CHAPTER 1

An Overview of Insider Trading

Chapter Contents

§ 1.01 Reasons for Prohibition
§ 1.02 Insider Trading—Sources of the Law
[1] The Federal Securities Laws
[a] Exchange Act Section 16(b)
[b] Exchange Act Section 10(b)
[c] Exchange Act Section 14(e)
[d] Securities Act Section 17(a)
[e] Criminal Liability
[2] Mail Fraud, Wire Fraud, and the New Crime of Securities Fraud
[3] RICO

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§ 1.01 Reasons for Prohibition

A number of prominent securities law scholars have written extensively on the subject of insider trading and have taken the position that insider trading should not be legally prohibited. Some offer arguments that insider trading can benefit markets by promoting market efficiency through the swift incorporation of new information into the marketplace.[1] Others contend that insider trading is an appropriate method of compensating executives and entrepreneurs and that such trading results in no significant injury to corporate investors.[2] It also

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[1] See Carlton and Fischel, "The Regulation of Insider Trading," 35 Stan. L. Rev. 857, 866 (1983) (emphasizing that "[i]f insiders trade, the share price will move closer to what it would have been had the information been disclosed").

[2] See Manne, *Insider Trading and the Stock Market* (1966); Manne, "In Defense of Insider Trading," Harv. Bus. Rev., at 113 (Nov.-Dec. 1966); Manne, "Insider Trading

has been argued, more recently, that insider trading serves as a useful signaling device that alerts capital markets to fraud and other corporate wrongdoings.[3] Given the vast resources required to combat insider trading, why proscribe an activity that may encourage economic gains to society?

As many others have been quick to point out, there are several reasons to prohibit insider trading. First, insider trading distorts economic incentives for corporate decision-makers and market participants.[4] It allows corporate managers to profit at the expense of the corporation, and thus tempts managers to undertake non-optimal ventures.[5] Insider trading also discourages swift public disclosure of corporate

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and the Law Professors," 23 Vand. L. Rev. 547 (1970). For commentary honoring Professor Henry Manne and his significant intellectual contributions to the debate surrounding insider trading regulation, see 50 Case W. Res. L. Rev. 269-323 (2000) (containing essays by Professors Jonathan Macey, Robert Thompson, Richard Painter, David Haddock and Michael Dooley). See also, "Insider Trading Symposium," 4 J. of Law Econ. & Pol'y 225-465 (2008) (containing articles by Professors Henry Manne, Alexandre Padilla, Laura Beny, Stanislav Dolgopolov, H. Nejat Seyhun, Joseph Piotroski, Darren Roulstone and Robin Hanson). Although Professor Manne continues to argue that insider trading is beneficial because it moves securities prices in more accurate directions, he has backed away from his prior view that it is an efficient form of management compensation. See Manne, "Insider Trading: Hayek, Virtual Markets, and the Dog That Did Not Bark," 31 J. Corp. L. 167, 170-175 (2005) (referencing recent debates and studies about executive compensation and acknowledging that this "positive" argument for insider trading "is perhaps less robust than I and other proponents had originally assumed").

[3] Macey, "Getting the Word Out About Fraud: A Theoretical Analysis of Whistleblowing and Insider Trading," 105 Mich. L. Rev. 1899, 1903 (2007) (contending that a "limited and tightly regulated ability to 'sell short' can credibly signal to the market that the trader has negative information about a company"). See also, Kobayashi and Ribstein, "Outsider Trading as an Incentive Device," 40 U.C. Davis L. Rev. 21, 67-69 (2006) (contending that low-level employees and former employees would have greater incentives to report corporate wrongdoing if they could reap trading profits by selling or shorting the issuer's securities prior to blowing the whistle). For a critique of these arguments, see Prentice and Donelson, "Insider Trading as a Signaling Device," 47 Am. Bus. L.J. 1, 59 (2010) (emphasizing that "[r]ewards or bounties carry several advantages over insider trading as incentive devices to encourage whistleblowing").

[4] See Fried, "Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure," 71 S. Cal. L. Rev. 303, 314 (1998) (emphasizing that "[a]lthough in theory, insider trading can generate desirable as well as undesirable incentives, the empirical data that are available suggest that—on balance—insider trading creates undesirable incentives").

[5] See: Easterbrook, "Insider Trading as an Agency Problem," Pratt and Zeckhauser, *Principals and Agents: The Structure of Business* 81 (1985); Haft, "The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation," 80 Mich. L. Rev. 1051, 1053 (1982) (contending that the prohibition of "insider trading may enhance business decision-making in large corporations").

information,[6] and promotes pernicious, manipulative, collateral activities in the marketplace.[7] Most commentators agree that these distortions outweigh whatever temporary gains in allocational efficiency the marketplace may enjoy as a side effect of insider trading.

Second, as Congress realized when it passed the Exchange Act in 1934,[8] and as many commentators have emphasized since, insider trading is unfair to non-insiders,[9] who suffer an insurmountable trading disadvantage.[10] Although the general public will, inevitably, be less informed than market professionals, insider trading promotes the impression that markets are "rigged"[11] and thereby undercuts public confidence in the investment process and hampers capital formation.[12]

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[6] See: "Report of the Task Force on Regulation of Insider Trading," Part 1, 41 Bus. Law 223, 227-228 (1985); Schotland, "Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market," 53 Va. L. Rev. 1435, 1448-1449 (1967). See also, In re Orfa Securities Litigation, [1987 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,225 (D.N.J. Feb. 10, 1987) (delayed corporate reports accompanied insider trading).

[7] See The Insider Trading Proscriptions Act of 1987: Hearings on S. 1380 Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 3 (1987) [hereinafter Senate Hearings] (statement of Professor James D. Cox, Duke University). See also, Froid v. Berger, [1987 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,201 (D.N.J. Dec. 19, 1986) (falsely optimistic forecasts issued while corporate insiders sold stock).

[8] See § 1.02 *infra*.

[9] See Lee, "Fairness and Insider Trading," Colum. Bus. L. Rev. 119, 191 (2002) (contending that "a fair market—a system of cooperative exchange between parties respectful of one another's autonomy—is one in which the parties do not withhold information relevant to their trading partners' decision"); Strudler and Orts, "Moral Principle in the Law of Insider Trading," 78 Tex. L. Rev. 375 (1999) (arguing that "there are good moral reasons . . . to recognize a duty to disclose in certain circumstances when people with material nonpublic information trade with those who lack such information"); Schepple, "'It's Just Not Right': The Ethics of Insider Trading," 56 Law & Contemp. Probs. 123 (Summer 1993) (emphasizing arguments based on morality and fairness).

[10] See, e.g., Brudney, "Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws," 93 Harv. L. Rev. 322 (1979). See also, Wang, "Stock Market Insider Trading: Victims, Violators and Remedies (Including an Analogy to Fraud in the Sale of a Used Car with a Generic Defect," 45 Vill. L. Rev. 27, 29 (2000) (contending that "each act of stock market insider trading has specific victims," and identifying the victims as including both those investors who are harmed by the trader's nondisclosure as well as those investors whose trades were either preempted or induced by the insider trade).

[11] See American Bar Association, "Report of the Task Force on the Regulation of Insider Trading, Committee on Federal Regulation of Securities," 41 Bus. Law. 223, 227 (1985) ("people will not entrust their resources to a marketplace they don't believe is fair, any more than a card player will put his chips on the table in a poker game that may be fixed").

[12] See Brudney, N. 10 *supra*, at 356 ("If the market is thought to be systematically populated with . . . transactors [trading on the basis of confidential information] some investors will refrain from dealing altogether"); Seligman, "The Reformulation

In short, insider trading is said to erode the incentive to create and invest, thereby subverting the general integrity of the capital markets.[13]

Insider trading may also increase trading costs for all investors because market makers and specialists may have to increase their bid-ask spreads to protect themselves from trades with parties with access to material nonpublic information. Insider trading may thus render stock prices less efficient and may reduce the aggregate amount of securities trading.[14] The practice of insider trading may also subject option market makers to unique risks.[15]

The view that insider trading should be subject to prohibition has, in recent years, been accepted worldwide. Indeed, as recent commentators have observed, "the fact that insider trading is illegal, at least on the books, in virtually every country with a stock market suggests that lawmakers around the world, unlike some scholars, believe the better policy is to make rights to trade on corporate information more equally available."[16] The arguments in favor of stringent regulation are bolstered by empirical evidence demonstrating that countries with more prohibitive insider trading laws generally have more dispersed

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of Federal Securities Law Concerning Nonpublic Information," 73 Geo. L.J. 1083, 1115 (1985) (contending that the primary policy reason for proscribing insider trading "is to make investors confident that they can trade securities without being subject to informational disadvantages").

[13] See United States v. O'Hagan, 521 U.S. 642, 658, 117 S.Ct. 2199, 138 L.Ed.2d 724 (1997) (emphasizing that federal regulation of insider trading serves important policy goals of promoting market integrity and investor confidence because "investors would likely hesitate to venture their capital in a market where trading based on misappropriated information is unchecked by law").

[14] Ayres and Choi, "Internalizing Outsider Trading," 101 Mich. L. Rev. 313, 334-335 (2002) (observing that "the presence of informational disparities in the market may also put market makers at risk, raising the bid-ask spread the market makers demand for the liquidity service they provide to the market"); Chung and Charoenwong, "Insider Trading and the Bid-Ask Spread," 33 Fin. Rev. 1-20 (1998) (empirical study suggesting that market makers protect themselves by maintaining larger spreads in stocks with a greater extent of insider trading). But see: Kobayashi and Ribstein, "Outsider Trading as an Incentive Device," 40 U.C. Davis L. Rev. 21, 75-77 (2006) (questioning whether insider trading affects bid-ask spreads, and even if so, questioning "whether this justifies regulation"); Dolgopolov, "Insider Trading and the Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market Making," 33 Cap. U. L. Rev. 83 (2004) (arguing that the relationship between insider trading and bid-ask price is generally weak, with option markets as a notable and important exception).

[15] Dolgopolov, "Risks and Hedges of Providing Liquidity in Complex Securities: The Impact of Insider Trading on Option Market Makers," 15 Ford. J. Corp. & Fin. L. 387, 437 (2010) (arguing that "the brunt of insider trading often falls on option market makers in contrast to their counterparts in equity markets").

[16] See Anand and Beny, "Private Regulation of Insider Trading in the Shadow of Lax Public Enforcement (and a Strong Neighbor): Evidence from Canadian Firms," Mich. L. & Econ., Olin Working Paper No. 07-019, Oct. 2008, at p. 4 n.2, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1013482.

equity ownership, more informative stock prices, and more liquid stock markets.[17]

In addition to these market-based and fairness rationales for the federal regulation of insider trading, there is at least one other type of justification that has been advanced by a number of securities law scholars: the federal prohibition against insider trading may be viewed as a means to protect a corporation's property rights in confidential commercial information.[18] That is, by proscribing securities transactions that are "in connection with" information misappropriated from its rightful owner, the federal prohibition of insider trading functions to protect and encourage the social good of producing commercial information.[19] Proponents of this "private property" rationale for the insider trading prohibition generally reject both market-based and fairness justifications.[20] But, as critics of the "private property" justification are

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[17] Beny, "Insider Trading Laws and Stock Markets Around the World: An Empirical Contribution to the Theoretical Law and Economics Debate," 32 J. Corp. L. 237, 240 (2007) (reporting results using financial, legal and institutional data from a cross-section of thirty-three countries).

[18] See, e.g.: Bainbridge, "Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition," 52 Wash. & Lee L. Rev. 1189, 1192 (1995) (concluding that "the insider trading prohibition is justified solely by the need to protect property rights in valuable information"); Easterbrook, "Insider Trading, Secret Agents, Evidentiary Privileges, and the Production Of Information," 1981 Sup. Ct. Rev. 309, 313 (stating that "[a] rule allowing information to be used freely, once in existence . . . would reduce the ability of those who create information to appropriate the benefits of their efforts; people would create less information and take costly precautions to keep what they do create"); Krawiec, "Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age," 95 Nw. U. L. Rev. 443 (2001) (contending that the regulation of insider trading provides a means of allocating valuable property rights in information); Macey, "From Fairness to Contract: The New Direction of the Rules Against Insider Trading," 13 Hofstra L. Rev 9, 30-37 (1984) (discussing the economic function of property rights in information).

[19] Professor (now-Judge) Easterbrook's scholarship, see Ns. 5 and 18 *supra,* particularly informed the thinking of Second Circuit Judge Ralph Winter, who summarized this "property rights" theory in his partial dissent in United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (*en banc*), *cert. denied* 503 U.S. 1004 (1992):

> "Information is perhaps the most precious commodity in commercial markets. It is expensive to produce, and, because it involves facts and ideas that can easily be photocopied or carried in one's head, there is a ubiquitous risk that those who pay to produce information will see others reap the profit from it. Where the profit from an activity is likely to be diverted, investment in that activity will decline. If the law fails to protect property rights in commercial information, therefore, less will be invested in generating such information."

Id. at 576-577 (Winter, J., concurring in part, dissenting in part) (citing Easterbrook, N. 18 *supra*, at 313).

[20] See, e.g.: Bainbridge, "Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud," 52 SMU L. Rev. 1589, 1650 (1999)

quick to point out, the goal of protecting a corporation's right to its non-tangible property may be one that is far removed from the underlying purposes of the federal securities laws.[21]

(arguing that "[a]s a policy matter, regulating insider trading makes sense only as a means of protecting property rights in information . . ."); Easterbrook, N. 18 *supra*, at 323-330 (contending that "fairness arguments get us nowhere"); Macey, *Insider Trading: Economics, Politics, and Policy* 67 (1991) (contending that "[t]he regulation of insider trading cannot be justified on the grounds that it promotes the goals of efficiency, fairness, or market integrity" and that attempts to do so "simply reflect efforts by a farrago of special interest groups to obtain private advantage through the regulatory and legislative process").

[21] See Karmel, "Outsider Trading on Confidential Information: A Breach in Search of a Duty," 20 Cardozo L. Rev. 83 (1998). According to Professor Karmel:

> "The easiest criticism of the property rights theory is that when Congress passed and subsequently amended the Exchange Act, it was concerned about fairness and the protection of investors, not the protection of property rights in information held by issuers and traders. Protecting the source of confidential information is illogical when the parties injured by traders possessing informational advantages are those who purchase or sell securities without access to the material information."

Id. at 113. See also, Karmel, "The Relationship Between Mandatory Disclosure and Prohibitions Against Insider Trading: Why A Property Rights Theory of Inside Information Is Untenable," 59 Brook. L. Rev. 149, 173 (1993) (contending that "a theory that attempts to protect inside information as intellectual property . . . is very wide of the mark").

§ 1.02 Insider Trading—Sources of the Law

[1]—The Federal Securities Laws

[a]—Exchange Act Section 16(b)

The only provision of the federal securities statutes that expressly regulates insider trading is Section 16(b) of the Exchange Act,[1] which restricts "short swing" profits by officers, directors and the direct or indirect beneficial owners of more than 10% of any class of equity securities issued by a publicly traded corporation. "Short swing" profits are those realized "from any purchase and sale, or any sale and purchase, of an equity security . . . (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted."[2]

[b]—Exchange Act Section 10(b)

Present-day liability for insider trading stems primarily from Section 10(b) of the Exchange Act[3] and SEC Rule 10b-5[4] thereunder,

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[1] 15 U.S.C. § 78p(b). The full text of Section 16(b) provides:

"For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months."

[2] *Id.*

[3] 15 U.S.C. § 78j(b). Section 10(b) states that:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

[4] 17 C.F.R. § 240.10b-5. Rule 10b-5 provides that:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

"a. To employ any device, scheme, or artifice to defraud, which prohibit acts, practices or courses of business that operate as a fraud or deceit upon any person in connection with the purchase or sale of securities. In the insider trading context, Section 10(b) and Rule 10b-5 have been interpreted to mean that in certain settings one cannot buy or sell the securities of a company about which one has material, nonpublic information or tip others to buy or sell on the basis of such information. However, Section 10(b) and Rule 10b-5 do not formally define (or even mention) insider trading.

In August 2000, the SEC enacted a new rule, Rule 10b5-1, that was intended to resolve a debate among the circuits as to whether the government (or a private plaintiff) must prove the defendant's actual use of material, nonpublic information in a securities transaction, or only the defendant's knowing possession, for liability to attach under Rule 10b-5.[5] The text of Rule 10b5-1 specifically sets out a "general rule" providing that:

> "The 'manipulative and deceptive devices' prohibited by Section 10(b) of the Act and Rule 10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any person who is the source of the material non-public information."[6]

The SEC Release proposing Rule 10b5-1 made clear that this general rule "incorporates all theories of insider trading liability under [Rule 10b-5] case law—classical insider trading, temporary insider theory, tippee liability, and trading by someone who misappropriated the inside information."[7] Rule 10b5-1 therefore holds significance well beyond the "possession vs. use" issue that prompted its enactment.

"b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

[5] See § 2.01[5] *infra* (discussing the so-called "possession vs. use" debate).

[6] 17 C.F.R. § 240.10b5-1(a).

[7] See Selective Disclosure and Insider Trading, Exchange Act Rel. No. 42259 [1999-2000 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 86,228, p. 82,846, at 82,860 (Dec. 20, 1999) (citing United States v. O'Hagan, 521 U.S. 642, 117 S.Ct. 2199, 138 L.Ed.2d 724 (1997); Dirks v. Securities and Exchange Commission, 463 U.S. 646, 103 S.Ct. 3255, 77 L.Ed.2d 911 (1983); Chiarella v. United States, 445 U.S. 222, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980)).

[c]—Exchange Act Section 14(e)

Section 14(e) of the Exchange Act,[8] enacted in 1968 as part of the Williams Act, similarly prohibits "fraudulent, deceptive, or manipulative acts or practices" in connection with tender offers. In Rule 14e-3(a) promulgated thereunder,[9] the SEC has explicitly prohibited insider trading in connection with tender offers.[10]

[d]—Securities Act Section 17(a)

Section 17(a) of the Securities Act of 1933 prohibits fraud "in the offer or sale of any securities."[11] Although at one time some federal courts were willing to recognize a private right of action under Section 17(a), the more recent view is that only the government (e.g., the SEC in civil cases and the U.S. Justice Department in criminal cases)

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[8] 15 U.S.C. § 78n(e).

[9] 17 C.F.R. § 240.14e-3. Rule 14e-3(a) specifies that:

> "If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the [Exchange] Act for any other person who is in possession of material nonpublic information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:
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> "(1) The offering person,
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> "(2) The issuer of the securities sought or to be sought by such tender offer,
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> "(3) Any officer, director, partner or employee or any person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities . . . unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise."

[10] The Supreme Court has concluded that Rule 14e-3 constitutes a valid exercise of the SEC's rulemaking authority under Section 14(e) of the Exchange Act. See United States v. O'Hagan, 521 U.S. 642, 117 S.Ct. 2199, 138 L.Ed.2d 724 (1997), discussed in § 2.04[3] *infra*.

[11] 15 U.S.C. § 77(q)(a). The full text of Section 17(a) provides that:

> "It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
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> "1. to employ any device, scheme, or artifice to defraud, or
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> "2. to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> "3. to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

may state a claim for a violation of Section 17(a).[12] Accordingly, when an insider trading case involves a defendant's *sales* of securities (sales which are typically prompted by the defendant's knowledge of secret bad news about the company), the government, in certain cases, may choose to plead a violation of Section 17(a) instead of or in conjunction with a claim under Section 10(b) and Rule 10b-5—the principal antifraud provisions in the federal securities laws, prohibiting fraud in connection with both *purchases and sales* of any security.

Although courts have emphasized that the standards for insider trading are essentially the same under Section 17(a) as under Rule 10b-5,[13] there are at least three differences between the two provisions that may have relevance in particular cases. First, because Section 17(a) prohibits fraud only in the "offer or sale" of securities, it would not extend to a situation in which an insider purchases securities while in possession of secret good news about a company. Second, unlike the "in connection with" phraseology in Section 10(b) and Rule 10b-5, the prohibited fraud in Section 17(a) cases must occur "in" the offer or sale of securities. Section 17(a)'s slightly narrower wording could potentially be relevant in an insider trading case premised on the misappropriation theory because, under that theory, the prohibited fraud is the one that is perpetrated on the source of the information rather than on the investor with whom the misappropriator trades.[14] Finally, because Section 17(a)(2) and 17(a)(3)'s prohibition of fraud supports a cause of action for a defendant's negligent misconduct,[15] the provision could serve as an important alternative to Rule 10b-5 in insider trading cases in which the SEC cannot establish the defendant's scienter.[16]

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[12] See, e.g., Maldonado v. Dominguez, 137 F.3d 1, 7 (1st Cir. 1998) (citing cases and concluding that, "[i]n recent years, every circuit to have addressed the issue has refused to recognize a private right of action under section 17(a), including four circuits which originally had held otherwise").

[13] See SEC v. Lyon, 529 F. Supp.2d 444, 453 (S.D.N.Y. 2008) (observing that "'[e]ssentially the same elements are required' to prove fraud under section 17(a) as are required under section 10(b) of the Exchange Act"), quoting SEC v. Monarch Funding Corp., 192 F.3d 295, 308 (2d Cir.1999). See also, SEC v. Rocklage, 470 F.3d 1, 4 & n.1 (1st Cir. 2006) (noting that "[a]ll parties agree that the [insider trading] analysis under § 17(a) is identical to the analysis under § 10(b) and Rule 10b-5").

[14] See § 2.02[6][d] *infra*. See also, Wang and Steinberg, *Insider Trading* § 10:3 (2d ed. 2006) (discussing Section 17(a) and the misappropriation theory).

[15] See Aaron v. Securities and Exchange Commission, 446 U.S. 680, 689-696, 110 S.Ct. 1945, 64 L.Ed.2d 611 (1980) (finding scienter a necessary element of Section 17(a)(1), but not of Section 17(a)(2) or Section 17(a)(3)). Section 17(a)(3) makes it unlawful "to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." 15 U.S.C. § 77(q)(a)(3).

[16] See Sturc & Cummer, "Possession vs. Use for Insider Trading Liability," Insights, June 1998, at 3, 6 (concluding that, "in theory, liability could be imposed

[e]—Criminal Liability

Pursuant to Section 32(a) of the Exchange Act[17] and Section 24 of the Securities Act,[18] criminal penalties may attach to "willful" violations of the federal securities laws.[19] The SEC, however, does not have the authority to prosecute criminal violations. Rather, the authority to initiate criminal proceedings for violations of the federal securities laws belongs to the Department of Justice, which typically acts through the various United States Attorneys' Offices located throughout the country.

[2]—Mail Fraud, Wire Fraud, and the New Crime of Securities Fraud

The federal mail fraud statute prohibits "use"[20] of the mail to further any "scheme or artifice to defraud" a person of property.[21]

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under Section 17(a) for a kind of 'negligent' trading while in possession of inside information"). See also, § 2.01[5][b] *infra* (discussing the "possession vs. use" debate).

[17] Section 32(a) of the Exchange Act, 15 U.S.C. § 78ff(a), provides that:

> "Any person who willfully violates any provision of this title (other than section 30A), 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 title, or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this title or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 15, or by any self-regulatory organization in connection with an application for membership or participation therein or to become associated with a member thereof, which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than $5,000,000, or imprisoned not more than 20 years, or both, except that when such person is a person other than a natural person, a fine not exceeding $25,000,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation."

[18] Section 24 of the Securities Act, 15 U.S.C. § 77x, provides that:

> "Any person who willfully violates any of the provisions of this title, or the rules and regulations promulgated by the Commission under authority thereof, or any person who willfully, in a registration statement filed under this title, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than $10,000 or imprisoned not more than five years, or both."

[19] For discussion of the element of willfulness in criminal cases, see § 2.01[4][b] *infra*.

[20] United States v. Mooney, 401 F.3d 940, 946 (8th Cir. 2005) (because a "broker's use of the mails is attributable to the investor's buy or sell order, it is sufficient to satisfy the requirement of use of the mails in furtherance of a fraudulent scheme").

[21] 18 U.S.C. § 1341.

Similarly, the wire fraud statute prohibits the "use" of wire, radio or television communications in furtherance of a fraudulent scheme.[22] Criminal insider trading prosecutions charging violations of these broad statutes became rather routine after the Supreme Court's decisions in *Carpenter v. United States*[23] and *United States v. O'Hagan*.[24]

In July 2002, as part of the Sarbanes-Oxley Act, Congress vested federal prosecutors with an additional weapon against insider trading by creating the entirely new crime of "securities fraud."[25] This crime, codified as Title 18 U.S.C. Section 1348, makes it unlawful to knowingly execute, or attempt to execute, a scheme or artifice that (1) defrauds any person in connection with any security of a public company or (2) obtains, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any security of a public company.[26]

[3]—RICO

The Racketeer Influenced and Corrupt Organizations Act ("RICO")[27] prohibits the infiltration of any enterprise engaged in

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[22] 18 U.S.C. § 1343.

[23] Carpenter v. United States, 484 U.S. 19, 108 S.Ct. 316, 98 L.Ed.2d 275 (1987).

[24] United States v. O'Hagan, 521 U.S. 642, 117 S.Ct. 2199, 138 L.Ed.2d 724 (1997). Both *Carpenter* and *O'Hagan* involved trading on the basis of material, nonpublic information that had been misappropriated from each defendant's employer. In addition to finding violations of the federal securities laws, the Supreme Court held in each case that the confidential business information constituted "property," and that use of that information in securities trading violated the federal mail fraud statutes. See § 2.02[6][c], [d] *infra*. For a more extensive discussion of the use of federal mail and wire fraud statutes by federal prosecutors to combat insider trading, see § 2.03 *infra*.

[25] Pub. L. No. 107-204, § 807, 116 Stat. 745 (July 30, 2002), codified as 18 U.S.C. § 1348.

[26] 18 U.S.C. § 1348. See Breen and Miller, "Securities Fraud: Insider Trading Charges Under Section 1348—Without the 'Technical Elements,?'" 32 Champion 49 (Oct. 2008); Tracey and Fiorelli, "Nothing Concentrates the Mind Like the Prospect of a Hanging: The Criminalization of the Sarbanes-Oxley Act," 25 N. Ill. U. L. Rev. 125, 148 (2004). For an example of an insider trading prosecution under Section 1348, see United States v. Mahaffy, 499 F. Supp.2d 291 (E.D.N.Y. 2007), *aff'd* 283 Fed. App'x 852 (2d Cir. 2008) (defendants' acquittals on related charges did not preclude their retrial on charge of conspiracy to commit securities fraud). As discussed more fully in § 2.03[3] *infra*, the indictment in *Mahaffy* charged defendants with operating a fraudulent front-running scheme whereby stockbrokers allegedly shared confidential proprietary information with day traders, who then used that information to trade ahead of the brokerage customers' orders. The jury rendered a guilty verdict, but the defendants' convictions were ultimately vacated on appeal because the government was found to have committed *Brady* violations. United States v. Mahaffy, 693 F.3d 113 (2d Cir. 2012).

[27] 18 U.S.C. §§ 1961-1968, enacted as Title IX of the Organized Crime Control Act of 1970, Pub. L. No. 91-452, 84 Stat. 922 (Oct. 15, 1970).

interstate commerce by any person involved in "a pattern of racketeering activity,"[28] which is defined as two or more acts of specified illegalities, including mail and wire fraud or "any offense involving . . . fraud in the sale of securities."[29] Although RICO was enacted to combat organized crime's infiltration of legitimate businesses,[30] the statute, as currently interpreted by most courts, has a far broader reach.[31] In addition, the statute contains a private right of action permitting "any person injured in his business or property by reason of a violation of section 1962" to sue for damages.[32]

In the 1980s, federal prosecutors frequently turned to RICO to address insider trading violations. During that period, the government relied on RICO in a number of high-profile cases, including those against executives of Princeton-Newport Partners L.P.,[33] and against Drexel Burnham Lambert[34] and its executive, Michael Milken.[35] More

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[28] 18 U.S.C. § 1962.

[29] 18 U.S.C. § 1961.

[30] United States v. Turkette, 452 U.S. 576, 591, 593, 101 S.Ct. 2524, 69 L.Ed.2d 246 (1981). *Accord*, Sedima, S.P.R.L. v. Imrex Co., 473 U.S. 479, 516-517, 105 S.Ct. 3275, 87 L.Ed.2d 346 (1985) (Marshall, J., dissenting).

[31] See H.J. Inc. v. Northwestern Bell Telephone Co., 492 U.S. 229, 249, 109 S.Ct. 2893, 106 L.Ed.2d 195 (1989) (declining "the invitation to invent a rule that RICO's pattern of racketeering concept requires an allegation and proof of an organized crime nexus"). See also, Scheidler v. National Organization for Women, Inc., 510 U.S. 249, 114 S.Ct. 798, 127 L.Ed.2d 99 (1994) (RICO claim does not require proof that either the racketeering enterprise or the predicate acts of racketeering were motivated by an economic purpose).

But see: Scheidler v. National Organization for Women, Inc., 547 U.S. 9, 126 S.Ct. 1264, 164 L.Ed.2d 10 (2006) (*per curiam*) (predicate offense could not be based on Hobbs Act because physical violence unrelated to robbery or extortion falls outside of its scope); Scheidler v. National Organization for Women, Inc., 537 U.S. 393, 123 S.Ct. 1057, 154 L.Ed.2d 991 (2003) (reversing RICO convictions because abortion protestor defendants did not "obtain" or attempt to obtain property from plaintiffs, and so did not commit the predicate offense of extortion under either the Hobbs Act or state law).

RICO's breadth is also evidenced by the number of state and local government entities that have been found to be "enterprises" within the meaning of the statute. See Podgor, "State and Local Entities as RICO Enterprises: A Matter of Perception," 98 W. Va. L. Rev. 853, 854-856 (1996) (discussing cases).

[32] 18 U.S.C. § 1964(c).

[33] United States v. Regan, 726 F. Supp. 447 (S.D.N.Y. 1989), *aff'd in part and vacated in part* 937 F.2d 823 (2d Cir. 1991), *decision amended* 946 F.2d 188 (2d Cir. 1991), *cert. denied sub nom.* Zarzecki v. United States, 504 U.S. 940 (1992).

[34] United States v. Drexel Burnham Lambert, Inc., 89 Cr. 0041 (S.D.N.Y. Jan. 4, 1989) (Drexel subsequently pleaded guilty to six non-RICO counts, including two counts of mail fraud and four counts of fraud in the sale of securities).

[35] United States v. Milken, 89 Cr. 0041 (S.D.N.Y. March 29, 1989). The grand jury charged Milken, his brother Lowell, and Bruce L. Newberg, a former Drexel high-yield bond trader, with ninety-eight counts of securities and mail fraud, insider

recently, prosecutors have used RICO to attack "front-running," a practice involving the use of material, nonpublic information concerning the market for a company's securities—that is, information such as an imminent, large order to purchase or sell securities or a pending article or report related to the company.[36]

In the 1980s and early 1990s, private plaintiffs also turned to RICO to redress injuries allegedly stemming from insider trading violations.[37] This litigation strategy, however, was substantially frustrated in 1995, when Congress enacted the Private Securities Litigation Reform Act ("PSLRA").[38] As it applies to RICO, the PSLRA removed securities fraud as a "predicate act" of racketeering in any civil RICO action initiated by a private plaintiff, unless the defendant against whom private liability is asserted has previously been convicted of a criminal securities law violation involving that same predicate.[39] However, in insider trading cases, the PSLRA's "criminal conviction" exception may prove very useful to private plaintiffs, because many such cases are pursued by federal prosecutors and often result in criminal convictions.[40]

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trading, making false statements to the government and racketeering. Milken ultimately pled guilty to six non-RICO counts. See § 2.06[4] *infra*.

[36] See United States v. Singer, 92 Cr. 964 (S.D.N.Y. Nov. 10, 1992). The indictment alleged that Gary Singer, co-chairman of the Cooper Companies ("Cooper"), a manufacturer of contact lenses and other health care products, diverted corporate assets to fund an intricate front-running scheme. According to the indictment, Singer entered into a covert scheme with G. Albert Griggs, Jr., an analyst and investment adviser to certain mutual funds administered by the Keystone Group. Griggs tipped Singer to Griggs's recommendations concerning the mutual funds' prospective purchases of junk bonds. At Singer's direction, Cooper then purchased the bonds. Cooper subsequently resold the bonds to the funds. Cooper's well-timed purchases allegedly increased the price paid by the funds for the bonds. On January 13, 1994, Gary Singer was convicted of twenty-one counts, including RICO, money laundering, and mail and wire fraud violations. See "Report of Investigation in the Matter of the Cooper Companies, Inc. As It Relates to the Conduct of Cooper's Board of Directors," Exchange Act Release No. 35082 (Dec. 12, 1994).

[37] See, e.g.:

Second Circuit: Litton Industries, Inc. v. Lehman Brothers Kuhn Loeb Inc., 967 F.2d 742 (2d Cir. 1992); Sperber v. Boesky, 849 F.2d 60 (2d Cir. 1988); In re Boesky Securities Litigation, 125 F.R.D. 402 (S.D.N.Y. 1989); Moss v. Morgan Stanley, Inc., 553 F. Supp. 1347 (S.D.N.Y. 1983), *aff'd* 719 F.2d 5 (2d Cir. 1983), *cert. denied* 465 U.S. 1025 (1984).

Fifth Circuit: Johnston v. Wilbourn, 760 F. Supp. 578 (S.D. Miss. 1991).

Seventh Circuit: FMC Corp. v. Boesky, 852 F.2d 981 (7th Cir. 1988).

[38] Pub. L. No. 104-67, 109 Stat. 737 (Dec. 22, 1995). See also, Popp Telecom, Inc. v. American Sharecom, Inc., 361 F.3d 482 (8th Cir. 2004) (precluding a civil RICO action based on alleged acts of securities fraud).

[39] See § 18 U.S.C. § 1964(c). See also, § 3.07 *infra* (discussing private actions under RICO).

[40] See §§ 2.03 and 2.07 *infra*.