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What Were They Thinking? State of Mind Puzzles in Insider Trading

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ABSTRACT: Insider trading law is famously incoherent, the well-recognized product of its piecemeal creation by the judiciary rather than Congress or (with exceptions) SEC rulemaking. Asking what the insider or tippee was thinking is both a doctrinal inquiry and an expression of exasperation aimed at those whose trading doesn’t seem worth the risk. This essay seeks to situate state of mind questions as they address both reasons for asking, and to show that the case law on the subject is even more puzzling than generally thought.

1. INTRODUCTION

There is ample disagreement among lawmakers, practitioners, and academics about whether, when, and why insider trading should be proscribed. To be sure, most insider cases brought by the SEC are run-of-the-mill in terms of existing precedent, and do not require judges to dig deeply in the doctrinal weeds. But often enough, we encounter puzzles in the law that are reminders of how elusive its first principles can be.

Many of these puzzles are about the necessary state of mind of the insider trader (or tipper) for there to be civil or criminal liability. “What were they thinking?” can therefore be thought of initially as a legal question to be answered in a court of law. If the insider trading

* Thomas Aquinas Reynolds Professor of Law, Georgetown University Law Center. Copyright, 2022, by the author. This is a substantial revision of my chapter on the same subject in Stephen M. Bainbridge, Ed., Research Handbook on Insider Trading 52 (2012). This revised chapter is to appear in the forthcoming second edition of this HANDBOOK.

2 For an amusing but still instructive review of the economics of insider trading via a fictional trial disputing the harms and benefits of insider trading and its regulation, see Utpal Bhattacharya, Insider Trading Controversies: A Literature Review, in 6 ANN. REV. FIN. ECON. 385 (2014).
prohibition is motivated by the belief that insider trading is inherently abhorrent and abusive, enforcement cases should be looking for evidence of deliberate, wrongful abuse of material nonpublic information (“MNPI”). But cases amply arise where the defendant concedes the fact of trading but denies its wrongfulness, responding to the prosecution by offering an innocent internal account for why it happened. Who then has the burden of proving wrongfulness in the face of such counterfactual claims, and what is the default? The challenges get even harder in tipping cases, where judges or juries must assess the state of mind of both tipper and tippee, whose guilty knowledge may differ depending on their relationship and the route the trading advantage took in moving from an insider to—directly or indirectly—one or more recipients. On this, the law here has wobbled back and forth, noticeably so since 2012. We survey the current state of these quandaries in Part 2.

What we discover is a surprisingly large amount of doctrinal confusion and inconsistency, which is troubling given how much judicial effort has gone into fashioning the law of insider trading for such a long time. But it is the peculiar nature of these disagreements that justifies an especially close look at state of mind in insider trading. Almost all insider trading cases are brought under Rule 10b-5, adopted pursuant to the SEC’s rulemaking authority granted by Section 10(b) of the Securities Exchange Act of 1934. As a result of a pivotal Supreme Court decision handed down before the Court ever had a chance to address insider trading, Rule 10b-5 requires proof of scienter, something akin

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7 Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). One question that courts largely ignore is which of the three prohibitions in the text of Rule 10b-5 bars insider trading, and why? The implicit assumption is (a) (proscribing devices, schemes and artifices to defraud), and/or (c) (acts and practices that operate or would operate as a fraud or deceit. Neither fits particularly well, but (b) by all accounts fits not at all. The best answer is (c), on the simple but questionable assumption that a duty to abstain or disclose is sufficiently deceptive to operate as a fraud. By contrast, most cases not involving insider trading are decided under subsection (b), which involves false or misleading statements and to which scienter applies most easily. See Lorenzo v. SEC, 139 S.Ct. 1094 (2019). *Hochfelder* based its finding of a scienter requirement on the statutory rulemaking authority to proscribe manipulative or deceptive devices or contrivances, which does not easily support an insider trading prohibition either.
to intentionality or bad faith. Lower courts have subsequently added recklessness as an acceptable form of scienter.

So, shouldn’t state of mind standards for insider trading simply mirror the scienter requirement? As we shall see, some courts do just that. The surprise is how many times doctrinal moves that involve state of mind are not so grounded but are instead sui generis to insider trading. The often-unarticulated judicial motivation here seems based on distinctiveness of insider trading from forms of securities fraud involving false publicity or face-to-face deceit. As many have pointed out, the kind of deception we look for in conventional fraud cases simply cannot be found in insider trading. If so, then it would be unwise to let the scienter case law developed as part of that body of case law play too big a role in insider trading cases. But since scienter always applies under Rule 10b-5, we end up with two different state of mind directives, which often do not cohere.

There is another, more exasperated reason to ask the “what were they thinking” question besides assessing guilt or innocence. As a practical matter, given the state of insider trading law and potential penalties for violation, why do people risk these penalties in the first place? The evidence is that the volume of trading in advance of the release of material nonpublic information is considerable, some of which is surely unlawful. Of course, traders may be making a cold calculation based on little likelihood of detection, but so many cases seem to fail even the rational basis test for taking the chance. Interviews and testimonies by insider traders themselves often suggest how easy it is to rationalize the taking of trading or tipping opportunities in the moment of temptation, so that the risk of sanction and perception of wrongfulness exit from consciousness altogether or are shaded to near-nothing. We survey this territory in Part 3. Finally, Part 4 turns to the intersection between the doctrinal tussles and what might really be going on in the mind of the insider when the violation happens.

2. WHAT WERE THEY THINKING? LEGAL ISSUES

Suffice it to say that the Supreme Court was not being its textualist self when it found insider trading consistent with Section 10(b) and Rule 10b-5: as I have said elsewhere, by the time Chiarella was decided, “[i]nsider trading had already taken on an expressive value far beyond its economic importance, which judges were reluctant to undercut.” Langevoort, Fine Distinctions, supra, at 433.
2.1 Traders

2.1.1 Possession versus Use

We turn first to a long-standing puzzle. The intuitive definition of insider trading is when a person duty-bound to respect the confidential nature of MNPI takes advantage of that information by buying or selling stock for a profit. To take advantage of means that the information was the reason or motivation for the trading, i.e., there was a causal relationship between the receipt of the information and a profitable trade. This idea is expressed in the familiar phrase that the insider traded “on the basis” of the MNPI, intentionally using the information to his or her personal benefit.\(^8\)

The earliest insider trading cases disagreed about what burden if any the SEC or criminal prosecutors had with respect to the misuse of MNPI, as opposed to its simple possession.\(^9\) Eventually, the SEC came to insist that possession suffices, on the inference that a tight-enough coupling between the receipt of the information and a significant trade means it is highly likely that the information was the basis for the trade and that substantial mischief could follow from letting the defendant pursue the claim that he or she would have traded anyway, even without

\(^8\) See Allan Horwich, Possession versus Use: Is There a Causation Element in the Prohibition on Insider Trading? 52 BUS. LAW. 1235 (1997). The “use” test is sometimes referred to as a causation standard, in the sense that receipt of the MNPI causes the transaction in the mind of the alleged insider trader. This is not to be confused with the causation test under Rule 10b-5, which focuses on victims being misled by false information and trading consequently. Neither the SEC nor criminal prosecutors must prove the latter form of causation. Lawmakers wrestle with this issue around the world, not just in the U.S. See Hui Huang, The Insider Trading “Possession versus Use” Debate: An International Analysis, 34 SEC. REG. L.J. 130 (2006).

\(^9\) In the early 1970s, financial institutions feared that they would be held liable for insider trading if a person in, say, the investment banking department of the firm learned MNPI from a client of the firm; while meanwhile, the portfolio managers—without having learned of the information—in the mutual fund or proprietary trading arm of the firm happened to buy or sell the stock. The information wasn’t used in making the trades. Concern about this outcome led to the first demands in litigation that a “use” test conformed better to the realities of securities research and securities trading in multi-service firms than one based simply on possession, to which the SEC initially seemed sensitive. See In the Matter of Investors Management Co., 44 S.E.C. 643 (1971).
the information. It eventually received a boost in dicta from a Second Circuit decision, *United States v. Teicher*,\(^\text{10}\) where the court said:

> Because the advantage is in the form of information, it only exists in the mind of the trader. Unlike a loaded weapon, which may stand ready but unused, information cannot lay idle in the human brain. The individual with such information may decide to trade upon that information, to alter a previously decided-upon transaction, to continue with the previously planned transaction, to continue with a previously planned transaction even though publicly available information would now suggest otherwise or simply do nothing . . . . As a matter of policy, then, a required of causal connection between the information and a trade could frustrate attempts to distinguish between legitimate trades and those conducted in connection with insider trading.

This justification for a possession standard contains clear echoes of concern about trading with an informational advantage, stemming from the 1970s era cases that embraced the need for flexibility in the law to even the playing field. Following *Teicher*, the Second Circuit (where most insider trading cases are litigated) has consistently embraced the possession test as the law of the circuit.\(^\text{11}\)

That was a pragmatic move, and the court in *Teicher* distanced itself from claiming that the possession test was based in the law of scienter. Some insider trading defendants began to argue that even though they might have learned MNPI in a fiduciary capacity, the trade would have occurred anyway because a determination had been made to buy or sell before the information was received. For example, in *SEC v. Adler*,\(^\text{12}\) the defendant claimed that the adverse information about the issuer that he received as a corporate director was irrelevant because he planned to sell the stock in question to raise funds to help his son go into the long-haul trucking business. Or perhaps an insider had an estate planning reason for the trade.

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\(^\text{10}\) 987 F.2d 112 (2d Cir. 1993). *Teicher* is interesting in that it grounds the possession test in the “in connection with the purchase or sale of a security” language in Rule 10b-5, and not the scienter requirement. Other courts have described that relationship as hard to make sense of.

\(^\text{11}\) See Steginsky v. Xcelera Inc., 741 F.3d 365 (2d Cir. 2014); United States v. Royer, 549 F.3d 886 (2d Cir. 2008). Interestingly, however, prosecutors in the Second Circuit seem to acquiesce in jury charges that make causation an issue in the determination of guilt, albeit one easily satisfied. See United States v. Rajaratnam, 719 F.3d 139 (2d Cir. 2013); United States v. Steinberg, 21 F. Supp. 3d 309 (S.D.N.Y. 2014).

\(^\text{12}\) 137 F.3d 1325 (11th Cir. 1998).
In *Adler*, the Eleventh Circuit took a middle ground approach to this, seemingly grounded in the scienter requirement. The court said that actual misuse was required, so that a defendant would be able to avoid liability by showing that the trade would have occurred anyway. That was bad news for the SEC. However, the court went on to say that the SEC could create an inference of misuse by showing possession—the burden of production would then shift to the defendant to explain that the trading involved no use of the MNPI. The factfinder would then choose between the competing explanations. Soon, a case in the Ninth Circuit, *United States v. Smith*, went a step further in a criminal prosecution to say that the government must prove that the inside information was the basis for the decision to trade without the aid of any presumption. *Smith* explicitly derived this result from the scienter requirement. These cases were not outliers, as other courts adopted some version of *Adler* and *Smith* over the next few years. While these courts have recognized the greater burden they are placing on enforcers, they stress that the question of misuse can be addressed via circumstantial inference (smoking gun evidence is not required), and that the factfinder should find liability if the factfinder determined that the inside information played any significant role in the insider’s decision to trade.

In the face of these and other decisions questioning the possession standard, the SEC adopted Rule 10b5-1 presumably to take back what it had lost. The first part of the rule effectively set the legal standard as one of awareness by the insider of material nonpublic information at the time of the trade—essentially the same as knowing possession. The impact on frequent traders was softened somewhat insofar as the rule

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13 155 F.3d 1051, 1068 (9th Cir. 1998).
14 E.g., SEC v. Lipson, 278 F.3d 656 (7th Cir. 2002). The court was strict in requiring a showing by the defendant that “only if the illegitimate purpose had no causal efficacy because the legitimate one would have caused him to sell the shares when he did and in the amount he did would the existence of the legitimate purpose be a defense.” Along the same lines, *Lipson* stresses that if there are two motives for the trading, one not dependent on the MNPI, the other based on it, liability will still ensue: the innocent will not sanitize the improper. See also SEC v. Bauer, 723 F.3d 758 (7th Cir. 2014) (“In other words, the defendant could avoid liability if he could show that he would have made the exact same trade whether or not he possessed material nonpublic information”); DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT AND PREVENTION sec. 3:13, 3:14 (2022 ed.) (collecting cases).
16 In the *Lipson* case, supra, Judge Richard Posner took note that the Rule 10b5-1 might control going forward but arguably misread the rule to be essentially a codification of the *Adler* approach (i.e, inference of use upon a showing of possession).
goes on to allow insiders to adopt so-called 10b5-1 plans, directing that a predetermined number of shares be bought or sold at some future point in time even though the insider might have MNPI in his or her possession at the time of the trade itself, so long as there was no such advantage at the time the plan was implemented or instructions given. (Controversies about whether this safe harbor was too often being abused by insiders arose almost immediately, eventually leading the SEC to make significant reforms in late 2022.\(^\text{17}\)) Finally, Rule 10b5-1(c) addresses the issue that set off the debate in the 1970s,\(^\text{18}\) providing a safe harbor that allows financial institutions to trade even if persons in other departments or affiliates of the firm are aware of inside information, so long as the information is not possessed by the portfolio traders at the time of the trade and a reasonable system of barriers exists to wall off traders from MNPI that might taint the trade with illegality.

Oddly, the adopting release for Rule 10b5-1 takes the position that the rule does not address scienter, and that scienter must separately be proved.\(^\text{19}\) This threatens to undermine the rule because a court could then say that the use test remains necessary for scienter, while possession simply satisfies the threshold for what constitutes insider trading. That cannot possibly have been the Commission’s intent, and most but not all courts have assumed that its purpose was to settle in its favor the varying standards for liability whatever the element of an insider trading case that is being addressed.\(^\text{20}\) In the 2022 release adopting substantive reforms to Rule 10b5-1(c), the Commission said explicitly that the holdout courts in the Eleventh Circuit (and presumably elsewhere) were “erroneous” in continuing to employ their


\(^{18}\) See note – supra.

\(^{19}\) “Rule 10b5-1 is designed to address only the use/possession issue in insider trading cases under Rule 10b-5. The rule does not modify or address any other aspect of insider trading law, which has been established by case law. Scienter remains a necessary element for liability under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Rule 10b5-1 does not change this.” Rel. 33-7881, Aug. 15, 2000, text accompanying notes 100-101.

\(^{20}\) E.g., SEC v. Panuat, 2022 WL 633306 (C.D. Cal. 2022). The court’s discussion of this issue is under the heading “Scienter.”
version of the use test. But the mess was something of its own making. The Commission might have lessened the problem by pointing out that scienter does not require motivation, causation or use in securities fraud cases generally, and shouldn’t in insider trading cases either. In fact, an awareness standard prevails in false publicity cases—i.e., a person acts with scienter if he knows (or recklessly disregards, see below) that what he or she was saying is false, regardless of the motivation for the lie.

So, what should the law be? The answer is a trade-off between the risk of a false negative (-dismissing an enforcement action because the factfinder believes the lawful trading story) and the chilling effect on lawful trading for fear that a lawful trading story won’t be believed. I am suspicious of misuse of the use standard, but as courts have applied it, the risk is not great so long as they keep in mind it is not enough for the defendant to claim he or she was thinking of trading but hadn’t yet done so until the final bit of MNPI was received. That is still a form of “use.” In criminal cases the use standard seems right. Remembering that insider trading really isn’t deceptive but is allowed—for good reasons—to be treated as if it is, the working definition of insider trading should be about violating expectations of faithfulness, exploiting privileged access, and taking advantage of others: active verbs connoting deliberation beyond mere awareness.

2.1.2 Reckless or Negligent Insider Trading

As in the previous discussion, courts in insider trading cases sometimes borrow from the scienter requirement generally to impose a more exacting standard for enforcers to satisfy. Other times, scienter precedent is invoked to expand the scope of liability. The non-insider

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21 “The decision in Fried v. Stiefel Labs., Inc., 814 F.3d 1288, 1295 (11th Cir. 2016), erroneously suggests that a person must ‘use’ the inside information to purchase or sell securities, but the court did not address Rule 10b5-1 in that private action.” Rel. 33-11013, supra, at n.9.


23 In a thorough study of the possession versus use debate, Andrew Verstein concludes that neither gets the standard right. He recommends a “primary” motivation test that compares the relative potency of the lawful independent grounds for trading against the influence of the unlawfully used inside information. Verstein, Mixed Motives, supra.

24 Langevoort, Fine Distinctions, at 440.
trading case law under Rule 10b-5 recognizes (though the Supreme Court has never so held) that scienter can be established by showing recklessness on the part of the defendant. Though there is still some judicial disagreement about what recklessness means, a common articulation asks whether the defendant acted with a subjective awareness of the risk that what was said was untrue, even if he or she did not know that it was false.

Does recklessness have a place in the law of insider trading? This is a lively issue in tipper-tippee cases, discussed infra, where the answer seems to be yes. Where the insider is the trader, one can imagine situations reminiscent of the Martha Stewart case, discussed infra, where the defense is raised that the defendant failed to appreciate (or misunderstood) that the information that he or she possessed or used was either material or nonpublic. Recklessness could be a sensible standard against which to test whether that misappreciation, assuming it was genuine, offers a good defense.

Where such disregard is careless rather than reckless, Rule 10b-5 does not apply and thus offers a potential defense to insiders who claim that they mistakenly failed to appreciate the MNPI in their possession. The remaining possibility for SEC enforcers is to invoke Section 17(a)(3) of the Securities Act of 1933, which has been interpreted to require negligence for liability.

There have been occasional SEC cases that invoke 17(a)(3) for liability, but usually as part of an uncontested settlement with the defendant such that scope issues are never litigated.²⁵ Cases discussing this statutory alternative are rare. Certainly, pleading a case before a judge or jury that concedes the possibility that the violation was only a matter of inadvertence takes away the “good versus evil” staging that SEC enforcers and criminal prosecutors like to project in their arguments. And there is a statutory hurdle—Section 17(a) applies to the offer or sale of a security, not purchases. Hence, only insider selling cases (i.e., motivated by bad news) fit in this remedy. Marc Steinberg and Abel Ramirez have recommended a statutory amendment for Section 17(a)(3) that would expand its scope to purchases as well, discussing insider trading cases that would have been possible to bring.

successfully with the statute so amended. To this point, government enforcers do not seem all that anxious to use negligence as anything more than a back-up argument against defendants who offer a simple foolishness explanation.

2.1.3 Issuer Repurchases

Another high visibility puzzle has to do with issuer repurchasers when the issuer is in possession of MNPI. The issuer can only “know” information if that knowledge is attributed to it via the knowledge of its officers and employees. The test for attribution is not clear as a matter of law, nor its nexus with the decision to authorize the repurchases. But there is a bigger problem: corporations are not generally understood to owe a fiduciary duty to shareholders, the key to liability under the classical theory of insider trading liability. And it is not likely that repurchases would be viewed as selfish or corrupt on the part of those implementing the program—they are normally welcomed by investors. Guilty state of mind is thus quite challenging to locate. That said, the SEC and most of the handful of courts addressing the issue have concluded that issuer repurchases while in possession of or using MNPI violate Rule 10b-5, a result deriving from doctrinal fiat and a dose of common sense.

2.1.4 A Note on Misappropriation

Misappropriation cases are ones where enforcers claim that the trader engaged in fraud by “feigning loyalty” to the person who entrusted them with a valuable secret in the form of MNPI by trading while in possession of or using that information to their advantage. There must be a fiduciary or fiduciary-like relationship between the trader and the source. Because the resulting fraud is on the source of the information, there is no need to show any fraud on contemporaneous marketplace trades as there is under the alternative “classical”

27 See LANGEVOORT, INSIDER TRADING, supra, at 3-6.
approach to insider trading. A well-publicized case shows its wide scope particularly well, involving co-members of Alcoholics Anonymous and the use of a secret shared by an insider at a meeting.28

The state of mind issues we have already discussed, as well as the tipper-tippee conundrums yet to come, are largely the same whether the theory of the case is misappropriation or classical. Because of its expansiveness, misappropriation doctrine sometimes encounters the question of whether the defendant must understand at the time that he owes a duty of trust and confidence vis-à-vis the source, or recklessly or negligently disregards such fiduciary-like status, or whether instead fiduciary duty is a legal status used to determine deception, to which scienter is entirely distinct. The answer is unclear,29 but by and large enforcers understand that when fiduciary status is not self-evident as a matter of law, they should introduce state of mind evidence that the defendant was at least on notice that the source of the information expected the information to be kept confidential and not used for illicit profits.

2.2 Tippers and Tippees

2.2.1 Tipping

Many of the hardest puzzles in insider trading law arise out of tips, i.e., where the insider allegedly conveys MNPI to someone else

28 United States v. McGee, 763 F.3d 304 (3d Cir. 2014) (upholding conviction). A borderline case illustrating the difficulty of addressing awareness of fiduciary duty is Veleron Holding v. Morgan Stanley, 117 F. Supp. 3d 404 (S.D.N.Y. 2015). Defendant—arguing that the contractual arrangement between the two sophisticated parties disclaimed fiduciary duties—prevailed at trial, and the verdict was affirmed by the Second Circuit. Veleron Holdings B.V. v. Morgan Stanley, 694 Fed. App’x 858 (2d Cir. 2017). Entity liability for insider trading, which must by nature be addressed via attribution to and from the natural persons acting on the entity’s behalf, involves an extra layer of legal complexity drawn from agency law; those issues are outside the scope of this chapter.

29 With respect to tipping, discussed infra, SEC v. Obus, 693 F.3d 276 (2d Cir. 2012) reads Dirks to say that awareness of fiduciary-like status is within the scope of scienter, saying that “the tipper must know (or be reckless in not knowing) that to disseminate the information would violate a fiduciary duty. While the tipper need not have specific knowledge of the legal nature of a breach of fiduciary duty, he must understand that tipping the information would be violating a confidence.” Presumably, the same logic, if followed, would apply as to traders as well.
(usually an outsider) who trades, or who tips others along a chain that involves purchases or sales somewhere down the line. The framework of the law for purposes of the classical theory was established by the Supreme Court in *Dirks v. SEC*,\(^{30}\) followed by the much more recent decision in *Salman v. United States*.\(^{31}\) The so-called “*Dirks test*” creates joint tipper and tippee liability when the tipper seeks or gains a personal benefit from the tippee’s profitable trading in breach of fiduciary duty, and the tippee knows or should know of the breach. Issues of knowledge and intent are obviously connected to these inquiries, but the law here has shifted considerably in the last decade, in unexpected directions.\(^{32}\)

Initially, the answer may seem obvious. Tipping occurs when the tipper *seeks* a personal benefit in breach of the fiduciary duty of loyalty by conveying the information. Under this purposive or motivational approach, which so far as I can tell is what most judges think the law to be (and I think they are right), the personal benefit test requires the tip to be consciously self-serving, akin to bad faith.

But there are some textual obstacles. In the relevant part of the *Dirks* opinion, the language describing the relevant test for tipper-tippee liability toggles back and forth between this motivational standard and a quite different “objective” standard that looks for an actual benefit, not simply an intended one. In brief, there is a lingering ambiguity on this, for reasons that cannot be recounted simply but have to do with a disagreement between Justices Powell and O’Connor when the *Dirks* opinion was being drafted, the ambiguity is hopeless.\(^{33}\) The ambiguity is then made worse by Justice Powell’s statement that this issue raised in the case before the Court *has nothing to do with scienter*. Instead, he says, the test is being employed solely for the purpose of determining whether there was a breach of duty to abstain or disclose that would satisfy the deception requirement.\(^{34}\) There was not. Thus, the analysis stopped there, leaving a list of open questions.

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\(^{31}\) 137 S.Ct. 420 (2016).

\(^{32}\) See generally Langevoort, *Wobble*, supra.

\(^{33}\) For a thorough assessment, see A.C. Pritchard, *Dirks and the Genesis of Personal Benefit*, 68 SMU L. REV. 857 (2015); for my journey through this same territory, see Langevoort, *Wobble*, supra, at 510-15. There is little doubt from drafts written by Powell and his clerk before the O’Connor-inspired revisions that the purpose test was his preference. See also Michael D. Guttentag, *Insider Trading and Selective Disclosure*, 69 FLA. L. REV. 519 (2017).

\(^{34}\) On the tipper’s awareness that he or she is breaching a fiduciary duty, see note – supra.
As has been well demonstrated by insider trading scholars, the first thirty years of tipper-tippee case law turned out to be very enforcer-friendly, and the Dirks test coming close to being a dead letter. But then, battling broke out in the Second Circuit, which led to a dramatic turn in United States v. Newman, that was in many ways a “stealth overruling” of SEC v. Obus, the “Delphic” opinion that started the skirmish and confused other judges in the circuit. The Supreme Court handed prosecutors a win in Salman on the meaning of gift benefit, but the law has remained less stable on other key issues raised in Newman, as will be discussed shortly. As a result, enforcers have become more gun shy. We shall see some of the consequences in Part 3.

Of all the state of mind questions resolved or muddled over the last decade, one of the most interesting arises when an insider-tipper gives information to someone who is not a family member or close friend solely for the purpose of benefiting the recipient? We know from the Supreme Court’s Salman decision that when family members or friends are the recipients, a personal benefit to the tipper will be inferred because enriching important people in one’s our lives indirectly enriches the giver as well. That is more difficult to see in gifts to people we deal with at arms-length.

Most commentators deeply engaged in insider trading law had long thought that the personal benefit motive was the sine qua non for tipper-tippee liability under Dirks—quid pro quo, reputational or gift-based when family and friends are the recipients. In United States v. Martoma, the majority in a split panel decision said otherwise: that Dirks requires personal benefit or an intentional tip, so that the three categories of self-serving conveyance of MNPI are simply a circumstantial means of establishing liability if there are doubts about the alleged tipper's intentions. I was (and still am) a bit skeptical about

35 This was part of what Donna Nagy characterized as a slow demise of fiduciary duty in insider trading law. See Donna Nagy, Insider Trading and the Gradual Demise of Fiduciary Principles, 94 IOWA L. REV. 1315 (2009).
36 773 F.3d 448 (2d Cir. 2014).
38 Salman did little except say that the Dirks test could justifiably be applied to a tipping scheme among brothers, without the need for the gloss that Newman put on the meaning of tip. Perhaps of greater curiosity was the Solicitor General’s brief in Salman, which conceded several interpretive points regarding criminal liability if not liability generally under Rule 10b-5 that had never been addressed by the Supreme Court.
39 894 F.3d 64 (2d Cir. 2018).
this revisionism but a close look at the language in the *Dirks* opinion (especially the placement of a comma in the key sentence) and at Justice Powell’s file of memos and drafts in writing that opinion leads me to think that this may truly have been his intent as drafter, for what it’s worth.\(^{40}\)

Amidst all this confusion, a more straightforward question remains. Putting aside personal benefit, what does the tipper have to be thinking when the tip is given? In other words, where does scienter fit in? To be sure, we can infer a fraudulent purpose from the opportunistic nature of the benefit being sought, or if we follow *Martoma*, from the intention to benefit the recipient. Both assume the kind of deliberateness to satisfy the scienter case law. To be more precise, a common locution is that the tipper must “expect” trading by the tippee, though one prominent Second Circuit case uses the word “intend” instead.\(^{41}\) Note the nuance here—expectation may offer enforcers some greater wiggle-room when purpose is less apparent.\(^{42}\)

What about reckless tipping? In *Obus*, which set in motion so many of the wobbles of the last decade, the Second Circuit clearly invited the SEC to make recklessness claims when appropriate, at least in civil enforcement actions. In dicta, it posed a hypothetical about an insider riding in the club car of a commuter train speaking audibly on his cell phone near an acquaintance whom the insider knows to be a professional investor. Putting aside for the moment the kind of personal benefit in question, what is the right word to use in describing the conveyance of the MNPI? Without more to the story, it does not seem to


\(^{41}\) United States v. Stewart, 907 F.3d 677 (2d Cir. 2018).

\(^{42}\) As I explain elsewhere, at for much of the 1990s and early 2000s, the law in the Second Circuit was trending toward a property-based embezzlement approach to cases arising under the misappropriation theory, and in the process rejecting the personal benefit element of the *Dirks* test. With that separation, it was possible to have a more capacious approach to the meaning of “tip,” most clearly articulated by Judge Ralph Winter in United States v. Libera, 989 F.2d 596 (2d Cir. 1993); see also United States v. Falcone, 257 F.3d 226 (2d Cir. 2001). In *Libera*, Judge Winter dismissed concerns about the specific intent behind the tip, saying that it surely was “not for nothing.” Id. at 600. It was the *Obus* case that put an end to this looseness by holding that *Dirks* applies the same under both theories. See Langevoort, *Wobble*, supra, at 520. But *Obus*’ citation for this proposition was *Falcone*, which on close reading does not support its assertion. Langevoort, *Wobble*, at 521-22.
be intended to cause trading. “Expect” is a reasonable possibility but may as well be too demanding.\textsuperscript{43} Recklessness is thus needed to justify such a result, as the court suggests. The question once again becomes whether the kind of behavior described in the hypothetical is wrongful enough to deserve the insider trading caption, as well as tied closely enough to some meaningful definition of personal benefit.

2.2.2 Tippee Trading

\textit{Dirks} treats the tippee in an insider trading case as a participant after the fact of the tippers breach of loyalty, even though he or she is the one (often the only one) directly profiting from the trade. Thus, the \textit{Dirks} test for tippee liability builds off the test for tipper liability: the tippee must “know or should know” of the tipper’s breach. Under this joint test, there cannot logically be tippee liability without a breach by the tipper, but there can be tipper liability even if the tippee who trades fails the knowledge test.\textsuperscript{44} It is not entirely symmetrical.

Questions jump out right away. How much does the tippee who receives MNPI have to know about the tipper’s misconduct? Savvy tippees don’t want to know too much and may well not know anything of the circumstances of how the insider got the information or why he is passing it on. A good example was the case of \textit{SEC v. Musella},\textsuperscript{45} which involved multiple tips, which at the end of the chain meant the recipients knew little about how the information came to them—only that it was consistently high quality MNPI. They named their unknown source the “goose that laid the golden egg.” The court found sufficient evidence of awareness largely from the absence of any plausible innocent explanation, emphasizing the “should know” part of the test.

But that simply points to another issue, because “should know,” seems to be a loose, negligence-like standard. How does that square with scienter? Before \textit{Obus}, courts could not decide whether to take the “should know” language seriously or use recklessness as the exclusive

\textsuperscript{43} In a pre-\textit{Dirks} case, the Second Circuit said that “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.” \textit{Elkind v. Liggett Myers}, 635 F.2d 156 (2d Cir. 1980).
\textsuperscript{44} See \textit{SEC v. Clark}, 915 F.2d 439 (9th Cir. 1990).
\textsuperscript{45} 678 F. Supp. 1060 (S.D.N.Y. 1988).
alternative to actual knowledge, both of which are problematic. But recall Powell’s admonition in *Dirks* that the test of which this is a key part only serves as a means for determining whether there is a co-venture between tipper and tippee that establishes joint fiduciary-like responsibility. Scintion is separate, about which the Supreme Court sayeth not, then or subsequently. So *Obus* addressed the question Powell ducked: what more than or different from “know or should know” does scintion require, once we find the duty/deception test satisfied? *Obus*, in its “Delphic” ambition, seized on Powell’s dicta that as to duty and deception (i.e., what the tippee knows about the breach and personal benefit), the “*Dirks* test” suffices to establish the requisite state of mind. As the court put it:

> We think the best way to reconcile *Dirks* and *Hochfelder* in a tipping situation is to recognize that the two cases were not discussing the same knowledge requirement when they announced apparently conflicting scintion standards. *Dirks’s* knows or should know standard pertains to a tippee’s knowledge that the tipper breached a duty, either to his corporation’s shareholders (under the classical theory) or to his principal (under the misappropriation theory), by relaying confidential information. This is a fact-specific inquiry turning on the tippee’s own knowledge and sophistication and on whether the tipper’s conduct raised red flags that confidential information was being transmitted confidentially. *Hochfelder’s* requirement of intentional [or reckless] conduct pertains to the tippee’s eventual use of the tip through trading or further dissemination of the information. Thus, tippee liability can be established if a tippee knew or had reason to know that confidential information was initially obtained and transmitted improperly (and thus through deception), and if the tippee intentionally or recklessly traded while in knowing possession of that information.

This was a more forgiving test than courts had theretofore been using, and explicitly did not require particularized knowledge of how the tipper was benefiting. At the same time, *Obus* quashed the three-decade effort to limit the *Dirks* test to classical cases, not misappropriation, so lower

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46 To say that “should know” sets the boundary for liability is inconsistent with the requirement of scintion, while setting the boundary at recklessness seems to render the *Dirks* test superfluous, as if Justice Powell simply made a drafting error. That said, many cases read one way or the other. During this time, the law was also trending toward one that rejects the *Dirks* test’s applicability in misappropriation cases. One reason for this trend, no doubt, was precisely because of this incoherence.

47 This is the description given to it by Judge Jed Rakoff, who was not impressed. United States v. Whitman, 904 F. Supp. 2d 363, 371 (S.D.N.Y. 2012).

48 *Obus*, at 286.
courts had no means to escape these new strictures. That did not set well with courts now asked to apply the new restatement.

What happened next was clearly an act of defiance by a separate panel of judges, in *Newman*, as discussed earlier. There, the court gave a much stricter reading the standard for “gift benefit” under *Dirks* than was common in the case law. We can ignore that holding because, as noted earlier, the Supreme Court rejected it in *Salman*. Much more consequential was *Newman’s* test for tippee liability: the court insisted on proof that the tippee knew of the tipper’s breach, including the personal benefit. Even recklessness drops out. That language has been repeated so that now reads as authoritative.\(^{49}\)

As a result, the resulting confusion about tippee state of mind is still with us. To many commentators, the only plausible resolution is to distinguish the applicable law that applies in civil cases brought by the SEC (where *Obus* governs) and criminal prosecutions (where *Newman’s* gloss prevails). While there is dicta in both cases that might support that reading, the cases do not endorse criminal exceptionalism in any straightforward way.\(^{50}\) In Rule 10b-5 cases, the courts have simply tied themselves into knots.

2.2.3 Frozen

Andrew Verstein has explored the possibility that some conveyances of MNPI are intended by the insider to *prevent* trading by the recipient, not enable it.\(^{51}\) This would be the case if the insider feared that a large investor was about to sell a large block of stock to the issuers

\(^{49}\) To be clear, the court in *Newman* said that the details of the tip need not be known, nor even the identity of the tipper. See *Newman*, n. 3.

\(^{50}\) The First Circuit has been more transparent about this. See United States v. Parigian, 824 F.3d 5 (1st Cir. 2016). As a separate matter, the Second Circuit added to the muddles via a later holding that when criminal prosecutions are based on wire fraud or a criminal statute added in the Sarbanes-Oxley Act, the *Dirks* test does not apply at all. United States v. Blaszczyk, 947 F.3d 19 (2d Cir. 2019). But that decision was vacated on unrelated grounds by the Supreme Court. 2021 WL 78043 (S.Ct., Jan. 11, 2021). The case has not yet had a final disposition.

\(^{51}\) See Andrew Verstein, *Information Tainting: Strategic Tipping of Material Nonpublic Information*, 112 Nw. U. L. Rev. 725 (2018). If the recipient had consented not to misuse, the misappropriation theory might be invoked even if there is no tip. But even with such consent, once the source’s ruse is clear, the recipient’s trade can hardly be seen as feigning loyalty if he or she sells anyway.
or insider’s detriment. The insider would then communicate some MNPI to the outsider to freeze the outsider’s shares. Does it work? Not quite, in the sense that this is not a tip to facilitate trading in securities but to prevent it, thus failing the tipping test. Verstein recognizes the problem, but rightly points out—given the prominence of the “equal playing field” norm in insider trading law and lore—that the outsider would have to be brave to trade anyway.52

3. **Explaining Insider Trading: What *Were* They Thinking?**

The foregoing surveyed the remarkably rich—and often contested—ways in which various state of mind standards are at work in insider trading enforcement. The work of the legal system is to determine whether, collectively, the standards are met, which requires that inferences be drawn about what the defendant was thinking.

There is no reason to believe that the reality of insider trading maps particularly well onto the judicially crafted elements of the cause of action. That raises long-standing concerns about notice and due process and laments about the long-standing failure of Congress or the SEC to clarify through codification sound norms for liability. This Part will examine why insiders might tip or trade in the face of the risk of detection and sanctions that can be quite painful,53 for gains that may not seem worth that risk. When judges impose sanctions, especially jail time, they seem to want word of the risk to get out as a reminder to

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52 Verstein and a group of colleagues have also explored the non-trivial issue of the insider trading consequences associated with charitable contributions of stock. See S. Burcu Avci et al., *Insider Giving*, 71 DUKE L.J. 619 (2021). That occurs when an insider gives stock to a charity (thereby receiving tax benefits for the contribution) about which the insider knows MNPI. The charity then sells the stock without ever having been told the confidential information. So we have no actual tip, but a constructive one based on the insider’s pecuniary motivations. Prompted by this research, the SEC seems to think that abusive gifting of this sort is a 10b-5 violation, though its main strategy would be to force more disclosure of gifts by high-level insiders and insist that issuers monitor more closely for evidence of abuse.

future traders by threatening hellfire to the greedy. But the reality is much more complicated.

3.1 Rational Choice

There is no good reason to doubt that much of the insider trading that exists is simply based on the conscious assessment or gut feeling that insider trading is commonplace and the probability of detection and significant sanction low. Various estimates have been made to support the inference that non-sanctioned insider trading far exceeds that which is detected and sanctioned. Partly, this is the product of limited regulatory resources. The SEC and criminal prosecutors bring roughly 50-60 insider trading cases in a year, with offices stretched thin. Michael Perino observes that cases against truly sophisticated traders are rare; they, he suspects, know how to hide their trading by a variety of strategies (options in particular) that evade the stock trading-based surveillance systems that regulators have at their disposal. Even when the evidence is suspicious, some of the legal norms discussed in Part 2 (e.g., looking for evidence of unexpected trading patterns as evidence of misuse) operate in the professionals’ favor. Consistent with this, there is empirical evidence that sophisticated traders are sensitive to unexpected doctrinal and enforcement shifts that cause changes in their behavior. For example, a close look at trading during the hedge fund prosecutions of the early 2010s saw a drop in aggressive trading when more assertive Preet Bharara took over the U.S. Attorney’s office in the Southern District of New York, and an increase when the surprise Newman decision was handed down by the Second Circuit.

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56 Vinay Patel & Talis Putnins, How Much Insider Trading Really Happens in Stock Markets? available at SSRN 3764192 (2021) (estimating that the ratio of unprosecuted to prosecuted insider trading at 4:1 and that the detection rate is 15% for common types of insider trading).
57 See Perino, supra, at 1705-06.
interesting empirical study of insider trading networks show that the professionals position themselves at least three steps removed from the original tip, at which point the lingering effect of the *Newman* case keeps them reasonably safe.59

For less sophisticated persons who come into possession of MNPI about some unexpected deal, it is not hard reasonably to underestimate the probability of detection and liability. For example, many potential traders believe that if they trade in relatively small amounts or only a few transactions, they will be of no interest to enforcers. But it is not unusual for small traders to get caught up in an investigation where there are bigger fish of primary interest. The SEC also goes after the smaller fish identified by the same means, just to show that no one is outside the Commission’s reach. Both the SEC and FINRA have invested considerable resources in artificial intelligence and related “big data” surveillance mechanisms that are not well known to average businesspeople, much less their friends and family who get sucked into an effort to conceal.

Along the same lines, there are misperceptions about the law of insider trading. Ordinary insiders often seem to think that information is material only if it represents a “sure thing,” whereas the law is clear that even speculative inferences can taint information that has come into their possession because of the advantage they confer. As well, it is very easy to think that information is public when financial or social media is speculating on some imminent event; the insider who knows the inside story about the same matter often has a trading advantage even as to a matter already of considerable public interest. These are not unreasonable beliefs, even if incorrect as a general matter, where it is costly to become better educated about the law and the value of such knowledge minimal except in unusual circumstances.

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59 See Ahern, supra, at 28–29. He points out that information tends to flow “from subordinates to bosses, from younger tippers to older tippees, and from children to parents.” Id. at 28. This status-driven and trust-based networking provides a first layer of protection from detection, though illicit transactions can increasingly be spotted with the aid of sophisticated computers. On the signals given off by insider trading visible to even human surveillants, see Thomas Stockl & Stefan Palan, *Catch Me If You Can: Can Human Observers Identify Insiders in Asset Markets?* 67 J. ECON. PSYCH. 1 (2018).
In assessing the rationality of insider trading, we need not assume that its benefits are entirely monetary.\(^6^0\) On the softer end, trading and (especially) tipping can produce various forms of utility: excitement, ego satisfaction, status, the hope that favors will be repaid, etc.\(^6^1\) The law of tipper liability discussed earlier in this Chapter maps onto this well. There are pecuniary benefits in some situations, reputational in others, and the psychic satisfaction of making a gift. This is the reason I am sympathetic to the Martoma case. The utility function is capacious enough to include the satisfaction of secretly claiming dominion over someone else’s proprietary information; the law of fiduciary duty plainly forbids such disloyalty. There is no good reason to draw an artificial line at friends and family where there is an intentional tip, or even a consciously reckless one. Where there is no plausible business (i.e., source-regarding) reason for a tip, the work of the motivational inquiry is done.

3.2 Self-Deception and the Triangle of Fraud

A common way of approaching white-collar crime is via the “triangle of fraud,” which predicts misbehavior based on the degree of opportunity, means, and rationalizations.\(^6^2\) As applied to insider

\(^{60}\) An interesting empirical study takes up the foregoing discussion, hypothesizing that relatively more insider trading will be undertaken by “poorer” insiders than “richer” ones, because the former have less to lose by taking the chance. Finding to their surprise that this was not true, they conclude that something other than wealth-maximizing gambles are at work. See Utpal Bhattacharaya & Cassandra Marshall, Do They Do It for the Money? 18 J. Corp. Fin. 92 (2012).

\(^{61}\) See Cheat Sheet: Insider Trading, N.Y. Times Mag., May 6, 2018, at 39, where a tippee/tipper in the high level hedge fund scandal involving Raj Rajaratnam describes how carefully she cultivated her sources—“insider traders try to be casual and friendly; people are more easily persuaded to share if they are made to feel powerful, wanted, and included in the upper echelon of financial society.” Ahern, supra, at 28, adds the observation that patterns in the insider trading networks he examined reveal “that social hierarchies may lead lower status tippers to try to win favor with higher status tippees.”

trading, opportunity can be rare or frequent, but almost always tempting. The means are usually simple: trading itself is easy, though it may take some care to anticipate and avoid detection, as just discussed. Given that, the likelihood of insider trading is heavily influenced by the insider’s ability to rationalize conduct that may be unlawful, making it feel right to take the opportunity. Many explanations for the incidence of insider trading make this their focal point. In recent years, the field of behavioral ethics has deepened our understanding of the circumstances in which self-deception thrives.

Two well-known insider trading stories pose the “what were they thinking” question quite poignantly. The first was at the heart of the hedge fund trading scandals from a decade ago, involving trading by Raj Rajaratnam, a successful private portfolio manager. A core allegation involved a tip by Rajit Gupta, a well-known management consultant who sat on Goldman Sachs’ board of directors during the financial crisis, when even institutions like Goldman were at risk. Gupta learned that a private infusion of capital was forthcoming from Warren Buffett—good news for Goldman. Shortly after learning this, Gupta tipped Rajaratnam, who traded accordingly.

Why? There was no evidence of any pecuniary benefit involved: Gupta made not a penny from the conveyance. He was a wealthy, honorable, sophisticated businessperson amply on notice of the norms of board confidentiality and the basics of the law of insider tipping and trading by corporate directors. What he didn’t know is that the phone was tapped. Eventually, both Rajaratnam and Gupta were tried, convicted, and sent to jail, with the courts determining that the Dirks test was met mainly by the close relationship the two had developed.

At sentencing, Judge Jed Rakoff was troubled, and struggled to make sense of the facts. He found Gupta near-saintly for his charitable activities other good works. There had been no tangible harm shown to the victim, Goldman Sachs, even though what Gupta did was clearly

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63 United States v. Gupta, 904 F. Supp.2d 347 (S.D.N.Y. 2012). See also Haugh, supra, at 3150-55. Soltes, supra, looks at another set of tips from Anil Kumar to Rajaratnam, which predictably increased in specificity and value from beginning to end, and notes how carefully Rajaratnam played to Kamar’s sense of self-worth and competitiveness by suggesting that he wasn’t necessarily earning his compensation compared to his other sources: “If Rajaratnam had simply asked Kumar to give him proprietary information his client during the initial conversation, Kumar would almost certainly been taken aback and declined.” SOLTES, supra, at 145.
wrong. Yet the Sentencing Guidelines before him pointed to a lengthy jail sentence based largely on Rajaratnam’s profits. He balked and gave the lowest sentence he could (a not inconsiderable two years) within the framework. The best he could do was to speculate that the relationship with Rajaratnam had become “an avenue to future benefits, opportunities and even excitement,” the latter a way of escaping the straitjacket of responsibilities that had come to dominate his life.\footnote{904 F. Supp.2d at 354. See also LANGEVOORT, SELLING HOPE, supra, at 80-82.}

That may be right, but could there be more to the story? One of the most powerful findings in behavioral ethics is a familiar one to many: the slippery slope. It is the idea that a series of behaviors can move from innocent to wrongful in small imperceptible steps. Each is gradual enough that have taken one step in a direction, it becomes harder not to take the next one, and so on until one is in the deep muck. Numerous insider tipping narratives begin with a conversation about confidential information that is inappropriate but not unlawful. That is rationalized to diminish the threat of impropriety, and so when the next opportunity arises to pass on information, a little more is offered. It becomes hard to say no, because that is inconsistent with the prior choices that had been carefully cleansed (a phenomenon famously known as cognitive dissonance). Soon enough, there are Dirks-certified tips awaiting detection.\footnote{The tipper in the Martoma case, Dr. Gilman, slid quickly: “But he recalled a moment when Martoma asked, repeatedly, about the side effects that one might expect to see from bapi. ‘I didn’t quite recognize it for what I think it was, which was an attempt to find confidential information,’ Gilman said. Initially, he offered theoretical responses, but Martoma ‘persisted in wanting to know what really happened,’ and finally the answers ‘slipped out.’” Patrick Radden Keefe, The Empire of Edge, THE NEW YORKER, Oct. 13, 2014. After that, the tips flowed freely.}

There is some support here from neuroscientific research. Much of what we think of as conscience (guilt-avoidance) is the function in the brain of the amygdala. Faced with a normative dilemma, the amygdala increases the energy devoted to the problem. In a fascinating experimental observation, researchers have noticed that when the same or a similar conundrum is presented a second time, the amount of energy diminishes. And so on, just as the slippery slope predicts. Soon enough, the amygdala has dimmed to darkness, putting up little resistance to the ethical and, perhaps, legal
compromise about to be made. The person in question has become thoroughly jaded and cynical.

There is more we can say about Gupta’s actions, and so we will come back to Judge Rakoff’s angst. For now, we can treat them under the umbrella concept of motivated inference—judgments that are biased in the direction of seeing what we want to see, subconsciously rationalizing as appropriate what is strongly desired. “Wants” take on a protective coating that disarms ethical impulses. William Bernstein writes for an audience of portfolio managers:

Being evolutionarily ancient, the human limbic system does not look very different from that of frogs or reptiles. Located in the limbic system’s front part, just behind the eye, is a pair of structures called the nuclei accumbens. Neuroscientists have determined that these tiny, paired structures respond most intensely to anticipation of reward (be it culinary, sexual, social, or monetary) as opposed to the reward itself, and that this anticipation response can be rapidly conditioned by a few preceding rewards. To label the nuclei accumbens our “greed center” is not too much of an exaggeration. They activate each time an investor turns on CNBC television at 9:20 a.m. during a bull market and connect Maria Bartiromo’s winsome vintage with his or her escalating net worth, or when a banker contemplates a risky but potentially profitable loan transaction.

We will return to this as well, but first turn to an even more famous insider trading narrative, involving Martha Stewart. As is well known, Stewart became a wealthy celebrity though her television and other media ventures. She had an investment account at Merrill Lynch. Compared to her net worth, her investment portfolio was relatively small, consisting largely of IPO allocations that she never sold off, which were now net losses. There was an exception: ImClone, a biopharmaceutical company with promising cancer drugs under development. It was her one profitable holding at this point. She was

66 See Jan Engelmann & Ernst Fehr, The Slippery Slope of Dishonesty, 19 NATURE NEUROSCIENCE 1543 (2016) (commentary on laboratory results).
69 The facts here are taken from Meir Statman, Martha Stewart’s Lessons in Behavioral Finance, 7 J. INV. CONSULTING 1 (2005). See also JOAN MACLEOD HEMINWAY, MARTHA STEWART’S LEGAL TROUBLES (2007).
friends with the founder of ImClone, and they shared the same Merrill Lynch broker.

But one day near the end of the year, while Stewart was on route to Mexico on vacation, she got a phone call from the broker’s assistant that the price of ImClone stock was dropping (which implied that ImClone might not be getting the FDA approval it expected for the key drug), and the founder and his family were selling. She had him sell her ImClone stock immediately, avoiding a loss of about $47,000, a tiny fraction of her wealth.

This certainly seems like insider trading, though there are defenses—most notably the real possibility that she construed the message to mean that information about the drug had reached the market and triggered a general sell-off (i.e., was now public). Indeed, she was never prosecuted for insider trading, but rather went to jail for her and her broker’s inartful efforts to cover-up the trading that was otherwise in plain sight in her Merrill account, quickly uncovered by the compliance people at the firm.

But what was she thinking when she gave the instructions to sell? She was a former stockbroker and knew the basic rules. Recklessness was certainly a possibility, if not actual knowledge. But now let’s add some additional facts. After waiting much too long, Stewart had sold off all her non-ImClone shares to take a tax loss. This had made here sick to her stomach, having to acknowledge her bad investment choices. So, when she got the message about ImClone, she was about to lose her last winner, surely a blow to her considerable professional ego. She was primed for denial as she avoided the loss by selling immediately. I can certainly see the possibility that within that loss frame, she construed the situation to enable the selling with little conscious doubt. I have no idea whether she would have been criminally convicted or not for insider trading; as to the inartful cover-up for which she was convicted, that, too, can probably be better understood through the lens of a threatened ego and, as a result, severe anxiety.

3.3 Cognitive Bias and Legal Construal

The question of when and why people take legal risks is a core concern of behavioral ethics. We have seen from the Gupta and Stewart examples how this can be highly situational, and not entirely conscious.
Legal construal encompasses determining what the law requires, the likelihood of detection and sanction, and the legitimacy of the law’s potential intervention. Each of subject to self-serving inference and other sources of bias.

As to the first, the law of insider trading is complicated in its detail, even though the basic principles are easy to articulate. Part 1 demonstrated this as to those aspects of the law that require some state particular of mind for liability. Most potential insider traders do not have enough knowledge of the law to make expert judgments, yet they develop impressions as to what it says and means. These may be quite (or somewhat) erroneous; insights from the psychological research suggest that there will be self-serving inference (i.e., bolstering the desired course of action when the law is ambiguous). Some of the common misconceptions like insider trading law only applies to corporate officers and directors or that material information is limited to “sure thing” trades probably can remain disproved for lengthy amounts of time without proper compliance training (which most tippees and low-level misappropriators never receive). Sam Waksal, the ImClone CEO mentioned earlier in the Martha Stewart story, tipped his daughter to sell at the same time Martha was getting the message via the same broker that she shared with Waksal to do the same, says he thought that the news must be finalized (i.e., a negative letter from the FDA) to be material, which is perhaps plausible if you don’t give it a second thought.

To the extent understood or even vaguely intuited by a potential trader, the law can make rationalizations easier or harder. Take the possession versus use debate. The quote from the Teicher case is probably right that inside information once possessed becomes a constant temptation to use but easily reimagined in terms of other motivations that had been lurking around all along. The accounts become more believable to the defendant the more they are rehearsed internally: people come to believe that which they strongly want or need to be believed. The legal standard for use probably tamps down on this well enough in most cases. But the firmly held belief that the trader’s own insight dominated the influence of the MNPI can be very ego-tempting as well as potentially guilt-deflecting.

The likelihood of sanction is also easily construed as low, as we saw earlier. It is possible that the prevailing conceptions are too low

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70 SOLTES, supra, at 203.
given the growing sophistication of surveillance technology, but the temptation to trade may override the fear of detection for those on the risk-prefering end of the spectrum, and probably many in the middle.

That leaves the potential for guilt as the main remaining obstacle. Under conditions of low detection, there is room for moral judgment unless external conditions overwhelm the mental space as they seemingly did for Stewart. But this is where rationalization pokes holes at ethicality and strong law-abidingness. As Eugene Soltes emphasizes in the insider trading chapter of *Why They Do It*, a study of white-collar criminality based on interviews with convicted wrongdoers, it is easy to see insider trading as victimless, making the temptation hard to resist.71 And the mind has plenty to work with: as the history of the debates over regulating insider trading amply shows, the case for tangible harm resulting from directly from MNPI-influenced trading *is* often difficult. While there are good reasons to regulate the misuse of MNPI, they are subtle and sophisticated, requiring some mental heavy lifting.72 The rhetoric of insider trading as a form of theft or embezzlement that pervades public discourse on the subject can readily be shunted aside by the simple recognition that the information in question remains in the source’s possession, not taken away.

From that, the rationalizations can go viral inside the brain. For lower-level traders (e.g., clerical personnel, friends and family of the tipper), the self-serving beliefs are often opposition. Insider trading unfairly targets the little guy, it is often said, leaving Wall Street mainly untouched. That was Preet Bharara’s reason for his criminal campaign against the hedge funds, which hit a big speedbump in the *Newman* case from which the campaign has not recovered, *Salman* notwithstanding. Or insider trading lets you do some good for family or friends, a form of rationalization known in the social science literature as the altruism bias. Or insider trading is life’s way of remedying the slights and denials that so many feel, leaving them short of the goals they deserve.

Most instances of insider trading involve the higher ups, whose access to MNPI is expected. We have already seen some of the ways the brain sanitizes the temptation. How much the potential for guilt must

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71 Id., ch. 11; see also LANGEVOORT, SELLING HOPE, supra, at 77-79; Guttentag, supra.
be diminished to enable tipping or trading is a matter of disposition, in particular the taste for risk. Many successful people get where they are by taking chances, which correlates with optimism, confidence, the impulse to dominate, etc. As individuals, such persons need little to motivate them to trade. The problem is that in well governed (and heavily regulated) corporations, mechanisms exist to keep an eye on their trading and other forms of potentially self-serving behavior. Especially if the highest-ranking executives are powerful enough, there are legal ways to gain immense wealth that lessen the temptation.

Yet evidence of high-level opportunism is not hard to find. The research on 10b5-1 plans offered circumstantial evidence of abuse, leading the SEC to its recent proposal to take away some of the now-familiar ways that executives game the system. A particularly interesting empirical study by of trading by insiders in advance of quarterly earnings reports by Ali and Hirshleifer shows a considerable range of profitable opportunism that persists over time and—provocatively—that the taste for insider trading risk is associated with other kinds of managerial misconduct (evidence of earnings management, restatements, non-insider trading SEC enforcement actions, etc.). This is consistent with the inference that risk-taking is not domain specific, but rather represents a trait of significance to a wide range of managerial actions, both unlawful and simply a matter of personal gambles. Ali and Hirshleifer make the point that these kinds of managerial risk-taking can easily become part of the firm’s ethos, prompting engagement in and toleration of illicit behaviors by other managers as well. Issuer repurchases while in possession of MNPI are well known for the potential to enrich insiders collectively, albeit indirectly, and thus are particularly tempting in a risk-taking culture with weak internal controls.

All this research poses the question of the extent to which insider trading is indeed mainly a crime of opportunity and situational rationalization or whether, instead, certain types of people (or traits among them) are disposed to insider trading and comparable self-serving behavior. There is extensive research on white collar crime and executive misbehavior that connects individual risk-taking to high testosterone, narcissism, sociopathic tendencies, Machiavellianism, individualism, competitive arousal, and enhanced or diminished self-

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control, among many others. All this poses interesting questions about the degree to which these tendencies simultaneously stimulate misbehavior and, under certain circumstances and make it more likely that the executive will succeed in gaining and maintaining power (i.e., be adaptive). But as fascinating as this all is, the multiplicity of personal and environmental factors potentially at work in explaining insider trading cautions against generalization.

3.4 Cultural Influences and Insider Trading

Insider trading is a natural subject for the study of risk-based corporate cultures insofar as such cultures can support the rationalization and normalization of “victimless” trading. But there are organizational limitations to this. The greater the number of insiders from the same company trading at any given time, the greater the threat of detection of all the trading activity by regulators. Whistleblowers may sense the likelihood of trading if evidence of it becomes too open and notorious in the firm. And depending on the type of issuer and its governance infrastructure, considerable effort might go into compliance programs, ramping up on surveillance to push back on the temptations.

At a higher level, what about public attitudes toward insider trading and its prohibition? Over the last decades, there have been surveys taken (in varying depth) on such questions as whether insider trading should be illegal, and whether the respondent would trade if given the opportunity to trade on MNPI with relatively little fear of detection. The most recent of these was quite extensive and illuminating. The researchers found increasing public support for an insider trading prohibition over time, but not overwhelmingly—and less among the economically and demographically privileged. At the same

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74 This literature is extensive. For introductory surveys with bibliographic references relating specifically to corporate fraud, including but not limited to insider trading, see SOLTES, supra, at 55-58; LANGEVOORT, SELLING HOPE, supra, at 26-28, 33-40; see also Donald C. Langevoort, Chasing the Greased Pig Down Wall Street: A Gatekeeper’s Guide to the Psychology, Culture, and Ethics of Financial Risk-taking, 98 CORNELL L. REV. 1209 (2011).


76 Anderson et al., Public Perceptions, supra.
time, a significant number of respondents who support illegality would trade if given the opportunity to do so. Consistent with a point made by the critics of strong insider trading regulation, the researchers found little data that would suggest that fear of insider trading causes significant number of people to avoid investing in stocks, undermining the investor confidence rationale for a strong prohibition.

All this suggests that public attitudes are too mixed to act as a strong normative constraint on insider trading in the U.S. Those inclined to see trading in individual stocks as something of a lottery-like game and believing (overconfidently, as psychologists predict) that they have a good chance of winning will find plenty of support for their beliefs in risk-preferring communities in person and online. Those in the elite who come across MNPI frequently in the work probably care little about what the people think.

What about beliefs about insider trading elsewhere? This is a relevant question in two respects: first, as issuers and financial institutions become more global and diverse in their managerial hierarchy; second, as more and more countries have their own insider trading laws. The latter are often stricter that that of the U.S., as written if not as enforced. The research here is less recent, and so may have to be read cautiously.

The object of this research is to see if cultural attitudes toward insider trading vary significantly in different countries. Again, consistent with the U.S. survey research, the U.S. has a relatively stronger norm against insider trading. So do Western European countries like the Netherlands. By contrast, larger numbers of otherwise similarly situated respondents in countries like Italy, Turkey and India accepted insider trading as a legitimate private benefit of power. So, to the extent that this belief translated into behavior, we would expect insider trading to be more of a problem and its regulation

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77 From 1986 to 2019, the percentage of respondents saying insider trading is common went from 63% to 80%, and the percentage saying that insider trading should be illegal went from 52% to 66%. Id. at 1075.

less intensely enforced in those countries.\textsuperscript{79} But what about when persons from those countries emigrate to the U.S.?

This subject must be approached cautiously, for the chance for offensive stereotyping is strong. One could predict that high-status immigrants will bring their lax attitudes with them; or that they will understand the need to embrace American norms more strongly to be given their opportunity to succeed. In the last decade or so, this became more than a matter of conjecture as high-profile insider trading cases happened to involve defendants with names like Gupta, Rajaratnam, Salman, and Martoma.

In fact, there is a sizable body of research in financial economics that studies the extent that risky managerial choices made by first- or second-generation immigrants from other countries who rose to become CEOs are influenced by their childhood or family acculturation.\textsuperscript{80} Whether that provides an explanation for why someone would trade or tip on MNPI is within the realm of plausibility but far from certain and inevitably dangerous. An interesting take on all this comes from Anita Raghavan in her book \textit{The Billionaire’s Apprentice}, about the Rajaratnam-Gupta saga, who after considering many explanations for why Gupta did what he did, found more plausible to be Gupta’s place in the close-knit community of Indian “strivers” who successfully overcame outsider status upon coming to the U.S., and who feel obliged to help others doing the same when asked. Altruistically motivated cheating, in other words, though still wrong.

4. \textbf{Conclusion}

The remaining task is to connect the state of mind indeterminacy of Part 2 with Part 3’s deeper look into when and why insider trading happens. Of course, there are too many puzzles that ought to be solved in pursuit of greater clarity and consistency. But what should drive the

\textsuperscript{79} An interesting puzzle is that even though cultural norms vary, all significant capital marketplace countries have insider trading prohibitions. John Anderson calls this an exercise in “regulatory ritualism” in \textit{Regulatory Ritualism and Other Lessons from the Global Experience of Insider Trading Law}, 24 U. PENN. J. BUS. L. 25 (2021).

\textsuperscript{80} See, e.g., Anh Pham et al., \textit{CEO Cultural Heritage and the Pricing of Audit Services}, 49 J. BUS. FIN. & ACCT’G 181 (2022).
choice of solutions? To be sure, this is not a call for strong cognitive or behavioral defenses to insider trading and other forms of white-collar crimes. That is too hard, and there is little reason to believe that judges and juries, acting in hindsight, will necessarily get the inferences right if asked to go deep into the mind of the trader or tipper on the awareness of duty, materiality, or scienter. Although I have mixed feelings about the possession/use conundrum, I concede that the Second Circuit’s Teicher opinion makes a good point about the flexibility of the human brain in settings of great temptation. Motive, purpose and intent are slippery constructs, for the actor and the observer.

Securities regulation exists in a complex social ecosystem where the optimal degree of regulation is often a mystery. Capital markets can adjust on their own to many threats to their integrity without catastrophic harm, but where the tipping point might be is something neither regulators nor market participants really want to find out. They respond to this uncertainty performatively, acting out their beliefs about regulation with more confidence than warranted.

Not surprisingly, the regulatory strategy is usually to inflate the severity of the sanction by painting insider trading in the darkest of hues and making criminal prosecutions and enforcement actions the stage for public condemnation of the market miscreants. More than any other aspect of securities law, insider trading has an expressive dimension, enabled considerably by the financial media in their portrayals of the characters forced to be on stage. Many noteworthies have done their star turns as antagonists in the legal drama.

There is an interesting duality here that takes us back to the state of mind questions that pop up when cases get litigated. By all accounts, the enforcer’s script calls for the defendant to play the role of greedy cheater, wantonly abusing marketplace innocents. But in legal battles over intentionality that we saw—the use versus possession debate, the definition of a tip, the role of recklessness—there is a determined effort to expand the scope of liability to capture those who don’t quite fit the part. If the defendant more likely than not would have traded anyway without coming into possession of MNPI, there is no market abuse. Of course, there are many structural changes to insider trading law that would eliminate or diminish state of mind issues, running from a pure “informational equality” standard to radical deregulation of insider trading. Those are well outside the scope of this chapter.

81 Of course, there are many structural changes to insider trading law that would eliminate or diminish state of mind issues, running from a pure “informational equality” standard to radical deregulation of insider trading. Those are well outside the scope of this chapter.
83 See p. – supra.
course, a possession test makes enforcement easier, but dilutes the
wrong. Awkwardly, it pushes enforcers to try to justify the expansive
scope to the doctrine in terms of excluding from the playing field those
with informational advantages, but that taps into a philosophy long
abandoned.

All this said, enforcers at the SEC and the Department of Justice
cannot be faulted for pursuing their cases aggressively before the judge
and jury.\textsuperscript{84} This, as I have said before, is a useful way of promoting the
Commission’s brand of investor protection,\textsuperscript{85} but not necessarily (or
effectively) promoting the legitimacy of those legal claims for the
audience of potential wrongdoers. So are we left with a subcommunity
of insiders inclined by culture and cognition to rationalize tips and
trades and thus hard to shame, meaning a steady flow of insider trading
indefinitely into the future?

Perhaps, though I think an opportunity is on the horizon. The
SEC has proposed a rule that public companies report on their internal
controls over insider trading. Most companies have such systems, but
procedures, commitment and resources vary. Presumably, there will be
pressure to upgrade if the system becomes mandatory. That means that
corporations wanting stay on the good side of the SEC will have to pay
more attention to governance issues, effective teaching about insider
trading law (avoiding the misperceptions noted earlier), and above all
speaking to the legitimacy of serious restraints on trading from not only
an investor protection standpoint but in terms of corporate interests and
incentives, and capital market depth and liquidity. States of mind may
be changed, but only if the organization makes the genuine
commitment.

\textsuperscript{84} If anything, many commentators outside the defense bar and its clients think the
SEC may not be aggressive enough. See Perino, supra.

\textsuperscript{85} See Donald C. Langevoort, \textit{Re-reading} Cady Roberts: The Ideology and Practice of