(NOT) HOLDING FIRMS CRIMINALLY RESPONSIBLE FOR THE RECKLESS INSIDER TRADING OF THEIR EMPLOYEES

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I. INTRODUCTION

Late in 2013, federal prosecutors announced a plea agreement[1] relating to criminal insider trading charges earlier brought against S.A.C. Capital Advisors, L.P. and some of its affiliates (SAC) under Section 10(b) of the Securities Exchange Act of 1934, as amended (Section 10(b)),[2] and Rule 10b–5 adopted by the United States Securities and Exchange Commission (SEC) under Section 10(b) (Rule 10b–5).[3] To be the subject of criminal liability, violations of insider trading prohibitions under Section 10(b) and Rule 10b–5 must be willful.[4] The indictment asserts that SAC actively encouraged the unlawful use of material nonpublic information in the conduct of its business.[5] We may never know the precise facts as to the level of culpability and state of mind of the employees of SAC whose activities founded the indictment. But the indictment and public portrayals of the firm and its employees focus on the systemic nature of the alleged violative conduct—a pattern of incentives, policies, and behaviors that indicate highly reckless, if not intentional, misconduct.[6]

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1. Press Release, U.S. Att'y Office S.D.N.Y., *Manhattan U.S. Attorney Announces Guilty Plea Agreement with SAC Capital Management Companies* (Nov. 4, 2013), *available at* http://www.justice.gov/usao/nys/pressreleases/November13/SACPleaPR.php.

2. 15 U.S.C. § 78j(b) (2012).

3. 17 C.F.R. § 240.10b–5 (LexisNexis, LexisAdvance through the July 13, 2016 issue of the Federal Register).

4. 15 U.S.C. § 78ff(a) (2012).

5. *See* Indictment, United States v. S.A.C. Capital Advisors, L.P. et al., 13 Crim. 541 (S.D.N.Y. July 24, 2013), *available at* https://www.justice.gov/sites/default/files/usao-sdny/legacy/2015/03/25/SAC%20Indictment%20%28Stamped%29_0.pdf (noting in paragraph 6 that "[t]he SAC ENTITY DEFENDANTS enabled and promoted the Insider Trading scheme through several means," including hiring practices, financial incentives, and ineffective compliance procedures) [hereinafter SAC Indictment].

6. *See*, *e.g.*, *id.* at ¶ 15:

Having been exposed in my time as a lawyer and law professor to many instances of insider trading that resulted from reckless behavior, I have found myself pondering the possibility—and considering the appropriateness—of corporate criminal liability[7] for insider trading based on reckless employee conduct. Could reckless employee conduct result in a willful violation of Section 10(b) and Rule 10b–5 and, therefore, criminal liability for the firm that employs them? I admittedly am troubled by the possibility. Something just does not seem right about holding someone (even if that someone is a business entity) criminally responsible for the less-than-intentional acts of someone else (even if that someone else is an agent of the business entity against whom criminal enforcement is sought). What about, for example, *mens rea*—the requisite state of mind necessary for criminal intent—in that context?

This Article explores these areas of concern, proceeding in five parts. In Part II, the Article reviews the basis for criminal enforcement of the insider trading prohibitions established in Section 10(b) and Rule 10b–5.[8] Part III describes the basis and rationale for corporate criminal liability, a liability that derives from the activities of agents

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> [T]he insider trading scheme committed by the SAC ENTITY DEFENDANTS through the conduct of their agents was facilitated through practices employed by the SAC ENTITY DEFENDANTS that encouraged SAC PMs and SAC RAs to pursue industry contact networks to obtain an information 'edge' unavailable to other investors, without effective corresponding controls to prevent that 'edge' from consisting of Inside Information.

See also Nate Raymond & Emily Flitter, *SAC Capital Agrees to Pay $1.8 Billion in Largest Insider Trading Settlement In History*, BUS. INSIDER (Apr. 10, 2014, 10:24 PM), http://www.businessinsider.com/sac-capital-settlement-2014-4 ("An indictment in July alleged systemic insider trading took place at SAC Capital involving the stocks of more than 20 publicly-traded companies from 1999 through 2010.").

7. Although the term "corporate criminal liability" is used throughout for ease of reference, most of what is said in this Article about the potential liability of an employer for employee conduct relates to both corporations and other forms of entities (as well as to principals of sole proprietorships).

8. This Article does not undertake to incorporate the continuing debate regarding the propriety of regulating insider trading. *See generally* Frank J. Sensenbrenner & Margaret Ryznar, *The Law and Economics of Insider Trading*, 50 WAKE FOREST L. REV. 1155, 1158 (2015) (highlighting this debate).

> Insider trading bans have been among the most controversial aspects of securities regulation since the SEC condemned the practice in the 1961 *Cady Roberts* case. Professor Henry Manne shortly thereafter published his famous book criticizing, on economics grounds, the decision to prohibit insider trading. Since Manne, there have been many people skeptical of insider trading bans, and for various reasons.

Id. (footnotes omitted). Rather, it assumes the continued regulation of insider trading at the federal level, together with the prospect of both civil (private and public) and criminal enforcement.

undertaken in the course of the firm's business. Part IV then reflects on the first two parts—first identifying the potential for corporate criminal liability for the reckless insider trading violations of employees under Section 10(b) and Rule 10b–5, then arguing against that liability and suggesting ways to eliminate it. A brief conclusion follows in Part V.

II. CRIMINAL ENFORCEMENT OF SECTION 10(B) AND RULE 10B–5 INSIDER TRADING PROHIBITIONS

Criminal enforcement of the insider trading prohibitions under Section 10(b) and Rule 10b–5 is the root of corporate criminal liability for insider trading in the United States. A complete description of criminal liability for insider trading violations under Section 10(b) and Rule 10b–5 involves two steps. First, one must establish the bases for unlawful insider trading under Section 10(b) and Rule 10b–5. Second, one must establish the criminal enforcement authority for insider trading violations actionable under Section 10(b) and Rule 10b–5. Both steps are described in the remainder of this Part of the Article.

A. Insider Trading Liability Under Section 10(b) and Rule 10b–5

Although it is not well understood outside the securities regulation and white-collar crime communities, liability for insider trading in the United States is conceptualized as securities fraud.[9] The original codification of federal securities law in the early 1930s provided for the disgorgement by corporate insiders of deemed profits on purchases and sales of the corporation's shares made within a six-month period as a form of insider trading liability,[10] but it did not include a rule that prohibited or restricted trading by corporate insiders.[11] Congress has been reluctant to enact federal legislation defining insider trading over the intervening years.[12]

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9. *See generally* Chiarella v. United States, 445 U.S. 222 (1980) (establishing insider trading liability under Section 10(b) and Rule 10b–5 as "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" (quoting Section 10(b))); *see also*, *e.g.*, J. Kelly Strader, *(Re)Conceptualizing Insider Trading:* United States v. Newman *and the Intent to Defraud*, 80 BROOK. L. REV. 1419, 1422 (2015) ("[I]nsider trading is a form of securities fraud that is primarily judicially-defined . . . .").

10. 15 U.S.C. § 78p (2012) (known as the "short-swing profit" rule).

11. *Id.*

12. *See* Robert Steinbuch, *Mere Thieves*, 67 MD. L. REV. 570, 612–13 (2008) ("Congress did not include any definition whatsoever in the statute. No definition has been codified since. Instead, Congress has—essentially through institutional paralysis—effectively acceded to the judiciary's development of this area of the law." (footnotes omitted)); Joseph J. Humke, Comment, *The*

Insider trading was first recognized as securities fraud actionable under Section 10(b) and Rule 10b–5 just over half a century ago.[13] In 1961, an SEC administrative law judge wrote an opinion finding that a corporate insider who trades in an issuer's stock while in possession of material nonpublic information relating to that stock without disclosure of the material information in his or her possession may violate regulatory proscriptions on the use of practices that operate as a fraud or deceit on securities purchasers.[14] The administrative law judge found that those types of practices violate Section 17(a) of the Securities Act of 1933, as amended,[15] and constitute manipulative or deceptive devices or contrivances within the meaning of Section 10(b):

> The three main subdivisions of Section 17 and Rule 10b–5 have been considered to be mutually supporting rather than mutually exclusive. Thus, a breach of duty of disclosure may be viewed as a device or scheme, an implied misrepresentation, and an act or practice, violative of all three subdivisions. . . . We hold that, in these circumstances, Gintel's conduct at least violated clause (3) as a practice which operated as a fraud or deceit upon the purchasers. Therefore, we need not decide the scope of clauses (1) and (2).[16]

Subsequently, federal courts credited this argument with Supreme Court decisions endorsing insider trading as a Section 10(b) violation in 1980,[17] 1983,[18] and 1997.[19] These Supreme Court decisions shaped the U.S. insider trading doctrine in foundational ways—e.g., by defining insider status as a function of a duty of trust and confidence,[20] by identifying the nature and scope of tipper and tippee liability when an insider wrongfully discloses material nonpublic information directly or indirectly to a third party who trades,[21] and by extending insider

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Misappropriation Theory of Insider Trading: Outside the Lines of Section 10(b), 80 MARQ. L. REV. 819, 847 (1997) ("Congress has twice flirted with codifying a comprehensive definition of 'insider trading.' Both the Insider Trading Sanction Act of 1984 and Insider Trading and Securities Fraud Enforcement Act of 1988 contemplated doing so, but neither altered the then existing substantive law." (footnotes omitted)).

13. *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

14. *Id.* at 911–13.

15. 15 U.S.C. § 77q(a) (2012).

16. *Cady*, 40 S.E.C. at 913 (footnote omitted).

17. Chiarella v. United States, 445 U.S. 222 (1980).

18. Dirks v. SEC, 463 U.S. 646 (1983).

19. United States v. O'Hagan, 521 U.S. 642 (1997).

20. *See Chiarella*, 445 U.S. at 230 ("[L]iability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction.").

21. *Dirks*, 463 U.S. at 660 (footnotes omitted).

trading prohibitions to outsiders who breach duties of trust and confidence in connection with the purchase or sale of a security.[22]

At the heart of insider trading liability under Section 10(b) and Rule 10b–5 under the established rules in these cases is the breach of a duty of trust and confidence through trading on, or improper disclosure of, material nonpublic information. Duties can be breached through simple or gross negligence, recklessness, or intentional misconduct.[23] Although federal statutes, SEC rules, and decisional law at the Supreme Court level have not definitively established a predicate standard of culpability in this regard (referred to as "scienter"), recklessness is presumed to be a sufficient basis for liability under Supreme Court *dicta* (taken together with repeated judicial decision-making in the federal courts at the trial and appellate levels).[24]

Most of the cases exploring and defining scienter under Section 10(b) and Rule 10b–5 are securities fraud cases outside the insider trading context. These cases identify multiple contextual standards for recklessness, many attempting to describe a level of awareness—something analogous to a cognizant indifference to the effect of the accused's conduct.[25] Moreover, judicial opinions disagree as to whether

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> [T]ippees must assume an insider's duty to the shareholders . . . because it has been made available to them *improperly*. . . . [A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.

Id.

22. *See O'Hagan*, 521 U.S. at 652, 665 (endorsing the misappropriation theory of insider trading, which generally "premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information," finding that theory of insider trading liability "both consistent with the statute and with our precedent").

23. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1962).

24. *See, e.g.*, Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 n.3 (2007) ("Every Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required."); *Hochfelder*, 425 U.S. at 193 n.12 ("In this opinion the term 'scienter' refers to a mental state embracing intent to deceive, manipulate, or defraud. . . . We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b–5."); Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc., 594 F.3d 783, 790 (11th Cir. 2010) ("In this circuit, scienter consists of intent to defraud or 'severe recklessness' on the part of the defendant."); *In re* Comshare, Inc. Sec. Litig., 183 F.3d 542, 550 (6th Cir. 1999) ("[V]irtually every circuit to consider the issue held that recklessness could amount to scienter under § 10b and Rule 10b–5."); *In re* Orbital Scis. Corp. Sec. Litig., 58 F. Supp. 2d 682, 685 (E.D. Va. 1999) ("The element of scienter requires the Plaintiffs to allege that the Defendants acted recklessly or with the intent to deceive, manipulate, or defraud . . . .").

25. *See, e.g.*, Aldridge v. A.T. Cross Corp., 284 F.3d 72, 82 (1st Cir. 2002) ("To win a section 10(b) case, the plaintiff must show either that the defendants consciously intended to defraud, or

a motive or specific intent to deceive is a necessary predicate to liability or whether an appreciation of the propensity of the conduct to deceive is sufficient.[26] The law in the area remains largely unsettled as a result.[27]

Scienter in the insider trading context under Section 10(b) and Rule 10b–5 is no exception. In fact, the exact contours of scienter are arguably even more ill-defined in the various potential insider trading settings than they are in Section 10(b) and Rule 10b–5 cases outside the insider trading context.[28] Rule 10b5–1, adopted by the SEC in 2000, seemingly clarified one scienter issue in insider trading cases by providing that the awareness of material nonpublic information is a sufficient basis for liability—that public and private enforcement agents need not prove that the material nonpublic information was used in (i.e., motivated) the insider's trade.[29] Yet some courts appear to

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that they acted with a high degree of recklessness."); In re *Comshare, Inc.*, 183 F.3d at 550 ("[I]t is clear that recklessness, understood as a mental state apart from negligence and akin to conscious disregard, may constitute scienter . . . ."); Rolf v. Blyth, Eastman Dillon & Co., Inc., 570 F.2d 38, 47 (2d Cir. 1978), *amended sub nom*. Rolf v. Blyth Eastman Dillon & Co., Inc., No. 77-7104, 1978 WL 4098 (2d Cir. May 22, 1978) ("Reckless conduct is, at the least, conduct which is 'highly unreasonable' and which represents 'an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" (citing Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977))); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977) ("[T]he danger of misleading buyers must be actually known or so obvious that any reasonable man would be legally bound as knowing, and the omission must derive from something more egregious than even 'white heart/empty head' good faith." (footnotes omitted)); Goldman v. McMahan, Brafman, Morgan & Co., 706 F. Supp. 256, 259 (S.D.N.Y. 1989) ("An egregious refusal to see the obvious, or to investigate the doubtful, may in some cases give rise to an inference of gross negligence which can be the functional equivalent of recklessness." (citing Jordan v. Madison Leasing Co., 596 F. Supp. 707, 710 (S.D.N.Y.1984))); Coleco Indus., Inc. v. Berman, 423 F. Supp. 275, 296 (E.D. Pa. 1976), *aff'd in part, remanded in part*, 567 F.2d 569 (3d Cir. 1977):

> [W]e hold that to establish the element of scienter in an action brought under section 10(b) and Rule 10b–5, a party must prove injury resulting from a conscious deception or from a misrepresentation so recklessly made that the culpability attaching to such reckless conduct closely approaches that which attaches to conscious deception.

See also Donald C. Langevoort, *"Fine Distinctions" in the Contemporary Law of Insider Trading*, 2013 COLUM. BUS. L. REV. 429, 436–37 (describing scienter in the insider trading context, noting that a desire or purpose to mislead is not required; "awareness of the falsity and its propensity to mislead is enough").

26. *See* Langevoort, *supra* note 25, at 437–38 (noting this point of divergence in applicable court opinions).

27. *See*, *e.g.*, SEC v. Obus, 693 F.3d 276, 287 (2d Cir. 2012) ("The line between unactionable negligence and actionable recklessness is not a bright one."); Langevoort, *supra* note 25, at 436 (noting the convergence on recklessness as the standard of culpability, but observing that courts "diverge quite noticeably when it comes to explaining precisely what recklessness is").

28. *See, e.g.*, *Obus*, 693 F.3d at 287 ("Because a defendant cannot be held liable for negligently tipping information, difficult questions may arise when a tip is not apparently deliberate or when the alleged tipper's knowledge is uncertain." (internal citations omitted)).

29. 17 C.F.R. § 240.10b5–1(b) (2016); *see also* Langevoort, *supra* note 25, at 438–39 (summarizing contentious scienter questions in insider trading cases).

avoid or ignore the prescriptions of Rule 10b5–1.[30] Trial and appellate courts responding to the individual facts in the respective cases before them identify various principles relevant to scienter determinations,[31] but the resulting body of law is neither clear nor comprehensive.

The overall lack of clarity around the substance of insider trading law is something that I have commented on at length in other works.[32] It affords enforcement agents a wider base of power in taking enforcement action. While the broad enforcement authority arising out of unclear insider trading doctrine may have desirable deterrent effects, the doctrinal uncertainty may over-deter[33] and allow for the inequitable or otherwise inappropriate exercise of enforcement discretion.[34]

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30. *See, e.g.*, SEC v. Talbot, 430 F. Supp. 2d 1029, 1045–46 (C.D. Cal. 2006), *rev'd on other grounds*, 530 F.3d 1085 (9th Cir. 2008) (requiring the SEC to "show that the defendant knowingly possessed or used material nonpublic information in formulating and consummating the purchase or sale of a security," rather than mere awareness of material nonpublic information); *see also* Langevoort, *supra* note 25, at 439:

> Prior to the adoption of 10b5–1, some courts in both civil and criminal cases held that the test was based on use, although possession might create a rebuttable presumption of use. . . . [T]his line of case law developed with enough strength that some courts have ignored the adoption of Rule 10b5–1 and continue even today to make causation an element of the cause of action, or at least the subject of an affirmative defense.

31. *See, e.g.*, *Obus*, 693 F.3d at 287 ("[A] tipper cannot avoid liability merely by demonstrating that he did not know to a certainty that the person to whom he gave the information would trade on it."); Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 167 (2d Cir. 1980) ("One who deliberately tips information which he knows to be material and non-public to an outsider who may reasonably be expected to use it to his advantage has the requisite scienter." (footnotes omitted)).

32. *See, e.g.*, Joan MacLeod Heminway, *Just Do It! Specific Rulemaking on Materiality Guidance in Insider Trading*, 72 LA. L. REV. 999 (2012) (addressing a lack of clarity regarding materiality); Joan MacLeod Heminway, *Martha Stewart and the Forbidden Fruit: A New Story of Eve*, 2009 MICH. ST. L. REV. 1017 (2009) [hereinafter *Forbidden Fruit*] (describing and illustrating uncertainties in U.S. insider trading policy and doctrine); Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 AM. U. L. REV. 1131 (2003) [hereinafter *Materiality Guidance*] (addressing a lack of clarity regarding materiality); Joan MacLeod Heminway, *Save Martha Stewart? Observations about Equal Justice in U.S. Insider Trading Regulation*, 12 TEX. J. WOMEN & L. 247 (2003) [hereinafter *Equal Justice*] (describing various uncertainties in U.S. insider trading doctrine).

33. *See* Heminway, *Materiality Guidance*, *supra* note 32, at 1174–77 (describing how ambiguities in insider trading regulation may result in foregone transactions that would be efficient and desirable).

34. *See* Heminway, *Equal Justice*, *supra* note 32, at 284 ("The system and enforcement of insider trading regulation in the United States present significant opportunities for selective enforcement and the exercise of enforcement bias. These prospects for selectivity and bias arise out of . . . the unclear and imprecise substance of U.S. insider trading regulation . . . ."); Heminway, *Forbidden Fruit*, *supra* note 32, at 1046 ("[G]iven the uncertain basis for insider trading regulation and the unclear elements associated with potentially violative conduct, enforcement activities may be directed inequitably or inappropriately . . . .").

B. Criminal Enforcement of Insider Trading under Section 10(b) and Rule 10b–5

Willful violations of the Section 10(b) and Rule 10b–5 may subject transgressors to criminal enforcement.[35] Specifically, the relevant statute provides the following language:

> Any person who willfully violates any provision of this chapter . . . or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter, . . . shall upon conviction be fined not more than [five million dollars], or imprisoned not more than [twenty] years, or both, except that when such person is a person other than a natural person, a fine not exceeding [twenty-five million dollars] may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.[36]

Congressional authority to criminalize violations of federal securities law is not widely challenged.[37]

However, the existence of dual civil and criminal enforcement regimes for U.S. insider trading violations raises a number of significant questions for scholars and other commentators. Among the concerns are: the unclear relationship between the elements of civil and criminal actions for the same wrongful conduct; issues that arise from the potential for civil actions to lead to criminal actions (and vice versa); and a blurring of the independent rationale for criminal, as opposed to civil, remedies.[38] The issues are necessarily interrelated.

Congress' adoption of a law criminalizing insider trading—by tacking a willfulness requirement onto the elements of a civil action for insider trading—generates interesting and difficult doctrinal and practical questions. Paramount among them is the relationship between willfulness and scienter. Scienter, as a required element of a civil insider trading claim brought under Section 10(b) and Rule 10b–5, is widely understood to require at least reckless conduct, as earlier

35. 15 U.S.C. § 78ff(a) (2012).

36. *Id.*

37. *See* Geraldine Szott Moohr, *What the Martha Stewart Case Tells Us About White Collar Criminal Law*, 43 HOUS. L. REV. 591, 596 (2006) ("[T]here is little controversy about treating securities crimes as a federal offense. Congress has constitutional jurisdiction under the Commerce Clause to enact laws that regulate capital markets, and the federal interest in protecting the national securities markets is robust." (footnotes omitted)).

38. *Infra* notes 39–49 and accompanying text.

noted.[39] It is generally also understood that conduct representing a knowing violation of law is willful.[40] But is reckless conduct meeting the scienter requirement of Section 10(b) and Rule 10b–5 always or ever willful? One prominent scholar responds to that question as follows:

> There is no definition of the culpability, or *mens rea*, element of "willful" in the criminal statute. In this vacuum, courts have applied standards that are strikingly similar to the civil scienter standard to criminal cases. The merger of civil and criminal standards means that the only distinction between civil and criminal liability is the standard of proof in a criminal case, beyond a reasonable doubt.[41]

In a recent article, Professor Kelly Strader describes this struggle in differentiating the requisite *mens rea* for criminal insider trading liability from the civil liability standard of conduct in some detail.[42] This blurring of the culpability elements of the civil and criminal claims narrows distinctions between civil and criminal claims—perhaps (as the above quote indicates) to differences in the standard of proof.[43] Accordingly, a range of enforcement options may be available for the same allegedly wrongful conduct, with overlapping authority over that conduct between civil and criminal investigative and enforcement agents.

Not surprisingly, public enforcement agents in the Department of Justice and the SEC typically collaborate—or at least consult—on insider trading and other securities law investigations.[44] As a result,

39. *Supra* note 24 and accompanying text.

40. *See generally* Joan MacLeod Heminway, *Martha Stewart Saved! Insider Violations of Rule 10b–5 for Misrepresented or Undisclosed Personal Facts*, 65 MD. L. REV. 380, 389 (2006) ("[D]ecisional law under the 1934 Act and other federal statutes generally indicates that the government must at least show that the defendant acted with knowledge of the wrongfulness of his conduct under the law that he is accused of violating.").

41. Moohr, *supra* note 37, at 601 (footnote omitted); *see also* John C. Coffee, Jr., *Does "Unlawful" Mean "Criminal?": Reflections on the Disappearing Tort/Crime Distinction in American Law*, 71 B.U. L. REV. 193, 198 (1991) ("[A] trend is evident toward the diminution of the mental element (or '*mens rea*') in crime, particularly in many regulatory offenses."); Heminway, *supra* note 40, at 389 n.51 ("There is some debate over whether the scienter requirement, as an element of a Rule 10b–5 claim, collapses into or is synonymous with the willfulness requirement imposed on criminal prosecutions under Rule 10b–5.").

42. Strader, *supra* note 9, at 1465–68.

43. *See generally supra* notes 41–42 (noting the thin line between civil and criminal liability in insider trading). Kelly Strader similarly observes: "Courts, including the Supreme Court, consistently cite and rely upon civil and criminal cases fairly indiscriminately. In fact, it is difficult to discern a clear distinction between the standards for civil and criminal cases. . . . Some overlap between civil and criminal liability is unavoidable . . . ." Strader, *supra* note 9, at 1485 n.43.

44. *See* Mary Jo White, Chair, SEC, *All-Encompassing Enforcement: The Robust Use of Civil and Criminal Actions to Police the Markets* (Mar. 31, 2014), http://www.sec.gov/News/Speech/Detail/

parallel and sequential enforcement actions for insider trading (and other securities law enforcement actions) have been prevalent and have become more common.[45] The possibility of both civil and criminal enforcement arising from the same conduct creates difficult issues for alleged offenders and their legal counsel.[46] Moreover, the decision on the part of civil and criminal enforcement agents as to whether and how to exercise enforcement discretion becomes more complex in this context, involving investigative and enforcement authorities from different governmental units. In the criminal enforcement context, the prosecutor's decision to pursue charges is the critical element.[47]

Federal insider trading enforcement discretion is exercised in an environment that offers fewer and fewer means of distinguishing between civil wrongs and criminal wrongs. This challenge is not new. Over twenty years ago, one leading scholar decried "the disappearance of any clearly definable line between civil and criminal law"[48] and noted that "criminal law seems much closer to being used interchangeably with civil remedies."[49] As to the latter point, it has been observed that "the use of administrative and criminal penalties

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Speech/1370541342996#.VAp5t7xdW50 ("In the vast majority of criminal securities fraud prosecutions, the SEC's Enforcement staff works closely with the criminal authorities, whether it be DOJ, the FBI, or state and local law enforcement.").

45. *See id.* (noting that criminal cases related to SEC proceedings and instances in which the SEC grants access to its files to other law enforcement authorities had at least doubled between 1993 and 2014).

46. Moohr, *supra* note 37, at 601. Specifically:

> [P]ractitioners must be very careful not to implicate clients in the criminal matter when representing clients who may have violated civil provisions. Providing information to administrative authorities or civil parties may result in a forfeiture of attorney-client and work-product privileges in the criminal case. And the threat of criminal charges obviously strengthens the government's position in negotiations over the civil matter.

Id.

47. *See id.* at 597:

> The decision to indict—or not—rests in the discretion of the federal prosecutor in charge of the case. Nominally, the grand jury investigating the case decides whether a criminal charge is warranted. Because a prosecutor has great influence over the grand jury, in practice the decision to indict rests with the government, not its citizens.

48. Coffee, *supra* note 41, at 193. Professor Geraldine Moohr notes in this regard that

> [t]he only distinctions between civil and criminal liability in many statutes are the defendant's felonious intent, the mens rea element that bedevils law students, and the prosecution's burden to prove all elements of the crime beyond a reasonable doubt. In short, if the government believes it can prove that the defendant acted with criminal intent—as defined in the relevant statute—a civil violation can be treated as a crime.

Moohr, *supra* note 37, at 600–01.

49. Coffee, *supra* note 41, at 199.

raises constitutional due process issues and obscures the reasons for and confuses the standards for punishment."[50]

III. THE BASIS AND RATIONALE FOR CORPORATE CRIMINAL LIABILITY

In an environment where criminal culpability is ill-defined and difficult to distinguish from civil culpability, *corporate* criminal liability has an even more tenuous foundation. A statutory business entity is a legal person that may be subject to legal action based on its conduct or position.[51] Statutes, for example, may make corporations criminally liable for actions taken by their agents in the ordinary course of the corporation's business.[52] Yet, this is not common under U.S. federal law:

> [M]ost federal criminal statutes . . . do *not* set forth a rule for imposing vicarious liability. Instead, most federal criminal statutes refer to crimes committed by a "person" or "whoever," and the United States Code defines those terms to include corporations and other business associations. So, while these statutes clearly provide for corporate criminal liability, they do not set forth a legal rule for deciding when this should be so.[53]

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50. Moohr, *supra* note 37, at 601.

51. The observation that corporations are legal persons has been made in legal actions and scholarship seeking to hold corporations responsible for their wrongful conduct, including without limitation, court opinions and law review articles on the criminal liability of corporations and other business entities. *See, e.g.*, United States v. Van Schaick, 134 F. 592, 602 (S.D.N.Y. 1904) ("A corporation can be guilty of causing death by its wrongful act. It can with equal propriety be punished in a civil or criminal action."); United States v. John Kelso Co., 86 F. 304, 306 (N.D. Cal. 1898) ("[W]hen a statute in general terms prohibits the doing of an act which can be performed by a corporation, and does not expressly exempt corporations from its provisions, there is no reason why such statute should be construed as not applying to them, when the punishment provided for its infraction is one that can be inflicted upon a corporation . . . ."); Daniel J.H. Greenwood, Essay, *Telling Stories of Shareholder Supremacy*, 2009 MICH. ST. L. REV. 1049, 1074 (2009) ("To be sure, 'persons' often means 'legally recognized actors' in legal jargon: . . . corporations, trusts, and other legal entities may be 'legal persons' in tort, contract, property, criminal, and sometimes even tax law."); Daniel J.H. Greenwood, *Discussing Corporate Misbehavior: The Conflicting Norms of Market, Agency, Profit and Loyalty*, 70 BROOK. L. REV. 1213, 1215 (2005) ("Environmental law, constitutional law, criminal law, labor law and so on, generally regulate the corporation as a 'person' . . . ."); *see generally* Joan MacLeod Heminway, *Thoughts on the Corporation as a Person for Purposes of Corporate Criminal Liability*, 41 STETSON L. REV. 137 (2011) (commenting on the role of corporate personhood in criminal liability).

52. *See, e.g.*, Elizabeth K. Ainslie, *Indicting Corporations Revisited: Lessons of the Arthur Andersen Prosecution*, 43 AM. CRIM. L. REV. 107, 124–25 (2006) (noting that some states model statutory provisions after the Model Penal Code while "[o]ther states have enacted statutes that impose criminal liability on corporations through individual statutes addressing specific actions, or that define 'person' to include corporations and other business entities").

53. Paul E. McGreal, *Corporate Compliance Survey*, 65 BUS. LAW. 193, 221 (2009) (footnotes omitted).

As a result, the basis for most federal corporate criminal liability is an agency theory of liability—a variant of the tort liability of a principal for the actions of its agent.[54]

> [T]his is the rule when the act is done by the agent in the course of his employment, although done wantonly or recklessly or against the express orders of the principal. In such cases the liability is not imputed because the principal actually participates in the malice or fraud, but because the act is done for the benefit of the principal, while the agent is acting within the scope of his employment in the business of the principal, and justice requires that the latter shall be held responsible for damages to the individual who has suffered by such conduct.
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> . . .
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> Applying the principle governing civil liability, we go only a step farther in holding that the act of the agent, while exercising the authority delegated to him to make rates for transportation, may be controlled, in the interest of public policy, by imputing his act to his employer and imposing penalties upon the corporation for which he is acting in the premises.[55]

Understanding the agency-based legal roots of corporate criminal liability, however, does not offer us a reason, rooted in policy or theory, for labeling an entity's conduct criminal rather than tortious.[56] In fact,

54. Coffee, *supra* note 41, at 195; *see also* John P. Anderson, *When Does Corporate Criminal Liability for Insider Trading Make Sense?*, 46 STETSON L. REV. 147, 148–51 (2016) (describing the U.S. Supreme Court's opinion in New York Central & Hudson River Railroad Co. v. United States, which endorsed corporate criminal liability as a matter of public policy).

55. N.Y. Cent. & Hudson River R.R. Co. v. United States, 212 U.S. 481, 493–94 (1909) (internal citations omitted).

56. The Court offers the following explanation for its imposition of corporate criminal liability in *New York Central*:

> We see no valid objection in law, and every reason in public policy, why the corporation which profits by the transaction, and can only act through its agents and officers, shall be held punishable by fine because of the knowledge and intent of its agents to whom it has intrusted authority to act in the subject-matter . . . and whose knowledge and purposes may well be attributed to the corporation for which the agents act. While the law should have regard to the rights of all, and to those of corporations no less than to those of individuals, it cannot shut its eyes to the fact that the great majority of business transactions in modern times are conducted through these bodies, and particularly that interstate commerce is almost entirely in their hands, and to give them immunity from all punishment because of the old and exploded doctrine that a corporation cannot commit a crime would virtually take away the only means of effectually controlling the subject-matter and correcting the abuses aimed at.

one pair of commentators pointedly note, "The history of the development of criminal corporate liability is, at bottom, the story of a practice in search of a theory."[57] As a result, commentators divide the basis for corporate criminal liability in various ways and attack it from a number of different angles.

The nature of the business entity and a generalized fear of its societal power and capacity for harm may be a strong motivating force for the judicial imposition of corporate criminal liability. Yet, this may not be a sufficient rationale for criminal, rather than tortious, liability.

> It is no universal solvent to declare that a corporation should be a criminal defendant because the aggregation of capital it represents poses a greater risk of harm if that power is used for criminal purposes. Such a rationale would support a decision to make the corporation civilly liable for its misdeeds, but sweeps little farther. There is, however, no question that this rationale underpins a great deal of federal law criminalizing corporate conduct. The decision to criminalize should not be made so casually. Criminal conduct, as Henry Hart reminded us, "is conduct which, if duly shown to have taken place, will incur a formal and solemn pronouncement of the moral condemnation of the community." Criminalizing a broad range of otherwise marginally acceptable business conduct trivializes the criminal sanction and breeds contempt for it, at least among rational actors, which most white collar offenders are.[58]

Others have similarly noted that the vicarious corporate liability generally seems better suited to civil, rather than criminal, enforcement based on the nature of the perceived societal harm:

> Conceptually, vicarious criminal liability for failing to prevent the agent from acting illegally seems a form of behavior that should be priced, rather than prohibited. This is because society must make a judgment about the appropriate amount of behavior (i.e., preventive monitoring) to demand and cannot take a simple all-or-nothing position. Once it is conceded that some level of monitoring could be excessive, then the cost to the corporation must be compared to the benefit to society.[59]

Id. at 495–96.

57. Andrew Weissmann & David Newman, *Rethinking Criminal Corporate Liability*, 82 IND. L.J. 411, 418 (2007).

58. Michael E. Tigar, *It Does the Crime but Not the Time: Corporate Criminal Liability in Federal Law*, 17 AM. J. CRIM. L. 211, 213 (1990) (footnote omitted).

59. Coffee, *supra* note 41, at 195–96 (footnote omitted).

Still, others question the vicarious liability of corporations for the conduct of their agents based on the theories of criminal punishment, noting specifically that a policy of that strict corporate liability for the criminal actions of corporate agents serves neither deterrence nor retribution, in the following terms:

> The legal system should not impose criminal liability, as distinct from civil liability, on a corporation anytime an employee commits a crime within the scope of employment that is intended by the employee to benefit the company in whole or in part. Such a system of strict liability for a corporation, while often warranted and in tune with the goals of civil liability, has no place in the criminal law. Strict liability is antithetical to the dual goals in the criminal law of deterrence and retribution.[60]

Ironically, the strict liability of a firm for the criminal activities of its employees may mean that the firm pays a fine for criminal conduct that does not inure to its benefit.[61]

The criticisms of corporate criminal liability are broad and varied. Yet, the persistence and cogency of these criticisms have had little, if any, influence to date on the doctrine. The common law application of criminal liability to corporations endures and has been expansively interpreted over time—it appears to be here to stay.[62]

Despite the wide-ranging potential for corporate criminal liability, it has been infrequently imposed. Constraints include memoranda on the appropriate exercise of prosecutorial discretion over corporate conduct and the effects of federal sentencing rules applicable to corporate criminal conduct.[63] While the sparing use of corporate criminal prosecutions may make some less concerned about corporate criminal liability, it is the *potential* for that liability, rather than its actual assertion or imposition, that troubles many of those who criticize the availability of corporate criminal enforcement.[64] The

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60. Weissmann & Newman, *supra* note 57, at 412.

61. *See* Anderson, *supra* note 54, at 150 ("The employee's action need not actually benefit the corporation to satisfy the test; it may even prove *detrimental* to the corporation." (footnotes omitted)).

62. *See id.* at 150–51 ("Ultimately, the two-part *New York Central* test for corporate criminal liability has been interpreted so liberally by the courts that it has, as one commentator puts it, been rendered 'almost meaningless.'" (footnote omitted)).

63. *See, e.g.*, *id.* at 151–53 (describing these constraints on prosecutorial and penal discretion).

64. *See, e.g.*, *id.* at 164. Professor Anderson opines that

> [p]rosecutors are mindful of the . . . collateral consequences of a corporate indictment. Experience has taught them that the mere threat of an indictment gives them all the

possibility of corporate criminal liability typically results in the retention of specialized legal counsel and management distraction from the firm's business—both potentially significant costs to the firm over time. The resulting incentives to settle civil claims and plea bargain with criminal prosecutors—even for claims and charges that the firm believes are without merit—may damage the community and society as a whole more than the potential corporate criminal liability benefits society. It is this concern with the effects of potential corporate criminal liability that motivates my argument that reckless employee insider trading should not result in corporate criminal liability.

IV. CORPORATE CRIMINAL LIABILITY FOR RECKLESS INSIDER TRADING VIOLATIONS OF EMPLOYEES UNDER SECTION 10(B) AND RULE 10B–5

The potential for corporate criminal liability for reckless employee insider trading derives from the possibility that the employee's reckless trading may be deemed to be a willful violation of the 1934 Act for which the employer is liable under the agency theory—*respondeat superior*. This fact scenario is most likely to occur in a private equity, investment management, or other financial services firm (like SAC). However, other employers—including, for example, personal holding companies[65] and acquisition-minded firms—also may engage in securities trading in the ordinary course of their respective businesses. The criminal liability of an employer for reckless insider trading of an employee rests on vague notions of corporate criminal liability—ill-defined as a matter of policy or theory—layered on top of uncertainties about the availability of criminal liability for reckless insider trading because of the indistinct contours of the requisite element of willfulness. The availability of criminal liability and sanctions in this inherently unstable doctrinal environment strains the credibility of criminal law and weakens its signaling power in the community.

There must be a better way. The idea for that better way is a simple one, although it may not be easily implemented. Given the tendentious nature of criminal liability for reckless insider trading and the questionable footing of corporate criminal liability, this Article suggests the elimination of corporate criminal liability for reckless

> power they need to either force a change in firms' compliance practices, or to force corporations to cooperate in the government's investigations of the firm or its employees.

Id. at 163 (footnote omitted).

65. *See* 26 U.S.C. § 542 (2012) (defining personal holding companies).

employee insider trading violations. In other words, this Article proposes that corporate criminal liability be taken off the table altogether when an employee's asserted violation of Section 10(b) and Rule 10b–5 is reckless, as opposed to a knowing violation of law.

How might this be accomplished? There are a number of options. Another article in this publication argues for the elimination of corporate criminal liability for insider trading based on the type of insider trading at issue.[66] That solution makes infinite sense based on the analysis forwarded in that article. This Article, however, takes a more narrow approach to possible solutions consistent with the arguments made here, focusing on bespoke options addressing corporate criminal liability in the specific context of reckless employee insider trading.

Congress or the courts could, for example, clarify that reckless conduct is not, by its nature, willful conduct. A rule or interpretation of this kind would consign enforcement of the employee violation to the civil realm and thus also relegate any derivative (vicarious) liability to civil enforcement. This curative option would easily solve the corporate criminal liability problem identified in the Introduction of this Article.[67]

However, resolving the corporate criminal liability problem in this way also would take away the possibility of criminal enforcement against the individual. The *in terrorem* or educational effect on an individual of potential criminal liability is different, because the individual, unlike a business entity, may be incarcerated.

> [P]rison is the distinctive sanction of the criminal law because it fulfills a pedagogical function that fines do not. Not only are prisons highly visible reminders of the deterrent threat of the law, but the use of imprisonment broadcasts a special communitarian message about the equality of all citizens before the law. . . . Alone, it tells

66. *See* Anderson, *supra* note 54, at 164–65 (noting that "true insider trading and source-employee outsider trading are crimes that cannot be committed by a company. Corporate criminal liability in these circumstances yields the absurd result of punishing the victims for the crime."). Specifically, Professor Anderson proposes

> [s]tatutory constraints . . . on prosecutors when indicting corporations for insider trading under Section 10(b). Prosecutors should be permitted to exercise their discretion in bringing indictments against firms whose employees are engaged in third-party insider or outsider trading within the scope of their employment and for the benefit of the firm, but they should be expressly precluded from bringing indictments against corporations for the insider trading of their employees under Section 10(b) in all other circumstances.

Id. at 163.

67. *Supra* Part I.

> members of an audience who may identify themselves as belonging to very different communities (in terms of wealth, race, etc.) that each is a citizen of the same society, subject to the same duties and punishment. The use of imprisonment can symbolize the equality of all before the law, and thus it affirms the existence of a single community.[68]

Although the precise communitarian lessons to be learned by employees who engage in reckless insider trading may be difficult to discern given the overall lack of clarity in U.S. insider trading law,[69] it may be desirable to retain the threat of criminal sanctions as well as civil sanctions for individuals because of the distinctive deterrent and educative functions of incarceration in that context.

The elimination of corporate criminal liability for reckless employee insider trading also could be accomplished by circumscribing corporate criminal liability directly. The U.S. Congress could enact legislation clarifying that such liability is unavailable or the federal judiciary could rule that corporate criminal liability for reckless insider trading by employees is against public policy—or at least not warranted as a matter of public policy. These two options are narrowly tailored but would require legislative or judicial attention to codifying embedded legal concepts (recklessness among them) that currently are not well defined. The implementation of either approach, therefore, would require significant additional thought and attention not undertaken here.

Finally, in the absence of a legislative or judicial response, prosecutorial guidelines could be issued prohibiting corporate criminal prosecutions for reckless employee insider trading. Although this manner of handling the elimination of corporate criminal liability is suboptimal (given that the rules may more easily be changed), a willing Department of Justice could implement efficacious guidelines in a relatively straightforward manner.

Although Congress, the courts, or the Department of Justice may impose restrictions on corporate criminal enforcement for reckless employee insider trading, I (like others that have come before me) understand that a resolution of this kind from these rule-making institutions is unlikely for various reasons. There is, perhaps, one

68. Coffee, *supra* note 41, at 224.

69. *Id.* at 237 ("[T]he 'technicalization' of crime . . . means that the broad mass of public opinion will never quite understand what the law required or why the behavior was illegal." (footnote omitted)).

additional, albeit less desirable, alternative: to adjust the imposition of penalties for corporate criminal liability in this context through sentencing guidelines.[70] This alternative, however, still allows enforcement agents to threaten corporate criminal liability in circumstances where civil liability remedies may adequately serve society's needs (whether for deterrence, punishment, community education, or something else).

To that end, an important footnote must be left here to assuage the concerns of those who worry that eliminating corporate criminal liability for reckless employee insider trading will serve to disincentivize firms from monitoring and guiding employee compliance with insider trading prohibitions. Eradicating corporate criminal liability for reckless insider trading violations would not absolve firms from responsibility for their employees' wrongful conduct. The potential for tort liability (including public—SEC—actions based on aider and abettor liability for providing substantial assistance to a primary violator with the required scienter) remains,[71] as does the possibility of statutory civil liabilities. In the insider trading area, these statutory bases for civil liability include, for example, potential controlling person liability under Section 20(a) of the 1934 Act ("unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action").[72] In addition, the SEC has authority to levy civil penalties on employers as controlling persons under Section 21A of the 1934 Act[73] or impose a cease and desist order on an employer that causes an employee's insider trading violation.[74] These potential liabilities and remedies should provide firms with adequate incentives to ensure employee compliance with U.S. insider trading prohibitions.

V. CONCLUSION

This Article challenges and ultimately denounces corporate criminal liability for reckless employee insider trading. The rationale? Underlying doctrinal, policy-based, and theoretical foundations for this type of criminal liability are weak to the extent they exist at all. Public

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70. *See id.* at 241–42 (suggesting corporate criminal liability reform through sentencing guidelines).

71. *See, e.g.*, Graham v. SEC, 222 F.3d 994 (D.C. Cir. 2000) (considering aider and abettor liability under Section 10(b) and Rule 10b–5 in connection with a stock-kiting scheme).

72. 15 U.S.C. § 78t(a) (2012).

73. *Id.* § 78u–1(a)(1)(B).

74. *Id.* § 78u–3(a).

civil liability serves the same objectives as corporate criminal liability—and more—in this context.

The argument offered in this Article exists at the intersection of a number of strains in related scholarship. It is, of course, an argument based in over-criminalization. "Once everything wrongful is made criminal, society's ability to reserve special condemnation for some forms of misconduct is either lost or simply reduced to a matter of prosecutorial discretion."[75] However, the Article also contributes to ongoing scholarly conversations about the actual and potential implications of unclear statutory, regulatory, and decisional law, including implications that interact with prosecutorial discretion. The viewpoints of those who read this will undoubtedly be shaped by their positions on these and other issues, some of which may be in conflict.

Ultimately, achievement of the result advocated in this Article may be improbable. Regardless, the ideas presented in the foregoing pages are designed to encourage the consideration of the embedded issues in the described legal setting and in other similar contexts. These certainly provide ample opportunity to start new conversations that may be productive to the development of insider trading law or the law governing corporate criminal liability. I look forward to those conversations.

75. Coffee, *supra* note 41, at 201.