 2 (yes).
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6 *Tippling activity of defendant/tipper*
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8 Tipping activity of defendant/tipper was coded as 1 (no) and 2 (yes).
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11 *Tippees relationship to tipper*
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13 In cases where the defendant/tipper passed material, nonpublic information to outsiders,
14 tippee(s) relationship to the tipper were classified according to whether they were: (1)
15 acquaintances; (2) business associates; (3) close personal friends; or (4) family members.
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20 *Purpose of breach by defendant/tipper*
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22 The purpose of breach of duty by the defendant/tipper was classified according to
23 whether the defendant/tipper: (1) received a direct financial benefit or pecuniary gain; (2)
24 obtained a reputational benefit, such as enhanced goodwill of the business or trust from clients;
25 or (3) simply gave a gift of confidential information to the tippees (*United States v. Newman*,
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31 2014).
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34 *Tipper's knowledge of tippee's intent to use inside information (tipper Mens Rea)*
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36 Tipper's knowledge of tippee's intent to use inside information was classified into: (1)
37 tipper did not know that tippee would use the information; (2) tipper should have known that
38 tippee would use information (negligence); (3) tipper knew that tippee may or was likely to trade
39 on information (recklessness); or (4) tipper knew that tippee would trade on information
40 (knowledge) (*United States v. Newman*, 2014).
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48 *Tippee's knowledge of tipper's breach of duty (tippee Mens Rea)*
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50 Tippee's knowledge of tipper's breach of duty was classified into: (1) tippee did not know
51 that tipper obtained personal benefit in exchange for disclosing information; (2) tippee should
52 have known, had reason to know, or had a general understanding that tipper was disclosing
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3 information for personal benefit (negligence); (3) tippee deliberately avoided knowing whether
4 tipper breached his duty by disclosing information for personal benefit (recklessness); or (4)
5 tippee knew that tipper breached his duty by disclosing information (knowledge) (*United States*
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10 *v. Newman*, 2014).

11 *Settlement with SEC*

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13 Settlement with SEC was coded as 1 (no), 2 (pending), or 3 (yes).

14 *Amount of profit, amount of settlement, amount of judgment, and length of imprisonment*

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17 Amount of settlement by defendant/tipper/s, amount of settlement by tippee/s, total
18 amount of settlement, amount of profit of defendant/tipper, amount of profit by tippee, total
19 amount of profit, and amount of judgment/penalty were all coded in US Dollars (U.S.\$). Length
20 of imprisonment was coded in months.
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28 **RESULTS**

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31 The data was examined to compare civil enforcement proceedings against criminal
32 enforcement proceedings. The mean settlement by defendant/tipper/s, mean settlement by
33 tippee/s, mean total settlement, mean profit of defendant/tipper, mean profit by tippee, mean total
34 profit, and mean amount of judgment/penalty were compared between civil and criminal
35 defendants. Trading activities of the defendant tipper were examined to determine motivations of
36 the defendant/tipper for breaching a known duty to either the corporation-employer or the source
37 of inside information. Finally, tipping activities of the defendant/tipper were further analyzed to
38 determine the tippees' relationship to the tipper.
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49 **Type of Insider Trader**

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51 Comparison of civil enforcement and criminal proceedings show that more than half of
52 the defendants in both cases (52% of civil defendants and 57% of criminal defendants) were
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3 corporate insiders (e.g. director, officer, employee) who worked directly for the corporation from
4 whom the material, nonpublic information was obtained and either traded on or passed to others
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6 (see Table 1). Less than half of the defendants (46% of civil cases and 42% of criminal
7
8 defendants) were outsiders who misappropriated information.
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11 **Industry of Insider**

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14 Defendants belonging to the legal, finance, and banking industry constitute almost half
15 (42.9%) of the criminal defendants and approximately a third (29%) of the civil defendants.
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17 More than a quarter of the perpetrators of insider trading also come from the technology, media,
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19 and investor relations industry (28.6% of criminal defendants and 27.5% of civil defendants). A
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21 growing number of civil defendants come from the health and pharmaceutical industry (14.3% of
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23 criminal defendants and 21.7% of civil defendants). Members of the securities and brokerage
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25 industry constituted 14.3% of criminal defendants and 10% of civil defendants. Only 7% of the
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27 civil defendants belonged to the engineering, oil, and chemical industry. The findings are in
28
29 contrast to the study of Szockyj and Geis (2002) who found that one-third of all defendants (civil
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31 and criminal) came from the business sector, whereas only 18.2% came from the securities
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33 industry.
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40 Comparison of the figures in Table 1 also show that civil cases are more often resorted to
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42 instead of criminal cases against members of the health and pharmaceutical industry (21.7% of
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44 civil defendants compared to 14.3% of criminal defendants), engineering, oil, and chemical
45
46 industry (7.2% of civil defendants compared to 0% of criminal defendants), and retail industry
47
48 (4.3% of civil defendants compared to 0% of criminal defendants). In contrast, criminal cases
49
50 are more often resorted against members of the: (1) legal, finance, and banking industry (“legal
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52 and financial services”); (2) technology, media, and investor relations industry (“technology and
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3 communications”); and (3) securities and brokerage industry (“securities and brokerage”). The
4
5 SEC and DOJ have discretion on whether to file civil enforcement proceedings or criminal cases
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7 against defendants of insider trading. Criminal cases may be the predominant legal actions
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9 against members of professions that are perceived to be more accountable due to their
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11 specialized knowledge of, and the nature of their position in, the financial and economic sector.
12
13 Individuals employed in legal and financial services, technology and communications, and
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15 securities and brokerage are presumably more aware and familiar with economic, financial, and
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17 securities laws, rules and regulations. On the other hand, industries such as the health and
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19 pharmaceutical industry, the engineering, oil, and chemical industry, and the retail industry do
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21 not directly deal with securities and finance but with other aspects of the market economy, such
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23 as production and manufacturing.
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28 **Breach of Duty and Entity Harmed by Breach**

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31 Almost all civil (97.1%) and all criminal defendants (100%) breached a known duty by
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33 trading on material nonpublic information or disclosing such information to other tippers who
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35 proceeded to trade for their personal gain. Half of the civil defendants (50%) and more than half
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37 of the criminal defendants (64.3%) breached their duty to their corporation, while half of the
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39 civil defendants (50%) and more than a third of the criminal defendants (35.7%) breached their
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41 duty to the source of information (e.g., law firm)
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Insert Table 1 Here

Trading Activities of Insider

Insider trading covers scenarios where the corporate insider does not himself trade but passes material nonpublic information to an outsider who trades on the information. The insider who does not trade and the tippee who trades are both liable under current insider trading laws. About 60.9% of the civil defendants and 64.3% of the criminal defendants traded on the information.

Liability under current insider trading laws, however, requires that the tipper must disclose material, nonpublic confidential information for his or her personal benefit, “broadly defined to include not only pecuniary gain, but also, *inter alia*, any reputational benefit that will translate into future earnings and the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend” (*United States v. Newman*, 2014, p. 452).

Insert Table 2 Here

Table 2 shows that a defendant in a civil or criminal insider trading case is more likely to trade on the information and breach his or her duty when he receives a direct, financial benefit in the form of pecuniary gain, and is less likely to trade on the information when he merely receives a reputational benefit, such as increased goodwill, that does not translate into any financial reward or when he gives a gift of confidential information to another individual who trades on the information (chi-square is significant at the $p < .001$). Although the defendant does not trade on the material nonpublic information due to the lack of financial benefits, he passes the information to another to enhance his reputation or as a gift to the recipient. The information is used by the tippee who illegally trades at the expense of the corporation. Under current laws, the

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2
3 tippee is similarly liable if he or she knows or should have known that: (1) the tipper breached a
4 duty of confidentiality to the owner of the information for personal benefit; and (2) the tipper
5 intended the tippee to trade on the information (*United States v. Newman*, 2014; Strader, 2015).
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8 **Tipper's Knowledge of Tippee's Intent to Use Inside Information (Mens Rea)**

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10 The requisite tipper's mens rea was present in both civil and criminal cases (see Table
11 1). In civil cases 87% of the defendants knew that the tippee would trade on the information. In
12 criminal cases, 91.7% of the defendants knew that the tippee would trade on the information.
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14 Only less than 10% of the civil and criminal defendants did not know that the tippee would use
15 and trade on the information.
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24 **Tippee's Knowledge of Tipper's Breach of Duty**

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26 Approximately three-fourths of civil defendants who were tippees and 90.7% of criminal
27 defendant-tippees knew that their tippers breached a duty of confidentiality to their corporate
28 employers or the source of information (see Table 1). None of the civil defendant-tippees and
29 less than 10% of the criminal defendant-tippees did not know that their tippers breached a duty
30 of confidentiality.
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38 **Tippering Activity and Tipper-Tippee Relationship**

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40 Table 1 shows that more than three-fourths of both civil (76.8%) and criminal (78.6)
41 defendants tipped others on the material nonpublic information. Almost half of the tippees in
42 civil proceedings were close personal friends, 33% were business associates, and 17% were
43 family members. On the other hand, almost 60% of the tippees in criminal proceedings were
44 business associates while only 40% were close personal friends. In both civil and criminal cases,
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51 Table 3 shows that the defendant-tipper was more likely to pass on the information to a tippee
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3 who was a close personal friend, business associate, or family member (chi-square is significant
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5 at the $p < .01$).
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Insert Table 3 Here

Amount of Profit and Settlement

Table 4 shows the results of an independent samples t-test comparison of means for civil enforcement and criminal litigation proceedings. There was a statistically significant difference in the amount of profits obtained by defendants in civil ($M = \$5,126,254.60$; $SD = \$21,203,083.40$) and criminal cases ($M = \$27,107,391.40$; $SD = \$22,541,772.00$; $t(43) = -2.172$, $p < .035$ two-tailed). The magnitude of the difference in the means (mean difference = $-\$21,981,136.79$) was moderate to large (eta squared = 0.989). The total amount of profits obtained by tippers and tippees also significantly differed between civil ($M = \$11,250,063.74$; $SD = \$47,413,166.16$) and criminal cases ($M = \$43,961,451.70$; $SD = \$75,909,643.75$; $t(75) = -2.028$, $p < .046$ two-tailed). The magnitude of the difference in the means (mean difference = $-\$32,711,387.95$) was moderate (eta squared = 0.052). The amount of settlement of civil defendant-tippees ($M = \$4,141,626.23$; $SD = \$8,724,368$) also significantly differed from criminal defendant-tippees ($M = \$33,020,825.00$; $t(22) = -3.240$, $p < .004$ two-tailed). The magnitude of the mean difference ($-\$28,879,198.76$) was large (eta squared = 0.32).

Insert Table 4 Here

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3 Criminal proceedings involved defendants who made more profits compared to civil
4 defendants. At the same time, the amount of settlement of tippee-defendants in criminal
5 proceedings was more than the amount of settlement paid by civil tippee-defendants.
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10 CONCLUSION

11
12 Results of the article show support for the rational choice theory of crime. First, a
13 defendant in a civil or criminal insider trading case is more likely to trade on the information
14 when he receives a direct, financial benefit from breaching his duty of confidentiality. However,
15 he is less likely to trade on the information when he merely receives a reputational benefit, such
16 as increased goodwill, that does not translate into any financial reward or when he gives a gift of
17 confidential information to another individual who trades on the information (chi-square
18 significant $p < .001$). Second, the defendant-tipper was more likely to pass on the information to a
19 tippee who was a close personal friend, business associate, or family member (chi-square
20 significant $p < .01$). Almost half of the tippees in civil proceedings were close personal friends
21 (49%), business associates (32.7%), or family members (16.4%). Almost 60% of tippees in
22 criminal proceedings were business associates or close personal friends (41.7%). The average
23 amount of profit of a defendant tipper (in both civil and criminal proceedings) was
24 \$4,103,459.53, while the average amount of his or her settlement with the SEC was only
25 \$602,252.09. On the other hand, the average amount of profit of a defendant tippee tipper (in
26 both civil and criminal proceedings) was \$11,855,900.31, while the average amount of his or her
27 settlement with the SEC was only \$1,545,520.82.
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49 Paternoster and Simpson's (1996) rational choice model explains that an individual's
50 decision to offend is based on a balancing of the subjective expectations of rewards and benefits
51 against the perceived costs of offending. Individual decisions to commit corporate crimes are
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3 also influenced by perceived benefits not only for themselves but also for their firm or company
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5 (Paternoster & Simpson, 1996). Respondents in their study were significantly more likely to
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7 report that they would commit an illegal act (corporate offending) if the act resulted in “direct
8
9 financial benefits for the company” such as higher revenues or if it “enhanced a sense of
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11 organizational pride or esteem” (Paternoster & Simpson, 1996, p. 568). While insider trading
12
13 defendants were more likely to trade on material nonpublic information if the purpose of their
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15 breach of confidential duty resulted in financial gain, they were also likely to tip close personal
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17 friends, business associates, or family members. Their tipping activities are not motivated by
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19 altruistic motives because they receive benefits in the form of increased reputation and goodwill.
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21 At the same time, their tippees have also benefitted through the act of tipping by obtaining
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23 massive amounts of profit. The individual’s decision to engage in insider trading is not only
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25 based on perceived benefits to himself but also on perceived gains to his firm (by passing on
26
27 information to business associates), his close personal friends (who give him either financial
28
29 benefits in kind or regard him highly for his gift of confidential information), or his family
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31 members. In all instances, the choice is still based on a rational calculation of perceived gains for
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33 him and his close circle of family, friends, and business associates.
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40 This article adds to the growing literature by offering a perspective of insider trading
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42 based on rational calculations of benefits not only to the individual defendant but also perceived
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44 benefits to his family and associates. Although the threat of civil enforcement and criminal
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46 proceedings may possibly deter him or her from committing the crime, results indicate that the
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48 amount of settlement in both instances are considerably lower than the amount of profits
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50 obtained from the offense. A weakness of this study lies in analysis of a limited time frame of
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52 three years of insider trading litigation (2012-2014). Also, securities class actions (derivative
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3 shareholders suit) were not analyzed. In securities class action litigation, the plaintiff is not the
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5 SEC and the litigator is not the DOJ. Private shareholders file civil actions against the company
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7 who they perceive are liable for insider trading. Since private shareholders suit employ private
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9 lawyers to litigate the action, it is possible that the amount of settlement may be larger than in
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11 SEC civil enforcement actions or in DOJ-prosecuted criminal cases. Future studies may also
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13 examine a larger sample, covering a longer period of time, with multivariate statistics.
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Table 1. Comparison of Securities and Exchange Commission Civil Enforcement Proceedings and Securities Fraud Criminal Litigation from 2012-2014 (N=83)

Variables	Civil (N=69)	Enforcement	Criminal Litigation (N=14)
<i>Type of defendant or tipper</i>			
Corporate Insider (e.g. employee, officer, director)	36 (52.2%)		8 (57.1%)
Outsider who misappropriates (e.g. lawyer, outside consultant)	32 (46.4%)		6 (42.9%)
Outsider who makes affirmative misrepresentation (e.g., hacker)	1 (1.4%)		0 (0%)
<i>Industry of insider</i>			
Health and pharmaceutical industry	15 (21.7%)		2 (14.3%)
Securities and brokerage industry	7 (10.1%)		2 (14.3%)
Engineering, oil, and chemical industry	5 (7.2%)		0 (0%)
Technology, media, investor relations industry	19 (27.5%)		4 (28.6%)
Retail industry	3 (4.3%)		0 (0%)
Legal, finance, and banking industry	20 (29%)		6 (42.9%)
<i>Breach of duty</i>			
Yes	67 (97.1%)		14 (100%)
No	2 (2.9%)		0 (0%)
<i>Entity to whom defendant or tipper breached duty</i>			
Corporation whose shares were traded	34 (50%)		9 (64.3%)
Source of inside information/principal	34 (50%)		5 (35.7%)
<i>Did defendant or tipper trade on information?</i>			
Yes	42 (60.9%)		9 (64.3%)
No	27 (39.1%)		5 (35.7%)
<i>Did defendant tip others on the information?</i>			
Yes	53 (76.8%)		11 (78.6%)
No	16 (23.2%)		3 (21.4%)
<i>Tippee's relationship to tipper</i>			
Acquaintance	1 (1.8%)		0 (0%)
Business associate	18 (32.7%)		7 (58.3%)
Close personal friend	27 (49.1%)		5 (41.7%)
Family member	9 (16.4%)		0 (0%)
<i>Purpose of breach by defendant or tipper</i>			
Direct financial benefit to tipper	52 (80%)		10 (100.0%)
Reputational benefit to tipper	2 (3.1%)		0 (0%)
Gift of confidential information to tippee	11 (16.9%)		0 (0%)
<i>Tipper's knowledge of tippee's intent to use inside information (tipper Mens Rea)</i>			
Tipper knew that tippee would trade on information (knowledge)	47 (87.0%)		11 (91.7%)
Tipper knew that tippee may or was likely to trade on information (recklessness)	2 (3.7%)		0 (0%)
Tipper should have known that tippee would use information (negligence)	0 (0%)		0 (0%)
Tipper did not know that tippee would use the information	5 (9.3%)		1 (8.3%)
<i>Tippee's Knowledge of tipper's Breach of Duty (tippee Mens Rea)</i>			
Tippee knew that tipper breached his duty by disclosing information (knowledge)	49 (90.7%)		8 (72.7)
Tippee deliberately avoided knowing whether tipper breached his duty by disclosing information (recklessness)	0 (0%)		1 (9.1%)
Tippee should've known, had reason to know, or had a general understanding that tipper was disclosing information for personal benefit (negligence)	5 (9.3%)		1 (9.1%)
Tippee did not know that tipper obtained personal benefit in exchange for disclosing information	0 (0%)		1 (9.1%)
<i>Settlement with SEC</i>			
Yes	24 (34.8%)		2 (50%)
Pending	45 (65.2%)		1 (25%)
No	0 (0%)		1 (25%)

Table 2. Contingency Table. Trading Activity of tipper by Purpose of Breach

Purpose of Breach by Defendant or tipper	Did defendant or tipper trade on the information?		
	No	Yes	Total
Direct financial benefit to tipper	25.8% (16)	74.2% (46)	100.00% (62)
Reputational benefit to tipper	100.00% (2)	0% (0)	100.00% (2)
Gift of confidential information to tippee	90.9% (10)	9.1% (1)	100.00% (11)
Total	37.3% (28)	62.7% (47)	100% (75)
Chi-Square *** p<.001	20.374***		

Note: Information in the parenthesis indicates frequencies in each category.

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Table 3. Contingency Table. Tipping Activity by tippee's Relationship to tipper

Tippee's relationship to tipper	Did defendant tip others on the information?		
	No	Yes	Total
Acquaintance	100.00% (1)	0% (0)	100.00% (1)
Business associate	12% (3)	88% (22)	100.00% (25)
Close personal friend	6.3% (2)	93.7% (30)	100.00% (32)
Family member	0% (0)	100.00% (9)	100.00% (9)
Total	9.0% (6)	91.00% (61)	100% (67)
Chi-Square	11.623**		
** p<.01			

Note: Information in the parenthesis indicates frequencies in each category.

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Table 4. T-test Comparison of Means for SEC Civil Enforcement Proceedings and Securities Fraud Criminal Litigation from 2012-2014 (N=83)

Variables	Civil Enforcement (N=69)	Criminal Litigation (N=14)
Amount of Settlement by Defendant/Tipper/s (in U.S. Dollars) ^a	\$2,506,450.00	\$400.00
Amount of Settlement by Tippee/s (in U.S. Dollars) ^a	\$4,141,626.23**	\$33,020,825.00**
Total Amount of Settlement (in U.S. Dollars) ^a	\$4,405,648.38	\$16,510,612.50
Amount of Profit of Defendant/Tipper (in U.S. Dollars) ^a	\$5,126,254.60*	\$27,107,391.40*
Amount of Profit by Tippee ^a	\$12,186,861.60	\$54,495,239.38
Total Amount of Profit ^a	\$11,250,063.74*	\$43,961,451.70*
Amount of Judgment/Penalty (U.S.\$) ^a	\$26,472,576.21	\$16,486,637.86
Length of Imprisonment (in months)	0	98

^aT-test comparison of means* $p < .05$; ** $p < .01$; *** $p < .001$