

THE CASE FOR INSIDER-TRADING CRIMINALIZATION AND SENTENCING REFORM

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I. INTRODUCTION

In October 2009, Raj Rajaratnam—head of the Galleon Group hedge fund—was arrested and charged with insider trading in several companies, including Intel Corp., I.B.M., and McKinsey & Company,¹ as part of what constituted “the biggest Wall Street trading scandal in a generation.”² Rajaratnam was accused of creating a “corrupt network of well-placed tipsters,” which allowed him to generate approximately \$72 million in illicit gain.³ Due to the large amount of loss, the prosecution asked district judge Richard Holwell for a sentence of at least nineteen and a half years.⁴ In May 2011, Rajaratnam was convicted by a jury and several months later received an eleven year prison term, the longest ever imposed for insider trading.⁵

Albeit unprecedented, the sentence was not unexpected; it was announced in the midst of a recent federal crackdown on white-collar crime. During this crackdown, inside traders have been indicted more frequently and have faced harsher

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¹ Peter Lattman, *Galleon Chief Sentenced to 11-Year Term in Insider Case*, DEALBOOK (Oct. 13, 2011, 9:14 PM), <http://dealbook.nytimes.com/2011/10/13/rajaratnam-is-sentenced-to-11-years/>.

² Grant McCool, *Rajaratnam Sentenced to 11 Years in Prison*, REUTERS (Oct. 13, 2011), <http://www.reuters.com/article/2011/10/13/galleon-rajaratnam-sentence-idUSWEN933420111013>.

³ Lattman, *supra* note 1.

⁴ Grant McCool, *New October 13 Date Set for Rajaratnam Sentencing*, REUTERS (Sept. 21, 2011), <http://www.reuters.com/article/2011/09/21/us-galleon-rajaratnam-idUSTRE78K7IF20110921>.

⁵ Lattman, *supra* note 1. In addition, Judge Holwell ordered Rajaratnam to forfeit much of his illegal profit. *Id.*

penalties than they did in the past.⁶ This article sets out to expose the issue that, despite these recent prosecutorial and sentencing trends, insider-trading law is shockingly vague and merits serious study and reconsideration. Indeed, there is no consensus among scholars and academics on the question of whether it should be criminalized in the first place: empirical research has failed to clearly demonstrate that the practice inflicts any harm on the market or on market participants, with some commentators suggesting that it may in fact have beneficial effects. In waging war on the practice, the Securities and Exchange Commission (“SEC” or “Commission”) did not formulate a coherent social policy that would justify its agenda and, more importantly, chose to target insider trading at the expense of more problematic white-collar practices, such as accounting fraud. Even assuming that insider trading is harmful and ought to be prohibited, the government’s approach to promoting deterrence has been largely misguided, as it has not provided any evidence that increased prosecution and penalties are going to improve deterrence.

This article advances two arguments. First, in the absence of compelling empirical research on the harmfulness of insider-trading activities, the criminalization of the practice rests on dubious assumptions and uncertain realities. Second, even if insider trading is harmful or otherwise morally wrongful and ought to be proscribed, lengthy sentences are hardly the most efficient way to achieve deterrence. There are alternative sanctioning methods that are less wasteful of scarce enforcement and prevention resources but will promote deterrence just as effectively. To set the foundation for these arguments, this article first provides an in-depth look at the legal theory and history of insider-trading regulation, all the while seeking to highlight the definitional and moral ambiguity surrounding the practice. This article then proceeds to introduce intermediate punishments as an alternative to across-the-board incarceration and argues that those alternative punishments are particularly well-suited for non-violent, morally ambiguous offenses like insider trading. Ultimately, this article submits that convictions accompanied by shaming, rather than prison terms, should substitute the current regulatory regime.

II. UNDERSTANDING INSIDER TRADING

Insider trading first came to broad public attention in the mid-1980s with a series of high-profile scandals involving investment bankers and lawyers who were

⁶ See Chad Bray & Rob Barry, *Long Jail Terms on Rise*, WALL ST. J., Oct. 13, 2011, at C1, available at <http://online.wsj.com/article/SB10001424052970204774604576626991955196026.html>.

charged with illegally trading in securities or tipping others about the company takeovers planned by their clients.⁷ The most infamous of those scandals, known as “Wall Street’s Watergate,”⁸ involved a financial district arbitrageur, Ivan Boesky.⁹ The SEC charged Boesky for amassing close to \$200 million by trading on inside information just days in advance of major takeover announcements,¹⁰ as a result, Boesky had to pay a \$100 million penalty and plead guilty to a criminal charge.¹¹

While the Boesky scandal was the “real bombshell” of the 1980s, over the span of just a few years the government had initiated more than a dozen similar enforcement actions.¹² Despite the increased prominence of insider-trading practices, however, the legislature did not enact a specific statutory prohibition in response and instead left it to the courts to define the elements and parameters of the offense.¹³ In turn, the SEC resorted to prosecuting inside traders pursuant to Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (“Exchange Act”), under their general prohibition on the purchase or sale of securities using deceptive devices.¹⁴

Section A of this Part discusses the classical theory of insider trading that the Supreme Court developed over a couple of decades. Section B focuses on how the traditional parameters of the practice—particularly the fiduciary duty requirement—have been challenged by two recent circuit court decisions, *SEC v. Dorozhko* and *SEC v. Cuban*. Section C tracks the government’s crackdown on insider trading,

⁷ See Jeanne M. Hauch, Note, *Insider Trading by Intermediaries: A Contract Remedy for Acquirers’ Increased Costs of Takeovers*, 97 YALE L.J. 115, 115 (1987).

⁸ Steve Brody, *Criminal Insider Trading: Prosecution, Legislation, and Justification*, 1.2 J. APPLIED ECON. 85, 88 (Oct. 2009), available at http://works.bepress.com/steven_brody/1.

⁹ Hauch, *supra* note 7, at 115 n.1.

¹⁰ Brody, *supra* note 8, at 88.

¹¹ Hauch, *supra* note 7, at 115 n.1.

¹² *Id.*

¹³ See Donna M. Nagy, *Insider Trading, Congressional Officials, and Duties of Entrustment*, 91 B.U. L. REV. 1105, 1112 (2011) (citing H.R. Rep. No. 100-910, at 11 (1988), reprinted in 1988 U.S.C.C.A.N. 6043, 6048).

¹⁴ Robert Bailey, Jr., *SEC v. Cuban: The Misappropriation Theory and its Application to Confidentiality Agreements under Section 10(b) and Rule 10b5-2 of the Securities Exchange Act of 1934*, 35 DEL. J. CORP. L. 539, 540 (2010).

while Section D contrasts this prosecutorial zeal with judges' reluctance to impose hefty penalties on inside traders at the sentencing level. Section E seeks a possible explanation for this trend in the moral ambiguity that surrounds the practice.

A. Classical Theory of Insider Trading

Under the Supreme Court's classical theory of insider trading, corporate insiders must disclose, or abstain from trading on, "material non-public information, obtained from their unique position within a corporation"¹⁵ A relationship with the company gives rise to such a duty because of a perceived necessity to prevent corporate insiders from obtaining unfair benefits at the expense of the less informed.¹⁶ In *Chiarella v. United States*, for instance, the Court held that a printer who took steps to find out the names of the target companies in a takeover bid and then purchased stock in them was not liable for insider trading because he did not owe a fiduciary duty to the target company.¹⁷ The Court reasoned that liability is explicitly premised on the existence of a "relationship of trust and confidence"¹⁸ between the parties to a transaction and that Chiarella, as a non-insider, did not have an obligation to reveal material facts.¹⁹

In *Dirks v. SEC*, the Court expanded the classical theory of liability by holding that "[n]ot only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain."²⁰ Conversely, an outsider, known as a "tippee," is only liable for trading on material, non-public information if the tippee knows or should have known that the insider breached a fiduciary duty to the shareholders by disclosing the information to the tippee.²¹ In effect, the tippee

¹⁵ *Id.*

¹⁶ *See* *Chiarella v. United States*, 445 U.S. 222, 228–29 (1980).

¹⁷ *See id.*

¹⁸ *Id.* at 230.

¹⁹ *Id.* at 235.

²⁰ *Dirks v. SEC*, 463 U.S. 646, 659 (1983).

²¹ James A. Jones II, *Outsider Hacking and Insider Trading: The Expansion of Liability Absent a Fiduciary Duty*, 6 WASH. J.L. TECH. & ARTS 111, 114 (2010).

acquires a fiduciary duty to the shareholders of a corporation, which allows for liability to attach despite the absence of a traditional fiduciary-like relationship.²²

More recently, the Supreme Court developed a misappropriation theory of insider trading, which extends liability to traders who owe a fiduciary duty to the source of the information, rather than the corporation.²³ In the principal case of *United States v. O'Hagan*, a lawyer representing a corporation in a confidential tender offer plan used his access to material, non-public information to purchase stock in the target company.²⁴ Even though O'Hagan did not owe a fiduciary duty to the target company or its shareholders, the Court nonetheless found him liable for insider trading because a “fiduciary who [pretends] loyalty to the principal while secretly converting the principal's information for personal gain' . . . defrauds the principal.”²⁵

In light of *Chiarella*, *Dirks*, and *O'Hagan*, insider trading has traditionally been thought inapplicable to individuals without fiduciary duties.²⁶ The Court in *Chiarella* specifically observed that Congress and the SEC have never indicated intent to introduce a “parity-of-information” rule to the marketplace; therefore, the Court rejected a broad disclose-or-abstain duty that would affect all market participants in possession of material, non-public information.²⁷

B. *Emerging Theory of Insider Trading*

Two recent circuit-level cases challenged these established, decades-old parameters of insider trading. The first case, *SEC v. Dorozhko*, involved a Ukrainian national and resident, Oleksandr Dorozhko, who obtained material, non-public information by hacking into a computer database and subsequently traded on that information.²⁸ Relying on Supreme Court precedent, the district court for the Southern District of New York previously held that, while Dorozhko's conduct was

²² See *Dirks*, 463 U.S. at 660.

²³ *United States v. O'Hagan*, 521 U.S. 642, 652 (1997).

²⁴ *Id.* at 647-48.

²⁵ *Id.* at 653-54 (citing Brief for the United States at 17) (alteration in original).

²⁶ See Elizabeth A. Odian, Note, *SEC v. Dorozhko's Affirmative Misrepresentation Theory of Insider Trading: An Improper Means to a Proper End*, 94 MARQ. L. REV. 1313, 1316 (2011).

²⁷ *Chiarella v. United States*, 445 U.S. 222, 233 (1980).

²⁸ *SEC v. Dorozhko*, 574 F.3d 42, 44-45 (2d Cir. 2009).

illegal, he was not guilty of insider trading because he did not owe a fiduciary duty to the source of information or to market participants generally.²⁹ The district court was further troubled by the fact that Dorozhko's theft did not sit comfortably with a statutory provision that required fraud in order for insider-trading liability to arise.³⁰ Noting that "no federal court has *ever* held that those who steal material nonpublic information and then trade on it violate § 10(b),"³¹ the district court suggested that the case should have instead been prosecuted under a criminal statute.³²

The Second Circuit strongly disagreed with the district court's decision and found that, even though Dorozhko did not owe a fiduciary duty to the source of information, he may, nonetheless, be liable for insider trading.³³ To distinguish *Dorozhko* from *Chiarella* and to thereby circumvent the fiduciary duty requirement, the Second Circuit treated the case as one involving an affirmative misrepresentation, which is also actionable under Section 10(b).³⁴ The court argued that even in the absence of a disclose-or-abstain duty, there is still an affirmative obligation not to mislead while carrying out commercial dealings.³⁵

Like the district court, the Second Circuit acknowledged the lack of precedent characterizing theft as a deceptive practice in *Dorozhko*.³⁶ The Second Circuit, however, saw the case as an opportunity to interpret Section 10(b) broadly.³⁷ Yet, in stating that remedial statutes ought to be read flexibly to effectuate their purposes,³⁸ the court failed to provide a compelling explanation as to why hacking constitutes fraud rather than theft.³⁹ Indeed, prior to *Dorozhko*, "legal scholars

²⁹ SEC v. Dorozhko, 606 F. Supp. 2d 321, 324 (S.D.N.Y. 2008).

³⁰ *Id.* at 339.

³¹ *Id.* (emphasis in original).

³² *Dorozhko*, 574 F.3d at 50 n.6 (citing SEC v. Dorozhko, 606 F. Supp. 2d 321 (S.D.N.Y. 2008)).

³³ *See id.* at 48-49.

³⁴ *Id.* at 49-51.

³⁵ *Id.* at 49.

³⁶ *Id.* at 51.

³⁷ *See id.* at 49-50.

³⁸ *Id.*

³⁹ *See* Stephen Bainbridge, *The Second Circuit's Egregious Decision in SEC v. Dorozhko*, PROFESSORBAINBRIDGE.COM: STEPHEN BAINBRIDGE'S J. L. POL. & CULTURE (July 29, 2009, 04:36

generally thought that theft of inside information, while punishable under criminal codes, would not give rise to insider trading liability.”⁴⁰ Furthermore, even if one assumes that hacking is fraudulent, the Supreme Court has “emphasized that ‘the statute must not be construed so broadly as to convert every common-law fraud that happens to involve securities into a violation of § 10(b).’”⁴¹

In *SEC v. Cuban*, the Fifth Circuit also left open many questions regarding the scope of insider-trading liability.⁴² The facts of the case are simple: Mark Cuban—a business magnate and owner of the Dallas Mavericks basketball team⁴³—purchased a 6.3 percent stake in the company Mamma.com; not long thereafter, the company’s CEO called and informed Cuban that he had some confidential information to discuss.⁴⁴ Upon obtaining Cuban’s agreement to keep the information confidential, the CEO proceeded to invite him to participate in a private placement of the company’s equity.⁴⁵ Concerned that this would dilute his shares in the company, Cuban sought out additional confidential information and eventually sold his stake, avoiding substantial loss.⁴⁶

Alleging that Cuban undertook a duty of non-use of information, the SEC brought a suit against him under the misappropriation theory of insider trading.⁴⁷ The district court for the Northern District of Texas held that while a nondisclosure agreement could support insider-trading liability, the SEC failed to adequately allege that Cuban entered into an agreement sufficient to create such a duty.⁴⁸ On appeal,

AM), <http://www.professorbainbridge.com/professorbainbridgecom/2009/07/the-second-circuits-recent-decision-in-sec-v-dorozhko-available-here-dealt-with-one-of-the-questions-left-open-by-the.html/>; *Dorozhko*, 574 F.3d at 49-51.

⁴⁰ Odian, *supra* note 26, at 1330.

⁴¹ Bainbridge, *The Second Circuit’s Egregious Decision in SEC v. Dorozhko*, *supra* note 39 (citing *SEC v. Zandford*, 535 U.S. 813, 820 (2002)).

⁴² *See SEC v. Cuban*, 620 F.3d 551 (5th Cir. 2010).

⁴³ *Id.* at 552.

⁴⁴ *Id.* at 555.

⁴⁵ *Id.*

⁴⁶ *Id.* at 555-56.

⁴⁷ *SEC v. Cuban*, 634 F. Supp. 2d 713, 717 (N.D. Tex. 2009).

⁴⁸ *Id.* at 726-27.

the Fifth Circuit stated that the presented inquiry was “inherently fact-bound” and that it was not clear whether Cuban had agreed to refrain from trading; the court therefore remanded the case for discovery and further proceedings.⁴⁹ Depending on the final outcome of *Cuban*, “a confidentiality agreement between an investor and a company may now be deemed sufficient to satisfy the fiduciary-duty requirement even where the parties lacked a preexisting fiduciary relationship, as long as the agreement contains a promise not to trade on the [material,] nonpublic information.”⁵⁰

Together, *Dorozhko* and *Cuban* mark a dramatic departure from established Supreme Court precedent and indicate that insider-trading jurisprudence is moving in a direction in which all market participants in possession of material, non-public information may have a duty to refrain from trading.⁵¹ This changing scope of liability is manifested in two ways. First, in equating theft with deceit, the Second Circuit failed to create a limiting principle, intimating that a wide range of activities that could not serve as a predicate for insider-trading liability before may now satisfy the statutory requirement for a “deceptive” practice.⁵² Second, the presence of a fiduciary relationship between the parties to a transaction seems to have lost its traditional significance.⁵³ Under the classical theory of insider trading, there is no general duty to refrain from trading on material, non-public information—such a duty arises only on the basis of a particular relationship between the parties.⁵⁴ In contrast, “[t]he *Cuban* decision allows for complete strangers in arms-length negotiations to be judicially determined to have become fiduciaries by agreement, and the *Dorozhko* decision allows for insider-trading liability to arise even in the complete absence of a fiduciary relationship.”⁵⁵

⁴⁹ *Cuban*, 620 F.3d at 557-58.

⁵⁰ Joel M. Cohen, *Erosion of the Fiduciary Duty Requirement in Insider Trading Actions*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 29, 2010, 9:22 AM), <http://blogs.law.harvard.edu/corpgov/2010/07/29/erosion-of-the-fiduciary-duty-requirement-in-insider-trading-actions/>.

⁵¹ *Id.*

⁵² SEC v. Dorozhko, 574 F.3d 42, 49–50 (2d Cir. 2009).

⁵³ Cohen, *supra* note 50.

⁵⁴ See *Dirks v. SEC*, 463 U.S. 646, 654 (1983); *Chiarella v. United States*, 445 U.S. 222, 232–33 (1980).

⁵⁵ Cohen, *supra* note 50.

Some scholars argue that expanding the scope of insider-trading liability is a positive development because business practices change and promoting public safety requires the law to be flexible.⁵⁶ They also focus on the guiding purpose behind federal securities laws, which is to institute an environment of disclosure and fairness and to foster investor confidence in the financial markets;⁵⁷ this purpose, the argument goes, would support a parity-of-information approach to insider-trading regulation.⁵⁸ Others, however, perceive the decisions in *Dorozhko* and *Cuban* as problematic and argue that there is an overarching need to enhance the certainty, stability, and predictability of the law; in that regard, the fiduciary duty prerequisite to insider-trading liability provides lower courts and market participants with guidance on what constitutes “deception” and who would fall within the purview of the statute, thereby ensuring the uniform application of the law.⁵⁹ Some scholars even more assertively note that the two cases may encounter constitutional challenges because “imposing punishment for actions that the law does not clearly and explicitly prohibit presents a clear due process issue.”⁶⁰

Regardless of whether *Dorozhko* and *Cuban* herald a positive or negative shift in the administration of insider-trading liability, the two cases undoubtedly introduce a level of uncertainty into this area of the law. Lower courts will be unsure whether to follow Supreme Court precedent and risk the possibility of reversal or espouse the emerging theory of insider trading from the outset. Actors may also struggle to understand whether they have acquired a fiduciary duty to a company; this is somewhat less problematic in *Dorozhko*-type situations where defendants are likely aware that they are violating the law, though not necessarily insider-trading law.⁶¹ In

⁵⁶ See Odian, *supra* note 26, at 1349.

⁵⁷ Matthew T.M. Feeks, *Turned Inside-Out: The Development of “Outsider Trading” and How Dorozhko May Expand the Scope of Insider Trading Liability*, 7 J.L. ECON. & POL’Y 61, 87 (2010).

⁵⁸ *Id.* at 86–87.

⁵⁹ *Id.* at 85.

⁶⁰ *Id.* at 87.

⁶¹ See SEC v. Dorozhko, 574 F.3d. 42 (2d Cir. 2009) (involving a defendant who allegedly gained access to material non-public information by hacking into a company’s computer system).

Cuban-type situations, however, defendants may reasonably believe that their actions are legal.⁶²

C. Government Crackdown on Insider Trading

1. 1980s Crackdown

Even though insider trading has been a federal crime since the enactment of the Exchange Act in 1934, criminal prosecutions resulting in incarceration were “nearly unheard of” until very recently.⁶³ Prior to 1984, the Southern District of New York, which is responsible for handling the overwhelming majority of insider-trading cases, had only prosecuted a total of twelve criminal insider-trading cases.⁶⁴ With their fiduciary duty requirement, *Chiarella* and *Dirks* additionally frustrated the already isolated prosecutorial efforts in this area.⁶⁵ Before the mid-to-late 1980s, the very attitude of corporate officers toward insider trading was “positively blasé,” with many indicating that they would readily trade on inside information and would expect their colleagues to do so as well.⁶⁶

By the end of the decade, the political climate had changed drastically, and the government launched a campaign against insider trading.⁶⁷ Several social and economic transformations have been credited with spurring such sudden prosecutorial zeal. First, the 1960s witnessed the rapid expansion of social welfare and consumer protection programs, though their inadequate controls created many loopholes and enabled white-collar transgressions.⁶⁸ In the 1970s, the Watergate scandal was influential in making the public sensitive to white-collar crime issues and caused a widespread disappointment in government leadership.⁶⁹ Second, during the severe recession of the early 1980s, many traditionally American industries

⁶² See *SEC v. Cuban*, 634 F. Supp. 2d. 713 (N.D. Tex. 2009) (involving a defendant who may have agreed not to trade on information provided and, thus, created a duty of non-use of the information).

⁶³ Brody, *supra* note 8, at 85.

⁶⁴ *Id.* at 87-88.

⁶⁵ *Id.* at 87.

⁶⁶ *Id.*

⁶⁷ See Kip Schlegel et al., *Are White-Collar Crimes Overcriminalized? Some Evidence on the Use of Criminal Sanctions Against Securities Violators*, 28 W. ST. U. L. REV. 117, 118-19 (2000).

⁶⁸ *Id.* at 118.

⁶⁹ See *id.*

“succumbed to foreign competition . . . creat[ing] economic uncertainty for a large segment of the public.”⁷⁰ Third, the 1980s were also a time of growing economic disparity: while the economy as a whole was struggling, the stock market boom created enormous wealth for those who were already prosperous.⁷¹ The synergistic effect of these developments paved the way for what would, by the end of the decade, mature into a “social movement against white collar crime,”⁷² if not “populist envy of the rich.”⁷³

At such a time of severe economic uncertainty, the government sought to repair its post-Watergate image and to “legitimate itself in the eyes of the American public” by turning its attention to white-collar crime.⁷⁴ Curiously, the main focus was on insider trading,⁷⁵ with the government—which had previously “look[ed] the other way as people made big bets with inside information”—suddenly deciding “to put an end to the practice.”⁷⁶ Insider trading proved to be a more convenient target than other types of white-collar crime simply because it was an easily translatable symbol of the country’s economic anxieties:⁷⁷ it allowed the government to “reframe a complex, inchoate problem (such as vague economic uncertainty) as a narrow, more easily addressed one (such as insider trading).”⁷⁸ Moreover, from a law-enforcement perspective, insider trading could be dealt with through straightforward and inexpensive legislative action, increased enforcement and stricter penalties.⁷⁹ In comparison, other white-collar offenses, such as accounting fraud, run deeper, frequently involving complex schemes of misusing or misdirecting funds in addition

⁷⁰ Thomas W. Joo, *Legislation and Legitimation: Congress and Insider Trading in the 1980s*, 82 IND. L.J. 575, 576 (2007).

⁷¹ *Id.* at 602-03.

⁷² Schlegel, *supra* note 67, at 118 (quoting Jack Katz, *The Social Movement Against White-Collar Crime*, in 2 CRIMINOLOGY REVIEW YEARBOOK 161 (Egon Bittner & Sheldon L. Messinger eds., 1980)).

⁷³ Joo, *supra* note 70, at 602.

⁷⁴ *See id.* at 576.

⁷⁵ *Id.*

⁷⁶ James J. Cramer, *Bad Boys, Bad Boys*, N.Y. MAG. (Oct. 20, 2003), http://nymag.com/nymetro/news/bizfinance/columns/bottomline/n_9352/.

⁷⁷ *See* Joo, *supra* note 70, at 582.

⁷⁸ *Id.* at 585.

⁷⁹ *Id.* at 607.

to being intertwined with perfectly legitimate business practices.⁸⁰ In targeting insider trading, then, the government was perhaps well aware that pursuing accounting reform would have been a far more time-costly, resource-costly, politically polarizing, and less publicly visible endeavor that would have contributed very little to its quest for legitimacy and public approval.⁸¹ As a result during the 1980s, the choice was clear: “insider trading had no defenders in Washington” and was an easy target capable of producing quick benefits.⁸²

The government’s chosen path to legitimization has been severely criticized. For one, the crackdown on insider trading was accompanied by a remarkable lack of evidence suggesting that the practice had become more prevalent.⁸³ Furthermore, at no point did the government make an attempt to estimate the deterrent value of increased prosecution and penalties.⁸⁴ Most problematically, the overemphasis on insider trading caused the government to ignore the far more important causes of economic troubles; failure to address those issues, accounting fraud in particular, came back to “haunt” decision makers with Enron’s collapse.⁸⁵

2. Current Crackdown

The last decade witnessed an even broader crackdown on white-collar crime, spurred by what many describe as a “watershed moment” in the history of corporate governance, the failure of the Houston-based Enron Corporation.⁸⁶ While accounting fraud was not a new phenomenon in the early 2000s, the abuses uncovered at Enron far surpassed their predecessors in magnitude and daring: the company’s collapse became known as the “biggest financial fraud and . . . audit failure,” as well as “the largest bankruptcy reorganization in American history.”⁸⁷

⁸⁰ *See id.* at 590.

⁸¹ *See id.*

⁸² *Id.* at 594.

⁸³ *Id.* at 592.

⁸⁴ *Id.* at 608.

⁸⁵ *Id.* at 590.

⁸⁶ Charles M. Elson & Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 WAKE FOREST L. REV. 855, 855–56 (2003).

⁸⁷ William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1276-77 (2002).

Enron abuses resulted in a call for reform, and with the subsequent accounting fraud at WorldCom,⁸⁸ the government responded promptly by passing the Sarbanes-Oxley Act (“Sarbanes-Oxley”) and, after the 2008 financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).⁸⁹

While Dodd-Frank identifies and seeks to address the more significant, deeper-running causes of the late-2000s financial crisis, none of which bears relation to insider trading,⁹⁰ it continues to be a surprising enforcement priority. Much like in the 1980s, the reinvigorated prosecution of high-profile, inside traders today has allowed the SEC to achieve more immediate and publicly noticeable results.⁹¹ The prosecution of Raj Rajaratnam is a preeminent example; closely scrutinized by the media, the case was widely perceived to be a “must-win” and a crucial step toward restoring the government’s legitimacy with the public.⁹² The SEC’s pursuit of “readily observable objectives,” however, has yet again occurred “at the expense of

⁸⁸ Mary-Jo Kranacher, *The Future of Sarbanes-Oxley: An Exclusive Interview with Former U.S. Senator Paul S. Sarbanes*, 78 CPA J. 16, 21 (Oct. 2008).

⁸⁹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank]; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) [hereinafter Sarbanes-Oxley].

⁹⁰ While Dodd-Frank is a bulky piece of legislation, its key provisions and the problems they are meant to solve are easily identifiable. First, the act’s Volcker rule is concerned with the fact that banks, by becoming involved in trading, market making, and hedge fund activities, have increased their risk profiles and have added greater complexity to their balance sheets; therefore, the rule restricts banking entities from engaging in proprietary trading activities and from becoming involved with hedge funds and private equity funds. Dodd-Frank § 619. Second, Dodd-Frank creates the Financial Stability Oversight Council, whose task is to identify non-bank financial firms that pose risks to the country’s financial stability and to make recommendations concerning the establishment of heightened standards and safeguards. *Id.* §§ 111, 112, 113, 114, 115, 120. The underlying concern is that many large financial companies that engage in bank-like activities escape regulation because they do not qualify as banks, but ought to be regulated because they carry out activities that might pose systemic risks to the entire financial system. *See id.* Third, Dodd-Frank institutes a new federal receivership process, pursuant to which the Federal Deposit Insurance Corporation may serve as a receiver for large, interconnected financial companies whose failure could endanger the financial stability of the country. *Id.* §§ 201, 203, 204, 206, 214. This so-called Orderly Liquidation Authority is evidently meant to prevent bailouts and the wasteful expenditure of taxpayer funds. *See id.*

⁹¹ Jonathan R. Macey, *The Distorting Incentives Facing the U.S. Securities and Exchange Commission*, 33 HARV. J.L. & PUB. POL’Y 639, 668 (2010).

⁹² *See* Berry W. Rashkover et al., *The Raj Rajaratnam Conviction: What Does It Really Indicate?*, 3 FIN. FRAUD L. REP. 695, 696 (2011).

more important but less observable objectives.”⁹³ It was a similar, unwarranted focus on “measurable indicia of success,” for instance, that led the SEC to continually ignore the red flags at Bernard L. Madoff Investment Securities, LLC.⁹⁴

In light of the above, it is not surprising that insider-trading prosecutions have become more and more frequent in recent years. Between 1993 and 1999, fewer than half of the twenty-three insider-trading cases that came before the Eastern and Southern Districts of New York resulted in prison terms, and, of those, the average sentence was twelve months.⁹⁵ Between 2000 and 2006, an identical time period, the number of cases went up to thirty-four.⁹⁶ Of those, sixty-five percent included a prison term, and the average sentence was twenty-seven months.⁹⁷ Between 2007 and September 2011, a significantly shorter time period, the two districts handled fifty-one insider-trading cases; sixty-five percent involved an incarceration penalty with an average prison term of thirty-six months.⁹⁸

Inside traders today are not only prosecuted more frequently, but also face increasingly harsh penalties.⁹⁹ Offenders, if found guilty, are sentenced under the general economic crime provisions of the Sentencing Guidelines (“Guidelines”) promulgated by the U.S. Sentencing Commission (“Commission”).¹⁰⁰ The Guidelines adopt a point-based, multi-step system of calculating two different categories: the defendant’s total offense level and criminal history.¹⁰¹ A sentencing chart tracks the intersection of the two categories and produces a “range of months indicating the defendant’s potential sentence.”¹⁰² The Commission sought to ensure

⁹³ Macey, *supra* note 91, at 639.

⁹⁴ *Id.* at 639–41.

⁹⁵ *Inside Trades Draw Lengthier Sentences*, WALL ST. J. (Oct. 13, 2011), <http://online.wsj.com/article/SB10001424052970203914304576629053026510350.html>.

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *See id.*; Cramer, *supra* note 76.

¹⁰⁰ Danielle DeMasi Chatten, Note, *The More You Gain, the More You Lose: Sentencing Insider Trading under the U.S. Sentencing Guidelines*, 79 *FORDHAM L. REV.* 165, 165 (2010).

¹⁰¹ *Id.* at 185–86.

¹⁰² *Id.* at 186.

that white-collar criminals would receive a “short but definite period of confinement’ rather than probation.”¹⁰³ Thus, in an effort to end the courts’ practice of sentencing economic offenders to probation, they classified insider trading as a “serious” offense and called for prison terms of thirty-seven to forty-six months for insider trading resulting in gains of over \$5 million.¹⁰⁴ Today, the Guidelines continue to focus on the gain or loss resulting from an offense and identify it as the most relevant sentencing factor, with a goal of reducing the magnitude of the offense to something objective and measurable.¹⁰⁵ For example, a loss of more than \$30,000 increases the defendant’s offense level by six; a loss of more than \$1 million increases it by sixteen; and, ultimately, a loss of more than \$400 million adds thirty offense levels.¹⁰⁶

Critics of this sentencing system have argued that the Guidelines place too much weight on the loss calculation, which often leads to unreasonably high sentences.¹⁰⁷ Indeed, when factored into an insider-trading defendant’s base offense level of eight, these added levels can have a tremendous impact. “[S]uccessful public companies typically issue millions of publicly traded shares,” and, with the exposure of fraud within the company, the price of those shares declines rapidly, producing a “multiplier effect” and leading to prescribed offense levels that are, “quite literally, off the chart.”¹⁰⁸ In addition to employing a rather crude methodology for calculating insider-trading sentences, the Guidelines also fail to explain how gain or loss should be calculated, leaving it up to the courts to make “reasonable” estimates.¹⁰⁹ For simplicity, most courts have adopted an irrebuttable presumption

¹⁰³ *Id.* (quoting Steven Breyer, *The Federal Sentencing Guidelines and the Key Compromises Upon Which They Rest*, 17 HOFSTRA L. REV. 1, 22 (1988)).

¹⁰⁴ Brody, *supra* note 8, at 89 (citing U.S. SENT’G COMMISSION, GUIDELINES MANUAL § 5(A) (1988)). Curiously, the first Guidelines regarded insider trading as a more grave offense than larceny and embezzlement and, consequently, gave it a much higher base offense level. *Id.*

¹⁰⁵ Chattin, *supra* note 100, at 186.

¹⁰⁶ Derick R. Vollrath, *Losing the Loss Calculation: Toward a More Just Sentencing Regime in White-Collar Criminal Cases*, 59 DUKE L.J. 1001, 1017 (2010) (citing U.S. SENT’G COMMISSION, GUIDELINES MANUAL § 2B1.1(b)(1) (2009)).

¹⁰⁷ Chattin, *supra* note 100, at 187.

¹⁰⁸ *Id.* (quoting *United States v. Adelson*, 441 F. Supp. 2d 506, 509 (S.D.N.Y. 2006)); *see also* Vollrath, *supra* note 106, at 1017–18 (describing how “[t]he loss calculation alone can transform a sentence”).

¹⁰⁹ Vollrath, *supra* note 106, at 1018–19.

that a trader's crime spans the period from the stock purchase through its sale.¹¹⁰ While the presumption is convenient, it causes courts to altogether ignore the precise time at which the defendant came into possession of the inside information.¹¹¹ Since the purchase may have taken place years before obtaining the information and selling the stock, the loss calculation often produces sentences that are grossly disproportionate to the offense.¹¹²

In addition to prescribing high penalties, the Guidelines also correlate poorly with the defendant's culpability. For example, take Chattin's hypothetical situation adopted from *United States v. Mooney*:

Imagine three corporate executives who share the same positive, material, nonpublic information about the future of their corporation. Based on this information, all three buy 1000 shares of stock at five dollars per share, costing them \$5000 each. The positive information is publicized four weeks later. After the fifth week, the market has absorbed the information and it is reflected in the stock price, which is now fifteen dollars per share. On this day, Officer A sells his 1000 shares, making \$10,000. Officer B retains his shares until three months later, when the stock price has risen to fifty dollars per share. Officer B pockets \$45,000. Officer C was not so lucky; the market crashes six months later, the stock price drops to two dollars per share, and Officer C sustains a loss.¹¹³

Even though Officers A, B, and C are all guilty of insider trading, the Guidelines prescribe different sentences for each of them: A will be sentenced based on a \$10,000 gain (imprisonment of six to twelve months), and B will be sentenced based on a \$45,000 gain (imprisonment of fifteen to twenty-one months), while C will be sentenced at the base level (no imprisonment or imprisonment of up to six months).¹¹⁴ Since the three offenders committed the exact same crime, the

¹¹⁰ Brody, *supra* note 8, at 95.

¹¹¹ *See id.*

¹¹² *Id.*

¹¹³ Chattin, *supra* note 100, at 167. Hypothetical situation adapted from *United States v. Mooney*, 425 F.3d 1093, 1107 (8th Cir. 2005) (en banc) (Bright, J., dissenting).

¹¹⁴ *Id.*

recommended sentences seem to reflect actual culpability to a very limited extent, if at all.¹¹⁵

D. *Judicial Doubt*

Although the Guidelines were originally styled as mandatory, the Supreme Court's 2005 decision in *United States v. Booker* declared them advisory and no longer binding upon sentencing courts.¹¹⁶ Two years later, in *Kimbrough v. United States*, the Court explicitly sanctioned deviations from the Guidelines based on a sentencing judge's policy disagreement with a specific recommendation.¹¹⁷ Thus, due to *Booker* and *Kimbrough*, judges are afforded greater flexibility in setting prison terms. This is particularly relevant to the insider-trading context, as judges since 2009 have frequently departed downward from the Guidelines, despite the government's vigorous crackdown on the practice.¹¹⁸ Indeed, out of fifteen insider-trading sentences imposed in 2009 and 2010 in cases brought by the U.S. Attorney in New York, as many as thirteen, close to eighty-seven percent, were more lenient than what the Guidelines recommended, and seven did not involve a prison term at all.¹¹⁹ Notably, this trend is limited to insider-trading scenarios.¹²⁰ The prison terms handed down for all other cases considered by New York federal judges, including various types of securities fraud, were more likely to fall within the Guidelines' prescribed range.¹²¹

One possible explanation for judges' relative leniency in insider-trading cases is that the offenders are better positioned than other white-collar criminals to strike a sympathetic chord with adjudicators:

¹¹⁵ *Id.* at 168.

¹¹⁶ *United States v. Booker*, 543 U.S. 220, 226-27 (2005).

¹¹⁷ Vollrath, *supra* note 106, at 1027; *Kimbrough v. United States*, 552 U.S. 85, 91 (2007) (allowing broad policy discretion when dealing with a sentence that is per se unreasonable and outside the range of the Sentencing Guidelines).

¹¹⁸ Andrew Longstreth, *Why U.S. Inside Traders Escape Harsh Sentences*, REUTERS (Jan. 6, 2011), <http://www.reuters.com/article/2011/01/06/us-insider-trading-idUSTRE7055JP20110106>.

¹¹⁹ *Id.*

¹²⁰ See Andrew Longstreth, *Rajaratnam Prison Term Follows Sentencing Trends*, REUTERS (Oct. 13, 2011), <http://www.reuters.com/article/2011/10/13/galleon-rajaratnam-guidelinesidUSN1E79C25920111013>.

¹²¹ *Id.*

[I]nsider-trading defendants more commonly present the sentencing judge with glowing character references from friends, family, and colleagues, and these are often effective in persuading judges that a short prison term would be a sufficient deterrent. And unlike cases involving violent crimes or other types of white-collar crimes such as Ponzi schemes and shareholder fraud, insider trading, which no doubt harms the investing public, typically doesn't produce anyone to deliver heart-tugging victim-impact statements to the judge.¹²²

This theory contains two important points. First, there seems to be a sense that, in insider-trading cases, the incremental value of imposing longer sentences is going to be negligible.¹²³ This may be partially due to the defendants' ability to develop compelling stories; on the other hand, it is also well established that the government launched its most recent crackdown on the practice in the absence of any evidence that increased prosecutions or heavier penalties would improve deterrence.¹²⁴ The downward departures from the Guidelines may therefore reflect judges' case-by-case determinations that insider trading can be deterred more efficiently.

Second, there is concern that insider trading is not capable of producing as much harm as other types of white-collar crime. For example, while the accounting fraud committed in Enron "ruined the lives and livelihoods of scores of victims," one would be hard-pressed to allege that those who trade on material, non-public information victimize others in the traditional sense of the word.¹²⁵ Some scholars also contend that the harm inflicted through accounting fraud is more "measureable;" in comparison, the impact of insider trading, whether it is adverse or not, is not well-defined and less understood.¹²⁶

Consider as an example a Ponzi scheme purporting to develop and sell skin-care products. Investors are induced to provide lump-sum, passive payments of \$100,000 that would enable research and production and are promised monthly

¹²² Longstreth, *Why U.S. Inside Traders Escape Harsh Sentences*, *supra* note 118.

¹²³ Brody, *supra* note 8, at 89-91.

¹²⁴ *Id.* at 85.

¹²⁵ Peter Lattman, *In Galleon Case, Prison Term is Seen as Test*, DEALBOOK (Sept. 19, 2011, 8:33 PM), <http://dealbook.nytimes.com/2011/09/19/in-galleon-insider-case-prison-term-is-seen-as-test/>.

¹²⁶ *See id.*

returns of \$500 in perpetuity. In reality, however, the skin-care business is entirely non-existent. The company does not generate revenues from actual sales and is simply paying earlier investors with the funds supplied from later investors. Five years after the company is set up, the perpetrators are no longer able to recruit new investors; soon, they stop making monthly payments, and the scheme eventually collapses. An investor who contributed in the very beginning will have received five years' worth of monthly payments, or a total of \$30,000. An investor who joined the scheme just two months prior to its collapse, however, will have received a single payment, \$500. Consequently, the first investor lost \$70,000 and the second investor, \$99,500. This example demonstrates that, not only are the losses resulting from accounting fraud easily calculable, but the victimized investors are particular, readily identifiable individuals. A real-world Ponzi scheme would, of course, entangle far more than just two investors, but the principle remains the same.

In contrast, insider trading works much differently. Suppose that a shareholder trades in a security contemporaneously with insiders who are in possession of material, non-public information.¹²⁷ The shareholder sells his 1000 shares in a company at ten dollars per share, but the subsequent disclosure of certain positive information pushes the price up to fifteen dollars per share. At first blush, it may seem that the seller suffered a \$5,000 loss. From a probability standpoint, however, the seller is very unlikely to have sold the shares to an insider because publicly-traded companies have numerous investors. Even if the shareholder happens to have sold his shares to an insider, the gain corresponding to the "loss" accrues not just on inside traders, but also on all contemporaneous purchasers, regardless of whether they had any access to the inside information.¹²⁸ More importantly, the informational asymmetry that caused the shareholder's "loss" would have existed even if the insiders had abstained from trading. This is due to the fact that Section 10(b) does not require immediate disclosure of material information.¹²⁹ Thus, the injury can be attributed, not to the fact that someone else trading in the

¹²⁷ This is a slightly modified version of an example included in Bainbridge, *Insider Trading*, *infra* note 128.

¹²⁸ Stephen Bainbridge, *Insider Trading*, in *ENCYCLOPEDIA OF LAW AND ECONOMICS* 772, 785 (Boudewijn Bouckaert & Gerrit De Geest eds., 1999), *available at* <http://encyclo.findlaw.com/5650book.pdf>.

¹²⁹ *Id.*

same securities had inside information, but to the nature of securities regulation.¹³⁰

The above examples illustrate the important differences between accounting fraud and insider trading. The victims of the former are easily ascertainable and their losses are just as easily measurable. The latter, on the other hand, theoretically occurs at the expense of the public, but connecting the dots between one person's insider trading and another person's loss presents some challenges.¹³¹ Hence, judges presiding over insider-trading cases may be making downward adjustments at the sentencing level because of the idea that trading on material, non-public information does not have victims, at least not in any measurable sense.¹³²

E. Moral Ambiguity

Although insider trading has been a crime since 1934 and the government has prosecuted offenders with noteworthy eagerness since the late 1980s, there is an on-going and rather contentious debate in academic and professional circles about whether the practice should be criminalized at all. The following sections present and evaluate some of the major arguments for and against insider-trading regulation.

1. Fairness-Based Arguments

Those in favor of criminalization emphasize the unfairness of putting outsiders—investors without access to material, non-public information—at such an obvious disadvantage in the marketplace.¹³³ This is precisely the theory the SEC relied on when it waged war on insider trading in the 1980s.¹³⁴ The basic underlying principle is that information is a public good, meaning that additional members of the public can generally enjoy a single piece of information at no extra cost.¹³⁵ Some therefore argue that from a fairness perspective, regulation should not allow insiders

¹³⁰ *See id.*

¹³¹ *See* Vollrath, *supra* note 106, at 1018-19.

¹³² Longstreth, *Why U.S. Insiders Escape Harsh Sentences*, *supra* note 118.

¹³³ James Altucher, *Should Insider Trading be Made Legal?*, HUFFINGTON POST (Oct. 20, 2009, 6:51 PM), http://www.huffingtonpost.com/james-altucher/should-insider-trading-be_b_324409.html.

¹³⁴ JONATHAN R. MACEY, *INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY* 41, 60-63 (1991).

¹³⁵ Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443, 452 (2001).

to monopolize specific informational units but should instead strive to achieve informational equality by placing all market participants on an equal footing.¹³⁶

The argument is problematic for two reasons. First, it assumes that in the absence of insider trading, “the resulting gains will be spread randomly among other traders.”¹³⁷ In reality, even if insider trading were prohibited, market professionals would still have an advantage over the average investor and would capture profit far more swiftly than the public.¹³⁸ With or without insider trading, then, the idea of a level playing field is largely utopian. Second, most market participants hold diversified portfolios and are consequently insulated from insider trading in any one security altogether.¹³⁹ Market professionals, as not-so-average investors, make a living through undiversified trading, meaning that they are the ones with a vested interest in banning insider trading so that they can have the playing field tilted in their favor.¹⁴⁰ Hence, in practice, the only investors without an inherent advantage at the marketplace—those holding fully diversified portfolios—are by default indifferent to the existence of insider trading.¹⁴¹

Fairness-based arguments can also go the other way and are sometimes advanced to support the deregulation of insider trading. One such argument is that insider-trading prohibitions are “unavoidably biased” because refraining from buying or selling stock, just like actively buying or selling stock, can be the result of misusing material, non-public information.¹⁴² To the extent that non-trading is impossible to detect and prosecute, the offense is likely to be unfairly regulated.¹⁴³

2. “Accurate Pricing” Arguments

An efficiency-based argument often made in favor of regulation is that insider trading harms investors and, thus, damages public confidence in the capital

¹³⁶ *Id.* at 459.

¹³⁷ MACEY, *supra* note 134, at 42.

¹³⁸ *Id.* at 41–42.

¹³⁹ *Id.* at 43.

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² Donald J. Boudreaux, *Learning to Love Insider Trading*, WALL ST. J. (Oct. 24, 2009), <http://online.wsj.com/article/SB10001424052748704224004574489324091790350.html>.

¹⁴³ *Id.*

markets.¹⁴⁴ An investor is said to incur harm by trading at the “wrong price” or by being induced to enter into poorly-advised transactions.¹⁴⁵

The securities-pricing theory underlying this argument is largely accurate. As its name suggests, the price of a publicly-traded security reflects all publicly available information about that security.¹⁴⁶ Any material, non-public information is, by definition, not reflected in the price.¹⁴⁷ The argument for criminalization, therefore, focuses on the idea that, by not revealing such information to the public, inside traders promote imprecise securities pricing.¹⁴⁸ If the information withheld is particularly important, the discrepancy between the actual and accurate stock price will be all the more significant.¹⁴⁹ Suppose, for instance, that Procter & Gamble (“P&G”) stock trades for \$15 per share. Through their relationship with the company, several insiders have access to some information that, if made available to the public, would cause the price to plummet to \$9 per share. Technically speaking, an investor who makes a purchase at the \$15 per share price trades at the “wrong price” and arguably enters into a “poorly advised transaction” because the investor should forgo trading in P&G stock altogether.¹⁵⁰

This is a variation of the argument made by the shareholder in Part D, to little success. Indeed, information asymmetry in the stock market is a function of securities laws enabling companies to keep material information, even when it is instrumental to an investor’s decision making.¹⁵¹ Such asymmetry would exist with or without insider trading.¹⁵² Admittedly, if the disclose-or-abstain rule were replaced with a simple “disclose” mandate, the asymmetry would disappear and prices would be “right.”¹⁵³ Such a rule, however, would be clearly unreasonable; after all, it is

¹⁴⁴ Todd A. Bauman, *Insider Trading at Common Law*, 51 U. CHI. L. REV. 838, 847 (1984).

¹⁴⁵ Bainbridge, *Insider Trading*, *supra* note 128, at 785.

¹⁴⁶ *Basic, Inc. v. Levinson*, 485 U.S. 224, 246 (1988).

¹⁴⁷ See Bainbridge, *Insider Trading*, *supra* note 128, at 785.

¹⁴⁸ See *id.* at 785-86.

¹⁴⁹ *Id.* at 778.

¹⁵⁰ *Id.* at 785.

¹⁵¹ *Id.*

¹⁵² *Id.*

¹⁵³ *Id.*

namely the ability to withhold certain material information in legitimate business transactions that enables companies to remain profitable.¹⁵⁴

Some scholars fundamentally disagree that insider trading promotes inaccurate pricing to begin with. They argue that deregulation may in fact cause stock prices to move towards the level at which they would be if inside information were available publicly.¹⁵⁵ In the P&G example above, for instance, if insiders are allowed to trade freely, they will start selling their shares immediately upon acquiring the negative information about the company, thereby boosting the supply of P&G shares on the market and causing a drop in the share price. In the course of time, insider trading is, at least theoretically, capable of adjusting market prices to a more accurate level.¹⁵⁶ Presumably, then, a ban on the practice would block the information provided by those who are most knowledgeable about the companies that the public invests in,¹⁵⁷ worsening “the lot of the uninformed investor.”¹⁵⁸

While this theory is compelling, empirical research has been unable to prove it definitively.¹⁵⁹ Some studies indeed confirm the existence of so-called “derivatively informed trading,” the gradual “leakage or tipping of [inside] information or through observation of insider trades.”¹⁶⁰ Other studies, however, find that while the process does affect the market, it only does so slowly and sporadically, meaning that derivatively-informed trading will very rarely have any practical significance.¹⁶¹ Unless and until there is conclusive empirical evidence on whether insider trading has an impact on stock prices, it will remain unclear whether it can indeed induce

¹⁵⁴ MACEY, *supra* note 134, at 30.

¹⁵⁵ See Hayne E. Leland, *Insider Trading: Should it be Prohibited?*, 100 J. POL. ECON. 859, 862 (1992).

¹⁵⁶ Stephen Bainbridge, *Regulate Insider Trading*, CAPITALISM MAG. (Sept. 24, 2004), <http://www.capitalismmagazine.com/2004/09/regulate-insider-trading/>.

¹⁵⁷ *Time to Make Insider Trading Legal?*, FOX BUSINESS (Jan. 27, 2011), <http://www.foxbusiness.com/markets/2011/01/27/time-make-insider-trading-legal/#ixzz1buN5hj14>.

¹⁵⁸ Brody, *supra* note 8, at 98.

¹⁵⁹ Bainbridge, *Insider Trading*, *supra* note 128, at 779.

¹⁶⁰ Bainbridge, *Regulate Insider Trading*, *supra* note 156.

¹⁶¹ *Id.*

investors to enter into inopportune transactions.¹⁶² Further empirical findings are also needed in order to test the complementary claim that insider trading leads to the erosion of investor confidence in the capital markets.¹⁶³

3. “Harm to Company-Issuer” Arguments

Some arguments in favor of regulation focus on the effects of insider trading on the company-issuer itself rather than the effects on the market.¹⁶⁴ Their proponents stress that the company-issuer can be impacted adversely when the practice interferes with corporate plans and causes managers to undertake riskier projects than they normally would.¹⁶⁵

Albeit likely accurate with respect to inside traders’ incentives, this argument ignores the fact that shareholders have no interest in being protected against excessive risk.¹⁶⁶ Unlike bondholders, shareholders prefer riskier undertakings because they are residual claimants and, as such, are entitled to “all the gains associated with successful risky projects, [while] their exposure to loss is limited to the amount of their investment.”¹⁶⁷ Thus, if given the opportunity to choose what strategies the company should engage in, shareholders would choose the riskier ones as well.¹⁶⁸ As fixed claimants, bondholders are not jeopardized by managers’ incentives either. They are generally expected (and given the chance) to draft covenants to protect themselves from excessive risk-taking on the part of the managers.¹⁶⁹ The fact that, unlike bondholders, shareholders opt out of this arrangement further corroborates the argument that they are not concerned about the incentives that insider trading might create for the managers.¹⁷⁰ Quite to the

¹⁶² See generally Stanislav Dolgoplov, *Insider Trading*, THE CONCISE ENCYCLOPEDIA OF ECONOMICS (David R. Henderson ed., 2008), available at <http://www.econlib.org/library/Enc/InsiderTrading.html>.

¹⁶³ See Bainbridge, *Insider Trading*, *supra* note 128, at 786.

¹⁶⁴ See Bainbridge, *Regulate Insider Trading*, *supra* note 156.

¹⁶⁵ Bainbridge, *Insider Trading*, *supra* note 128, at 789.

¹⁶⁶ MACEY, *supra* note 134, at 32.

¹⁶⁷ *Id.*

¹⁶⁸ *Id.* at 32-33.

¹⁶⁹ *Id.* at 32.

¹⁷⁰ *Id.* at 32-33.

contrary, shareholders may in fact *want* managers to engage in insider trading. Because managers are compensated in the form of a fixed salary (i.e., a fixed claim on the firm's earnings), their interests tend to be aligned with those of the bondholders, and they will normally prefer safer projects that provide stable returns.¹⁷¹ If managers engage in insider trading, however, they are more likely to choose riskier projects, just like the shareholders would want them to.¹⁷²

4. Compensation-Based Arguments

Supporters of deregulation emphasize that insider trading can be treated as an effective compensation substitute.¹⁷³ The argument distinguishes between corporate managers on one hand and corporate entrepreneurs on the other: the former “operate the firm according to predetermined guidelines,” while the latter’s “contribution to the firm consists of producing new valuable information.”¹⁷⁴ Because of these different responsibilities, the two types of employees also enjoy different compensation structures.¹⁷⁵ Managers have fixed responsibilities, making a fixed salary a preferred form of compensation; conversely, entrepreneurs are incentivized to produce more information, and a superior form of compensation would be pegged to their actual contributions to the company.¹⁷⁶ Thus, some scholars argue that entrepreneurs, if given the opportunity to trade on the information they produce, would be both appropriately compensated and incentivized to continue contributing.¹⁷⁷ They also stress that such an arrangement is more effective because, unlike contractual renegotiations or bonuses, it measures the value of the innovation to the company more accurately.¹⁷⁸

This compensation-based justification for insider trading has not escaped criticism. Some scholars point out that the typical insider-trading defendant is rarely

¹⁷¹ *Id.* at 33.

¹⁷² *See id.* at 32-33.

¹⁷³ Bainbridge, *Insider Trading*, *supra* note 128, at 780.

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ *Id.* at 780-81.

¹⁷⁸ *See id.* at 781.

an entrepreneur, but, instead, a manager, attorney, or some other type of advisor.¹⁷⁹ Moreover, compensation structures have evolved significantly over the last decade and are now “aimed directly at compensating start-up entrepreneurs and balancing their return with others who contribute to the enterprise.”¹⁸⁰ These payment mechanisms may have several advantages over insider-trading-based compensation.¹⁸¹ First, unlike insider trading, which may reward the wrong people or may lead to information leakages, direct compensation allows for better targeting.¹⁸² Second, formal methods of compensation are more transparent and easier to monitor.¹⁸³ Third, the insiders, to the extent that they are risk-averse, may themselves prefer a more certain payment structure.¹⁸⁴ Fourth, there is some empirical evidence showing that insiders’ gains stem primarily from their assessment and knowledge of the company and not so much from the exploitation of inside information.¹⁸⁵ If this is the case, then the “compensation argument rests on fundamentally flawed assumptions.”¹⁸⁶

5. Implications

The evident problem with the debate on whether insider trading should be criminalized is that that debate is largely grounded in anecdotal observations; “in the absence of decisive empirical evidence, the insider trading debate turns on who gets to choose the null hypothesis—the proposition that the other side must refute—and on that issue there is unlikely to be agreement.”¹⁸⁷ Regrettably, because the practice is illegal and transactions are infrequently reported, the problem with insufficient data samples will likely continue to obstruct empirical research in the future.¹⁸⁸

¹⁷⁹ Robert B. Thompson, *Insider Trading, Investor Harm, and Executive Compensation*, 50 CASE W. RES. L. REV. 291, 302 (1999).

¹⁸⁰ *Id.* at 302–03.

¹⁸¹ *Id.* at 303.

¹⁸² *Id.*

¹⁸³ *Id.*

¹⁸⁴ Bainbridge, *Insider Trading*, *supra* note 128, at 782.

¹⁸⁵ *Id.*

¹⁸⁶ *Id.*

¹⁸⁷ *Id.* at 797.

¹⁸⁸ *See id.*

While scholars are for now unable to reach a consensus on the question of criminalization, the very fact that there is an ongoing, contentious discussion indicates a certain level of uncertainty about just how harmful or wrongful insider trading is. Indeed, the moral content of insider trading may quite possibly be lacking in both social harmfulness and moral wrongfulness. Social harmfulness describes the factual or potential harm caused by a criminal act,¹⁸⁹ and, as already suggested, the question of whether insider trading has harmful effects is very much open to debate. Moral wrongfulness, on the other hand, refers to the idea that punishable conduct must carry “the judgment of community condemnation.”¹⁹⁰ To be sure, the public likely does consider insider trading to be wrongful; in evaluating community condemnation, however, one must also bear in mind that, in the context of corporate offenses, the public often tends to overreact “due to the infiltration of negative emotions like envy and resentment.”¹⁹¹ In deeming insider trading morally wrongful, then, the public may be relying on the commonly-held belief that corporate offenders are greedy, arrogant, and corrupt without evaluating any particular action evenhandedly.¹⁹² Academics too have suggested that it is likely unreasonable to expect that public perceptions of moral wrongfulness can draw a clear, accurate line between clever entrepreneurship and zealous business practices on one hand and criminal conduct on the other.¹⁹³ In light of *Cuban*, even the most sophisticated observers struggle to differentiate between lawful tactics and unlawful behavior.¹⁹⁴

In deciding whether to regulate specific conduct, the government ought to take into consideration such important nuances behind the conduct’s moral content. Indeed, ever since the time of the Founding Fathers, there has been a concern that “the passions of the public, unfiltered by deliberation, might lead to dangerous

¹⁸⁹ Stuart P. Green, *Why It’s a Crime to Tear the Tag Off a Mattress: Overcriminalization and the Moral Content of Regulatory Offenses*, 46 EMORY L.J. 1533, 1549 (1997).

¹⁹⁰ John C. Coffee, Jr., *Does “Unlawful” Mean “Criminal”?: Reflections on the Disappearing Tort/Crime Distinction in American Law*, 71 B.U. L. REV. 193, 235 (1991) (quoting Henry M. Hart, Jr., *The Aims of the Criminal Law*, 23 L. & CONTEMP. PROBS. 401, 404 (1958)).

¹⁹¹ Sandeep Gopalan, *Skilling’s Martyrdom: The Case for Criminalization Without Incarceration*, 44 U.S.F. L. REV. 459, 468-69 (citing Hart, *supra* note 190, at 420).

¹⁹² *Id.*

¹⁹³ *Id.* at 468.

¹⁹⁴ See Cohen, *supra* note 50.

results.”¹⁹⁵ The public has a very strong disincentive to become informed because of a sense that each opinion will only have a negligible effect on communal decision-making.¹⁹⁶ Furthermore, people do not like to admit their ignorance on a particular topic and, if pressed to opine, they will often choose a position “at random,” even though they might be unable to back it up convincingly.¹⁹⁷ Some scholars have thus noted that, while democracy presupposes the inclusion of all voices, achieving sustainable public policies means that universal inclusion has to be accompanied by “conditions where [the public is] effectively motivated to *really* think about the issues.”¹⁹⁸

III. PROPOSALS FOR INSIDER-TRADING REFORM

Part I highlighted the fact that whether federal securities law should ban insider trading is one of the most controversial questions in white-collar criminal law. Among other issues, commentators struggle to agree on whether the practice causes losses to market participants, whether it is harmful to the company-issuer, and whether it improves or impedes market efficiency. Congress and the SEC have similarly failed to articulate a coherent social policy that would justify criminalization or how vigorous prosecution would further that policy.¹⁹⁹ In this vein the recent prosecutorial trends were likely not spurred by a real evaluation of which white-collar practices are most prevalent or most problematic, but, instead, by the government’s decision to act where it feels pressure in a time of economic difficulty, at the expense of where action is truly needed.²⁰⁰ Moreover, in launching an attack on insider trading, the government may have relied on the public’s perceptions of moral wrongfulness to an unwarranted extent; as suggested, the public has a tendency to condemn the practice due to piled-up anger toward corporate America, often

¹⁹⁵ JAMES S. FISHKIN, *WHEN THE PEOPLE SPEAK: DELIBERATIVE DEMOCRACY AND PUBLIC CONSULTATION* 18 (2009).

¹⁹⁶ *Id.* at 2.

¹⁹⁷ *Id.*

¹⁹⁸ *Id.* at 1 (emphasis added).

¹⁹⁹ See Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375, 383-84 (1999).

²⁰⁰ See Christine Hurt, *The Undercivilization of Corporate Law*, 33 J. CORP. L. 361, 372 (2008).

without understanding the mechanics of it at all.²⁰¹ To top it all off, recent case law renders the scope of insider-trading liability remarkably vague.²⁰²

In light of this contentious debate, the legal rules governing insider trading merit careful and thorough reexamination. First and foremost, there ought to be extensive research clearing up the uncertainties surrounding whether the practice in fact inflicts harm on the market and the public and whether it is more unfair to outsiders than any other alternative arrangement. If it is sufficiently harmful or promotes unfair trading practices, then the government should clearly formulate the policy goals that will be served through criminalization and specify the exact activities and individuals that will be affected by the proposed regulatory scheme. On the other hand, if the practice has neutral to beneficial effects, it should be permitted, with special consideration given to public perceptions of moral wrongfulness. In particular, while “moral condemnation is heaped upon insider trading with uncommon hostility,”²⁰³ scholars have yet to sharpen their argument as to whether, why, and in what respects the practice is morally objectionable.²⁰⁴ If future studies reveal that insider trading is not harmful but is nonetheless legitimately worthy of social opprobrium for one reason or another, then the government may consider permitting the practice conditionally or partially.

At present, the poorly-developed moral and definitional contours of insider trading and the absence of conclusive empirical research on the above points preclude an informed discussion of whether the practice should be criminalized. Consequently, this article frames its analysis around the status quo, a regulatory regime in which insider trading is punishable as a federal crime, and argues that a much-needed reform should occur at the sentencing stage. Assuming, *arguendo*, that insider trading is harmful or unfair and should thus be deterred, lengthy incarceration is hardly necessary or economically sensible. There are alternative sanctioning approaches that can be just as successful in addition to imposing significantly lower direct and indirect costs.

²⁰¹ Gopalan, *supra* note 191, at 468-69.

²⁰² See Ryan M. Davis, *Trimming the “Judicial Oak”: Rule 10b5-2(b)(1), Confidentiality Agreements, and the Proper Scope of Insider Trading Liability*, 63 VAND. L. REV. 1469, 1470-71 (2010).

²⁰³ Gary Lawson, *The Ethics of Insider Trading*, 11 HARV. J.L. & PUB. POL’Y 727, 727 (1988).

²⁰⁴ *Id.* at 783 (“[T]he moral approach to insider trading that can attract a clear consensus has yet to be advanced.”).

Section A expounds on the government's problematic tendency to criminalize morally ambiguous offenses—a tendency that threatens to undermine the integrity of the criminal law. Section B argues that overcriminalization and the accompanying overuse of imprisonment penalties can be mitigated through a more frequent resort to intermediate punishments, especially in the context of non-violent offenses. Section C describes the characteristics of inside traders that make them highly responsive to deterrent efforts in the form of intermediate penalties. Finally, because insider trading is a particularly good candidate for alternative sanctioning, Section D advocates for a regulatory regime in which convictions are not accompanied by prison terms but by shaming. Such penalties are not only cheaper to administer, but also will promote deterrence just as effectively as lengthy imprisonment.

A. Overcriminalization

For decades now scholars have been concerned with the gradual expansion of the criminal system and the corresponding “disappearance of any clearly definable line between civil and criminal law.”²⁰⁵ Indeed, there are currently over 4,500 federal crimes, and in the last few decades the number has been growing steadily at a rate of about fifty new crimes each year.²⁰⁶ As new crimes are enacted, people who previously faced civil liability or escaped the reach of the law altogether are now subjected to criminal sanctions.²⁰⁷ In recent years, overcriminalization has primarily affected non-violent acts, with most of the recent growth in prison populations involving non-violent offenders.²⁰⁸

Scholars have identified the two most important causes of overcriminalization. First, lawmakers have a strong incentive to assume a tough stance on crime that “offer[s] ready-made publicity stunts, but face[s] no countervailing political pressure to scale back the criminal justice system.”²⁰⁹ When advocating for the enactment of new offenses or higher penalties for already existing offenses, lawmakers are rarely asked to provide evidence that their proposals will

²⁰⁵ Coffee, *supra* note 190, at 193.

²⁰⁶ Ilya Somin, *The Expansion of Federal Criminal Law*, THE VOLOKH CONSPIRACY (July 15, 2008, 1:21 PM), <http://volokh.com/posts/1216142517.shtml>.

²⁰⁷ DOUGLAS N. HUSAK, OVERCRIMINALIZATION: THE LIMITS OF THE CRIMINAL LAW 17 (2007).

²⁰⁸ *Id.* at 16.

²⁰⁹ Erik Luna, *The Overcriminalization Phenomenon*, 54 AM. U. L. REV. 703, 719 (2005).

improve deterrence.²¹⁰ Thus, not only are such proposals easy to advance, but there are also no meaningful restrictions on the legislative power to criminalize and punish conduct.²¹¹ Some commentators further argue that the Supreme Court's 2005 decision in *Gonzales v. Raich*, which held that the commerce clause can be used to criminalize the use of home-grown marijuana even when states have approved the practice for medicinal purposes, will make it easier for Congress to regulate an even broader array of conduct.²¹²

Second, scholars attribute overcriminalization to the fact that allegations of harm are so ubiquitous that they render the harm principle—the idea that conduct should be prohibited only when it inflicts damage or injury—meaningless.²¹³ They argue that the term “harm” is a quasi-political tool, “with groups seeking public recognition of the righteousness of their worldviews through the criminalization of behavior associated with their perceived enemies.”²¹⁴ Criminal sanctions are, therefore, increasingly used to curb regulatory-type offenses that are not ostensibly harmful or wrongful.²¹⁵ Some alleged attenuated need or hardship, or the use of tropes like “corporate greed,” for example, is often sufficient to justify criminalization.²¹⁶

While overcriminalization is desirable in some contexts,²¹⁷ in many ways the trend is problematic.²¹⁸ First and foremost, it tends to corrupt the moral authority of the law by encroaching on activities where “sufficiently clear partitions cannot be erected between the unlawful behavior and closely related lawful behavior to justify a

²¹⁰ *See Id.* at 719-21.

²¹¹ *Id.* at 721-23.

²¹² *See* Ilya Somin, *Gonzales v. Raich: Federalism as a Casualty of the War on Drugs*, 15 CORNELL J.L. & PUB. POL'Y 507, 508 (2006).

²¹³ Luna, *supra* note 209, at 720 (citing Bernard E. Harcourt, *The Collapse of the Harm Principle*, 90 J. CRIM. L. & CRIMINOLOGY 109, 113 (1999)).

²¹⁴ *Id.* at 721.

²¹⁵ *See* Coffee, *supra* note 190, at 197.

²¹⁶ Luna, *supra* note 209, at 722.

²¹⁷ HUSAK, *supra* note 207, at 18 (explaining that “[i]n England, . . . rape could not be perpetrated between husband and wife until 1991”).

²¹⁸ *See Id.* at 17-18.

prohibitory policy.”²¹⁹ A criminal law that assigns stigma haphazardly, without regard for notions of morality and harmfulness, may altogether lose its authority to impose just punishment or to promote deterrence.²²⁰ Furthermore, overcriminalization imposes significant direct and indirect costs. The direct costs take the form of inefficiently expended enforcement resources,²²¹ while the indirect costs include the “financial, emotional, and social costs when otherwise productive individuals are unable to contribute to society [and] when families are left without breadwinners”²²² Finally, the existence of countless criminal offenses creates tremendous prosecutorial discretion and often leaves the defendant unaware of what charges are going to be raised.²²³ Suppose, for instance, that an officer of a publicly-held corporation obtains certain confidential information and uses it to trade in his company’s stock for several years, accumulating profits of \$100,000.²²⁴ Throughout the entire time, he deposits all profits in his private bank account.²²⁵ The possible charges that the prosecution can bring against him include “multiple counts of some combination of mail fraud, racketeering offenses, securities violations, money laundering, and a host of others.”²²⁶ Similarly, the possible sanctions can span from probation to a six-year prison term.²²⁷ Even if prudently implemented, such broad, unchecked discretion may be incompatible with the rule of law.²²⁸

In sum, the scope of the criminal law has expanded in recent decades, and many offenders who previously faced civil liability are now often subject to criminal

²¹⁹ Coffee, *supra* note 190, at 197.

²²⁰ Michael D. Silberfarb, Note, *Justifying Punishment for White-Collar Crime: A Utilitarian and Retributive Analysis of the Sarbanes-Oxley Act*, 13 B.U. PUB. INT. L.J. 95, 98 (2003). See, e.g., Luna, *supra* note 209, at 727.

²²¹ Green, *supra* note 189, at 1536.

²²² Luna, *supra* note 209, at 728.

²²³ See HUSAK, *supra* note 207, at 26.

²²⁴ *Id.* (citing Jeffrey Standen, *An Economic Perspective on Federal Criminal Law Reform*, 2 BUFF. CRIM. L. REV. 249, 252-54 (1998)).

²²⁵ *Id.*

²²⁶ *Id.*

²²⁷ *Id.*

²²⁸ *Id.* at 27.

prosecution and sanctions in the form of prison terms.²²⁹ This development has numerous negative repercussions and few benefits that are primarily limited to effective crowd-pleasing. Commentators have, therefore, noted that, to prevent substantive injustice and maintain integrity, imprisonment should be reserved for “the most damaging wrongs and the most culpable defendants.”²³⁰

B. Intermediate Punishment Theory

In 1965, the eminent criminologist Norval Morris confidently predicted that by the end of the twentieth century prisons would be extinct.²³¹ Indeed, due to a widespread dissatisfaction with detention facilities in the 1960s and 1970s, “prison populations fell, decarceration programs rose, and alternatives to incarceration proliferated.”²³² The trend was, nevertheless, more short-lived than Morris imagined: starting in the 1980s, prison populations in the United States began growing at a record pace, surpassing two million in the last decade,²³³ while the problem of prison overcrowding created conditions that violated the Eighth Amendment’s ban on cruel and unusual punishments.²³⁴

The big picture is staggering: with only five percent of the world’s population, the United States had nearly a quarter of the world’s prisoners in 2008.²³⁵ The country’s incarceration rate is unparalleled among industrialized nations, and its prison system is viewed not just skeptically, but with dismay.²³⁶ The rate of incarceration among non-violent criminals is particularly notorious, though “it is the

²²⁹ Luna, *supra* note 209, at 722.

²³⁰ John C. Coffee, Jr., *Paradigms Lost: The Blurring of the Criminal and Civil Law Models-- And What Can Be Done About It*, 101 YALE L.J. 1875, 1875 (1992) (citing Kenneth Mann, *Punitive Civil Sanctions: The Middleground Between Criminal and Civil Law*, 101 YALE L.J. 1795, 1802 (1992)).

²³¹ Michael Tonry, *Has the Prison a Future?*, in *THE FUTURE OF IMPRISONMENT* 3 (Michael Tonry ed., 2004).

²³² *Id.* at 3–4.

²³³ *Id.* at 4.

²³⁴ See *Brown v. Plata*, 131 S. Ct. 1910, 1926–27 (2011) (recognizing that the conditions of California’s overcrowded prisons led to deficiencies in necessary medical care, which violated the constitutional ban on cruel and unusual punishment).

²³⁵ Adam Liptak, *Inmate Count In U.S. Dwarfs Other Nations’*, N.Y. TIMES, Apr. 23, 2008, at A1.

²³⁶ *Id.*

length of sentences that truly distinguishes American prison policy.²³⁷ Thus, convicts in this country are not only more likely to go to prison but are also more likely to stay there longer.²³⁸ Many commentators have bemoaned these developments, pointing out that imprisonment is “harsh and degrading for offenders and extraordinarily expensive for society.”²³⁹

This problem is rooted in the country’s “polarized and ill-adapted” punishment system that does not account for the fact that different crimes have different levels of severity.²⁴⁰ It deemphasizes intermediate sanctions and, all too often, relies on only two forms of punishment that stand at the opposite extremes of the penological spectrum: probation and imprisonment.²⁴¹ If a sentence involves a prison term, in many instances there is little, if any, evidence that incarceration is more conducive to a decrease in crime than a lighter term or alternative forms of punishment.²⁴² Indeed, scholars distinguish between violent and non-violent criminals and argue that lengthy incapacitation only makes sense with respect to the former.²⁴³ In the context of non-violent crimes, evidence overwhelmingly indicates that longer prison sentences offer no improvements in deterrence: “[t]he relatively modest preventative gains that prisons can claim come at great cost in money, blighted lives, diminished life chances, and unnecessary damage to children, families, and communities.”²⁴⁴

Intermediate sanctions, such as fines, community service, shaming, and house arrest, among others, can inject a level of gradation into the punishment system, in addition to reducing the direct and indirect costs associated with imprisonment.²⁴⁵ And yet, even though intermediate sanctions have been available

²³⁷ *Id.* at A14.

²³⁸ *Id.*

²³⁹ Dan M. Kahan, *What Do Alternative Sanctions Mean?*, 63 U. CHI. L. REV. 591, 592 (1996).

²⁴⁰ NORVAL MORRIS & MICHAEL TONRY, *BETWEEN PRISON AND PROBATION: INTERMEDIATE PUNISHMENTS IN A RATIONAL SENTENCING SYSTEM* 14 (1990).

²⁴¹ *Id.*

²⁴² Kahan, *supra* note 239, at 592.

²⁴³ Tonry, *supra* note 231, at 5.

²⁴⁴ *Id.*

²⁴⁵ *See generally* Kahan, *supra* note 239 (arguing that alternatives to incarceration may be more effective in deterring crime and less expensive).

for decades, society often looks down upon these alternatives with skepticism.²⁴⁶ Specifically, while they do not constitute lighter forms of punishment, intermediate sanctions can be perceived as “insufficiently expressive of condemnation.”²⁴⁷ Unlike institutionalization, which is universally recognized as stigmatizing, they often convey moral disapproval in a much more ambivalent way.²⁴⁸

As an example, consider a situation in which inside traders are no longer imprisoned, but are instead required to pay fines. Fines are not without positive attributes; they are, for instance, cheap to administer, whereas incarceration is extraordinarily expensive for society and uses up resources in the form of personnel, shelter, food, and clothing, to name a few.²⁴⁹ Thus, “[n]ot only do [prison terms] fail to compensate, but they also require ‘victims’ to spend additional resources in carrying out the punishment.”²⁵⁰ Even though they are cheaper than imprisonment and compensate the victim, fines have been severely criticized. Perhaps more so than any other type of punishment, fines are morally problematic because they seem to set an explicit price for committing an offense.²⁵¹ Objectively speaking, the same is true for any punitive measure, though employing a monetary rather than temporal unit of measurement strikes the conscience as particularly offensive.²⁵² Furthermore, some commentators suggest that fines simply fail to fully compensate victims as much as prison terms.²⁵³

Such perceptions of unequal severity, albeit deprived of empirical backing,²⁵⁴

²⁴⁶ *Id.* at 592.

²⁴⁷ *Id.* at 620.

²⁴⁸ *See id.* at 621.

²⁴⁹ Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 193 (1968).

²⁵⁰ *Id.* at 194.

²⁵¹ *Id.* at 194–95.

²⁵² *Id.* at 195.

²⁵³ *See id.*

²⁵⁴ MORRIS & TONRY, *supra* note 240, at 114–15. *See also* Kahan, *supra* note 239, at 619 (“The only reliable way to gauge the disutility associated with a particular penalty is to see what effect the threat of it has on behavior. If potential offenders would be as deterred by a particular fine as they would by a particular term of imprisonment, it can be inferred that losing that amount of money hurts them just as much as that amount of incarceration.”).

have stood in the way of sentencing reform.²⁵⁵ Some scholars argue that, at a deeper level, fines have found little success as an alternative to imprisonment, not because they constitute a lighter form of punishment, but because they do not sufficiently denounce the offender's conduct as morally wrong.²⁵⁶ In other words, different punishments, even if they are equivalent in their severity, may not be interchangeable because society may not value them equivalently.²⁵⁷ To be politically palatable, then, alternative sanctions have to channel public reproach as effectively and forcibly as incarceration.²⁵⁸

C. Characteristics of Inside Traders in the Context of Alternative Sanctioning

The specific characteristics of inside traders make them particularly well suited for alternative sanctioning. First, they are non-violent, non-dangerous offenders who do not need to be removed from society to protect public safety. In addition, they rarely have prior criminal records.²⁵⁹ In contrast to “three strikes” laws, which mandate increased sentences for repeat offenders, the lack of criminal history should reasonably function as a mitigating factor.²⁶⁰ Second, inside traders, like most white-collar offenders, are believed to be especially amenable to deterrent efforts due to their “rational and profit-oriented motivation.”²⁶¹ Studies suggest that they are hardly “committed to a lifestyle of illegality”²⁶² and are, therefore, uniquely sensitive to the prospect of punishment, to a point of physiological instability.²⁶³

²⁵⁵ Kahan, *supra* note 239, at 624.

²⁵⁶ *Id.* at 623 (“[T]he expressive inadequacy of fines is directly borne out by opinion surveys. Such studies consistently show that the public and (democratically accountable) decision makers view fines, by themselves, as insufficiently condemnatory for ‘serious’ offenses.”).

²⁵⁷ *Id.* at 621.

²⁵⁸ *See id.*

²⁵⁹ Ellen S. Podgor, *The Challenge of White Collar Sentencing*, 97 J. CRIM. L. & CRIMINOLOGY 731, 732-33, 738 (2007).

²⁶⁰ *See id.* at 733.

²⁶¹ Elizabeth Szockyj, *Imprisoning White-Collar Criminals?*, 23 S. ILL. U. L.J. 485, 492 (1999).

²⁶² *Id.* But see Mary Kreiner Ramirez, *Just in Crime: Guiding Economic Crime Reform After the Sarbanes-Oxley Act of 2002*, 34 LOY. U. CHI. L.J. 359, 414-15 (2003) (explaining that deterrence is difficult to measure because people generally do not make their decision to eschew misconduct publically known, thereby obstructing empirical research).

²⁶³ Szockyj, *supra* note 261, at 492.

Perhaps most importantly, as people of relatively high social status and esteem, inside traders “have further to go when they fall from grace”²⁶⁴ and are exposed to numerous collateral consequences that follow a conviction.²⁶⁵ For instance, “[u]nlike the plumber or gardener, [an inside trader] is often unable to return to his or her livelihood after serving imprisonment. Licensing, debarment, and government exclusion from benefits may preclude these professionals from resuming the livelihoods held before their convictions.”²⁶⁶ Inside traders are also very sensitive to losing their reputation in the community and the respect of family and colleagues.²⁶⁷ The fact that they are “front-pagers” and are often subjected to public scrutiny further exacerbates the impact of such collateral consequences.²⁶⁸

The idea that, unlike the average burglar or thief, an inside trader is more likely to be reputation-conscious and suffer broader repercussions following a conviction is captured by the concept of “disutility” in two contexts: disutility of conviction and disutility of imprisonment.²⁶⁹ Inside traders are highly conscious of their public image and are convicted at a relatively older age, which suggests that they experience disproportionately high disutility from a mere conviction.²⁷⁰ Thus, “while the disutility of the first year [in prison] is likely to be very high, this declines as the person ages because the alternative of being released at an old age without any prospect of an income or caregivers might be more unpalatable than staying in jail.”²⁷¹ In other words, a mere conviction will impact an inside trader so profoundly that it will effectively obliterate future earning capacity and prospects for professional development.²⁷² In contrast, the average thief is reputation-indifferent and capable of resuming a previous occupation upon serving a term. A mere conviction will not serve as a sufficient deterrent to average thieves because it will

²⁶⁴ *Id.* at 500.

²⁶⁵ Podgor, *supra* note 259, at 739.

²⁶⁶ *Id.*

²⁶⁷ Szockyj, *supra* note 261, at 500.

²⁶⁸ Podgor, *supra* note 259, at 740 (“Being a ‘front-pager’ can subject the individual to more scrutiny and negative publicity, something that might not be felt by individuals of lesser status in society.”).

²⁶⁹ Gopalan, *supra* note 191, at 475-76.

²⁷⁰ *Id.* at 477.

²⁷¹ *Id.* at 476.

²⁷² *See id.* at 477-78.

not affect future earning potential or professional opportunities. In order to properly deter such reputation-indifferent people, then, the punishment system must deprive them of their liberty for a significant period of time.²⁷³

D. Optimal Sanctions for Inside Traders

In advancing a proposal for the optimal sanctioning of inside traders, this article envisions a system that pays heed to, and strikes a fine balance between, efficient deterrence on one hand and the appropriate expression of moral condemnation on the other. The first component concerns the idea that a punishment system focused on the efficient administration of deterrent techniques should not ignore the peculiar characteristics of inside traders and ought to closely track the qualitative differences between defendants' disutilities of conviction.²⁷⁴ Given the high disutility that inside traders face upon a mere conviction, the criminal justice system seems to be squandering unnecessary resources when it mandates lengthy imprisonment; indeed, the threat of a conviction accompanied by a loss in reputation and an inability to resume professional employment is sufficient.²⁷⁵ By the same token, to the extent that insider trading is assumed to inflict social harm, a conviction is sufficient to eliminate an offender's ability to hold fiduciary positions, thereby precluding the inside trader from inflicting further harm.²⁷⁶

The second component of optimal sanctioning, the appropriate expression of moral condemnation, refers to the idea that the public is very sensitive to forms of punishment that do not condemn wrongful activities as strongly and unequivocally as incarceration. While a mere conviction is expected to achieve just as much deterrence as a conviction followed by a prison term, society may not perceive this as an appropriate punishment for insider trading.²⁷⁷ Indeed, there seems to be a strong sense among the public that white-collar offenders are not being held sufficiently accountable.²⁷⁸ Thus, in order to be politically as well as publicly acceptable,

²⁷³ See *id.* at 476.

²⁷⁴ See *id.* at 477.

²⁷⁵ See *id.* 503–04.

²⁷⁶ *Id.* at 504.

²⁷⁷ See Anthony N. Doob & Voula Marinos, *Reconceptualizing Punishment: Understanding the Limitations on the Use of Intermediate Punishments*, 2 U. CHI. L. SCH. ROUNDTABLE 413, 414, 433 (1995).

²⁷⁸ See William S. Lerach, *Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders*, 8 STAN. J.L. BUS. & FIN. 69, 121 (2002).

alternative sanctions “must be devised and implemented in a manner that is sensitive to their complex meanings in . . . society.”²⁷⁹

This article, therefore, submits that a conviction administered in conjunction with a shaming penalty will fulfill both aspects of optimal sanctioning, in addition to imposing only a minimal financial burden on the criminal justice system. Public embarrassment, known as shaming, has been an accepted form of punishment for centuries.²⁸⁰ It involves a “process by which citizens publicly and self-consciously draw attention to the bad dispositions or actions of an offender, as a way of punishing [the offender] for having those dispositions or engaging in those actions.”²⁸¹ The goals of shaming sanctions are two-fold: first, they enable community activism in crime control by serving as a conduit for society’s disapproval; second, they seek to invoke remorse in the offender and to deter future wrongdoing.²⁸² Because they are thought to serve both purposes well, shaming sanctions have reappeared sporadically in the United States.²⁸³

While there is no consensus in scientific circles on the innateness of shame and the existence of universal emotions,²⁸⁴ it is nonetheless well accepted that there is

²⁷⁹ Doob & Marinos, *supra* note 277, at 433.

²⁸⁰ John B. Owens, *Have We No Shame?: Thoughts of Shaming, “White Collar” Criminals, and the Federal Sentencing Guidelines*, 49 AM. U. L. REV. 1047, 1047 (2000). Even though the concept is long-standing, the practice itself has evolved. Nowadays, public embarrassment “[does] not often assume the lurid shapes [it] took in the early-modern or Maoist worlds. In particular, modern American shame sanctions lack the air of physical violence that has commonly hung about the shame sanctions of other times and places.” James Q. Whitman, *What is Wrong With Inflicting Shame Sanctions?*, 107 YALE L.J. 1055, 1056 (1998).

²⁸¹ Dan M. Kahan & Eric A. Posner, *Shaming White-Collar Criminals: A Proposal for Reform of the Federal Sentencing Guidelines*, 42 J.L. & ECON. 365, 368 (1999).

²⁸² Allison Morris, *Revisiting Reintegrative Shaming*, RESTORATIVE JUSTICE ONLINE (Sept. 2001), <http://www.restorativejustice.org/10fulltext/morris>.

²⁸³ Whitman, *supra* note 280, at 1056.

²⁸⁴ Some commentators observe that American culture has become shameless and thus view shaming sanctions as largely ineffective. Toni M. Massaro, *The Meanings of Shame: Implications for Legal Reform*, 3 PSYCHOL. PUB. POL’Y & L. 645, 650 (1997) (“Social critics and journalists warn that we have ceased to be embarrassed, let alone mortified, by immorality, irresponsibility, ignorance, sexual infidelity or crudity, unethical and illegal behavior, or revelation of what were once regarded as highly intimate matters.”). Others acknowledge that shame, as a psychological concept, is little understood and subject to many variations, but still maintain that it is in fact innate. *Id.* at 648.

a pronounced relationship between shame and the biologically-driven pursuit for social esteem.²⁸⁵ At some point in human psychological development, people are bound to compare themselves to others. With this evaluation comes the “pain of unfavorable comparisons, as . . . there are others who are bigger, stronger, and more competent”²⁸⁶ Regardless of whether it is innate or not, shame results from a recognition of one’s own limitations and is “an inevitable byproduct of maturation”²⁸⁷

Shaming sanctions are highly applicable to insider-trading cases. Whereas shame is a “*highly* context-, individual-, and culture-dependent emotion,”²⁸⁸ reputation and the loss of reputation are of particular importance to inside traders, who are unlikely to take challenges to their public images lightly.²⁸⁹ Studies strongly suggest that, for corporate offenders, “fear of being shamed before their family members and peers may even exceed the fear of criminal prosecution, exposure to civil lawsuits, or other forms of officially imposed sanctions.”²⁹⁰ This trend highlights the fact that, aside from channeling public condemnation, shaming sanctions also have a substantial deterrent effect in their own right.²⁹¹

Once it is established that inside traders are very amenable to shaming, the challenge for the criminal justice system is to properly determine the circumstances that will best trigger the emotion in the wrongdoer.²⁹² Generally, there are two types

²⁸⁵ *Id.* at 658–59.

²⁸⁶ *Id.* at 661.

²⁸⁷ *Id.* at 661.

²⁸⁸ *Id.* at 672 (emphasis in original).

²⁸⁹ Jayne W. Barnard, *Reintegrative Shaming in Corporate Sentencing*, 72 S. CAL. L. REV. 959, 966 (1999) (“In such a community, information travels, impressions are formed and hardened, loyalties are tested, and reputations are built and dismantled, extremely efficiently, often with just a few phone calls. In a rarefied community such as this, the role of reputation is significant.”).

²⁹⁰ *Id.* at 967.

²⁹¹ See Raymond Paternoster & Sally Simpson, *Sanction Threats and Appeals to Morality: Testing a Rational Choice Model of Corporate Crime*, 30 LAW & SOC’Y REV. 549, 572 (1996).

²⁹² Massaro, *supra* note 284, at 662 (citing SILVAN S. TOMKINS, AFFECT, IMAGERY CONSCIOUSNESS: VOL. II: THE NEGATIVE AFFECTS 187 (1963)) (explaining that there is no ascertainable relationship between the existence of shame in general and the prediction of its exact occurrences).

of shaming: stigmatic and reintegrative.²⁹³ In the simplest terms, stigmatic shaming draws a permanent line between the offender and society.²⁹⁴ In contrast, reintegrative shaming envisions a ritual that condemns the offender's misconduct with the ultimate goal to reintegrate the offender back into the community and to encourage the offender to "attend to the moral claims of the criminal law"²⁹⁵ Supporters of reintegrative shaming stress that this type of sanctioning is more socially productive in that it does not aim to create outcasts.²⁹⁶ They further argue that reintegrative shaming will result in fewer offenses: "[M]oralizing which then leaves agency in the hands of the citizen is more likely to work in the long run than a policy of attempting to remove agency from the citizen by repressive control."²⁹⁷

Consider the possibility of a judge requiring an offender's family members and professional contacts to attend the sentencing ceremony where the judge expresses the community's condemnation of the offender's act.²⁹⁸ The sentencing judge may also demand a public statement by the offender, in which the offender admits to having traded on inside information, details the related misconduct, and expresses strong personal remorse.²⁹⁹ Alternatively, a judge might order later shaming by requiring the offender "every business day to ring the opening bell at the stock exchange while wearing [a] prison jumpsuit."³⁰⁰ Requiring an offender "to

²⁹³ Nathan Harris & Shadd Maruna, *Shame, Shaming and Restorative Justice: A Critical Appraisal*, in HANDBOOK OF RESTORATIVE JUSTICE: A GLOBAL PERSPECTIVE 452, 452 (Dennis Sullivan & Larry Tiffitt eds., 2006).

²⁹⁴ *Id.* at 453.

²⁹⁵ JOHN BRAITHWAITE, CRIME, SHAME AND REINTEGRATION 9 (1989). An offender who refuses to do so will continue facing social disapproval. *See id.* at 9-10.

²⁹⁶ *See* John Braithwaite, *Shame and Modernity*, 33 BRIT. J. CRIMINOLOGY 1, 1 (1993).

²⁹⁷ BRAITHWAITE, *supra* note 295, at 10; Harris & Maruna, *supra* note 293, at 453.

²⁹⁸ This approach builds on the work of Barnard, *supra* note 289, at 966-84. Barnard focuses on white-collar criminals generally and discusses shaming in situations in which a corporation, rather than a particular individual, is sentenced for violations of federal law. *See id.* Unlike this article, Barnard's approach also assumes that shaming sanctions will be administered in conjunction with imprisonment. *See id.*

²⁹⁹ *See id.*

³⁰⁰ Douglas Berman, *What Will Deter Insider Trading?*, TIME (Oct. 18, 2011), <http://ideas.time.com/2011/10/18/what-will-deter-insider-trading/>.

wear publicly a sign saying 'I am a thief'³⁰¹ may be more productive in preventing insider trading than escalated incarceration.

IV. CONCLUSION

This article attempts to shed light on the profound deficiencies in insider-trading law and regulation and identifies ways in which these deficiencies can be overcome. Unlike other types of white-collar crime, insider trading is not conclusively harmful and may in fact be beneficial. Until this hypothesis is fully tested, though, the government's sweeping crackdown on the practice seems rushed and misguided. Even if insider trading is indeed harmful, the government's preferred path to deterrence is unnecessarily wasteful. Either way, insider trading is one area of white-collar criminal law where reform is truly needed.

³⁰¹ *Id.*