Insider Trading and the Myth of Market Confidence

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INTRODUCTION

Promoting public confidence in securities markets is a policy goal that is frequently cited by commentators, Congress, the courts, regulators, and prosecutors for the adoption and vigorous enforcement of insider trading laws.[1] For example, in describing a motivating purpose and need for the Insider Trading and Securities Enforcement Act of 1988, Congress explained that insider trading "diminishes the public's faith" in capital markets, adding that "the small investor will be—and has been—reluctant to invest in the market if he feels it is rigged against him."[2] In the seminal insider trading case *United States v. O'Hagan*, the U.S. Supreme Court explained that "investors likely would hesitate to venture their capital in a market where [insider trading] is unchecked by law."[3] More recently, Preet Bharara, who earned the title of "Wall Street Sheriff" by successfully prosecuting over seventy insider trading cases in the wake of the 2008 financial crisis, emphasized that part of his job as the U.S. Attorney for the Southern District of New York was to aggressively prosecute insider trading cases "to bring people back to a level of confidence in the market."[4] Such expressions of the link between insider trading and market confidence, however, assume far more than they explain.

At least three claims seem implicit in the market-confidence argument. First, that a large portion of the general public shares the perception that

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1. *See, e.g.*, Stephen Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1234 (1995) (noting that there are three rationales for regulating insider trading that directly relate to the purposes of the securities laws in the United States: "protection of the mandatory disclosure system, protection of investors, and maintaining public confidence in the securities market").

2. H.R. Rep. No. 100-910, at 7–8 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6044.

3. 521 U.S. 642, 658 (1997).

4. Steve Schaefer, *Wall Street Sheriff Preet Bharara Talks Insider Trading*, FORBES (Jul. 18, 2012), https://www.forbes.com/sites/steveschaefer/2012/07/18/wall-street-sheriff-preet-bharara-talks-insider-trading/#4d13add86690.

insider trading is economically harmful and morally wrong. Second, that this perception will lead potential market participants to stand on the sidelines of any market in which insiders are free to trade on their material nonpublic information. Third, that this chilling effect upon market participation will be significant enough to result in an appreciable decrease in market liquidity and therefore an increase in the cost of capital for those who would put it to socially beneficial uses.

This Article challenges the validity of the market-confidence claim as a justification for the regulation of insider trading on two grounds. First, insofar as it relies on a sociopsychological claim—that most investors perceive insider trading as economically harmful or morally wrong—it is subject to the problem of false consciousness (i.e., the psychological claim could be true though the shared belief is demonstrably false).

Second, even if the problem of false consciousness is set aside, the market-confidence argument's empirical claims of a chilling effect among potential investors must be proven, not simply assumed. Empirical evidence for the market-confidence theory is, however, decidedly weak. Studies testing public attitudes concerning insider trading have reflected more ambivalence than fear or indignation. Moreover, there is no clear empirical evidence of decreased market confidence in reaction to major insider trading prosecutions, news of pervasive insider trading, major court decisions affecting the government's power to enforce against insider trading, or the adoption of insider trading regulations in countries that did not previously regulate it. Perhaps more concerning for the market-confidence theory, however, is the ease with which its proponents can explain away data that might conflict with its claim by shifting explanations.[5] This raises the concern that the market-confidence theory may not just be unproven, but worse, unprovable.

The Article concludes by cautioning against relying upon such an unproven or unfalsifiable claim as a justification for existing or expanded civil and criminal insider trading enforcement powers.

5. *See infra*, Part II.

I. THE PROBLEM OF FALSE CONSCIOUSNESS

The market-confidence argument for regulating insider trading rests on the assumption that the trading public perceives insider trading to be inefficient or morally wrong, and that this shared attitude would motivate a nontrivial number of these potential traders to stand on the sidelines of any market that failed to regulate it effectively.[6] But, what if this attitude exists despite the fact that, in reality, insider trading is neither inefficient nor morally wrong? In other words, what if the prevailing ethical attitudes regarding insider trading are just wrong? Professors Dan Kahan and Eric Posner have offered an illustration of how such a false consciousness concerning insider trading might arise, persist, and even strengthen over time.[7]

According to Kahan and Posner, an enterprising politician or prosecutor could effectively change public attitudes concerning the moral permissibility of insider trading by linking the behavior to a catastrophic market event, such as a market crash, and then aggressively prosecuting individuals for insider trading under a vague criminal law, such as securities fraud.[8] While there may be no clear link between insider trading and the market crash, the enterprising prosecutor would nevertheless publicly appear to be taking aggressive action in the midst of the crisis.[9] Even if they do not buy the rhetoric at first, law-abiding citizens would refrain from insider trading to avoid social and legal sanctions.[10] The only people who would continue to engage in insider trading, therefore, would

6. *See, e.g.*, H.R. Rep. No. 100-910, at 7-8 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6044 (expressing concern that investors will not participate in markets that are perceived to be unfair or "rigged" by insider trading); *O'Hagan*, 521 U.S. at 658 (investors "would hesitate to venture their capital in a market where [insider trading] is unchecked by law").

7. Dan M. Kahan & Eric A. Posner, *Shaming White-Collar Criminals: A Proposal for Reform of the Federal Sentencing Guidelines*, 42 J.L. & ECON. 365, 376–78 (1999). *See* John P. Anderson, *Greed, Envy, and the Criminalization of Insider Trading*, 2014 UTAH L. REV. 1, 50–51 (using the Kahan and Posner example to offer a sociopsychological explanation for the criminalization of the morally permissible and economically harmless conduct of issuer-licensed insider trading). It should be noted that Kahan and Posner do not argue that insider trading *is* morally permissible, and that any contrary attitudes developed by a public would be false. Their point is rather to show how reputational signals can change moral attitudes independent of any appeal to moral reasons.

8. Kahan & Posner, *supra* note 7, at 377.

9. Kahan & Posner, *supra* note 7, at 377.

10. Kahan & Posner, *supra* note 7, at 377.

be unsavory characters who are not law abiding.[11] This would give law-abiding citizens yet another reason for refraining from insider trading: they would not want to be mistaken for a bad person.[12] Some citizens would even start to encourage more prosecution of insider traders to signal to others that they are against bad people too.[13] This may lead to cognitive dissonance: the same citizen who encourages punishment of insider trading also believes, deep down, it is morally innocent.[14] Over time, however, most citizens would resolve this dissonance by convincing "themselves, through a psychological process that is not well understood, that not only do bad people engage in insider trading but that insider trading is morally wrong."[15]

The preceding narrative is not an actual historical account of how public attitudes toward insider trading developed in the United States or anywhere else, but illustrates how such a false consciousness *might* take hold by reputational signaling. The point is that if such false consciousness does take hold, the mere perception of moral risk (though false) would, under the market-confidence argument, still affect liquidity, cost of capital, and market value in precisely the same way as if it were true. As a result, conduct that is not itself wrong or harmful to investors would end up having harmful consequences simply because others falsely perceive it to be wrongful. The question then becomes how should those who recognized public attitudes as false react to its effect on market confidence.

One response may be to continue to regulate insider trading solely to prevent the pervasive false consciousness from reducing market participation. This response would, however, be unwise because it confronts a false consciousness that negatively impacts market performance by reinforcing and perpetuating it. Further, it results in wrongful punishment by targeting individuals for conduct that is neither economically harmful nor morally wrong.

An alternative response is to educate the public to correct the false

11. Kahan & Posner, *supra* note 7, at 377.
12. Kahan & Posner, *supra* note 7, at 377.
13. Kahan & Posner, *supra* note 7, at 377.
14. Kahan & Posner, *supra* note 7, at 377-78.
15. Kahan & Posner, *supra* note 7, at 378.

consciousness. This takes the far wiser tack of addressing the inefficient and harmful attitude by correcting it. With this in mind, it should be understood that the market-confidence argument offers a sound justification for regulating insider trading *if and only if* insider trading is proven to be economically harmful and morally wrong on grounds quite independent of the public's attitudes toward it. This moral claim must be proven, not assumed, by proponents of the market-confidence argument.[16]

Assume *arguendo*, however, that the moral claim is proven and the problem of false consciousness is overcome. The next step in the market-confidence argument is its empirical claim: that belief in the harmful effects of insider trading is indeed prevalent, and that this pervasive attitude has a negative effect on markets that do not vigorously enforce insider trading regulations. Like the moral claim, this empirical claim also must be proven.

II. THE EMPIRICAL CLAIM

Because the market-confidence argument depends crucially on public attitudes, and the extent to which attitudes discourage market participation, it is notoriously difficult to prove or measure. Few studies have been done to gauge the public's perception of insider trading, and those that have been done are inconclusive.[17] For example, a 1986 *Business Week/Harris* poll taken in the aftermath of the Ivan Boesky insider trading scandal found that while "Wall Street may be in a tizzy, . . . Americans don't seem

16. I have argued elsewhere that two of the three categories of insider trading that are currently proscribed under U.S. law are indeed morally impermissible and economically harmful, but that one form, issuer-licensed insider trading, is neither morally wrong nor harmful. *See, e.g.*, Anderson, *supra* note 7, at 27-43; John P. Anderson, *Anticipating a Sea Change for Insider Trading Law: From Trading Plan Crisis to Rational Reform*, 2015 UTAH L. REV. 339, 382–387 (2015); John P. Anderson, *What's the Harm in Issuer-Licensed Insider Trading?*, 69 U. MIAMI L. REV. 795, 797–802 (2015); John P. Anderson, *Solving the Paradox of Insider Trading Compliance*, 88 TEMPLE L. REV. 273, 303 (2016); John P. Anderson, *The Final Step to Reform: Answering the "It's Just Not Right!" Objection to Insider Trading*, 12 J. L., ECON. & POL'Y 279, 295–300 (2016).

17. *See, e.g.*, Stuart P. Green & Mathew B. Kugler, *When Is It Wrong to Trade Stocks on the Basis of Non-Public Information? Public Views of the Morality of Insider Trading*, 39 FORDHAM URB. L.J. 445, 452 (2011) (noting that literature on "community attitudes towards insider trading is quite limited"). Green and Kugler cite to one previous study concerning global attitudes regarding insider trading, but they identify a number of its flaws. *See id.*, at 452-3 (citing Meir Statman, *Is It Fair? Perceptions of Fair Investment Behavior across Countries*, 12 J. INV. CONSULTING 45 (2011).

to be particularly upset with the spreading insider trading scandal."[18] The study found that sixty-seven percent of Americans were convinced it was "common" for people on Wall Street to engage in insider trading, up from sixty-three percent just before news of the scandal broke.[19] And, while sixty-six percent thought insider trading should be illegal (up from fifty-two percent just before the scandal broke), fifty-five percent said they themselves would trade on an inside tip.[20] Of those who said they would *not* trade on an inside tip, only thirty-five percent said they would refrain from trading because it was "just plain wrong."[21] The rest said they would not trade because "it would be illegal" (22%), they "might get caught" (3%), "the tip might be wrong" (34%), or they were "not sure" (6%).[22] Professor Stephen Bainbridge has argued these paradoxical attitudes show that any anger the public may feel over insider trading "has nothing to do with a loss of confidence in the integrity of the market, but instead arises principally from envy of the insider's greater access to information."[23]

A more recent study by Professors Stuart Green and Mathew Kugler reflects a similar ambivalence among the general public concerning insider trading.[24] Green and Kugler found that, while their subjects "seemed to have strong intuitions that insider trading is wrong, they were unable to isolate the victim in one case from the victim in another."[25] Green and Kugler concluded that the study's results suggest "that professionals and the lay public are united in their confusion over the rationale for prohibiting insider trading."[26] Such ambivalence concerning what (if any) harm results from insider trading suggests a problem for the market-confidence thesis. For, as Bainbridge has noted, absent "a credible investor injury story, . . . it is difficult to see why insider trading should undermine

18. *Business Week/Harris Poll: Outsiders Aren't Upset by Insider Trading*, BUSINESS WEEK, Dec. 8, 1986, at 34.

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.*

23. Bainbridge, *supra* note 1, at 1242.

24. Stuart P. Green & Mathew B. Kugler, *When Is It Wrong to Trade Stocks on the Basis of Non-Public Information? Public Views of the Morality of Insider Trading*, 39 FORDHAM URB. L.J. 445 (2011).

25. *Id.* at 484.

26. *Id.*

investor confidence in the integrity of the securities markets."[27]

Of course, "one swallow does not make a spring,"[28] and two studies are not dispositive of the general public's attitudes concerning insider trading. More empirical work must be done. Importantly, neither the Green and Kugler study nor the *Business Week/Harris* poll specifically asked how (if at all) the subjects' attitudes concerning insider trading affect their willingness to participate in the stock market, a crucial question for testing the market-confidence claim. What we do learn from these studies, however, does not offer strong support for the Supreme Court's claim in *O'Hagan* that "investors likely would hesitate to venture their capital in a market where [insider trading] is unchecked by law."[29] These studies suggest that the majority of people think insider trading *is* prevalent,[30] that they cannot identify the harm,[31] and that they *might trade on inside information themselves* if they had the chance.[32] There may, however, be other ways of testing the market-confidence theory's empirical claims.

Another approach to testing the market-confidence thesis might be to track the market's reaction to headline-catching insider trading releases, enforcement actions, or changes in the law.

For example, one hypothesis might be that, if the market-confidence claim is valid, then news of prevalent insider trading in the market will be followed by a market downturn as disillusioned investors flee the market.[33] So, on this hypothesis, the market-confidence theory would predict investors to flee the market after *Business Week* ran an April 1985 cover story titled "The Epidemic of Insider Trading: The SEC Is Fighting a Losing Battle to Halt Stock Market Abuses."[34] But, it turns out that the Dow Jones Industrial average jumped 27.66% in 1985, its largest yearly

27. STEPHEN M. BAINBRIDGE, INSIDER TRADING: LAW AND POLICY 195 (2014).

28. ARISTOTLE, NICHOMACHEAN ETHICS 17 (Terence Irwin trans., Hackett Publishing Co. 1985).

29. 521 U.S. at 658.

30. See *Business Week/Harris Poll: Outsiders Aren't Upset by Insider Trading*, *supra* note 18, at 34.

31. Green & Kugler, *supra* note 17, at 484.

32. *Business Week/Harris Poll: Outsiders Aren't Upset by Insider Trading*, *supra* note 18, at 34.

33. This hypothesis fits the *O'Hagan* Court's assumption that "investors likely would hesitate to venture their capital in a market where [insider trading] is unchecked by law." 521 U.S. at 658.

34. Jeffrey M. Laderman, *The Epidemic of Insider Trading: The SEC Is Fighting a Losing Battle to Halt Stock-Market Abuses*, BUSINESS WEEK, Apr. 29, 1985, at 78.

gain in ten years.[35] Similarly, if the market-confidence argument holds, one might expect that the market would have reacted negatively when news broke of Ivan Boesky's insider-trading charges in November 1986—at that point the biggest insider trading case in history.[36] Boesky's story put insider trading on the radar of the average investor like no other insider trading case before it.[37] Nevertheless, as one scholar noted, "while the market took a one-day dip, it quickly recovered all of those losses and more, suggesting little concern with Boesky's" tens of millions of dollars in insider trading profits.[38] In fact, shortly after the case went public, the Chairman of the SEC "assured Congress that the Boesky revelations had an insignificant effect on the market."[39] The market's subsequent performance supports this claim: soon after news of the Boesky scandal hit Wall Street, the U.S. stock market began its epic run of 1987, in which it gained forty-four percent over just seven months.[40]

Of course, a contradictory interpretation of the post-Boesky market performance is available. One might hypothesize that Boesky's highly publicized arrest brought market participants new confidence that insider trading would be aggressively prosecuted and controlled. This new confidence, in turn, may have provided a catalyst for the bull market of 1987. This was presumably Preet Bharara's point when he suggested that his aggressive prosecution of insider traders in the wake of the 2008

35. *See* Bill Sing, *1985—A Year of Easy Money in the Stock Market: Dow Surges to Its Best Annual Gain Since 1975*, LOS ANGELES TIMES, Jan. 2, 1986.

36. For an in-depth and fascinating account of the Ivan Boesky insider trading investigation, arrest, and aftermath, see generally JAMES B. STEWART, DEN OF THIEVES (1991, 2010) (see pages 340-348 for details of the announcement and immediate market and media reaction).

37. *Id*.

38. William J. Carney, *Signaling and Causation in Insider Trading*, 36 CATH. U. L. REV. 863, 896 (1987). *See also*, Charles C. Cox and Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L. J. 353, 354 (1988) (noting that "the highly publicized insider trading prosecutions of 1986, including the Dennis Levine and Ivan Boesky cases, although widely interpreted as evidence of pervasive insider trading, seemed to have no substantial long-term impact on investment in securities, which continued to increase").

39. Carney, *supra* note 38, at 896.

40. *See* Donald Bernhardt & Marshall Eckblad, *Stock Market Crash of 1987*, FEDERAL RESERVE HISTORY, (Nov. 22, 2013), https://www.federalreservehistory.org/essays/stock_market_crash_of1987. As Professor Stephen Bainbridge notes, "[t]he enormous publicity given those scandals put all investors on notice that insider trading is a common securities violation." But, Bainbridge goes on, "the years since the scandals have been one of the stock market's most robust periods. One can but conclude that insider trading does not seriously threaten the confidence of investors in the securities markets." Bainbridge, *supra* note 1, at 1242–43.

market collapse would "bring people back to a level of confidence in the market."[41] Yet, it is difficult to reconcile this latter hypothesis with the fact that, for example, the Dow Jones Industrial Average (DJIA) rose more than 200 points on October 5, 2015,[42] the day the U.S. Supreme Court let stand the Second Circuit's ruling in *United States v. Newman*[43] that, according to the government, "raise[d] the bar to prosecuting insider trading" and "increase[d] the chances that such conduct will proliferate."[44] Prosecutors repeatedly warned that letting *Newman* stand would license "trading by insiders' favored tippees, thereby shifting losses to investors who lack access to confidential corporate information and eroding public confidence in the integrity of securities markets," yet the market seemed unconcerned by the news.[45] Equally problematic for the market-confidence theory under this interpretation is the fact that on August 23, 2017, the day that the Second Circuit overruled *Newman* in *United States v. Martoma*,[46] the DJIA was down 38.18 points.[47] If the market-confidence theory has validity, one would expect *Martoma* to have been market-moving news; yet, the market's movement was in the opposite direction of what the theory would predict. It does no good for the proponent of the market-confidence theory to dismiss this data on grounds that market participants do not trade based on court decisions because, of course, if the *O'Hagan* Court's claim that "investors likely would hesitate to venture their capital in a market where [insider trading] is unchecked by law" is correct, then one would expect that high-profile court decisions that weaken insider trading enforcement would influence trading.[48]

Another empirical test for the market-confidence theory may be to look at countries that have newly-implemented insider trading enforcement

41. Schaefer, *supra* note 4.

42. See historical data reflecting that the market opened at 16,502.10 and closed at 16,776.43, YAHOO FINANCE, https://finance.yahoo.com/quote/%5EDJI/history?period1=1444021200&period2=1444107 600&interval=1d&filter=history&frequency=1d.

43. 773 F.3d 438 (2d Cir. 2014).

44. Petition for Writ of Certiorari at 33, Newman, 773 F.3d 438 (No. 15-137), http://www.scotusblog. com/wp-content/uploads/2015/08/Newman-cert-petition.pdf.

45. *Id.* at 26.

46. 869 F.3d 58 (2d Cir., 2017).

47. See historical data reflecting that the market opened at 21,850.27 and closed at 21,812.09 on August 23, 2017, YAHOO FINANCE, https://finance.yahoo.com/quote/%5EDJI/history?period1=1503464400&period2=1503464400&interval=1d&filter=history&frequency=1d.

48. 521 U.S. at 658.

regimes. Do those countries' markets show increased liquidity or improved performance after adopting insider trading regulations? If so, this would offer some evidence of a correlation between insider trading regulation and market confidence. The recent proliferation of insider trading enforcement regimes around the world provides a great deal of data for proving this hypothesis. Of the eighty-seven countries with insider trading laws on the books by the year 2000, seventy-seven adopted those laws after 1980.[49] The average year of adoption for developed countries was 1990, and the average year of adoption for undeveloped countries was 1991.[50] The limited empirical research that has been done in this area, however, offers little evidence that the adoption of insider trading regulations improves market performance.[51] In fact, there are some glaring examples to the contrary. Professor Mark Ramseyer has noted the irony that Japan's initial implementation of its insider trading regime in 1988 was soon followed by a dramatic decrease in market liquidity and an historic collapse in market value.[52] This is certainly not to suggest that the Japanese market collapse at the close of the 1980s was a response to recently implemented insider trading regulation. There were a myriad of causes.[53] The Japanese experience does, however, offer a significant, major-market counterexample to anyone suggesting that the adoption of insider trading regulation improves market confidence and therefore market performance. As Ramseyer put it, "Perhaps banning insider trading

49. *See* Laura Nyantung Beny, *The Political Economy of Insider Trading Laws and Enforcement: Law vs. Politics? International Evidence*, *in* RESEARCH HANDBOOK ON INSIDER TRADING 266, 287–89 (Stephen Bainbridge ed., 2013).

50. Beny, *supra* note 49, at 287–89.

51. *See, e.g.*, Uptal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75 (2002) (finding virtually no correlation between the mere adoption of insider trading regulations in other countries and increased market performance—but finding some evidence of improved market conditions after the first insider trading enforcement action in a given country). *See also*, STEPHEN BAINBRIDGE, INSIDER TRADING LAW AND POLICY 189 (2014) (noting that the "empirical case for market liquidity-based theories is further undermined by the well-known observation that highly liquid and efficient stock markets exist in several countries that do not prohibit insider trading or fail to enforce the laws on the books").

52. Mark Ramseyer, *Insider Trading Regulation in Japan*, *in* RESEARCH HANDBOOK ON INSIDER TRADING, *supra* note 49, at 347–48.

53. *See, e.g.*, Eric Johnston, *Japan's Bubble Economy: Lesson's from When the Bubble Burst*, THE JAPAN TIMES (Jan. 6, 2010), https://www.japantimes.co.jp/news/2009/01/06/reference/lessons-from-when-the-bubble-burst/#.Wlf637ynHcs (suggesting that the real-estate and stock price bubbles were among the principal causes of the collapse).

reassures investors about the integrity of the securities markets. But only perhaps. If the Japanese experience suggests anything at all, it suggests exactly the opposite."[54]

The preceding counterexamples are certainly not offered as definitive proof that there is no correlation between the regulation of insider trading and market confidence. Rather, they are offered in an attempt to shift the burden of proof upon those scholars, legislators, judges, regulators, and prosecutors who have simply assumed such a correlation exists without evidence. If the market-confidence theory is to continue as an express justification for sending people to jail for insider trading, the burden should be on the government to prove the correlation by appeal to a comprehensive empirical study.

As things stand, the empirical evidence for and against the market-confidence argument is meager, and the preceding discussion highlights some significant counterexamples and challenges that any future empirical study looking to prove or disprove the market-confidence thesis will have to overcome. First, as shown above, studies testing public attitudes reflect more ambivalence than indignation or anxiety concerning the prevalence of insider trading in securities markets, and they do not specifically address the question of how (if at all) investor attitudes concerning insider trading affect their willingness to participate in securities markets.[55] Second, to be convincing, an empirical study testing the correlation between an insider trading event (e.g., a news story, announcement of a plea agreement, legislation, or important court decision) and broad market reaction must account for the problem of alternative explanations for such a reaction. But, as the discussion above reflects, this will be challenging, if not entirely impracticable. As reflected in the empirical event analyses sampled above, the concern is that proponents of the market-confidence theory can always dismiss conflicting data as driven by alternate causes: a market upswing after a major insider trading prosecution is announced may reflect new confidence that future traders will be deterred,[56] but a

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54. Mark Ramseyer, *Insider Trading Regulation in Japan*, *in* RESEARCH HANDBOOK ON INSIDER TRADING, *supra* note 49, at 347.

55. See *Business Week/Harris Poll: Outsiders Aren't Upset by Insider Trading*, *supra* note 18, at 34; Green & Kugler, *supra* note 17, at 484.

56. For example, this result would be consistent with the *O'Hagan* Court's expectation that investor confidence will improve with proof that insider trading is being actively "checked" by the

market downturn after a major arrest may be interpreted as fear that insider trading is more pervasive that once thought.[57] A bull market following, for example, a major court decision that limits the government's power to enforce insider trading laws (or a bear market after the implementation of new insider trading regulations designed to boost enforcement) may be explained as driven by other catalysts.[58] One begins to see how easy it may be to dismiss counterexample after counterexample by shifting explanations for the data—and this raises the suspicion that the empirical claim underlying the market-confidence theory itself may be unfalsifiable.[59]

Unfalsifiable theories can neither be proven true nor false by objective criteria. Espousing such theories signals a departure from rational discourse and entry into the realm of myth, faith, and dogma. These and other considerations have driven many to conclude that the hitherto received assumption that insider trading undermines market confidence may be unfounded.[60]

III. SCOPE AND MAGNITUDE

If the market-confidence theory is at best unproven and at worst unprovable, then what consequences should this have for the current state

law. *See* 521 U.S. at 658. See also U.S. Attorney, Preet Bharara's suggestion that aggressive insider trading prosecution "bring[s] people back to a level of confidence in the market." Schaefer, *supra* note 4.

57. For example, this result would be consistent with Congress's expectation that a potential market participant will be "reluctant to invest in the market if he feels it is rigged against him." H.R. Rep. No. 100-910, at 7-8, *supra* note 2.

58. For example, as noted above, the Japanese bear market subsequent to the adoption of significant insider trading regulations in 1988 is explained as driven by the Japanese economy's price asset bubble, not as a reaction to Japan's newly-implemented insider trading regulations. *See* Johnston, *supra* note 53.

59. Though I express here the worry that the market-confidence theory may be unfalsifiable, I hold out hope that a careful study that addresses the concerns raised in this paper may yet prove enlightening. Indeed this author is currently working with coauthors on such a study.

60. *See, e.g.*, Jeanne L. Schroeder, *Taking Stock: Insider and Outsider Trading by Congress*, 5 WM. & MARY BUS. L. REV. 159, 173 (2014) (noting that if anything, "the meager evidence can be read as an indication [the] widespread suspicion that insider trading often occurs has had little effect on market participation"); Bainbridge,, *supra* note 1, at 1243 ("insider trading does not seriously threaten the confidence of investors in the securities markets"); Cox & Fogarty, *supra* note 38, at 353 ("The contention that the existence of insider trading will cause investors to desert the securities markets is doubtful and certainly unproven").

of insider trading law in the United States? First, if it is assumed that each instance of insider trading is wrongful and has harmful consequences independent of its measurable effect on broader market confidence, then the failure of the market-confidence argument does not undermine the claim that such trading should be illegal, or that civil and criminal sanctions should be imposed. The failure of the market-confidence argument, however, may give cause for revisiting the important question of how broad regulators' and prosecutors' insider-trading enforcement powers must be; it may also give cause for revisiting the magnitude of the sanctions warranted for violations.

The SEC and Congress have historically resisted a statutory definition of insider trading, arguing that any such definition would limit flexibility in enforcement.[61] The claim has been that, since the harm of insider trading is so broad in reach and great in effect, and since market participants are likely to continue to find creative new ways to trade on material nonpublic information in violation of fiduciary duties, the government needs some vagueness in the law to allow it to address new forms of predatory trading as they arise.[62]

Similarly, the government recently opposed the Second Circuit's narrow interpretation of the "personal benefit" test for tipper-tippee liability in *Newman*, which required proof of a "meaningfully close personal relationship [between tipper and tippee] that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[63] Prosecutors

61. *See Raising the Stakes – Corporate Take-Overs and Insider Trading Scandals in the 1980s*, From *Fair to All People: The SEC and the Regulation of Insider Trading*, SECURITIES AND EXCHANGE COMMISSION HISTORICAL SOCIETY, http://www.sechistorical.org/museum/ galleries/it/raisingStakes_a.php (last visited Mar. 7, 2017). *See also*, BAINBRIDGE, INSIDER TRADING: LAW AND POLICY, *supra* note 51, at 145 n. 30 (noting that "any definition would have to be so broad as to be unworkable or so narrow as to reduce the SEC's and the courts' flexibility to address new forms of trading").

62. *See id*.

63. *United States v. Newman*, 773 F.3d 438, 452 (2d Cir. 2014). The Supreme Court has since held that, "[t]o the extent that the Second Circuit in Newman held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to a trading relative, that rule is inconsistent with" prior Supreme Court precedent. Salman v. United States, 137 S.Ct.420, 422 (2016). A split panel of the Second Circuit recently overruled the remainder of the Newman personal benefit test in *United States v. Martoma*, 869 F.3d 58 (2d Cir., 2017). There was, however, a strongly worded dissenting opinion by Judge Rosemary Pooler, and it is likely Martoma will seek en banc

argued that *Newman* interpreted "the securities laws in a way that will limit the ability to prosecute people who trade on leaked inside information."[64] And this, in turn, will undermine market confidence.[65]

If the market-confidence claim is dismissed as myth, however, the need for such flexibility and broad power to enforce is diminished. If the harm of predatory trading is local and is not amplified by the threat to market confidence, then there is significantly less risk in addressing new forms of insider trading by amending or revising statutory language, and there is also less risk to markets in holding the government to strict and meaningful constraints on the common law elements of insider trading.

Anglo-American jurisprudence historically has disfavored common law crimes and vagueness in criminal statutory schemes because they violate the principle of legality—the requirement that a clear rule of law be in place before the government may impose sanctions for illegal conduct.[66] The principle of legality expresses our shared intuition that justice demands that people be given reasonable notice that their conduct may result in civil or criminal sanctions before such sanctions may be imposed. The same moral intuition stands behind our Constitution's proscription of *ex post facto* laws.[67] The government has implicitly suggested that concerns over lack of notice are overridden by the need to address the imminent risk that insider trading poses to market confidence. As noted above, if the market-confidence claim is a myth, however, then the need for such flexibility in enforcement diminishes, and presumably would fail to outweigh the presumption against vagueness in the criminal law. Therefore, perhaps Congress should give new consideration to codifying the law of insider trading to satisfy the principle of legality, and perhaps the courts should take weakness in the market-confidence argument into

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review by the Second Circuit.

64. Everett Rosenfeld, *Did Insider Trading Just Change Forever?*, CNBC (Dec. 11, 2014, 10:05 AM), https://www.cnbc.com/2014/12/11/fallout-from-the-newman-chiasson-ruling-on-insider-trading.html. (quoting then U.S. Attorney for the Southern District of New York, Preet Bharara),

65. *See, e.g.,* Brief for the United States at 13, Salman v. United States, 137 S.Ct. 420 (2016) (No. 15–628) (arguing the "'pecuniary gain' limitation would seriously . . . damage confidence in the fairness of the nation's securities markets").

66. *See e.g.*, DAVID A.J. RICHARDS, THE MORAL CRITICISM OF LAW 195 (1997). *See also* Anderson, *Anticipating a Sea Change for Insider Trading Law*, *supra* note 16, at 369-70; Miriam H. Baer, *Insider Trading's Legality Problem*, 127 YALE L.J. F. 129 (2017).

67. *See* U.S. CONST. art. I, § 9, cl. 3; § 10, cl. 1.

account when determining whether the government needs broader flexibility for insider trading enforcement under the existing common-law regime.

Finally, the current law imposes stiff civil and criminal penalties for violations of insider trading laws. As one author noted, "[u]nder the federal guidelines, the maximum sentence for insider trading is nineteen to twenty-four years, while a rapist could get fifteen years to life in prison."[68] The availability of such penalties led Professor James Cox to ask, "where are the bodies, where is the blood?"[69] The civil penalties for insider trading are also severe, up to "three times the profit gained or loss avoided as a result of [each] unlawful purchase, sale, or communication."[70] Corporate employers and other controlling persons are also exposed to significant derivative civil and criminal liability for the insider trading of their employees.[71] To the extent that these stiff penalties are driven in part by faith in the market-confidence argument,[72] and the consequent need for added deterrence, then, pending new empirical evidence, the conclusions of this Article may warrant reform in the area of civil and criminal sanctions for insider trading as well.

CONCLUSION

This Article has identified a number of problems for the claim that public attitudes about insider trading affect market health and performance. Insofar as the claim turns crucially on sociopsychology, it is subject to the problem of false consciousness—investor behavior may be affected by false beliefs about the economic and moral consequences of

68. CHARLES GASPARINO, CIRCLE OF FRIENDS 155 (2013).

69. *See* Jonathan Stempel, *Rajaratnam Sentencing May Be a Fight to the Death*, REUTERS (Aug. 10, 2011, 1:35 PM), http://www.reuters.com/article/2011/08/10us-galleon-rajaratnam-insidertrading-idUSTRE7795MV20110810.

70. 15 U.S.C. § 78u-1(a)(2) (2016).

71. Controlling persons are also subject to stiff penalties: "the greater of [$2,011,061], or three times the amount of the profit gained or loss avoided as a result of such controlled person's violation." 15 U.S.C. §78u-1(a)(3) (2016). The penalty is now annually adjusted for inflation. 17 C.F.R. § 201.1001 (2017). Corporations are also subject to criminal fines of up to $25,000,000. *See* 15 U.S.C. § 78ff(a) (2016).

72. *See e.g*„ Brief for the United States of America at 115, United States v. Newman 773 F.3d 438 (2014) (No. 13–1837), 2013 WL 6163307 (arguing that stiff penalties are warranted in part because "insider trading undermines the public's confidence in the integrity of the financial markets").

insider trading. But, even assuming that insider trading is in fact harmful, the market-confidence argument's empirical claims are unproven, and perhaps unprovable. Most market data can be interpreted to cut both ways, and it is hard to imagine how one might hope to develop a decisive test for the market-confidence claim. In philosophy and science, one refers to such claims as unfalsifiable. An unfalsifiable claim has no predictive or explanatory power. But the fact that unfalsifiable claims cannot be disproven sometimes allows them to continue to influence popular attitudes. In light of these concerns, and pending new empirical evidence of a clear correlation between insider trading and market confidence, this Article cautions Congress and the courts against embracing the market-confidence claim as support for broad enforcement powers and stiff penalties in the context of insider trading.