

# WHEN DOES CORPORATE CRIMINAL LIABILITY FOR INSIDER TRADING MAKE SENSE?

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## I. INTRODUCTION

Corporations are subject to broad criminal liability for the insider trading of their employees. Critics have noted that this results in a harsh irony. “After all,” Professor Jonathan Macey of Yale Law argues, “it is generally the employer who is *harmed* by the insider trading.”<sup>1</sup> In the same vein, former chairman of the Securities and Exchange Commission (SEC) Harvey L. Pitt and former attorney of the Division of Enforcement of the SEC Karen L. Shapiro point out that, “[f]ar from being responsible for their employees’ violations of the law . . . most of the employers who have had the unfortunate experience of employing [insider traders] are in fact the only true victims, in an otherwise victimless crime.”<sup>2</sup>

It is clear that not all insider trading is victimless, and not all employers of insider traders are innocent. But I am convinced that these critics are correct to point out that the current enforcement regime is absurdly overbroad in that it affords no principled guarantee to corporate victims of insider trading that they will not be indicted for the crimes perpetrated against them.

The law should be reformed to ensure that corporations are only held criminally liable where they are guilty of some wrongdoing. Part II of this Article outlines current law in the United States concerning corporate criminal liability in general. Part III looks at corporate

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1. JONATHAN R. MACEY, *INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY* 65–66 (1991).

2. Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 *YALE J. ON REG.* 149, 240 (1990).

liability for insider trading under the current regime. Part IV explains why the current regime is absurdly overbroad and in dire need of reform. Part V suggests some reforms that would render corporate criminal liability for insider trading more rational, efficient, and just.

## II. CORPORATE CRIMINAL LIABILITY IN GENERAL

Some have argued that the very idea of corporate criminal liability is incoherent.<sup>3</sup> After all, a crime requires both an *actus reus* (a guilty act) and a *mens rea* (a guilty mind), but “corporations have no bodies or limbs with which to perform actions and no brains in which mental states can reside.”<sup>4</sup> Indeed, up until the beginning of the twentieth century, the general rule appeared to be that “[a] corporation cannot commit trea[s]on, or felony, or other crim[es], in [its] corporate capacity: though [its] members may, in their di[s]tinct individual capacities.”<sup>5</sup>

Nevertheless, the rule that corporations could not incur criminal liability was rejected by the United States Supreme Court in *New York Central & Hudson River Railroad Co. v. United States*.<sup>6</sup> A railroad company and its assistant traffic managers were convicted for the payment of illegal rebates on the shipment of sugar.<sup>7</sup> Despite the objection that imposing criminal liability on a corporation “is in reality to punish the innocent stockholders,” the Court applied the civil

3. See generally, e.g., John Hasnas, *The Centenary of a Mistake: One Hundred Years of Corporate Criminal Liability*, 46 AM. CRIM. L. REV. 1329, 1333 (2009) (arguing that corporations are “not morally responsible agents” and therefore cannot be “subject to criminal punishment”); Manuel Velasquez, *Debunking Corporate Moral Responsibility*, 13 BUS. ETHICS Q. 531 (2003) (discussing the fallacies attributed to the collectivist view that a corporation can be held criminally liable).

4. Hasnas, *supra* note 3, at 1337. Professor Hasnas goes on to make the point that corporate criminal liability is also problematic because corporate criminal punishment violates all three of the following necessary conditions for criminal punishment:

- (1) Criminal sanctions may be applied only when doing so advances a legitimate purpose of punishment;
- (2) [c]riminal sanctions may be applied only when doing so does not create an unacceptable risk of prosecutorial error or abuse; and
- (3) [c]riminal sanctions may be applied only when necessary to address a public harm.

*Id.* at 1336.

5. WILLIAM BLACKSTONE, 1 COMMENTARIES ON THE LAWS OF ENGLAND 455, 464 (1765). This view was not, however, universally held. The Supreme Court’s opinion in *New York Central & Hudson River Railroad Co. v. United States*, 212 U.S. 481, 492–93 (1909) cites an emerging trend of contrary authorities. See also HARRY FIRST, BUSINESS CRIME 180 (1990) (“English courts even before Blackstone had imposed liability on government entities for nuisance arising out of a failure to keep up bridges and roads.”).

6. 212 U.S. 481 (1909).

7. *Id.* at 489.

doctrine of *respondeat superior* to uphold the railroad's conviction.<sup>8</sup> The Court explained that, "in the interest of public policy," it is necessary to extend the civil doctrine of vicarious liability to the criminal context in those circumstances where the law could not otherwise be "effectually enforced."<sup>9</sup> The Court went on,

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 . . . .<sup>10</sup>

At the end of the day, the Court concluded that "it cannot shut its eyes to the fact that the great majority of business transactions in modern times are conducted through [corporations]."<sup>11</sup> Consequently, "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."<sup>12</sup>

The Court in *New York Central* laid out a basic two-part test for when corporations may be held criminally liable for the acts of their employees: (1) the employee must perform the criminal act within the scope of their employment, and (2) the corporation must be an intended beneficiary of the act.<sup>13</sup> Subsequent courts have interpreted these elements expansively. For example, in *United States v. Hilton Hotels Corp.*,<sup>14</sup> the Ninth Circuit held that the employee's authority need only be *apparent*, and it may be found even where the employee acts contrary to express company policy or instructions.<sup>15</sup> Some courts have gone so far as to find that even criminal actions beyond the scope of an employee's real or apparent authority might be attributed to the

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8. *Id.* at 492.

9. *Id.* at 494-95.

10. *Id.* at 495.

11. *Id.*

12. *Id.* at 495-96.

13. *Id.* at 493-96.

14. 467 F.2d 1000 (9th Cir. 1973). *See also* *United States v. Basic Constr. Co.*, 711 F.2d 570, 573 (4th Cir. 1985) (holding that the lower court properly instructed the jury that corporate intent can be shown by the actions or statements of those who "have *apparent* authority to make policy for the corporation" (emphasis added)).

15. *Hilton Hotels*, 467 F.2d at 1004; *see also Basic Constr.*, 711 F.2d at 573 (recognizing that a corporation can be held criminally responsible even when an employee's acts "were against corporate policy or express instruction").

corporation if management or the board does not take active measures to stop it.<sup>16</sup>

The test for whether an employee's criminal act was "with the intent to benefit the corporation" has also been interpreted quite liberally.<sup>17</sup> The employee's action need not actually benefit the corporation to satisfy the test;<sup>18</sup> it may even prove *detrimental* to the corporation.<sup>19</sup> It need not even be the case that the employee's primary intent was to benefit the firm;<sup>20</sup> acts motivated principally by self-interest may be imputed to the corporation where a jury might find that at least part of the employee's motivation—"however befuddled"—was to benefit the corporation.<sup>21</sup> Indeed, at least one commentator suggests that corporate liability may be found where, absent any clear intent to benefit the firm, employees could have reasonably *believed* the firm would benefit.<sup>22</sup>

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

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16. See, e.g., *Cont'l Baking Co. v. United States*, 281 F.2d 137, 149 (6th Cir. 1960) (finding that a jury could infer the employees' authority when their superiors "failed to object to" the employees' acts); see also Mark A. Rush & Brian F. Saulnier, *How Corporations Can Avoid or Minimize Federal Criminal Liability for the Illegal Acts of Employees* (1999), available at [http://www.klgates.com/files/Publication/2ddc7f0b-92d6-4d25-b51be845d32b3c01/Presentation/PublicationAttachment/98788628-f44c-43f4-aa04-1e92459b954c/Article\\_on\\_Corporate\\_Criminal\\_Liability.pdf](http://www.klgates.com/files/Publication/2ddc7f0b-92d6-4d25-b51be845d32b3c01/Presentation/PublicationAttachment/98788628-f44c-43f4-aa04-1e92459b954c/Article_on_Corporate_Criminal_Liability.pdf) (discussing how courts have extended liability to instances where employees acted outside the scope of actual or apparent authority but those actions went unchecked, "giving the appearance of official approval") (citing KATHLEEN F. BRICKEY, CORPORATE CRIMINAL LIABILITY § 3:07, at 107 (2d ed. 1991)).

17. See, e.g., Pamela H. Bucy, *Corporate Ethos: A Standard for Imposing Corporate Criminal Liability*, 75 MINN. L. REV. 1095, 1102-03 (1991) (discussing the requirement that a criminal act be committed with the intent to benefit the corporation and how an act can satisfy that requirement when the corporation received no benefit from the offense and those within the corporation were unaware of the conduct when it occurred).

18. See, e.g., *Standard Oil Co. of Tex. v. United States*, 307 F.2d 120, 128 (5th Cir. 1962) (stating that an actual benefit to the corporation is not necessary to create liability).

19. *United States v. Automated Med. Lab., Inc.*, 770 F.2d 399, 406-07 (4th Cir. 1985).

20. See, e.g., *Automated Med. Lab.*, 770 F.2d at 407 (stating that liability can exist when an agent acts for both his or her own benefit and for the corporation's benefit); *United States v. Gold*, 743 F.2d 800, 823 (11th Cir. 1984) (finding that an employee must only intend to benefit the corporation "in part"); *United States v. Beusch*, 596 F.2d 871, 877-78 (9th Cir. 1979) (discussing the requirement of the intent to benefit the corporation).

21. *United States v. Sun-Diamond Growers of Cal.*, 138 F.3d 961, 970 (D.C. Cir. 1998). See also *Local 1814, Int'l Longshorem'n's Ass'n v. NLRB*, 735 F.2d 1384, 1395 (D.C. Cir. 1984) ("[T]he acts of an agent motivated partly by self-interest—even where self-interest is the predominant motive—lie within the scope of employment so long as the agent is actuated by the principal's business purposes 'to any appreciable extent.'").

22. See, e.g., Hasnas, *supra* note 3, at 1338 (citing *Steere Tank Lines v. United States*, 330 F.2d 719, 722-24 (5th Cir. 1964) as holding that "a corporation could be liable for the illegal actions of truck drivers who reasonably could believe the corporation benefited from and demanded such actions.").

meaningless.”<sup>23</sup> The practical reality is that whether a corporation is or is not charged for the crimes of its employees is less a function of the two-part *New York Central* test than it is a matter of prosecutorial whim.<sup>24</sup> This breadth in prosecutorial discretion leaves corporations extremely vulnerable and “invites abuse.”<sup>25</sup>

In January 2003, the then Deputy Attorney General Larry D. Thompson issued a memorandum (Thompson Memorandum) offering guidelines for prosecutors in the exercise of their discretion to charge a corporation with a criminal offense.<sup>26</sup> The Thompson Memorandum encouraged prosecutors to consider factors such as the “nature and seriousness of the offense,” the “pervasiveness of wrongdoing within the corporation,” the “adequacy of the corporation’s compliance program,” and the corporation’s “voluntary disclosure of wrongdoing and its willingness to cooperate.”<sup>27</sup> Most controversially, in determining whether a corporation was willing to “cooperate,” the Thompson Memorandum permitted prosecutors to consider (1) whether a firm was willing to waive its “attorney-client and work product protection”<sup>28</sup> and (2) whether it has declined to pay attorneys’ fees for implicated employees.<sup>29</sup> These latter factors demonstrate just how far the Department of Justice (DOJ) managed to leverage its virtually limitless discretion to prosecute corporations and force firms to effectively “[sign] on as deputy prosecutorial agents” against themselves and their own employees.<sup>30</sup> The government may, however, have become a bit too greedy in pressing its advantage. Backlash from business groups, civil liberties organizations, and judges ultimately forced the Department of Justice to soften its stance somewhat.<sup>31</sup> In

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23. Bucy, *supra* note 17, at 1102.

24. See *Sun-Diamond*, 138 F.3d at 970 (providing “the only thing that keeps deceived corporations from being indicted for the acts of their employee-deceivers is not some fixed rule of law or logic but simply the sound exercise of prosecutorial discretion”). See also Howard J. Kaplan, *Corporate Criminal Liability for Insider Trading*, ABA SECTION OF LITIGATION (December 4, 2014), <http://apps.americanbar.org/litigation/committees/securities/articles/fall2014-1114-corporate-criminal-liability-insider-trading.html> (providing the same quotation from *Sun-Diamond*).

25. Hasnas, *supra* note 3, at 1342.

26. Memorandum from Larry D. Thompson, Deputy Att’y Gen., U.S. Dep’t of Justice, to Heads of Dep’t Components & All U.S. Attorneys, *Principles of Federal Prosecutions of Business Organizations* (Jan. 20, 2003), available at [http://www.americanbar.org/content/dam/aba/migrated/poladv/priorities/privilegewaiver/2003jan20\\_privwaiv\\_dojthomp.authcheckdam.pdf](http://www.americanbar.org/content/dam/aba/migrated/poladv/priorities/privilegewaiver/2003jan20_privwaiv_dojthomp.authcheckdam.pdf) [hereinafter Thompson Memorandum].

27. *Id.* at 4.

28. *Id.*

29. *Id.* at 7–8.

30. Hasnas, *supra* note 3, at 1354.

31. See, e.g., Ashby Jones, *Thompson Memo Out, McNulty Memo In*, WALL ST. J. (Dec. 12, 2006), available at <http://blogs.wsj.com/law/2006/12/12/thompson-memo-out-mcnulty-memo-in> (providing a report on the “McNulty Memorandum” written by U.S. Deputy Attorney General Paul

December 2006, then Deputy Attorney General Paul J. McNulty issued new guidelines that, while retaining most of the same language from the Thompson Memorandum, now require that prosecutors seek approval from the Deputy Attorney General before requesting that firms waive privilege and only allow consideration of advancing attorneys' fees for employees under extraordinary circumstances.<sup>32</sup> Nevertheless, a recent memorandum issued by Deputy Attorney General Sally Quillian Yates looks to recover some of this lost ground and functionally revive the privilege waiver demand by requiring that entities turn over "all relevant facts" in order to receive "any" cooperation credit.<sup>33</sup> In sum, vast prosecutorial discretion continues to leave the government holding all the cards. As U.S. Attorney Preet Bharara, who made the cover of *Time Magazine* in 2012 as the man who is "Busting Wall Street," himself put it, "the corporation is particularly ill-equipped to defend itself... against the power of prosecutors to prove *virtually any corporate entity guilty upon showing criminal conduct on the part of at least one employee.*"<sup>34</sup> In other words, corporations have no choice but to "cooperate," and prosecutors are free to decide what that means.<sup>35</sup>

Even before the Thompson, McNulty, and Yates Memoranda, the Federal Sentencing Guidelines, promulgated in 1991, imposed essentially the same incentive structure on corporations to self-police and "cooperate" with the government. Under the Sentencing Guidelines, a corporation reduces its culpability score by maintaining "effective compliance and ethics programs," and by "self-reporting, cooperation, or acceptance of responsibility."<sup>36</sup> Though these credits

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J. McNulty to supplement the Thompson Memorandum). See also *United States v. Stein*, 541 F.3d 130, 136 (2d Cir. 2008) (finding the defendants not guilty and instead ruling that the government had an "overwhelming influence").

32. Memorandum from Paul J. McNulty, Deputy Att'y Gen., U.S. Dep't of Justice, to Heads of Dep't Components & All U.S. Attorneys, *Principles of Federal Prosecutions of Business Organizations* (Dec. 12, 2006), available at [http://www.justice.gov/sites/default/files/dag/legacy/2007/07/05/mcnulty\\_memo.pdf](http://www.justice.gov/sites/default/files/dag/legacy/2007/07/05/mcnulty_memo.pdf) [hereinafter McNulty Memorandum].

33. Memorandum from Sally Quillian Yates, Deputy Att'y Gen., U.S. Dep't of Justice, to Heads of Dep't Components & All U.S. Attorneys, *Individual Accountability for Corporate Wrongdoing* at 3-4 (Sept. 9, 2015) available at <https://www.justice.gov/dag/file/769036/download> [hereinafter Yates Memorandum].

34. Preet Bharara, *Corporations Cry Uncle and Their Employees Cry Foul: Rethinking Prosecutorial Pressure on Corporate Defendants*, 44 AM. CRIM. L. REV. 53, 70-71 (2007) (emphasis added).

35. See generally Lisa Kern Griffin, *Compelled Cooperation and the New Corporate Criminal Procedure*, 82 N.Y.U. L. REV. 311 (2007) (examining the constitutional implications of the corporate cooperation doctrine).

36. U.S. SENTENCING GUIDELINES MANUAL § 8A1.1, at 499, § 8B2.1 at 509 (2015); see also Ellen S. Podgor, *Educating Compliance*, 46 AM. CRIM. L. REV. 1523, 1528 n.37 (2009) (elaborating on the ways that a corporation can reduce culpability through the Sentencing Guidelines).

under the Sentencing Guidelines are offered in the form of post-conviction carrots, they end up functioning as hefty pre-indictment sticks when coupled with limitless prosecutorial discretion under the courts' liberal interpretations of *New York Central*. These Sentencing Guidelines, like the above-described DOJ memoranda, effectively deputize corporations against their employees and themselves.<sup>37</sup>

But recall that the guiding policy behind *New York Central*'s recognition of corporate criminal liability was to fill an enforcement gap—to create otherwise absent incentives for firms to police the conduct of their own employees. In other words, effectively deputizing firms to perform a law-enforcement function was precisely the Supreme Court's objective. Presumably the idea was that the clear benefits of increased enforcement would outweigh the inevitable harm of punishing innocent shareholders. Even keeping this broad policy justification in mind, however, corporate criminal liability in the context of insider trading presents some unique problems.

### III. CORPORATE CRIMINAL LIABILITY FOR INSIDER TRADING: THE PERFECT STORM

The crime of insider trading has never been defined by statute or by rule. Congress and the SEC have elected to allow the definition of insider trading to develop through the courts and administrative proceedings. The primary statutory authority for insider trading liability is Section 10(b) of the Securities Exchange Act of 1934,<sup>38</sup> which is implemented by the SEC in Exchange Act Rule 10b-5.<sup>39</sup> Section 10(b) prohibits the employment of “any manipulative or deceptive device or contrivance” in “connection with the purchase or sale of any security.”<sup>40</sup> Though Congress intended Section 10(b) as a “catchall” provision, the Supreme Court has held that “what it catches must be fraud.”<sup>41</sup> Insider traders, however, typically gain their trading advantage by failing to disclose material nonpublic information, not by making affirmative misrepresentations. Under the common law, such trading is fraudulent only where there is a *duty* to disclose.<sup>42</sup> The

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37. See, e.g., Hasnas, *supra* note 3, at 1354 (“[T]he *New York Central* standard brings almost irresistible pressure on corporations to do whatever they can to avoid indictment, which means signing on as deputy prosecutorial agents.” (footnote omitted)).

38. 15 U.S.C. § 78j(b) (2012).

39. 17 C.F.R. § 240.10b5-1 (2014).

40. 15 U.S.C. § 78j(b).

41. *Chiarella v. United States*, 445 U.S. 222, 234–35 (1980).

42. *Id.* at 228 (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1977)).

Supreme Court has recognized two theories whereby Section 10(b) insider trading liability will result from a failure to disclose: (1) the “classical theory,” which addresses true insider trading (trading by issuers, their employees, or persons otherwise affiliated with the issuer); and (2) the “misappropriation theory,” which is broad enough to address outsider trading (trading by persons who are not affiliated with the issuer).<sup>43</sup>

Liability is incurred under the classical theory where the issuer, its employee, or someone otherwise affiliated with the issuer seeks to benefit from trading (or tipping others who trade) that firm’s shares based on material nonpublic information. Here the insider violates a “fiduciary or other similar relation of trust and confidence” to the current or prospective shareholder on the other side of the transaction.<sup>44</sup> Under the misappropriation theory, Section 10(b) liability is incurred where one misappropriates material nonpublic information and, unbeknownst to the source, seeks to benefit by trading (or tipping others who trade) on this information. While the classical theory finds the trader’s duty to disclose in a fiduciary relationship with the counterparty to the trade, “the misappropriation theory premises liability on a fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information” by cheating them “of the exclusive use of that information.”<sup>45</sup>

Section 10(b) is not a criminal statute, but Section 32(a) of the Exchange Act makes any willful violation of the Act a crime. Under Section 32(a),

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.<sup>46</sup>

These criminal penalties are stiff. And, in addition, the Insider Trading and Securities Enforcement Act of 1988 (ITSFEA) extended the civil

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43. See *United States v. O’Hagan*, 521 U.S. 642, 651–53 (1997) (describing the differences between the classical theory and the misappropriation theory).

44. *Chiarella*, 445 U.S. at 228.

45. *O’Hagan*, 521 U.S. at 652.

46. 15 U.S.C. § 78ff(a).



penalty of treble damages—once reserved to individual traders<sup>47</sup>—to “controlling persons.”<sup>48</sup> When the prosecutor’s complete discretion to charge corporations for any and all insider trading by their employees under *New York Central* and its progeny is combined with the threat of these considerable sanctions, corporations’ incentives to self-police—for example, by implementing strong insider trading compliance programs—is obvious.

But there is a problem that renders firms even more helpless at the hands of prosecutors when facing potential insider trading liability. Both the classical and misappropriation theories of insider trading liability involve persons who seek to “benefit” from trading “on the basis of” “material” “nonpublic” information in violation of a “fiduciary or other similar relation of trust and confidence,” but no one seems to agree on a clear definition of any one of these terms.<sup>49</sup> Though the SEC and Congress have had ample opportunity to bring clarity to the law by promulgating a statutory or rule-based definition of insider trading, they have expressly declined to do so for fear that it would deprive prosecutors and regulators of necessary flexibility in enforcement.<sup>50</sup> The result is a perfect storm for corporations. They cannot avoid liability for the insider trading of their employees, but they cannot prevent it through effective compliance programs because they do not have a clear idea of what it is they are supposed to prevent.

This problem is particularly acute for issuers, who often compensate their employees with firm shares and therefore must provide those employees with some opportunity to sell their shares. I have described this problem elsewhere as the “paradox of insider trading compliance.”<sup>51</sup> But this is not the only problem with insider trading liability for corporations; it also has the defect of often being completely incoherent.

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47. See WILLAM K.S. WANG & MARC I. STIENBERG, *INSIDER TRADING* 812 (3d ed. 2010).

48. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (codified in scattered sections of 15 U.S.C. § 78 (2012)).

49. See, e.g., John P. Anderson, *Solving the Paradox of Insider Trading Compliance*, 88 *TEMPLE L. REV.* 273, 278-87 (2016) (elaborating on the absence of definitions for the elements of insider trading but instead calling for not only definitions, but the current enforcement regime to be liberalized generally).

50. See, e.g., STEPHEN BAINBRIDGE, *INSIDER TRADING: LAW AND POLICY* 145 n.30 (2014) (“The [House] committee feared that any definition would have to be either so broad as to be unworkable or so narrow as to reduce the SEC’s and the court’s flexibility to address new forms of trading.”).

51. See Anderson, *supra* note 49, at 295-96 (“This is the paradox of insider trading compliance for issuers: ambiguity in the law combined with the threat of stiff reputational and legal sanctions creates a perverse incentive to adopt compliance programs that are highly inefficient and ultimately costly to shareholders.” (citations omitted)).

#### IV. DOES IT MAKE SENSE?

There is a great deal of controversy over whether insider trading is a victimless crime. I think the answer is that insider trading does not have to create victims. Under a different insider trading enforcement regime, some forms of insider trading would be both morally permissible and economically beneficial for society as a whole.<sup>52</sup> But that is not the regime under which we live. The current regime—irrational and inefficient as it is—has created market expectations that are disappointed by insider trading. The victims of insider trading are not always the counterparties to the insider's transactions; they vary depending on the type of insider trading that occurs. This Part begins by identifying the different victims that the law identifies as resulting from the various categories of insider trading under the current U.S. enforcement regime. Identifying these victims of insider trading exposes an absurdity in the context of corporate criminal liability. It turns out that in most (though not all) cases where a corporation is subject to criminal liability for the insider trading of its employees, it (or its shareholders) is by theory of law also the principal victim of that same trading. This leads to the absurd result that the victim is liable for the crime.

##### A. Victim of True Insider Trading Under the Classical Theory

As noted above, under the classical theory, when a true insider (whether the issuer itself, a board member, senior management, or a low-level employee) profits by trading in the firm's shares based on material nonpublic information, the fraud is perpetrated on the counterparty.<sup>53</sup> In such cases, the counterparty will always be a current or prospective shareholder who, as such, is owed a fiduciary or similar duty of trust and confidence that warrants disclosure prior to trading. The insider profits by deception, and the current or prospective shareholder with whom she trades is the victim of this deception.

As noted above, corporate criminal liability exposes firms to astronomical monetary fines.<sup>54</sup> Moreover, history suggests that the

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52. See, e.g., John P. Anderson, *Greed, Envy, and the Criminalization of Insider Trading*, 2014 UTAH L. REV. 1 (2014); see also John P. Anderson, *What's the Harm in Issuer-Licensed Insider Trading?*, 69 U. MIAMI L. REV. 795 (2015) (arguing that "non-promissory" or "issuer-licensed" insider trading is morally permissible under the right conditions, and that permitting such trading would likely improve market efficiency).

53. *Supra* Part III.

54. *Id.*

uncertainty accompanying a criminal indictment alone can cause a corporation's sources of capital to evaporate, ultimately resulting in the firm's collapse.<sup>55</sup> Who suffers these consequences? As Professor Hasnas explains, "To the extent that such a loss cannot be passed along to consumers, it is the owners of the corporation, the shareholders, who incur the penalty."<sup>56</sup> But, while almost all corporate criminal liability forces innocent shareholders to bear the punishment,<sup>57</sup> the case of insider trading is unique in that, as demonstrated above, the theory of criminal liability itself also identifies these same shareholders as the *victims*.<sup>58</sup> Consequently, shareholders are forced to suffer the crime *and* the punishment!

Recall that in *New York Central*, the Court weighed the concern that imposing corporate criminal liability might sometimes force innocent shareholders to pay a price for the corporation's crimes.<sup>59</sup> With this concern in mind, the Court nevertheless held that corporate criminal liability may still be warranted in those cases where no other effective means of protecting the public are available.<sup>60</sup> The Court presumably reasoned that in such cases, the wrong of penalizing innocent shareholders was outweighed by the wrong of leaving innocent victims unprotected or by the wrong of undermining the policy advanced by the relevant statute.<sup>61</sup> But this rationale cannot justify corporate criminal liability for true insider trading under the classical theory. Imposing harsh penalties on the innocent shareholders whom the theory of liability also identifies as the victims of the crime is just plain absurd, and it does not jibe with the Court's reasoning in *New York Central*.

#### B. Victim of True Insider Trading Under the Misappropriation Theory

As a number of scholars have pointed out, there is no reason that true insiders cannot also incur Section 10(b) liability for insider trading

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55. Witness the collapse of Drexel Burnham Lambert in the 1980s and the collapse of Arthur Anderson in the wake of the Enron scandal of 2001. *See, e.g.*, JAMES B. STEWART, *THE DEN OF THIEVES* (1991, 2010) (chronicling the demise of Drexel Burnham Lambert).

56. Hasnas, *supra* note 3, at 1339.

57. *Id.* ("The defining characteristic of the modern corporation is the separation of ownership and control. The shareholders . . . have no direct control over or knowledge of the behavior of the corporate employees who commit the criminal offenses.")

58. *Supra* Part III.

59. *Supra* Part II.

60. *Id.*

61. *Id.*

based on the misappropriation theory.<sup>62</sup> As Professor Donna Nagy puts it, “Although *O’Hagan* depicted its misappropriation theory as a ‘complement’ to the classical theory, there is no reason for eschewing a misappropriation analysis simply because an insider owes disclosure duties to the corporation’s shareholders as well [as to] the corporation that entrusted him with the information.”<sup>63</sup> When a true insider incurs Section 10(b) liability under the misappropriation theory, the fraud is actually perpetrated on the issuer. The *O’Hagan* Court explained that “[a] company’s confidential information . . . qualifies as property to which the company has a right of exclusive use. The undisclosed misappropriation of such information, in violation of a fiduciary duty . . . constitutes fraud akin to embezzlement.”<sup>64</sup>

The incoherence of derivative corporate criminal liability for the true insider trading of its employees under the misappropriation theory is even more blatant than under the classical theory. The absurdity of holding a firm criminally liable for its employees’ embezzlement is palpable, but this is precisely what corporate criminal liability for true insider trading amounts to under the misappropriation theory. Certainly the policy rational behind *New York Central* cannot support corporate criminal liability under such circumstances.

### C. Victim of Source-Employee Outsider Trading Under the Misappropriation Theory

The Supreme Court first recognized the misappropriation theory to fill a gap in the classical theory’s coverage—namely that it failed to capture *outsiders* who look to profit by trading on material, nonpublic information in breach of a fiduciary or similar duty of trust and

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62. See, e.g., DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT & PREVENTION § 6-1 (West vol. 18, 2015) (“Virtually all cases that could be brought [under the classical theory] can also be styled as misappropriation cases.”); WANG & STEINBERG, *supra* note 47, at 492 (“In most instances, both the Commission and private plaintiffs could recast a classical special relationship case as involving ‘misappropriation.’”).

63. Donna M. Nagy, *Beyond Dirks: Gratuitous Tipping and Insider Trading*, 42 J. CORP. L. (forthcoming Fall 2016) (manuscript at 21–22), available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2665820](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2665820). Indeed, Professor Nagy suggests that misappropriation may become the theory of liability *de jour* for the SEC and prosecutors in even true insider trading cases if the Second Circuit’s decision in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014) stands. *Id.* at 24–26. Nagy points out that the misappropriation theory as articulated in *O’Hagan* and other cases may not require the same showing of a *quid pro quo* to establish the benefit element for insider trading liability. *Id.* at 20–22. Though the Supreme Court denied certiorari on *Newman*, 84 USLW 3064 (Oct. 5, 2015), it has since granted certiorari in another tipper/tippee insider trading case, *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015).

64. *United States v. O’Hagan*, 521 U.S. 642, 654 (1997) (citations omitted).

confidence.<sup>65</sup> The *O'Hagan* Court held that since the impact on the parties and the market is the same in both cases, it makes little sense to hold a lawyer, like O'Hagan, liable under section 10(b) if he works for a law firm representing the target of a takeover (as he would be under the classical theory), but not if he works for the bidder.<sup>66</sup>

This Part focuses on "source-employee" outsider trading under the misappropriation theory. Here the outsider misappropriation trading is done by an employee of the information's source. Such insider trading is perpetrated by an employee against his employer.<sup>67</sup> Take, for example, the case of *Carpenter v. United States*.<sup>68</sup> In that case, a *Wall Street Journal (Journal)* reporter was prosecuted for trading in advance of the publication of his daily stock-picking column.<sup>69</sup> The column was popular and usually had an impact on stock prices. The *Journal's* policy was that, prior to publication, the content of the column was the *Journal's* confidential information.<sup>70</sup> In violation of this policy, the reporter, R. Foster Winans, entered into an arrangement whereby he and others would profit by trading on this information in advance of publication.<sup>71</sup> Under the *New York Central* test, there is nothing other than the exercise of prosecutorial discretion that prevented the *Journal* from being indicted for Winan's trading. This, as Professor Macey points out, is "ironic in light of the fact that the Supreme Court 'went to great lengths to indicate that the [*Journal*] had been victimized by Winans and his cohorts.'"<sup>72</sup>

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65. *Id.* at 659.

66. *Id.*

67. The facts of *Chiarella v. United States* offer an example. 445 U.S. 222 (1980). In that case, the mark-up man for a financial printer learned the identities of takeover targets in advance of the market. *Id.* He then profited on this nonpublic information by purchasing shares in the target companies in advance of the public announcements. *Id.* at 224. Though the Supreme Court had not recognized the misappropriation theory at the time *Chiarella* was decided, these facts would support liability under the misappropriation theory because *Chiarella* breached a duty of trust and confidence to his employer in using the information to trade. *Id.* The facts in *O'Hagan*, the case in which the Court expressly recognized the misappropriation theory, involved a partner's misappropriation of information concerning a takeover bid from his law firm. *O'Hagan*, 521 U.S. at 648. Based on this nonpublic information, O'Hagan acquired positions in the target company and profited by over four million dollars when the takeover was announced. *Id.*

68. 484 U.S. 19 (1987).

69. *Id.* at 22-23.

70. *Id.* at 23.

71. *Id.* *Carpenter* was convicted under federal mail and wire fraud statutes, as well as under the misappropriation theory of Section 10(b) liability. On appeal, the Supreme Court was evenly divided with respect to the convictions pursuant to the misappropriation theory of 10(b) liability. *Id.* at 24. Thus, while the lower court's judgment was affirmed, the misappropriation theory did not become Supreme Court precedent until *O'Hagan* was decided ten years later.

72. MACEY, *supra* note 1, at 65-66 (quoting Pitt & Shapiro, *supra* note 2, at 240-41, n.388).

#### D. Victim of Third-Party Insider/Outsider Trading

What I shall refer to as “third-party” insider or outsider trading occurs where the violation of fiduciary or similar duty of trust and confidence that makes the trading fraudulent is committed against someone other than the trader’s employer or shareholders in the trader’s firm. Third-party traders are sometimes tippees, who may be held derivatively liable under either the classical or misappropriation theories of liability.<sup>73</sup> But third-party traders might also be directly liable under the misappropriation theory where they trade in violation of a fiduciary or similar duty of trust and confidence to a third party.<sup>74</sup> For purposes of this Article, I am only concerned with third-party traders whose trading might somehow be interpreted as being within the scope of their employment and for the benefit of their employer under *New York Central*.<sup>75</sup> Third-party traders fitting this description are typically employed within the financial industry.

Imagine that Timmy, a trader for the hedge fund ABC Capital, pays an insider at Big-Strike Mining Corporation for material, nonpublic information concerning the company’s recent discovery of a major gold deposit in North Dakota. Timmy purchases all the ABC shares he can get his hands on for ABC Capital. ABC makes millions after the announcement, and Timmy receives a generous bonus. Who are the victims of Timmy’s insider trading? As explained above, under the classical theory, the counterparties to the trading are the victims, and under the misappropriation theory, Big Strike is the victim. ABC Capital is not a victim under either theory. Moreover, Timmy’s trades benefited ABC and were squarely within his scope of employment under *New York Central*. Consequently, by contrast to the trading analyzed in Parts IV(A),<sup>76</sup> IV(B),<sup>77</sup> and IV(C)<sup>78</sup> above, holding ABC Capital derivatively

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73. See, e.g., *Dirks v. SEC*, 463 U.S. 646, 659–60 (1982) (discussing tippee liability). Though *Dirks* addressed tipper/tippee liability under the classical theory, subsequent cases make it clear that the same derivative liability applies in the misappropriation context as well. See, e.g., J. Kelly Strader, *(Re)Conceptualizing Insider Trading*, 80 BROOK. L. REV. 1419, 1435 (2015) (applying *Dirks* to misappropriation cases).

74. The recent indictment of Tiger Asia Management LLC offers an example. See, e.g., David Voreacos, *Tiger Asia Admits Guilt in \$60 Million Court Settlement*, BLOOMBERG (Dec. 13, 2012), <http://www.bloomberg.com/news/articles/2012-12-12/tiger-asia-management-hedge-fund-said-to-plan-guilty-plea>.

75. For example, even under the most liberal interpretation, the *New York Central* test would not license derivative corporate liability for Dunkin’ Donuts when one of its employees trades in Apple shares based on an illegal tip from an insider at Apple.

76. *Supra* Part IV(A).

77. *Supra* Part IV(B).

78. *Supra* Part IV(C).

liable under Section 10(b) for Timmy's insider trading does *not* suffer the irony of holding the victim liable for the crime.

Moreover, consider the ABC Capital example above in light of the policy considerations informing *New York Central*. Despite the risk that corporate criminal liability will often punish innocent shareholders for the crimes of the firm's employees, the Court held that such liability was warranted where, absent the incentives for self-regulation imposed by the threat of corporate criminal liability, there would be no other effective means of protecting the public from morally hazardous incentives set by the corporation.<sup>79</sup> This is precisely the situation presented by third-party trading through hedge funds like ABC Capital and other financial service firms. The recent example of SAC Capital and its founder Steve Cohen (dubbed "the king of hedge funds"<sup>80</sup>) is instructive.

As Professor Joan MacLeod Heminway puts it, in "terms of actual knowledge, SAC's business model may have kept Cohen purposefully in the dark about the origins of information possessed by his analysts and traders."<sup>81</sup> When you combine SAC's strict stated policy against insider trading and large compliance department<sup>82</sup> with its extensive use of "expert networks"<sup>83</sup> and the "mosaic theory"<sup>84</sup> to inform trading decisions, Cohen, the firm's principal, may have constructed a virtually impregnable institutional shield of plausible deniability. From behind this shield, Cohen was then free to pressure and lavishly incentivize SAC's traders to "develop an edge with information that no one else had" or risk termination.<sup>85</sup> Heminway suggests that the doctrine of willful blindness might offer an avenue to tippee liability for principals like Cohen, but its "elements may be difficult for public and private enforcement agents to prove. And the relevant facts may be easy to manipulate to the advantage of putative tippees."<sup>86</sup> The result at SAC was that, though a number of employees were indicted and convicted

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79. *N.Y. Cent. & Hudson River R.R. Co. v. United States*, 212 U.S. 481, 495-99 (1909).

80. Frances E. Chapman, Marianne Jennings & Lauren Tarasuk, *SAC Capital: Firm Criminal Liability, Civil Fines, and the Insulated CEO*, 4 AM. U. BUS. L. REV. 441, 443 (2015).

81. Joan MacLeod Heminway, *Willful Blindness, Plausible Deniability and Tippee Liability: SAC, Steven Cohen, and the Court's Opinion in Dirks*, 15 TRANSACTIONS TENN. J. BUS. L. 47, 51 (2013). Heminway goes on, "[I]t may be that fund principals like Cohen can construct an information gathering and trading operation that relies on the willful blindness of the principals, enabling them to avoid insider trading liability as tippees." *Id.* at 54.

82. Chapman, Jennings & Tarasuk, *supra* note 80, at 447.

83. Heminway, *supra* note 81, at 50.

84. CHARLES GASPARINO, *CIRCLE OF FRIENDS* 94 (2013).

85. *Id.* at 206.

86. Heminway, *supra* note 81, at 56.

of insider trading, Cohen was effectively “untouchable.”<sup>87</sup> As other scholars put it, the law allows someone like Cohen “to set up an operation in which they shield themselves from liability. They can pay their fines, pay their employees’ legal fees, and still have a corporation left to manage their personal fortune.”<sup>88</sup> It turned out that the only way to penetrate this “tight-knit circle of greed”<sup>89</sup> and reach Cohen himself was to indict SAC Capital, and the DOJ did just that in July of 2013.<sup>90</sup> It is precisely this type of situation that the Supreme Court had in mind when it recognized corporate criminal liability in *New York Central*. In sum, if corporate criminal liability for insider trading is ever justified, it is justified in these circumstances where a firm’s employees are engaged in third-party insider or outsider trading.

## V. PROPOSED REFORMS

To this point, I have argued that corporate criminal liability for true insider trading under the classical theory,<sup>91</sup> true insider trading under the misappropriation theory,<sup>92</sup> and source-employee outsider trading under the misappropriation theory leads to the absurd result of punishing the victim for the crime.<sup>93</sup> Moreover, recognizing corporate criminal liability in these three circumstances is inconsistent with the broader policy goals motivating *New York Central*.<sup>94</sup> But not all corporate criminal liability is problematic. The victim of third-party trading for a financial services firm is always someone outside the firm (the counterparty or the third-party source of the information). There is therefore no obvious incoherence in punishing the corporation for the employee’s crime.<sup>95</sup> Moreover, in some cases a corporate criminal indictment may be the *only* effective means of checking third-party tippee trading that is encouraged by a hedge fund or other financial

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87. Chapman, Jennings & Tarasuk, *supra* note 80, at 445.

88. *Id.* at 459.

89. *Id.* at 448 (quoting U.S. Att’y Preet Bharara).

90. *Id.* at 443–44.

91. *Supra* Part IV(A).

92. *Supra* Part IV(B).

93. *Supra* Part IV(C).

94. *See generally* N.Y. Cent. & Hudson River R.R. Co. v. United States, 212 U.S. 481 (1909) (holding that the corporation should be liable for the acts of its agents).

95. I say no “obvious” incoherence to account for the arguments of Hasnas and Velasquez (above) that all corporate criminal liability is problematic at least in part because it involves the punishment of innocent shareholders. *See generally* Hasnas, *supra* note 3 (discussing the morality of corporate criminal responsibility). Indeed, David Cohen reportedly complained that he, as principal shareholder for SAC Capital was forced to pay more than one billion dollars in fines “for the actions of what he calls ‘rogue employees.’” Chapman, Jennings & Tarasuk, *supra* note 80, at 460.



services firm's morally hazardous incentive structure. This is particularly true where the high-level architects of the firm's incentive structure are themselves effectively immune from insider trading liability, and this is precisely the concern that motivated the Court's recognition of corporate criminal liability in *New York Central*.

Consistent with these conclusions, this Article proposes the following reforms, though there is no space to develop them here. Statutory constraints should be placed 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. This proposed reform would, of course, still leave all employees individually liable for their illegal insider trading.

I anticipate the objection that this is all much ado about nothing in that corporations are rarely indicted for insider trading, and, when they are, it is precisely the firms I have suggested that are legitimate targets. Prior to the 1988 indictment of Drexel Burnham Lambert, only individuals had been indicted for insider trading.<sup>96</sup> Since then, very few firms have been indicted for insider trading, and most of those that have been indicted would be legitimate targets even if the proposed reform were implemented.<sup>97</sup> But this only tells half the story. Prosecutors are mindful of the often disastrous, and therefore politically harmful, collateral consequences of a corporate indictment.<sup>98</sup> Experience has taught them that the mere threat of an indictment gives them all the 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. The recent increase in Deferred Prosecution Agreements and the recent Yates

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96. See FIRST, *supra* note 5, at 159. This indictment, and other events surrounding it, ultimately led to the firm's collapse in 1990. For a brilliant account of this, see STEWART, *supra* note 55.

97. See, e.g., *United States v. Teicher*, 987 F.2d 112 (2d Cir. 1993) (third-party investment firm); *United States v. Marcus Schloss & Co., Inc.*, 724 F. Supp. 1123 (S.D.N.Y. 1989) (third-party brokerage firm); *Voreacos*, *supra* note 74 (third-party hedge fund); see also *United States v. S.A.C. Capital Advisors, L.P.*, No. 13 Civ. 5182, 2013 WL 5913921 (S.D.N.Y. Nov. 5, 2013) (third-party hedge fund).

98. *Supra* note 55. The downfalls of Arthur Anderson and Drexel Burnham Lambert offer recent examples.

Memorandum are clear reflections of this strategy. As Professor Hasnas puts it,

It has become apparent that the purpose of corporate criminal liability is not to punish corporations, but to force them to cooperate in the prosecution of their employees. This is evidenced by the constantly increasing number of federal criminal investigations of business organizations that end in Deferred Prosecution Agreement coupled with a constantly decreasing number which end with corporate indictments and convictions. It is anachronistic to think of the purpose of corporate prosecution as the imposition of punishment upon conviction. Today, it is corporate indictment that is the punishment and lack of cooperation that is the offense.<sup>99</sup>

The mere threat of indictment for the insider trading of its employees has forced issuers to adopt overbroad insider trading compliance programs that come at a heavy price in terms of corporate culture, cost of compensation, share liquidity, and cost of capital.<sup>100</sup> Moreover, recent criminal investigations of employee use of Exchange Act Rule 10b5-1(c) trading plans<sup>101</sup> have also put issuers on the defensive concerning the possible insider trading of their employees.<sup>102</sup> This Article has suggested that *any* leverage derived by prosecutors from (1) the threat of indicting issuers for the insider trading of their employees under either the classical or misappropriation theories, or (2) from the threat of indicting source-companies for the insider trading of their employees under the misappropriation theory, is illegitimate.

## VI. CONCLUSION

The Court in *New York Central* recognized that “there are some crimes, which in their nature cannot be committed by corporations.”<sup>103</sup> This Article has suggested 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

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99. Hasnas, *supra* note 3, at 1354.

100. See generally Anderson, *Solving the Paradox of Insider Trading Compliance*, *supra* note 49 (explaining the costs and issues associated with insider trading compliance programs).

101. 17 C.F.R. § 240.10b5-1(c) (2014).

102. See, e.g., John P. Anderson, *Anticipating a Sea Change for Insider Trading Law: From Trading Plan Crisis to Rational Reform*, 2015 UTAH L. REV. 339 (2015) (discussing the vast amount of change that has occurred within the area of insider trading).

103. N.Y. Cent. & Hudson River R.R. Co. v. United States, 212 U.S. 481, 494 (1909).

absurd result of punishing the victims for the crime. Prosecutors should, however, continue to enjoy discretion to hold corporations liable for the third-party insider or outsider trading of their employees. Finally, the reforms proposed here would not affect individual liability for insider trading under any theory.