DO FEDERAL COURTS HAVE CONSTITUTIONAL AUTHORITY TO ADJUDICATE CRIMINAL INSIDER-TRADING CASES?

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TABLE OF CONTENTS

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I. INTRODUCTION

Nullum crimen sine lege. This Latin expression captures a bedrock principle of Western legal thought: No crime (not *malum per se*)[1] without law. In this context, law for the federal government of the United States has meant a properly enacted congressional bill or joint resolution (except for a proposed constitutional amendment), signed by the President, defining the elements of criminal conduct with sufficient

1. *See* J.R. LUCAS, ON JUSTICE 116 (1980) [hereinafter LUCAS, ON JUSTICE] ("The war criminals of Nuremberg did not need a statute to tell them that genocide was wrong.").

precision that it provides notice of what is prohibited to a person of ordinary intelligence.[2] The increasingly vigorous federal criminal enforcement of insider trading[3] runs counter to these fundamental principles. As currently enforced by federal courts, insider trading is a crime not defined by nor mentioned in any federal criminal statute.[4] Its modern development originated from enforcement of an administrative agency regulation that does not define insider trading, and the regulation's interstices have been broadened and deepened by the agency and federal judges announcing criminal insider-trading rules case-by-case—that is, enforcing *federal criminal common law.*

The central concern of this Article is the federal enforcement of a legal rule against insider trading through criminal common law.[5] Its

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2. The argument for prior notice of criminal conduct is one for liberty, not for justice. "It is a great enhancement of liberty to have all the laws written down explicitly and not locked up in the hearts of judges, no matter how just." *Id.* at 143. The essence of this idea is captured in words engraved in Langdell Hall at Harvard Law School, read each year by the Harvard University president to the Law School graduating class: "You are ready to aid in the shaping and application of *those wise restraints that make men free.*" Drew Faust, *Wise Restraints*, HARV. MAG. (Jan.–Feb. 2016) (emphasis added), http://harvardmagazine.com/2015/12/wise-restraints.

3. "The prosecution of insider trading violations has been more vigorous in the United States than in any other country." Daniel James Standen, *Insider Trading Reforms Sweep Across Germany: Bracing for the Cold Winds of Change*, 36 HARV. INT'L L.J. 177, 179 (1995); *see also* Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 859 n.11 (1983) ("Th[e] relative absence of enforcement may be changing [circa 1983] with the recent crusade of the SEC against insider trading." (second alteration added)).

4. *But see* Stop Trading on Congressional Knowledge Act of 2012 ("STOCK Act"), Pub. L. No. 112-105, §§ 4, 9, 126 Stat. 291, 292–93, 297–98 (to be codified in scattered sections of 15 U.S.C. and 5 U.S.C. app.) (neglecting to define elements of insider trading but affirming that members and employees of Congress, executive branch employees, judicial employees, and officers are not exempt from "the *insider trading prohibitions arising under the securities laws*, including section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder" (emphasis added)). The Securities and Exchange Commission (SEC) has used Rule 10b-5 as a basis to bring insider trading civil cases, and prosecutors have used violation of the Rule as a basis to file criminal charges because Congress has made it a crime to violate properly promulgated SEC regulations under the securities laws. Oddly, Rule 10b-5 neither mentions nor defines "insider trading," much less the type of insider-trading fraud prohibited by the Rule. *See infra* Section IV.A.

5. The federal criminal common law of insider trading differs from the general common law of the states.

> At common law, managers and other insiders[, absent 'special facts,'] may trade the stock of public corporations on the basis of their inside information unless obliged by contract not to. Insiders need not disclose what they know. When federal securities laws do not apply (for example, when the transaction does not take place in interstate commerce), this is contemporary law.

FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE thesis is that the federal courts lack constitutional authority to adjudicate criminal common law cases, including insider-trading ones. To provide context for the argument, the Article discusses the issues raised by current legal doctrine of insider trading and the difficulties encountered in the formulation and application of the current legal prohibition against insider trading. It also briefly summarizes economic arguments for and against insider trading in general and current enforcement doctrine in particular. Whether one believes that the case for or against federal criminal or civil enforcement of insider trading has been made—including whether current doctrine is eminently sound or not—in no way affects the merits of the constitutional issue raised by this Article. These are arguments of policy that are best addressed to the legislative branch. To the extent that complexities in doctrinal development of the insider-trading rule are not susceptible to judicial resolution (and I argue they are not), those complexities cut in favor of judicial restraint and discontinuance of continued enforcement of criminal common law in this area in deference to a legislative resolution of both the constitutional issue and the doctrinal complexities. The federal courts should not be sending people to jail for long periods without express and specific statutory authority from Congress.

In recent years, there has been considerable debate among practitioners and jurists over: (i) the authority of federal courts to decline to enforce SEC neither-admit-nor-deny settlements that contain requests for injunctive relief without adequate factual support;[6] (ii) the fairness and constitutionality under the appointments clause of the SEC administrative law judges (ALJ);[7] (iii) the announced intent of the

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LAW 264 (1991) (footnote omitted); *see also* Carlton & Fischel, *supra* note 3, at 883 ("The general common law rule is that insider trading in publicly traded corporations is permitted." (citing Goodwin v. Agassiz, 186 N.E. 659 (Mass. 1933))).

6. *See, e.g.*, SEC v. Citigroup Glob. Mkts., Inc., 752 F.3d 285, 293–95 (2d Cir. 2014).

7. U.S. CONST. art. II, § 2, cl. 2. All courts of appeals that have considered this issue have denied district court jurisdiction to consider collateral constitutional challenges to the SEC administrative appointments process and have required that respondents go through that process and then raise their challenge on appeal from an SEC final order. *See* Bennett v. SEC, 844 F.3d 174, 177–78, 188 (4th Cir. 2016); Gray Fin. Grp., Inc., v. SEC, 825 F.3d 1236, 1237–38 (11th Cir. 2016); Tilton v. SEC, 824 F.3d 276, 279 (2d Cir. 2016); Jarkesy v. SEC, 803 F.3d 9, 15 (D.C. Cir. 2015) (denying jurisdiction to review constitutional issue); Bebo v. SEC, 799 F.3d 765, 775 (7th Cir. 2015), *cert. denied*, 136 S. Ct. 1500 (2016); Altman v. SEC, 687 F.3d 44, 46 (2d Cir. 2012) (per curiam); Duka v. SEC, 103 F. Supp. 3d 382 (S.D.N.Y. 2015), *abrogated by Tilton*, 824 F.3d at 281.

The District of Columbia Circuit in a case that raised the constitutional issue after respondents completed the SEC administrative process denied the petition for review of the SEC decision. The Court of Appeals upheld the constitutionality of the SEC ALJ appointments process. Raymond J. Lucia Cos. v. SEC, 832 F.3d 277, 296 (D.C. Cir.

SEC to make greater use of its internal administrative process for insider-trading cases;[8] (iv) the evidence required to prove the element of trading "on the basis of" inside information;[9] and (v) the nature and precise contours of the personal-benefit element in insider-trading cases discussed in this Article.[10]

Surprisingly, while the courts and litigants have focused on a host of procedural and substantive issues about securities litigation, and on the substantive elements of criminal insider-trading law, there has hardly been any discussion of the fundamental issue of whether federal courts even have constitutional authority to decide *criminal common law* insider-trading cases.[11] In the early constitutional history of the United States, the issue of whether federal courts had constitutional authority to decide common law criminal cases was a matter of great constitutional debate between the Federalists and Anti-Federalists.[12] In 1812, the Supreme Court resolved that issue, holding that the federal courts lack constitutional authority to enforce criminal common law.[13] The rationale was that the general common law of England was not deemed to be part of "the Laws of the United States" under the Constitution.[14] While few, if any, would today deny that Congress has constitutional authority to enact a statute making insider trading a crime—because of powers specifically granted to the national legislature in Article I of the Constitution coupled with the "necessary and proper" clause of that article—the federal courts, and even the

2016). The Court of Appeals ruled that the SEC ALJs were not constitutional "inferior Officers" because they lack authority to issue final orders, and that by delegated statutory authority and rule-making the SEC has reserved only to the Commission "the sovereign power" to make "the final decision." *Id.* at 285–87. In a December 27, 2016 decision, the Tenth Circuit has created a circuit conflict by ruling that the SEC ALJs are "inferior Officers" within the meaning of the Constitution, and the process by which they are appointed to preside over SEC administrative proceedings violates the appointments clause. Bandimere v. SEC, 844 F.3d 1168, 1188 (10th Cir. 2016). On February 16, 2017, the District of Columbia Circuit granted rehearing *en banc* in *Raymond J. Lucia Cos.*

8. *See* Part IV & Part V.

9. *See* Part IV & Part V.

10. *See* United States v. Parigian, 824 F.3d 5, 15–16 (1st Cir. 2016); United States v. Salman, 792 F.3d 1087, 1092 (9th Cir. 2015), *aff'd*, 137 S. Ct. 420 (2016); United States v. Newman, 773 F.3d 438, 445–46 (2d Cir. 2014) (*Newman II*), *abrogated in part by* 137 S. Ct. 420 (2016).

11. For an earlier discussion of this issue based on the delegation doctrine, see generally Otto G. Obermaier & Robert Berezin, *SEC Now Defining Crimes?*, N.Y.L.J., July 10, 2000.

12. *Cf.* Stewart Jay, *Origins of Federal Common Law: Part One*, 133 U. PA. L. REV. 1003, 1003 (1985) (citing Turner v. Bank of N. Am., 4. U.S. (4 Dall.) 8, 11 (1799)).

13. United States v. Hudson, 11 U.S. (7 Cranch) 32, 34 (1812).

14. U.S. CONST. art. III, § 2, cl. 1.

Supreme Court (as the only federal court mandated by the Constitution), lack such law-making power under Article III. As a result, it is as improper for the federal courts to assert such unauthorized power as it is for Congress to acquiesce to such conduct through deliberate decisions not to exercise its constitutional authority to pass appropriate legislation.[15]

For more than 200 years, Supreme Court precedents have concluded that federal courts lack authority to adjudicate cases based on common law crimes. Since insider trading, as currently enforced by federal courts, is conceded by nearly all to be a common law crime, the Supreme Court, in deciding the *Salman* case,[16] for the second time since

15. "In 1984, the Congress, consistent with the views of the [SEC] Commission's then-Director of Enforcement, expressly declined to include a definition of the predicate offense of 'insider trading' in the Insider Trading Sanctions Act of 1984 . . . ." Harvey L. Pitt & Karen L. Shapiro, *The Insider Trading Proscriptions Act of 1987: A Legislative Initiative for a Sorely Needed Clarification of the Law Against Insider Trading*, 39 ALA. L. REV. 415, 416 (1988); *see also* Carlyle H. Dauenhauer, *Justice in Equity*: Newman *and Egalitarian Reconciliation for Insider-Trading Theory*, 12 RUTGERS BUS. L. REV. 41, 44 (2015) ("Nowhere in contemporary legal statutory codification, upon which federal courts convict for insider trading, is the specific crime of insider trading definitively outlined and circumscribed."); Allan Horwich, *Possession Versus Use: Is There a Causation Element in the Prohibition on Insider Trading?*, 52 BUS. LAW. 1235, 1258 (1997) ("Congress has never enacted a definition of unlawful insider trading. This is not for lack of proposals."); Harvey L. Pitt et al., *Problems of Enforcement in the Multinational Securities Market*, 9 U. PA. J. INT'L BUS. L. 375, 382 (1987) ("Nowhere in the federal securities laws does there appear a definition of insider trading. Rather, the SEC and the courts have shaped an evolving definition of the offense."). *But see* Lewis v. United States, 523 U.S. 155, 180 (1998) (Scalia, J., concurring in judgment) ("The structure of the criminal law, like the basic categories of human vice, has remained quite stable over the centuries. There have been a few genuine innovations recently; I have in mind, for example, antitrust or securities crimes, which did not exist in 1825. But Congress has been the principal innovator in most of those areas, and I doubt that courts will confront many new 'offence' candidates that are not already covered by the federal criminal law."). Justice Scalia is clearly more right with respect to antitrust.

16. United States v. Salman, 792 F.3d 1087 (9th Cir. 2015). Without doing so directly and expressly, *Salman* had invited the Court to consider the constitutional issue discussed in this Article. Counsel for Salman invited the Court to consider whether there is statutory authority to prohibit insider trading. *See* Brief for Petitioner at 22–24, 36–37, 39–40, *Salman*, No. 15-628 (U.S. filed May 6, 2016) ("If the Court were inclined to reconsider its prior cases, it could readily hold, based on the plain language of the statute, that §10(b) does not prohibit insider trading at all – at least in the usual case where transactions are conducted anonymously in public markets, with no interaction with or deception of a counterparty."). Without statutory authority, the constitutional issue is squarely presented. Neither the statutory nor the constitutional issue, however, had been raised in the lower courts in *Salman*, and thus those issues were not preserved for appellate review.

The lower courts, participants in the securities markets, and their legal advisors

1980 passed up the opportunity to resolve the fundamentally important question regarding the authority of federal courts to enforce criminal insider-trading law either by applying its earlier precedents or by articulating the reasons why they are inapplicable as a result of specific congressional authority. In *United States v. Chestman*,[17] Judge Ralph Winter noted the Court's first missed opportunity in *Chiarella v. United States*[18] to address the issue regarding the statutory source for a prohibition against insider trading.[19] In deciding *Salman*—after a nearly twenty-year absence from deciding criminal insider-trading cases, a period during which lower federal courts and litigants and their advisors struggled to make sense of the legal rules from the Court's precedents—*Salman* provided the occasion for much-needed clarification of the SEC's statutory authority to ban insider trading and the federal courts' constitutional jurisdiction to enforce the insider-trading rules as criminal law governing a core area of our free-enterprise system.[20]

II. THE REJECTION OF THE DOCTRINE OF FEDERAL COMMON LAW CRIMES

Enforcement of federal criminal common law runs counter to Supreme Court rulings since 1812.[21] Like the judicially created *Swift v.*

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would doubtless have benefited from the Court's explanation of why the structure of the securities laws in general and the text of section 10(b) of the Exchange Act in particular support enforcement of a rule against insider trading. Regrettably, unanimously deciding *Salman* on the narrowest of grounds, the Court failed to provide any guidance to the lower courts on the nature of the personal-benefit element of the crime other than to hold that that element is present where closely-knit family members share confidential corporate information for the purpose of trading.

17. 947 F.2d 551 (2d Cir. 1991) (en banc). Judge Winter's statement is quoted *infra* at note 233.

18. 445 U.S. 222 (1980).

19. *Chestman*, 947 F.2d at 575.

20. Since the issue goes to the fundamental allocation of constitutional authority between the federal courts and Congress, and the courts' jurisdictional authority to decide a class of cases, the Court need not wait for a party expressly to raise the issue to decide it. Whether the Court should decide the issue with or without requesting that the parties specifically brief it is worthy of consideration, although the importance of the constitutional issue makes the overriding consideration "whether the opinion is sound, not whether it manifested an '*ex cathedra approach*.'" Henry J. Friendly, *In Praise of* Erie *– and of the New Federal Common Law*, 39 N.Y.U. L. REV. 383, 399 n.71 (1964) (emphasis added) (citation omitted).

21. United States v. Coolidge, 14 U.S. 415, 415 (1816); United States v. Hudson, 11 U.S. (7 Cranch) 32, 34 (1812) ("The legislative authority of the Union must first make an act a crime, affix a punishment to it, and declare the Court that shall have jurisdiction of the offence."); United States v. Worrall, 2 U.S. (2 Dall.) 384, 394 (C.C. Pa. 1798) (expressing views, in an opinion by Justice Samuel Chase, as a Circuit judge on "circuit-

Tyson doctrine,[22] which allowed federal courts to create an independent body of federal common law enforced by federal courts for ninety-six years without constitutional authority,[23] it is time to reconsider and repudiate federal *criminal* enforcement of insider trading common law.

A. *Origins of the* Hudson *Doctrine*

The *Hudson* doctrine resulted from the hotly contested political dispute between the Hamiltonian Federalists and the Jeffersonian Republicans. Professor Julius Goebel sums up the controversy:

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riding" duties in the Circuit Court for the district of Pennsylvania, against common law criminal jurisdiction of federal courts that the Court later followed in *Hudson* in 1812). For a summary of the *Worrall* decision, see JULIUS GOEBEL, JR., HISTORY OF THE SUPREME COURT OF THE UNITED STATES: ANTECEDENTS AND BEGINNINGS TO 1801, at 631–32 (1971). I will refer to these rulings as the "*Hudson* doctrine."

Although the Supreme Court reports do not reflect that there was a dissent from the Court's ruling in *Hudson*, it is likely that three of the seven Justices dissented. Justice Joseph Story, although an appointee of President Madison, and a Jeffersonian, sided with the Court's two Federalists, John Marshall and Bushrod Washington, in dissent. WILLIAM W. CROSSKEY, POLITICS AND THE CONSTITUTION IN THE HISTORY OF THE UNITED STATES 782 (1953). Justice Washington's dissent seems a bit odd because in 1805 he had taken an apparently inconsistent position: "I am not one of those who think it a commendable quality in a judge, to enlarge, by construction, the sphere of his jurisdiction." *Ex parte* Cabrera, 4 F. Cas. 964, 966 (1805), *quoted in* Charles Warren, *New Light on the History of the Federal Judiciary Act of 1789*, 37 HARV. L. REV. 49, 68 n.45 (1923)). Justice William Johnson's opinion for the Court in *Hudson* does make clear that it "is the opinion of the majority of this Court." *Hudson*, 11 U.S. at 33.

The *Hudson* doctrine has been accepted since 1812. *See* ROBERT H. JACKSON, THE SUPREME COURT IN THE AMERICAN SYSTEM OF GOVERNMENT 31 (1955) ("In 1812, the Supreme Court put to rest the division of opinion which had theretofore prevailed and held that the courts of the United States have no common law criminal jurisdiction."); L.B. Schwartz, *Federal Criminal Jurisdiction and Prosecutors' Discretion*, 13 LAW & CONTEMP. PROB. 64, 64 (1948) ("[T]he great bulk of federal criminal activity rests upon the constitutional power of Congress to enact laws 'necessary and proper' to the execution of specifically conferred powers, for there are no common-law crimes in federal jurisprudence."); *see also* 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, 1878 (1992) ("Early in the legal history of the United States, the separation of powers doctrine was interpreted to bar federal judges from creating common law crimes (as they did in Great Britain). But even apart from our unique constitutional context, in all common law countries, advance legislative specification today constitutes a fundamental prerequisite to a criminal prosecution." (citing United States v. Coolidge, 14 U.S. 415 (1816); United States v. Hudson, 11 U.S. (7 Cranch) 34 (1812))).

22. *See* 41 U.S. 1, 19 (1842). *Swift*, authored by Justice Joseph Story, was based, as it turned out, on what some would later claim was an erroneous interpretation of section 34 of the Judiciary Act of 1789. *See infra* Part VI.

23. *Swift*, 41 U.S. at 19, *overruled by* Erie R.R. Co. v. Tompkins, 304 U.S. 64, 78 (1938) ("There is no federal general common law.").

> The criminal jurisdiction of the Circuit Courts was insulated by the fact that the Congress did not see fit to provide for [a writ of] error—not even in prosecutions for misdemeanor long permitted in English law. Criminal procedure was left by Congress so far at large that in this area the Circuit Courts were free within the limits of the Bill of Rights to effect a reception of common law practices. The list of crimes against the United States was an attenuated one, and but for the addition of the Sedition Act in 1798, the administration of the criminal law was a matter neither of public solicitude nor of great public interest. It was a partisan wrath over the enforcement of this new act that was to bring on a calculated wave of criticism against the Circuit Courts and eventually to raise the issue of a federal common law, to lead to an attempted disherison of judicial review and to become a ponderable factor in the later assault upon the federal judicia[ry].[24]

To put it mildly, the enactment of the Alien and Sedition Acts of 1798 by the Federalists was a source of considerable anger among Jeffersonians.[25] The law provided for federal prosecutions for seditious libel of public officials.[26] In enacting this statute, the Federalists intended to protect the federal government, the President, and both houses of Congress from the "false scandalous and malicious" writings that they claimed the Jeffersonians distributed about the Federalists.[27] To make the law less controversial, the Sedition Act of 1798 departed from the common law of criminal libel in two ways: first, it made truth a defense to the charge, and, second, it permitted the jury to determine both the law and the facts with guidance from the judge.[28] As a result, one argument in support of the Sedition Act of 1798 was that it liberalized the common law of England adopted by the Constitution because, at common law, truth was not a defense to criminal libel, and the jury was confined to determine the facts regarding publication of the charged libel.[29]

Paradoxically, the liberalizing function allocated to the jury in the Sedition Act of 1798 posed a difficulty that the Federalists initially had to overcome in response to a "major assault on the constitutionality" of

24. GOEBEL, *supra* note 21, at xix.
25. *See id.* at 654.
26. *See id.* at 646.
27. *Id.* at 634.
28. *Id.* at 635.
29. *See id.* at 636.

that law mounted in *United States v. Callender* in 1800.[30] Because the jury could decide both issues of fact and law, the Jeffersonians sought to have the jury declare the statute unconstitutional.[31] They argued in *Callender* that if "the law under which defendant [Callender] was prosecuted was an infraction of the Constitution, it was without legal vigor, and if defendant was guilty under such an act, the jurymen would be violating their oaths."[32] Anticipating that argument, the well-prepared Federalist Justice Samuel Chase, presiding in that case at the Circuit Court for the Virginia district, dismissed counsel's argument as a non sequitur. Justice Chase's opinion, which he read from the bench, would later provide much of the basis for Chief Justice Marshall's ruling in *Marbury v. Madison*.[33] In the view of Justice Chase, only the federal courts had the judicial power to decide whether an act of Congress was contrary to the federal Constitution.[34] In this vortex of political and constitutional controversy, the Court would later decide the *Hudson* case by following the rationale of another ruling by Justice Chase to create, what I have characterized as, the *Hudson* doctrine.[35]

B. *The* Hudson *Decision*

The *Hudson* case was the product of a common law seditious libel case out of the district of Connecticut.[36] This case, and others like it from Connecticut, presented several problems for the Jeffersonians.[37] To begin with, there was political awkwardness for the Jeffersonians, who then were in power, to vigorously enforce a law that they had

30. *Id.* at 648. *See generally* United States v. Callender, 25 F. Cas. 239 (C.C.D. Va. 1800).
31. GOEBEL, *supra* note 21, at 649.
32. *Id.* at 649.
33. *See id.* at 650 nn.146–47.
34. *See id.* at 650–51.
35. United States v. Hudson, 11 U.S. (7 Cranch) 32, 33 (1812).
36. *See id.*
37. It also presented a personal problem for President Jefferson. CROSSKEY, *supra* note 21, at 767. One of the five cases brought in the district of Connecticut against a minister involved the utterance during a sermon of an alleged sexual indiscretion by Jefferson. The statement was apparently true and could probably have been proven true by the defendant in that case. *See id.* at 781. The minister refused to demur to the charge and insisted on pleading not guilty, no doubt confident that his defense of truth would prevail at trial. *Id.* at 777. President Jefferson, who insisted that truth be allowed as a defense in the Connecticut cases, may not at first have been aware of the nature of the charge against the minister. *Id.* at 780–81. Jefferson later learned the nature of the case. *Id.* at 781. That case was eventually dismissed by the United States attorney with a *nolle prosequi*. *Id.*

denounced vehemently when used against them by the Federalists.[38] That, however, was not their most difficult problem. In truth, their objective in using the law was to strike a deathblow at the heart of the constitutional foundation of the doctrine of common law crimes that the Federalists had adopted to enforce the Sedition Act of 1798.[39] More practically, the challenge the Jeffersonians therefore faced was to have the grand jury return the indictments and to create a conflict of view between the Circuit Court justice and the district judge on the merits of the prosecution. This would then serve as a test case subject to Supreme Court review that would ultimately decide whether the federal courts were authorized by the Constitution to adjudicate common law crimes.[40] And the timing of this had to be such that the case would reach the Court when the justices appointed by Jefferson were in the majority—a goal finally achieved in September 1810.[41] With luck and disingenuous conduct,[42] the Jeffersonians accomplished their objective, producing a ruling whose rationale has withstood the test of time and has been strongly praised.

Messrs. Hudson and Goodwin, publishers of *The Connecticut Courant* in Hartford, were charged with having republished a libelous article against President Jefferson and the Congress that had been printed in another paper.[43] More specifically, the charge against the defendants was a libel against the President and Congress for alleging that they had voted in secret to grant $2 million to Napoléon Bonaparte for permission for the United States to enter into a treaty with Spain.[44] This was a federal indictment in the Circuit Court, but there was no substantive federal statute in effect at the time.[45] The Sedition Act of 1798, which remained in force until March 3, 1801, was not applicable when Hudson and Goodwin were indicted in September 1806.[46] However, Connecticut, a strong Federalist state during the highly contentious election of 1800 (which ultimately resulted in the selection of Jefferson as president by the House of Representatives), had followed the Federalist position in the Sedition Act of 1798 in enacting a sedition

38. *See id.* at 767.
39. *See id.* at 766.
40. *See id.* at 766–67.
41. *Id.* at 766.
42. The story of how and why the *Hudson* case, decided in the Circuit Court in 1808, did not reach the Court until its 1812 session, is recounted at *id.* at 766–84; it does not show the Jeffersonians at their finest hour.
43. *Id.* at 772.
44. United States v. Hudson, 11 U.S. (7 Cranch) 32, 32 (1812).
45. *Id.*
46. Jay, *supra* note 12, at 1013.

law in 1804.[47] In the *Hudson* case, the Court ruled that the charge was governed by the Connecticut libel law of 1804 (one of many questionable rulings and conduct engaged in by the presiding district judge, Pierpont Edwards—a Jefferson appointee).[48] That law permitted truth as a defense to criminal libel.[49]

In March 1808, the two judges of the Circuit Court (District Judge Edwards and Justice Henry Livingston) were divided on the question of "whether the Circuit Court of the United States had a common law jurisdiction in cases of libel."[50] The question was eventually certified to the Court at its 1812 session by the clerk of the Connecticut Circuit Court (Judge Edwards's son).[51] The Court, in an opinion by Justice William Johnson, reformulated the lower-court certified issue:

> The only question which this case presents is, whether the Circuit Courts of the United States can exercise a common law jurisdiction in criminal cases. We state it thus broadly because a decision on a case of libel will apply to every case in which jurisdiction is not vested in those Courts by statute.[52]

The Court's rationale for its decision was straightforward:

> The course of reasoning which leads to this conclusion is simple, obvious, and admits of but little illustration. The powers of the general Government are made up of concessions from the several states—whatever is not expressly given to the former, the latter expressly reserve. The judicial power of the United States is a constituent part of those concessions,—that power is to be exercised by Courts organized for the purpose, and brought into existence by an effort of the legislative power of the Union. Of all the Courts which the United States may, under their general powers, constitute, one only, the Supreme Court, possesses jurisdiction derived immediately from the Constitution, and of which the legislative power cannot deprive it. All other Courts created by the general Government possess no jurisdiction but what is given them by the power that creates

47. CROSSKEY, *supra* note 21, at 770.
48. *Id.* at 770–71.
49. *Id.* at 770. Judge Edwards relied on section 34 of the Judiciary Act of 1789 for his questionable ruling. *See* CROSSKEY, *supra* note 21, at 770–74. For the history of early prosecutions for common-law crime, see GOEBEL, *supra* note 21, at 623–61.
50. *Hudson,* 11 U.S. at 32 (emphasis omitted).
51. *Id.*; CROSSKEY, *supra* note 21, at 781–82.
52. *Hudson,* 11 U.S. at 32.

> them, and can be vested with none but what the power ceded to the general Government will authorize them to confer.
>
> It is not necessary to inquire whether the general Government, in any and what extent, possesses the power of conferring on its Courts a jurisdiction in cases similar to the present; it is enough that such jurisdiction has not been conferred by any legislative act, if it does not result to those Courts as a consequence of their creation.[53]

While denying common-law jurisdiction in criminal cases, the Court in *Hudson* made clear that "implied powers must necessarily result to our Courts of justice from the nature of their institution."[54] Thus, "[t]o fine for contempt—imprison for contumacy—inforce the observance of order . . . are powers which cannot be dispensed with in a Court, because they are necessary to the exercise of all others."[55] The Court concluded that these are among the non-statutory powers "our Courts no doubt possess . . . but all exercise of criminal jurisdiction in common law cases we are of opinion is not within their implied powers."[56]

C. *Judicial Support for the* Hudson *Doctrine*

The controversy in the late eighteenth and early nineteenth century over whether federal courts had criminal common-law jurisdiction was among the most contentious issues separating the Hamilton Federalists from the Jeffersonian Anti-Federalists, also known as the Republicans.[57] The Hamilton Federalists strongly in favor of, and the Jeffersonian Republicans strongly opposed to, the assertion of jurisdiction vigorously debated and argued their respective views.[58] In 1812, the Court resolved the issue in *Hudson* in favor of the Republican position.[59] In the *Hudson* opinion, Justice Johnson stated, "Although

53. *Id.* at 33.
54. *Id.* at 34.
55. *Id.*
56. *Id.*
57. CROSSKEY, *supra* note 21, at 764–84; 1 CHARLES WARREN, THE SUPREME COURT IN UNITED STATES HISTORY 190–91 (1937) ("The action of the United States Courts in asserting a jurisdiction to try persons indicted at common law was regarded by the Anti-Federalists as an extension of Federal authority and a prostration of State sovereignty not to be tolerated.").
58. 1 WARREN, *supra* note 57, at 206.
59. *Hudson,* 11 U.S. at 34. The shenanigans and fortuitous circumstances that resulted in having this case presented to the Court at its 1812 session, when the Jeffersonians had a safe "majority in power," are described in CROSSKEY, *supra* note 21, at

this question is brought up now for the first time to be decided by this Court, we consider it as having been long since settled in public opinion."[60]

In 1955, Justice Robert Jackson, as indicated above, noted in a lecture the settled ruling of the *Hudson* doctrine and expressed no disagreement.[61] In 1964, in his famous article about *Erie,* Second Circuit Judge Henry Friendly, like Justice Chase, expressed agreement with the principle of the *Hudson* case: "[I]f all the grants of judicial power in Article III imply power in the federal courts to make substantive law for their disposition, some rather famous cases may have been wrongly decided."[62] In 2014, in an insider trading case where the Court denied certiorari, Justices Antonin Scalia and Clarence Thomas expressed agreement with the fundamental rationale of the *Hudson* doctrine—only Congress can "define crimes and fix punishments."[63] The *Hudson* doctrine therefore has been firmly entrenched in our jurisprudence since 1812.[64]

III. THE DEVELOPMENT OF FEDERAL INSIDER-TRADING LAW

For more than fifty years, however, the federal courts, contrary to the *Hudson* doctrine, have enforced insider trading criminal common

770–82. Warren, however, credits "the Federalist Judge, Samuel Chase," with having provided support for this outcome, probably referring to his ruling in the Circuit Court case of *Worrall* in April 1798. Warren, *supra* note 21, at 73. It bears noting that Crosskey characterizes Justice Chase as "the anti-Jeffersonian Anti-Federalist." CROSSKEY, *supra* note 21, at 775. Paradoxically, after the election of 1804, the Jeffersonians, to increase the number of Republicans on the Court, impeached Justice Chase—a move that failed to remove him. *Id.* Justice Chase died before the 1812 ruling in *Hudson*. *Id.* at 766.

60. *Hudson,* 11 U.S. at 32.

61. *See* JACKSON, *supra* note 21, at 30–31.

62. Friendly, *supra* note 20, at 395 (citing United States v. Coolidge, 14 U.S. 415 (1816); *Hudson,* 11 U.S. at 32).

63. Whitman v. United States, 135 S. Ct. 352, 354 (2014) (Scalia, J., respecting the denial of certiorari) (discussing denial of certiorari); *see also infra* note 178.

64. The *Hudson* doctrine has not been criticized or undermined in the Court's recent jurisprudence. Welch v. United States, 136 S. Ct. 1257, 1268 (2016) ("[O]nly Congress, and not the courts, . . . can make conduct criminal" (quoting Bousley v. United States, 523 U.S. 614, 620–21 (1998))); United States v. Oakland Cannabis Buyers' Coop., 532 U.S. 483, 490 (2001) ("[U]nder our constitutional system . . . federal crimes are defined by statute rather than by common law . . . ." (citing *Hudson,* 11 U.S. 32)); *Bousley,* 523 U.S. at 621 (citing *Hudson,* 11 U.S. at 32); Lewis v. United States, 523 U.S. 155, 160 (1998) (noting where federal statutory law did not make conduct occurring on "federal enclaves" criminal, "federal courts lacked the power to supplement these few statutory crimes through the use of the common law" (citing *Hudson,* 11 U.S. at 34)). The Court, however, has not yet had occasion in a case squarely presenting the issue to apply the *Hudson* doctrine to criminal prosecutions for insider trading.

law. Some courts concede that

> neither the statute [(section 10(b) of the Exchange Act)] nor the regulations issued pursuant to it, including Rule 10b-5, expressly prohibit insider trading. Rather, the unlawfulness of insider trading is predicated on the notion that insider trading is a type of securities fraud proscribed by section 10(b) and Rule 10b-5.[65]

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65. United States v. Newman, 773 F.3d 438, 445 (2014) (citing Chiarella v. United States, 445 U.S. 222, 226–30 (1980)). When first enacted on May 21, 1942, Rule 10b-5 was patterned on section 17(a) of the Securities Act of 1933 ("1933 Act"). SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring) ("The derivation of Rule 10b-5 is peculiar. Although the authority for the Rule comes from § 10(b) of the Securities and Exchange Act of 1934, the draftsmen turned their backs on the language of that section and borrowed the words of § 17 of the Securities Act of 1933, simply broadening these to include frauds on the seller as well as on the buyer.").

The SEC promulgated Rule 10b-5 to close a then-existing gap in the law. Before that Rule, the only prohibition of fraud in the "sale or purchase" of securities was contained in

> Section 17(a) of the 1933 Act [that] only made it unlawful to defraud or deceive purchasers of securities, and Section 15(c) of the 1934 Act dealt only with fraudulent practices by security brokers or dealers in over-the-counter markets. No prohibition existed against fraud on a seller of securities by the purchaser if the latter was not a broker or a dealer.

Birnbaum v. Newport Steel Corp., 193 F.2d 461, 463 (2d Cir. 1952). Judge Augustus Hand in *Birnbaum* viewed section 16(b) of the Exchange Act as the only statutory provision that "Congress intended to protect the stockholders of a corporation against a breach of fiduciary duty by corporate insiders." *Id.* at 464.

The "peculiar" aspect of Rule 10b-5 to which Judge Friendly alluded in *Texas Gulf Sulphur* is that paragraph two of Rule 10b-5 took section 17(a)(2) of the 1933 Act and turned it into a powerful weapon against insider trading by corporate officers and others and a private damage remedy for both sellers and buyers of securities. Section 17(a)(2) was constrained by "restrictions as to the kinds of plaintiffs, due diligence defenses, a short statute of limitations, or an undertaking for costs that were insisted on by the investment community" and was intended, according to "unanimity among the commentators, including some who were in a peculiarly good position to know, . . . only to afford a basis for injunctive relief and, on a proper showing, for criminal liability, and was never believed to supplement the actions for damages" in other sections of the 1933 Act. 401 F.2d at 867. Rule 10b-5(b) effectively removed the constraints imposed by Congress on section 17(a)(2) of the 1933 Act. It bears noting that "[u]nlike rule 10b-5[, which makes no reference to insider trading], rule 14e-3 is a clear and specific prohibition of insider trading. The rule identifies the type of information on which one may not trade and the sources of such information." Fred D'Amato, Comment, *Equitable Claims to Disgorged Insider Trading Profits*, 1989 WIS. L. REV. 1433, 1439 (1989); *see also* 17 C.F.R. § 240.14e-3 (2016).

While the Court has pretty much upheld enforcement of Rule 10b-5 in civil cases as being authorized by section 10(b) of the 1934 Act, the Court has yet to decide whether

Without a federal statute, the source of substantive insider-trading law is essentially federal common law based on a general congressional statutory delegation that the SEC has interpreted as authority to prohibit insider trading as a fraud and federal court decisions interpreting, applying, and enforcing the SEC interpretation of its regulation as criminal law.[66] Despite its earlier contrary precedents, the Court has not addressed the constitutional source of its authority to enforce a common law crime of insider trading without a federal statute clearly defining the crime.[67]

A. *The Disclose-or-Abstain Rule*

The SEC first enforced the anti-fraud provisions of the federal securities laws against corporate outsiders for the use of inside information—that is, material non-public information obtained from a corporate insider—in *In re Cady, Roberts & Co*.[68] The SEC imposed the duty not to trade on confidential inside information owed by a corporate fiduciary on a partner of a registered broker-dealer, who had acquired that information from a corporate director (who was also a registered representative of the broker-dealer).[69] The confidential information involved an upcoming dividend reduction approved by the board on which the director sat.[70] The SEC standard required disclosure before, or abstention from, trading until the information was disclosed to the market .[71]

Unlike common-law fraud, the SEC rule did not require a relationship creating a fiduciary duty between the trader and the buyers to whom he sold on the exchange market that would impose a

the insider-trading doctrine of Rule 10b-5, when enforced as criminal law, is a common-law crime that federal courts lack constitutional authority to enforce.

66. *See* Steginsky v. Xcelera Inc., 741 F.3d 365, 371 (2d Cir. 2014) ("[T]he fiduciary-like duty against insider trading under section 10(b) is imposed and defined by federal common law . . . ."); Coffee, *supra* note 21, at 1880 ("The law defining insider trading is also wholly judge-made, and has expanded recurrently." (footnote omitted)).

67. In *Chiarella*, "rather than making an *ab initio* determination of whether Section 10(b) prohibited insider trading, the Court described the state of the caselaw in the SEC and lower federal courts, including *Cady, Roberts & Co.* and [*Texas Gulf Sulphur*], and impliedly adopted that caselaw." United States v. Chestman, 947 F.2d 551, 575 (2d Cir. 1991) (Winter, J., concurring in part and dissenting in part) (citing Chiarella v. United States, 445 U.S. 222, 225–30 (1980)).

68. Cady, Roberts, & Co., 40 S.E.C. 907 (1961).

69. *Id.* at 917–18.

70. *Id.* at 907.

71. *Id.* at 911.

duty on the trader to disclose material information.[72] In the SEC's view, a requirement for an affirmative duty to disclose by the director, which would exist only for current company stockholders, would have resulted in an "approach [that] is too narrow," and would have ignored "the plight of the buying public—wholly unprotected from the misuse of special information."[73] In other words, new buyers on a stock exchange must be as protected as existing owners who buy additional stock or sellers who unload stock already owned. Instead, the SEC based the obligation of disclosure on two factors: (1) "the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone"; and (2) "the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."[74]

The courts followed the SEC with adoption and broadening of the catchall "disclose-or-abstain rule" governing insider trading.[75] In *SEC v.*

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72. The SEC's argument involved what logicians call a *petitio principii.* It assumed in the premise what is to be proven, that the director's "relationship to the company clearly prohibited him from selling the securities affected by the information without disclosure." *Id.* at 912. It then imposed a corresponding obligation on the broker-dealer and its partner. *Id.* Apparently, there was no evidence in *In re Cady, Roberts & Co.* that any of the buyers were already stockholders. *See id.* at 913 n.21. Nor was there any evidence they were not stockholders. *Id.* If they were not already stockholders, at common law, a director of the company would not have had any affirmative duty to disclose material information before selling—especially on an exchange market. The cases cited by the SEC to support its position are not to the contrary. *Id.* at 911 n.13 (listing cases). *But see* Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir. 1951) (Hand, J.), *cert. denied*, 341 U.S. 920 (1951) ("When they [director and officers] sold shares, it could indeed be argued that they were not dealing with a beneficiary [assuming a new buyer of the stock], but with one whom his purchase made a beneficiary. That should not, however, have obscured the fact that the director or officer assumed a fiduciary relation to the buyer by the very sale; for it would be a sorry distinction to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary, although he was forbidden to do so, once the buyer had become one."); *Cady, Roberts, & Co.*, 40 S.E.C. at 914 n.23. In this instance, it may be wise to follow the anonymous saying that one should "quote Learned [in *Gratz*] but follow Gus [in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952)]." James Oakes, *Personal Reflection on Learned Hand and the Second Circuit*, 47 STAN. L. REV. 387, 389 n.17 (1995). Like Holmes, whose pithy remarks are eminently quotable, "to quote from [Learned Hand's] opinions is to string pearls." IRVING DILLIARD, THE SPIRIT OF LIBERTY: PAPERS AND ADDRESSES OF LEARNED HAND, at xx (3d ed. 1960). The power of Learned Hand's prose often evoked a persuasive logic that, on rare occasions, was not backed by strict legal doctrine, as was the case in *Gratz.*

73. *Cady, Roberts & Co.*, 40 S.E.C. at 913.

74. *Id.* at 912.

75. SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); *see also* Coffee, *supra* note 21, at 1890 n.41 ("In fact, the first

Texas Gulf Sulphur ("*TGS*"), the Second Circuit held:

> [A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or [if] he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.[76]

To comply with the law as stated in *TGS*, an insider with material nonpublic information must either disclose or abstain from trading on the basis of that information, until it is publicly (and not selectively) disclosed.[77] Like Holmes's overall conception of contract law as an option by the promisor to perform or pay damages,[78] one might think of the disclose-or-abstain insider trading rule as granting the insider "the option of either disclosing the nonpublic information or refraining from trading."[79] In fact, despite the laudable good intentions of those who seek to protect investors from the greed of some insiders by imposing the disclose-or-abstain rule, the rule may accomplish different objectives.[80] Where disclosure of information may result in the loss of its value (despite, or perhaps because of, the potential informative function to investors), an insider may choose neither to disclose nor to trade.[81] Where disclosure is feasible and not harmful to the firm, an insider whose trading gains are lessened by disclosure may decide not to trade.[82] In short, the disclose-or-abstain rule may just lead to a no-trading rule.[83]

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case to define and proscribe insider trading was an administrative decision, and courts have uniformly deferred to it since (properly, in my judgment).").

76. *Tex. Gulf Sulphur*, 401 F.2d at 848.

77. *Id.*

78. Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897), *reprinted in* DAVID KENNEDY & WILLIAM W. FISHER III, THE CANON OF AMERICAN LEGAL THOUGHT 32 (David Kennedy & William W. Fisher III eds., 2006) [hereinafter Holmes, *The Path of the Law*] ("The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it, — and nothing else. If you commit a tort, you are liable to pay a compensatory sum. If you commit a contract, you are liable to pay a compensatory sum unless the promised event comes to pass, and that is all the difference. But such a mode of looking at the matter stinks in the nostrils of those who think it advantageous to get as much ethics into the law as they can.").

79. Carlton & Fischel, *supra* note 3, at 885.

80. *Id.*

81. *Id.*

82. *Id.*

83. *Id.* at 885–86. In any event, the enforcement of current insider trading legal rules may be an impediment where the "good" insider has sound economic and business reasons

An insider, however, may choose neither (a) to disclose (in some instances, for good reasons such as where disclosure might reduce or eliminate the value of the information) nor, in some cases, (b) to abstain from trading (a legal requirement without disclosure).[84] Instead, some

not to disclose (e.g., future acquisitions, corporate identification of valuable minerals in land the company will seek to acquire) and the uncertainties regarding the legal bar against trading by that insider in such a circumstance results in no trading, and thus serves to deprive the market of valuable information that might affect the stock price, which in turn provides (in a market economy) helpful investment information to investors. *See* ROBERT DORFMAN, PRICES AND MARKETS 7 (Otto Eckstein ed., 1967). The insider trading rule may therefore create a tension between compliance with the rule and conveying helpful information to the market. *But see* Michael Manove, *The Harm from Insider Trading and Informed Speculation*, 104 Q.J. ECON. 823, 843 (1989) ("A headline such as 'ABC Discovers Copper' may be a more efficient way of communicating information to the investing public than an unexplained rise in the share price of a firm's shares would be. This reasoning lends some support to the 'disclose or abstain' rule of *Chiarella*.").

84. The objective of the disclose-or-abstain legal rule, it was later decided, is not to require parity of information or substantive fairness between sellers and buyers of securities as a condition to trading; such a rule has been rejected by the Court. Chiarella v. United States, 445 U.S. 222, 232–35 (1980). The legal rule against insider trading accepts that all trade or exchange involves asymmetrical information or an "informed-uninformed trader problem" in the sense that one party may know more than the other party. Carlton & Fischel, *supra* note 3, at 879–80. Carlton and Fischel have defined this as "insider trading in an economic sense." *Id.* at 860. Apparently, the main objective of the legal insider-trading rule is to prevent the basis of that asymmetrical relationship from being created by insider short-swing profits, improper access to material undisclosed inside information, or by illegal means such as theft of material inside information. *See, e.g.*, *id.* at 860–62, 890–93.

According to some, a requirement of information-parity would provide "little incentive to trade" because it would deny the "opportunity to profit by virtue of superior information." EASTERBROOK & FISCHEL, *supra* note 5, at 253–54. But superior information is not always the product of superior talent. *See, e.g.*, Speed v. Transamerica Corp., 99 F. Supp. 808, 816, 834–43, 848–49 (D. Del. 1951) (containing facts in which corporate parent of jointly owned subsidiary corporation buys out other shareholders of the subsidiary after it learns, without disclosure to minority shareholders, that the financial statements grossly understated the assets of the subsidiary; after purchase, it liquidates the subsidiary and sells the assets at substantial profit). The "opportunity to profit" here appears to be based on a notion of "absolute advantage" by one side against the other, which permits the party with that absolute advantage to obtain an unfair bargain. The asymmetrical relationship here was the result of deception, not superior information based on skill.

The parity-of-information standard, it should be noted, contained an element of fairness, as articulated by the second element advanced by the SEC in *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961), and followed by the Second Circuit in *TGS*, SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (holding that Rule 10b-5 is based on "the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information"). "The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should insiders might decide to circumvent the legal rule by sharing the confidential inside information with another person (friend or relative) outside of the company, who then trades using the confidential inside information.[85] In addition, outsiders, through illegal or, in some cases, innocent and legal, means might learn of the confidential inside information before public disclosure, and use it to trade.

To prevent these loopholes from rendering the insider-trading rule wholly ineffective, the disclose-or-abstain rule evolved into two theories.

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have equal access to the rewards of participation in securities transactions." *Tex. Gulf Sulphur*, 401 F.2d at 851–52; *accord* United States v. Chestman, 947 F.2d 551, 574 (2d Cir. 1991) (Winter, J., concurring in part and dissenting in part) ("*TGS* . . . emphasized . . . the perceived unfairness to those who trade with the insider."). In the context of proposed mergers, for example, a principle of fairness can mitigate the unjust outcomes of absolute advantage based solely on inside access to information by requiring that insiders not engage in trading before disclosure of the fact of the upcoming merger without mandating disclosure of "their analysis of whether the [merger] information makes the corporation's stock a good investment at a particular price." D'Amato, *supra* note 65, at 1441. As just noted, the Court in *Chiarella* invalidated the parity-of-information doctrine and its element of fairness, a basis on which the *Chiarella* opinion has been criticized. *Chestman*, 947 F.2d at 575 (Winter, J., concurring in part and dissenting in part) (characterizing the "*Chiarella* opinion [as] an enigma").

As David Ricardo's refinement of Adam Smith's doctrine of absolute advantage shows, the "incentive to trade" stems from "comparative advantage" of the two parties, which results in a trade benefitting both. *See* EASTERBROOK & FISCHEL, *supra* note 5, at 253; ROBERTO MANGABEIRA UNGER, FREE TRADE REIMAGINED: THE WORLD DIVISION OF LABOR AND THE METHOD OF ECONOMICS 25–27 (2007). Each trading party creates comparative advantage by specializing in production of those products or services in which it has a lower opportunity cost of production than other countries with which it trades. UNGER, *supra* note 84, at 25–27. This is David Ricardo's theoretical argument for why trade among nations (i.e., international trade) is to the advantage of all nations. *Id.* Based on specialization of production, and exchange in trade between parties producing goods and services at different opportunity costs, all parties are better off than they would be if each produced all of their goods and services. *Id.* Moreover, comparative advantage is not a natural phenomenon, and specialization that results in comparative advantage can therefore be developed through education, training, and greater access to technology. *See id.* at 12.

85. Here, we transition from the potentially "good" insider (an economic perspective) acting as a rational economic agent (who transmits valuable information to the market) to the potential fraudster or criminal under current law (who uses material confidential corporate information for his or his family or friends' financial benefit). Under current law, the would-be criminal makes a "gift" of the valuable inside information to a friend or family member for an improper purpose and benefits personally from making that "gift." *See* Dirks v. SEC, 463 U.S. 646, 659–64 (1983). The challenge of federal insider trading law is to draw the line in a way that is suitable to capture the latter actors when they breach their fiduciary duty purely for personal benefit while not hindering the former. This is a task with substantial difficulty, and it is doubtful that it can be achieved through case-by-case adjudication of criminal cases selected by prosecutors. Any effort to do so raises substantial due process issues of *ex post* definition of criminal conduct.

The first—the "classical theory"—was designed to reach insider-tippers who breached their duty to the company by disclosing material inside information to benefit friends or relatives. These persons, appropriately enough, are referred to in the case law as "tippees" (borrowing a word introduced by Professor Louis Loss). The second—the "misappropriation theory"—sought to reach outsiders who purloined or received inside information for trading.

My focus in this Article is on insider trading that is prohibited as a criminal fraud and enforced by federal courts. There are two kinds of insider trading in contemporary federal legal doctrine. First, there is what may be called "direct insider trading" where directors, officers, owners of more than 10% of a firm are prohibited from making short-swing profits through trading within six (6) months. Such trading is regulated by section 16 of the Exchange Act.[86] Under certain conditions, corporate insiders are legally permitted to, and often do, trade on their companies' stock and are required to make reports of their trades to the SEC on Form 4.[87] Such "direct insider trading" by "statutory insiders" is not the subject of this Article. Second, there is what may be called "indirect insider trading" by a broader class than those defined as "statutory insiders" in section 16 and others once-removed from such persons, including downstream tippees.[88] Trading by such individuals based on material undisclosed inside information is subject to regulation by Rule 10b-5.[89] Indirect insider trading of this kind, when enforced as criminal law by federal courts, is the main subject of this Article.

B. *The Classical Theory*

In the traditional so-called classical theory involving a classic corporate insider (an employee, officer, director, or controlling shareholder of a company) or those closely connected to corporate insiders such as underwriters, outside counsel, accountants, and consultants,[90] the legal rule requires (a) breach of a fiduciary duty by a tipper (the corporate insider) to the company and its shareholders (b) for pecuniary or, at least, personal benefit of some kind (to the insider-

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86. 15 U.S.C. § 78p (2012)

87. 17 C.F.R. § 240.16a-3 (2016).

88. *See* Henry G. Manne, *Insider Trading and the Law Professors,* 23 VAND. L. REV. 547, 559 n.39, 562 n.44 (1970).

89. 17 C.F.R. § 240.10b-5.

90. These individuals are deemed temporary insiders who acquire fiduciary duties to the shareholders of the corporation by virtue of their "special confidential relationship." Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983).

tipper) and (c) knowledge of such breach and personal benefit by a tippee.[91] The classical theory is widely accepted by courts.[92] As the scope of those having access to and using material inside information broadened beyond traditional insiders, the classical theory was at first expanded to encompass, as the language of footnote fourteen of the *Dirks* opinion suggests, those called "constructive insiders" or just "temporary insiders."[93]

C. The Misappropriation Theory

The misappropriation theory was developed to capture pure outsiders who are family or friends of insiders, or strangers who somehow gained access to insiders and then misappropriated material inside corporate information.[94] Although the misappropriation theory was developed at about the same time as the classical theory, misappropriation later gained wider acceptance, and it is now the theory most frequently relied upon to bring insider-trading cases.[95]

The misappropriation theory imposes a duty to disclose or abstain if one obtains material nonpublic corporate information through misappropriation or theft.[96] Like the classical theory, misappropriation requires breach of fiduciary duty to another person who is the source of the confidential information stolen or misappropriated.[97] In other words, in classical-theory cases the duty is owed to the insider's corporation and its shareholders, while in misappropriation cases, the duty is to the misappropriator's employer or other source of the confidential information.[98] In *Chiarella*, when first confronted with the

91. *Id.* at 660–63; *see also* Chiarella v. United States, 445 U.S. 222, 227–30 (1980).

92. *See, e.g., Dirks*, 463 U.S. at 660–63; *Chiarella*, 445 U.S. at 227–30.

93. United States v. O'Hagan, 521 U.S. 642, 652 (1997) (citing *Dirks*, 463 U.S. at 655 n.14).

94. Amy E. Fahey, Note, United States v. O'Hagan: *The Supreme Court Abandons Textualism to Adopt the Misappropriation Theory*, 25 FORDHAM URB. L.J. 507, 514–20 (1997).

95. *See id.*

96. *See O'Hagan*, 521 U.S. at 652–53.

97. *See id.*

98. *See id.* at 651–52; *see also* Carpenter v. United States, 484 U.S. 19, 24, 28 (1987) (dividing evenly on securities fraud and not adopting the misappropriation theory, but affirming the Second Circuit judgment by an equally divided Court). Oddly, the duty does not run to the counterparty in the trading transaction but instead is owed to the source of the confidential information or corporate shareholders, who may not be a party in the trade. The acceptance of a breach-of-fiduciary-duty element as part of insider-trading doctrine (to conform the doctrine to the fraud theory of Rule 10b-5) has led to an incoherent legal doctrine yielding many tortured legal rulings to establish a breach of duty. In contrast, the insider doctrine defined in Rule 14e-3 dealing with tender offers

misappropriation theory, the Court declined to adopt a broad version advanced by Chief Justice Burger in dissent.[99] In 1981, the Second Circuit adopted a narrower version of the misappropriation theory[100]

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does not require a breach of fiduciary duty. *See infra* Section IV.C.

99. Chiarella v. United States, 445 U.S. 222, 240–45 (1980) (Burger, C.J., dissenting) (advocating a broader misappropriation theory to require disclosure to any third party with whom the misappropriator traded). The printer in *Chiarella* was a pure outsider who breached his duty to his employer and stole material inside information about a tender offer for trading on the stock of the target company, but the Court reversed his conviction because he owed no duty to the target company and its shareholders, as required by the classical theory—the only theory on which the case was tried and submitted to the jury. *Id.* at 224–25 (majority opinion). The Court declined to consider the misappropriation theory because it "was not submitted to the jury." *Id.* at 236; *O'Hagan*, 521 U.S. at 650 n.4 ("[T]he jury had received no misappropriation theory instructions [in *Chiarella*] . . . .").

100. *See* United States v. Newman, 664 F.2d 12, 15–19 (2d Cir. 1981), *aff'd after remand*, 722 F.2d 729 (2d Cir. 1983), *cert. denied*, 464 U.S. 863 (1983) (*Newman I*). The Second Circuit became the first court to adopt and apply the misappropriation theory. *See id.* The Second Circuit and lower courts within that Circuit then applied the fiduciary duty standard of the misappropriation theory to a variety of persons and circumstances. *See, e.g.*, United States v. Willis, 737 F. Supp. 269, 270–72, 274–75 (S.D.N.Y. 1990). In *Willis*, the Southern District of New York applied the misappropriation theory to the case of a psychiatrist who learned confidential corporate information from a patient who was the wife of a corporate executive seeking to become the CEO of a major bank. *Id.* The psychiatrist disclosed that information to his broker and bought stock in the bank; he was indicted—the indictment predicated on the breach of doctor-patient relationship of trust and confidence, which was said to create a duty not to trade on information learned in that context. *Id.* The psychiatrist, the court concluded, "defrauded his patient in connection with the purchase" of the securities of the bank, because, by not disclosing to his patient his intention to profit from the confidential information, "Dr. Willis fraudulently induced his patient to confide in him in connection with his purchase and sale of securities." *Id.* at 272, 274.

It is unlikely the psychiatrist induced his patient to disclose the confidential information for the purpose of engaging in insider trading. After learning the information, he clearly breached, in some sense, his duty to his patient by sharing her confidential information disclosed in a protected context, and violated current insider-trading doctrine. However, it is hard to see how the psychiatrist's breach of duty to his patient in any way defrauded or monetarily harmed the patient in connection with the purchase of bank stock. More troubling, it is even more difficult to see how the psychiatrist defrauded the bank stock sellers in an open market. The psychiatrist did not owe any duty to disclose to the sellers; at common law, there is nothing in that relationship to create a duty of disclosure, and Congress has not enacted any law imposing such a duty on a person with inside information. The psychiatrist's conduct, to be sure, was doubly wrongful vis-à-vis his patient and the sellers of the bank's stock, but, in a strict legal sense, the psychiatrist did not defraud the sellers to whom he owed no duty. Apart from an SEC regulation enforced by federal courts, there is no common or statutory law that makes the psychiatrist's conduct a criminal insider trading act. *See* United States v. Chestman, 947 F.2d 551, 570–71 (2d Cir. 1991) (en banc) (reversing conviction based on misappropriation theory for lack of fiduciary duty among family members), *cert. denied*, 503 U.S. 1004 (1992).

that the Court later accepted.[101] In 1997, the Court in *O'Hagan* reversed a court of appeals ruling that had reversed O'Hagan's jury conviction[102] and adopted a narrower misappropriation doctrine than that which Chief Justice Burger had advocated in *Chiarella*.[103] In the narrower misappropriation doctrine, it is important to note that the defrauded party or the party to whom a fiduciary duty was owed and then breached (i.e., the source of the material confidential information) is usually at best tangentially related, and may even be wholly unrelated, to the counterparty to the underlying securities purchase or sale transaction.[104]

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101. *O'Hagan*, 521 U.S. at 650 & n.4.

102. *Id.* at 649, 678.

103. *See id.* at 655 n.6 (accepting a narrower misappropriation doctrine requiring disclosure of confidential information to corporate source of that information to whom a duty is owed). The outside attorney whose firm represented the company making the tender offer in *O'Hagan* was a "constructive insider" of the kind referred to in *Dirks*. *See infra* Part VIII; *see also O'Hagan*, 521 U.S. at 647–50. Four other circuits had also adopted the misappropriation theory before the Court did so in *O'Hagan*. *O'Hagan*, 521 U.S. at 650 & n.3 (listing cases); *Chestman*, 947 F.2d at 566 (same); Fahey, *supra* note 94, at 519–20, 520 n.79 (same).

According to the Court in *O'Hagan*, the government did not advocate adoption of the broader misappropriation theory that Chief Justice Burger urged the Court to adopt in *Chiarella*. *O'Hagan*, 521 U.S. at 655 n.6. On remand, the court of appeals affirmed the conviction of the defendant on the securities and mail fraud counts. United States v. O'Hagan, 139 F.3d 641, 658–59 (8th Cir. 1998).

The Court's adoption of the misappropriation theory was criticized by some commentators. Fahey, *supra* note 94, at 507–08, 508 nn.7–8, 531 (criticizing the Court for its departure in *O'Hagan* from its traditional textualist approach in construing section 10(b) and Rule 10b-5 to a "purposivist approach" in adopting the misappropriation theory).

104. *O'Hagan*, 521 U.S. at 656. In the Second Circuit, there is some controversy now on whether the element of personal benefit to the tipper is required for liability under the misappropriation theory in criminal cases. *Newman II,* 773 F.3d 438, 446 (2d Cir. 2014); *see also* United States v. Jiau, 734 F.3d 147, 152–53 (2d Cir. 2013) (holding in a classical-theory criminal case that proof is required that "insider-tippers benefited in some way from their disclosure"); SEC v. Obus, 693 F.3d 276, 285–89 (2d Cir. 2012) (holding that personal benefit is required in civil misappropriation case); United States v. Libera, 989 F.2d 596, 600 (2d Cir. 1993) (holding in a criminal misappropriation case that the tipper need not have knowledge of the tippee's trading on confidential information and stating that the two elements of criminal insider trading are breach of duty by the tipper and the tippee's knowledge of such breach, without mentioning the third element of personal benefit to the tipper-misappropriator).

After Newman II, the courts and the one administrative law judge who have ruled on this issue thus far have rejected the view that the misappropriation theory does not require personal benefit to the tipper. E.g., SEC v. Payton, 155 F. Supp. 3d 428, 430 n.1 (S.D.N.Y. 2015) (citing Newman II, 773 F.3d at 450); SEC v. Payton, 97 F. Supp. 3d 558, 562 (S.D.N.Y. 2015)) (noting that "key holdings" of Newman II "expressly apply" to misappropriation cases); United States v. Conradt, No. 12 Cr. 887, 2015 WL 480419, at *1

IV. RECENT DEVELOPMENTS SUPPORT RECONSIDERATION OF FEDERAL CRIMINAL INSIDER-TRADING LAW

A. *The Legal Basis of Federal Insider-Trading Law*

The existence of federal criminal insider-trading law is explainable by the history and structure of the federal securities laws.[105] First, the 1933 Act and the Exchange Act contain general anti-fraud provisions, violations of which are made criminal. [106] Second, Congress has granted broad authority to the SEC to enforce these anti-fraud provisions,[107] and that has resulted in the promulgation of SEC Rule 10b-5.[108] Third,

(S.D.N.Y. Jan. 22, 2015) (rejecting government position that the stricter personal-benefit standard of Newman II does not apply in misappropriation case); Bolan, S.E.C. Release No. 877, 2015 WL 5316569, at *27–28 (ALJ Sept. 14, 2015) (initial order) (noting that proof of personal benefit required in misappropriation case). After Newman II, the First Circuit continues to adhere to its rule, without specifically deciding the issue, that a personal benefit to the tipper is required, and that "the mere giving of a gift to a relative or friend is a sufficient personal benefit." United States v. Parigian, 824 F.3d 5, 15 (1st Cir. 2016) (quoting SEC v. Rocklage, 470 F.3d 1, 7 n.4 (1st Cir. 2006)). At least in regard to closely-knit relatives by blood or marriage (and perhaps also with close friends), the Parigian standard is the legal rule announced in Salman, as discussed below. *See infra* Part VIII. The Court did not decide in *Salman* whether the personal-benefit rule announced in Dirks applies both to classical and misappropriation cases. Salman v. United States, 137 S. Ct. 420, 425 n.2 (2016) ("The parties do not dispute that *Dirks*'s personal-benefit analysis applies in both classical and misappropriation cases, so we will proceed on the assumption that it does.").

105. *See Chestman*, 947 F.2d at 572–78 (Winter, J., concurring in part and dissenting in part); Daniel J. Bacastow, Comment, *Due Process and Criminal Penalties Under Rule 10b-5: The Unconstitutionality and Inefficiency of Criminal Prosecutions for Insider Trading*, 73 J. CRIM. L. & CRIMINOLOGY 96, 96–111 (1982).

106. Examples include section 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (2012), and section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) (2012). Section 10(b) is broad in that it prohibits manipulation in connection with the purchase and sale of any security, even if the security is not traded on the national securities exchanges. 15 U.S.C. § 78j(b). Section 14(e) of the Exchange Act, 15 U.S.C. §78n(e) (2012), and Rule 14e-3(a) thereunder, 17 C.F.R. § 240.14e-3 (2016), prohibit insider trading in connection with tender offers. Unlike Rule 10b-5, Rule 14e-3, which is a clear prohibition of insider trading, does not require breach of a pre-existing fiduciary duty. *Chestman*, 947 F.2d at 557. In the tender-offer context, the statute grants the SEC greater authority to proscribe inchoate conduct before it becomes fraudulent. *Id.* at 558–63 (noting that the 1970 amendment to section 14(e) gives the SEC "latitude to regulate *nondeceptive* activities as a 'reasonably designed' means of preventing manipulative acts" (emphasis added) (quoting Schreiber v. Burlington N., Inc., 472 U.S. 1, 11 n.11 (1985))).

107. *See* 15 U.S.C. §§ 77t(a), 78u(a) (2012).

108. 17 C.F.R. § 240.10b-5 (2016). Section 10(b) of the Exchange Act makes it unlawful to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of" rules promulgated by the SEC. 15 U.S.C. § 78(j)(b); *see also In re* Enron Corp. Secs., 235 F. Supp. 2d. 549, 568–

Congress made it a crime to violate any properly promulgated SEC regulation.[109] Fourth, despite various proposals in the early 1980s for

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69 (S.D. Tex. 2002). Rule 10b-5 provides that it is unlawful:

> (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

The SEC has also promulgated Rule 10b-5(1), defining when a person is deemed to have traded "on the basis of" material nonpublic information in violation of Rule 10b-5 and section 10(b) of the Exchange Act. 17 C.F.R. § 240.10b-5(1). Rule 10b-5(1) discusses the two standards announced by the courts in the case law, the "use" or "knowing possession" rule, but formally adopts a definition of trading "on the basis of" of material nonpublic information to mean that the "person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale." 17 C.F.R. § 240.10b-5(1)(b); Selective Disclosure and Insider Trading, 65 Fed. Reg. 51716, 51727–29 (Aug. 24, 2000). The SEC-adopted Rule creates several affirmative defenses. 17 C.F.R. § 240.10b-5(1)(c). In its Preliminary Note to Rule 10b-5(1), the SEC, after announcing that the Rule defines the "on the basis of" element of insider trading, concludes: "The law of insider trading is *otherwise defined by judicial opinions* construing Rule 10b-5." 17 C.F.R. § 240.10b-5(1) (emphasis added). In 2000, the SEC promulgated the regulatory standard to expand the reach of insider-trading law after judicial setbacks. Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51716 & n.7. The Court recently denied certiorari in a case raising the issue of whether the legal standard here requires "use" or "knowing possession" of the undisclosed information. Fried v. Stiefel Labs., Inc., 814 F.3d 1288 (11th Cir.), *cert. denied*, 137 S. Ct. 102 (2016).

Courts generally do not accept this SEC Rule 10b-5(1) standard, at least in criminal insider-trading cases, and require proof of knowledge of material nonpublic information at the time of trading and of use of such information in connection with the sale or purchase. *See infra* Part V. In other words, there must be a connection, if not a causal relation, between the person's knowledge of the inside information and its use to trade. *See infra* Part V. The SEC position is often called in the case law the "knowing possession" standard or the "awareness and possession" standard; however, the knowing possession standard, as used by courts, creates a presumption of use from knowledge of material inside information, whereas the SEC Rule merely requires possession of inside information before trading. *See infra* Section V.A. The stricter test is called the "use" or "causal connection" test. *See infra* Part V. The two extreme tests are the SEC mere possession rule and the use or causality rule. In between are various tests used by the courts, including "intentional use," "a factor," "a substantial factor," "a significant factor," and "the motivating factor" in trading based on inside information.

109. 15 U.S.C. §§ 77x, 78ff(a) (2012) (addressing criminal sanctions for 1933 Act and Exchange Act, respectively). The sanction is up to twenty years' imprisonment plus substantial monetary fines of up to $5 million for an individual and $25 million for a corporation and forfeiture of illegally obtained assets. *Id.* Arguably, promulgation of insider-trading prohibition by means of Rule 10b-5 violates the delegation doctrine, which imposes constitutional limits on Congress's ability to delegate legislative power "without providing 'intelligible' standards for the agency to use in exercising discretion." Bernard

an insider-trading statute, Congress has refrained from enacting a specific statute defining the kind of insider trading prohibited (partly, on occasion, because of SEC objections)[110] and has permitted the SEC, the federal prosecutors, and the federal courts to develop the law in this area—the better to capture an evolving set of insider-trading schemes engaged in by fraudsters.[111] Lastly, the federal courts have obliged Congress, the prosecutors, and the SEC in *benign neglect* of the well-established Supreme Court *Hudson* doctrine while developments in insider-trading law (mainly pushing back on the more aggressive theories for enforcement by the SEC and prosecutors) occurred largely in federal decisions.[112] In the words of Louis Loss and Joel Seligman, "[I]t is difficult to think of another instance in the entire *corpus juris* in which the interaction of the legislature, administrative rulemaking, and judicial processes has produced so much from so little."[113] In the future, the federal courts may not continue to have a monopoly on developing federal insider-trading law.

B. *The Dodd-Frank Statute and Broader SEC Administrative Jurisdiction*

Under section 929P(a)(2) of the 2010 Dodd-Frank statute[114] Congress has granted the SEC authority to bring administrative

W. Bell, *Using Statutory Interpretation to Improve the Legislative Process: Can it be Done in the Post-Chevron Era?*, 13 J.L. & POL. 105, 150 n.231 (1997); *accord* United States v. Nacchio, 519 F. 3d 1140, 1158 (10th Cir. 2008) ("The[securities] statutes [15 U.S.C. §§ 78j & 78ff] delegate the power to define criminal liability to the Securities and Exchange Commission . . . ."), *vacated in part on reh'g en banc*, 555 F.3d 1234 (10th Cir. 2009).

110. The SEC has infrequently endorsed legislation to define the crime of insider trading. *See* Pitt & Shapiro, *supra* note 15, at 435 & n.79.

111. *See* United States v. O'Hagan, 521 U.S. 642, 691 (1997) (Thomas, J., concurring in the judgment in part and dissenting in part) (noting the government's argument that "the very aim of [section 10(b)] was to pick up unforeseen, cunning, deceptive devices that people might cleverly use in the securities market[]"). While section 10(b) has been described as a "catchall provision," what it seeks ultimately to ensnare is fraud, an element of which is breach of fiduciary duty to the person defrauded. *See* Chiarella v. United States, 445 U.S. 222, 234–35 (1980). Unless changed by congressional legislation, this is the common-law rule. *See id.*

112. *See O'Hagan*, 521 U.S. at 651 (majority opinion) ("Liability under Rule 10b-5, our precedent indicates, does not extend beyond conduct encompassed by [the Exchange Act] § 10(b)'s prohibition." (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976))).

113. Dauenhauer, *supra* note 15, at 84 n.132 (alteration in original) (quoting LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3485 (3d ed. 1991)).

114. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929 P(a)(1), 124 Stat. 1376, 1862–63 (2010) (codified as amended at 15 U.S.C. § 77h-1 (2012)).

enforcement actions against non-regulated persons violating the federal securities laws and to impose substantial monetary penalties.[115] Since being granted the broadened jurisdictional authority under Dodd-Frank in 2010, the SEC has shown great enthusiasm, tempered only by a slight increase in early 2016 of its high-profile cases filed in federal courts,[116] to use its broadened administrative jurisdiction to bring more of its insider-trading cases internally.[117] This is perhaps to avoid frequent SEC defeats in federal courts.[118] The federal courts should therefore begin to re-think their self-imposed checking-function role in the development of federal insider-trading law. That function may increasingly decline depending on whether or not the SEC, in its sole discretion, decides to continue to make more use of its internal administrative process in the future.[119]

C. *Judicial Efforts to Constrain Insider Trading*

Two recent federal court developments point in different directions

115. *See* William F. Johnson & Amelia R. Medina, *SEC's Administrative Enforcement Intensifies Fairness Debate*, N.Y.L.J. (Nov. 6, 2014), http://www.newyorklawjournal.com/id=1202675574765/SECs-Administrative-Enforcement-Intensifies-Fairness-Debate?slreturn=20160908142652.

116. *See 2016 Mid-Year Securities Enforcement Update*, CLIENT UPDATE (Gibson, Dunn & Crutcher, Los Angeles, Ca.), July 13, 2016, at 5, www.gibsondunn.com/publications/Pages/2016-Mid-Year-Securities-Enforcement-Update.aspx. ("[A]necdotally it appears that the SEC has stepped back somewhat from its increased reliance on administrative proceedings, with most of its more high profile pieces of litigation this year [2016] filed in federal court.").

117. *See* Andrew Ceresney, Dir., SEC, Keynote Speech at New York City Bar 4th Annual White Collar Institute 2–3 (May 12, 2015), http://www.sec.gov/news/speech/ceresney-nyc-bar-4th-white-collar-key-note.html (stating that SEC will use both federal courts and its in-house administrative process as it deems appropriate); Joel M. Cohen et al., *SEC Plans to Play Insider-Trading Cases on Home Court*, NAT'L L.J. (Sept. 16, 2014), http://www.nationallawjournal.com/id=1202670286446/SEC-Plans-to-Pay-InsiderTrading-Cases-on-Home-Court-; Johnson & Medina, *supra* note 115 (citing statements of SEC Enforcement Director Andrew Ceresney and Chief of Foreign Corrupt Practices Unit).

118. *Cf.* Coffee, *supra* note 21, at 1887, 1887 n.38 (concluding that the SEC won fifty-eight of sixty-two cases litigated in-house during a five-year period and that "the SEC always seems to win before its in-house [ALJ] judges" (citing *ABA Task Force Survey Finds ALJs Almost Always Uphold SEC Charges*, 21 Sec. Reg. & L. Rep. (BNA) No. 40, at 1531 (Oct. 13, 1989))); Jean Eaglesham, *In-House Judges Help SEC Rack Up Wins*, WALL ST. J. (May 6, 2015, 10:30 PM), http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803; Jean Eaglesham, *SEC is Steering More Trials to Judges it Appoints*, WALL ST. J. (Oct. 21, 2014, 9:40 AM), http://www.wsj.com/articles/sec-is-steering-more-trials-to-judges-it-appoints-1413849590 ("In the 12 months through September [2014], the SEC won all six contested administrative hearings where verdicts were issued, but only 61%—11 out of 18—federal-court trials . . . .").

119. *See* Keynote Speech from Andrew Ceresney, *supra* note 117, at 2–3.

to constrain insider trading. In an insider-trading case where certiorari was denied, Justices Scalia and Thomas expressed a preference for declining deference to the SEC because its statutory authority includes dual-purpose (civil and criminal) laws.[120] This approach[121] would grant the SEC more room to enforce its civil statutes and confine its reach and influence—at least in regard to its influence on the enforcement of its regulations as crimes by, for example, promulgating interpretive rules such as Rule 10b-5(1) (defining "on the basis of")[122] or Rule 10b-5(2) (defining "duty of trust or confidence" for misappropriation)[123]—and would increase and broaden the role of federal courts in enforcing securities criminal laws.

Another development comes from the Second Circuit's *Newman II* ruling announcing a stricter personal-benefit standard that would make it harder to prove criminal and perhaps civil insider-trading cases against casual social friends and downstream tippees.[124] The Court rejected this stricter personal benefit standard in *Salman*—at least in cases involving close family members and perhaps friends. In *Newman II*, the Second Circuit held that criminal insider trading requires proof that the tipper breached a fiduciary duty for a personal benefit—defined to require an "exchange" that is "objective" and of some "consequence" beyond mere "personal relationship" resulting in a gift of profits from trading based on inside information—and that the tippee defendant had knowledge of insider disclosure of confidential information for such personal benefit to the tipper.[125] Significantly, *Newman II* made clear that receipt of a personal benefit cannot be proven by the "mere fact of a friendship, particularly of a casual or social nature."[126]

Arguably, while *Salman* rejected the *Newman II* standard for cases involving family members and relatives by marriage that would require a personal benefit of a "pecuniary or similarly valuable nature," the

120. *See* Whitman v. United States, 135 S. Ct. 352, 353–54 (2014) (Scalia, J., respecting the denial of certiorari) (denying writ of certiorari and questioning the appropriateness of *Chevron* deference to SEC interpretation of federal securities laws "to which criminal prohibitions are attached"); *see also* United States v. O'Hagan, 521 U.S. 642, 679 (1997) (Scalia, J., concurring in part and dissenting in part).

121. Declining deference to agency rulings interpreting dual-purpose statutes is discussed *infra* at Section V.C.

122. 17 C.F.R. § 240.10b5-1 (2016).

123. § 240.10b5-2.

124. The *Newman II* ruling regarding the proof of knowledge required by downstream traders to convict for insider trading was not an issue in the *Salman* case. Salman v. United States, 137 S. Ct. 420, 425 n.1 (2016).

125. *Newman II*, 773 F.3d 438, 450–52 (2d Cir. 2014).

126. *Id.* at 452.

Second Circuit may continue to apply its definition of personal benefit in other contexts involving casual friends or mere social acquaintances. Moreover, *Newman II* was a classical insider-trading case involving insider-tippers; it remains to be seen whether the Second Circuit will hold that a personal-benefit element is necessary in misappropriation cases and, if so, also apply the *Newman II* robust definition of personal benefit to misappropriation cases.

The Ninth Circuit, in an opinion issued by Senior District Judge for the Southern District of New York, Jed S. Rakoff, declined to follow the *Newman II* personal-benefit standard to "the extent [it] can be read to go so far" as to impose a stricter definition of "personal benefit" to the corporate insider than that required by *Dirks*.[127] The Courts of Appeals rulings in *Newman II* and *Salman* are inconsistent but not directly in conflict. Indeed, *Salman* recognized that *Newman II* acknowledged the more lenient personal-benefit standard of Dirks applied by *Salman* when the tipper and tippee are "trading relative[s]."[128] The Court upheld the Ninth Circuit view in *Salman*. Whether the Court would adopt the *Newman II* personal-benefit standard where the parties are merely casual friends or social acquaintances and the tippees are three or more levels removed from the tipper is an open issue.

1. *Newman II* and *Salman*

Newman II involved friendship between the tippers and third- and fourth-level-removed tippees. The *Salman* courts addressed the issue in the context of material nonpublic information disclosure between "tightly knit" relatives (i.e., two brothers, one of whom was the tipper, and a brother-in-law as second-level tippee). The tipper-relative knew the information would be used for trading.[129] The brother-in-law tippee also knew that the confidential information was coming from the younger brother of his source, and there was evidence that he knew of the brothers' "close fraternal relationship."[130]

On its facts, *Salman* therefore applied a personal-benefit standard to a transaction involving an insider "gift" to a trading relative where the second-level tippee knew the source of the information and the close family relationship between the insider-tipper and the first-level tippee.[131] Salman may not, however, have known about any personal

127. United States v. Salman, 792 F.3d 1087, 1093 (9th Cir. 2015).
128. *Id.* at 1093–94 (quoting *Newman II*, 773 F.3d at 452).
129. *Id.* at 1090; *see Newman II*, 773 F.3d at 443–44.
130. *Salman*, 792 F.3d at 1089–90.
131. *Id.* at 1093–94.

benefit (other than an inference of intangible benefits flowing from the blood relationship) to the tipper-brother of his source.[132] The Court in *Salman* held that was enough to sustain a conviction.[133]

In contrast, *Newman II* involved friends, not trading relatives; third- and fourth-level tippees without knowledge of the relationship between the insider-tipper and first-level tippee; and the government evidence was insufficient to prove that the tippees had knowledge of (or even consciously avoided knowing about) any benefit received by the insider-tipper.[134] The Second Circuit therefore applied a different, and more rigorous, personal-benefit standard.[135] Moreover, *Newman II* involved not relationships between close friends or family members but relationships "of a casual or social nature."[136] The Second Circuit, as the *Salman* Court of Appeals ruling acknowledged, did not reject the *Dirks* mere gift-to-a-friend-or-family-member standard.[137] Instead, *Newman II* required that the relationship—presumably between friends—be a "meaningfully close personal relationship that generates . . . objective" and tangible pecuniary gains.[138]

2. The Court's *Salman* Decision

The Court's *Salman* ruling reaffirmed the *Dirks* rationale that requires a breach of fiduciary duty for a personal benefit. The Court, quoting from the *Dirks* opinion, held that it is sufficient to infer the requisite personal benefit where the tipper "makes a gift of confidential information to a trading relative or friend."[139] What the Court does not tell us is more significant than what it says: There is no definition of the nature of the personal benefit that may be inferred.

Absent a direct pecuniary gain to the tipper-relative, in the case of trading relatives gifting confidential information to each other knowing

132. *See* Brief for the United States at 7, Salman v. United States, 137 U.S. 420 (2016) (No. 15-628), 2016 WL 4088380 ("[P]etitioner knew about the close relationship between Maher [tipper] and Michael [tippee-brother]"). The government does not contend that Salman knew about the intangible benefits to Maher of supplying the confidential inside information to Michael. *See id.* at 4 (describing the intangible benefits Maher enjoyed from leaking information to Michael). The Court of Appeals held that, consistent with the *Dirks* ruling, this evidence was sufficient to convict Salman and affirmed. *See id.* at 9–11. The Court agreed. Salman v. United States, 137 S. Ct. 420, 423–24 (2016).

133. *Salman*, 137 S. Ct. at 423–24.

134. *Newman II*, 773 F.3d at 443–44.

135. *Id.* at 442.

136. *Id.* at 452.

137. *Salman*, 792 F.3d at 1093.

138. 773 F.3d at 452.

139. Salman v. United States, 137 S. Ct. 420, 423 (2016).

that the recipient will use the information in trading, one can infer a variety of benefits. It may be that the tipper-relative gains a psychological benefit from helping a financially strapped relative, the tipper-relative may be an altruist who simply feels better helping out others, including relatives whether or not they are in need, the tipper-relative may thereby avoid a familial obligation to care for a relative in need, the tipper-relative may indirectly share in the trading profits made by the tippee-relative, or (like Don Corleone in the *Godfather*) the tipper-relative simply expects a certain amount of reciprocity in future benefits from the tippee-relative for whom he has done a favor in gifting the confidential information.

Some of these benefits to the tipper-relative are not inconsistent with the *Newman II* standard. But, in rejecting that standard and in ruling that it is sufficient to make the necessary inference of personal benefit for conviction merely from the family relationship without articulating the nature of the required benefit or even stating that the benefit cannot simply be intangible, the *Salman* Court fails to provide guidance on which of these permissible inferences of benefit would be sufficient for conviction. It leaves lower courts to decide whether even psychological benefits might be sufficient in some instances.[140] For example, is it sufficient if a disgruntled director discloses confidential information to a close friend or family member knowing the person will use it to trade, but not requesting or expecting anything in return other than the satisfaction of having settled scores with his detractors in the company? Moreover, the *Newman II* ruling showed sensitivity to the fact that even blood relatives may not be close, and seemed to impose a requirement that the facts must establish the extent to which the blood relatives or friends are close and how that might result in a tangible pecuniary and objective personal benefit to the insider-tipper.[141]

The Court's effort to provide a valid argument in support of its ruling in *Salman* is unconvincing. Again, quoting from *Dirks*, the argument is that "when an insider makes a gift of confidential information to a trading relative or friend,"[142] the "[t]ip and trade

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140. The Court realized that "[d]etermining whether an insider personally benefits from a particular disclosure [is] a question of fact [that] will not always be easy for courts," but it leaves that to the lower courts, concluding "there is no need for us to address these difficult cases today." Salman v. United States, 137 S. Ct. 420, 429 (2016) (first alteration in original) (first quoting Dirks v. SEC, 463 U.S. 646, 664 (1983)).

141. *See* United States v. Reed, 601 F. Supp. 685, 706 (S.D.N.Y.) ("'However mere kinship does not of itself establish a confidential relation.' Rather, the existence of a confidential relationship must be determined independently of a preexisting family relationship." (citations omitted)), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985)

142. *Salman*, 137 S. Ct. at 427 (emphasis omitted) (quoting *Dirks*, 463 U.S. at 664).

resemble trading by the insider followed by a gift of the profits to the recipient."[143] In particular, the Court notes that "Salman's counsel acknowledged at oral argument, Maher [the tipper-relative] would have breached his duty had he personally traded on the information here himself then given the proceeds as a gift to his brother [Michael, the tippee]."[144] From this concession, the Court concludes: "It is obvious that Maher would personally benefit in that situation. But Maher effectively achieved the same result [Giving money to Michael? Personal benefit to Maher?] by disclosing the information to Michael, and allowing him to trade on it."[145] The crucial questions here are, what is meant by "the same result?" And from whose perspective? To the Court, the same result is that Maher as "the tipper benefits personally because giving a gift of trading information [from which we may infer an intent to "provide the equivalent of a cash gift"] is the same thing as trading by the tipper followed by a gift of the proceeds."[146] To be sure, if we accept the Court's premises, in both cases Maher gives cash to Michael, but in the case of confidential gift-giving, what is the benefit to Maher required for conviction? We are not told by the Court.

The argument is flawed in any event. It is not true from Maher's perspective the same result is achieved. In the first, Maher violates the law, makes money, and then gives it away. In the second, he may or may not have violated the law (depending on whether he got a benefit), he does not make any money, but gives the sure-bet opportunity to make money to his brother. In some sense, he may get a benefit from that gift, but the nature of any benefit he received for purposes of determining whether he violated the law is left undefined and indeterminate. It is true that from Michael's perspective the same result is achieved in both scenarios: He receives money from Maher. It does not follow that, from Michael's perspective, in legal contemplation the same result obtains in both situations. In the first, Maher violates the insider law by trading on the information; he does not violate the insider rule *because* he gives his profits to his brother. That fact is entirely irrelevant to the legal determination of Maher's conduct under the insider law. Unless Michael knew about and participated in Maher's scheme in the first situation, Michael has not violated the law. In the second, Maher breached his duty to the company, in my view, but he has not violated insider trading law, unless he received a personal benefit from Michael. Michael has also not violated the law, unless he

143. *Id.* (quoting *Dirks*, 463 U.S. at 664).
144. *Id.* at 427–28.
145. *Id.* at 428.
146. *Id.*

knew that Maher breached his duty for a personal benefit. In the Court's view, in the second situation both violate the insider rule because caring for one's brother is a sufficient personal benefit. That is a slender reed upon which to base criminal prosecution.

The difficult gap to close in the *Salman* decision is the failure to define the nature of the personal benefit that must be proven in both cases for the government to convict. In the first, the monetary benefit to Maher is clear, and imposition of liability is warranted independent of what he does with the trading profits. In the second, imposition of liability on Maher may also be warranted depending on the facts, but a rule of law that requires some type of undefined personal benefit to Maher before holding Michael (and others with whom he shares the information) liable invites confusion among those expected to comply.

Consider the following hypothetical to illustrate the difficulty of the courts bridging this gap. Suppose a person takes a gun, pulls the trigger, and kills another person. Now, suppose a person is cleaning a weapon, accidentally pulls the trigger, and kills another individual nearby. In both cases, the victim is dead. But for the shooter the moral and legal consequences of the acts are radically different. In the first, he has committed an immoral act, a horrible crime, and is subject to prosecution for murder. In the second, assessment of his moral and legal culpability is far more complicated, and it is best accomplished through a legislative classification scheme that defines various categories of crimes to which he might be subject from reckless endangerment to criminally negligent or involuntary manslaughter depending on the circumstances.

3. Unintended Consequences of Judicial Efforts to Constrain Insider-Trading Doctrine

The developments discussed above to cope with the criminal consequences of a regulatory insider trading standard and the proper definition of the personal benefit element of that crime may result in unintended consequences that could be harmful to enforcement of insider-trading prohibition. The position advocated by Justices Scalia and Thomas in *Whitman* may succeed in confining the SEC enforcement role to its civil jurisdiction but at the cost of developing two inconsistent bodies of insider-trading rules that may not be reconcilable by the federal courts.[147] The personal-benefit rule announced in *Newman II,* if applied after the Court's *Salman* ruling to cases other than those involving close family members or friends, may

147. *See Whitman*, 135 S. Ct. at 353 (Scalia, J., respecting the denial of certiorari).

unintentionally encourage the SEC to make greater use of its internal process, where it has the authority to review de novo and reverse its ALJ rulings to fashion its own standard.[148] The SEC may apply the Court's *Salman* personal-benefit standard to all insider-trading cases adjudicated internally (involving social acquaintances, friends or family members by blood or marriage, whether or not they are closely related or alienated from each other). In effect, if the SEC does not like the legal standard developed by federal courts to adjudicate its insider-trading cases, the SEC can fashion its own rule within its bureaucratic structure. It can shape the administrative record to constrain federal appellate review, succeeding, at the very least, in imposing costs on litigants and the appellate courts and in frustrating the coherent development of doctrine in an important area of law.[149]

The SEC has broadly interpreted its adjudicatory function under its statutory authority. While its ALJs may "conduct hearings, take testimony," supervise the conduct of discovery, and "issue initial decisions," in the SEC's view nothing is final until and unless the Commission affirmatively acts to issue its final order.[150] By practice, it grants all petitions for review of initial decisions, and it may on its own motion decide to review an initial decision not appealed to the Commission.[151] In conducting its review, the SEC construes its authority as empowering it to "affirm, reverse, . . . remand[,] . . . hear additional evidence, . . . [and] make any findings or conclusions that in [our] judgment are proper and on the basis of the record."[152] In short, the SEC "ultimately controls the record for review [by the federal courts of appeals] and decides what is in the record."[153] While paying lip service to its ALJs by characterizing their role as "significant . . . in helping to shape the administrative record," in fact the SEC conceives of them as "employees," lacking independence and effective discretionary authority, whose main function is to serve as aides-de-camp.[154] The SEC's conception of its statutory authority seeks to transform its ALJs, in the words of the Tenth Circuit in *Bandimere*, "into lesser functionaries."[155]

If ultimately accepted by the Court, some aspects of the two

148. *See, e.g.*, Raymond J. Lucia Cos., Exchange Act Release No. 75837, 2015 WL 5172953, at *21 (Sept. 3, 2015).

149. *See id.*

150. *Id.* at *22 (citing 17 C.F.R. § 201.360(a)(1), (d) (2016)).

151. *See id.*

152. *Id.* (third alteration in original) (citing 17 C.F.R. § 201.411(a)).

153. *Id.*

154. *See id.* at *22–23 & nn.120–21.

155. Bandimere v. SEC, 844 F.3d 1168, 1188 (10th Cir. 2016).

doctrinal developments discussed above will impose higher standards for criminal insider-trading cases and make it harder, in cases other than those involving close family members and friends, for the government and the SEC to prove their cases in federal courts.[156] Acceptance of these doctrinal developments also run the risk of bifurcating insider-trading enforcement under two different regimes (one administrative and one judicial). More troubling is that even if these two legal developments are fully adopted by the Court, they will not remove the federal courts from their current role of retrospectively adjudicating, case-by-case, the *common-law crime* of insider trading. A better approach to assert the authority of the federal courts in enforcement of criminal law, not burdened by administrative guidance to which deference is required, is to invalidate the federal doctrine of insider-trading common-law crime. That doctrine is not supported by constitutional foundation as announced in the *Hudson* doctrine.[157] The

156. In its certiorari petition in *Newman II*, the government argued for a less strict standard of personal benefit as between tipper and tippee friends than the one announced by the Second Circuit. *See* Petition for a Writ of Certiorari at 14–22, United States v. Newman, 136 S. Ct. 242 (2015) (No. 15-137), 2015 WL 4572753. The government argued for reversal of the *Newman II* standard because, in its view, the personal-benefit definition there announced was contrary to the *Dirks* decision and its harmful consequences "will be to hurt market participants, disadvantage scrupulous market analysts, and impair the government's ability to protect the fairness and integrity of the securities markets." *Id.* at 15. The Court declined to review the *Newman II* decision. United States v. Newman, 136 S. Ct. 242 (2015).

In *Salman*, the Court reaffirmed the personal benefit standard announced in *Dirks* at least for closely related family member tippers and tippees. *See supra* Part III. The government, in its brief in *Salman*, had argued for re-affirmance and broadening of the *Dirks* rule: "when the objective facts show that information was provided as a gift [to *any* person, not just relative or friend] for securities trading, and no corporate purpose exists for the disclosure, the personal-benefit test is satisfied." Brief for the United States, *supra* note 131, at 11, 18–28. In the government's view, personal gifts "inherently provide tangible and intangible benefits to the giver." *Id.* at 11. Accordingly, the government's view of *Dirks* is that it requires no detailed inquiry into the nature and closeness of the relationship between an insider-tipper and tippees. *Id.* at 28. The opinion in *Salman* noted the government's argument but neither endorsed nor repudiated it. *See* Salman v. United States, 137 S. Ct. 420, 427–28 (2016).

157. Declaring that federal courts lack constitutional authority to enforce the common-law crime of insider trading would not end the debate on the propriety of enforcing or banning insider trading; it would shift the focus of the debate from the judiciary to Congress, where it belongs. *See* GOEBEL, *supra* note 21, at xix. Congress has authority and could enact an appropriate statute, if it were persuaded to do so. *See id.* Meantime, in appropriate cases of clearly wrongful conduct, insider trading might be prosecuted under the mail and wire fraud statutes. 18 U.S.C. §§ 1341, 1343 (2012); *see also* Carpenter v. United States, 484 U.S. 19, 27 (1987) (holding that an insider trading scheme was not outside the mail and wire fraud statutes). Those who commit "insider trading" through, say, theft may also be subject to prosecution under other criminal statutes, depending on

Court should leave it to Congress, if it chooses to do so, to make insider trading a crime by statute, to synchronize the enforcement of that law (as only Congress can), and clearly to allocate jurisdiction between the federal courts and the SEC. Together, Congress and the courts can achieve the "ideal of a unified system of judge-made and statute law woven into a seamless whole by the processes of adjudication";[158] or so I shall argue.

V. COORDINATION OF FEDERAL INSIDER-TRADING DOCTRINE BY COURTS AND THE SEC

Except for a higher burden of proof (beyond a reasonable doubt) and the additional mental state of *mens rea* ("willfully," that is, knowingly and purposefully engaging in conduct) in criminal cases,[159] ideally the substantive elements of civil and criminal insider trading, deriving as they do from the same statutory and regulatory texts, should be the same. Under existing law, that is unfortunately not the case.[160]

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the nature of the conduct. Without criminal enforcement by the U.S. Attorneys (absent prompt congressional legislation in the case of constitutional invalidation), certain types of insider trading would still remain a fraud subject to civil liability. *See* Strong v. Repide, 213 U.S. 419, 434–35 (1909); SEC v. Payton, 97 F. Supp. 3d 558, 559 (S.D.N.Y. 2015). Civil enforcement by the SEC (in federal courts, at least for claims required by statute to be brought there, or in administrative cases where the SEC has a choice) and by private parties (under Rule 10b-5 and section 20A, 15 U.S.C. §78t-1(a), of the Exchange Act private cause of action) would therefore remain viable.

158. Harlan F. Stone, *The Common Law in the United States*, 50 HARV. L. REV. 4, 12 (1936).

159. In a criminal case, the government must prove every element of the crime beyond a reasonable doubt. *E.g.*, Jackson v. Virginia, 443 U.S. 307, 313–14 (1979); *In re* Winship, 397 U.S. 358, 362 (1970). Thus, for example, to establish the element of knowledge of breach of duty and personal benefit in a criminal case, the government must prove beyond a reasonable doubt that the tippee knew or consciously avoided knowing of facts establishing those elements; but in a civil case, the SEC need only prove by a preponderance of evidence that the tippee knew or *should have known* of such facts. *See* United States v. Gansman, 657 F.3d 85, 91 n.7 (2d Cir. 2011) (citing SEC v. McNulty, 137 F.3d 732, 741 (2d Cir. 1998)); SEC v. Adler, 137 F.3d 1325, 1343 n.48 (11th Cir. 1998). Proof of civil securities fraud requires scienter—a showing of "a mental state embracing intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976). However, the scienter element differs for criminal and civil cases. *See* United States v. Parigian, 824 F.3d 5, 11 (1st Cir. 2016); *Gansman*, 657 F.3d at 91 n.7 (stating that in criminal cases, the government must prove willfulness; in civil cases, SEC liability can be proven from reckless conduct). The federal securities laws permit a defendant to avoid imprisonment for violation of Rule 10b-5 by "prov[ing] that he had no knowledge of such rule or regulation." 15 U.S.C. § 78ff(a) (2012); *see also* United States v. O'Hagan, 521 U.S. 642, 666 (1997).

160. *See supra* Part III.

A. *Elements of Civil and Criminal Insider Trading: On the Basis of Inside Information*

This point is well illustrated by the controversy in current case law about the evidence needed to establish that someone traded "on the basis of" inside information, a required element of an insider-trading violation.[161] The SEC position, which has varied, makes mere awareness or possession of inside information followed by trading[162] sufficient to establish the element of "on the basis of," unless rebutted by certain affirmative defenses.[163] The federal courts have not reached uniformity on this issue, and most do not share the SEC position—at least in criminal cases.[164] In civil cases, some courts substantially agree with the SEC Rule 10b-5(1) standard by applying a "knowing possession" standard—knowing possession of insider information creates a presumption of its use in buying or selling securities;[165] most courts disagree, however, and adopt the "use" or "causal connection" test.[166] In criminal cases, on the other hand, the courts tend to disavow

161. 17 C.F.R. § 240.10b5-1 (2016).

162. It is not entirely clear that the SEC position distinguishes between possession of material inside information before a decision to trade is made and after such decision but before actual trading occurs. *See Adler*, 137 F.3d at 1336. In any event, as explained in the Appendix to this Article, the SEC position in Rule 10b-5(1) encounters significant philosophical and logical difficulties. *See infra* Appendix.

163. 17 C.F.R. § 240.10b5-1.

164. *See, e.g., Gansman*, 657 F.3d at 91 n.7.

165. *See, e.g., Adler*, 137 F.3d at 1335 n.24, 1337–39 (discussing the then-existing case law on this issue, concluding "that they do not persuade us to adopt the knowing possession test," and adopting the standard that possession creates "strong inference" of use). The SEC's position on this issue has fluctuated over time. *Id.* at 1336. SEC Rule 10b-5(1) was promulgated after (and suggested by) the *Adler* decision and became effective on October 23, 2000. *See id.* at 1337 n.33; Selective Disclosure and Insider Trading, 65 F.R. 51716, 51716 (Aug. 24, 2000); 17 C.F.R. § 240.10b-5(1)(b). Some cases accept the mere awareness or possession standard. SEC v. Moshayedi, SACV 12-01179, 2013 U.S. Dist. LEXIS 143624, at *44 (C.D. Cal., Sept. 23, 2013) (relying on SEC promulgation of Rule 10b-5(1) after United States v. Smith, 155 F.3d 1051 (9th Cir. 1998), *cert. denied*, 525 U.S. 1071 (1999), district court concludes that "awareness or possession" of inside information is enough to prove civil liability). Others apply the *Adler* standard. *See* Johnson v. Aljian, 394 F. Supp. 2d 1184, 1196–99 (C.D. Cal. 2004) (applying the *Adler* presumption test to a civil insider trading case under section 20A, 15 U.S.C. § 78t-1(a), to impose liability on insider to one "who traded contemporaneously with the insider," and distinguishing Ninth Circuit's *Smith* test because it was a criminal case). The SEC has adopted the possession standard for tender offers. 17 C.F.R. § 240.14e-3(a).

166. *See* SEC v. Bauer, 723 F.3d 758, 776 (7th Cir. 2013) ("We upheld . . . the general weight of authority that the SEC has the burden to prove that inside information played a *causal* role in the trade." (emphasis added) (citing SEC v. Lipton, 278 F.3d 656, 660 (7th Cir. 2002))); SEC v. Life Partners Holdings, Inc., 41 F. Supp. 3d 550, 560 (W.D. Tex. 2013)

the "knowing possession" standard,[167] accepted only by the Second Circuit in criminal and civil cases,[168] and require proof of actual use of material nonpublic information for conviction.[169]

In the Second Circuit, the "Mother Court" for securities cases,[170] *Newman II*, has now created substantial additional uncertainty about the nature of the "personal benefit" that must be proven in criminal

("[SEC] must prove that . . . [defendant] 'intentionally used this material, nonpublic information in making this trade.'" (quoting SEC v. Snyder, No. H-03-04658, 2006 WL 1806164, at *9 (S.D. Tex., June 29, 2006))); SEC v. Talbot, 430 F. Supp. 2d 1029, 1045 n.50 (C.D. Cal. 2006) (stating the court did not decide whether SEC must prove "use" or mere "possession" because evidence shows that defendant "not only possessed, but used, material nonpublic information"), *rev'd on other grounds*, 530 F.3d 1085 (9th Cir. 2008). For a comprehensive review of the case law (including congressional efforts) in this area as it existed as of June 1997, which concluded that the issue is "a difficult one" and that it "should be resolved definitively in favor of a causation test, preferably through well-crafted legislation," see Horwich, *supra* note 15, at 1278.

167. *See* United States v. Anderson, 533 F.3d 623, 630–31 (8th Cir. 2008) (stating mere possession of inside information is not enough; government must prove the defendant used the information and that it was a "significant factor"); United States v. Larrabee, 240 F.3d 18, 24–25 (1st Cir. 2001) (holding that possession, coupled with surrounding circumstances, can support conclusion of intended use); *Smith*, 155 F.3d at 1066–69 (rejecting "knowing possession" for actual "use" of inside information in criminal case partly because of constitutional issue that might otherwise arise from burden-shifting to defendant, but leaves open issue of presumption of use from possession in civil case); United States v. Causey, No. H-04-025-SS, 2005 WL 3560632, at *5–6 (S.D. Tex. Dec. 29, 2005) (holding that insider information must at least be "a factor" in the trade for violation of Section 10(b)). *But see* United States v. Nacchio, 519 F.3d 1140, 1167–68 (10th Cir. 2008) (concluding that the district court jury instruction that defendant must have "actually used material non-public information in deciding to trade" to be found guilty and that such information had to have been a "significant factor" in trading is "arguably incorrect" in view of SEC Rule 10b-5(1), but reviewing the sufficiency of the evidence for conviction using the government's proposed instruction adopting use-as-a-factor test, since Rule 10b-5(1) was not challenged on appeal).

168. *See* United States v. Whitman, 555 F. App'x. 98, 107 (2d Cir. 2014), *cert. denied*, 135 S. Ct. 352 (2014) (applying Circuit law and noting that only an en banc court could adopt Ninth Circuit ruling in *Smith*); United States v. Rajaratnam, 719 F.3d 139, 157–60 (2d Cir. 2013) (declining the defendant's request to adopt some causation element and applying knowing possession standard); United States v. Royer, 549 F.3d 886, 899 (2d Cir. 2008) (adopting *Teicher* knowing possession standard as law of the Circuit); United States v. Teicher, 987 F.2d 112, 119–21 (2d Cir. 1993) (indicating in dicta that the Second Circuit would accept the "knowing possession" standard in a criminal case). The Second Circuit applies the same test in civil cases. *See* Steginsky v. Xcelera Inc., 741 F.3d 365, 370 (2d Cir. 2014); SEC v. Obus, 693 F.3d 276, 288 (2d Cir. 2012).

169. *See, e.g.*, United States v. Dombrowski, No. 14 CR 41, 2014 WL 3454320, at *2 (N.D. Ill. 2014) (holding that an indictment need not specifically allege that the defendant possessed and actually used the inside information).

170. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 762 (1975) (Blackmun, J., dissenting).

cases not involving closely knit family members or close friends and whether that element is even required in misappropriation criminal cases. The courts are agreed that breach of fiduciary duty by the insider-tipper *simpliciter* is insufficient to establish insider-trading fraud under the securities statutes, and that the breach of duty must be for some improper purpose or accompanied by a "personal benefit" of some kind to the insider to render the breach of duty fraudulent.[171] In other words, "the insider's disclosure of confidential information, standing alone, is not a breach [for the purpose of insider trading]."[172]

B. The Personal Benefit Controversy

The dispute spawned by *Newman II* is over the nature of the personal benefit and the circumstances from which an inference of that benefit and its knowledge by a tippee can be inferred when the tipper and tippee are social friends, and not relatives.[173] The problem is more acute the further removed from the tipper the tippee stands.[174] In the words of the Second Circuit:

> To the extent Dirks suggests that a personal benefit may be inferred from a personal relationship between the tipper and tippee, where the tippee's trades 'resemble trading by the insider himself followed by a gift of the profits to the recipient,' . . . such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.[175]

The *Newman II* and *Salman* standards are plainly inconsistent. It

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171. *See Newman II*, 773 F.3d 438, 448 (2d Cir. 2014).

172. *Id.*

173. *See id.* at 452. In *Salman*, the Court resolved the issue when the tipper and tippees are close blood relatives or related by marriage, the tipper-relative knows that the family member tippee will trade using the confidential information, and the second-level tippee knows the tipper is a family member who breached his fiduciary duty in disclosing confidential corporate information to another relative. *See supra* Section IV.C. That is enough to infer a personal benefit, the Court held in *Salman*, and the more rigorous standard announced in *Newman II* is not required. *See supra* Section IV.C.

174. *Id.* at 443 (noting that tippees were three to four levels removed from the tippers).

175. *Id.* at 452 (internal citation omitted); *cf.* United States v. Salman, 792 F.3d 1087, 1092 ("The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend." (alteration and emphases omitted) (quoting Dirks v. SEC, 463 U.S. 646, 664 (1983))).

may well be that the inconsistency is explainable by the different factual contexts of the two cases. Would the *Salman* Court, for example, apply its standard to a transaction involving a "gift" of inside information between casual social friends, including persons far removed from the tipper? Would the *Newman II* Court, on the other hand, apply the *Salman* standard to trading by close-knit family members based on confidential information provided by a blood relative, even if the "gift giver" is a distant cousin? Or would it require proof of both a close relationship notwithstanding the blood connection and of a tangible pecuniary benefit? The Court's ruling in *Salman* strongly points in the direction of applying the *Dirks* standard at least where close family members (by blood or marriage) are involved, but it does not directly address which standard to apply in cases of casual friends or social acquaintances.

Resolution of the inconsistency between standards announced by these two cases, however, will only achieve consistency among the federal courts. It will leave untouched potential conflict between the federal courts' standard and whatever standard the SEC ultimately settles on to decide administrative insider-trading cases.[176] Moreover, differing standards between the federal courts and the SEC may provide future occasions for unseemly public disputes between the Department of Justice (DOJ) and the SEC of the sort that occurred in *Dirks*.[177] The unfortunate problem is that there may be no adequate mechanism for the federal courts to resolve a future difference regarding insider-trading standards applied by the federal courts and by the SEC. The development of doctrine in this area, if not synchronized between courts and administrative agencies, may therefore result in perverse consequences.

C. *Using* Chevron *Deference to Check the SEC*

An anomaly in granting deference to the SEC in regard to interpretation of Section 10(b) of the Exchange Act and Rule 10b-5 under that statute to prohibit insider trading is that the courts treat the failure of Congress expressly to provide for a definition of insider

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176. An SEC ALJ initial decision adopting the stricter *Newman II* personal-benefit standard is on petition for *de novo* review by the SEC Commissioners. *See* discussion *supra* note 7.

177. 463 U.S. at 648. As amicus, the DOJ urged the Court to reject the SEC insider-trading theory used to charge Dirks, a securities analyst, who shared information with clients and investors about a corporate fraud obtained from an insider acting mainly to expose the fraud. *Id.* at 665 n.25. The *Dirks* case is discussed Section III *supra*.

trading in the statute as a statutory "ambiguity."[178] This position requires that the courts read the statutory language to prohibit "use [or employment], in connection with the purchase or sale of any security [of] . . . any manipulative or deceptive device or contrivance" as sufficiently ambiguous to permit an administrative rule that bans use of "any device, scheme, or artifice to defraud," use of any "untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading," and to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person," whether or not the fraud or deceit is toward a counterparty in the trading transaction.[179]

Despite the clear statement of intent in the *legislative history* to allow an insider-trading prohibition, the Court might well conclude the statutory language is not sufficiently clear to permit the SEC to disconnect the fraud and deceit from the trading transaction.[180] As a result of such construction, the Court could deny deference to SEC Rule 10b-5. Whether the Court ultimately continues to grant deference to SEC administrative decisions under *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*,[181] or reverses course and declines deference, we may wind up with two separate bodies of substantive insider-trading law.[182]

Under *Chevron* deference, federal courts will grant substantial

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178. *See* Whitman v. United States, 135 S. Ct. 352, 354 (2014) (Scalia, J., respecting the denial of certiorari) ("Congress cannot, through ambiguity, effectively leave the function to the courts—much less to the administrative bureaucracy." (citing United States v. Wiltberger , 5 Wheat. 76, 95 (1820))). One cannot plausibly read the absence of inclusion of an insider-trading offense in the legislation as an unambiguous statement of congressional intent not to ban insider trading, in part because committees of Congress have affirmatively expressed acquiescence in the doctrine as enforced by federal courts under Rule 10b-5.

179. *See* 17 C.F.R. § 240.10b-5 (2016).

180. In civil securities fraud cases, the Court requires "a connection between the misrepresentation or omission and the purchase or sale of a security." Erica P. John Fund, Inc. v. Halliburton Co., 563 U.S. 804, 809–10 (2011) (quoting Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 37–38 (2011)).

181. 467 U.S. 837 (1984); *see* Bell, *supra* note 109, at 118–21.

182. The divergence may not be as wide and deep because the Court reaffirmed the *Dirks* standard in cases involving closely knit family members, as the government urged it to do in *Salman*. *See supra* Section IV.C. The SEC will presumably follow the *Salman* standard and may seek to apply it in all insider cases. But that consistency will be achieved at the cost of extreme uncertainty for downstream traders with knowledge of information not widely disclosed in the markets and whatever impact the conduct of such participants would have in the efficient operations of the securities markets. Balancing those costs and making the policy choice of where to draw the line is a job for Congress, and not for the courts (even if they were institutionally suited to perform the task).

deference to an administrative agency's interpretation of an ambiguous statute it administers, where the agency position is reasonable, permissible, and articulated in a rule or regulation outside of a litigation context.[183] If, on the other hand, Congress has addressed the issue in the statutory text or made its intent clear in the text, the statutory structure, and legislative history, the courts under *Chevron* must enforce whatever they conclude is the congressional mandate without granting deference to an agency's view.[184] Thus, absent an unambiguous statute, the federal courts of appeals (to which SEC rulings are appealed) will presume administrative rulings approved by the SEC to be correct unless judged unreasonable.[185] On the other hand, securities cases reaching the courts of appeals from the federal district courts do not enjoy such deference on issues of law.[186] The courts of appeals will use a *de novo* standard to review lower federal court rulings.[187]

If the SEC continues to enjoy *Chevron* deference, we may wind up with a body of law developed by federal courts in criminal cases and in private actions, while the SEC applies a different (and perhaps inconsistent) set of rules in administrative cases. If the Court were to deny *Chevron* deference to SEC rulings because the statutes under which it operates provides for both criminal and civil sanctions, and if (contrary to federal rulings) the SEC pursued its own administrative agency interpretations, we may, as a practical matter, be presented with two substantive bodies of insider-trading law, even though the legal problem would in principle be less acute. This would require frequent appeals to the courts of appeals by losing respondents in SEC administrative proceedings.[188]

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183. *See, e.g.*, Conn. Office of Prot. & Advocacy for Persons with Disabilities v. Hartford Bd. of Educ., 464 F.3d 229, 239 (2d Cir. 2006) ("Where, as here, an agency advances a statutory interpretation in an amicus brief that has not been articulated before in a rule or regulation, we do not apply the high level of deference due under [*Chevron*]."); Bell, *supra* note 109, at 120 ("Some courts also have found *Chevron* inapplicable when the agency promulgates an interpretation by means of interpretive rules, policy statements, or more informal documents." (listing cases))

184. *See Chevron*, 867 U.S. at 843–44.

185. 15 U.S.C. §78y(a)(4) (2012) (providing that SEC findings of fact are "conclusive" if supported "by substantial evidence").

186. *See* United States v. Anderson, 533 F.3d 623, 629 (8th Cir. 2008).

187. *See id.*

188. Needless to say, this would increase the workload of the already overburdened federal appellate courts and result in increased legal costs to litigants. Unlike the Soviet Union, the courts of appeals have survived well pass 1984, despite the increasing caseload and the steady level of judges. *See* Richard A. Posner, *Will the Federal Courts of Appeals Survive Until 1984? An Essay on Delegation and Specialization of the Judicial Function,*

Ideally, of course, the courts and the administrative bureaucracy with adjudicatory authority should coordinate functions in a state, such as the United States, where administrative agencies are responsible for and administer a vast area of public law:

> [C]ourt and agency are not to be regarded as wholly independent and unrelated instrumentalities of justice, each acting in the performance of its prescribed statutory duty without regard to the appropriate function of the other in securing the plainly indicated objects of the statute. Court and agency are the means adopted to attain the prescribed end, and so far as their duties are defined by the words of the statute, those words should be construed so as to attain that end through co-ordinated action. Neither body should repeat in this day the mistake made by the courts of law when equity was struggling for recognition as an ameliorating system of justice; neither can rightly be regarded by the other as an alien intruder, to be tolerated if must be, but never to be encouraged or aided by the other in the attainment of the common aim.[189]

The better practice, therefore, is for an administrative agency like the SEC and its in-house ALJs with authority to adjudicate civil, but not criminal, actions under dual-purpose (civil and criminal statutes) to follow whatever federal standard is announced by the Court.[190]

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56 S. CAL. L. REV. 761, 761–62 (1983) (discussing the federal courts of appeals "caseload crisis" and some proposed remedies). There is, however, statistical evidence to suggest that overburdening the appellate courts impacts the quality of their work product, and does not just result in the tweaking of process to shorten the queue, and expedite the disposition, of cases heard on appeal. *See generally* Bert I. Huang, *Lightened Scrutiny*, 124 HARV. L. REV. 1109 (2011). At the court of appeals level, the chances of reversal are greater where the SEC has reversed an ALJ ruling. *See* Flannery v. SEC, 810 F.3d 1, 9 (1st Cir. 2015).

189. United States v. Morgan, 307 U.S. 183, 191 (1939) (footnote omitted).

190. *See, e.g.*, Bolan, S.E.C. Release No. 2309, 2015 WL 12734754, at *1–2 (ALJ Feb. 12, 2015); Stephanie Russell-Kraft, *SEC Admin Judge Will Apply Newman to Insider Trading Case*, LAW360 (Feb. 11, 2015, 7:18 PM), http://www.law360.com/articles/620709/sec-admin-judge-will-apply-newman-to-insider-trading-case. Even with the stricter *Newman II* personal-benefit standard, the application of that standard will ultimately turn upon the interpretation by the trier of fact of the nature of the personal relationship between the tipper and tippee. *See* Bolan, S.E.C. Release No. 2350, 2015 WL 12734754, at *3 (ALJ Feb. 25, 2015) (sum. disposition) ("[I]t is . . . an open question whether and what sort of friendship may satisfy the personal benefit element . . . ."). The ALJ ultimately ruled that the SEC had not met the stricter standard of personal benefit announced in *Newman II*. Bolan, S.E.C. Release No. 877, 2015 WL 5316569, at *1 (ALJ Sept. 14, 2015) (initial decision). That initial decision is now on petition for *de novo* review by the SEC

D. Limits to Checking Agency Action

There are, however, limits on the extent to which both the executive and the judiciary can control administrative agency action.[191] This is especially the case when dealing with an agency like the SEC that is widely perceived to be an agency within, but "independent" from, the executive branch.[192] Thus, there is no assurance that the SEC will

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Commissioners. *See* Bolan, Exchange Act Release No. 76614, 2015 WL 8519533, at *1 (Dec. 10, 2015).

191. Courts can try to control agencies through the standards used to review agency interpretation of statutes or agency adjudicatory action and rule-making. *See* Bell, *supra* note 109, at 118–47. In reviewing agency statutory interpretations, the courts confine their review to an agency's ultimate conclusion without examining the interpretive methodology used by the agency to reach that conclusion. *Id.* at 121. Agencies are therefore free to do what courts may decide not to do: rely on legislative history, promote a particular policy choice, disregard canons of statutory construction, and so on. *Id.* at 128–29. The courts use this standard on the premise that Congress has implicitly delegated to the agency the task of deciding issues left unresolved in the statutory text. *Id.* at 118. In ordinary review of agency action, the courts basically use the two standards of (1) arbitrary and capricious and (2) substantial evidence test. *Id.* at 121 n.86. With these tests, the reviewing court is still limited to the agency's factual record, and if it disagrees with the conclusion or analysis, the court must remand the case for agency reconsideration. *Id.*

In contrast, when courts conduct plenary or *de novo* review, they re-determine the issue without being limited by matters not considered by the initial decision maker, and that person's view is accorded no weight. *Id.* at 122. Moreover, the hierarchical and authoritative structure of agencies make it more likely that agencies will be quicker to "create uniform legal standards." *Id.* at 147. On the other hand, with thirteen courts of appeals and only one Supreme Court to issue authoritative rulings, it is far more difficult for the federal judiciary to achieve uniformity in its doctrine. *Id.*

As to executive control of agencies, while the President can exercise the power of appointment and removal in many cases not involving independent agencies, the President is not able to reverse agency decisions to exercise political control. Congress also has various means to exercise control over agencies, although "political accountability can, like agency expertise, be overstated." *Id.* at 147.

192. In a strict legal sense, the SEC's independence is not entirely free from doubt. *See* Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 561 U.S. 477, 483 (2010). Independent agencies are "agencies run by principal officers appointed by the President, whom the President may not remove at will but only for good cause." *Id.* at 479. The Court notes that the "parties agree that the [SEC] Commissioners cannot themselves be removed by the President except under the *Humphrey's Executor* standard of 'inefficiency, neglect of duty, or malfeasance in office,' and we decide the case with that understanding." *Id.* at 487 (internal citations omitted). The dissent questioned that view. *Id.* at 546 (Breyer, J., dissenting) ("It is certainly not obvious that the SEC Commissioners enjoy 'for cause' protection. Unlike the statutes establishing the 48 federal [independent] agencies listed in Appendix A, the statute that established the Commission says nothing about removal. It *is silent* on the question. As far as its text is concerned, the President's authority to remove the Commissioners is no different from his authority to

follow the federal courts in interpreting insider-trading law. Indeed, the SEC decision to pursue more of its cases in administrative proceedings does not augur well for agency deference to, and enforcement coordination with, the federal judiciary. And there is no indication that Congress would strip the SEC of its greater authority to bring cases in-house or even require it to follow federal court rulings in insider-trading cases so soon after passing Dodd-Frank as a panacea to regulating Wall Street (and given the current political populist environment).[193]

In the near- or mid-term, the landscape we confront in this area is pretty much set, and the performance of the human actors in each sphere is, like particles in the natural world, likely to collide, perhaps in inconsistent, if not contradictory ways. Without a God-like Higgs boson to maintain equilibrium, chaos may well reign supreme. In such a legal landscape, to quote a Swahili proverb, when the elephants fight the grass gets hurt; that is, when the federal courts and the SEC fight, the participants in the securities markets are likely to suffer.[194]

VI. THE DANGERS OF PARALLEL LEGAL DEVELOPMENT

Without a mechanism for authoritative and final reconciliation of differing views between the courts and the SEC, parallel development of insider-trading law could turn out to be somewhat reminiscent of the substantive development of insurance law during the era of *Swift v. Tyson*.[195] That doctrine, announced by Justice Joseph Story in 1842, essentially held "that upon questions of general commercial law the Court would ascertain the law for itself and would not be bound by State decisions."[196]

A. *Insurance Law Under the* Swift v. Tyson *Regime*

In the mid-nineteenth century, it was thought for a long time that the business of insurance was subject only to state regulation because it was not part of interstate commerce. Therefore, under the *Swift v. Tyson* doctrine, in cases coming to the federal courts from the insurance

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remove the Secretary of State or the Attorney General." (internal citation omitted)). *See generally* Note, *The SEC is Not an Independent Agency*, 126 HARV. L. REV. 781 (2013).

193. In any event, enforcing such a requirement would create practical difficulties and impose additional costs on the legal system and litigants.

194. *See* African Proverb of the Month November, 2001, AFRIPROV.ORG, http://www.afriprov.org/african-proverb-of-the-month/27-2001proverbs/172-nov2001.html (last visited Jan. 1, 2016).

195. 41 U.S. 1 (1842).

196. WARREN, *supra* note 57, at 420.

industry the "federal courts were at liberty to develop a federal common law independent of that of the states."[197] As a result, in insurance cases in federal courts under diversity jurisdiction, the lower federal courts (where the states had not enacted a statute) developed and applied a substantive federal common law of insurance—a body of law not necessarily consistent with state substantive insurance law.

In the first half of the nineteenth century, the Court's tergiversation on which substantive law governed matters of general commercial disputes in federal courts based on diversity jurisdiction caused litigants to suffer from unjust outcomes and unfairness as a result of differing rulings by state and federal courts. In some cases, federal judges were personally deeply troubled by such unfairness but were obligated by duty to disregard their personal convictions and to apply the federal common law regime of *Swift v. Tyson*.[198] As Charles Warren points out, during that period one could "see the long line of municipal bond cases, in which the Federal Courts administer the law in one way in favor of a [state] non-citizen, and the State Courts the law in another way, in favor of a citizen."[199]

Worse still, in the insurance industry, a consequence of these judicial rulings was that "the making of insurance law was held to be within federal judicial power, but not within federal Congressional power."[200] The federal courts were creating substantive legal rules to govern private parties in an area over which Congress had no constitutional power! Unlike the situation we now confront with criminal enforcement of insider trading (where Congress has the authority, and the courts, in my view, lack it), Congress was deemed then without constitutional authority to regulate insurance, but federal courts enjoyed the power to develop the substantive law of insurance—without the authority of Congress to invalidate their rulings in this area.[201]

197. PAUL A. FREUND, THE SUPREME COURT OF THE UNITED STATES 18 (1972).

198. ROBERT H. JACKSON, THE STRUGGLE FOR JUDICIAL SUPREMACY: A STUDY OF A CRISIS IN AMERICAN POWER POLITICS 272–80 (1941) [hereinafter JACKSON, THE STRUGGLE FOR JUDICIAL SUPREMACY].

199. Warren, *supra* note 20, at 85 n.83.

200. JACKSON, THE STRUGGLE FOR JUDICIAL SUPREMACY, *supra* note 185, at 280–81.

201. *See id.* In 1944, the Court declared insurance to be part of interstate commerce subject to congressional regulation. United States v. Se. Underwriters Ass'n, 322 U.S. 533, 545 (1944). Congress later ceded (with exceptions) its constitutional power to the states in the McCarran-Ferguson Act. 15 U.S.C. §§ 1011–15 (2012).

B. *The* Erie *Revolution*

Until corrected by the Court, the *Swift v. Tyson* regime resulted in two substantive bodies of law applied by different courts depending on the fortuitous existence of federal jurisdiction.[202] Federal courts achieved consistency among their rulings at the price of creating variance between federal law and some state court rulings.[203] The Supreme Court, without request from the parties, self-corrected that error by declaring the doctrine of *Swift v. Tyson* unconstitutional in *Erie R.R. Co. v. Tompkins*.[204]

There, as all first-year law students are taught, the Pennsylvania plaintiff, injured while walking on a parallel right-of-way of the New York railroad in Pennsylvania, sued the railroad in the Southern District of New York based on diversity jurisdiction.[205] In all likelihood, plaintiff sought to avoid the unfavorable rule of Pennsylvania against trespassers on a railroad right-of-way. In the New York federal court, plaintiff obtained a judgment based on the more favorable federal standard.[206] Based on then-existing law, plaintiff's victory seemed a sure thing.

The Supreme Court granted the railroad's request to review the judgment and, although not requested by the railroad to reverse *Swift v. Tyson*, the Court did just that.[207] The Court concluded that for ninety-six years the federal courts had been exercising a power not conferred by the Constitution either to the courts or to Congress.[208] Today, although criticized in its early years, *Erie* is highly praised as a correctly decided case by eminent authority[209] that, in the view of some

202. Erie R.R. Co. v. Tompkins, 304 U.S. 64, 71 (1938).

203. *Id.* at 74.

204. *Id.* at 77–78 ("If only a question of statutory construction were involved, we should not be prepared to abandon a doctrine so widely applied throughout nearly a century. But the unconstitutionality of the course pursued has now been made clear and compels us to do so.") (footnote omitted)).

205. *Id.* at 69.

206. *See id.*

207. *Id.* at 78–80.

208. JACKSON, THE STRUGGLE FOR JUDICIAL SUPREMACY, *supra* note 185, at 272.

209. *See* Friendly, *supra* note 20, at 422 ("The complementary concepts—that federal courts must follow state decisions on matters of substantive law appropriately cognizable by the states whereas state courts must follow federal decisions on subjects within national legislative power where Congress has so directed or the basic scheme of the Constitution demands—seem so beautifully simple, and so simply beautiful, that we must wonder why a century and a half was needed to discover them, and must wonder even more why anyone should want to shy away once the discovery was made. We may not yet have achieved the best of all possible worlds with respect to the relationship between state and federal law. But the combination of *Erie* with *Clearfield*[*Trust Co. v. United*

students of the Court, remedied a judicially inflicted wound.

VII. TRADITIONAL TECHNIQUES FOR JUDICIAL CONTAINMENT OF INSIDER TRADING

A. *The Constitutional Avoidance Doctrine*

The courts, for good reasons, are reluctant to strike down legislation or even widely accepted judicial doctrine for unconstitutionality.[210] When confronted with legislation raising serious constitutional issues, the Court has frequently interpreted or "construed" the constitutional infirmities away by rewriting the law passed by Congress to uphold its constitutionality.[211]

States, 318 U.S. 363 (1943),] and [*Textile Workers v.*]*Lincoln Mills*[,353 U.S. 448 (1957),] has brought us to a far, far better one than we have ever known before."). Judge Friendly concluded that *Erie* "not only reached the right result but reached it for the only right reason." *Id.* at 384.

Writing in 1964, Judge Friendly also discussed the impact of *Erie*'s progeny on civil securities cases. *Id.* at 413–14. The growth in the development of criminal insider-trading enforcement was to come much later. The "number of reported criminal cases involving criminal violations of 10b-5 [before 1961] is not large." Bacastow, *supra* note 105, at 110 (citing 3 LOUIS LOSS, SECURITIES REGULATION 1449 n.15 (2d ed. 1961 & 1969 Supp. at 3559) (collecting cases to 1961)).

210. WARREN, *supra* note 56, at 24 & n.1 (describing this strong "canon of interpretation" articulated by Justice James Iredell in 1798 and citing early cases in the Court's history subscribing to the canon).

211. Edward J. DeBartolo Corp. v. Fla. Gulf Coast Bldg. & Constr. Trades Council, 485 U.S. 568, 575 (1988) (listing cases).

This is often referred to as the doctrine of constitutional avoidance. *See id.*; Ashwander v. Tenn. Valley Auth., 297 U.S. 288, 347 (1936) (Brandeis, J., concurring) ("[Courts] will not pass upon a constitutional question although properly presented by the record, if there is also present some other ground upon which the case may be disposed of."). In its benign form, the constitutional avoidance doctrine is used by the Court to interpret a statute susceptible to different interpretations by adopting that interpretation that avoids deciding a constitutional question. *See Edward J. DeBartolo Corp.*, 485 U.S. at 575; *Ashwander*, 297 U.S. at 347. In its nefarious form, the doctrine is used in essence to rewrite a statutory text to avoid invalidating a statute of doubtful constitutionality or to conform the statute to the Court's post-enactment constitutional interpretation or even to correct a plain unconstitutional error by Congress. *Cf.* Levin v. Commerce Energy, Inc., 560 U.S. 413, 427 (2010) ("[C]ourts may attempt . . . to implement what the legislature would have willed had it been apprised of the constitutional infirmity." (citing Heckler v. Mathews, 465 U.S. 728, 739 n.5 (1984))). As noted by Justice Ginsburg in *Skilling v. United States*, such cases from the Court are "legion." 561 U.S. 358, 409 n.43 (2010).

The doctrine has deep roots in our jurisprudence. *See* Warren, *supra* note 20, at 79 & n.72 (1924) (referring to an instance where the Court, to uphold a congressional statute as "valid, was obliged, twenty years later, to read into it a limitation which it did not actually contain." (citing Hodgson v. Bowerbank, 9 U.S. 303, 303–04 (1809) (a case in

In recent years, for example, the Court has excised the mandatory portions of the Federal Sentencing Guidelines to conform the law to the Court's post-enactment interpretation of the Sixth Amendment—thus making the mandatory sentencing guidelines advisory and permissive upon the ground that Congress would have preferred that option if presented with the Court's Sixth Amendment rulings requiring jury findings of any fact (except for a previous conviction) used to enhance a sentence.[212] In the case of the so-called "honest services" statute,[213] the Court upheld the constitutionality of an otherwise unconstitutionally vague statute by confining its scope to a judicial gloss making it applicable only where the defendant received bribes or kickbacks.[214]

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which Chief Justice Marshall construed a diversity jurisdictional grant to "be between an alien and a United States citizen, although the Section, in specific language, gave jurisdiction whenever an alien was a party."))).

In virtually all the categories of the cases mentioned above, the Court is making a policy choice that Congress would not necessarily have made if presented with the statutory options framed by the Court's constitutional ruling. *See Skilling*, 561 U.S. at 411 n.43; *Levin*, 560 U.S. at 427; *Edward J. DeBartolo Corp.*, 485 U.S. at 575; *Ashwander*, 297 U.S. at 288; *Hodgson*, 9 U.S. at 303–04. Admittedly, any policy choice made by the Court in choosing among the possible different statutory interpretations or in rewriting congressional legislation can be overturned by Congress. *See* Bell, *supra* note 109, at 151–56. But even if Congress would have made the policy choice selected by the Court, in a democratic society it is preferable that policy choices (especially a choice to declare a course of conduct criminal) embody political legitimacy by being made by the elected representatives of the people in the legislative and executive branches. *See id.*

Moreover, the difficulty of getting the required votes in Congress plus presidential consent to enact corrective legislation after a judicial interpretation that many (even a majority less than two-thirds) in Congress may find incorrect gives the Court, an institution made up of fewer members and thus capable of reaching a decision relatively quicker than Congress, a disproportionate voice, vis-à-vis Congress, in formulating policy choices that should be made by representatives of the country's citizens. *See* U.S. CONST. art. I, § 7, cl. 2; U.S. CONST. art. V. Unless Congress is able to marshal the votes to overturn an incorrect ruling (including sufficient votes to override a presidential veto), the Court's decision stands as law. *See* U.S. CONST. art. V. Of course, in cases of constitutional rulings invalidating congressional enactments as contrary to the Constitution or denying any constitutional authority to Congress to act, the road to reversal is even more difficult to travel, requiring two-thirds of Congress to recommend and three-fourths of state legislatures to ratify. *See id.* It bears emphasizing that in the case of the doctrine under consideration in this Article, a declaration of the lack of judicial authority to enforce common-law crimes does not, in my view, negate the constitutional power of Congress to enact legislation making insider trading a crime. *See id.*

In all such cases, it is, therefore, best for the Court to rule on the dispositive constitutional issues and leave it up to Congress and the president to make policy choices in light of the Court's rulings.

212. *See* United States v. Booker, 543 U.S. 220, 226, 243–44 (2005).

213. *See* 18 U.S.C. § 1346 (2012).

214. *Skilling*, 561 U.S. at 368, 399–409 ("Construing the honest-services statute to

Here, the congressional legislation that the SEC has used to promulgate insider-trading rules makes no mention of such doctrine.[215] The SEC has used its legislatively delegated authority to identify insider trading as a type of fraud or unfair conduct prohibited by the antifraud provisions of the Exchange Act, and the prosecutors have used the criminal sanctions of that Act to indict individuals for insider trading.[216] The federal courts, without constitutional authority, have added their judicial imprimatur to the conduct of the prosecutors and regulators.[217] Since federal enforcement of criminal insider trading is entirely judicially created, the doctrine of constitutional avoidance therefore cannot be used to avoid the constitutional issue of the federal courts' constitutional authority.

B. The Judicial Legislation Doctrine

The infrequently used doctrine of "judicial legislation," which the Court used in its early construction of the Sherman Act to correct a legislative error in the Act, is also not available to remedy the constitutional defects of enforcing insider-trading doctrine as a common-law crime.[218] The Court interpreted the Sherman Act to prohibit only contracts in "unreasonable" restraints of trade rather than "every" contractual restraints of trade, as the statue provided.[219]

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extend beyond that core meaning, we conclude, would encounter a vagueness shoal.").

215. *See* 15 U.S.C. §§ 77t(a), 78u(a) (2012).

216. *See* 17 C.F.R. §§ 240.10b-5(a)–(c), 240.10b5-1 (2016); 15 U.S.C. §§ 77t(a), 78u(a) (2012).

217. *See* United States v. O'Hagan, 521 U.S. 642, 651 (1997) (citation omitted) (citing to precedent in interpreting liability under Rule 10b-5).

218. *See* Warren, *supra* note 20, at 89. There is no weighty consideration here that compels the Court to continue to issue insider-trading "decisions tantamount to judicial legislation." *Id.* at 89 & n.87 (discussing the unfortunate consequence of an omission in the Judiciary Act of 1789 to "make any provision regarding jurisdiction as to corporations" that made it "possible [for] such judicial legislation as occurred when the Court, in a series of cases beginning in 1844, decided, through the device of a conclusive presumption as to citizenship of stockholders, to regard a corporation as a citizen of the State in which it was chartered." (listing cases)). In the insider-trading area, there has been no omission by oversight in need of judicial correction; Congress has decided not to exercise its constitutional power to enact an insider-trading criminal statute while the Court continues to enforce the doctrine as a common-law crime. *See id.* at 73, 89–90.

219. The Sherman Act is particularly instructive here, not only because of the history of judicial interpretation discussed in the text but also because the same statutory language there authorizes both criminal and civil sanctions—a choice committed to the unreviewable discretion of prosecutors. *See* United States v. U.S. Gypsum Co., 438 U.S. 422, 435–39 (1978). The significant difference between that law and the securities laws is that Congress chose the language of the Sherman Act, but insider trading is enforced by the SEC based on its regulations (that do not define insider trading) promulgated on

In 1890, Congress enacted the Sherman Antitrust Act, which provides for criminal and civil sanctions, declaring illegal "[e]very contract . . . in restraint of trade or commerce among the several States, or with foreign nations."[220] In 1897, rejecting the argument that the statute only bans a contract that "is only in unreasonable restraint of trade or commerce," the Court declined to engage in "judicial legislation" and applied that law to a private agreement not sanctioned by federal law regulating rates among more than seventeen competing railroads transporting articles between states:[221]

> When, therefore, the body of an act pronounces as illegal every contract or combination in restraint of trade or commerce among the several states, etc., the plain and ordinary meaning of such language is not limited to that kind of contract alone which is in unreasonable restraint of trade, but all contracts are included in such language, and no exception or limitation can be added without placing in the act that which has been omitted by

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delegation of authority by a broad congressional legislation that (by choice) does not define insider trading. *See id.* at 439–43.

A peculiar aspect of these dual-purpose statutes is that the courts generally tend to construe them differently in civil and in criminal cases. *But see* Crandon v. United States, 494 U.S. 152, 158 (1990) (finding that in government civil action based on substantive legal standards contained in a criminal statute, the Court concluded that "because the governing standard is set forth in a criminal statute, it is appropriate to apply the rule of lenity in resolving any ambiguity in the ambit of the statute's coverage," and, according to the Court, "'this time-honored interpretive guideline' serves to ensure both that there is fair warning of the boundaries of criminal conduct and that legislatures, not courts, define criminal liability." (quoting Liparota v. United States, 471 U.S. 419, 427 (1985))). In civil cases, to promote remedial purposes, dual-purpose statutes are construed broadly, as they should be. *See id.* at 157–58; Chevron U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 864–66 (1984); *U.S. Gypsum Co.,* 438 U.S. at 438–40. In criminal cases, to comply with the rule of lenity or the canon of construing penal laws strictly in favor of the defendant, the same statute tends to receive a different and narrowly tailored construction. *See* United States v. Wiltberger, 18 U.S. 76, 95 (1820) ("The rule that penal laws are to be construed strictly, is perhaps not much less old than construction itself. It is founded on the tenderness of the law for the rights of individuals; and on the plain principle that the power of punishment is vested in the legislative, not in the judicial department."). In both instances, the courts are acting properly, but the results may lead to confusion and could certainly be problematic for *Chevron* deference purposes in construing dual-purpose regulatory statutes. *See* Whitman v. United States, 135 S. Ct. 352, 352–54 (2014) (Scalia, J., dissenting). Contrary to this general tendency, before the *Newman II* decision, the courts generally applied in insider-trading criminal cases a broad interpretation of Rule 10b-5 in deference to the SEC. *See generally* Bacastow, *supra* note 105.

220. 15 U.S.C. § 1 (2012).

221. United States v. Trans-Mo. Freight Ass'n, 166 U.S. 290, 327, 340 (1897).

Congress.[222]

In 1911, the Court reversed course in interpreting the statute with Chief Justice White, who dissented in *Trans-Missouri Freight Ass'n.*,[223] writing the majority opinion in *Standard Oil Co. of New Jersey v. United States*.[224] Chief Justice White agreed with Justice Peckham that "[legislative] debates may not be used as a means for interpreting a statute"[225] but then concluded that "that rule, in the nature of things, is not violated by resorting to debates as a means of ascertaining the environment at the time of the enactment of a particular law; that is, the history of the period when it was adopted."[226] To determine the meaning of the Sherman Act, Chief Justice White looked to the history of English and American common law prior to enactment of that Act.[227] From that history, the Court deduced that every contract restraining a person from engaging in a trade or calling was at first deemed illegal because it was by definition a restraint on trade between the parties to the contract, and to some extent a restraint of trade or commerce generally.[228] However, to accommodate "the freedom of individuals to contract," English and American law came to the view that "if the restraint was partial in its operation, and was otherwise reasonable, the contract was held to be valid."[229] In short, the upshot of the Court's analysis was to conclude that the law ultimately treated as "illegal all

222. *Id.* at 328. Justice Peckham, author of the *Trans-Missouri Freight Ass'n* opinion, was an early textualist. *See id.* at 318 ("[T]he only proper way to construe a legislative act is from the language used in the act . . . ."). Justice Peckham was also the author of the Court's majority opinion in the infamous *Lochner v. New York*, 198 U.S. 45 (1905), decision, which invalidated a New York law limiting the number of hours a bakery employee could work each day and during a week, and he joined the Court's majority opinion in *Plessy v. Ferguson*, 163 U.S. 537 (1896). Justice Peckham authored the Court's ruling in *Ex parte* Young, 209 U.S. 123, 160 (1908), upholding the authority of federal courts to enjoin state officials from enforcing state laws contrary to federal law. In December 1895, Justice Peckham, whose brother (Wheeler) was a failed Supreme Court nominee in 1894 by Democratic President Grover Cleveland, was nominated by President Cleveland and confirmed within six days by a Republican-controlled Senate. Carl Hulse, *Supreme Court Fight Rescues a Justice From Obscurity*, N.Y. TIMES (Apr. 1, 2016), http://www.nytimes.com/2016/04/02/us/politics/supreme-court-fight-rescues-a-justice-from-obscurity.html.

223. 166 U.S. at 343–74 (White, J., dissenting).

224. 221 U.S. 1, 30 (1911) (White, C.J.).

225. He cited to the same page previously cited to show that Justice Peckham was a textualist. *Id.* at 50 (citing *Trans-Missouri Freight Ass'n.*, 166 U.S. at 318).

226. *Id.*

227. *Id.* at 51.

228. *Id.*

229. *Id.*

contracts or acts which were unreasonably restrictive of competitive conditions."[230] The Court therefore ruled, contrary to the language of the statute, that only contracts that imposed "undue" restraint on competition were barred by sections 1 and 2 of the Sherman Act.[231]

There is, however, no criminal statute that defines insider trading as a crime to which judicial legislation might apply. When enacted, the federal securities statutes did not even mention insider trading as the doctrine is currently understood and applied.[232] Significantly, section 16 of the Securities Exchange Act, as initially enacted by Congress, "does not contain a provision found in an early draft which made the sanctions imposed by the section applicable to any person who realized profits from short-swing speculation based on confidential information received from an insider."[233] Before the enactment of the Exchange Act in 1934, "the corporate insider was relatively free to trade in his company's securities, as most courts found no fiduciary relationship between officers or directors and their stockholders in these

230. *Id.* at 58. The difference in statutory interpretation made no difference to the outcome: the Court substantially upheld the violation of the Sherman Act by the oil trusts with some modifications of the remedial decree. *See id.* at 81–82. In partial concurrence and partial dissent, Justice Harlan charged that the Court's statutory interpretation had "usurped the constitutional functions of the legislative branch of the government." *Id.* at 83, 103–06 (Harlan, J., concurring in part and dissenting in part); *see also* United States v. Am. Tobacco Co., 221 U.S. 106, 175–88 (1911) (applying the rule of reason interpretation and declaring the tobacco trust in violation of the Sherman Act).

231. *Standard Oil Co.*, 221 U.S. at 60–62.

232. *See* Donald Cook & Myer Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 385, 387, 407 (1953) (explaining that the only reference to insider trading in the statute concerns short-swing profit resulting from insider purchases or sales within six months, which are prohibited by section 16 of the Exchange Act). There, Congress required certain disclosures, prohibited certain activities, such as insiders short-selling the securities of their own companies, and created a cause of action for the corporation or its shareholders suing derivatively to recover short-swing profits from an insider. *Id.* at 386–87. Section 16 is thus different from section 10(b) and Rule 10b-5: it is not limited to material undisclosed inside information, it applies to purchases and sales within six months, it covers certain statutorily defined insiders, and it grants the cause of action to the corporation. EASTERBROOK & FISCHEL, *supra* note 5, at 272–75.

233. Cook & Feldman, *supra* note 219, at 397 n.52; *cf.* United States v. Chestman, 947 F.2d 551, 572 (2d Cir. 1991) (Winter, J., concurring in part and dissenting in part) (footnote omitted) ("The existence of Section 16(b), which indicates that Congress expressly addressed the issue, might well have led the SEC and the courts to conclude that Congress intended that Section 16(b) be the sole provision governing insider trading. No other provision explicitly addresses the problem, and Section 16(b) eliminates what is perhaps the most obvious danger inherent in insider trading, namely the creation of an incentive for directors or officers to make share price volatile in order to profit from short-swing trading.").

transactions."[234]

Even when courts found "special facts" and imposed common law fraud liability, as the Supreme Court did in *Strong v. Repide*,[235] such liability was never

> extended . . . to securities bought and sold on an exchange market. Since such transactions involved no direct communication between buyer and seller, it was felt that no disclosure was appropriate. On an impersonal market, it was said, each person determined for himself what course of action he should take, without influence from any other person.[236]

The federal securities laws therefore provide no occasion for application of judicial legislation regarding insider trading.[237] More fundamentally, the absence of a specific statute, or even a regulation defining insider trading, squarely presents the issue of the very power of federal courts to develop a common law of insider trading enforced as criminal law in view of the Court's settled *Hudson* doctrine since 1812.[238] However sound and reasonable the judge-made insider-trading doctrine is considered by some, its foundation is not tethered to constitutional power of the federal courts because Congress has not enacted a criminal insider-trading law.[239] Like the court-created doctrine of *Swift v. Tyson*,[240] the Court should therefore squarely confront the constitutional issue raised by enforcement of criminal insider-trading rules promulgated by the SEC.

There is no good way to duck deciding this issue. In *Erie R.R. Co. v. Tompkins*,[241] for example, since the Constitution grants diversity jurisdiction to the federal courts, as authorized by Congress, the Court had the option of avoiding a constitutional ruling by invalidating the

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234. Cook & Feldman, *supra* note 219, at 408.

235. 213 U.S. 419 (1909).

236. Cook & Feldman, *supra* note 219, at 409 (citing Goodwin v. Agassiz, 186 N.E. 659 (Mass. 1933)).

237. *See* Pitt & Shapiro, *supra* note 15, at 426.

238. *See* United States v. Hudson, 11 U.S. (7 Cranch) 32, 34 (1812); CROSSKEY, *supra* note 21, at 782.

239. *See Newman II*, 773 F.3d 438, 445 (2014) ("[N]either [Section 10(b) of the 1934 Act] nor the regulations issued pursuant to it, including Rule 10b–5, expressly prohibit insider trading. Rather, the unlawfulness of insider trading is predicated on the notion that insider trading is a type of securities fraud proscribed by section 10(b) and Rule 10b–5." (citing Chiarella v. United States, 445 U.S. 222, 226–30 (1980))).

240. 41 U.S. 1, 13–15 (1842).

241. 304 U.S. 64 (1938).

Swift v. Tyson doctrine on "sound rules of practice for federal courts."[242] It could have ruled that section 34 of the Judiciary Act of 1789 in its reference to "laws" as "rules of decision" in diversity cases required federal courts to apply both state statutory and common-law rules to issues governed by state law in diversity-based disputes in federal court.[243] In criminal insider-trading cases, however, either the federal courts have constitutional authority to enforce common-law crime or they do not.[244] There can be no dispute that insider trading, as currently enforced, is a common law crime.

VIII. THE VIRTUES OF JUDICIAL SELF-CORRECTION

After *Newman II*, prosecutors in the Second Circuit will have to think, in the words of the United States Attorney for the Southern District of New York, "long and hard" before charging certain individuals [except for family members, relatives by marriage, and possibly close friends] who traded based on receipt of confidential material information from casual insider "friends" who expected, and received, nothing in return.[245] The Court had many options in deciding *Salman*: it could have accepted the stricter *Newman II* standard of a personal benefit to the insider who improperly discloses confidential information for all cases, it could have rejected it in favor of reaffirming

242. JACKSON, THE STRUGGLE FOR JUDICIAL SUPREMACY, *supra* note 185, at 282–83; *see also Erie R.R. Co.*, 304 U.S. at 90–92 (Reed, J., concurring in part). Other bases might also have been used to avoid deciding a constitutional issue. *See* Friendly, *supra* note 20, at 386–91.

243. *See* JACKSON, THE STRUGGLE FOR JUDICIAL SUPREMACY, *supra* note 185, at 273–74.

244. Despite their differences about the Judiciary Act of 1789, William Crosskey and Charles Warren are in agreement that under section 34 of the Judiciary Act of 1789, "national criminal prosecutions for offenses against the United States were not 'cases where [state laws] apply'" as a "rule of decision." CROSSKEY, *supra* note 21, at 774. For Crosskey's view of the first Judiciary Act, see *id.* at 757 ("[T]he first Judiciary Act was about as unwisely contrived as an act could be."). Charles Warren, with a more favorable view of that Act, noted that section 34 was introduced in the Draft Bill in the Senate late in the process, and for that reason was "inserted next to the last section and between two sections dealing with criminal matters with which it had no connection." Warren, *supra* note 20, at 108 n.134 ("Section 34 applied only to civil cases at common law, and not to criminal offenses against the United States." (citing United States v. Reid, 53 U.S. (12 How.) 361 (1851))). In *United States v. Callender*, 25 F. Cas. 239 (C.C.D. Va. 1800), a criminal libel case in 1800, see *supra* note 30, Justice Samuel Chase denied the defense's theory and applied federal rather than the law of Virginia as governing law under section 34 of the Judiciary Act of 1789. *See* GOEBEL, *supra* note 21, at 651.

245. Stewart Bishop, *Bharara Shows Path to Post-*Newman *Wins in Stewart Trial*, LAW360 (Aug. 18, 2016, 9:26PM), http://www.law360.com/articles/830031/bharara-shows-path-to-post-newman-wins-in-stewart-trial.

Dirks, it could have, as the government had requested,[246] expanded the *Dirks* standard, it could have announced a rule combining elements of the two standards, it could have formulated an entirely new definition of personal benefit, and it could even have rejected personal benefit to the insider tipper as a required element of the crime. It chose instead to view *Salman* as presenting a "narrow issue" that it resolved by reaffirming a comment in *Dirks* and elevating that comment to a rule of law for application to cases involving closely-knit family members and their relatives and friends. Significantly, the Court did not say that the standard applied in *Salman* should also govern cases involving casual friends of the kind that *Newman II* confronted. Any judicially announced standard, however, will inevitably fall short of anticipating all the circumstances in which friends (close or casual) and relatives (by blood and marriage, close or alienated) motivated by greed—a "response to the equalizing power of money"[247]—will seek to help each other get rich quickly through insider trading.

Members of the financial services industry (all of whom must not be presumed to be criminals), especially their compliance officers, must continue to operate under conditions of extreme uncertainty with significant risks if their judgments should turn out wrong—the risks of either being prosecuted or not making money based on perfectly legal behavior.[248] Those who are risk-averse will hesitate, and, like generals who lose battles because they paused too long, they will cede the securities trading field to their more aggressive and high-risk competitors.[249] The securities markets will be none the better for this kind of "race to the bottom" behavior encouraged by conditions of extreme uncertainty regarding the legal rules.[250]

A. *The Certainty of Legal Rules is a Virtue of Justice*

Insider trading is neither a *malum per se* like homicide or rape nor is it entirely a *malum prohibitum*.[251] It falls in the category of an

246. *See* Brief for the United States, *supra* note 131, at 11.

247. PAUL A. FREUND, ON LAW AND JUSTICE 41 (1968); *see also* Holmes, *The Path of the Law*, *supra* note 78, at 478 ("But, as Hegel says, 'It is in the end not the appetite, but the opinion, which has to be satisfied.' To an imagination of any scope the most far-reaching form of power is not money, it is the command of ideas." (footnote omitted)).

248. *See* Pitt & Shapiro, *supra* note 15, at 416–17; Bacastow, *supra* note 105, at 131–32.

249. Manne, *supra* note 88, at 555.

250. *See* Paul Engelmayer, *Congress: U.S. Needs an Insider Trading Law*, N.Y.L.J. (Oct. 23, 2015), http://www.newyorklawjournal.com/id=1202740459962/Congress-US-Needs-an-Insider-Trading-Law?slreturn=20160719085545.

251. *See* LUCAS, ON JUSTICE, *supra* note 1, at 116 ("Even without a speed limit, it

intermediate case. In some instances, such as an insider trading on inside information about an upcoming earnings report or corporate control transaction or an officer short-selling the stock of his own company,[252] the wrongfulness of the conduct is obvious and it is almost always conceded by virtually all, and its nefarious impact on the securities market and a company whose stock is traded based on inside information is plain. In many other cases of insider trading, there is considerable debate about the wrongfulness of the conduct and the economic harm caused by it. Thus, before giving prosecutors discretion to prosecute any and all kinds of insider trading, we should adhere to the principle that "people should not be expected to know what not to do unless they had been definitely told."[253] As the English philosopher John Lucas explains,

> Difficulty [in enforcement of legal rules] arises in intermediate cases, where some, but not all, citizens can see that an action is wrong, or where there are arguments either way, and it is not clear where the balance lies.[254]

1. Prohibiting Insider Trading is Reasonably Debatable

There are good arguments made by respectable scholars for and against insider-trading prohibitions.[255] Moreover, the economic harm

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might be wrong, and criminal, for me to drive at more than 70 m.p.h., e.g. in a built-up area, because it was inherently dangerous.").

252. *But see* Carlton & Fischel, *supra* note 3, at 872–74 (arguing that the argument against short-selling by insider of his own company's stock is "far from persuasive").

253. LUCAS, ON JUSTICE, *supra* note 1, at 116.

254. *Id.*

255. *See* SEC v. Lipson, 278 F.3d 656, 659 (7th Cir. 2002) (citing to scholarly works of "skeptics about the prohibition of insider trading"); United States v. Chestman, 947 F.2d 551, 572 n.1 (2d Cir. 1991) (Winter, J., concurring in part and dissenting in part) (noting that "the public appears to have a strongly negative view of insider trading" and citing to scholarly works reflecting "considerable diversity as to why insider trading should be regulated . . . among its academic opponents"). For a general discussion of the arguments for and against insider trading from the perspective of economic efficiency by authors who conclude that "the case for public enforcement, particularly federal enforcement, has not been made," see Carlton & Fischel, *supra* note 3, at 890–91. For a survey of the literature pro and con of insider trading, see Stanislav Dolgopolov, *The Concise Encyclopedia of Economics: Insider Trading*, LIBR. ECON. & LIBERTY, http://www.econlib.org/library/Enc/InsiderTrading.html (last visited Jan. 1, 2016); Dauenhauer, *supra* note 15, at 44 n.13 (citing Stephen M. Bainbridge, *Insider Trading*, *in* ENCYCLOPEDIA OF LAW AND ECONOMICS 772 (Boudewijn Bouckaert & Gerrit De Geest, eds. 1998) (citing 261 papers discussing arguments for and against regulation of insider trading)). While criticizing in certain respects the *Newman II* decision, *id.* at 53–65, Dauenhauer proposes

> a reformed insider-trading regulatory paradigm . . . to reinforce the perpetuation

caused by all insider trading is still a matter of considerable debate.[256] In general, there are two types of arguments in favor of deregulating insider trading.

Some economists, like Nobel laureate Milton Friedman, believe we should have more, not less, insider trading because it benefits investors by introducing more information in the markets from people most likely to have knowledge of internal corporate deficiencies.[257] According to

> of an egalitarian marketplace and interrelated sustainable economy [through] legislative enactment of an *ex ante* statutory codification that permanently circumscribes and defines insider-trading as a crime against the securities marketplace.

Id. at 41.

256. Dauenhauer, *supra* note 15, at 68 ("[M]any experts still maintain that the economic impact of insider trading is unsettled."). *But see* Brief for the United States, *supra* note 30, at 51 n. 11 ("[The argument that insider-trading regulation harms the securities markets] has been rejected by a near-consensus of academics." (citing Alexandre Padilla & Brian Gardiner, *Insider Trading: Is There an Economist in the Room?*, 24 J. PRIVATE ENTERPRISE 113, 123 (2009))). Dauenhauer is not in favor of deregulation; he is a proponent of prohibition who favors legislation and who criticizes the *Newman II* decision because it "has resulted in the formation of a category of trading upon material nonpublic information, which now remains nonprohibited." Dauenhauer, *supra* note 15, at 75.

257. *See Milton Friedman on Insider Trading*, ELITETRADER (Mar. 12, 2003), https://www.elitetrader.com/et/threads/milton-friedman-on-insider-trading.14996/. Henry G. Manne is also often cited as a legal scholar who believes that insider trading "creates significant economic benefits and in fact contributes to the efficiency of the market by insuring more rapid dissemination of information." *See* Bacastow, *supra* note 105, at 109 n.71 (citing HENRY MANNE, INSIDER TRADING AND THE STOCK MARKET (1966)). Professor Manne, a lawyer who taught law and political science, was a fiercely independent critic of the SEC as a "Government agency and [of] its totally unexamined 'philosophy.'" Manne, *supra* note 88, at 548. In fairness to Professor Manne, it should be noted that he argued against *government enforcement* of a rule prohibiting insider trading; he was not opposed to individual firms making a decision to bar insider trading by their officers, directors, controlling shareholders, and employees. *Id.* at 581, 556 n.29.

This Article takes no position on the issue of whether insider trading should be legalized or banned entirely. Its thesis is merely that the federal courts have no constitutional authority to decide criminal insider-trading cases without a statute. Congress has constitutional authority to act in this area; the national and international capital and securities markets using the facilities of national securities exchanges, the mails, and interstate and foreign commerce are sufficient to provide a basis of federal jurisdiction under the Constitution's commerce and "necessary and proper" clauses. U.S. CONST. art. I, § 8, cl. 3, cl. 18. Congress may decide to punish, as crimes, certain conduct it deems wrongful in these markets, even if the conduct is a *malum prohibitum*, and, in the view of some, its prohibition makes little economic sense. There is, however, no virtue in the courts and Congress acquiescing by silence in continued exercise by the federal courts of an authority that lacks constitutional foundation without congressional action. Therein lies the danger of undermining the virtues of a *written* constitution to preserve the structure of a government designed, in part, to breakup power among the institutions of

Friedman, "[O]ne of the reasons we've gotten things like Enron is because we've been increasingly outlawing insider trading, but insider (trading) is the most effective means of making sure a company that does the wrong thing is penalized for doing so."[258] Other deregulation

the federal government and between them and the states—in the interest of promoting individual freedom.

Whether Congress should make some or all insider-trading acts criminal (as a felony or misdemeanor with trebled damages and civil monetary penalties) is an issue deserving of separate treatment in another article. *See, e.g.*, Fahey, *supra* note 94, at 539 n.195 (supporting criminal liability for certain types of unlawful insider trading, but quoting Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 237–38 (1991), which advocates reconsideration of insider trading as a crime because it "cannot readily be equated with either stealing or lying")).

Recent trends to criminalize conduct that should be treated as civil frauds or regulatory petty offenses are not a salutary development in legal doctrine. Non-criminal sanctions or "punitive civil sanctions" may be just as effective and perhaps even more efficient (because they are not constrained by the rigors and costs of criminal procedure) in deterring and punishing certain conduct violating regulatory regimes. For a discussion of these issues and the complexities involved, see generally Coffee, *supra* note 21, at 1875–77 (expressing skepticism about the ability to effectively carry out Professor Mann's thesis to "shrink" the criminal law; arguing that enforcing substantive criminal standards in civil punitive or administrative proceedings would result in continued over-criminalization through expansion of the scope of criminal law (e.g., criminally enforcing properly promulgated agency rule) but agreeing that "the criminal law should be reserved for the most damaging wrongs and the most culpable defendants"); Kenneth Mann, *Punitive Civil Sanctions: The Middleground Between Criminal and Civil Law*, 101 YALE L.J. 1795 (1992) (advocating a middleground jurisprudence between criminal and civil law that consciously promotes punitive civil sanctions to serve functions of criminal punishment in civil or administrative proceedings with greater procedural protections for defendants).

More important, we cheapen the moral condemnatory element in the currency of the criminal conviction when we make almost everything a crime. When too many people are indicted and convicted for offenses not widely viewed as core criminal conduct, the concept of "crime" is diluted of its traditional meaning, and there is little or no moral opprobrium attached to being a convicted person. *See* J.R. LUCAS, THE FREEDOM OF THE WILL 10–11 (1970) [hereinafter LUCAS, THE FREEDOM]. Lucas describes a hypothetical case of a college student reading psychology who shocks his aunt by ascribing all her conduct from church-going to art exhibitions to charity work as being sexually motivated, and thus "an alternative form of sex satisfaction." *Id.* After her initial shock, the astute aunt responds by pointing out that she had no objection to manifestations of sex as church-going, helping others, and looking at art, "but only [objected] to those manifestations of sex that were concerned with the genitals." *Id.* The young man was at a loss for a reply. By using the word "sex" to cover all types of human activity, he had deprived it of its normal association with the genital organs, and thus deprived it of its power to shock and distress his aunt. It is only because the word "sex" is not applied to some sorts of human activity that it has any meaning. *Id.* at 11. It is a categorical mistake to expand the application of a word or concept such as "crime" to nearly all conduct because at some point we "evacuate it of all content." *Id.*

258. *Milton Friedman on Insider Trading*, *supra* note 244.

proponents argue that allowing insider trading will promote the "efficiency of corporate management incentivization."[259] In other words, the benefits of insider trading to management will become part of management's compensation package and provide incentives to perform better and more efficiently at the cost of lower compensation if they fail. For example, Easterbrook and Fischel argue that an outright ban on all insider trading may not be necessary. Using a property-rights approach to information ownership, they contend that firms and their managers can decide individually whether to allow or prohibit insider trading through contract.[260] Where the enforcement of the private contract regime is less than optimal due to difficulty of detecting violations, they recommend public enforcement to supplement the private contract prohibition regime.[261] Many others and the SEC, as an institution, are firmly in the group of those who strongly oppose deregulation and firmly believe that vigorous enforcement of the insider-trading prohibition promotes a fair and efficient market in corporate securities.[262]

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259. Dauenhauer, *supra* note 15, at 68–69 (citing MANNE, *supra* note 244).

260. EASTERBROOK & FISCHEL, *supra* note 5, at 253–75. In their chapter on insider trading in their book, *The Economic Structure of Corporate Law*, Easterbrook and Fischel, among the skeptics of the virtues of insider-trading regulation, discuss instances where it makes sense to prohibit insider use of material nonpublic information and where it does not. *Id.* at 256–64; *see also* Donald J. Boudreaux, *Learning to Love Insider Trading*, WALL ST. J., http://www.wsj.com/articles/SB10001424052748704224004574489324091790350 (last updated Oct. 24, 2009, 12:01 AM) (noting that current insider trading law fails to reach the "nontrading" person who profits from a decision not to sell after learning of favorable material inside information about a company; regulation of insider trading to determine proprietary from non-proprietary information should be left to each corporation to regulate in its by-laws); Justin Rohrlich, *Should Insider Trading Be Legalized?*, MINYANVILLE (Oct. 19, 2009, 7:35 AM), http://www.minyanville.com/businessmarkets/articles/insider-trading-Rajaratnam-minyanville/10/19/2009/id/24985?page=full.

261. EASTERBROOK & FISCHEL, *supra* note 5, at 253–75.

262. Pitt et al., *supra* note 15, at 383 (containing an article by two of three authors who are former SEC officials generally in favor of enforcement of insider trading that acknowledges that "[t]wo schools of thought reach opposite conclusions as to whether insider trading should be proscribed"). One writer has concluded that the "weight of authority as well as the weight of economic theory rests with those who argue that the economic harm caused by insider trading outweighs any of the incidental benefits which might accompany that trading." Bacastow, *supra* note 105, at 109 n.71 (citing 2 ALAN BROMBERG, SECURITIES LAW: FRAUD § 7.4(6)(b) at 179 n.166). For discussion of an economic model that demonstrates the harms from insider trading, *see* Michael Manove, *supra* note 83, at 824 (arguing that trading by insiders and their cohorts who receive the insiders' confidential information leads to partial misappropriation of shareholder value from corporate investments, resulting in lessened "shareholder support for corporate investment" and (1) where the investments are "inherently risky" insider trading "induces corporate underinvestment" and (2) where they are "less risky" such trading "can, in

2. Dirks Supports Opponents of Insider-Trading Enforcement

In a strict legal, but not economic, sense, *Dirks* and the subsequent difficulty reflected in case law interpretation of the legal rule it announced provides some support for those who oppose an insider-trading prohibition. There, largely to expose corporate fraud at an insurance company, a former officer of the company disclosed nonpublic information about fraudulent activity (i.e., vast overstatement of the assets of his former company) to an officer (Raymond Dirks) of a securities analyst at a firm "providing investment analysis of insurance compan[ies] . . . to institutional investors."[263] The information had been first disclosed to the SEC by multiple sources and, after the SEC disclosure proved unproductive, was then disclosed to Dirks.[264] Dirks conducted a two-week investigation of the fraud (including an unsuccessful attempt to get the *Wall Street Journal* to publish an article about the fraud he uncovered); Dirks made selective disclosure of the fraud to clients and investors of his firm, some of whom sold their stock after learning the inside information.[265] The stock price dropped by more than fifty percent during the two weeks of Dirks's investigation.[266] "Neither Dirks nor his firm owned" stock in the insurance company engaging in the fraud.[267]

Alas, although the insider's disclosure and Dirks's efforts resulted in wider public disclosure of a massive fraud, Dirks was charged with insider trading; but because of his work exposing the fraud, he was "only censured" by the SEC.[268] The District of Columbia Court of Appeals affirmed, but the Supreme Court reversed.[269]

3. The *Dirks* Personal-Benefit Standard

In *Dirks*, the Court was confronted with the proverbial hard case

principle, lead to corporate overinvestment."

The argument of this Article does not turn upon the truth of the views of either side of this debate. It is sufficient that respectable thinkers on both sides advance arguments for and against the regulation of insider trading. In itself that should result in considerable pause to development by the courts of criminal insider trading without a statute by Congress.

263. Dirks v. SEC, 463 U.S. 646, 648–49 (1983).

264. *Id.* at 649.

265. *Id.* at 649–50, 670.

266. *Id.*

267. *Id.* at 649.

268. *Id.* at 651–52.

269. *Id.* at 652.

that makes bad law.[270] Dirks should never have been charged. Confronted with a judgment of liability against Dirks, the Court fashioned a rule of law that over-determined the outcome to absolve Dirks of liability.[271] That rule, unlike the fiduciary duty not to mismanage corporate assets, required that the insider have breached his fiduciary duty to the shareholders (not the company) in the sense of having used confidential information intended for benefit of his company in an improper way and having received a personal benefit (i.e., a "personal gain" or "personal advantage").[272] In addition, liability of a tippee like Dirks required the tippee to be aware of the insider's breach of duty and the receipt of a "personal benefit" for that breach (thus making the tippee functionally an accessory after the fact).[273] In short, the rule requires that an insider disclose confidential information for an "improper purpose" and that the tippee have knowledge of this.[274] If these conditions are met, the tippee cannot legally trade on the basis of the inside information.[275] Assessed against that standard, it was clear that the judgment against Dirks had to be reversed.

Since the *Dirks* ruling, however, the elements of breach of duty, personal benefit, and knowledge by a tippee of these elements have wreaked havoc in the development of insider-trading law, as the *Newman II* and *Salman* cases demonstrate. Largely, this stems from the Court's definition of the elements of breach of duty and, in particular, personal benefit to the insider.[276] After characterizing these as being determinable from "objective criteria, *i.e.*, whether the insider receives a direct or indirect personal benefit from disclosure, such as a pecuniary gain or a reputational benefit that will translate into future

270. N. Sec. Co. v. United States, 193 U.S. 197, 400 (1904) (Holmes, J., dissenting) ("Great cases, like hard cases, make bad law.").

271. *See Dirks*, 463 U.S. at 665–67.

272. *See id.* at 661–63.

273. *See id.*

274. *See id.* at 659–60.

275. *Id.* at 662 ("Whether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure."). The Court concludes that the former corporate insider (Ronald Secrist) was "motivated by a desire to expose the fraud." *Id.* at 667. If so, in choosing to disclose to Dirks, Secrist erred in judgment and breached his duty to the shareholders. The same day he told Dirks, Secrist disclosed the fraud to insurance regulators in New York; that disclosure led to a chain reaction that resulted in the fraud being uncovered by the Illinois regulators and the insurer being placed in receivership. *Id.* at 668 n.2 (Blackmun, J., dissenting). In any event, the SEC compounded Secrist's error of judgment by charging Dirks, whose reasonable conduct in part exposed a massive fraud even as some of those to whom he made selective disclosure (mainly his firm's clients) unfairly benefited. *See id.* at 668–70.

276. *See* United States v. Salman, 792 F.3d 1087, 1092 (9th Cir. 2015).

earnings,"[277] the Court, almost as an after-thought, adds these problematic sentences:

> The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.[278]

The interpretation of this language is at the core of the inconsistency in the *Newman II* and *Salman* Court of Appeals decisions. Yet, the language was not necessary for the Court's ruling: Dirks and Secrist were neither relatives nor friends, and there is no indication in the Court's opinion that the sharing of the inside information was made in the context of a close professional or personal relationship.[279] Secrist was not giving Dirks inside information based on which he could trade and benefit (and from which Secrist would receive some type of personal benefit); Secrist just wanted someone to investigate and expose a massive fraud, which Dirks succeeded in doing.[280] At worst, Secrist acted out of mixed motive (he had been fired by the insurance company), even if his judgment was less than ideal (perhaps distorted by his frustration and inability to get the regulators to pursue his claim of suspected fraud). Even Dirks's mixed motivations in pursuing the investigation and making selective disclosures to his firm's clients makes the case a hard one in which to impose liability.

4. The Difficulties of the *Dirks* Standard

For various reasons, "[t]he Court's reasoning in *Dirks* is dubious."[281]

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277. *Dirks*, 463 U.S. at 663.

278. *Id.* at 664.

279. *See id.* at 649.

280. *Id.* at 648–51.

281. Carlton & Fischel, *supra* note 3, at 885 n.93. The authors conclude that the Court's allocation of "the property right in valuable information" to the corporate shareholders lacks any basis and that the application of the personal benefit "test will also be difficult." *Id.* They note that the personal-benefit test would "allow an employee to give tips to individuals in anger or spite as long as he doesn't 'profit'" and that "[t]ips to strangers are legal but tips to relatives are not." *Id*; *see also* United States v. Reed, 601 F. Supp. 685, 699 (S.D.N.Y. 1985) ("From the perspective of public policy, the constellation of principles enunciated in *Chiarella* and *Dirks* present this Court with a troubling anomaly. As applied, those principles indicate that an individual who receives from a corporate insider nonpublic, confidential information that is likely to affect the value of a corporation's securities will be liable if the insider made the disclosure out of a desire for personal material gain but not if the insider acted with a more benign purpose.").

It is not clear why the insider breach of fiduciary duty in insider-trading cases, as *Dirks* requires, should turn on the motivation of the insider in making disclosure or in a requirement of personal benefit to the insider. Confidential information of the corporation is itself a valuable asset of the entity, and the Court in *Dirks*, while recognizing this point, failed to explain why its disclosure to others outside the company (who may trade on the information whether or not the corporate officer intends this or receives a tangible benefit) is not a breach of duty based on mismanagement of corporate assets for violation of the legal insider-trading rule.

The distinction the Court makes—stating but not making an argument in support of its point—between a duty to the shareholders (which depends on whether the insider trades or gets a personal benefit) and to the corporation itself (merely by disclosing confidential information) is not, on its face, entirely persuasive. To quote the Court:

> The duty that insiders owe to the corporation's shareholders not to trade on inside information differs from the common law duty that officers and directors also have to the corporation itself not to mismanage corporate assets, of which confidential information is one. In holding that breaches of this duty to shareholders violated the Securities Exchange Act, the *Cady, Roberts* Commission recognized, and we agree, that "[a] significant purpose of the Exchange Act was to eliminate the idea that use of inside information for personal advantage was a normal emolument of corporate office."[282]

But the shareholders are the corporate owners to whom fiduciary duties are owed by corporate officers.[283] One of those duties is the duty not to disclose confidential inside information that may have a material (good or bad) impact on the operations of the company—whether or not one receives a personal benefit.[284] Adding the element of personal benefit (and knowledge of that benefit by tippees when they trade based on the insider's information) to make out a claim of insider trading complicates the rule when, as in *Newman II*, it is applied to fourth-level downstream tippees.[285] To avoid unfairness, *Newman II* sought to

282. *Dirks,* 463 U.S. at 653 n.10 (alteration in original) (citations omitted).

283. *See* Chiarella v. United States, 445 U.S. 222, 228 (1980) ("[A] relationship of trust and confidence [exists] between the *shareholders* of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation." (emphasis added)).

284. *See Newman II,* 773 F.3d 438, 445 (2d Cir. 2014).

285. *Id.* at 443.

impose a stricter personal-benefit standard that departed somewhat from the *Dirks* rule. That rule seemed intended also to capture instances of family members and close friends making gifts to each other of valuable material corporate inside information to circumvent the spirit, if not the letter, of legal insider-trading rules without the tipper getting or expecting any pecuniary gain or reputational benefit in return.[286]

5. The Difficulties of the *Dirks* Rule Stem from the Failure to Define Insider Trading

The difficulties and uncertainties created by the *Dirks* rule stem largely from the failure of Congress to define the precise conduct that insider-trading law seeks to prohibit and the policy that the prohibition seeks to promote.[287] If the objective, or, to use the language of the Court in *Dirks*, a "significant purpose," is to prevent corporate officers from using internal confidential information as a corporate till, as it were, into which they may dip for personal benefit, the rule that requires an element of personal benefit makes sense.[288] While that conduct seems to be one within the regulatory province of state corporation law governing the internal operations of a corporation, in any event it is in fact clear that the federal insider-trading rule is not limited to that objective.

The insider-trading rule, in the view of many of its supporters, largely seeks also to protect the integrity of the securities markets.[289] For instance, the misappropriation theory targets outsiders who obtain material inside confidential information through illegal means, even when there is no breach of duty to a counter-trading party. Moreover, insider-trading prohibition seeks to reassure investors, especially the

286. *Id.* at 452.

287. Pitt & Shapiro, *supra* note 15, at 417 ("Congress never has articulated its view of the public policy considerations underlying the prohibition against insider trading . . . .").

288. *Dirks*, 463 U.S. at 653 n.10. I assume, as the *Dirks* opinion did, that the material and valuable inside information belongs to the company's shareholders, and thus its use by corporate officials to their financial advantage and perhaps to the detriment of the shareholders is inappropriate. *Id.* at 660. In some cases, however, it may be the case that corporate management created the value contained in that information and they may have a justifiable claim to at least share in its value with the shareholders. *Cf.* Carpenter v. United States, 484 U.S. 19, 22–23 (1987) (examining a situation where *Wall Street Journal* reporter contributed to the creation of the contents of his column and therefore its value); United States v. Willis, 737 F. Supp. 269, 270–71 (S.D.N.Y. 1990) (examining situation where psychiatrist breached doctor-patient relationship and purloined the contents of information in which he had no role, and the value of which he served no part, in creating).

289. *See* United States v. O'Hagan, 521 U.S. 642, 652–53, 658–59 (1997).

smaller investors, that the securities markets are not rigged against them. Such investors may therefore trade with confidence that they are not being disadvantaged by their counterparts having access to material and confidential internal corporate data that would impact the market price of stocks. Access to such data by one party is viewed as particularly pernicious and unfair when it has not been obtained by superior financial skills analyzing corporate data publicly available.[290] To accomplish these objectives, the legal rule against insider trading has to bring within its scope not just corporate insiders, but also temporary insiders, all their tippees, and outsiders who illegally misappropriate corporate information.[291]

The legal rule currently prohibiting insider trading is overburdened with policies that ultimately overwhelm its capacity to satisfy them all. To illustrate the problem, consider that not all persons who receive inside information would be considered tippees; to be so considered, one must know that the disclosure came from an insider who breached his duty for a personal benefit.[292] Thus, the recipient of material inside information from listening to idle chatter in a public train is not a tippee, and he would presumably not be subject to criminal insider-trading charges if he traded based on that information. A thief who gains access to a corporate server and obtains material inside information from corporate computers (without breaching any fiduciary duty) on which he then trades is subject to prosecution for other crimes, but not for insider trading.[293] It is unclear why the recipient who gets inside information on which he trades, and who does not qualify as a

290. *Id.* at 658–59 ("Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law. An investor's informational disadvantage vis-a-vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill." (citing Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFTSRA L. REV. 101, 122–23 (1984); Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 356 (1979)).

291. The policy rationale for adopting misappropriation as a valid theory to prohibit a particular type of insider trading does so at the cost of losing "any obvious relationship to Section 10(b) . . . because theft rather than fraud or deceit[] seems the gravamen of the prohibition." United States v. Chestman, 947 F.2d 551, 578 (2d Cir. 1991) (Winter, J., concurring in part and dissenting in part).

292. *Dirks*, 463 U.S. at 662–663.

293. *See O'Hagan*, 521 U.S. at 648–49. The law firm partner who purloined and traded on confidential information of his firm's client in *O'Hagan* was also "convicted of theft in state court" for embezzlement and conversion of unrelated client trust funds. *Id.* at 648 n.2.

tippee under current law making him subject to suit or prosecution, has any lesser impact on the integrity of the securities markets than the other tippees who do meet the legal requirements and are subject to prosecution.[294]

The enforcement of current insider-trading doctrine combines the characteristic paradigms of the criminal law (individualized mental element for subjective liability) and of the civil law (requiring an objective standard of liability).[295] To the extent we want to deter the corporate insider from using his office as an emolument beyond the prohibitions of section 16 of the Exchange Act (the classical theory), the rule requires on the part of the corporate insider a subjective element of a breach of duty and personal benefit.[296] Moreover, to establish the liability of the tippee, it must be shown that he had personal knowledge of that breach of duty and personal benefit.[297] On the other hand, to the extent we want to protect the integrity of the securities markets (the misappropriation theory), we enforce a less subjective and more objective rule that assesses the impact of conduct on those markets.[298] But not all of the factors assessed to determine the presence *vel non* of objective criteria are themselves "objective"; for example, the reputational gain to the insider and the nature and closeness of the friendship between the insider and the tippee are not measurable in purely objective criteria.[299] Moreover, where there is no basis for a legal inference of a fiduciary duty between the parties to the trading transaction, the breach of fiduciary duty in misappropriation cases may even be wholly unconnected to the purchase or sale of stock.[300]

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294. *See id.* at 659 n.9 (precluding liability due to disclosure of trading plan to source of confidential information, "even though such conduct may affect the securities markets in the same manner as the conduct reached by the misappropriation theory"). While the majority in *O'Hagan* conceded this point, its ruling failed to address the apparently unanswerable argument of two of the dissenters: "That the dishonesty aspect of misappropriation might be eliminated via disclosure or authorization is wholly besides the point. The dishonesty in misappropriation is in the relationship between the fiduciary and the principal, not in any relationship between the misappropriator and the market. No market transaction is made more or less honest by disclosure to a third-party principal, rather than to the market as a whole. As far as the market is concerned, a trade based on confidential information is no more 'honest' because some third party may know of it so long as those on the other side of the trade remain in the dark." *Id.* at 690 n. 6 (Thomas, J., & Rehnquist, C. J., concurring in the judgment in part and dissenting in part).

295. *See supra* Part V.

296. *See supra* Part V.

297. *See supra* Part V.

298. *See supra* Part V.

299. *See, e.g.*, *Newman II*, 773 F.3d 438, 450–52 (2d Cir. 2014).

300. *See supra* Section III.C.

Combining these two legal theories into an effective legal insider-trading rule that announces a fair standard of insider trading that is made illegal is an impossible task for courts. Moreover, introduction of an element of breach of fiduciary duty to an entity that has no connection to the underlying securities transaction in an insider trading case (e.g., the *Wall Street Journal* in *Carpenter* and the printing company in *Chiarella*)[301] only serves to further complicate the task of fashioning an appropriate legal rule. Enforcing such a rule as a crime without a specific statute further complicates the challenge and raises profound issues of justice and liberty. A breach of duty without personal benefit can also adversely impact the operations of the securities markets and disadvantage some investors (e.g., a corporate insider disclosure of material information out of spite or anger). A recipient of information ultimately from an insider source who does not know of any breach of duty and personal benefit and who trades based on that information is also adversely impacting the integrity of the securities markets. An insider-trading rule that captures all (assuming the law wanted to do so) or even only some but excluding others of these potential scenarios within its scope cannot fairly be developed through case-by-case adjudication.[302]

B. *Insider Trading is Unsuitable to Judicial Legislation*

These difficulties serve to highlight the inappropriateness of judicial legislation in this area. A legislative solution can define the crime, exempt certain categories of conduct, stipulate the elements of the crime, and separate the element of fiduciary duty from that of personal benefit, assuming the latter was even retained.[303] For instance, a

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301. Chief Justice Burger's broader conception of the misappropriation theory in his *Chiarella* dissent would not encounter such difficulty. *See* discussion *supra* Section III.C.

302. United States v. Reed, 601 F. Supp. 685, 699 n.24 (S.D.N.Y. 1985) ("Regardless of how the defendant received the information . . . , public investors are equally in need of protection. Furthermore, there is nothing in the language of section 10(b) or rule 10b-5 that suggests such a distinction." (quoting Norman S. Poser, *Misuse of Confidential Information Concerning a Tender Offer as a Securities Fraud*, 40 BROOK. L. REV. 1265, 1270 (1983))).

303. In recent years, the tendency has been to criminalize breaches of fiduciary duty. *See* Coffee, *supra* note 21, at 1879–80 (discussing this issue in the context of the mail and wire fraud and securities statutes). One must therefore assume that if current insider-trading doctrine continues to be enforced with or without a statute, breach of fiduciary duty, or at least breach of a relationship of trust and confidence, will remain as an element of the crime. Indeed, in one recent case from the First Circuit, the government charged that the corporate insider disclosed material inside information to another person on the expressed understanding that that person would not further disseminate the

disclosure of material confidential information by one with a fiduciary duty not to make such disclosure, without more, could be said to suffice to prove a breach of such duty and an element of an insider-trading violation under certain conditions. But, as *Dirks* demonstrates, not every such breach of duty needs to be an element of insider trading.[304] A breach of duty in certain circumstances can be deemed privileged or excused for good reasons.[305]

Such an alternative conception might view the corporate insider like an attorney who discloses confidential client information to prevent a crime or fraud likely to cause death or serious bodily harm or to prevent substantial financial loss. The disclosure by the attorney is otherwise a breach of her duty to the client (there is no waiver of the client's confidential attorney-client privilege protection), but the disclosure is deemed privileged in these circumstances and is permitted—in certain states, required—by some state ethics rules.[306]

Like an attorney, the corporate insider's selective disclosure to expose a massive corporate fraud can be viewed as a breach of duty, but it is one that can be deemed privileged or excused, especially when it is made to regulatory authorities after exhausting internal channels of corporate personnel and institutions from the general counsel, the compliance department, the CEO, and the board. No element of personal benefit to the insider should be *required* to establish a breach

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confidential information. United States v. Parigian, 824 F.3d 5, 8–9 (1st Cir. 2016). The tippee breached the agreement, and he disclosed the information to a group of golfing buddies, one of whom traded based on the information and was charged with insider trading. *Id.* at 9–10. The government used the misappropriation theory on the ground that the first-level tippee (who was separately charged and convicted by a jury) had misappropriated the information from the insider to whom he owed a "duty of trust and confidence." *Id.* at 10. The opinion indicates that the legal basis of this duty of trust and confidence whose breach resulted in a breach of fiduciary duty is the SEC's "clarification" of the kinds of "relationships [that] could give rise to a 'duty of confidence'" in Rule 10b-5(2) (proposed on December 28, 1999). *Id.* at 13 (citing 17 C.F.R. § 240.10b-5(2) (2016)). In affirming the trading defendant's guilty plea, the court stated that he "does not dispute that the misappropriation theory of criminal securities fraud can apply in this manner to a remote tippee." *Id.* at 10. *But see* United States v. Chestman, 947 F.2d 551, 571 (2d Cir. 1991) (upholding insider-trading conviction under Rule 14e-3, but reversing conviction based on misappropriation theory for lack of fiduciary duty among family members), *cert. denied*, 503 U.S. 1004 (1992) (decided before the SEC proposed Rule 10b-5(2).

304. *See* 463 U.S. 645, 661–63 (1983).

305. *See, e.g.*, United States v. Willis, 737 F. Supp. 269, 275 (S.D.N.Y. 1990).

306. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §§ 66–67 (AM. LAW INST. 2000). Many states permit, and some require, under their Model Rules of Professional Conduct, an attorney to "reveal information relating to the representation of a client" to prevent "death," "substantial bodily harm," and "substantial injury to . . . financial interests." *See* MODEL CODE OF PROF'L CONDUCT R. 1.6(b) (AM. BAR. ASS'N 2015)

of duty, although the presence of a personal benefit could be probative evidence of a non-privileged or non-excused disclosure.

In cases of information adversely impacting corporate operations,[307] to the extent corporate shareholders suffer injury from having bought stock before the fraud was fully disclosed to the market, their injury stemmed from the underlying corporate fraud (for which the shareholder may have a civil claim), and not from its non-disclosure by sellers (without fiduciary duty to the buyers) who knew of, but failed to

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307. It is difficult to think of confidential inside information that may *benefit* future corporate operations whose unauthorized and premature disclosure by an insider could be deemed privileged or excused. A father telling his son about a future corporate merger by the company of which he is a director into another company should be a breach of his fiduciary duty to his company and its shareholders that may result in economic harm to the insider's company and its potential merger partner. This is not an altruistic act serving any valuable public purpose, even if the father insists upon the son treating the information confidentially. *Cf. Reed*, 601 F. Supp. at 699 (declining to charge father after he made several disclosures to his son about proposed merger of company of which father is a director on the belief, based on their close relationship and previous history of business discussions, the son would keep the information confidential; the father was viewed as "the victim of his son's connivance," although the government concluded the father's conduct was a breach of his fiduciary duty to his corporation; only the son was charged, who allegedly breached his duty of trust and confidence owed to his father).

Such a disclosure should not be a privileged or excused disclosure. Unlike the marital privilege widely recognized between spouses (which would support the husband's disclosure to his wife in *Willis*), the law generally does not recognize a parent-child privilege. *Id.* at 706 n.32 (listing cases). Absent a legal prohibition on insider trading, an insider would be able to convey valuable information to the market through her action (e.g., buying target company stock) without disclosing the nature of the future (good) corporate information at all and certainly without disclosing it only to family members, as was done in *Reed*. *Id.* at 699.

The government in *Reed* did not rely on the father's expectation that the son would keep the father's confidential information private. *Id.* at 691. Instead, using the misappropriation theory, the government charged the son with having misappropriated the confidential information in breach of a duty of trust and confidence he had with his father based on their "special relationship" and history of talking about confidential business affairs. *Id.* at 699–703. In declining to dismiss the two securities fraud counts of the Indictment for insufficiency, Judge Robert Ward conducted an extensive review of the case law under the misappropriation theory and exhaustively examined the law to determine the legal consequences that flow from the facts of the "special relationship" between the defendant and his father. *Id.* at 695–720. Judge Ward correctly reads *Chiarella* not to interpret the "disclose or abstain" rule to prohibit trading when one is in possession of inside information; the illegality of insider trading, according to Judge Ward, is triggered "only from a relationship of trust and confidence either between the parties to a market transaction or between the trading party and the source of that information." *Id.* at 696. In *Reed*, only the latter test was implicated. Judge Ward's thorough and poignant analysis of the legal rules that imply a duty of trust and confidence out of the "special relationship" present in the *Reed* case is well worth the effort and time to read. *Id.* at 703–20.

disclose the fraud to their purchasers—thereby taking advantage of the purchasers' lack of knowledge.[308]

1. An Insider Trading Statute is Required for Criminal Enforcement

These situations all point to the difficulty of deciding which of many trading transactions based on inside information should be criminalized and what the elements of such crimes should be. They all point in the direction of statutory enactment and away from judicial development of legal rules based on case-by-case adjudication.

Assuming Congress wanted to make insider trading a criminal act in some circumstances,[309] the required elements might include the following: (1) breach of fiduciary duty by insider or temporary insider (intentional, reckless, or even negligent); (2) theft or other misappropriation by pure outsider (breach of duty would not be required here, although it might be present); (3) material undisclosed confidential information reasonably likely to impact the stock price if and when disclosed; (4) knowledge by the person making and receiving the disclosure of the likely economic value of the material undisclosed confidential information; (5) knowledge by the recipient-user that such confidential information is undisclosed; and (6) trading in the stock by the recipient-user on the basis of that material information. The current elements of personal benefit to the insider-tipper and knowledge by a tippee of breach of duty and such personal benefit may not be required, and can perhaps even be eliminated.[310] These elements would well serve the objective of protecting the integrity of the securities markets by outlawing conduct that is wrong and unfair and causes harm to the market.

The congressional statute need not be overly complicated or exhaustive.[311] In menu-like fashion, it can define categories of conduct

308. *See* D'Amato, *supra* note 65, at 1447–49 (discussing the issue of damage causation from insider trading and distribution and allocation by courts of disgorged profits obtained by the SEC from insider traders).

309. *See, e.g.*, Bacastow, *supra* note 105, at 103 n.43. The transaction would need to involve, for jurisdictional purposes, a sale or purchase of security in interstate or foreign commerce, use of the mails, or use of any facility of any national securities exchange, and the element of willfulness for criminal conduct.

310. John C. Coffee, Jr., *How to Get Away with Insider Trading*, N.Y. TIMES (May 23, 2016), http://www.nytimes.com/2016/05/23/opinion/how-to-get-away-with-insider-trading.html?_r=0 (arguing that "legislation now seems the best answer" and advocating elimination of "the need to prove a 'personal benefit' to the tipper").

311. There are various models from which Congress may draw guidance, if not inspiration. California, for example, has an insider trading statute. *See* Bacastow, *supra*

subject to criminal sanctions, stipulate the basic elements of the defined criminal conduct and the penalties, exempt certain conduct, allocate jurisdiction to the courts and the SEC, and leave it up to the courts to fill the interstices of the statutory crime. As Judge Friendly noted,

> One of the beauties of the *Lincoln Mills* doctrine [permitting development of a federal body of labor-management contract law from a federal statute] for our day and age is that it permits overworked federal legislators, who must vote with one eye on the clock and the other on the next election, so easily to transfer a part of their load to federal judges, who have time for reflection and freedom from fear as to tenure and are ready, even eager, to resume their historic law-making function—with Congress always able to set matters right if they go too far off the desired beam.[312]

C. *Constitutional Doctrine Mandates Judicial Confession of Error*

From the brief discussion in this article of some of the current central issues in insider trading criminal law, it is difficult to dispute that we don't know where the "balance lies." Whatever one thinks of the merits of the positions for and against insider trading, their existence strengthens the argument for a statutory definition of the precise conduct to be criminalized.[313] More important, the Court has long held

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note 105, at 103–04 n.43. In 1978, with Professor Louis Loss as Reporter, the American Law Institute, after a decade or more of work, developed a proposed *Federal Securities Code*. According to one author, the SEC recommended that Congress adopt the ALI Code with minor changes. *Id.* at 130–31 n.189. Congress did not do so. *See id.*

312. Friendly, *supra* note 20, at 419 (footnote omitted). Judge Friendly was writing in 1964; today, given the substantial growth of their workload, federal judges may be less ready and eager to assume a greater law-making function, although they certainly make time for reflection and have freedom from fear.

313. While "[d]octrines of vagueness in criminal and constitutional law are designed more to limit the discretion of police and prosecutors than to ensure that statutes be intelligible to persons pondering criminal activity," and "few *criminals* are careful readers of judicial reports until they are imprisoned and have leisure to explore the prison's law library," certain conduct charged as criminal insider trading is not of the sort widely thought to be a *malum per se*; the actor is not considered, by many, to be similar to the hypothetical individual in *White* who seeks to obtain money by false pretenses. United States v. White, 882 F.2d 250, 252 (7th Cir. 1989) (emphasis added). For example, R. Foster Winans, the *Wall Street Journal* reporter who broke his contract with, and his duty to, his employer, is not widely thought to be a *criminal*. *See* Carpenter v. United States, 484 U.S. 19, 24, 27 (1987) (affirming the fraud conviction for defrauding the newspaper, but splitting evenly (4-4) on the securities law question based on a misappropriation theory, which resulted in an affirmance of the court of appeals judgment

that the Constitution denies to federal courts common law criminal jurisdiction.[314] Together, these are strong arguments for invalidation of continued federal enforcement of the judge-made doctrine of insider trading as a crime. Congressman Jim Himes of Connecticut has it just right: "If we're sending people to jail, it's probably better that [Congress does] that."[315] Like it did in *Erie*, the Court is well advised to self-correct this judicially created error.[316] The Court should not exercise a power not conferred by the Constitution even if Congress has, as undoubtedly it has regarding insider trading, silently deferred to such enforcement.[317] The federal judiciary's historically developed supremacy

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upholding the securities fraud conviction). In misusing information from his columns before publication, while Winans acted in a way that was wrong, and even reprehensible, his criminal prosecution depended upon the conflict-of-interest policy of his paper. Absent that, he probably could not have been prosecuted. *See* Pitt & Shapiro, *supra* note 15, at 428–29 n.47. Perversely, Vincent Chiarella, who, in the words of Chief Justice Burger, "stole to put it bluntly" material inside information and traded on it, avoided a felony conviction because the Court in 1980 declined to address the misappropriation theory since the jury had not been instructed on that theory. Chiarella v. United States, 445 U.S. 222, 243–45 (1980) (Burger, C.J., dissenting). *But see* SEC v. Materia, 745 F.2d 197, 203 (2d Cir. 1984) (upholding liability of the printer under the misappropriation theory in civil case with similar fact pattern), *cert. denied*, 471 U.S. 1053 (1985).

Unlike the average person, members of the securities industry, especially compliance officers, do read reports about judicial opinions, if not the actual opinions, for guidance on what is potentially criminal insider trading. Here, providing fair notice through a statute interpreted by judicial opinions would be a salutary improvement to our existing system of retrospective case-by-case adjudication.

314. *See* United States v. Hudson, 11 U.S. (7 Cranch) 32, 34 (1812).

315. Ben Conarck, *SEC's White Says Agency Mulled Insider Trading Ban*, LAW360 (Mar. 24, 2015, 06:58 PM), http://www.law360.com/articles/635363/sec-s-white-says-agency-mulled-insider-trading-ban (quoting U.S. Representative Jim Himes) (noting that the SEC has considered a rule to codify insider trading); *see also* Whitman v. United States, 135 S. Ct. at 352, 354 (2014) (Scalia, J., respecting the denial of certiorari) ("[O]nly the *legislature* may define crimes and fix punishments. Congress cannot, through ambiguity, effectively leave the function to the courts—much less to the administrative bureaucracy."); United States v. Wiltberger, 18 U.S. 76, 95 (1820) ("It is the legislature, not the Court, which is to define a crime, and ordain its punishment.").

316. *See* Friendly, *supra* note 20, at 422.

317. *See* Marbury v. Madison, 5 U.S. 137, 175–76 (1803). In *Marbury*, the Court declined to exercise, as part of its original jurisdiction, statutory grant of power expressly granted by Congress to issue a writ of mandamus, because, it concluded, Congress (1) lacked constitutional authority to grant the Court original jurisdiction in the case, and (2) the grant of authority to issue a mandamus could not be exercised as part of the Court's appellate jurisdiction. The Court concluded, "The authority, therefore, given to the supreme court, by the act establishing the judicial courts of the United States, to issue writs of mandamus to public officers, appears not to be warranted by the Constitution; and it becomes necessary to enquire whether a jurisdiction, so conferred, can be exercised." *Id.* at 176. Assuming the authority to strike down congressional legislation contrary to the Constitution, the Court in *Marbury* went on to declare the congressional

over the interpretation of the Constitution, widely and deeply accepted by the American people, their elected representatives, and legal scholars and practitioners, imposes upon the Court a special obligation to confine its exercise of power only where the Constitution confers authority. Under the Constitution, the Court keeps Congress and the President within their constitutional authority and space (safeguarding individual liberty and ensuring the independent rights of the individual states *qua* political entities) and protects the federal constitutional system by exercising the power to invalidate state laws contrary to the Constitution. But no constitutional institution, other than the slender reed of the Court's self-restraint, serves the function of keeping the federal courts within the bounds of their constitutional authority.

After *Newman II* and *Salman*, there is wider acceptance by law professors, legislators, and judicial officers that we need an insider-trading statute.[318] Continued enforcement of common law crime in this

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grant of authority in that case unconstitutional. *Id.* at 180. Interestingly, Chief Justice Marshall's "justification of judicial review in *Marbury v. Madison*" was anticipated by Justice Samuel Chase in his opinion and jury charge in one of the criminal libel cases, *United States v. Callender*, 25 F. Cas. 239 (C.C.D. Va. 1800), May 1800 term of the Circuit Court for the Virginia district) in refuting defense counsel's argument that the constitutionality of the Sedition Act of 1798 was an issue for the jury to decide; "Marshall was present at Callender's trial when the opinion was delivered; Chase attended the term of the Supreme Court when *Marbury* was decided." GOEBEL, *supra* note 21, at 650–51 (footnotes omitted).

In construing the Constitution as a "superior, paramount law" establishing the framework for a limited government, Chief Justice Marshall states: "To what purpose are powers limited, and to what purpose is that limitation committed to writing, if these limits may, at any time, be passed by those intended to be restrained?" *Marbury*, 5 U.S. at 176–78. While Marshall penned those words in the context of addressing an issue involving legislative limits, regarding an expressed grant of authority to the Court by Congress, are they any less applicable to the Court's exercise of power belonging to Congress that the Court has long concluded has not been conferred by the Constitution to the judiciary?

Specifically, in the context of the doctrine discussed in this article, is there a difference in kind between an expressed grant of authority "repugnant to the constitution," as was the case in *Marbury*, and congressional acquiescence to the Court's enforcement of a doctrine developed by an administrative agency that the Court has long held to lack constitutional foundation, such that the former instance is held constitutionally invalid, while the latter is enforced without regard, *sub silentio*, to its constitutional dubiousness? To quote Judge Friendly (out of context but without, I hope, distorting the meaning of his words,) in considering the propriety of the federal courts' enforcement of criminal insider trading, "the long acquiescence of Congress [should] be irrelevant." Friendly, *supra* note 20, at 391.

318. Indeed, one prominent and highly regarded district court judge who has written widely in this field and has decided several important insider-trading cases, has recommended two statutes—a broad one for civil cases, a narrower one for criminal ones. Jed S. Rakoff, Hybrid Statutes: A Study in Uncertainty, Speech at Conference on

area, some have concluded, may not be worth the candle because of the unnecessary risks posed to maintaining the integrity of the securities markets, resulting from the uncertainty about legal rules governing the conduct of participants in the financial markets. Moreover, prosecutors entrusted with significant discretion in making charging decisions may become justifiably timid about bringing criminal charges even in cases in which "an insider . . . profits from the poor performance of his company—poor performance for which he may be responsible."[319]

In response to the diminished vigor of criminal enforcement, the SEC may become overly aggressive on the civil administrative side in charging as fraud conduct that is at best questionable but not necessarily harmful to shareholders or the securities markets. Some believe that the "SEC should have given [Ray Dirks] a medal";[320] instead, after Dirks learned information that the SEC had not pursued and effectively disclosed it to the market by sharing it with others who sold their stock in a fraudulent company, the agency charged him with insider-trading fraud, requiring use of substantial judicial (and private) resources and DOJ amicus support opposing the SEC before the Court reversed the judgment of liability entered against Dirks.

Parallel development of insider-trading legal doctrine within the federal system is fraught with potential unnecessary costs and unfairness to litigants (not to mention unseemly disputes between DOJ and the SEC refereed by the federal courts) not unlike the problems created by parallel development of insurance law between the states and the federal system under the regime of *Swift v. Tyson*.[321] Therefore, unless the Court disregards or reverses its early precedents barring federal court development of criminal law,[322] the current doctrine of insider trading, like that of *Swift v. Tyson*, should be invalidated despite the potential disruptive consequences of confessing error after more than fifty years of enforcement. A salutary consequence of such a ruling, even if unintended, is that it may well add urgency to the wind in back of congressional efforts already underway to enact insider-

Corporate Crime and Financial Misdealing (April 17, 2015) http://www.law.nyu.edu/sites/default/files/upload_documents/Judge%20Rakoff's%20Address%20NYU%202015-04-17.pdf.

319. SEC v. Lipson, 278 F.3d 656, 659 (7th Cir. 2002). The SEC initially hastily drafted Rule 10b-5 to deal with the situation of a corporate officer who "misinformed the shareholders of the condition of the corporation [and] subsequently purchased the shares of the company from the shareholders at depressed prices." Fahey, *supra* note 94, at 531–32 n.156.

320. EASTERBROOK & FISCHEL, *supra* note 5, at 267.

321. *See supra* Part VI.

322. I presume here that the Court will continue to adhere to the *Hudson* doctrine.

trading legislation, something Congress has eschewed several times since 1980.[323]

Of course, the Court may decide instead to invalidate the *Hudson* doctrine and uphold the continued enforcement of common law criminal-insider trading. Charles Warren was of the view that if the Justices of the Supreme Court had reviewed the manuscript of the original Draft Bill of the Judiciary Act of 1789, "it is probable that the decisions in United States v. Hudson, in 1812, and United States v. Coolidge, in 1816, might have been otherwise than they were."[324] In this instance, unlike his interpretation of section 34 of the Judiciary Act of 1789 at issue in *Erie*, where he argued that a change in legislative language was stylistic and not substantive, "Warren assumed a change [from a draft to the final version] was substantive rather than stylistic."[325]

Section 10 of the Draft Bill of the Judiciary Act of 1879 (section 9 of the Act) granted federal district courts jurisdiction over "all crimes and offences that shall be cognizable under the authority of the United

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323. *See* Horwich, *supra* note 15, at 1258–64 (discussing various legislative proposals dating to the American Law Institute proposal in 1978, the American Bar Association Task Force proposal in 1987, a proposal from a group of securities lawyers prepared at the request of the Senate Committee on Banking, Housing, and Urban Affairs, and an SEC proposed legislative solution). Senator Donald W. Riegle and Alfonse M. D'Amato introduced the Insider Trading Proscriptions Act of 1987 based on some of these proposals. *Id.* at 1260. In 1988, when Congress passed the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), it *chose* not to include a definition of insider trading, for reasons explained by the House Report:

> While cognizant of the importance of providing clear guidelines for behavior which may be subject to stiff criminal and civil penalties, the Committee [on Energy and Commerce] nevertheless declined to include a statutory definition in this bill for several reasons. First, the Committee believed that the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and that a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law. Second, the Committee did not believe that the lack of consensus over the proper delineation of an insider trading definition should impede progress on the needed enforcement reforms encompassed within this legislation. Accordingly, the Committee does not intend to alter the substantive law with respect to insider trading with this legislation. The legal principles governing insider trading cases are well-established and widely-known.

Id. at 1262–63 (citing H.R. REP. NO. 100-910, at 11 (1988)). While Congress has decided not to "statutorily define insider trading," it has made the task of federal courts more difficult by acting "to strengthen and clarify sanctions for insider trading." *See* D'Amato, *supra* note 65, at 1457–58. It would be more helpful if Congress would first define the legal claim and criminal conduct. *See id.*

324. Warren, supra note 20, at 73.

325. Friendly, supra note 20, at 389–90, 390 n.35.

States *and defined by the laws of the same*."[326] According to Warren, the Senate deliberately struck the italicized language, and thus "[t]he only rational meaning that can be given to this action . . . is . . . that Congress did not intend to limit criminal jurisdiction to crimes specifically defined by it."[327]

Whether Warren's interpretation of the Senate action is correct, his view begs the question as to which crimes and offenses the states ceded to federal authority in the constitutional scheme.[328] If they are all state common law crimes in the sense that the common law was one of "the Laws of the United States" (and not just the Constitution, treaties, and federal statutes as interpreted by federal courts) referred to in Article III of the Constitution, and the basis of federal jurisdiction in a particular case were, say, use of the mails, in adjudicating a case involving charged criminal conduct relating to use of the mails, absent a congressional statute, federal courts would have to apply state substantive common law. They would achieve consistency between their rulings and state laws within their geographic jurisdictions, while variance among federal courts could subject individuals to prosecution in one federal district but not necessarily in others where the state common law crime might be different.[329]

In short, on this view, in all cases where there is a basis for federal jurisdiction, conduct could be federally prosecuted by using state common-law doctrine without congressional legislation.[330] Thus, if Congress has constitutional authority to grant federal courts jurisdiction to adjudicate any crime or offense within the purview of federal jurisdiction without enacting a substantive statute, then all criminal conduct within federal jurisdiction, such as using the mails or "in or affecting interstate commerce"[331] or, even more broadly, "involving commerce"[332], could be federally prosecuted as federal common-law crimes merely from a grant of jurisdiction by Congress.[333]

This view was rejected by the *Hudson* doctrine for good reasons.[334] There, Justice Johnson concluded that even if one were to accept the premise that "upon the formation of any political body, an implied power to preserve its own existence and promote the end and object of

326. Warren, supra note 20, at 73 (emphasis added).
327. *Id.*
328. *See id.*
329. *See* U.S. CONST. art. III, § 2; Warren, *supra* note 20, at 73.
330. *See* Warren, *supra* note 20, at 73.
331. Federal Trade Commission Act, 15 U.S.C. § 45(a) (2012).
332. Federal Arbitration Act, 9 U.S.C. §§ 1, 2 (2012).
333. *See* Warren, *supra* note 20, at 77.
334. *See id.* at 73–74.

its creation, necessarily results to it," "it would not follow that the Courts of that Government are vested with jurisdiction over any particular act done by an individual in supposed violation of the peace and dignity of the sovereign power. The legislative authority of the Union must first make an act a crime, affix a punishment to it, and declare the Court that shall have jurisdiction of the offence."[335]

It is a mistake, and results in confusion, to talk as if the predicate for federal jurisdiction over a crime is itself the "gist" of the criminal conduct.[336] Use of the mails, for example, is the federal predicate for jurisdiction of the federal government to prosecute a fraud scheme; it is not the "gist" of that offense.[337] A scheme to defraud that includes five mailings is one criminal transaction, not five separate crimes.[338]

Under the *Hudson* doctrine, in areas where there is a predicate for federal criminal jurisdiction governing private individual or corporate conduct, both a jurisdictional and substantive criminal statute are required.[339] Moreover, consistency among federal courts is best accomplished with such a federal statute, even if that law incorporates some substantive state common law elements, or a body of substantive federal common law is created through incorporation into federal law by statute of common-law rules to apply in areas of uniquely federal interest or national concern. These areas include offenses on federal property, in the District of Columbia, in the territories, within the admiralty and maritime jurisdiction but outside the territorial jurisdiction of any state, labor-management relations, securities transactions, interstate carriers (trains and airliners), unfair competition, multistate media publication, and claims by or against federal officials, agencies, or federally created corporations.[340]

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335. United States v. Hudson, 11 U.S. (7 Cranch) 32, 33–34 (1812).

336. *See* Schwartz, *supra* note 21, at 73.

337. *Id.* at 73.

338. *Id.* at 79–80.

339. *See* Assimilative Crimes Act, 18 U.S.C. § 13 (2012); Lewis v. United States, 523 U.S. 155, 178–79 (1998) (Scalia, J., concurring).

340. *See* 18 U.S.C. § 13 (2012); *Lewis*, 523 U.S. at 178–79 (viewing ACA not as a federalism measure, but as designed "to fill in the gaps in the federal criminal law" and "at least in part a response to our decision in *United States v. Hudson*"); Friendly, *supra* note 20, at 405 ("[B]y leaving to the states what ought be left to them, Erie led to the emergence of a federal decisional law in areas of national concern that is truly uniform because, under the supremacy clause, it is binding in every forum, and therefore is predictable and useful as its predecessor, more general in subject matter but limited to the federal courts, was not.").

IX. CONCLUSION

The current state of federal insider-trading criminal law is in some areas both confused and confusing.[341] More than seventy years after the promulgation of Rule 10b-5 by the SEC (more than fifty years after In re Cady, Roberts & Co.), like string theorists who hope to reconcile general relativity with quantum mechanics, the federal courts are still engaged, as *Newman II* and *Salman* demonstrate, in an elusive quest to articulate a coherent and principled doctrine that would reconcile the case law under the classical and the misappropriation theories and provide adequate notice of the elements of the wrongful conduct that amounts to a crime.[342] Before the *Salman* ruling, the Court had not decided a criminal insider-trading case in nearly twenty years.[343] Rather than pressing on down this path to await the emergence of a coherent doctrine from accumulated precedents for another fifty years (while continuing to send people to jail), perhaps it is time to concede that, in this area of law, the task is plainly a legislative one (as the Constitution requires) for which the common-law methodology of the courts is institutionally unsuited.[344]

Under the Constitution, criminal enforcement of insider trading, if we are to have that at all, requires a statute.[345] First, the role of Congress and the president in the statutory enactment process establishes the legitimacy of having Congress and the president agree

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341. Adjudication of criminal insider-trading cases would not thus far meet one of the quintessential merit of common-law adjudication: "It is the merit of the common law that it decides the case first and determines the principle afterwards." OLIVER WENDELL HOLMES, *Codes, and the Arrangement of the Law (1870)*, *in* THE COLLECTED WORKS OF JUSTICE HOLMES: COMPLETE PUBLIC WRITINGS AND SELECTED JUDICIAL OPINIONS OF OLIVER WENDELL HOLMES 212 (Sheldon M. Novick ed. 1995), *quoted in* LOUIS MENAND, THE METAPHYSICAL CLUB: A STORY OF IDEAS IN AMERICA 217 (2011); *see also* Stone, *supra* note 158, at 6 ("With the common law, unlike the civil law and its Roman law precursor, the formulation of general principles has not preceded decision. In its origin it is the law of the practitioner rather than the philosopher. Decision has drawn its inspiration and its strength from the very facts which frame the issues for decision. Once made, the decision controls the future judgments of courts in like or analogous cases.").

342. *See* United States v. Salman, 792 F.3d 1087, 1092–93 (9th Cir. 2015); *Newman II*, 773 F.3d 438, 442, 445–46 (2d Cir. 2014).

343. Kevin Dugan, *Supreme Court Agrees to Take on Pivotal Insider Trading Case*, N.Y. POST (Jan. 19, 2016, 10:25 PM), http://nypost.com/2016/01/19/supreme-court-agrees-to-take-on-pivotal-insider-trading-case/.

344. *Salman*, 792 F.3d at 1092–93; *see Newman II*, 773 F.3d at 445–46.

345. There are several bills pending in Congress to codify insider trading. Stephanie Russell-Kraft, *Litigators Fear Congressional Fixes to Newman*, LAW360 (March 31, 2015, 1:28 PM) http://www.law360.com/articles/636522/litigators-fear-congressional-fixes-to-newman.

to define certain conduct as criminal partly to reflect the general opprobrium of the constituents whom they represent.[346] Second, after full consideration as part of the legislative process (an institutional device unavailable to courts that must decide particular cases presented to them), a statute is likely to be far better suited to meet the definitional obstacles to capturing comprehensively the precise wrongful conduct involved in insider trading, and prohibiting only those aspects deemed harmful to the securities markets.

In this area, the challenges presented by the ingenuity of unscrupulous actors in the securities industry who are motivated by a basic human instinct that is the *a priori* presupposition of neoclassical economics (i.e., greed) cannot easily be cabined by the institutional arrangements of judicial case-by-case common law adjudication, while at the same time providing fair notice to those who wish to keep their behavior on the right side of law.[347] The current law of insider trading provides insufficient notice to actors in the securities markets and, in some ways, is both over- and under-inclusive in its reach.[348] Charging Dirks in a civil fraud case was an overreach; not subjecting to any charge the person who profits by deciding *not to sell* stock after learning favorable inside news about a company (because no purchase or sale is involved and, in any event, that conduct is virtually "undetectable"),[349] while exposing a person to a *criminal* prosecution who decides *to buy* the same stock based on the same inside information seems unfair and unjust to many ordinary citizens without any legal training.[350]

The certainty of legal rules, addressed as they are mainly to the "bad" actors among us, makes it possible for the vast majority of honest actors to conform their conduct to the rules, while providing ample and adequate notice to the "criminals" of the prohibited conduct long before they commit their crimes and go to the prison library and read about

346. *See id.*

347. HOLMES, *supra* note 328, at 61 ("People want to know under what circumstances and how far they will run the risk of coming against what is so much stronger than themselves [(i.e., the "whole power of the state," the command of which is "intrusted to the judges")] . . . .").

348. *See* Manne, *supra* note 88, at 550–51.

349. *See* United States v. Chestman, 947 F.2d 551, 578 n.5 (2d Cir. 1991) (Winter, J., concurring in part and dissenting in part) ("Comprehensive protection of those who trade with insiders is unattainable because the most common form of insider trading by far is failing to trade."); Manne, *supra* note 88, at 550–51 (footnote omitted) (referring to the facts of *TGS* corporate "officials buying stock with knowledge of a new ore vein have somehow done something immoral [insider trading], but the company itself buying surrounding land, *utilizing precisely the same information*, has merely performed in a business-like fashion"); Boudreaux, *supra* note 247, at 4.

350. *See* Boudreaux, *supra* note 247, at 4.

the wrongfulness of their conduct.[351] Not to be overlooked, legal certainty about the rules governing private transactions is among the most important necessary preconditions to an effective and efficient market economy.[352] Most important of all, the certainty of the legal rules is a necessary condition of justice.[353]

A volunteered confession of error here would demonstrate a principled commitment to constitutional allocation of power among the three branches of the federal government, much as *Erie R.R. Co.* showed a long overdue regard for the distribution of constitutional power between the states and the federal government.[354] It would also reflect well on the federal courts' traditional solicitous role in safeguarding individual freedom in disputes between the individual and a federal government of limited powers by declining enforcement of federal criminal cases, unless the conduct deemed criminal is defined by constitutionally valid legislation.[355] "To any person concerned with preserving civil liberties, it should be deeply troubling that a person can be prosecuted, and subjected to increasingly severe criminal penalties, for a crime that Congress has never defined."[356] The liberty of individuals, in the words of John Lucas, *is* best promoted when "all the [criminal] laws [are] written down explicitly and not locked up in the hearts of judges."

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351. *See* Friendly, *supra* note 20, at 387 n.23.

352. *See* United States v. Willis, 737 F. Supp. 269, 276–77 (S.D.N.Y. 1990); Friendly, *supra* note 20, at 387 n.23.

353. Friendly, *supra* note 20, at 387 n.23 ("Lord Bacon's maxim 'Certainty is so essential to law, that law cannot even be just without it.'"). The lack-of-adequate-notice argument for enforcing criminal insider-trading law has been rejected. *See Willis*, 737 F. Supp. at 276–77.

354. Standard Oil Co. v. United States, 221 U.S. 1, 103 (1911) (Harlan, J., concurring in part and dissenting in part) ("The illustrious men who laid the foundations of our institutions deemed no part of the national Constitution of more consequence or more essential to the permanency of our form of government than the provisions under which were distributed the powers of government among three separate, equal and co-ordinate departments,—legislative, executive, and judicial.").

355. Pitt & Shapiro, *supra* note 15, at 417.

356. *Id.*

APPENDIX

Note on David Hume and Causality

The legal requirement for an insider-trading violation is that a person had knowledge of material inside information and traded "on the basis of" that information in circumstances where the other elements of insider trading are present.[357] The "on the basis of" language plainly requires some connection beyond mere temporal association of information-possession and trading, if not a causal relationship, between these two factors.[358] It should be insufficient to prove this relationship merely by proving that the two factors were present in temporal sequence.[359] Yet, that is exactly what the SEC standard in Rule 10b-5(1) seeks to accomplish.[360] It seeks to infer the statutory element of causality or even connection merely from a temporal succession.[361]

This position encounters a fundamental problem in philosophy. The problem concerns the correctness of inductive reasoning. Its identification is generally attributed to the eighteenth-century Scottish philosopher David Hume.[362] The problem of causality that Hume identified, called "the problem of the justification of induction," remains under "considerable controversy" among philosophers.[363] Logicians refer to the causal fallacy as the *post hoc ergo propter hoc* or *post hoc* fallacy, taking the logical form of "after this; therefore, because of this."[364]

Hume's conception of causality was that it cannot be based simply

357. 17 C.F.R. § 240.10b-5(a)–(c) (2016).
358. *See id.*
359. *See id.*
360. *See id.*
361. *See id.*
362. DAVID HUME, A TREATISE OF HUMAN NATURE bk. I, pt. III, §§ II, III, XIV (1739); AN INQUIRY CONCERNING HUMAN UNDERSTANDING § IV (1748), *reprinted in* DAVID HUME, AN ENQUIRY CONCERNING HUMAN UNDERSTANDING and selections from A TREATISE OF HUMAN NATURE at 143–68 (TREATISE) and 4660 (ENQUIRY) (introd. by Thom Chitton 2004). Hume's metaphysical skepticism also led him to express reservations about our ability to justify claims of moral judgment. This remains a difficult and profound problem in moral philosophy. Hume's argument is that "value judgments cannot be justified by deducing them from statements of fact alone." WESLEY C. SALMON, LOGIC 11 (1984). This idea is often expressed in the notion that we cannot derive an "ought" proposition (a moral claim) from an "is" statement (a factual claim). *Id.* at 16 (citing HUME, A TREATISE OF HUMAN NATURE, Bk. III, Pt. I, § I).
363. SALMON, *supra* note 349, at 82–83.
364. *Cf.* United States v. O'Hagan, 521 U.S. 642, 690 n.7 (1997) (Thomas, J., concurring in part and dissenting in part) (charging majority opinion with an "error in logic . . . [in] [c]onflating causation and correlation"). SALMON, *supra* note 349, at 100–04.

on contiguity, sequential observation, and constant conjunction of events to which we attribute causal connection in our minds.[365] That would be merely a psychological inference.[366] For Hume, causality requires a "NECESSARY CONNEXION" in experience between cause and effect.[367] Without a necessary connection, which Hume concluded could not be established in experience, he believed that all we are left with is the presupposition of the "uniformity of nature" which enables us to make mental causal connections as a psychological reaction from sense impressions of multiple temporal associations over time.[368] Hume's account of causality forces us to scrutinize the frequent psychological inference we make from "after" to "because."[369]

Perhaps Hume's skepticism led him to an overly restrictive conception of reason and causation. Some modern philosophers take a different conception of reason and causality.[370] We could, for example, conceive of humans as not being passive recipients of sense impressions of "constant conjunctions" from the external world but as active agents whose actions are the "cause" of events that they want to happen in social interactions in the world we all inhabit. We act for the purpose of causing some particular consequence, but consequences are not logically necessary to certain acts.[371] All actions also have unintended consequences.[372] Causation, however, operates in the realm of action, not in the analytical realm of the mind.[373] Understanding events may therefore require us to comprehend human actions in all their complexity.[374]

In the context under discussion, to the SEC and prosecutors often the argument is quite simple: "You bought the stock *after* you learned the confidential material inside information; therefore, you traded *because* you possessed inside information."[375] This position often fails to

365. HUME, *supra* note 349, at 74–76.
366. *Id.*
367. *Id.* at 77.
368. *Id.* at 77–78.
369. *See id.* at 74–78.
370. *See* J.R. LUCAS, THE PRINCIPLES OF POLITICS, at x (1966) ("I have a less restricted notion of reason than Hume, and arguments which fail to conform to the canons of deductive or inductive inference can still, I believe, be reasonable and sound."); LUCAS, THE FREEDOM, *supra* note 245, at 62 (1970) ("For the notion of cause is based not, as Hume thought, on our *observing* constant conjunctions of events, but on our being able *to make things happen.*").
371. *See* HUME, *supra* note 298, at 76–77.
372. *See id.*
373. *See id.* at 73–74, 82–83.
374. *See id.* at 85.
375. *See* Horwich, *supra* note 15, at 1240.

scrutinize the connection the mind makes between "after" and "because."[376] From this temporal sequence, this position conflates the logical and the causal relationship between two independent concepts, namely, possession of inside information and trading on the basis of that information.[377] But,

> [t]he logical and the causal relationship differ in that the latter adds duration to sequence, whereas the former exhibits sequence alone. The joining of sequence and duration is called time. A causal explanation is always an account of the relationship among events in time. A logical analysis deals with the connection among concepts outside of time.[378]

Here, the relevant relationship sought to be proven between inside information and trading is a causal one within time.[379] Presumably, if a person traded (even if he was aware of inside information before trading) but did not use that inside information as a basis of such trade, no insider-trading violation occurred.[380] To establish such a relationship (and in a criminal case, it is the government's burden to do so beyond a reasonable doubt), the relevant actor's conduct must be examined in terms of his pre-inside-knowledge beliefs, thoughts, and actions, and his post-inside-knowledge, but pre-trading action must also come under similar scrutiny.[381] Moreover, the relevant actor's actions must be examined prospectively, not retrospectively.[382] Viewing history retrospectively (like "Monday morning quarterbacking") gives us the benefit of knowing the subsequent events that the actor whose conduct we are trying to understand did not know at the time she acted.[383] To

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376. *See id.*
377. *See* ROBERTO MANGABEIRA UNGER, LAW IN MODERN SOCIETY: TOWARD A CRITICISM OF SOCIAL THEORY 9–10 (1976).
378. *Id.*
379. *See id.* at 10.
380. *See* Bacastow, *supra* note 105, at 107–08, 108 n.67.
381. *See id.*
382. *See id.* Of course, the materiality of the inside information determined based on its impact on the stock price can only be realistically assessed after the information is disclosed and assimilated into the market stock price. *See id.* But the trader must make that determination *ex ante*, not *ex post*. *Id.*
383. In the more eloquent words of Professor Mary Sarah Bilder: "One purpose of history is to remind us that those who came before could not see the future." Mary Sarah Bilder, *Madison's Edits*, B.C. MAG. (2016), http://bcm.bc.edu/issues/winter_2016/endnotes/madisons-edits.html (adapted from her newest book, MADISON'S HAND: REVISING THE CONSTITUTIONAL CONVENTION (2015)); *see also* Friendly, *supra* note 20, at 396–97 & n.65 ("[S]ucceeding Ages viewing what is past by the present, conceive the former to have been like to that they live in." (quoting Sir Henry Spelman)).

fully understand human action, we must examine it taking into account only what the actor knew when she acted.[384] Only after an examination of these thoughts and events in time can we even hazard a conclusion about a causal relation between having inside information and trading on the basis of that information.[385]

It is logically possible to know of inside information, and not to use it for trading to one's advantage, although it is highly unlikely that a person knowing such "sure-bet" information would choose not to use it. As a practical matter, because the logical possibility of non-use is an exceptional case, absent clear and convincing evidence, we may conclude that there is a presumption that one with knowledge of inside information used it.[386] From a legal point of view (and not from a philosophical perspective), this is the core of the problem for insider-trading criminal cases. In all cases, even the exceptional cases (where non-use is logically possible), the government must prove the connection beyond a reasonable doubt.[387] It may not rely on the absence of clear and convincing evidence to infer a presumption in favor of the reasonable inference of use.[388]

Thus, it is not enough to say, as some courts do, that the nature of knowledge of certain types of confidential information is such that one cannot possibly isolate and disregard that knowledge in one's mind while trading in the stock of the relevant company.[389] Such a view is

384. *See* Friendly, *supra* note 20, at 396–97 & n.65

385. *See* HUME, *supra* note 249, at 73–77.

386. *See* Horwich, *supra* note 15, at 1277.

387. *See id.* at 1278.

388. *See id.*

389. United States v. Teicher, 987 F.2d 112, 120 (2d Cir. 1993) ("Unlike a loaded weapon which may stand ready but unused, material information can not lay idle in the human brain."). The analogy is not quite apt. A gun is an inanimate object without mental capacity. It is incapable of making a decision to fire or not to fire; it will always remain unused without a human actor intervening. Human agents, on the other hand, often possess material information in their minds that they decide, consciously or perhaps unconsciously, to act on or disregard in their actions. Moreover, the element of time when considered along with that of sequence means that on occasion the receipt of the material information may have occurred after the decision to act and before the actual execution of the action, and not before the decision to act.

Consider this hypothetical example. An insider (corporate officer) has an understanding with a good friend (a portfolio manager at a hedge fund) to give the manager a heads-up about upcoming adverse or good information about the insider's corporation. They agree on coded language. The insider calls his friend and leaves a message that quarterly earnings will be down substantially. Before the friend listened to the message, he had called a trader to ask him to sell that stock for independent reasons based on his own analysis. Before the trader executed the instruction, the friend listened to the insider's message. Let's assume there is no objective and independent way to prove based on human psychology and makes a logical point based on an observer's impression of sequential events; perhaps it provides an explanation of trading decisions by those with inside material nonpublic information, and even a good one, but it makes no causal connection, as the statute requires.[390] And because it makes no necessary causal connection, it may be, in a particular (even if it is a rare) case, false. The problem with using the logical argument in a criminal case to create the presumption of use of inside information is that it shifts the burden from the government to the defendant—an impermissible move in such a case.

What is more, how do we differentiate the legal position taken in insider-trading cases from a practice engaged in by many judges and routinely approved by appellate courts where the judge, at sentencing, in deciding a motion, or even a bench trial, accepts certain irrelevant and perhaps inflammatory evidence only to state that he will not

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when the friend listened to the message.

If the friend does not call the trader to cancel the sell order, is he subject to prosecution or civil action for insider trading? Does he have to prove the facts at trial (*i.e.*, he listened to the message after he gave the instruction to sell) to be acquitted of a criminal charge (he can't talk with the government pre-indictment and explain the facts without admitting to the conspiracy with his insider friend)?

Or does the government, in a criminal case at least, have to prove a causal relationship, above and beyond the reasonable inferences a trier of fact could draw from the basic facts (absent clear and convincing evidence to the contrary), between the portfolio manager's stock sale and pre-disclosure (but post-decision to sell) knowledge of the material inside information about the earnings report?

In close factual circumstances like those of this hypothetical, it is highly likely that the portfolio manager would at least face an SEC civil case. *See* SEC v. Obus, 693 F.3d 276, 279–83 (2d Cir. 2012). The defendants in *Obus* prevailed after a thirteen year battle and a trial. *See* Joel M. Cohen, et al., SEC v. Obus: *A Case Study on Taking the Government to Trial and Winning*, 47 REV. SEC. & COMMODITIES REG. 247, 247 (2014).

If it is true that material inside information about a company "can not lay idle in the human brain," we need to provide an explanation for why that is so in specific factual contexts and cannot presume the causal connection to be true *a posteriori*. *See Teicher*, 987 F.2d at 120. In a criminal case where the burden of proof of every element of criminal conduct is always on the government and never shifts (except somewhat in cases of affirmative defenses), this widely held legal presumption or inference should not serve (especially in the court's legal instructions to the jurors), in fact, to make the defendant have to prove that he did not act on the basis of the inside information to be acquitted of the insider-trading charge. *See* Horwich, *supra* note 15, at 1276 n.249, 1276–78. That is, to present the clear and convincing evidence to rebut the natural inference of use we often make in associating possession of material inside information with subsequent trading. *See id.*

390. LUCAS, *supra* note 219, at 33 ("The concept of explanation is linked with that of cause, although not identical with it. The word 'because' shows the link. It characteristically is used to introduce an explanation, but often also seems to state the cause.").

consider such evidence in his decision?[391] We also make the same judgment about the psychological abilities of a lay person juror when we presume that the juror can follow the judge's instruction to disregard irrelevant and inflammatory evidence improperly presented to the jury.[392]

Why is the psychological and logical analysis we make of the judge's ruling or a juror's verdict different from that made of the stock trader's in insider-trading cases?[393] Is it because we view the judge as a trained professional capable of compartmentalizing certain information as she conscientiously performs an important duty?[394] Is it because we think that the lay person juror takes seriously the duty to pass judgment on another person and so will scrupulously follow the judge's instruction?[395] Or is it just because, unlike the judge or juror, we think (based on group prejudice perhaps) that, for the stock trader, greed is such a powerful instinct to human action that we conclude that the trader in possession of valuable and material inside information will find the temptation to make a quick profit irresistible and will in fact not be able to resist acting on the information he possesses, even if it is logically possible to do so?[396] If that is so, why do we so readily dismiss the potential influence on jurors of bias and prejudice, equally powerful instincts to human action?[397]

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391. *See* Horwich, *supra* note 15, at 1250–51, 1263.

392. If we were to conclude that there was a real problem with juries improperly hearing illegal evidence, we could adopt a system in which proposed testimony is submitted in writing for review by the court to determine its propriety under the rules of evidence. *See* GOEBEL, *supra* note 21, at 643. In the criminal libel case of *United States v. Callender*, 25 F. Cas. 239, 251 (C.C.D. Va. 1800), Justice Samuel Chase in 1800, anticipating the defense strategy to have the jury invalidate the Sedition Act of 1798, required defense counsel to state all of what the witnesses would testify about in the case on the ground that "[j]uries are only to hear legal evidence, and the court are [sic] the only judges of what is or is not legal evidence, to support the issue joined between the parties." Professor Goebel sums up Justice Chase's position as follows: "Illegal evidence once heard would make a wrong impression and therefore should not be heard by a jury at all." GOEBEL, *supra* note 21, at 643.

393. *See* Warren, *supra* note 20, at 83.

394. *See id.*

395. *See id.*

396. *See id.*

397. In the Constitution, local prejudice is recognized by creating diversity citizenship jurisdiction in federal courts as means for out-of-state litigants to avoid local prejudice. *See id.* at 83 ("The chief and only real reason for this diverse citizenship jurisdiction was to afford a tribunal in which a foreigner or citizen of another State might have the law administered free from the local prejudices or passions which might prevail in a State Court against foreigners or non-citizens." (citing Bank of United States v. Deveaux, 9 U.S. 61, 87 (1809))). Warren, writing in 1923 to 1924, also concluded that such local prejudice

If it is a "metaphysical impossibility," as has been suggested,[398] to establish causation (and Hume's position suggests that it may be), and thus requiring such a standard will pose significant enforcement obstacles, the answer to that argument is a statutory definition of the crime of insider trading that would impose a less rigorous element of causation instead of the current "on-the-basis-of" standard or even no causation at all.[399] We could, for example, go to another extreme and make insider trading a strict-liability crime.[400] The law could simply provide that one is liable (criminally and civilly) for insider trading if one possesses material inside information (however acquired) not publicly disclosed before engaging in trading in the relevant stock.[401] Such a law would provide more certainty but would be unjust and unfair (not to mention unwise and perhaps of doubtful constitutionality) and would certainly undermine our concept of individual responsibility; it would at least provide fair notice of what is clearly prohibited.[402]

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had "now almost entirely disappeared," and thus diversity "jurisdiction might well be radically cut down." Warren, *supra* note 20, at 132. Warren was a proponent of curtailing federal judicial power in general. *Id.* at 69–70 ("In fact, it would probably now be better that the present broad jurisdiction granted by the Act of 1875 [the first statute granting broad federal question jurisdiction to federal district courts, Act of Mar. 3, 1875, ch. 137, 18 Stat. 470] should be abrogated, and that the State Courts should be left to a greater extent with jurisdiction, in the first instance, of cases arising under the Constitution and laws of the United States, Federal rights being amply safeguarded by right of appeal to the United States Supreme Court." (citation omitted)). Many practitioners who litigate in state and federal courts in 2017 would disagree that local bias and prejudice have "entirely disappeared." *See id.* at 132. Even among federal judges today, it is doubtful that Warren's view of federal question jurisdiction would be well received. *See id.* at 69–70.

398. *See* Horwich, *supra* note 15, at 1265 & n.190.

399. *See id.*

400. *See id.*

401. *See* SEC v. Tex. Gulf Sulfur Co., 401 F.2d 833, 875 (2d Cir. 1968) (1969) (Moore, J., dissenting) ("At one extreme is a rule that no officer or employee or any member of their families shall own stock of the company for which they work or purchase stock if he possesses 'material' inside information."). Judge Moore advocated for a "rule of reason" by "Congressional legislation and Commission rulings " between this rule at one extreme and the rule of *In Re Cady, Roberts* at another extreme, where the insider participated in a board decision whose disclosure, once made, would adversely affect the stock and who left the board meeting ahead of others to disclose his knowledge to an outsider to benefit before others learned of the board's decision. *Id.*

402. *See id.*

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