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GORDON GEKKO TO THE RESCUE?: INSIDER TRADING AS A TOOL TO COMBAT ACCOUNTING FRAUD

*Robert E. Wagner**

This Article puts forward that, counter-intuitively, one way to help avoid future accounting scandals such as WorldCom would be the legalization of “fraud-inhibiting insider trading.” Fraud-inhibiting insider trading is the subcategory of insider trading where: (1) information is present that would have a price-decreasing effect on stock if made public; (2) the traded stock belongs to an individual who will likely suffer financial injury from a subsequent stock price reduction if the trading does not take place; (3) the individual on whose behalf the trading occurs would have the ability to prevent the release of the information or to release distorted information to the public; and (4) the individual in question did not commit any fraudulent activities prior to availing himself of the safe harbor. Arguing that prohibiting all insider trading incentivizes corporate fraud, this Article begins by giving examples from recent cases in which insider trading could have been used to avoid significant harm. Next, the Article briefly discusses both the history of insider trading and the philosophical and policy arguments against it. This Article particularly focuses on the two most prominent arguments raised against insider trading: (1) that it erodes confidence in the market; and (2) that it is similar to theft and should be prosecuted accordingly. Previously unexamined empirical evidence suggests that the confidence argument may be incorrect and does not suffice to justify a prohibition on fraud-inhibiting insider trading. This Article also shows that while the property rights rationale is the strongest position against general insider trading, it is an insufficient basis to outlaw fraud-inhibiting insider trading. The Article concludes with a proposal that the courts, the Securities and Exchange Commission, or Congress enact a safe harbor to legalize fraud-inhibiting insider trading and thus enable the insider trading laws to more effectively achieve their purported goal of protecting the securities market and investors.

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I. INTRODUCTION

The last ten years have been marked by financial scandals, resulting in WorldCom and Enron becoming household names. While legislation such as the Sarbanes–Oxley Act seeks to avert future disasters, little attention has been paid to the complex relationship between accounting fraud and the existing blanket prohibition against insider trading. This Article will argue, however, that one can possibly trace some of the most significant recent instances of corporate fraud to this prohibition. As a consequence, the Article will propose the tailoring of the relevant regulations to allow “fraud-inhibiting insider trading.”

Federal law prohibits using inside information when buying or selling stocks of publicly traded corporations.¹ While some commentators have argued that insider trading has beneficial effects both for the securities market and the general economy,² these defenses have been the exception rather than the rule.³ The accusations against insider trading have ranged from general accusations that any gains made based on

1. Inside information is often defined as “the use of material nonpublic information in trading the shares of a company by a corporate insider or other person who owes a fiduciary duty to the company.” BLACK’S LAW DICTIONARY 866 (9th ed. 2009).

2. These arguments were first made more than forty years ago in Henry Manne’s seminal work, *INSIDER TRADING AND THE STOCK MARKET* (1966).

3. For one such defense, see Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983).

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inside information are inherently “unfair” or a form of “cheating,”⁴ to arguments that insider trading causes a loss of confidence on the part of investors and results in reduced trading in an apparently unjust market.⁵ This Article will show, however, that many of these attacks are both vague and may even be contrary to the empirical data available.

Insider trading regulation has been praised by Congress and the Securities and Exchange Commission (SEC) as one of the “central pillars” and proudest accomplishments of American securities law.⁶ Yet, not only is evidence of the beneficial impact of such regulation lacking both in quantity and quality, but there has been near-universal acceptance of the idea that if *any* insider trading is regulated, it should *all* be regulated. For example, the law has failed to distinguish between price-increasing insider trading and price-decreasing insider trading.⁷ Price-increasing insider trading is trading based on information that, when released, will raise the stock price of the securities in question; conversely, price-decreasing insider trading is trading on information that, when released, will lower the price of the securities.⁸ As one scholar points out, there are stronger arguments for regulating price-increasing insider trading than its counterpart because “price-decreasing insider trading provides significantly more value to investors than price-increasing insider trading [and combats] the problem of overvalued equity.”⁹

This Article specifically addresses the subcategory of price-decreasing insider trading that qualifies as fraud-inhibiting insider trading and for which there is the least justification for prohibition.¹⁰ The proposal here would allow insider trading in settings where: (1) price-decreasing information is present; (2) the traded stock belongs to an individual who himself (or his immediate family) will likely suffer financial injury from a subsequent stock price reduction if the trading does not take place; (3) the individual on whose behalf the trading occurs would have the ability to prevent the release of the information or could release distorted information to the public; and (4) the individual in question did not commit any fraudulent activities prior to availing

4. STUART P. GREEN, LYING, CHEATING, AND STEALING: A MORAL THEORY OF WHITE COLLAR CRIME 235 (2006).

5. See *infra* Parts IV & VI.

6. Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 S.M.U. L. REV. 1589, 1589 (1999).

7. For a good discussion of these two types of trading, see Thomas A. Lambert, *Overvalued Equity and the Case for an Asymmetric Insider Trading Regime*, 41 WAKE FOREST L. REV. 1045 (2006).

8. *Id.* at 1048.

9. *Id.*

10. *Id.* (defining price-decreasing versus price-increasing insider trading).

himself of the safe harbor. To defend the proposal, Part II of this Article demonstrates the detrimental effects of existing regulations via a description of the well-known WorldCom case and the contrasting example provided by the Supercuts case. Part III presents fraud-inhibiting insider trading itself in more detail. In Part IV, the Article discusses the legal history of insider trading regulation. Part V briefly presents how deontological and contractarian theories view insider trading, and then focuses on utilitarian theories to justify allowing fraud-inhibiting insider trading. Part VI of this Article addresses some of the classic arguments for prohibiting insider trading, with an emphasis on the market confidence and property rights rationales. Part VII responds to some of the other objections against insider trading and illustrates the benefits of allowing fraud-inhibiting insider trading. In conclusion, this Article briefly discusses the ability of the SEC, federal courts, and Congress to implement an exception to the general prohibition against insider trading in fraud-inhibiting insider trading situations.

II. TWO CONTRASTING EXAMPLES

Before examining the arguments in favor of and opposed to insider trading, it is helpful to look at two recent cases that demonstrate the possible ramifications of insider trading. The first instance is from the now-infamous case of Chief Executive Officer (CEO) Bernard Ebbers and his company WorldCom.¹¹ When looking at this case, one of the first questions that comes to mind is how a one-time teacher, coach, and warehouse manager¹² became a leader in one of corporate America's biggest frauds. It is instructive to first examine the crime itself to understand what drove Bernard Ebbers to commit these actions. WorldCom was a gigantic telecommunications company with about 90,000 employees in sixty-five countries and with reported revenues of

11. The circumstances surrounding the WorldCom scandal are not unique. A similar situation occurred at Doral Financial Corporation, which resulted in a conviction in April 2010. In that case, Mario Levis, the former treasurer and senior executive vice president for Doral Financial Corporation, was convicted for his role in defrauding investors and ultimately causing a four-billion dollar decline in his company's shares. See David Glovin & Thom Weidlich, *Doral's Levis Found Guilty in Securities-Fraud Case (Update2)*, BLOOMBERG BUSINESSWEEK, Apr. 29, 2010, available at <http://www.businessweek.com/news/2010-04-29/doral-s-levis-found-guilty-in-securities-fraud-case-update2.html>. Mr. Levis indicated in annual financial statements that the company was increasing in value year after year, until 2005 when he announced an approximate \$97.5 million write-down in the corporation's value and thus triggered a decline in its share price that resulted in a net loss of 70% of the corporation's total stock value. *Id.* Mr. Levis's family shareholdings had totaled more than 8% of the company's total shares. *Id.*

12. *United States v. Ebbers*, 458 F.3d 110, 113 (2d Cir. 2006).

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approximately \$39 billion as of 2000.¹³ Three issues started causing problems for WorldCom in 2000; first, when the “dot-com bubble” burst, many of WorldCom’s customers had difficulty paying their telecommunications bills; second, there simply were fewer companies for WorldCom to pursue as clients; and third, continued growth through acquisition was limited—the Department of Justice and the European Union had stopped a proposed purchase of Sprint due to antitrust concerns—and as a result of these problems, WorldCom found it increasingly difficult to fulfill stock market projections for its revenue.¹⁴

By the third quarter of 2000, Ebbers was informed that the company may need to tell investors that WorldCom would not meet its financial expectations.¹⁵ Ebbers found this unacceptable and informed his subordinates that they had to “hit [their] numbers,”¹⁶ meaning they had to publish revenue reports that conformed to what had been projected by Wall Street experts. Hence, they reported an additional \$133 million in anticipated revenue collection even though they knew they were not going to receive that money.¹⁷ Shortly thereafter, Ebbers was informed that WorldCom’s “line cost expenses” would be almost \$1 billion more than the company had anticipated, and he again responded that the company had to “hit its quarterly earnings estimates.”¹⁸ In response to his demands, the reported expenses were falsely lowered by almost \$825 million, and WorldCom’s reported earnings falsely went up by the same amount.¹⁹ Over the next several quarters, this pattern continued—expenses were higher than expected while revenues were lower—and Ebbers would instruct his financial team to alter figures and classify debts in such a way as to avoid “missing” the financial expectations.²⁰

It is significant to keep in mind that during much of this time, WorldCom grew. For example, in the third quarter of 2001, the revenue growth rate was about 5.5%, but it was still lower than expected and was artificially made to appear to be 12%.²¹ Another factor to remember is that during this time, a potential merger with Verizon was on the table, which could have been very beneficial to WorldCom employees and

13. *Id.*

14. *Id.*

15. *Id.* at 114.

16. Ken Belson & Seth Schiesel, *Did the Buck Stop Anywhere?*, N.Y. TIMES, Mar. 4, 2005, at C1, available at http://www.nytimes.com/2005/03/04/business/04ebbers.html?pagewanted=1&_r=1&ref=bernard_j_ebbers.

17. *Ebbers*, 458 F.3d at 114.

18. *Id.*

19. *Id.*

20. *Id.* at 114–16.

21. *Id.* at 116.

shareholders, but Ebbers abruptly ended it due to his fear that Verizon would discover WorldCom's fraudulent accounting practices.²² Finally, in the first quarter of 2002, even the fraudulent accounting practices were not enough to claim that WorldCom had hit its numbers, and WorldCom announced that its results had fallen below expectations.²³ In April 2002, Ebbers was forced to resign, and shortly thereafter an internal audit discovered and exposed the fraudulent practices.²⁴ In June 2002, WorldCom informed the public of the fraud, and its stock collapsed, losing 90% of its value and forcing WorldCom into bankruptcy.²⁵

To answer why Bernard Ebbers did this, one must take a look at his personal finances. Bernard Ebbers was extremely wealthy by the time WorldCom began to experience difficulties in 2000.²⁶ Unfortunately for Ebbers (and ultimately for WorldCom shareholders), his desires exceeded his income. Ebbers purchases included an enormous ranch, timber lands, and a yacht-building company, and his loans totaled over \$400 million.²⁷ To secure these loans, he used millions of shares of WorldCom stock as collateral.²⁸ Any time the price of WorldCom stock went down, he needed more cash or assets to maintain his collateral. At one of WorldCom's financial meetings, Ebbers told his employees that "his 'lifblood was in the stock of the company' and that if the price fell below approximately \$12 per share, he would be wiped out financially by margin calls."²⁹ Bernard Ebbers could not allow WorldCom's stock price to fall even if it was realistically inevitable that this would eventually occur. As Judge Winter stated, "[t]he methods used were specifically intended to create a false picture of profitability even for professional analysts that, in Ebbers's case, was motivated by his personal financial circumstances."³⁰

One may wonder why Ebbers did not sell all or some of his stock as soon as he first found out that WorldCom would not meet its expectations, which would have allowed him to obtain cash to secure his loans. Part of why he insisted on "hitting numbers" and on "his

22. Ken Belson, *Ebbers Avoided Verizon Deal, Trial Is Told*, N.Y. TIMES, Feb. 11, 2005, at C12, available at http://www.nytimes.com/2005/02/11/business/11ebbers.html?ref=bernard_j_ebbers.

23. *Ebbers*, 458 F.3d at 114, 116.

24. *Id.* at 117.

25. *Id.*

26. *Id.* at 113.

27. *Ebbers Defense Closing Argument: It's Sullivan's Fault*, Mar. 4, 2005, <http://www.foxnews.com/story/0,2933,149310,00.html>.

28. *Ebbers*, 458 F.3d at 113.

29. *Id.* at 116.

30. *Id.* at 130.

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lifeblood” being in the stock of the company is simply that insider trading regulations prohibited him from selling his stock in this situation. His choices were limited at that point: he could allow the reduction in stock value to destroy him financially, or he could pretend that there was nothing wrong and hope that he could find a solution before anyone figured out he was fudging the numbers. He opted for the latter and ultimately caused not only the decline in stock value but the loss of billions of dollars and damage to thousands of lives. In July 2002, WorldCom filed for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code, which made it the largest bankruptcy in American history.³¹ WorldCom’s collapse hurt a large group of investors, including the largest state pension fund in the country—the California public employees’ retirement system—which lost a reported \$580 million in the WorldCom meltdown.³² Further, when a corporation is devastated like Enron or WorldCom, the employees themselves are hit the hardest because they are often unable to diversify their investments, and many have their retirements wrapped up in the company’s stock.³³

It should be noted that Bernard Ebbers was not alone in this fraudulent activity. In fact, WorldCom Chief Financial Officer (CFO) Scott Sullivan helped perpetrate WorldCom’s \$11 billion accounting fraud because he wanted to maintain his \$700,000 salary, \$10 million bonus, and his stock options.³⁴ Therefore, both Ebbers and Sullivan participated in the fraud to secure, or at least attempt to secure, their own finances. As one scholar stated, “[o]nce there are pressures put on profits, the obvious incentive for management to maintain their lifestyle or their stock prices is to fiddle with the books.”³⁵ Unfortunately, this “fiddling” injures many more people than just those committing the

31. John Gibeaut, *As WorldCom Turns, Cases Pile Up*, 90 A.B.A. J. 40, 48 (2004).

32. Amanda Ripley, *Cynthia Cooper: The Night Detective*, TIME MAG., Dec. 30, 2002, at 45, available at www.time.com/time/printout/0,8816,1003990,00.html.

33. AFL-CIO, WORLD COM’S COLLAPSE AND THE CONSEQUENCES FOR WORKERS’ RETIREMENT SECURITY 1 (2002), <http://www.aflcio.org/mediacenter/resources/upload/worldcom401-kreport.pdf> (noting that most WorldCom employees just had a 401(k) plan and that many of them invested all or most of their 401(k) assets in WorldCom stock); Jonathan Macey, *Getting the Word out About Fraud: A Theoretical Analysis of Whistleblowing and Insider Trading*, 105 MICH. L. REV. 1899, 1930–31 (2007) (pointing out that when Enron fell, over 4,500 employees lost their jobs and 60% of Enron’s employees had their retirements as undiversified investments in Enron stock).

34. Lisa H. Nicholson, *Sarbanes–Oxley’s Purported Over-Criminalization of Corporate Offenders*, 2 J. BUS. & TECH. L. 43, 53 (2007) (citing Jennifer Bayot & Roben Farzad, *Ex-WorldCom Officer Sentenced to Five Years in Accounting Fraud*, N.Y. TIMES, Aug. 12, 2005, at C1).

35. Kurt Eichenwald, *After a Boom, There Will Be Scandal. Count on It.*, N.Y. TIMES, Dec. 16, 2002, at C1 (quoting Stephen L. Meagher), available at <http://www.nytimes.com/2002/12/16/news/economy-business-after-a-boom-there-will-be-scandal-count-on-it.html>.

fraud. The collapse of large corporations does not only hurt investors, but also innocent employees, small suppliers, local communities, and philanthropic organizations.³⁶ The last wave of corporate scandals, including both WorldCom and Enron, ultimately resulted in billions of dollars of stockholder losses and the loss of tens of thousands of jobs.³⁷ In Enron's case alone, 6,500 people became unemployed.³⁸

Commentators have argued that executives like those at Enron and WorldCom should have "found the courage" to acknowledge the overvaluation of the company rather than engage in the fraudulent activities that resulted in the corporations' total demise.³⁹ The position seems to be that more executives should behave like Toby Lenk, who lost approximately \$850 million when he refused to sell his stock although he and the general public knew that his company eToys was failing (even at the point where insider trading laws would not have precluded him from selling).⁴⁰ Lenk reportedly made a conscious decision to put his "personal well-being on the line in order to build a company."⁴¹ Yet, we do not live in a world full of such altruists. While it is possible that a CEO or CFO aware of lower-than-expected reported revenues could simply accept that his or her personal financial wellbeing was going to be potentially devastated, he or she may often take less savory courses of action.

There are many examples of insiders that, while not quite acting like Bernard Ebbers, took one of the other available options that society discourages.⁴² A typical case concerned David Lipson, who became the subject of litigation in *SEC v. Lipson*.⁴³ In early 1995, Lipson, the CEO of Supercuts⁴⁴ was informed that revenues were running lower and expenses higher than expected.⁴⁵ He sold 365,000 shares of Supercuts stock for \$9 per share and then publicly released the poor financial

36. Macey, *supra* note 33, at 1901. See Michael C. Jensen, *Agency Costs of Overvalued Equity*, 34 FIN. MGMT. 5, 7 (2005) (noting that when companies sink, they also destroy the social value that they signified in the forms of jobs, products, and services).

37. Kathleen F. Brickey, *Enron's Legacy*, 8 BUFF. CRIM. L. REV. 221, 222 (2004).

38. *Id.* at 225.

39. Jensen, *supra* note 36, at 11.

40. Michael Sokolove, *How to Lose \$850 Million—and Not Really Care*, N.Y. TIMES, June 9, 2002, § 6 (Magazine), at 64, available at <http://www.nytimes.com/2002/06/09/magazine/how-to-lose-850-million-and-not-really-care.html>.

41. *Id.*

42. See, e.g., *United States v. Anderson*, 533 F.3d 623 (8th Cir. 2008); *SEC v. Hupp*, 392 F.3d 12 (1st Cir. 2004).

43. 278 F.3d 656 (7th Cir. 2002).

44. Supercuts is a chain of hair-cutting salons.

45. *Lipson*, 278 F.3d at 659.

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information.⁴⁶ The Supercuts stock dropped to a low of \$6.50 per share and recovered to \$7.62 per share by the end of the week.⁴⁷ The SEC sued Lipson for violating insider trading rules and recovered \$621,875 (the amount that the court determined Lipson had avoided losing), plus \$348,097 in interest fees, and \$1,865,625, or three times the amount saved, in punitive damages.⁴⁸

When one contrasts the results of the Supercuts and WorldCom scenarios, most investors would agree that they would prefer the results of the insider trading that occurred in the Supercuts case as opposed to the utter devastation to which the lack of insider trading contributed in the WorldCom case. The insider trading that took place in the Supercuts case, however, was not only illegal but also more easily discoverable than accounting fraud. The Supercuts scenario involved trading in a public forum, while accounting fraud consists of actions hidden inside a company and that would not become visible if the company's situation redressed itself in a short period of time. Of course, companies such as WorldCom are often unable to turn matters around, and massive disasters occur. Nonetheless, because there is a chance of early redress, there are strong incentives for the CEO of an ailing company—when facing the choice of illegal insider trading or illegal accounting fraud—to opt for the latter. The incentive structure would, however, look completely different if the insider trading option was legal. In that case, a CEO could sell her stock based on inside information without the risk of losing all her money and facing prison time. This would reduce the incentive to commit accounting fraud and would likely save society money, jobs, and other assets. This Article proposes the adoption of a safe harbor within insider trading prohibitions for so-called “fraud-inhibiting insider trading,” which would help better align insider trading laws with the goal of protecting individual investors and the securities market generally.

III. FRAUD-INHIBITING INSIDER TRADING

Before discussing the criteria for fraud-inhibiting insider trading, it is helpful to understand the circumstances that can give rise to its use. When a firm produces earnings that beat the analyst forecast for the quarter, the stock price rises an average of 5.5%; when earnings fall below the forecast, the stock price falls an average of 5.04%.⁴⁹

46. *Id.*

47. *Id.*

48. *Id.* at 662.

49. Jensen, *supra* note 36, at 7.

“Generally, the only way for managers to meet those expectations year in and year out is to cook their numbers to mask the inherent uncertainty in their businesses.”⁵⁰ Once this type of overvaluation happens, a domino effect can occur that eventually obliterates most or all of a company’s worth.⁵¹ Many managers will manipulate their accounting numbers to simply put off bad news that would hurt their stock prices, and they thus begin a downward spiral that ends in blatant and potentially enormous accounting fraud.⁵² After overvaluations occur, managers sometimes “realize the markets will hammer [them] unless [their] company’s performance justifies the stock price,” and after exploring all value-creating alternatives, they start to take non-fraudulent actions that destroy long-term value but that they “hope will at least appear to generate the market’s expected performance in the short run.”⁵³ In an even worse scenario, managers simply begin fraudulent activities to support the erroneous valuation of their corporation.⁵⁴

The goal for managers when they realize that their firm is overvalued is to “postpone the day of reckoning” until they are no longer employed by their firms or they figure out a way to resolve the problem.⁵⁵ Essentially these managers are buying time until they can escape unharmed or they make the stock worth the amount at which it is trading.⁵⁶ The fraud perpetrated at Enron destroyed approximately \$30 billion of the corporation’s real value.⁵⁷ The purpose of fraud-inhibiting insider trading is to put in place a safety valve so that when managers realize that there is a problem with their firms’ valuations, they do not find themselves impaled on “Morton’s Fork”⁵⁸ when their choices are: (1) doing nothing and being financially devastated; (2) committing insider trading and potentially still ending up financially devastated if

50. *Id.*

51. *Id.* at 5.

52. Lambert, *supra* note 7, at 1091–92.

53. Jensen, *supra* note 36, at 8–10.

54. *Id.* at 10.

55. *Id.*

56. Lambert, *supra* note 7, at 1082.

57. Jensen, *supra* note 36, at 11 (“[S]enior managers’ efforts to defend the \$40 billion of excess valuation (which was a mistake that was going to go away anyway) effectively destroyed the \$30 billion core value.”).

58. A “Morton’s Fork” is a dilemma where people are faced with equally bad alternatives. What is Morton’s Fork, <http://www.wisegeek.com/what-is-mortons-fork.htm> (last viewed June 17, 2010). The term comes from Lord Chancellor John Morton, who worked in England under Henry VII. *Id.* According to Morton’s logic, wealthy subjects of the Crown obviously had money to be spared for high taxes, and poor subjects were clearly sitting on savings, so they could also bear paying high taxes. *Id.* Rich and poor alike found themselves at the points of “Morton’s Fork” and paying high taxes. *Id.*

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they get caught,⁵⁹ in addition to going to jail; or (3) performing fraudulent accounting in the hopes that fortuitous circumstances will somehow prevail and resolve the situation.⁶⁰

This Article argues that fraud-inhibiting insider trading would offer a way out of this dilemma and would increase the wealth of society without creating further victims.⁶¹ The idea is that an insider would be allowed to trade on her inside information when certain elements are satisfied. The first element is that the trading be based on negative information that will most likely lower the stock price when revealed. In other words, only price-reducing inside information would be eligible. The second element is that the trading be done on behalf of an individual who will himself (or his immediate family) be financially injured by the reduction in stock value, extending only to the stock he already owns. The third element required for the fraud-inhibiting insider trading safe harbor is that the individual have the ability to prevent the release of the information or to release distorted information to the public. The goal of the scheme is to avoid harm to society, and if the individual is not in a position to have an impact on the release of the information, then there is no global benefit to allowing him to use the safe harbor to avoid a harm that others will be facing. The final element is that the person in question must not have committed any fraudulent activities prior to availing himself of the safe harbor. Since the purpose

59. Insider trading may also result in the loss of any money saved or earned in the process if the government successfully prosecutes the trader. See Nicholson, *supra* note 34, at 57 (citations omitted).

60. Another option would be to both commit insider trading and simultaneously accounting fraud. This is apparently what happened in the case of Joseph Nacchio, the former CEO of Qwest Communications International. Nacchio was convicted of nineteen counts of insider trading. Dan Frosch, *Qwest's Nacchio Convicted of Insider Trading*, Apr. 18, 2007, available at www.nytimes.com/2007/04/18/technology/20qwest-web.html. The government argued that Nacchio attempted to avoid detection of his insider transactions, *United States v. Nacchio*, 519 F.3d 1140, 1169 (10th Cir. 2008), and also "engaged in a multi-faceted fraudulent scheme designed to mislead the investing public about the company's revenue and growth." Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Former Qwest CEO Joseph Nacchio and Eight Others with Massive Financial Disclosure Fraud (Mar. 15, 2005), <http://www.sec.gov/news/press/2005-36.htm>. As was the case with Enron and WorldCom, the fraudulent practices ultimately led to a near-complete destruction of Qwest's value. Qwest's stock value plummeted from a high of \$64.50 in March 2000 to a low of \$1.11 in August 2002, a reduction of over 98%. Ken Belson, *Ex-Chief of Qwest Is Indicted*, N.Y. TIMES, Dec. 21, 2005, at C1, available at www.nytimes.com/2005/12/21/business/21qwest.html?_r=1. As this Article discusses, *infra*, individuals like Nacchio would not be entitled to the fraud-inhibiting insider trading safe harbor if they participated in fraudulent activities. If this proposal were adopted and Nacchio had simply sold his shares when faced with a potential loss, he would have saved himself six years of prison time and his investors hundreds of millions of dollars.

61. It is important to bear in mind that virtually all the potential victims of the decreased stock value (i.e., the shareholders) would suffer the same or potentially greater loss if the insider trading were disallowed. From their perspective, fraud-inhibiting insider trading only affects the timing of when their loss is realized.

of the safe harbor is to enhance the protection of investors and other members of society in general, it would be self-defeating if the safe harbor were applied to those that had already harmed the public.

The fraud-inhibiting insider trading proposal does not affect other existing insider trading regulations. For example, § 16 of the Securities Exchange Act would still be applicable, which requires insiders—officers, directors, or owners of 10% or more of a company’s shares—to inform the SEC of their securities holdings within ten days after becoming insiders and report any changes in their holdings within two business days of transactions both electronically with the SEC and on the corporation’s website.⁶² Furthermore, the prohibitions in § 16 on “round trip” trading—any two trades occurring within a six-month period—and prevention of short-selling by insiders⁶³ would still apply. Maintaining these provisions is complementary to the purpose of fraud-inhibiting insider trading.

IV. THE LEGAL HISTORY OF INSIDER TRADING

To understand the prohibition of insider trading and the different legal options available in that area, it is important to analyze how the system came into existence.⁶⁴ Insider trading law was not created by well-thought-out (or even poorly-thought-out) statutory drafting.⁶⁵ In fact, insider trading regulations may be the closest thing the United States has to common-law-created federal criminal law.

A. *The Early Days of the Criminalization of Insider Trading*

The Supreme Court first ruled on an insider trading case in *Strong v. Repide*, where a majority shareholder bought some shares from a minority shareholder for a price ten times less than they were worth a few months later.⁶⁶ In *Repide*, the majority shareholder was negotiating the sale of the company’s sole asset and was the only one who knew that a very profitable sale was near completion.⁶⁷ He also went to great lengths to ensure the minority shareholder did not find out he was the

62. 15 U.S.C. § 78p(a) (2006).

63. *Id.* § 78p(b).

64. This Article seeks to present a brief description of the history of insider trading. For a more extensive review, see JONATHAN R. MACEY, INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY 28 (1991).

65. Michael P. Dooley, *Comment from an Enforcement Perspective*, 50 CASE W. RES. L. REV. 319, 320 (1999).

66. 213 U.S. 419, 422 (1909).

67. *Id.* at 424.

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one buying her shares.⁶⁸ Because the majority shareholder controlled all the relevant information and purposefully hid his identity when trading, the Court had little trouble ruling that the majority shareholder had committed fraud by inducing the minority shareholder to sell her shares.⁶⁹

Since the type of blatant face-to-face fraud that occurred in *Repide* is not usually present in insider trading, the SEC needed a legal theory of insider trading that was not based on such fraud if it wanted to punish the behavior more broadly. This started with its enforcement action *In the Matter of Cady, Roberts & Co.*, a case often said to have marked the beginning of the modern prohibition on insider trading.⁷⁰ In *Cady*, a broker received information from the director of a company indicating that the company had decided to reduce the amount of dividends that it was going to issue, and the broker then sold shares in the company for several of his clients before the information was publicly released.⁷¹ The SEC invoked Rule 10b-5⁷² to establish liability on the part of the broker who used this inside information.⁷³ Rule 10b-5 was enacted pursuant to the Securities Exchange Act of 1934 and prohibits any “manipulative or deceptive device or contrivance.”⁷⁴ The goal of the entire Securities Exchange Act and particularly Rule 10b-5 is “usually said to be the protection of investors and the maintenance of public confidence in the securities markets through the imposition of disclosure requirements and prohibitions of fraud.”⁷⁵ Rule 10b-5 does not even mention insider trading,⁷⁶ and it is not likely that Congress thought at the time that insider trading would be governed by § 10b.⁷⁷ In fact, § 16, which deals in part with short-swing profits,⁷⁸ was originally the only provision that seemed to discuss insider trading.⁷⁹

When “the Securities Act and the Securities Exchange Act were

68. *Id.* at 425.

69. *Id.* at 434.

70. *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). See Robert B. Thompson, *Insider Trading, Investor Harm, and Executive Compensation*, 50 CASE W. RES. L. REV. 291, 293 (1999).

71. *Cady*, 40 S.E.C. at 907.

72. 17 C.F.R. § 240.10b-5 (2010).

73. *Cady*, 40 S.E.C. at 911.

74. *Id.* at 910 n.7.

75. Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1238 (1995) (citations omitted).

76. Rule 10b-5 states in part that it is unlawful “[t]o employ any device, scheme, or artifice to defraud.” 17 C.F.R. § 240.10b-5(a) (2010).

77. Richard W. Painter et al., *Don’t Ask, Just Tell: Insider Trading After United States v. O’Hagan*, 84 VA. L. REV. 153, 160 (1998).

78. 15 U.S.C. § 78p(b) (2006).

79. Painter et al., *supra* note 77, at 161.

passed, classic insider trading—transactions between uninformed shareholders and corporate officials possessing inside information—was not regarded as fraudulent in most jurisdictions. The corporate officials' duties were considered to run to the corporation as an entity, not to individual shareholders.⁸⁰ The courts typically viewed insider trading as a corporate law problem that involved the fiduciary duties of officers and directors.⁸¹ Section 10b of the Securities and Exchange Act was intended to prevent fraudulent practices when fulfilling these duties.⁸²

The SEC took the opportunity in *Cady* to establish the obligation of insiders to disclose the information in their possession to the public or to refrain from trading the stocks concerned.⁸³ Even though there does not appear to be any actual breach of the insider's duty in *Cady*, the SEC determined that it was appropriate to sanction the tippee that used the information.⁸⁴ The SEC premised its decision in this administrative action upon the "need of regulation for the protection of investors."⁸⁵ The rule was announced as a form of "disclose or abstain," meaning that the insider had to either disclose his information or abstain from trading.⁸⁶ As many scholars have pointed out, however, disclosing is rarely an option due to other fiduciary duties to which the insider is often subject, so the default rule in reality amounts to just abstaining.⁸⁷

Cady was an administrative case that commentators at the time did not expect to result in a new rule or law, but it may precisely have been the SEC's intention to use this administrative case to establish a new rule regarding insider trading without public comment or congressional awareness at that early stage.⁸⁸ The SEC had strong motivation to include insider trading within its jurisdiction, namely to increase its prestige, power, and budget.⁸⁹ No matter what the SEC's original intent was, the rule in *Cady* turned out to have a lasting effect.

Seven years later, the Second Circuit decided *SEC v. Texas Gulf*

80. Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 361 (1988) (citations omitted).

81. Bainbridge, *supra* note 6, at 1590.

82. William R. McLucas et al., *Settlement of Insider Trading Cases with the SEC*, 48 BUS. LAW. 79, 81 (1993) (citing *Chiarella v. United States*, 445 U.S. 222, 226 (1980)).

83. *In re Cady, Roberts & Co.*, 40 S.E.C. 911 (1961).

84. *Id.* at 909 (stating that the information was given under the mistaken belief that it was already publicly available).

85. *Id.* at 910.

86. *Id.* at 911.

87. STEPHEN M. BAINBRIDGE, *SECURITIES LAW: INSIDER TRADING* 45, 67 (2007).

88. Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog That Did Not Bark*, 31 J. CORP. L. 167, 181 n.55 (2005).

89. Bainbridge, *supra* note 6, at 1597.

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Sulphur.⁹⁰ The case named as defendants several upper-level management and research employees of a company because they used inside information to buy stocks and options.⁹¹ The company had discovered mineral deposits in Canada that were going to be extremely valuable when the company mined them.⁹² The defendants were aware of this discovery well before the public and purchased stock in the company for prices as low as \$17.75 a share, whereas shares increased in value to \$58.25 after the information was released.⁹³ The Second Circuit held that the defendants had violated Rule 10b-5 when they participated in insider trading.⁹⁴ The court acknowledged that the intention of the Securities and Exchange Act, and therefore of Rule 10b-5, “is the protection of investors against fraud.”⁹⁵ The court interpreted this protection as mandating that all investors should have equal access to information and that trading on information unavailable to the general public should be prohibited.⁹⁶ Therefore, the court imposed the same rule of “disclose or abstain” as in *Cady*⁹⁷ because “[i]t was the intent of Congress that all members of the investing public should be subject to identical market risks.”⁹⁸ The court further specified that “[b]efore insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to ensure its availability to the investing public.”⁹⁹ In this early major federal case, the court suggested a parity of information approach that could have criminalized all trades where there was any material information disparity.¹⁰⁰ This approach was, however, unlikely to last long if for no other reason than the fact that “[i]nequality among investors is a basic reality of the market place.”¹⁰¹ For example, an ordinary day trader cannot call and talk to the CFO of a corporation the way that a major analyst could, and staff support and research capabilities vary widely among different investors.¹⁰²

90. 401 F.2d 833 (2d Cir. 1968).

91. *Id.* at 843.

92. *Id.* at 843–46.

93. *Id.* at 839 n.2, 847.

94. *Id.* at 864.

95. *Id.* at 861.

96. *Id.* at 848.

97. *Id.*

98. *Id.* at 852.

99. *Id.* at 854.

100. Thompson, *supra* note 70, at 293.

101. James P. Jalil, *Proposals for Insider Trading Regulation After the Fall of the House of Enron*, 8 *FORDHAM J. CORP. & FIN. L.* 689, 690 (2003).

102. *Id.*

B. From the Parity of Information Requirement to Fraud and Deceit Theories

The second wave of modern insider trading law was ushered in by *Chiarella v. United States*¹⁰³ and rejected the parity of information requirement, instead focusing on the fraudulent behavior of the inside trader and on tort concepts concerning deceit.¹⁰⁴ In *Chiarella*, the case surrounded a defendant who was employed at a financial printing company.¹⁰⁵ He was able to discern from the documents on which he was working the identities of companies that were subject to a pending acquisition or merger.¹⁰⁶ He used this information to buy shares in the companies before the information became public and their share prices went up, at which point he sold his shares for an easy profit.¹⁰⁷ The Supreme Court overturned his conviction, explaining that a Rule 10b-5 conviction must be based upon fraud and that his silence and subsequent trading could only be fraudulent if he had a duty to speak, which was not present in this case.¹⁰⁸ The Court also refused to entertain the argument that the fraud could be based on the defendant's "misappropriation" of information from his employer because, the Court reasoned, that theory was not presented to the jury.¹⁰⁹ After *Chiarella*, in an apparent attempt to avoid some of the requirements imposed by the Court, the SEC adopted Rule 14e-3, which addresses situations dealing with tender offers and imposes the "disclose or abstain" requirement (regardless of the existence of any fiduciary duty) that had just been rejected by the Supreme Court,¹¹⁰ but which limits itself to the context of tender offers, thereby partially working around the Supreme Court's ruling.

Three years later, in *Dirks v. SEC*,¹¹¹ the Court recognized the idea of information as a commodity.¹¹² This concept has led several commentators and jurists to conclude that the regulation of insider trading is properly based on a property rights justification.¹¹³ In *Dirks*, the defendant, a securities analyst, received information from an insider

103. 445 U.S. 222 (1980).

104. Thompson, *supra* note 70, at 294.

105. *Chiarella*, 445 U.S. at 224.

106. *Id.* at 224.

107. *Id.*

108. *Id.* at 235.

109. *Id.* at 236-37.

110. Ian B. Lee, *Fairness and Insider Trading*, 2002 COLUM. BUS. L. REV. 119, 126-27 (2002).

111. 463 U.S. 646 (1983).

112. Thompson, *supra* note 70, at 294.

113. See, e.g., Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges and the Production of Information*, 1981 SUP. CT. REV. 309.

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that a company was involved in massive fraud.¹¹⁴ The *Wall Street Journal* and the SEC had been repeatedly notified about this fraudulent activity, with no response.¹¹⁵ The analyst informed his clients, who in turn sold their shares in this company, which ultimately led to an investigation and public disclosure of the fraudulent practices.¹¹⁶ Rather than thanking the defendant for bringing this fraud to light and ending a practice that could have destroyed investors' lives, the SEC investigated and sanctioned the defendant for violating Rule 10b-5.¹¹⁷ The Supreme Court reversed that decision.¹¹⁸ The Court held that any liability for the defendant (the tippee) must be premised on liability attaching to the insider (the tipper) and that liability must be based on the breach of a duty that the tipper owes.¹¹⁹ Furthermore, whether there has been a breach of duty depends in part upon the purpose of the disclosure—if the disclosure was not based upon some benefit to the tipper, then there is no breach of duty.¹²⁰ The tipper in *Dirks* was motivated by a desire to expose fraud, he did not gain by his disclosure, and hence he did not breach his fiduciary duty; consequently, neither did the defendant breach any duty.¹²¹

The Court reiterated the requirements that it had previously used in *Chiarella* and that were inspired from *Cady*—i.e., that there had to be: “(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure.”¹²² Recognizing a property right in this kind of information would have enabled the company to prolong its illegal activities. Thus, because the company had no legitimate property interest in the nonpublic corporate information concerning its internal fraud, the insider did not wrongfully breach a fiduciary duty to the company by tipping off the defendant, and the defendant in turn breached no duty when using the information.¹²³ *Dirks* could be interpreted as standing for the proposition that not only are property rights involved in insider trading situations, but that a breach of duty is necessary as well. *Chiarella* and *Dirks* were quickly

114. *Dirks*, 463 U.S. at 649.

115. *Id.* at 649–50.

116. *Id.* at 651.

117. *Id.* at 650–51.

118. *Id.* at 652.

119. *Id.* at 660.

120. *Id.* at 662.

121. *Id.* at 667.

122. *Id.* at 653–54 (citing *Chiarella v. United States*, 445 U.S. 222, 227 (1990)).

123. MACEY, *supra* note 64, at 57–58 (citing *Dirks*, 463 U.S. at 662–67).

followed by the adoption of the Insider Trading Sanctions Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988.¹²⁴ While these laws established Congress's approval of insider trading prosecutions, the laws did not clarify exactly what should be prosecuted or why.

C. The Current State of Insider Trading Doctrine

The third wave in modern Supreme Court insider trading jurisprudence came with *United States v. O'Hagan*,¹²⁵ where the Court moved away from the tort-driven theory in *Chiarella* and closer toward a theory based on agency law and restitution.¹²⁶ *O'Hagan* dealt with a defendant who was a partner in the Minneapolis law firm of Dorsey and Whitney.¹²⁷ Dorsey and Whitney had been hired by its client Grand Met to work on the latter's intended acquisition of the Pillsbury Company.¹²⁸ The defendant became aware of the planned acquisition through his employment and bought large quantities of Pillsbury common stock and purchase options.¹²⁹ When the acquisition plan was publicly revealed, the price of Pillsbury stock increased, and the defendant sold his stock and options for a profit of \$4.3 million.¹³⁰

The defendant was convicted of violating Rule 10b-5 based upon the "misappropriation theory" that holds an individual liable under Rule 10b-5 when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.¹³¹ The misappropriation theory establishes liability for those who could be classified as "outsiders" that nonetheless have access to information that makes them liable for "insider trading."¹³² In justifying the misappropriation theory, the Court¹³³ referred to the

124. *Id.* at 1.

125. 521 U.S. 642 (1997).

126. Thompson, *supra* note 70, at 296.

127. *O'Hagan*, 521 U.S. at 647.

128. *Id.*

129. *Id.*

130. *Id.* at 648.

131. *Id.* at 652.

132. *Id.* at 653.

133. An ironic circumstance that dramatically changed the application of insider trading regulation concerned Justice Powell. Justice Powell did not think that the misappropriation theory was correct, and when another insider trading case, *Carpenter v. United States*, 484 U.S. 19 (1987), was originally denied certiorari, he wrote a dissent from the denial that apparently changed enough of the Justices' minds that they granted certiorari after all. Justice Powell then retired before the case was heard, and the Justices divided evenly on the misappropriation question, thereby leaving it open until the *O'Hagan* Court decided that the theory should indeed apply. A.C. Pritchard, *United States v. O'Hagan*:

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“animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence.”¹³⁴ The Court relied on the damage to investor confidence and resulting reduction in investment as well as the general impact on market participation to buttress its application of the misappropriation theory.¹³⁵ The *O’Hagan* decision began with an acknowledgement that “confidential information [belonging to a corporation] qualifies as property.”¹³⁶ It also stated that trading on misappropriated information harms investors in addition to deceiving the information provider.¹³⁷ Therefore, the *O’Hagan* Court both supported the idea that insider trading is based on property principles and endorsed the theory that prohibitions against the practice seek to protect the investor.

A few years after the *O’Hagan* decision and in the wake of several financial scandals, Congress passed the Sarbanes–Oxley Act (SOX)¹³⁸ in an attempt to prevent future economic turmoil. SOX included a provision that required insiders to report trades within two days after they took place.¹³⁹

Sarbanes–Oxley’s goals include improving accounting oversight, strengthening auditor independence, requiring more transparency in corporate financial matters, eliminating analyst conflicts of interest, and requiring greater accountability from corporate officials.¹⁴⁰

SOX also increased the possible penalties for insider trading to twenty-five years in prison and a \$5 million fine for individuals¹⁴¹ and contains a section authorizing a prison term of up to twenty-five years for knowing or attempted execution of “a scheme or artifice to defraud any person” in relation to a security of a registered or reporting company.¹⁴² Further, SOX instituted requirements for CEOs and CFOs to personally certify the accuracy of their periodic reports.¹⁴³ Yet, as a former SEC official pointed out, the increased penalties may have no effect because

Agency Law and Justice Powell’s Legacy for the Law of Insider Trading, 78 B.U. L. REV. 13, 16 (1998).

134. *O’Hagan*, 521 U.S. at 658.

135. *Id.* at 658–59.

136. *Id.* at 654.

137. *Id.* at 656.

138. Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.).

139. Jalil, *supra* note 101, at 702.

140. Kathleen F. Brickey, *From Enron to WorldCom and Beyond: Life and Crime After Sarbanes–Oxley*, 81 WASH. U. L.Q. 357, 359 (2003) (citations omitted).

141. Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime*, 55 FLA. L. REV. 937, 948 (2003) (citations omitted).

142. *Id.* at 948 (citation omitted).

143. *Id.* at 951.

if executives are “willing to risk five years, they’re going to risk [ten] years.”¹⁴⁴ The motives behind SOX—to “protect investors by improving the accuracy and reliability of corporate disclosures,”¹⁴⁵—were generally commendable, but the statute was passed in haste, partly due to political expediency. Furthermore, SOX primarily addressed how corporate fraud was conducted when it increased both the penalties imposed and the SEC’s resources,¹⁴⁶ but it did little to change some of the incentives that led individuals like Bernard Ebbers to commit the frauds in the first place. While the arguments in this Article mainly focus on maximizing utility and efficiency, the next Part provides a brief sketch of all three major philosophical rationales used to justify a prohibition on insider trading.¹⁴⁷

V. PHILOSOPHICAL PERSPECTIVES ON INSIDER TRADING REGULATION

A. Fairness and Deontological Arguments

Insider trading has been attacked and defended for over four decades based on several philosophical theories.¹⁴⁸ According to at least one former SEC Chairman, insider trading is not only “legally forbidden[,] [i]t’s is [also] morally wrong . . . [a]nd . . . economically dangerous.”¹⁴⁹ To determine if it is “morally wrong,” it is helpful to look at insider trading from several different perspectives. The first position that this Article will address is the claim that it is simply “unfair”¹⁵⁰ per se. As previous authors have pointed out, the concept of “fairness” is often vague and unhelpful,¹⁵¹ with little or no explanation as to what “fair” is or why insider trading is “unfair.”¹⁵² At least one scholar contends that this “fairness” or equal access approach “collapses into [an analysis] of

144. *Id.* at 955 (citation omitted).

145. *Id.* at 952.

146. Sarbanes–Oxley effectuated a 77% increase in the SEC’s budget and authorized the use of funds to hire an additional 200 professionals for the agency. Brickey, *supra* note 37, at 244.

147. A more intensive examination of the philosophical underpinnings of insider trading is outside the scope of this Article, so Part V only seeks to provide a basic overview.

148. Henry Manne has argued for over forty years that insider trading does not harm long-term investors, that it is an appropriate compensation mechanism, and that it contributes to the efficiency of stock-market pricing. Manne, *supra* note 88, at 168.

149. Charles Arthur Levitt, Chairman, Sec. & Exch. Comm’n, A Question of Integrity: Promoting Investor Confidence by Fighting Insider Trading, Remarks at the S.E.C. Speaks Conference (Feb. 27, 1998), available at www.sec.gov/news/speech/speecharchive/1998/spch202.txt.

150. As some scholars have noted, “if fairness is defined with reference to shareholders’ welfare, it is impossible to sustain the argument that insider trading is unfair, since the activity benefits the very group it is supposed to harm.” MACEY, *supra* note 64, at 28.

151. Lee, *supra* note 110, at 121–22.

152. MACEY, *supra* note 64, at 23.

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property rights when subjected to rigorous analysis.”¹⁵³ In a rare attempt to define the term in the context of insider trading, one author describes fairness “as a brake upon self-interest. It is the normative basis for a variety of social conventions that prevent individuals from doing that which would otherwise be in their own respective interest.”¹⁵⁴ This concept of fairness is based on “the deontological view that what makes an act morally justifiable is the respect it expresses for the autonomy, rights and dignity of those persons affected by it”¹⁵⁵ and “not merely the social welfare or the utility that the act produces.”¹⁵⁶ The argument in relation to insider trading is that taking advantage of one’s position in a case of information asymmetry means disrespecting the autonomy of the other actor¹⁵⁷ because information is central to rational deliberation, and therefore precluding this deliberation is violative of autonomy.¹⁵⁸ From this deontological viewpoint, “human choice is a source of value, and so long as a person competently makes choices in a manner that does not wrong others, morality requires that one refrain from interfering with these choices.”¹⁵⁹ In other words, precluding deliberation would be one such form of immoral interference. Furthermore, deontological theory maintains that benefits to society, to the interfering individuals, or even to the individuals against whom the interference took place cannot correct the harm caused by this interference with autonomous choices.¹⁶⁰

There are multiple responses to this possible deontological objection to insider trading. The first takes issue with the idea that fairness must inherently operate as a “brake upon self-interest.” Specifically, this position makes the assumption that self-interest and others’ interests are necessarily in conflict. If A’s interests and B’s interests are aligned, then of course there would be no need for this “brake” to be imposed upon A’s interests, and in fact, it could be argued that it would be “unfair” by our intuitive understanding of the term to have such a brake. Similarly, if social welfare or utility are aligned with autonomy and dignity, there is no need for a braking mechanism. Finally, it cannot be that for a situation to be “fair,” everyone must possess the exact same informational basis. Even if one acknowledges that equal access to

153. *Id.* at 24.

154. Lee, *supra* note 110, at 141.

155. *Id.* at 141 n.70 (citation omitted).

156. Allan Strudler & Eric W. Orts, *Moral Principles in the Law of Insider Trading*, 78 TEX. L. REV. 375, 381 (1999).

157. Lee, *supra* note 110, at 150.

158. *Id.* at 151.

159. Strudler & Orts, *supra* note 156, at 409.

160. *Id.*

information is not the same as equal information,¹⁶¹ a categorical ban on transactions involving disparities of information (or access to information) would be untenable and undesirable in many common interactions. Given the fact that most people would not classify all such situations as immoral in all their possible permutations, it is likely that further factors are necessary for the “unfair” or “immoral” characterization than simply the existence of inequality. To give an example, when buying a product, the consumer virtually never knows all the information about the product that the manufacturer does, even when the manufacturer has not purposefully concealed any data. Yet, one would not say that the buyer’s autonomy was violated as a result when she engages in the transaction. An information asymmetry is thus at best necessary, but definitely not sufficient to establish a loss of autonomy.

In sum, the following would have to be true in every insider trading situation for this kind of trading to be inherently unfair under such a deontological understanding: (1) self-interest and others’ interests are never aligned in an insider trading situation; and (2) autonomous decision-making is necessarily violated in a way that goes above and beyond the many unproblematic daily situations of information asymmetry that even deontological theory would likely deem unfair, such as buying a product without complete information.¹⁶² It is hard to see how all of these are true of every given instance of insider trading, and the deontological theory thus does not appear to suffice to prohibit every such instance.

Even assuming that insider trading is unfair in a meaningful way, this may in fact be mitigated by the way that corporations respond to the practice. For instance, a recent article suggests that companies adjust executive compensation based on the liberality of their own insider trading policies and give lower compensation where insiders have greater freedom to trade.¹⁶³ The article examines executives’ ability to trade under so-called “Rule 10b5-1 trading plans,” which allow executives to set up preplanned trades that can be cancelled before they take place, and argues that these plans have at times been manipulated to

161. Kim Lane Scheppele, “It’s Just Not Right”: *The Ethics of Insider Trading*, 56 *LAW & CONTEMP. PROBS.* 123, 125 (1993).

162. Additionally, some have argued that under deontological theories, it is inappropriate to penalize someone for an act if no one was harmed by the act. Strudler & Orts, *supra* note 156, at 387. If one adds this criterion, a third requirement would be that someone gets harmed in a measurable way every time insider trading occurs.

163. M. Todd Henderson, *Insider Trading and CEO Pay* 10 (Univ. of Chicago Law & Economics, Olin Working Paper No. 521, 2010) (quotation omitted), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1605170.

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incorporate inside information into trading.¹⁶⁴ Research conducted into the ability of corporate boards to take such “informed trading” into account when setting CEO compensation packages indicates that when this kind of trading is not contractually restricted by corporations, CEO compensation is lower by an average of 20%.¹⁶⁵ This suggests that where CEOs are able to use a loophole to practice some limited forms of insider trading, the corporation is better off overall because it can pay them lower salaries. “At least with respect to classic insider trading if boards are taking potential trading profits into consideration when setting pay, it is difficult to locate potential victims of the trade.”¹⁶⁶ Furthermore, “[i]f traders know about the potential for informed traders to be on the other side of a transaction, this risk should be priced by the market, and the firm should internalize these costs.”¹⁶⁷ These types of factors should at least reduce the concerns about the potential inherent unfairness of insider trading.

B. Contractarian Arguments

A second philosophical lens through which to look at insider trading would be a contractarian framework. This framework examines what preferences individuals would express if they were asked to give their opinions about a potential set of rules, assuming that they did not know their position in life in advance and there were no forms of coercion.¹⁶⁸ A key component of modern contractarian thought is the protection for the disadvantaged that is achieved by asking people “before they know what situations they will be in . . . to imagine the worst that could happen to them under alternative rules and to choose the rules that would avoid intolerable outcomes.”¹⁶⁹

Some commentators believe that the contractarian position would find insider trading unacceptable because “[p]eople would not agree to be part of a system where their disadvantage in access to knowledge could be turned into disadvantages in the distribution of other resources.”¹⁷⁰ This is, however, arguable. Typically, “[i]ndividuals want to be able to

164. *Id.* at 13.

165. *Id.* at 24.

166. *Id.* at 3.

167. *Id.* at 33. Even if the corporation should suffer a slight reduction in the value of its securities and thus a decline in the overall value of the firm, this reduction is compensated by the mentioned lowered CEO salaries. *Id.*

168. Scheppele, *supra* note 161, at 152. The most famous formulation of this theory is John Rawls’s “veil of ignorance.” JOHN RAWLS, *A THEORY OF JUSTICE* (1971).

169. Scheppele, *supra* note 161, at 154–55.

170. *Id.* at 162.

take chances, as long as they are protected from catastrophe.”¹⁷¹ Some forms of insider trading satisfy this desire by allowing people to take chances in the stock market and help to protect them from the type of disastrous consequences that occurred to the WorldCom investors. Furthermore, because “people feel that losses from the status quo are much worse than losses from an imaginary ideal state, economic arguments notwithstanding, opportunity costs are not as important in estimating well-being as are costs of losses from one’s current position.”¹⁷² This being the case, if asked beforehand if they prefer to allow an insider to gain, without the possibility of gain on their own part, or if they would rather possibly lose what they consider to be theirs, most people will presumably choose the former. That is the trade-off presented by some types of insider trading—i.e., the loss that individuals could (and almost certainly will) suffer if fraud is perpetrated under the current regime versus these individuals’ drastically reduced loss if some forms of insider trading are allowed.¹⁷³ Because the latter option presents many benefits under the *ex ante* perspective of contractarian theory, it is unclear why the theory should strictly prohibit insider trading.¹⁷⁴

C. Utilitarian Arguments

While there is some merit to viewing insider trading through the previously mentioned philosophical theories, they do not illuminate the issue as well as a third framework—the utilitarian lens. Utilitarianism, a theory usually credited to Jeremy Bentham,¹⁷⁵ provides a number of

171. *Id.* at 156.

172. *Id.* at 164 (citation omitted).

173. Furthermore, if the studies are correct that show how greater freedom for executives to engage in informed trading lowers executive compensation and ultimately benefits the firm, many investors would likely prefer a scenario of liberalized insider trading. See *supra* text accompanying notes 163–167.

174. One possible problem with the contractarian accepting insider trading could be seen in the “ultimatum game.” In this experiment, two individuals are told that they have to split-up money; the first individual is told to propose a division and the second can either accept the division or refuse to deal altogether. The idea is that the first would propose a division largely in favor of himself while thinking that the second individual can either accept the deal and be better off than with nothing or reject the deal and in fact end up with nothing. Yet, when the game was run as an experiment, neither of these two predictions really came true. The first individual actually often offered relatively equal rewards, and the second often rejected a share of 20% or less. Thompson, *supra* note 70, at 301. The outcome of the second prediction might suggest that people will sometimes prefer both actors to be worse off than for them to have a lower reward themselves. This is not entirely compelling if applied to insider trading, however, because the stakes contemplated in reality are considerably higher in both the positive and negative direction than those presented in the experiment.

175. JEREMY BENTHAM, AN INTRODUCTION TO THE PRINCIPLES OF MORALS AND LEGISLATION

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tools that allow one to calculate the costs and benefits of insider trading and, at the very least, approach some conclusions regarding its effects in economic terms. All crimes impose economic and other costs on society, and it is in great part to reduce these costs that society crafts laws and regulations that provide punishments as disincentives to commit crimes.¹⁷⁶ Would-be criminals themselves weigh the pros and cons of performing potentially criminal actions,¹⁷⁷ and thus, the law tries to carefully shape the rules such that these individuals take socially optimal actions—actions that will neither be so overly risk-averse as to prevent innovation and various forms of creative endeavors nor so daring that the community is harmed. Furthermore, utilitarianism is useful in this context because “[t]he general purpose of legal rules is to ensure that society’s resources are allocated responsibly.”¹⁷⁸ The utilitarian position basically dictates an evaluation of the good, which can be labeled as “happiness,” “wealth,” or “utility,” that a particular decision will bring about against the good that an alternative decision would create.¹⁷⁹ Thus, the decision that will result in the greatest amount of good is the correct decision. In the context of insider trading, this means that those forms of insider trading should be allowed that increase society’s overall wealth, regardless if that means increasing its gains or decreasing its losses as much as possible.

The criminal law operates under the theory of general deterrence, the idea being that if the system punishes individuals who break the law, other would-be criminals will refrain from doing so because they do not want to suffer the same fate.¹⁸⁰ An individual “will choose the course of action that will maximize his personal expected utility,”¹⁸¹ and therefore, “[e]ffective outcomes from this cost–benefit assessment require the risk of detection and apprehension, or the severity of punishment [to] be greater than any purported benefit to be gained from the prospective illegal act.”¹⁸² In particular, when we are discussing something as closely connected to finance as trading on the stock market, it makes intuitive sense to use a philosophical system that easily translates into an implementable set of rules. Many of the arguments against regulating insider trading can be attributed to the University of

(1789).

176. See generally Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968) (applying utilitarian theory to the criminal law).

177. Moohr, *supra* note 141, at 956.

178. MACEY, *supra* note 64, at 2.

179. Scheppele, *supra* note 161, at 150.

180. Nicholson, *supra* note 34, at 51–52.

181. *Id.* at 52 (internal quotation and citation omitted).

182. *Id.* (citation omitted).

Chicago's Law and Economics school of thought, which essentially proposes a cost-benefit analysis derived from the utilitarian position.¹⁸³ An evaluation under this method usually concludes with the proposition that an "an absolute ban [on insider trading] is pointless much of the time and welfare-reducing the rest of the time."¹⁸⁴ This Article will evaluate many of the specific claims about the possible benefits and detriments of insider trading under utilitarianism and show why utilitarianism would endorse the legalization of fraud-inhibiting insider trading. Specifically, the next Part will show that, from a utilitarian perspective, allowing fraud-inhibiting insider trading makes sense both if one's main concern is the effect of insider trading on investor confidence in the market and if one judges fraud-inhibiting insider trading under a property rights paradigm.

VI. THE MAJOR ARGUMENTS AGAINST INSIDER TRADING

From a utilitarian standpoint, insider trading should be prohibited if the costs of insider trading outweigh its benefits.¹⁸⁵ There are several arguments that have been made against insider trading, but two are by far the most prominent attacks. The first objection is based on the idea that insider trading affects the confidence of investors and in turn the types of investments they make. The second objection is related to the idea that insider trading is a form of theft because it violates a property interest in information.

A. The Confidence Argument

One of the most often cited reasons (though not usually by economists) for the prohibition of insider trading is the loss of confidence in the market and the subsequent desertion of the market by investors if they believe that there are unfair informational advantages at play.¹⁸⁶ This argument is based on the idea that, regardless of whether insider trading is harmful, people believe that it is and therefore will not trade if they think such trading is allowed.¹⁸⁷ The claim is made by proponents of insider trading prohibitions, by government agencies, and

183. See, e.g., Becker, *supra* note 176. See also Richard A. Posner, *An Economic Theory of the Criminal Law*, 85 COLUM. L. REV. 1193 (1985) (explaining how various criminal law doctrines can promote economic efficiency).

184. Lee, *supra* note 110, at 139.

185. Lambert, *supra* note 7, at 1057.

186. Cox & Fogarty, *supra* note 80, at 353, 354.

187. Lee, *supra* note 110, at 138.

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occasionally by the courts. They assert that insider trading “impairs investor confidence, thereby discouraging capital formation and reducing liquidity.”¹⁸⁸ The SEC usually argues that insider trading is unfair and reduces public confidence in the securities markets.¹⁸⁹ A former SEC Chairman, Arthur Levitt, stated in relation to insider trading that “if there is a perception of unfairness, there’ll be no investor confidence—and precious little investment.”¹⁹⁰ In fact, in the most recent insider trading Supreme Court case, *United States v. O’Hagan*, “there is no mention of individual harm in specific transactions. Rather, the focus is on the harm from a decrease in public confidence in the market.”¹⁹¹ A similar objection is that if insider trading is allowed, insiders will always have the advantage over outsiders and will therefore make better deals, which will in turn both reduce liquidity in the market and make outsiders suffer increased transaction costs associated with all trading.¹⁹² Proponents of insider trading regulation have suggested that “banning insider trading, however, by increasing the confidence of uninformed investors may lower the premium they require to transact and in turn lead to more stable and liquid markets.”¹⁹³

There are multiple responses to these arguments. One problem with the claim that insider trading must be prohibited to “protect the integrity of the nation’s capital markets” and that unless investors think they are playing on a “level playing field” they will lose confidence and stop investing¹⁹⁴ is the fact that if insider trading continues to be banned, this does not “level the playing field” but rather tilts it toward investment professionals.¹⁹⁵ “[I]f insiders are banned from trading, outsiders will not automatically profit. Rather, market professionals, who are the next-best information processors after insiders, will simply increase their profits.”¹⁹⁶ It is arguably due to this fact that there is strong support in the investment professional community for prohibiting insider trading.¹⁹⁷

188. Pritchard, *supra* note 133, at 48.

189. Roberta S. Karmel, *The Relationship Between Mandatory Disclosure and Prohibitions Against Insider Trading: Why a Property Rights Theory of Inside Information Is Untenable*, 59 *BROOK. L. REV.* 149, 150 (1993) (citations omitted).

190. Levitt, *supra* note 149, at 2.

191. Thompson, *supra* note 70, at 299.

192. Pritchard, *supra* note 133, at 49–50. *See also* Lee, *supra* note 110, at 165.

193. Jie Hu & Thomas H. Noe, *The Insider Trading Debate*, 82 *FED. RES. BANK OF ATLANTA ECON. REV.* 34, 40 (1997).

194. MACEY, *supra* note 64, at 41 (internal citations omitted).

195. *Id.* at 42.

196. *Id.* at 14. *See also* David D. Haddock & Jonathan Macey, *Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation*, 30 *J.L. & ECON.* 311 (1987).

197. MACEY, *supra* note 64, at 17. *See also* Bainbridge, *supra* note 6, at 1604.

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Furthermore, the position that insider trading will increase transaction costs again focuses on all types of insider trading taken together. Even assuming that, generally speaking, insider trading will result in better deals for the insider and higher costs for the outside trader, this argument is inaccurate when considering fraud-inhibiting insider trading. In the model that this Article presents, insider trading would only be authorized when an insider uses negative information that, but-for the trading, may have remained undisclosed for a longer period of time or may have been released in a distorted form. Under these conditions, insider trading may prevent potentially significant losses to both major and individual investors. This loss prevention would work as a safety valve, releasing pressure and reducing the transaction costs because of the lowered risk of corporate fraud and its consequences.

Such a safety valve could increase confidence in other contexts as well. For example, when questioned during a congressional inquiry into the recent financial crisis, a Bear Stearns executive stated that rumors caused a significant decline in his company's liquidity and that "[t]he market's loss of confidence, even though it was unjustified and irrational, became a self-fulfilling prophecy."¹⁹⁸ If fraud-inhibiting insider trading was in place to allow executives to get out, it would serve to reduce speculation and therefore increase investor confidence. Also, if investors knew that highly placed CEOs could get out if bad news was on the way and that investors would be informed if that occurred, they would be less inclined to speculate about pending disasters as long as they saw that the executives were not selling their stock.

Not only is it possible that fraud-inhibiting insider trading could increase confidence in the stock market, but as multiple commentators have pointed out, "the public has never shown any signs of losing confidence in the stock market because of the existence of insider trading."¹⁹⁹ The SEC's position that insider trading results in a loss of confidence by investors has little empirical backing and has been criticized by Henry Manne—one of the most ardent supporters of legal insider trading—as a "nearly unfalsifiable proposition."²⁰⁰ Yet, there are actually several different empirical measures that can be used to cast doubts on this theory. First, the theory is difficult to defend in light of the fact that during the 1980s, a very notorious incident of insider

198. *Bear Stearns Brought Down by 'Rumors': Ex-CEO*, BREITBART, May 5, 2010, http://www.breitbart.com/article.php?id=CNG.489ada6bb3c70a089e9ce555a6d00cf4.01&show_article=1.

199. Thompson, *supra* note 70, at 300 (quoting Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 577 (1970)).

200. Manne, *supra* note 88, at 168 n.5.

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trading was followed by one of the most robust periods in the stock market.²⁰¹ In April of 1985, *Businessweek* ran a headline reading “The Epidemic of Insider Trading: The SEC is Fighting a Losing Battle to Halt Stock Market Abuses.”²⁰² The insider trading scandals of the 1980s were some of the most sensational events in the popular business press of the time.²⁰³ One of the most publicized cases was that of Ivan Boesky²⁰⁴ and Michael Milken.²⁰⁵ Since the Boesky scandal—in which several individuals used insider trading information to earn large sums of money²⁰⁶—was such a well-known event, one can use its aftermath as an imperfect but interesting indicator to determine how insider trading affects the confidence and investments of existing and potential investors. Right before Boesky’s actions became public, the Dow Jones Industrial Average (Dow) was at 1873.59; a week later, it was up to 1893.56; a month later, it was up to 1922.81; after six months it was at 2325.49.²⁰⁷ Therefore, even though the most widespread insider trading scandal in the history of Wall Street had just been revealed and was still being reported on, the stock market value increased by almost 25%. While this does not provide any sort of ultimate proof, it makes the theory that insider trading events have large and damaging effects on the market less plausible.

At the same time, one should go further than just looking at the value of the stock market over that period of time because it is possible that investor confidence could have been affected, and hence investments may have gone down while the overall value of the Dow misleadingly still rose. This could, for instance, have occurred if a few large companies had substantial success during that period, causing their stock price to go up even though confidence and the quantity of investments were down. One can decrease the possibility of reaching an erroneous conclusion on this subject by also checking the volume (the number of trades with no reference to the value of the stocks) during the specific time frame. If one looks at the volume of stocks traded on the New York Stock Exchange (NYSE), there seems to be little evidence that insider trading led to a loss in investor confidence. In 1987, the year following the revelation and publicizing of Ivan Boesky’s insider trading

201. BAINBRIDGE, *supra* note 87. *See also* Bainbridge, *supra* note 75, at 1243.

202. JAMES B. STEWART, *DEN OF THIEVES* 273 (1991).

203. Hu & Noe, *supra* note 193, at 34.

204. Ivan Boesky was the inspiration for the blockbuster film *Wall Street* by Oliver Stone, released in the late 1980s. *WALL STREET* (Twentieth Century Fox Film Corporation 1987).

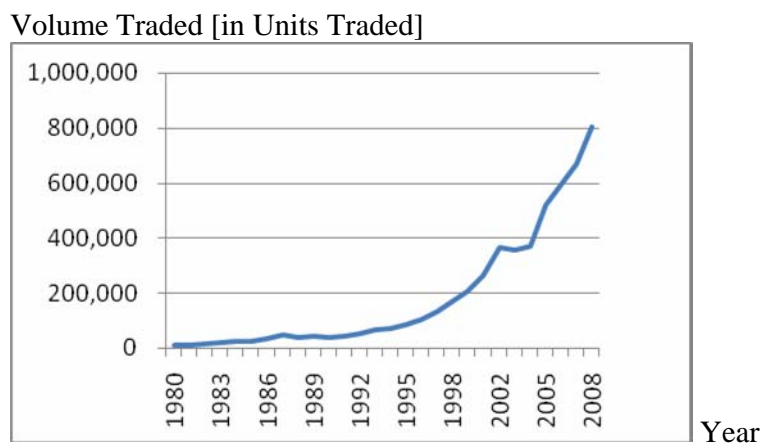
205. Hu & Noe, *supra* note 193, at 34.

206. For a detailed discussion of the Boesky scandal, see STEWART, *supra* note 202.

207. Cox & Fogarty, *supra* note 80, at 354 n.5.

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activities, there was an increase of approximately 34% in the volume of stock traded on the NYSE.²⁰⁸ In fact, over a twenty-eight year timeframe, namely from 1980 to 2008, the volume of trading on the NYSE only went down at two points in time, as can be seen in Figure 1 below.²⁰⁹ The first period was from 1988 to 1990 (with slight improvement in between), and the second period started around 2003. Both of these periods were preceded by calamitous events in the stock market. The late 1980's reduction in trading followed what has been termed "Black Monday," when the stock market lost more than 20% of its value in a single day,²¹⁰ and the reduction in 2003 came after the Enron and WorldCom financial meltdowns that resulted in two of the largest bankruptcies in American history as well as the loss of billions of dollars of value in the stock market and of thousands of jobs.

Figure 1²¹¹

208. For the numbers used to put together this graph, see U.S. Census Bureau, 2010 Statistical Abstract, available at http://www.census.gov/compendia/statab/cats/banking_finance_insurance.html (last visited June 16, 2010). Some may posit that while there was an increase in volume, perhaps the scandal made it a more modest increase compared to those in previous years. The data does not corroborate this hypothesis; the increases that preceded the 1986–1987 one, beginning with the 1980–1981 interval, were 4%, 38%, 31%, 7%, and 19%, respectively. See *id.* The 34% increase is thus, if anything, one of the stronger increases in that era.

209. *Id.*

210. Investopedia, Black Monday, <http://www.investopedia.com/terms/b/blackmonday.asp> (last visited June 27, 2010). It should be noted that while there is still disagreement about what caused the crash in 1987, there is virtually no suggestion that insider trading was the cause. Cox and Fogarty, *supra* note 80, at 354.

211. U.S. Census Bureau, *supra* note 208.

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These statistics potentially suggest that insider trading may not have a substantial impact on the amount of trading that occurs, but only indirectly gets at the question of whether there is a loss of confidence in the market or in business generally.

To get more direct evidence concerning this possible loss of confidence, one can look at the data collected in the General Social Survey (GSS). The GSS is a survey that has been conducted periodically by the University of Chicago since 1972.²¹² It includes two pertinent questions concerning Americans' confidence in the stock market and business in general. The first question is: "I am going to name some institutions in this country. As far as the people running these institutions are concerned, would you say you have (1) a great deal of confidence, (2) only some confidence, or (3) hardly any confidence at all in them?"²¹³ The interviewer then names several institutions, including "major companies" and "banks and other financial institutions."²¹⁴ Hence, a lower number on this scale represents a higher level of confidence. There are two periods of time covered by the GSS that provide important information for an inquiry into whether insider trading as opposed to accounting fraud is likely to lower confidence in the market. The first significant time period is that immediately following the Ivan Boesky insider trading scandal, specifically 1986 and 1987. During this period, the GSS was conducted in February through April of each year.²¹⁵ In the 1986 survey, the average response when asked how much confidence a person had in banks and financial institutions was 1.96; one year later, after the news of Ivan Boesky had been extensively reported on, including a cover story in *Time Magazine* in December of 1986,²¹⁶ the level of confidence was reported at 1.86.²¹⁷ Therefore, after the incident, confidence *rose*, and people on average felt more confident than they had in the time period before they were aware of the insider trading scandal. Another important time to consider is 2002, just after the Enron and later WorldCom accounting fraud

212. For general information about the GSS, see The Nat'l Data Program for the Sciences (NORC) at the Univ. of Chicago, GSS General Social Survey, <http://www.norc.org/GSS+Website/> (last visited June 13, 2010).

213. NAT'L OPINION RESEARCH CTR. UNIV. OF CHICAGO, GSS AMERICA'S SOCIAL SURVEY 21 (1987), available at <http://publicdata.norc.org:41000/gss/Documents/QUEX/1987/1987%20GSS.pdf>.

214. *Id.*

215. NAT'L OPINION RESEARCH CTR. UNIV. OF CHICAGO, GENERAL SOCIAL SURVEYS, 1972–2008: CUMULATIVE CODEBOOK 7 (2009), available at <http://www.norc.org/NR/rdonlyres/21C53AAC-1267-43B6-A915-A38857DC9D63/1645/50000INTRO.pdf>.

216. *Going After the Crooks*, TIME, Dec. 1, 1986, available at <http://www.time.com/time/magazine/article/0,9171,962963,00.html>.

217. See Univ. of California, Berkeley, Survey Documentation and Analysis, <http://sda.berkeley.edu/cgi-bin/hsda?harcsda+gss08> (last visited June 13, 2010).

scandals broke. At that point, the confidence in banks and financial institutions went from 1.84 in 2000 to 1.95 in 2002.²¹⁸ It makes intuitive sense that people would lose confidence after the Enron and WorldCom events given that dishonest dealings cost a lot of people their money and jobs, which was not the case with Boesky's and Milken's activities.

The second useful question for the analysis here relates to people's level of confidence in major business. In early 1986, before most people were aware of the massive insider trading that was taking place surrounding Boesky and Milken, this figure was 1.84, and in 1987, after the news broke, it was 1.77.²¹⁹ Therefore, people's level of confidence again rose after the scandal. Furthermore, in 2000, before the accounting fraud scandals, this confidence level was 1.81, and in 2002, it was 1.99.²²⁰ Hence, people's confidence in major business dropped after the Enron and WorldCom scandals along with their confidence in banks and financial institutions, but their confidence, if anything, slightly rose after the insider trading events.

The various data suggests that Enron and subsequent accounting fraud scandals inflicted not only huge financial losses but also caused a reduction in public confidence in the securities market.²²¹ Relatedly, Enron, WorldCom, and some smaller similar scandals had a very significant amount of press coverage.²²² In the ten weeks following the earnings report that showed the fraud, there were over 250 stories about Enron in the *New York Times* and *Wall Street Journal* alone.²²³ The press coverage did not quickly die down: from the time that the scandals broke to the time of the guilty verdicts for Enron executives Ken Lay and Jeffrey Skilling over four years later, there were more than 780 stories in just the *New York Times* and the *Wall Street Journal*.²²⁴ Even more appeared in some local papers; for example, the *Houston Chronicle* had nearly 2,000 different Enron stories.²²⁵ This suggests the possibility that what truly causes a loss of confidence in the nation's financial markets is corporate fraud.²²⁶ When these types of activities

218. *Id.* During those years, the survey was given biennially..

219. *Id.*

220. *Id.*

221. See also Kathleen F. Brickey, *In Enron's Wake: Corporate Executives on Trial*, 97 J. CRIM. L. & CRIMINOLOGY 397, 397 (2006).

222. Kathleen F. Brickey, *From Boardroom to Courtroom to Newsroom: The Media and the Corporate Governance Scandals*, 33 J. CORP. L. 625, 625 (2008).

223. *Id.* at 627.

224. *Id.* at 655.

225. *Id.*

226. Brickey, *supra* note 37, at 222.

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occur, the consequences are often long-lasting in both economic terms and in the amount of attention that is paid to them. Therefore, and based on the limited empirical data available and presented here, a commentator's statement in reference to insider trading that "nothing—not wars, not recessions, not political uncertainties—does greater damage to confidence in securities markets than the perception that trading is not elementally fair to all"²²⁷ seems at least potentially incorrect in that fraud and corporate collapse are possibly more damaging to confidence than is insider trading.²²⁸ Recognizing the lack of empirical evidence to support the thesis that insider trading damages investor confidence may lead utilitarian-minded scholars and policy-makers to a more open-minded stance toward insider trading. As a result, they may be willing to at least consider legalizing those forms of insider trading that could lower the risk of what appears to inflict greater damage to confidence—corporate fraud. As mentioned and as will be discussed further below, the model of legalized fraud-inhibiting insider trading presented in this Article seeks to achieve precisely the goal of preventing future Enron and WorldCom-type situations, thus bolstering confidence in the market.

B. The Property Argument

One of the other major justifications behind the prohibition on insider trading is that it protects property rights in information as opposed to investors.²²⁹ The argument relies on the idea that regulating insider trading gives an incentive for companies to produce socially valuable information.²³⁰ In this framework, insider trading represents a theft of corporate property.²³¹ Many scholars and judges feel that the property rationale is the strongest basis for prohibiting insider trading. In *United States v. Chestman*, Judge Winter stated:

227. Jalil, *supra* note 101, at 710–11.

228. Of course, the evidence presented here cannot conclusively refute the possibility that insider trading damages investor confidence. It is the case, however, that the proponents of that hypothesis both carry the burden of proof and have so far not provided empirical evidence supporting their claim. Additionally, alternative explanations of the data presented here, such as that insider trading did damage confidence but that other factors restored it, appear unlikely. One such theory would be that one or several very publicized positive events canceled out the effect of the Boesky and Miliken scandal. It is, however, not clear which event could have played this role in that particular time period. Some individuals may also posit that the government perhaps responded really effectively to the scandal and restored confidence that way. No actual significant measures were taken for several years, however, and the perpetrators received no punishments until much later (and arguably moderate ones at that).

229. Bainbridge, *supra* note 6, at 1606.

230. *Id.*

231. MACEY, *supra* note 64, at 44.

Information is perhaps the most precious commodity in commercial markets. It is expensive to produce, and, because it involves facts and ideas that can be easily photocopied or carried in one's head, there is a ubiquitous risk that those who pay to produce information will see others reap the profit from it. Where the profit from an activity is likely to be diverted, investment in that activity will decline. If the law fails to protect property rights in commercial information, therefore, less will be invested in generating such information.²³²

The Supreme Court also endorsed the property rationale for insider trading regulation in *O'Hagan* when it stated that “[a] company’s confidential information . . . qualifies as property to which the company has a right of exclusive use.”²³³ One property-based argument in favor of insider trading regulation is rooted in the premise that because the information is socially desirable, the law should provide incentives to create it, and insider trading regulation is such an incentive.²³⁴ This incentive motivation is, however, only applicable in some insider trading settings, such as the situation in the *Texas Gulf Sulphur* case where the information that minerals existed on a piece of land was expensive to discover and valuable to those that planned to collect them. Fraud-inhibiting insider trading scenarios, however, are different because the information there is typically not developed, but usually appears on its own and may cause significant loss in value to the corporation. One example would be a setting where a manager naturally finds out without extensive investigation that the price of raw materials that the company needs has unexpectedly gone up or that fewer consumers are buying the company’s products.

One proponent of the property justification is Jonathan Macey, who contends that “the search for a coherent justification for prohibiting insider trading is over: the right to trade on a piece of information about a corporation is simply a part of the larger, and more venerable, question of whether and how to allocate property rights in intangible things.”²³⁵ He further argues that insider trading can and should be regulated consistent with principles of fairness and fiduciary duty where this enforcement “will support a system of economic incentives that enhance social welfare and create incentives for the efficient allocation of resources.”²³⁶ Macey concludes that the property right (or ability to

232. 947 F.2d 551, 576–77 (2d Cir. 1991).

233. *United States v. O'Hagan*, 521 U.S. 642, 654 (1997).

234. Cox & Fogarty, *supra* note 80, at 359.

235. MACEY, *supra* note 64, at 2.

236. *Id.*

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trade on inside information) “ought to be allocated within the firm to maximize the welfare of the investors,” which sometimes will be benefited by the public disclosure of inside information and other times will not.²³⁷ Macey thinks that inside traders who “abscond with valuable corporate information in breach of a preexisting fiduciary relationship should be punished.”²³⁸ Henry Manne also stated that inside information could be classified as a valuable property right,²³⁹ and many other scholars support this position.²⁴⁰

While the position favoring insider trading regulation on a property rights basis is certainly not universal,²⁴¹ it holds plenty of support. Given the current alternatives, the property analysis seems to be the most appropriate and is based upon a utilitarian premise, which as this Article has discussed, is the most consistent framework to analyze insider trading. Yet, there are still a few lingering problems. For one, Macey and others believe that insider trading should be illegal if the inside trader “has no legitimate property interest in the information”²⁴² being used in the trade or where the trader has a legal duty to keep the information confidential and refrain from acting on it,²⁴³ but as this Article has indicated, it is not always a good idea to prohibit insider trading under those circumstances. Furthermore, Macey would allow short-selling in his theory of insider trading.²⁴⁴ While his position has its merits, it does not appear to address the risk of upper-management employees using their position in a way that could affirmatively hurt the corporation while making them wealthy through short-selling. For example, a manager could decide to fail to solve a problem within the company, knowing it will get larger and become public in a few months, while simultaneously making money by short-selling stock options once

237. *Id.* at 3.

238. *Id.* at 4.

239. MANNE, *supra* note 2, at 47–57.

240. For instance, Michael Dooley has also come to the conclusion that insider trading should really concern itself with property rights. Dooley, *supra* note 65, at 321. Stephen Bainbridge similarly states that “the insider trading prohibition is justified solely by the need to protect property rights in valuable information.” Bainbridge, *supra* note 75, at 1192.

241. At least one commentator has argued that “[t]he view that inside information is a property right that insiders should be permitted to exploit is morally obnoxious and legally unsound. Simply put, it is an attempt to transform the dark side of capitalism into a public good but it wholly ignores the public interest and public opinion.” Karmel, *supra* note 189, at 168 (internal citations omitted).

242. Macey, *supra* note 33, at 1902.

243. *Id.* at 1910.

244. *Id.* See also Jonathan Macey, *The Government Is Contributing to the Panic*, WALL ST. J., Oct. 11, 2008, at A13, available at <http://online.wsj.com/article/SB122367942018324645.html> (explaining that prohibitions on short-selling “prevent the market from imposing discipline on banks guilty of massive over-leveraging and excessive risk-taking” and “punish[] savvy traders who invested resources and effort in identifying companies with too much debt and unrealistically valued assets”).

the stock price of the company drops. The proposal in this Article, which would only allow fraud-inhibiting insider trading and not other forms of insider trading such as short-selling, does not have this potential downfall.²⁴⁵

Some commentators have proposed that Congress develop a statutory framework that clearly establishes insider trading as a crime based on the “property rights in information” theory.²⁴⁶ This model could be consistent with an adoption of the fraud-inhibiting insider trading proposal. In the statutory framework, it should be made clear that fraud-inhibiting insider trading would establish a safe harbor somewhat similar to the criminal defense of necessity.²⁴⁷ The defense of necessity is often referred to as a “choice of evils,” and includes the idea that “[i]f the harm that will result from compliance with the law is greater than that which will result from the violation of it, [an individual] is by virtue of the defense of necessity justified in violating it.”²⁴⁸ At times, society will experience greater benefits from allowing someone to break the law in this manner than having her refrain and cause even worse damage.²⁴⁹ Typical elements of the defense are: (1) a harm to be avoided (the larger harm) and a lesser harm necessary to avoid the former (the smaller harm); (2) an intention to avoid the larger harm; (3) no alternative course of action; and (4) no fault on the part of the defendant in bringing about the situation.²⁵⁰ Fraud-inhibiting insider trading does not fit this scheme perfectly and would accordingly require specific statutory provisions addressing it within any criminal law dealing with insider trading, but drawing some analogies to the classic necessity defense is nevertheless instructive.

Considering the first element of the defense in the context of fraud-inhibiting insider trading, the larger harm is the virtual destruction of the corporation that can and almost certainly will occur if a potential fraud is

245. The property rights rationale also need not imply a categorical ban on insider trading if one considers the possibility that insiders may in fact be paying for the ability to trade on information that they have acquired. If, as discussed previously, executive compensation is reduced when such trading is liberalized, one could characterize the situation as one where the corporation is selling its property and thereby benefitting both the corporation as a whole and individual shareholders. See *supra* text accompanying notes 163–167.

246. Painter, *supra* note 77, at 226.

247. For example, some courts have specifically stated that “economic necessity” per se in the sense of a defendant’s lack of funds is insufficient to constitute a defense; this would remain true, but an insider trading defendant *would* have a statutory defense if she could show that she met the fraud-inhibiting insider trading factors delineated in this Article. See WAYNE R. LAFAVE, 2 SUBSTANTIVE CRIMINAL LAW 123 (2d ed. 2003) (citing *State v. Moe*, 24 P.2d 638 (Wash. 1933)).

248. *Id.* at 116.

249. *Id.* at 118.

250. *Id.* at 124–33.

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perpetrated, and the smaller harm is the violation of general insider trading regulations. The second element is more complicated in this context because the motivating factor is usually not the preservation of the corporation and shareholders' interests. If the trader were that altruistically minded, she might accept personal economic devastation and commit neither the fraud nor the insider trading. At the same time, this asks too much of most CEO/CFO level executives, and having even one such individual commit fraud can have disastrous consequences if she happens to be placed in a high-level position within a large corporation. Therefore, in the statutory safe harbor for fraud-inhibiting insider trading, this element should require individuals to have "an intention to avoid the financial devastation that not trading would cause" if the only other alternatives are further types of unlawful conduct. For the third element, it is questionable whether there is ever another alternative that will cause less harm than that caused by violating the general prohibition on insider trading. Technically, one option is not trading and not committing fraud, but it is unclear that failing to trade will result in less harm than trading. Trading tends to bring about less harm than fraudulent activity that could destroy the company, but it also may not necessarily cause more harm on an individual basis than failing to trade. There is often no person that is likely to be harmed even fractionally, if at all, by an insider's trading as much as the insider will be harmed if he refrains from trading.²⁵¹

When an insider trades with other individuals in the market, there is typically no increase in the total amount of harm. If the stock goes down, there is the same reduction in stock value regardless of who owns it. If the owner of that stock is an executive that has most of his net worth tied up in the stock, however, the negative impact may be magnified. If a thousand people buy stock for \$2,000 dollars each, and it drops to a value of \$1,000 resulting in a loss to each shareholder of \$1,000 and a total loss of \$1 million, most investors are equipped to deal with that loss; yet, one executive who personally suffers a loss of \$1 million may not be able to deal with that and may be ruined. Thus, in the former scenario, nobody is essentially ruined whereas in the latter, one person is. Therefore, there is arguably no alternative besides insider trading that will cause less economic harm overall in such a situation.

The fourth element could remain the same: the defendant must bear

251. One could construct a scenario in which an individual is about to trade his over-valued stock when a second individual's insider trading sends a signal to the market, which then in turn decreases the stock price and the first individual loses a potential profit if he did not trade yet. This is, however, extremely unlikely and is in any case outweighed by the other disadvantages of prohibiting fraud-inhibiting insider trading.

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no intentional fault in bringing about the situation that gave rise to the need for insider trading. In the two examples of WorldCom and Supercuts, what brought the situations about were the increased costs and reduced revenues that were going to cause a fall in stock value. Furthermore, the safe harbor offered for fraud-inhibiting insider trading should include a provision disallowing insider trading if the individual has already participated in fraudulent activity that will detrimentally affect the corporation when publicly revealed.

VII. OTHER OBJECTIONS TO AND BENEFITS OF INSIDER TRADING

This Part briefly addresses some of the other objections that commentators have raised against insider trading, and specifically how they relate to the fraud-inhibiting insider trading model. It also shows some further benefits to allowing fraud-inhibiting insider trading on top of the reduction of corporate fraud.

The first additional argument for prohibiting insider trading is based on some of the direct harms that it could inflict on corporations. For example, if an insider knows about a pending acquisition that the corporation intends to make and she trades based on this information, it is possible that this could cause the price of the acquisition to increase and thereby harm the corporation.²⁵² This particular harm is generally limited to profit-increasing insider trading and does not apply to fraud-inhibiting insider trading.²⁵³ The second concern could be the possibility that if investors knew that employees were engaging in insider trading, this could cause a reputational harm to the corporation. It is difficult to give much weight to this argument under these circumstances because an investor, unlikely to be harmed by an insider's trading in a fraud-inhibiting insider trading scenario, would have little reason to develop negative feelings toward that insider's corporation, and hence, the corporation's reputation would usually remain intact.²⁵⁴ Also, under the fraud-inhibiting insider trading proposal, an investor is likely to benefit much more than lose from any insider trading in a corporation, and he may therefore be more likely to invest and view the reputation of the firm in a positive light.

252. Lambert, *supra* note 7, at 1097.

253. Furthermore, under the scheme proposed in this Article, corporations could still contractually prevent executives from engaging in insider trading and might choose to do so for industry-specific or other individual reasons.

254. Stephen M. Bainbridge, *Insider Trading Under the Restatement of the Law Governing Lawyers*, 19 IOWA J. CORP. L. 1, 12–16 (1993); BAINBRIDGE, *supra* note 87, at 172.

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The final argument requiring mention is that general agency principles and fiduciary duties justify the prohibition of insider trading. The idea is that an agent is typically restricted by his fiduciary duties from using confidential information from the principal either in competition with or to the injury of the principal without the principal's consent.²⁵⁵ Judge Frank Easterbrook and Daniel Fischel have pointed out that the legal principle of "duty of loyalty" should be defined with the consideration in mind that "because the process is contractual—because both principal and agent enter this understanding for gain—the details should be those that maximize that gain, which the contracting parties can divide."²⁵⁶ Furthermore, "legal rules can promote the benefits of contractual endeavors in a world of scarce information and high transactions costs by prescribing the outcomes the parties themselves would have reached had information been plentiful and negotiations costless."²⁵⁷ Given this analysis, the agency/fiduciary duty analysis of insider trading has basically the same result as the previously discussed contractarian position. As Judge Easterbrook and Fischel explain,

a "fiduciary" relation is a contractual one characterized by unusually high costs of specification and monitoring. The duty of loyalty replaces detailed contractual terms, and courts flesh out the duty of loyalty by prescribing the actions the parties themselves would have preferred if bargaining were cheap and all promises fully enforced.²⁵⁸

Given the option, most people may contract to allow fraud-inhibiting insider trading because it would usually maximize everyone's gains and minimize potential losses. Furthermore, with fraud-inhibiting insider trading, the trader would not be in competition with the principal—the corporation—which could potentially benefit investors because the firm could reduce the amount of executive compensation.²⁵⁹ Finally, it would be understood both at the corporate and investor level that the inside trader *would* be authorized to trade in these circumstances, and therefore, the trader would have the principal's consent. Easterbrook and Fischel point out that "a court setting out to protect principals from their agents must use the hypothetical contract approach; the only alternative is to injure the persons the rule makers want to help."²⁶⁰ By

255. Pritchard, *supra* note 133, at 47.

256. Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J. L. & ECON. 425, 426 (1993).

257. *Id.*

258. *Id.* at 427.

259. See *supra* text accompanying notes 163–167.

260. Easterbrook & Fischel, *supra* note 256, at 431.

prohibiting fraud-inhibiting insider trading, the rule makers are often effectively hurting exactly the parties that they are tasked to protect.

Allowing fraud-inhibiting insider trading would not only respond to these objections but also create a number of advantages in addition to reducing the incentives to commit fraud. Most economists agree that insider trading will usually produce more accurate stock prices because it results in more accurate information reaching the market.²⁶¹ In fact, there is considerable agreement that insider trading pushes stock prices in the correct direction, with some disagreement over the speed of this push.²⁶² The argument is that “trading by better-informed insiders is what causes share prices to adjust to new information, and since insiders will inevitably be the first to have access to it, permitting them to trade will ensure a quick adjustment to market prices.”²⁶³

Additionally, insider trading can be superior to other forms of disclosure because it is usually more believable.²⁶⁴ Financial experts are often slow to change long-standing trading recommendations. For example, even after Enron’s CFO had been forced to resign, the SEC had launched investigations, and the *Wall Street Journal* had published stories about Enron’s problems, the majority of large Wall Street firms still recommended buying Enron stock.²⁶⁵ If individuals “in the know” suddenly sell their own stock, however, this is likely to get people’s attention. A frequent criticism of that type of efficiency argument is that the trades are hidden, and therefore, the information does not reach the market.²⁶⁶ This criticism is at most a condemnation of insufficient disclosure requirements and not one against insider trading itself; the point holds even less weight when it comes to fraud-inhibiting insider trading because the executives who would be able to engage in it are already under higher disclosure requirements based on § 16.²⁶⁷

Finally, fraud-inhibiting insider trading can assist with better aligning manager interests with shareholder interests in some situations. One scholar provides the following example relevant to this point:

Sue, the CEO of Acme, Inc., has 100 shares of vested stock; the stock is trading at \$10 per share. Sue has the choice of two projects: Project A

261. Jonathan R. Macey, *Securities Trading: A Contractual Perspective*, 50 CASE W. RES. L. REV. 269, 276 (1999) (citing Henry G. Manne, *Insider Trading Property Rights in New Information*, 4 CATO J. 933, 934 (1985)).

262. Manne, *supra* note 88, at 169.

263. MACEY, *supra* note 64, at 11.

264. *Id.* at 46.

265. Lambert, *supra* note 7, at 1070.

266. Pritchard, *supra* note 133, at 52.

267. 15 U.S.C. § 78p(b) (2006). *See supra* Part III.

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has a 70 percent of increasing the stock price to \$15 in one year, and a 30 percent chance of decreasing the stock price to \$8 over the same period; Project B has a 70 percent chance of increasing the stock price to \$20, and a 30 percent chance of decreasing the stock price to zero. Diversified, risk-neutral shareholders prefer Project B, since its expected value (\$14) exceeds that of Project A (\$13). Sue, however, prefers project A, since the 30 percent chance of failure in Project B will result in not only economic losses, but also likely her job. Here we see classic agency cost problems – managers [sic] interests are not fully aligned with those of shareholders.²⁶⁸

Allowing fraud-inhibiting insider trading would increase the odds of Sue choosing Project B, which is the shareholders' preferred course of action, because she would at least have the ability to sell her stock if she became aware that she might soon suffer a major loss, which would happen 30% of the time. Hence, in this kind of scenario, both the manager and the shareholders would be better off if the manager was allowed to engage in insider trading.

VIII. CONCLUSION

Henry Manne asked the question forty years ago in his seminal work *Insider Trading and the Stock Market*:²⁶⁹ “[w]ho is harmed by trading on the basis of non-public information?”²⁷⁰ Many have since made the claim that insider trading in fact has no victims.²⁷¹ This controversial question need not be answered in absolute terms. Rather, the argument here addresses a simpler question: is the current absolute prohibition on insider trading the optimal choice to maximize society's financial well-being? This Article explains that this is likely not the case. Using fraud-inhibiting insider trading may result in better outcomes for virtually everyone involved and should be implemented as soon as possible. Furthermore, given the fact that insider trading regulation has had more changes in its brief history than most corporate law rules,²⁷² the corporate world should be able to adapt to this change without large upheaval.

There are three options to begin implementing the fraud-inhibiting

268. Henderson, *supra* note 163, at 40 (footnote omitted). Henderson calculated the expected values by multiplying the probability of a particular state of the world with the stock price that would result in that state (i.e., for Project A this would mean 70% x \$15 + 30% x \$8 = \$13 and for Project B 70% x \$20 + 30% x \$0 = \$14). *Id.* at 40 n.74.

269. MANNE, *supra* note 2.

270. Macey, *supra* note 261.

271. BAINBRIDGE, *supra* note 87, at 161.

272. *Id.* at 4.

insider trading proposal.²⁷³ The clearest and most obviously effective one would be for Congress to amend the Securities Exchange Act, specifically § 10b, to make it clear that trading done in conformity with fraud-inhibiting insider trading should not be prosecutable under the securities laws and regulations. Congress has stated that insider trading prohibitions are “necessary and appropriate in the public interest and for the protection of investors.”²⁷⁴ Lawmakers should follow the same rationale to implement a fraud-inhibiting insider trading safe harbor to protect investors. While having Congress amend the law is in some ways the most direct method to open the door to fraud-inhibiting insider trading, it may also be the most difficult from a political viewpoint because of the visceral reaction that many people have to insider trading.

A second option would be for federal courts to begin dismissing charges against defendants that have committed insider trading in the fraud-inhibiting insider trading context. There are at least two possible ways in which courts could legitimately accomplish this. The first would be to use the definition of insider trading that Justice Powell’s opinion in *Dirks* established. He wrote that two elements are required for a Rule 10b-5 violation: “(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the *unfairness* of allowing a corporate insider to take advantage of that information by trading without disclosure.”²⁷⁵ Courts could hold that it is not “unfair” in a fraud-inhibiting insider trading scenario to allow insider trading, and therefore, under these circumstances it is not appropriate for a Rule 10b-5 prosecution to proceed.

The other basis for a court to reject a fraud-inhibiting insider trading prosecution would be grounded in the modifications implemented through § 21(d)(5) of the Sarbanes–Oxley Act, which authorizes federal courts to grant “any equitable relief that may be appropriate or necessary for the benefit of investors.”²⁷⁶ Courts could rule that under fraud-inhibiting insider trading conditions, what is “appropriate or necessary” for the benefit of investors is to dismiss any charges that have been filed.

While some may view the idea of using courts to implement this

273. It should be noted that under all three options, if a state wants to maintain a state prohibition of this type of trading, it would still be able to do so. See *Diamond v. Oreamuno*, 248 N.E.2d 910 (N.Y. 1969) (ruling in a derivative suit against the chairman of the board and president of the company that state law prohibited the sale of their shares in the company before bad financial news was released). *But see* *Schein v. Chasen*, 313 So.2d 739 (Fla. 1975) (declining to follow *Oreamuno*); *Freeman v. Decio*, 584 F.2d 186 (7th Cir. 1978) (same).

274. Bainbridge, *supra* note 75, at 1232 (citation omitted).

275. *Dirks v. SEC*, 463 U.S. 646, 653–54 (emphasis added).

276. 15 U.S.C. § 78u(d)(5) (2006).

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proposal as radical at first blush, doing so could serve as one of the logical means to modify a doctrine that was rooted in judicial initiatives to begin with. As described in Part IV, *supra*, the courts played a crucial role in criminalizing insider trading, especially through their expansive interpretation of Rule 10b-5. In a series of cases, they continued to define the contours of the insider trading doctrine and what behaviors should fall under the purview of Rule 10b-5. Hence, removing fraud-inhibiting insider trading from the scope of criminal punishments mainly constitutes a correction of a past mistake by courts—that of providing sanctions against this form of trading without regard to how it might encourage fraudulent behavior.

The third possibility to implement a fraud-inhibiting insider trading safe harbor would be for the SEC to modify its existing rules to make it clear that this type of insider trading is an exception to the general prohibition. Former Supreme Court Justice and former SEC Chairman William O. Douglas stated that the SEC is supposed to focus on being “the investor’s advocate.”²⁷⁷ Even if, as previously pointed out, the SEC has an interest in maximizing its jurisdiction and budget, this safe harbor would do little to reduce the SEC’s domain because the agency would still need to verify that the inside trades did in fact qualify for the safe harbor.²⁷⁸ The SEC itself has also argued that “[t]he broad congressional purposes behind the [securities laws are] to protect investors from false and misleading practices that might harm them.”²⁷⁹ Therefore, the rules that apply should be those that best meet this objective.²⁸⁰

Whether Congress, the courts, or the SEC take on this issue, what is most important is that insider trading rules reflect economic realities and protect both investors and society at large. This Article has argued that one can change insider trading regulations without decreasing investor confidence or infringing against corporations’ property rights. Allowing fraud-inhibiting insider trading would help to avert WorldCom-scale disasters and improve stock valuations without quite unleashing an army

277. Levitt, *supra* note 149, at 1.

278. Hopefully, this SEC could do a better job of advocating for investors than the first “SEC” did—the Securities and Exchange Company is the name that Charles Ponzi of “Ponzi scheme” fame gave to his business! See Eichenwald, *supra* note 35.

279. Bainbridge, *supra* note 6, at 1604 (citing *Central Bank v. First Interstate Bank*, 511 U.S. 164, 173–74 (1994)); accord *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 859 (2d Cir. 1968) (explaining that the goal of the SEC is to protect investors).

280. This Article recognizes that insider trading regulation is an area subject to a complex interplay of federal, state, and local forces. While changing the federal rules would therefore not necessarily be sufficient in isolation to legalize fraud-inhibiting insider trading across the board, it would be the most critical step in doing so and would pave the way for localized reforms as well.

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of Gordon Gekkos onto Wall Street.