The Ethics of Insider Trading Reform

John P. Anderson
Vagueness in the law renders the insider trading enforcement regime in the United States unjust and irrational. One way to improve the current regime from the standpoint of justice and efficiency would be to recognize an express safe harbor for issuer-licensed insider trading. It is anticipated that any such move toward liberalization would meet political and cultural resistance on the premise that all insider trading (even if it is licensed by the issuer and economically efficient) is morally wrong. The goal of this paper is to clear the path to liberalization by answering such objections to reform in the ethical terms in which they are expressed.

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Introduction

Vagueness in the law of insider trading in the United States has yielded an enforcement regime that is unjust, irrational, and in need of reform. This paper suggests that reforming the current regime to permit issuer-licensed insider trading would solve a number of problems. A common objection to any such liberalization has been that all forms of insider trading (even when licensed by the issuer) are ethically objectionable and should therefore continue to be proscribed by law. Although such ethical claims are often asserted and accepted by the general public, they are rarely tested or defended by principled argument. This paper looks to clear the path to reform by answering the principal ethical objections to issuer-licensed insider trading.

In section 1, I outline the ways in which vagueness in the law has led to an unjust and irrational insider trading enforcement regime in the United States. Section 2 proposes the legalization of issuer-licensed insider trading as a promising means of reform. The remaining sections of the paper focus on answering potential ethical objections to issuer-licensed insider trading. Section 3 answers the criticism that issuer-licensed insider trading is harmful to others and therefore morally wrong, and section 4 addresses the concern that issuer-licensed insider trading should continue to be proscribed because it promotes the vice of greed.
1. Current Enforcement Regime Is Unjust and Irrational: Reform Is Needed

Even those convinced that all forms of insider trading are morally repugnant should admit that the current insider trading enforcement regime in the United States is unjust, irrational, and in need of significant reform.

Under the current insider trading regime in the United States, stiff penalties\(^1\) are imposed for a crime that has never been defined by statute or regulation.\(^2\) 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.”\(^3\) Though section 10(b) functions as a catchall provision, the Supreme Court has made it clear that “what it catches must be fraud.”\(^4\) But insiders typically gain their advantage by withholding their material nonpublic information while trading over anonymous exchanges. The common law regards such silence as fraudulent only where there is some independent duty to disclose. The Supreme Court recognizes such a duty to disclose under two theories, the classical theory and the misappropriation theory.\(^5\)

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 from tipping others who trade) that firm’s shares on the basis of material nonpublic information. In such cases, the

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\(^1\) 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”). 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. Nonnatural 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).

\(^2\) 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).


insider (or constructive insider) violates a fiduciary or other similar duty of trust and confidence by failing to disclose to the firm’s shareholder (or prospective shareholder) on the other side of the trade.\(^6\) Insider trading liability arises under the misappropriation theory when someone misappropriates material nonpublic information and then trades on it without first disclosing the intent to trade to the source of the information. The “misappropriation theory premises liability on a fiduciary-turned-trader’s violation of a duty to disclose to those who entrusted her with access to the confidential information” by cheating the source out of “the exclusive use of that information.”\(^7\)


The fact that insider trading has never been defined by statute results in the “jurisprudential scandal that insider trading is largely a federal common law offense.”\(^8\) The Western liberal jurisprudential tradition is suspicious of common-law crimes because they often violate the principle of legality, which is sometimes expressed in the Latin phrase *nullum crimen sine lege*.\(^9\) 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.”\(^10\) This principle gives expression to the public culture’s shared intuition that justice requires that persons be given reasonable notice of when criminal sanctions will be imposed.

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\(^6\) Chiarella, 445 U.S. at 228.

\(^7\) O’Hagan, 521 U.S. at 652.


\(^10\) Id.
Otherwise, persons would be unable to plan their lives to avoid such sanctions. The same moral intuition informs our repugnance toward ex post facto laws.\textsuperscript{11}

The history of US insider trading enforcement illustrates 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 the statutory authority of the Securities and Exchange Commission (SEC) under section 10(b).\textsuperscript{12} Moreover, despite the fact that the Supreme Court’s decision in \textit{Chiarella v. United States} rendered the legal status of the misappropriation theory of insider trading liability dubious,\textsuperscript{13} regulators continued to enforce it for the next 17 years before it finally received the Court’s imprimatur in \textit{United States v. O’Hagan}.\textsuperscript{14} The SEC has since continued to press for still broader insider trading...

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\textsuperscript{11} Such laws are, of course, unconstitutional pursuant to U.S. Const. art. I, §§ 9,10.
\textsuperscript{12} 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) (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 22 years for this interpretation to reach the Supreme Court, where 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 two parties . . . should not be undertaken absent some explicit evidence of congressional intent.” \textit{Chiarella}, 445 U.S. at 233.
\textsuperscript{13} Indeed, even the SEC admits that Justice Powell fought to grant certiorari in Carpenter v. United States, 484 U.S. 19 (1987), just to lead the Court in declaring the misappropriation theory invalid. \textit{See Fair to All People: The SEC and the Regulation of Insider Trading, Counterattack from the Supreme Court, SECURITIES AND EXCHANGE COMMISSION HISTORICAL SOCIETY}, available at http://sechistorical.org/museum/galleries/it/counterAttack\_d.php#ftn42. Powell, however, retired from the Court just before the case was heard, and the Court split four to four on the legality of the misappropriation theory.
\textsuperscript{14} \textit{O’Hagan}, 521 U.S. at 652–53. In \textit{Salman v. United States}, 137 S. Ct. 420 (2016), the Supreme Court revisited its insider trading jurisprudence for the first time in 20 years. The Court did not, however, use the opportunity to tweak or refine the law; rather, it limited the decision to the facts of the case and unanimously reaffirmed its prior precedent on insider trading.
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regulatory authority through its rulemaking and enforcement actions, and the record suggests that the SEC would rather ask forgiveness from the courts in this context than permission from Congress. Without a statutory definition, market participants must guess as to whether that expanded authority will be recognized by some judge. Most would rather settle than take the risk. This is precisely the injustice the principle of legality looks to avoid.

It should be emphasized that simply codifying the current working definition of insider trading would not solve the problem. Injustice owing 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” “nonpublic” 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. In Connally v. General Construction Company, the Supreme Court held that a law violates due process when a person of

15 For example, the SEC arguably did away with the requirement of scienter for insider trading liability when it adopted Exchange Act Rule 10b5-1(b), which defines trading “on the basis of” material nonpublic information as requiring only that the trader be “aware” of such information while trading. See, e.g., Allan Horwich, The Origin, Application, Validity, and Potential Misuse of Rule 10b5-1, 62 BUS. LAW. 913, 921–22 (2007); Carol B. Swanson, Insider Trading Madness: Rule 10b5-1 and the Death of Scienter, 52 U. KAN. L. REV. 147, 196–99 (2003). Moreover, in Exchange Act Rule 10b5-2, the SEC took the liberty of substituting the Supreme Court’s requirement of a breach of a duty of “trust and confidence” for insider trading liability with the requirement only of the breach of a duty of “trust or confidence.” 17 C.F.R. § 240.10b5-2. The change from the conjunctive “and” to the disjunctive “or” can be interpreted as clearing the way for insider trading liability without a breach of trust.

16 Enforcement actions against increasingly more remote tippees, accompanied by expansive interpretations of the material benefit test for insider trading liability, offers perhaps the most recent example of the SEC’s attempts at increasing its regulatory authority through creative enforcement actions. See, e.g., United States v. Newman, 773 F.3d 438, 448 (2014) (The Second Circuit rejected the SEC’s theory of material benefit and noted that “the Government has not cited, nor have we found, a single case in which tippees as remote as [the defendant] . . . have been held criminally liable for insider trading.”).

17 There have been multiple opportunities for the SEC to request and for Congress to adopt a clear statutory definition of insider trading, but the SEC has resisted this. In fact, some members of Congress proposed that a clear definition of insider trading be included in the Insider Trading Sanctions Act of 1984, but then SEC chairman John Shad advised against it. See Fair to All People: The SEC and the Regulation of Insider Trading, THE SECURITY AND EXCHANGE COMMISSION HISTORICAL SOCIETY, available at http://www.sechistorical.org/museum/galleries/it/raisingStakes_a.php. As Professor Stephen Bainbridge puts it, there was a fear “that any definition would have to be either so broad as to be unworkable or so narrow as to reduce the SEC’s and the courts’ flexibility to address new forms of trading.” STEPHEN BAINBRIDGE, INSIDER TRADING: LAW AND POLICY 143, n. 30 (2014).

“common intelligence must necessarily guess at its meaning.”\textsuperscript{19} Some scholars have suggested that the law against insider trading is unconstitutionally vague.\textsuperscript{20} 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, “It’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.”\textsuperscript{21} As the late 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.”\textsuperscript{22} 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 \textit{Kolender v. Lawson}:\textsuperscript{23}

\begin{quote}
[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.” Where the legislature fails to provide such minimal guidelines, a criminal statute may permit “a standardless sweep [that] allows policemen, prosecutors, and juries to pursue their personal predilections.”\textsuperscript{24}
\end{quote}

US Circuit Court Judge Barrington Parker expressed this concern during oral arguments in \textit{United States v. Newman},\textsuperscript{25} when he challenged the government’s “amorphous theory” of insider trading liability as leaving “all these institutions at the mercy of the government.”\textsuperscript{26} The

\textsuperscript{19}Connally v. General Construction Company, 269 U.S. 385, 391 (1926).
\textsuperscript{22}Kripke, \textit{supra} note 20, at 949.
\textsuperscript{24}Id. at 358 (quoting Smith v. Goguen, 415 U.S. 566, 574–75 (1974)).
\textsuperscript{25}United States v. Newman, 773 F.3d 438 (2d Cir. 2014).
motive and opportunity alone for such abuse—regardless of whether it has occurred in fact—has tainted the perceived legitimacy of insider trading enforcement over the past few decades.

For instance, some have suggested 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.\(^{27}\) In the wake of the subprime 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.”\(^{28}\) Some claim that 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.”\(^{29}\) 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. And these efforts put US 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.”\(^{30}\) The fact that experts agree that insider trading had nothing to do with the financial collapse seemed unimportant. Similar concerns were raised decades before when some suggested that then US Attorney Rudolph Giuliani had sensationalized his insider trading cases in the 1980s for political purposes and to support his imminent bid for public office. Again, I am not suggesting here that prosecutors did abuse their discretion in these cases, just that vagueness in the law invites the charge, and that such charges alone can taint the legitimacy of the enforcement regime.

\(^{27}\) Peter Henning, *What’s So Bad About Insider Trading?,* THE BUSINESS LAWYER 70, 751, 762 (2015).

\(^{28}\) GASPARINO, CIRCLE OF FRIENDS, *supra* note 1, at 17.

\(^{29}\) *Id.* at 201.

1.2. Current Regime Is Irrational: The Paradox of Compliance for Issuers

In addition to rendering the current regime unjust, vagueness in the law of insider trading creates uncertainty for market participants, and markets abhor uncertainty. The result is that the amorphous demands of the current enforcement regime often undermine many of the concrete market-related values the regulation of insider trading purports to promote. Thus, in addition to being unjust, the current regime is also irrational.

The problem of insider trading compliance for issuers offers just one example of this. Faced with ambiguity in the law, issuers are unable to design effective compliance programs that identify and preempt only illicit trades. Thus, 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 preclearance standards for employee trading and excessively long blackout periods during which employees are precluded from trading altogether. But 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.31

First, ambiguity in the law forces compliance officers conducting preclearance interviews to view with skepticism employee claims that they are not trading the firm’s shares based on material nonpublic information. Such scrutiny of motives can lead to resentment on the part of employees (who may not know themselves whether they possess material nonpublic information). 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.32 Issuers could

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31 See generally Anderson, Solving the Paradox of Insider Trading Compliance for Issuers, supra note 18.
32 See id. at 291.
try to avoid this internal tension by turning the preclearance process over to outside counsel, but such outsourcing is expensive, and these costs are ultimately borne by the shareholder.\textsuperscript{33}

Second, it is common for corporate insiders to receive a large portion of their compensation in firm shares.\textsuperscript{34} 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.\textsuperscript{35} This increased cost of compensation is, again, passed along to the firm’s shareholders in lost share value.\textsuperscript{36} One response to this concern is that illiquidity in firm shares issued as compensation is good because it helps ensure that manager and shareholder incentives are aligned. But, aside from the fact that shares that cannot be monetized have little power to incentivize behavior (one way or the other), some have argued that managers’ ability to sell their firm shares in times of crisis may actually benefit shareholders as insurance against accounting fraud.\textsuperscript{37}

\begin{footnotesize}
\begin{enumerate}
\item See, e.g., M. Todd Henderson, \textit{Insider Trading and CEO Pay}, 64 VAND. L. REV. 505, 508 (2011) (Between 1999 and 2008, “the average public company executive earned more than half her total pay in the form of stock options or restricted stock.”).
\item \textit{Id.} at 509–10.
\item See Heminway, \textit{supra} note 33, at 1174–77.
\item The personal wealth of managers is often tied directly to stock holdings in their company. When these managers acquire inside information they know will negatively affect the price of the stock, they may be forced to choose among the following alternatives: (1) hold onto their stock and release the information, resulting in personal financial ruin; (2) sell the stock and then release the information, subjecting themselves to disgorgement, fines, and criminal liability for insider trading; or (3) issue fraudulent financials that may buy them time to fix the problem. The third option is often the only one that does not result in immediate ruin for the manager. This was, for example, the decision faced by Bernard Ebbers of WorldCom. Professor Robert E. Wagner pointed out that if Ebbers could have sold his WorldCom stock before announcing the company’s earnings misses, his principal incentive for misrepresenting the company’s financials would have been eliminated, and perhaps the company might have avoided collapse. See Robert E. Wagner, \textit{Gordon Gekko to the Rescue? Insider Trading as a Tool to Combat Accounting Fraud}, 79 U. OF CINCINNATI L. REV. 973 (2011).
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Third, employees often account for a large proportion of an issuer’s outstanding shares. 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. Once more, these additional costs are ultimately borne 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. 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 it undermines these important values it purports to protect and promote.

All of the above is to suggest that the current insider trading enforcement regime would be unjust, irrational, and in need of reform even if all the insider trading that is currently regulated were socially harmful and morally impermissible. 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 argue that liberalizing the current regime to legalize issuer-licensed insider trading would solve many of its current problems but that winning acceptance for this reform will require answering some anticipated ethical objections.

38 See Jesse M. Fried, Insider Trading via the Corporation, 162 U. PENN. L. REV. 801, 804 (2014) (citing a study suggesting that directors and officers own an average of 24 to 32 percent of a given firm’s equity).
39 See Yakov Amihud & Haim Mendelson, Asset Pricing and the Bid-Ask Spread, 17 J. FIN. ECON. 223, 249 (1986) (the greater a security’s liquidity, the lower the expected return demanded by investors, which decreases the firm’s cost of capital).
40 See Anderson, Paradox of Compliance, supra note 18, at 295.

There is no single solution to the dysfunction that pervades the US insider trading enforcement regime. I am, however, convinced that one reform would dramatically improve clarity, justice, and rationality in the law, and it could be accomplished entirely through SEC rulemaking, without the need to amend section 10(b). The express authorization through SEC rulemaking of issuer-licensed insider trading is the proposed reform. 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.\footnote{I first proposed the following reform in Anticipating a Sea Change for Insider Trading Law: From Trading Plan Crisis to Rational Reform, 2015 UTAH L. REV. 339, 380–81 (2015). Although the model is one I have offered and defended elsewhere, it is not the only option. Alternative models have been proposed by others. See, e.g., Ian Ayres & Stephen Choi, Internalizing Outsider Trading, 101 MICH. L. REV. 313 (2002); Thomas A. Lambert, Decision Theory and the Case for an Optional Disclosure-Based Regime for Regulating Insider Trading, in RESEARCH HANDBOOK ON INSIDER TRADING (Stephen M. Bainbridge ed., 2014). The focus of this paper is not so much on the exact specifications of the issuer-licensed safe harbor that should be adopted as on (1) the fact that some such model should be adopted and (2) the ethical justification for any such model.}

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

2) the issuer authorizes that plan;

3) the issuer has previously made a general disclosure to the investing public that it will permit its employees to trade on its material nonpublic information through these plans when it is in the interest of the firm; and

4) the issuer discloses ex post facto 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 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 and morally wrong, and they should continue to be proscribed.42

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, offer 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 this 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 (and therefore the perception) of abuse of regulatory and prosecutorial discretion.

This reform would also resolve the paradox of insider trading compliance for issuers. 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

42 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 41, at 385–86; see also Henderson, supra note 3. Given, however, that the SEC would almost certainly challenge any such interpretation—and at least some lower courts would back this challenge—no firm would (or should) take the risk of testing the theory absent clear guidance from the SEC.
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 better alignment.

Of course, managers acting on behalf of the issuer will not always exercise sound business judgment in approving or rejecting proposed trading plans—just as they may not always exercise sound judgment in approving other forms of compensation for employees and upper management. Indeed, some managers may even approve or reject trading plans for self-serving reasons that run counter to the best interests of the firm.43 Such self-dealing would, however, be actionable (privately and perhaps even criminally) as a breach of fiduciary duty or conversion under existing state law. Ultimately, individual bad actors can never be entirely prevented from acting badly, but firms could guard against such abuse by dispersing the approval power for plans. Moreover, the requirement that trading plans (and issuer actions on them) be written, along with the requirement of subsequent reporting of profits earned, ensures that such self-dealing can be more easily exposed and proven by shareholders and prosecutors when it occurs. The expectation is that this transparency will provide adequate deterrence against abuse.

But there is another 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 always unfair, fraudulent, or otherwise immoral. Unless this challenge is confronted directly, and in the ethical

43 Of course, the fact that trading plans may be rejected for the wrong reasons (e.g., because the trading may expose management’s malfeasance) cannot be an argument against legalizing issuer-licensed trading because, without the plans, such trades would be precluded in any event.
terms in which it is posed, no proposal to liberalize America’s insider trading regime to permit issuer-licensed insider trading can hope to succeed.

3. Why Issuer-Licensed Insider Trading Is Morally Permissible

I have already argued that the current insider trading regime in the United States would be unjust and irrational even if all the conduct it sought to proscribe were 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.

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 a separate 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 prearranged rules of a cooperative scheme. 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 regulations.

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

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44 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 not helpful when the question is whether there are moral reasons for adopting those rules in first place.
worst from an impersonal standpoint.”45 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.46

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).47 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 consequences of a rule that everyone should perform the action in like circumstances.”48

Though there are certainly affinities between the economic analysis of law and rule utilitarianism (both are concerned with maximization strategies),49 the former is not grounded in the latter, and the two approaches to law can sometimes conflict.50 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 the late Professor Henry Manne and others helps to explain when insider trading is and is not morally permissible on utilitarian grounds.

45 Introduction to CONSEQUENTIALISM AND ITS CRITICS 1, 1 (Samuel Scheffler ed. 1988).
46 Id.
48 Id.
49 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”).
50 See, e.g., RICHARD POSNER, OVERCOMING THE LAW 403 (1995) (“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 that this will rarely occur. For example, conflicts will arise where economic and moral conceptions of happiness differ (e.g., preference versus hedonistic, relative versus nonrelative) and where conceptions of 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).
The economic consequences of insider trading have been hotly debated. The most commonly cited economic benefits of insider trading include increased stock price accuracy, provision of real-time information to the markets and to management, its market-smoothing effect, and its use as an efficient means of compensation. The most commonly cited economic harms associated with insider trading are that it increases the bid-ask spread set by market makers and that it undermines investor confidence in the markets, both of which increase the

51 For a more thorough summary of this debate, see John P. Anderson, Greed, Envy, and the Criminalization of Insider Trading, 2014 UTAH L. REV. 1, 7–17 (2014).
52 See, e.g., Dennis Carlton & Daniel Fischel, The Regulation of Insider Trading, 35 STAN. L. REV. 857, 868 (1983) (“If insiders trade, the share price will move closer to what it would have been had the information been disclosed.”).
53 Insider trading allows a company’s insiders’ 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.”)
54 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).
55 As Stephen Bainbridge explains, “Accurate 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 benefits from accurate pricing of its securities through reduced investor uncertainty and improved monitoring of management’s effectiveness.” Stephen Bainbridge, Insider Trading: An Overview, in ENCYCLOPEDIA OF LAW AND ECONOMICS 777–78 (Boudewijn Boukaert & Gerrit De Gees eds., 2000).
56 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 Insurance Professors, 23 VAND. L. REV. 547, 579 (1970).
57 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, in 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.
58 See, e.g., O’Hagan, 521 U.S. at 658 (“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.”).
cost of capital to firms.\textsuperscript{59} There is also the concern that insider trading creates a perverse incentive by giving employees an opportunity to profit from their company’s bad news.\textsuperscript{60}

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 the issuer or other source expected that 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,\textsuperscript{61} as well as the general market costs associated with a higher bid-ask spread and dampened market confidence, and the calculus suggests that these forms of insider trading are morally wrong on utilitarian grounds.\textsuperscript{62}

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 diminishes the risk of perverse employee

\textsuperscript{59} See, e.g., Dolgopolov, supra note 57 (“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”).


\textsuperscript{61} See Anderson, \textit{Greed, Envy}, supra note 51, at 29.

\textsuperscript{62} See id. at 29–30.
incentives. In addition, 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. Finally, any utility calculus must factor in the saved costs of enforcement and compliance where such trading is not proscribed. In sum, when these considerations are taken together, there can be little doubt that issuer-licensed insider trading is morally permissible on rule 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 this reform in the United States—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. No, the principal objection to issuer-licensed insider trading is that “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!”

Deontology is a duty-based moral theory. It judges the moral quality of an act not by its consequences but by its motive and whether that motive complies with the absolute commands of moral law. 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

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63 See id. at 41–42.
64 For example, the current regime’s regulation of issuer-licensed insider trading has given rise to the paradox of compliance outlined in section 1; a regime that permits such trading would resolve this paradox and align the interests of issuers and regulators.
65 This is a paraphrase of the often-quoted objection to insider trading raised by one of Henry Manne’s students after he presented his efficiency-based arguments. See HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 15, note 42 (1966).
67 The word deontology finds its root in the Greek word deon, meaning duty. PETER A. ANGELES, DICTIONARY OF PHILOSOPHY 60 (1981).
68 For a more complete summary of deontological moral theory and its application in this context, see Anderson, Greed, Envy, supra note 51, at 33–43. Much of what follows summarizes arguments first made in Greed, Envy.
treat humanity . . . always as an end and never as a means only.” 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 expediency or social welfare. It also offers an explicit theoretical articulation of our commonsense notions of justice and fairness. To the extent that the general public’s objections to insider trading are 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. Misappropriators gain the material nonpublic information on which they

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trade by making the promise not to trade. In breaking that promise and trading, they use the source of the information as the means to an end the source has expressly rejected.

Things look very different, however, 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 has disclosed 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 and the counterparty) are fully informed in advance of the trade and are therefore respected as ends in themselves and are not treated as mere means.

These deontological considerations (in addition to others that there is no space to develop here) deprive the opponent of legalizing issuer-licensed insider trading of any reason-based justification in terms of 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 be 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 Charles Cox and Kevin Fogarty put it, “The wave of major insider trading prosecutions has been taken by many as a symptom of cancerous greed on Wall Street.” Stephen 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.

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70 For a more complete exposition of these arguments, see Anderson, Greed, Envy, supra note 51, at 33–43.
if for no other reason than to send a message of censure on behalf of the American people.”

And Manhattan US 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. 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?

4. Greed Is Not Good, But It Should Not 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.” Ivan Boesky spoke these words in a 1986 commencement address to the Haas School of Business at the University of California, Berkeley. He would surrender to federal authorities on charges of insider trading and other securities violations just a few short months later. The fictional Gordon Gekko paraphrased Boesky’s remarks when he proclaimed that “Greed . . . is good” in Oliver Stone’s cult classic movie on insider trading, Wall Street. Boesky and Gekko are, of course, wrong. Greed is, by definition, not good.

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.”

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73 GASPARINO, supra note 1, at 104.
75 Id. at 265.
76 20th Century Fox (1987).
77 The following argument summarizes and in some cases expands on points I first made in Greed, Envy, supra note 51, at 48–53.
is one who will “both give and spend the right amount for the right purposes . . . and do this with pleasure.” The generous do not honor wealth for its own sake but nevertheless acquire it “for the sake of giving.” By contrast, the greedy are “shameful love[rs] of gain” who “go to excess in taking, by taking anything from any source.” In their pursuit of wealth for its own sake, they are prepared to go to “great efforts and put up with reproaches.”

There is no question that the facts of many insider-trading cases reflect the grasping smallness of character Aristotle describes. But although 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 when they are also unjust or unfair. I 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, then 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 at this juncture. First, though issuer-licensed insider trading may sometimes be motivated by greed, it need not always be so motivated. For example, the generous issuer-licensed insider trader may seek profits to help a family member get through college, or to pay for a friend’s expensive medical treatment, or to engage in some other form of philanthropy. Moreover, because issuer-licensed insider trading is just another form of corporate compensation, it is no more the reflection of a greedy disposition than is taking a paycheck. Thus, any legal prohibition of issuer-licensed insider trading based on greed would

79 Id.
80 Id. at 92.
81 Id. at 93.
82 Rajat Gupta, for example, an ex-director of Goldman Sachs 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), available at http://dealbook.nytimes.com/2012/10/17/in-sentencing-memos-two-views-of-gupta/?_r=0.
be overinclusive. More still, because there are many other opportunities for excessive profit making in our free-market system, it would also be woefully underinclusive.

Second, even if a good argument could be made that legalizing issuer-licensed insider trading will tempt citizens to the vice of greed, this alone is insufficient justification for its criminalization. It would place issuer-licensed insider trading into the same class as now-disfavored moralistic laws, such as those proscribing alcohol consumption or consensual sexual practices among adults. Such laws violate the long-standing 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.*”

Finally, if we are going to get into the business of criminalizing vicious character traits, perhaps we should first scrutinize some potentially vicious motives for regulating 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 hardworking 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.”

So understood, the prohibition of insider trading “is not so much an antifraud rule as a law against easy money.” Donald Langevoort adds that this view “smacks a bit of populism, of

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83 JOHN STUART MILL, ON LIBERTY 22 (2d ed. 1859).
84 Bainbridge, Incorporating State Law Fiduciary Duties, supra note 1, at 1242.
85 Cox & Fogarty, supra note 71, at 360.
envy and resentment directed at the privileges of class and wealth."86 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 agains the hostile acts to which [others’] envy makes [them] prone.”87 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, which is itself a threat to America’s prosperity and stability.

5. Conclusion

The current insider trading enforcement regime is unjust, irrational, and in need of reform. It has been argued that liberalizing the current regime to permit issuer-licensed insider trading would be a significant step in the right direction. Ethical objections to such liberalization must, however, be answered before this reform can hope to succeed. This working paper looks to clear the path by answering some of these ethical objections.

87 JOHN RAWLS, A THEORY OF JUSTICE 531 (1971).