

Legislation and Legitimation: Congress and Insider Trading in the 1980s[†]

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Orthodox corporate law and economics holds that American corporate and securities regulation has evolved inexorably toward economic efficiency. That position is difficult to square with the fact that regulation is the product of government actors and institutions. Indeed, the rational behavior assumptions of law and economics suggest that those actors and institutions would tend to place their own self-interest ahead of economic efficiency. This Article provides anecdotal evidence of such self-interest at work. Based on an analysis of legislative history—primarily congressional hearings—this Article argues that Congress had little interest in the economic policy effect of insider trading legislation in the 1980s. Rather, those laws were motivated primarily by a desire to legitimate the existing political and economic order.

The policy and doctrinal grounds for prohibiting insider trading are unclear. Yet Congress devoted a great amount of attention to increasing the penalties for insider trading in the 1980s. Meanwhile, more serious economic issues went unaddressed. What explains this odd focus? Congress routinely explains corporate and securities legislation as motivated by a need to bolster “investor confidence” and protect the capital formation process. In the 1980s, legislators argued that insider trading scandals were undermining investor confidence. That argument is unconvincing, however, because those scandals were contemporaneous with unprecedented stock prices.

An alternative explanation for the 1980s legislation is that Congress sought political legitimacy: not “investor confidence” in the markets, but “voter confidence” in the political-economic system. Our government has a symbiotic relationship with a capitalist system under which the power of business and finance sometimes rivals that of the state. This arrangement is acceptable to most voters during prosperous times but can undermine the legitimacy of the political-economic system in times of perceived economic crisis. Government crafts its responses to such crises to protect its legitimacy. The process of self-legitimation does not consist merely of responding to exogenous preferences of constituents. It also includes attempts to mold constituents’ preferences to be more consistent with the self-interest and problem-solving abilities of Congress.

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INTRODUCTION

The 1980s were a time of unsettling transition in the American economy. The U.S. economy suffered a severe recession early in the decade. American manufacturing industries went into decline and succumbed to foreign competition. Hostile takeovers changed the face of industry and corporate finance. Inflation, high interest rates, and unemployment created economic uncertainty for a large segment of the public. The subsequent recovery was accompanied by a new deregulatory philosophy in Washington—tax cuts for the wealthy and a soaring stock market—which increased real and perceived disparities in wealth. During this time, Congress devoted a significant amount of time to addressing a narrow aspect of securities regulation—insider trading. Congress passed insider trading legislation in both 1984 and 1988. Between 1986 and 1988, it held four sets of hearings specifically devoted to insider trading and raised the subject in hearings devoted to other securities law topics. Legislators repeatedly suggested that insider trading in the 1980s constituted a crisis on par with the stock market crash of 1929. This Article asks why Congress was so preoccupied with insider trading. An important part of the answer is Congress's need to legitimate itself in the eyes of the American public during a time of economic uncertainty. The need for legitimacy is an underexamined aspect of Congress's relationship to Wall Street and the economy, and of Congress's response to real or perceived crises in general.

Orthodox corporate law analysis focuses on the efficient distribution of the corporate surplus between shareholders and managers. Traditionally, this has proceeded under the assumption that corporate value should be maximized for the primary benefit of shareholders, the corporation's "owners." Alternate approaches defend management's interests or assert that "society" also has a claim to some of the corporate surplus. Regardless of one's normative views on the proper distribution of the surplus, the surplus is affected by the fact that corporate law—like all law—is the product of government actors and institutions. While corporate legal academia has scrutinized the agency costs imposed by professional managers, it has paid too little formal attention to the analogous costs imposed by the "managers" of corporate law: politicians, judges, and regulators. These government actors place additional claims on the surpluses generated by the corporate governance regime even as they shape its legal aspects. The same rational behavior assumptions that undergird orthodox corporate law analysis suggest that just as shareholders and management seek rents in the negotiation of the corporate "contract," government actors and institutions will tend to place their own self-interest ahead of economic efficiency in the design of corporate law.

Most legal scholars, as well as many political scientists, fail to consider the self-interest of lawmakers. When they consider Congress at all, they often view it as a frictionless conduit for the implementation of its constituents' demands.¹ Some see Congress as realizing the complex interests of "the public," while some see it as catering to the wealthy and powerful classes, or to those constituent subsets (so-called "special interest groups") with the most organized lobbying or deepest pockets. In this vein, corporate law scholars tend to assume corporate and securities laws are mostly efficient responses to economic conditions or, occasionally, the result of rent-seeking machinations by special interests. Just as neoclassical corporate law and economics assumes that securities markets efficiently express the interests of investors, the view of Congress as conduit assumes Congress (the product of political "markets") efficiently expresses the interests of its constituents. This assumption underemphasizes a phenomenon familiar to the layman: legislators' considerable autonomy.²

Richard Fenno famously characterized legislators as rational actors seeking "re-election, influence in the House, and good public policy," as well as "private gain."³ If legislators are viewed as agents of the public, "good public policy" is in the interest of their principals, while energy devoted to the other goals, to the extent that they do not contribute to improving policy, is a form of agency cost. Although agency costs are somewhat mitigated by elections, elections are rife with obvious market failures that prevent them from acting like ideal competitive markets: incumbent advantages, financial barriers to entry, the party system, districting rules, and so on.

In addition to the familiar kinds of personal self-aggrandizement Fenno identifies, legislators also have an interest in institutional self-legitimation—that is, the legitimation of Congress specifically and of the American government generally, including its symbiotic relationship with capitalism. Any institution must justify its existence and the power it wields. Thus, in addition to pleasing constituents and serving the "public interest," one of the functions of Congress and its members is to legitimate and thereby perpetuate itself as an institution. Current scholarly commentary pays little attention to legitimation *per se*. While responding to constituents' pre-existing preferences is one way to obtain legitimacy, it is not the only way. Politicians also try to influence constituents' preferences. They may do so in a sincere attempt to bring public attention to wrongly neglected issues. But they may also do so in a selfish attempt to convince voters that unproductive political posturing actually serves their interests.

Relying on Congressional hearings, this Article reads the story of insider trading legislation of the 1980s as an example of the legitimation process. This Article will proceed as follows: Part I summarizes the two major pieces of 1980s insider trading legislation, the Insider Trading Sanctions Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988. Part II expands upon this Article's political theory of law. The recession and the government response to it—deregulation and supply-side economics—invited doubts about the capitalist order and the government's role in it. To defend its legitimacy, Congress attempted to remake the concept of insider trading into a symbol of Americans' pessimism about the economy. Having

1. See DAVID R. MAYHEW, *AMERICA'S CONGRESS: ACTIONS IN THE PUBLIC SPHERE, JAMES MADISON THROUGH NEWT GINGRICH* (2000).

2. *Id.* at 12–13.

3. RICHARD FENNO, *CONGRESSMEN IN COMMITTEES* 1 (1973).

symbolically reduced America's economic problems to one relatively simple issue, Congress could address that issue directly, projecting an image of authority and competence while distancing Washington from Wall Street.

Like previous accounts of legislator autonomy, such as Fenno's, this research raises basic questions about the role of agency cost in legislative production. While the analysis of agency costs has traditionally been steeped in the moralistic tones of fiduciary duty discourse, the modern economic analysis of corporate law views management self-interest as a necessary cost of doing business. On the one hand, the credo of the invisible hand suggests this self-interest is potentially beneficial to shareholders and society. On the other hand, opportunistic abuse of authority may require regulatory intervention. We see this play out in the debates over executive compensation, corporate political contributions, and management power generally. An analogous inquiry should apply to legislators as well: Does their self-legitimizing behavior have socially beneficial results? To what extent does the electoral system provide checks on such behavior, and to what extent is intervention required? What institutions could provide such regulation?

Even more broadly, the role of legislators in preference formation challenges fundamental notions that voters set the public agenda. This is not to say that politicians tell the public what to think. As we shall see, Congress was not necessarily successful in its attempts to portray insider trading regulation as a symbolic economic panacea. But it certainly tried and suffered no major political backlash. A complex dialectic between the interests of governors and governed shapes the direction of public policy. Both the liberal ideal of purely autonomous voters and the paranoid notion of manipulative leaders should give way to an appreciation of this interplay.

Part III presents evidence from the hearings to support this argument. In hearings on insider trading, many legislators suggested it was a dire threat to the economy, despite a glaring lack of evidence. Congressional Democrats tied insider trading to larger policy issues such as hostile takeovers, which they had tried but failed to regulate. Congress also used the hearings to express disapproval of the excesses of capitalism without directly criticizing capitalism itself. In addition, by characterizing and addressing insider trading as a law enforcement issue, Congress remade the public's broad, unfocused economic anxiety into a more narrowly defined and tractable problem. Reframing the economic situation as a law-enforcement issue allowed Congress to portray itself as the "good guy" against identifiable "bad guys" and offer simple putative solutions, such as increased penalties and enforcement resources.

I. THE 1980S INSIDER TRADING LEGISLATION

In 1982, the Securities and Exchange Commission (SEC) proposed legislation that would allow it to seek civil penalties of up to three times actual trading profits in insider trading cases. In 1984, Congress passed the treble-damages rule as part of the Insider Trading Sanctions Act (ITSA). ITSA also increased the maximum criminal fine for Exchange Act violations from \$10,000 to \$100,000.⁴ Over the next few years, a

4. *Insider Trading Sanctions and SEC Enforcement Legislation: Hearing on H.R. 559 Before the Subcomm. on Telecomms., Consumer Protection, and Finance of the H. Comm. on Energy and Commerce*, 98th Cong. 29-30 (1983) [hereinafter H.R. Ser. No. 98-33] (statement of Hon. John S.R. Shad, Chairman, Securities and Exchange Commission).

number of high-profile insider trading scandals came to light. Some politicians argued that ITSA had been insufficient to deter insider trading.

In October 1988, Congress passed the Insider Trading and Securities Fraud Enforcement Act (ITSFEA). ITSFEA amended the sanctions for insider trading in three ways. First, it extended ITSA's penalty provisions to "control persons" of an insider trader if the control person acted in a "knowing or reckless" manner.⁵ Second, it increased the maximum individual criminal fine under the securities laws (which ITSA had recently increased from \$10,000 to \$100,000) to \$1 million and the maximum jail term to 10 years. The fine for "non-natural persons" was increased to \$2.5 million.⁶ Third, it gave parties that trade in a security contemporaneously with the insider trader a private cause of action against the insider trader.⁷

In addition to increasing maximum sanctions, ITSFEA also offered informants a "bounty" in the amount of ten percent of civil penalties recovered from insider traders apprehended on the basis of the informant's information.⁸ ITSFEA further required broker-dealers and investment advisers to establish procedures "reasonably designed . . . to prevent the misuse . . . of material, nonpublic information."⁹ The law empowered, but did not require, the SEC to establish rules in furtherance of this provision.¹⁰ ITSFEA also authorized the SEC to conduct investigations in response to a foreign government's request for assistance.¹¹ A further provision of ITSFEA directed the SEC to conduct a study to update the landmark 1963 "Special Study" of the securities markets.¹² In addition to some very broad instructions about the coverage of the study, this provision specifically required attention to insider trading. Congress did not appropriate the funds for the study, however, and it was never conducted.

ITSFEA also instructed the SEC to make recommendations for new legislation regarding its power to impose sanctions for other securities law violations. The SEC did so, and in 1990, Congress specifically authorized federal courts to impose civil penalties on securities law violations other than insider trading.¹³ But the potential civil

5. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 3(a), 102 Stat. 4677, 4678 [hereinafter "ITSFEA"] (amending Securities and Exchange Act of 1934 [hereinafter "Exchange Act"] by adding §§ 21A(a)(3) and (b)(1)) (codified as amended at 15 U.S.C. §§ 78u-1(a)(3), (b)(1) (2000 & Supp. II 2002)).

6. ITSFEA, § 4, *supra* note 5 (amending Exchange Act, § 32(a)) (codified as amended at 15 U.S.C. § 78ff (2000 & Supp. II 2002)). The Sarbanes-Oxley Act of 2002 further raised these penalties to \$5 million and twenty years for individuals and \$25 million for non-natural persons. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of II, 15, 18, 28 & 29 U.S.C.).

7. *See* ITSFEA § 5, *supra* note 5 (amending Exchange Act by adding § 20A) (codified as amended at 15 U.S.C. § 78t-1 (2000)).

8. ITSFEA § 3(a), *supra* note 5 (amending Exchange Act by adding § 21A(e)) (codified as amended at 15 U.S.C. § 78u-1(e) (2000 & Supp. II 2002)).

9. ITSFEA § 3(b), *supra* note 5 (amending Exchange Act § 15 by adding subsection (f)) (codified as amended at 15 U.S.C.A. § 78o(f) (2006)).

10. *Id.*

11. ITSFEA § 6, *supra* note 5 (amending Exchange Act § 3(a)) (codified as amended at 15 U.S.C.A. § 78c(a) (2006)).

12. ITSFEA § 7, *supra* note 5 (codified at 15 U.S.C. § 78b (2000)).

13. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429 [hereinafter "Remedies Act"] (codified as 15 U.S.C.A. §§ 78u-2, 78u-3 & 78q-2 (2006)). The Remedies Act expanded the SEC's penalty power in all cases by authorizing it to

liability for insider trading greatly exceeded, and still exceeds, that for other securities law violations. Insider trading was, and remains, the only violation subject to ITSA's trebling provision and ITSFEA's "control person" liability and \$1 million maximum fine.¹⁴

Most analyses of legislative history study how the content of legislation is produced by realpolitik, public choice, and rational and strategic behavior. Shortly after the passage of ITSFEA, for example, a congressional insider wrote a detailed description of the drafting and passage of ITSFEA.¹⁵ That account portrayed the legislative process as a series of practical political compromises among legislators and regulators with differing opinions on how to solve a common policy problem. That approach illuminates how Congress produced legislation once it determined that insider trading was a problem worthy of attention and that a penalty-focused response was appropriate. But rather than focusing on *how* Congress produced its packages of insider trading legislation, this Article asks *why* Congress chose to address insider trading to begin with. It examines the role of Congress in constructing the crisis, and the legitimating and expressive function of the hearings and legislation. This Article focuses on the rhetorical exercises in the legislative process rather than analyze evolving drafts as policy compromises. Admittedly, this approach also reveals only one facet of the legislative process, but it is one that is insufficiently explored.

The institutional characteristics of Congress further undermine the "conduit" theory of congressional action described and critiqued above. The legislature is a complex bureaucratic institution. Congress (the House in particular) is highly decentralized. Much of the political-science commentary on Congress focuses on how its diffuse, committee-based structure makes it hard to set big-picture policy agendas. According to two prominent political scientists, "[i]n large part, the history of the House has been a struggle to mold a coherent policy-making instrument out of a large and disparate collectivity. It has been, one might say, a struggle of the general versus the particular, in which the particular seems the more powerful force."¹⁶

Congressional hearings on the legislation served as the primary research resource for this Article. Congress ostensibly holds hearings to inform the lawmaking process, but they are poorly suited for gathering information.¹⁷ Legislators' attendance and attention are spotty. "Witnesses" tend to read from prepared testimony. Questioning rarely constitutes a sophisticated exchange among legislators and witnesses. Instead, "while one member asks questions his colleagues assume an attitude of benign interference."¹⁸ Furthermore, although witnesses may present differing views, there is rarely interaction among witnesses. Congressional hearings serve purposes other than information gathering, however:

issue cease and desist orders and to seek court orders barring violators of § 17 and § 10(b) (which includes insider trading violations) from serving as directors and officers.

14. The Remedies Act raised maximum civil penalties for other offenses to the greater of \$100,000 or actual gain. Remedies Act, *supra* note 13.

15. Stuart J. Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 BUS. LAW. 145 (1989). Kaswell served as Minority (that is, Republican) Counsel to the House Committee on Energy and Commerce.

16. ROGER H. DAVIDSON & WALTER J. OLESZEK, CONGRESS AGAINST ITSELF 19 (1977).

17. *See id.* at 82.

18. *Id.*

Hearings are public events and serve public purposes. Even though hearings may be poorly attended, they will be studied carefully by interested publics and specialized journalists. Hence, the participants—legislators no less than witnesses—must pay attention to the impact their words will have. Their purposes include personal advertisement, seeking publicity for their views, reminding influential constituents that they are on the job, and building a public record in support of a given course of action. A freewheeling, open-ended exchange would not serve these purposes as fully as does a more structured performance¹⁹

The 1980s hearings on insider trading and related issues conform to this description. As will be discussed below, legislators placed far more emphasis on expressing their preconceived viewpoints than in eliciting information.

II. LEGISLATION AND LEGITIMATION

A. *The Problem: Government and Capitalism*

In the United States, as in all capitalist countries, government and capitalism are highly interdependent. This interdependence can create suspicion that the government puts the interests of business and the wealthy ahead of those of the general public. Thus, government in a capitalist system must periodically distance itself from capitalism in order to maintain its legitimacy and defend itself against charges that it has been captured.²⁰ This is particularly true when average voters are plagued by economic fears, as they were in the 1970s and 1980s.

To avoid challenging the foundations of the economic and political order, however, government must distance itself from capitalism without disparaging capitalism *per se* or wealth *per se*. Condemning the *excesses* of capitalism strikes this balance. It legitimates the government as an independent keeper of order and legitimates market capitalism as a system whose unfairnesses are subject to occasional corrections by an independent government.²¹ Thus, insider trading was a politically useful symbol of America's complex economic anxieties. It gave Congress the opportunity to condemn capitalism's excesses, but not capitalism itself.

Other legal scholars have portrayed the need for government to distance itself from capitalism. Mark Roe, for example, argues that Populists and Progressives, suspicious of concentrated economic power, pressured Congress to restrict the role of large banks in corporate finance. These forces, according to Roe, contributed to the decentralized nature of American corporate ownership today.²² Donald Langevoort has suggested a

19. *Id.* at 82–83.

20. *Cf.* TONY POVEDA, *RETHINKING WHITE-COLLAR CRIME* 137 (1994) (arguing that despite the “elite power structure,” the government has an interest in prosecuting white-collar crime because “the state must sometimes make symbolic concessions to non-elites in order to maintain the stability and legitimacy of the political system”).

21. *Cf.* Donald C. Langevoort, *Managing the “Expectations Gap” in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 *VILL. L. REV.* 1139 (2003) (arguing that securities regulation, by ostensibly protecting investors from fraud, legitimates both the government and the markets).

22. *See* MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* 48–49 (1994).

different kind of political explanation for corporate and securities law. While Roe's model portrays lawmakers as reacting to interest group pressure, Langevoort argues that insider trading regulation attempts (perhaps clumsily) to express a "fundamental attitude that economic power and status demand a strong dose of self-restraint and accountability."²³ This Article agrees with that assessment, and asks further whether lawmakers express that attitude as passive conduits of their constituents' attitudes, or whether they choose to express that attitude, and how to express it, as autonomous actors seeking institutional legitimation.

While lawmakers are obviously influenced both by constituent pressure and self-interest, this Article focuses on the autonomous aspect, which tends to be underexplored. Economic uncertainty shakes public confidence not only in markets, but also in the government's ability to control social conditions—that is, it threatens the legitimacy of the government. Politicians and regulators often speak of building "investor confidence" in the markets and the economy generally. But the government also must maintain "voter confidence" in the government itself. In times of economic uncertainty, when the public questions the fairness of the capitalist system, the state needs a legitimating ideology to explain its role vis à vis the financial markets and capitalism generally. Thus, the state periodically mitigates its generally free-market position by placing some regulations on the market.

These regulations have consistently incorporated a significant degree of so-called self-regulation by the securities industry. Thus, the effect of these regulations is not to fundamentally remake the market system, but rather to signal that the state guarantees the fairness of the market. This process burnishes the reputation of both the market and the state—not to mention the reputations of individual politicians. The most obvious example of this process was the passage of the New Deal federal securities laws. The purpose of this Article is not to question the merits of insider trading law, our securities regulation regime generally, or the government's good faith in relying upon self-regulation. Rather, I wish to point out that the government's regulatory choices (whatever they may be) are inextricably tied up with the legitimation and perpetuation of the government itself.²⁴

On close examination, the insider trading legislation of the 1980s does not appear to be solely, or even primarily, about insider trading. The insider trading scandals of the 1980s presented Congress with an opportunity to argue to the American public that capitalism is fair—or at least that Congress strives to make it so, and that Congress is not controlled by the economic elite. For a government that is closely identified with capitalism and sometimes suspected of favoring big business and the wealthy over the general public, outlawing and prosecuting insider trading and other so-called white-collar crime can serve as "a symbolic way of maintaining legitimacy."²⁵ I do not mean to suggest here that economic elites call all the shots in Washington or that capitalism

23. Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 1999 COLUM. L. REV. 1319, 1328–29 (1999).

24. Cf. Faith Stevelman Kahn, *Bombing Markets, Subverting the Rule of Law: Enron, Financial Fraud, and September 11, 2001*, 76 TUL. L. REV. 1579, 1629–30 (2002) ("[T]he [Enron] hearings gave members of Congress a very public opportunity to attempt to reassert the authority of government and law over seemingly corrupt, lawless corporate firms and capital market participants.").

25. Tony G. Poveda, *White-Collar Crime and the Justice Department: The Institutionalization of a Concept*, 17 CRIME L. & SOC. CHANGE, 235, 237 (1992).

is an inherently fraudulent system that can be sustained only by political shenanigans. But government has an interest in maintaining the legitimacy of capitalism and government's symbiotic relationship with capitalism. Whether that relationship is a malign conspiracy or a good-faith partnership for the good of society is a debate well beyond the scope of this Article.

In addition to the general need to prove it was not captured by business interests, the Reagan administration faced legitimacy concerns specifically related to securities regulation and insider trading. Insider trading scandals emerged with regularity in the 1980s. Indeed, Reagan's first term saw two insider trading scandals involving administration officials. First, Thomas Reed, a White House assistant for national security affairs, resigned in 1983. He was later indicted on securities fraud charges. Second, Deputy Defense Secretary Paul Thayer resigned when the SEC brought insider trading charges against him in 1984. Thayer eventually served nineteen months in prison for perjury and obstruction of justice. Insider trading thus gained political salience and tarnished the legitimacy of the administration. Insider trading scandals continued to emerge throughout the decade. A high-profile scandal involving *Wall Street Journal* stock recommendations surfaced in early 1984.²⁶ The most infamous scandals—those involving Dennis Levine, Ivan Boesky, and Michael Milken²⁷—occurred after the passage of ITSA in 1984, setting the stage for ITSFEA.²⁸

The scandals—especially, but not only, those in the White House—help explain why the Democratically controlled Congress was so interested in insider trading, and why the deregulatory administration and congressional Republicans did not oppose the legislation. As insider trading scandals grabbed headlines, some show of government control was necessary in order to balance the Reagan administration's commitment to economic deregulation.²⁹

When Reagan took office in 1981, many expected that the SEC would relax securities enforcement. Reagan's choice to head the SEC, John Shad, famously declared upon taking office that he would come down with "hobnail boots" on insider traders.³⁰ Shad's strong statement may have been specifically intended to blunt

26. See *Carpenter v. United States*, 484 U.S. 19 (1987).

27. For the conventional account of these cases, casting the defendants as villains and the prosecutors as heroes, see JAMES B. STEWART, *DEN OF THIEVES* (1991). For a skeptical, revisionist assessment, see DANIEL R. FISCHER, *PAYBACK* (1995).

28. Larry Ribstein has recently advanced the novel theory that the 1987 film *Wall Street* further contributed to the perception of an insider trading "epidemic" and thus played a part in the passage of ITSFEA. See Larry E. Ribstein, *Imagining Wall Street*, (Univ. of Ill. Coll. of Law, Illinois Law & Economics Working Paper Series, Working Paper No. LE05-017, 2005), available at <http://ssrn.com/abstract=771724>.

29. The Enron-era scandals put the government in a similar position, leading to calls for regulation from the most unlikely of sources: "Off and on over the years, a few capitalists have done more to delegitimize capitalism than America's impotent socialist critics ever did or today's moribund left could hope to. It is the Republicans' special responsibility to punish such capitalists." George F. Will, . . . *Especially From Republicans*, WASH. POST, Jan. 15, 2002, at A19.

30. Kenneth A. Noble, *SEC Chief Plans Insider Trade Curb*, N.Y. TIMES, Oct. 26, 1981, at D1.

criticism of the administration's deregulatory philosophy.³¹ Shad came to the SEC chairmanship with instructions to deregulate and to reduce enforcement resources: the Reagan transition team recommended reducing the SEC budget by thirty percent over three years and cutting its Enforcement Division from two hundred members to fifty.³² The number of SEC staff remained the same from Shad's arrival in 1981 until 1984, and rose by only about one percent in 1985 and again in 1986.³³

The SEC also came under fire for excessive leniency in insider trading cases just prior to the passage of ITSA. When Thomas Reed settled civil insider trading charges with the SEC, the settlement was criticized because it required Reed only to disgorge his profits from the disputed transaction. He paid no penalty and did not admit guilt.³⁴ Around the same time, a federal district court criticized the SEC for seeking similar mild sanctions against an accused insider trader. The judge called the SEC "derelict in its duty." "These are thieves we're talking about," he stated in court. "The Government is prosecuting people for stealing Social Security checks out of the mail, welfare frauds, and here these people come down and get a slap on the wrist. That isn't much in the way of deterrence."³⁵

B. The Solution: Legislation as Legitimation

Congress responds to economic crises with new legislation because legislating is what Congress does, not necessarily because new legislation is an appropriate solution. John Coates has argued that new legislation, regardless of its merits, "allows politicians to show they can 'do something,' while inaction requires politicians to defend a status quo tainted in the voting public's mind by the salient fact of market downturn or scandal."³⁶ Action is especially attractive, according to Coates, when it is difficult for the public to verify whether legislative action will have a positive effect.

In response to the economic uncertainties of the 1980s, Congress needed to pass *something*. The root causes of America's economic problems were far too deep to be addressed by piecemeal legislation (and, ironically, the economy was well into recovery by the mid-1980s). As noted above, however, Congress is better suited to address the particular than the general.³⁷ Congress nonetheless felt pressure to respond to public anxiety about the economy. Providing a solution to a complex problem

31. See Donald C. Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273, 1275 (1984).

32. See Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation By Enforcement: A Look Ahead At the Next Decade*, 7 YALE J. ON REG. 149, 198 (1990) (quoting Final Report of Transition Team, Sec. Reg. & L. Rep. (BNA) no. 587, at K-1 (Jan 21, 1981)). The transition team also recommended turning the SEC's Division of Market Regulation into a "think tank" and eliminating the Washington headquarters of the Enforcement Division. *Id.*

33. JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 576 (3d ed. 2003).

34. The Senate held hearings to investigate the SEC's handling of the Reed case. Senator Alfonse M. D'Amato, Chair of the Banking Committee's Subcommittee on Securities, concluded that "the SEC staff acted in a wholly professional manner." H.R. Ser. No. 98-33, *supra* note 4, at 7 (letter from D'Amato to Rep. Timothy E. Wirth (Apr. 12, 1983)).

35. Kenneth B. Noble, *Insider Cases and the S.E.C.*, N.Y. TIMES, Jan. 25, 1983, at D2.

36. John C. Coates IV, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531, 569 (2001).

37. See DAVIDSON & OLESZEK, *supra* note 16, at 19.

necessarily involves framing the nature and scope of the problem. The way Congress frames a problem will inevitably be influenced by political concerns and practical limitations of Congress. There was little Congress could do about major issues such as global competitiveness and job security. Such issues are the stuff of industrial policy that America has traditionally left to market forces.

Congress can enhance the perceived value of its legislative action—and thus its legitimating effect—by influencing constituents' preferences. Mainstream political science, following mainstream rational choice theory, assumes that individual preferences are exogenous. Yet a growing body of theoretical and empirical work suggests that preferences are endogenous.³⁸ Elected representatives may play a role in shaping constituents' preferences in addition to simply aggregating them.³⁹ The multiplicity of varied and sometimes conflicting directives from constituents allows—indeed it requires—politicians to choose from a wide range of policy priorities. That is, in articulating policy justifications, legislators necessarily engage in some degree of *constructing* the publicly accepted justifications, not simply choosing them.⁴⁰ This is true whether legislators are consciously controlling the agenda (for selfish or high-minded purposes) or attempting in good faith to coherently serve the incoherent deluge of constituents' preferences.⁴¹ This type of autonomy is more than an agency cost—it undermines the basic structure of the traditional principal-agent model in which the principal sets the agenda.

Congress may, for example, reframe a complex, inchoate problem (such as vague economic uncertainty) as a narrow, more easily addressed one (such as insider trading). Having presented the newly defined problem to the public, Congress then sets out to address it. According to the old cliché, if the only tool you have is a hammer, everything starts looking like a nail. In focusing on insider trading, however, Congress did not just *mistake* economic problems for law-enforcement problems, but *chose* to reframe economic problems as law-enforcement “nails” that it could more easily solve with its legislative “hammer.”

38. See Elizabeth Gerber & John Jackson, *Endogenous Political Preferences and the Study of Institutions*, 87 AM. POL. SCI. REV. 639 (1993). Gerber and Jackson present empirical evidence suggesting that partisan voters' preferences with respect to civil rights reform and the Vietnam War changed along with shifts in their party's expressed position on those issues.

39. Cf. *id.* at 654 (“The role of institutions [e.g., political parties] in developing preferences may be more important than their role as aggregator of these preferences.”).

40. See MAYHEW, *supra* note 1, at 18. Given its prominent role in popular consciousness, it is understandably fashionable to credit “the media” for influencing public discourse. See, e.g., Ribstein, *supra* note 28 (arguing that the film *Wall Street* shaped public and congressional views of insider trading and influenced ITSFEA). Establishing the extent of the media role relative to Washington's role is beyond the scope of this paper, but some speculation on the issue is appropriate here. Obviously, media fascination with insider trading in the 1980s helped make it a prominent issue in the public imagination and thus a salient one for politicians. But there would have been no “insider trading” for the media to hype or distort without a legal and political construct of that name. Most likely, the media and Congress (as well as prosecutors), each having their own reasons to play up insider trading, acted symbiotically to construct the perception of an epidemic.

41. This is reminiscent of the debate in corporate governance over whether directors should owe legal duties to multiple constituents, with the goal of maximizing corporate or social welfare generally, or to shareholders only, in order to cabin directors' discretion.

My purpose here is to challenge the characterization of Congress as a passive conduit or mere agent. I do not mean to argue that voters are simply passive victims of false consciousness.⁴² Indeed, voters were not necessarily convinced by Congress's insistence that insider trading regulation was a fundamental problem. Most likely, legislation involves a complex combination of politicians acting in self-interest, catering to constituent preferences, and influencing those preferences.

III. EVIDENCE FROM THE HEARINGS

This Part presents evidence from the congressional hearings on insider trading legislation to support the argument that ITSA and ITSFEA were exercises in institutional self-legitimation. The hearings show Congress using insider trading as a symbol representing larger economic issues that threatened political legitimacy. Many legislators insisted that insider trading, the issue they had chosen to address, was the biggest problem on Wall Street, despite a lack of evidence. They then tried to present insider trading regulation as a substitute for a broader economic policy. They linked insider trading to larger economic issues such as hostile takeovers, which they had failed to regulate. Insider trading regulation also provided a way to express disapproval of the excesses of capitalism without criticizing capitalism *per se*. This is indicated by the lawmakers' framing of the issue as a moral failure of wealthy individuals, and not the product of entrenched disparities of wealth, influence, and access to information. Finally, focusing on insider trading, a law-enforcement issue, allowed Congress to portray itself as the "good guy" against identifiable "bad guys." America's underlying economic problems were hard to identify and explain, and even harder to solve. But a law-enforcement problem like insider trading is concrete and dramatic. Congress thus constructed an identifiable problem that was ostensibly amenable to simple solutions: increased penalties and enforcement resources.

A. Constructing the Insider Trading "Epidemic"

Congress ostensibly paid so much attention to insider trading in the 1980s because an epidemic of insider trading was in progress. Congress assumed that insider trading was a major problem, both in terms of its rate of incidence and the threat it posed to the economy. Perhaps the most remarkable aspect of the insider trading hearings is the absence of any testimony (other than bare statements of opinion) or other evidence tending to establish either of these points. Legislators did not receive or even ask for any hard evidence. Rather, they made repeated, unsubstantiated claims of a rising incidence of insider trading and the danger it posed to the markets. Indeed, Congress pressed on despite the SEC's insistence that there was no crisis, largely ignoring other issues that the SEC identified as more pressing.

It might be argued that it is irrelevant whether an insider trading epidemic was *actually* under way, because even a *perception* of an epidemic could undermine investor confidence and thus justify congressional action. Legislators and witnesses in the 1987 Senate hearings claimed that recent revelations of insider trading had

42. *Cf.* MAYHEW, *supra* note 1, at 19 ("There is nothing undemocratic or otherwise questionable about such voter plasticity; voters would have to be dense not to consider updating their preferences in response to relevant moves and events.").

damaged investor confidence. Senator Alfonse D'Amato (R-N.Y.) claimed that "[t]he public cannot help but think that the dice are loaded . . . [because of] the recent scandals If steps aren't taken to change this perception and restore public confidence, the public is going to exit from the market and not come back."⁴³ Similarly, Donald Marron, Chair and CEO of Paine Webber, argued that "[i]nsider trading abuses undermine confidence in our markets and could potentially drive foreign investors away."⁴⁴ Senator William Proxmire (D-Wis.) was in full agreement with Marron but asked for examples or proof. Marron did not attempt to do so, but merely repeated his assertions.

The hearings generated no evidence that insider trading was harming investor confidence, however. A 1986 poll showed 69% of adults believed that insider trading is common. The percentage was even higher—76%—among adults who invest in the markets.⁴⁵ But the strength of the markets in the 1980s contradicts the theory that a perception of widespread insider trading was discouraging investment. The markets were setting records by the middle of the decade. D'Amato himself observed in the 1987 hearing that the stock market was "reaching new highs almost daily" and that volatility was being caused by "program trading," not loss of confidence.⁴⁶ Senator Chic Hecht (R-Nev.) noted, "We have the highest volume in history and so obviously people still have respect for [the securities] industry."⁴⁷ Nor were investors clamoring for increased regulation of insider trading. In November 1986, after most of the major insider trading scandals of the 1980s had come to light, one survey found only 66% of respondents surveyed thought insider trading should be illegal at all. Seventy-eight percent of respondents thought most people would trade on an inside tip, and over half said they would trade on a tip.⁴⁸ Rather than discouraging investment, the belief that there were many successful, undiscovered insider traders may have encouraged investment by bolstering the perception that an investor can "beat the market" by amassing information.

The point here is not to determine empirically whether insider trading justified congressional attention, but to show that Congress had no interest in the answer to that question. This underscores the dual role of government in the construction, as well as the fulfillment, of political preferences. When the federal government began paying increased attention to insider trading cases, there was no doubt some real illegal

43. *Oversight of the Securities and Exchange Commission and the Securities Industry: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 100th Cong. 5 (1987) [hereinafter S. Hrg. 100-83] (statement of Sen. Alfonse M. D'Amato); see also *Insider Trading: Hearing Before the Subcomm. on Telecomms. and Finance of the H. Comm. on Energy and Commerce*, 100th Cong. 18 (1988) [hereinafter H.R. Ser. No.100-225] (remarks by Rep. Matthew J. Rinaldo); *Improper Activities in the Securities Industry: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 100th Cong. 4, 7 (1987) [hereinafter S. Hrg. 100-76] (remarks by Sen. Richard Shelby and Sen. Donald W. Riegle Jr.).

44. S. Hrg. 100-83, *supra* note 43, at 13.

45. Representative Rinaldo cited this poll in a 1986 hearing. *Insider Trading: Hearings Before the Subcomm. on Telecomms., Consumer Protection, and Finance of the H. Comm. on Energy and Commerce*, 99th Cong. 2 (1986) [hereinafter H.R. Ser. No. 99-168].

46. S. Hrg. 100-83, *supra* note 43, at 5.

47. *Id.* at 7.

48. See Pitt & Shapiro, *supra* note 32, at 226 n.325.

activity taking place as well as some real public sentiment against it. But the choice to focus on that particular activity was not merely a *response* to illegality or public sentiment. Prosecutors enjoy a great deal of discretion in choosing what cases to bring.⁴⁹ Congress too has a great deal of “legislative discretion” in choosing what issues to address through legislation. On one level Congress was reacting to a crisis, real or imagined, partly constructed by prosecutors. On another level Congress was actively attempting to construct the “insider trading crisis” as a political symbol.

The insider trading hearings support Davidson and Oleszek’s contention that congressional hearings are only nominally geared toward fact finding, and are in fact venues for politically minded performances.⁵⁰ Legislators seemed more concerned with decrying for the record the “problem” of insider trading than with obtaining any information about it. Their pronouncements about the extent and importance of the problem are largely confined to their opening statements.⁵¹ To the extent that witnesses discussed the matter at all, they tended to dispute the idea of an insider trading epidemic rather than support it. Such testimony does not disprove the existence of an epidemic. But the absence of serious testimony tending to show a widespread problem supports the thesis that the hearings did not serve serious fact-finding purposes. Indeed, the failure to request any such testimony suggests the hearings were not even intended to serve such purposes. Politicians had made up their minds to attack the “problem” before the hearings and used the hearings to justify that decision.⁵²

SEC Chair John Shad was a featured witness at most of the insider trading hearings, but he disputed the extent of the alleged insider trading problem. While the press and Congress sometimes portrayed him as an enforcer (for example, by quoting his “hobnail boots” declaration), he urged moderation to Congress in the hearings.⁵³

49. Rudolph Giuliani, as U.S. Attorney in New York City, brought most of the famous insider trading prosecutions of the mid-1980s. Fischel argues that Giuliani constructed an insider trading crisis in order to advance his political career. *See* FISCHEL, *supra* note 27. As Fischel notes, some of the high-profile prosecutions were eventually dropped, and others resulting in convictions were later overturned on appeal. *See id.* at 116, 126. Giuliani’s prosecutions are discussed further, *see infra* notes 64 & 156–159 and accompanying text.

50. *See* DAVIDSON & OLESZEK, *supra* note 16, at 82–83.

51. For example, Subcommittee Chair Markey opened the final House Hearings on ITSFEA by stating that “[t]he war against insider trading must be fought on many fronts.” H.R. Ser. No. 100-225, *supra* note 43, at 2. He also declared that “[d]uring a time when Wall Street has been set aflame with fraudulent activity, those of us in public office will not be seen as fiddling.” *Id.*

52. Congress did not place emphasis on fact finding outside of the hearing context, either. As mentioned above, ITSFEA contained a provision directing the SEC to conduct a study of the securities markets. The SEC had presented its last comprehensive study in 1963. The SEC never conducted the new study, however, because ITSFEA had made the study contingent on a subsequent congressional appropriation of \$5 million, which never occurred. Stuart Kaswell, Republican counsel to the House Energy and Commerce Committee during the drafting of ITSFEA, states that the Committee did not want the cost of the study to cut into SEC enforcement resources. *See* Kaswell, *supra* note 15, at 179. But the contingent nature of the provision also suggests that Congress was not very concerned with whether the study actually took place, or at least that it was more interested in enforcement than in determining whether enforcement was necessary. Kaswell, writing a very favorable assessment of ITSFEA shortly after its enactment, was least sanguine about the study provision, expressing skepticism that Congress would ever appropriate the funding “in an era of federal deficit reduction.” *Id.*

53. *See infra* text accompanying notes 56–59; Part III.D.3.

Throughout the ITSA and ITSFEA hearings, members of Congress repeatedly invited Shad to join them in declaring an insider trading epidemic. Shad consistently refused to do so. He may have been motivated in part by a desire to protect the markets from additional government regulation. Or he may have been trying to understate the corruption in the market in order to reassure investors. He may also have been motivated in part by loyalty to the budget cuts of the early Reagan years.⁵⁴ Until December 1986, Shad did not seek increased funding for enforcement, even when the Senate encouraged him to do so.⁵⁵

Although the SEC had drafted the bill that eventually became ITSA, Shad was cool and matter-of-fact in his testimony.⁵⁶ He answered questions tersely when asked, declining to join the legislators who fulminated at length about the evil of insider trading.⁵⁷ Shad did not even advocate for the bill that his own agency had advanced. Indeed, he seemed to suggest that private-sector resistance to ITSA was more well-considered than the SEC's own bill. He said ITSA was drafted by the SEC "staff" and that while the Commission approved it, "we did not have a Commission discussion in the kind of detail that has been raised by very responsible members of the bar and the securities dealers."⁵⁸ Shad's attitude toward ITSA was likely one of his many differences with the many Democrats who continued to hold key SEC staff positions after Shad assumed the chairmanship.⁵⁹

During the hearings on ITSA in 1983 and 1984, members of Congress tried unsuccessfully to get Shad to decry insider trading and its corrosive effect on investor confidence. Representative John Dingell (D-Mich.), Chair of the House Committee on Energy and Commerce, asked Shad whether there might be more insider trading activity than the SEC was able to detect.⁶⁰ Shad acknowledged this to be possible but added with implacable logic that for any type of securities law violation, indeed for any type of legal violation, "we do not know the cases that we do not identify." Dingell pressed on, asking whether those undetected cases might affect investors' returns and undermine "the overall confidence of the trading public in the marketplace." Again Shad declined to sound the alarm, replying that securities law violations were unlikely to affect the market if they were unknown to investors. Finally Dingell sought Shad's

54. See ANNE M. KHADEMIAN, *THE SEC AND CAPITAL MARKET REGULATION: THE POLITICS OF EXPERTISE* 181 (1992). All SEC Chairs are of course nominated by the White House, but Khademan believes Shad was especially partisan and close to the Reagan administration. See *id.* at 180-82.

55. See *infra* Part III.D.3.

56. Shad's restrained position contrasted with the legislative proposal the SEC sent to the House in 1982. The proposal identified insider trading as a "serious problem" that "undermines expectations of fairness," and argued that "[t]ougher sanctions are needed." Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 1984 U.S.C.A.N. (98 Stat.) 1264. A cover letter accompanying the proposal, signed by Shad, stated that the proposal represented the views of the Commission.

57. See *infra* Part III.D.3.

58. H.R. Ser. No. 98-33, *supra* note 4, at 53.

59. I am grateful to Donald Langevoort for suggesting this explanation. Shad was perceived as more partisan than his predecessors and broke with agency tradition by filling key agency posts with Republican outsiders, rather than career agency staffers, many of whom were Democrats. See KHADEMIAN, *supra* note 54, at 166-70, 179-82.

60. H.R. Ser. No. 98-33, *supra* note 4, at 65.

affirmation of the following, more restrained assessment: "There are certainly some rogues out there taking unfair advantages and behaving . . . like thieves." Shad agreed at last, but immediately qualified Dingell's mild statement even further: "I would like to try to put it in perspective . . . I believe that it is a very tiny fraction of the billions of dollars in securities that change hands daily."⁶¹

Even as the testimony raised doubts about the insider trading epidemic, it identified other issues as more important—issues that went unaddressed. James Treadway, then an SEC Commissioner, had recently identified accounting fraud as a greater threat to the markets than insider trading. In the House ITSA hearings, the head of the SEC Division of Enforcement, John Fedders, agreed with Treadway. According to Fedders,

there is no way that you can compare insider trading as a priority to two other areas, that being cooked books . . . and second, our enforcement program against regulated entities, broker dealers, [and] brokerage firms. Insider trading or any other priority that comes about will never replace those two as number one and number two because that is the business we are in.⁶²

Despite the opinions of Treadway and Fedders, Congress did not move to address the issues of accounting fraud and broker-dealer regulation.⁶³ What explains the success of arguably unimportant legislation increasing insider trading penalties, and the failure of the arguably more important issue of accounting reform—a failure that came back to haunt us in the Enron-WorldCom era? Recall the simple argument that Congress feels pressure to produce results—that is, legislation—to justify its legitimacy in times of economic uncertainty. Congress may have chosen to address insider trading in part because it is relatively easy to produce results in the form of increased penalties. It may have paid less attention to accounting reform because focusing on that complex issue, and taking on its powerful, entrenched opponents in the accounting profession, was less likely to bear fruit.

Two years after the passage of ITSA, Congress again held hearings on insider trading. The 1986 hearings were apparently motivated by recent revelations of insider

61. *Id.* This exchange may be further illuminated by the reputedly tense partisan conflict between Dingell and the Reagan administration generally, and Shad in particular. See KHADEMIAN, *supra* note 54, at 181.

62. H.R. Ser. No. 98-33, *supra* note 4, at 86. Fedders also downplayed the importance of insider trading in his Senate testimony on ITSA. *The Insider Trading Sanctions Act of 1983: Hearings Before the Subcomm. on Securities of the S. Comm. on Banking, Housing and Urban Affairs*, 98th Cong. 66 (1984) [hereinafter S. Hrg. 98-831].

63. The House convened hearings on accounting failures in 1985, apparently inspired by the early thrift failures that eventually snowballed into the savings and loan crisis of the late 1980s. Oddly, however, the hearings focused on accounting in public corporations, not thrifts. Rep. Ron Wyden (D-Or.) proposed an accounting reform bill in 1986. After it failed, he introduced a series of progressively more watered-down versions in subsequent years. These proposals yielded nothing until a small provision regarding auditor reporting of fraud was included in the Private Securities Litigation Reform Act of 1995. Securities Exchange Act of 1934, § 10A, 15 U.S.C. § 78j-1 (2000 & Supp. II 2002). See generally Thomas L. Riesenberg, *Trying to Hear the Whistle Blowing: The Widely Misunderstood "Illegal Act" Reporting Requirements of Exchange Act Section 10A*, 56 BUS. LAW. 1417 (2001); Quinton F. Seamons, *Audit Standards and Detection of Fraud Under the Private Securities Litigation Act of 1995*, 24 SEC. REG. L.J. 259, 260-67 (1996).

trading by investment banker Dennis Levine and by a group of defendants known in the press as the “Yuppie Five.”⁶⁴ The congressmen praised Shad effusively for his purportedly aggressive fight against insider trading.⁶⁵ But Shad again downplayed the scope of the insider trading problem. “There is too much insider trading,” he conceded, “but it should not be exaggerated out of proportion.”⁶⁶ He argued that: “[A]ll fraudulent securities activities, including insider trading, amount to a fraction of 1 percent of the multibillions of dollars of corporate and Government securities that trade daily in America. It should also be noted that insider trading is but one component of the Commission’s enforcement program.”⁶⁷ Asked whether he thought the incidence of insider trading had increased, Shad would offer only that: “I think the dollar amount is much greater than it’s been, because the dollar amount of everything else that’s going on in the market is so much higher than it’s ever been before.”⁶⁸ According to Shad, the public had an inflated picture of the incidence of insider trading because “[w]hat many think is insider trading is more often than not legal speculation on rumors and gossip.”⁶⁹

The witnesses’ testimony did not support the legislators’ assertions that insider trading was increasing. Gordon Macklin, president of the National Association of Securities Dealers (NASD), stated merely that insider trading “undermines the reasonable expectation that all participants in the securities markets play by the same rules.”⁷⁰ He said no more about the extent of the problem. John Phelan, head of the New York Stock Exchange (NYSE), went on at length about the corrosive effect of insider trading on investor confidence. But he did not argue that insider trading was on the rise. Rather, his testimony focused on describing and defending the NYSE’s internal detection programs. Although he conceded that these measures “may not be a final answer,” he argued that, along with ITSA, they “constitute a strong deterrent.” Arthur Levitt, then the chairman and CEO of the American Stock Exchange, directly challenged the idea of an insider trading “epidemic.” He acknowledged evidence of stock price movements prior to public announcements of takeovers, but argued that they could be the result of legal purchases by acquirers and speculators.⁷¹

64. The “Yuppie Five” were corporate lawyer Michael David, stockbroker Morton Shapiro, Shapiro’s client Daniel Silverman, and arbitrage analysts Andrew Solomon and Robert Salisbury, all of whom pleaded guilty to insider trading charges in 1986. See *Guilty Plea in “Yuppie 5” Case*, CHI. TRIB., Nov. 27, 1986, at C3.

65. H.R. Ser. No. 99-168, *supra* note 45, at 1 (Wirth), 2 (Rinaldo), 3 (Luken).

66. *Id.* at 12.

67. *Id.* at 5.

68. *Id.* at 39; see also *id.* at 44 (“We are now in the strongest bull market in history. So the whole marketplace has expanded enormously and there is no evidence that this activity has expanded more than the rest of the market.”). Shad further stated that the increase in tender offers has “given greater visibility, greater opportunity for abuse.” *Id.* at 44.

69. *Id.* at 5. As Shad’s comment indicates, the disagreement between legislators and witnesses over the prevalence of “insider trading” may be partly due to the lack of an agreed-upon definition of the term. Although defining the term would seem a prerequisite to any discussion of insider trading, Congress failed to do so. See *infra* Part III.D.1.

70. H.R. Ser. No. 99-168, *supra* note 45, at 150.

71. *Id.* at 149, 182.

Additional House hearings held just after the settlement of the Ivan Boesky case generated similar testimony.⁷² Stephen Hammerman, general counsel for Merrill Lynch, testified that he did not believe insider trading was widespread proportionate to the size of the industry, or that it was growing.⁷³ Representative Ronald Wyden (D-Or.) asked John Phelan whether Boesky's insider trading was just "the tip of the iceberg" or an "aberration."⁷⁴ Phelan said he was unable to answer. Wyden insisted on a response, but Phelan continued to demur. Finally, Phelan allowed that, "based on my 30 years of gut feeling . . . there has got to be more in that area than is out now, and maybe significantly more." Wyden thanked the witness for finally conceding to Wyden's predetermined conclusion. "Your 30 years' worth of gut feeling are certainly helpful and confirms [sic] what I have heard at this point." But no witness up to that point had argued that insider trading was on the rise.

In both hearings, the testimony of the stock exchanges and securities firms downplaying the significance of insider trading obviously had a self-serving element. But this negative testimony was the *only* relevant testimony. The House concluded that insider trading was a significant and growing problem even though the hearings adduced *no* meaningful evidence to that effect. Wyden's exchange with Phelan epitomizes the fact that legislators had made up their minds about the scourge of insider trading and would not let any hearing testimony affect their views.

In April 1987, the Senate held a hearing entitled "Improper Activities in the Securities Industry." The only witnesses were Gary Lynch, John Fedders's successor as the SEC's chief of enforcement, and Rudolph Giuliani, U.S. Attorney for the Southern District of New York. The hearing consisted largely of discussion of their recent investigation and prosecution of Dennis Levine and Ivan Boesky, two of the most notorious insider traders of the 1980s. Senator William Proxmire (D-Wis.), chair of the Committee on Banking, Housing, and Urban Affairs, lauded Lynch and Giuliani as "the Ferdinand Pecoras of the 1980's [sic]."⁷⁵ The comparison is far fetched to say the least. Pecora investigated and exposed large, established companies and banks as corrupt organizations.⁷⁶ Lynch and Giuliani, however, mounted no such challenge to the Wall Street establishment. Instead they prosecuted individual criminal defendants, none of whom were alleged to be acting at the behest of an established Wall Street organization.⁷⁷

As with the earlier House hearings, these hearings did not conduct investigation and fact finding. Rather, they started from the presumption that insider trading was a major problem and asked witnesses to agree with that opinion and to speculate about its frequency and economic effects. The senators congratulated Lynch and Giuliani for

72. *SEC and Insider Trading: Hearings Before the Subcomm. on Oversight and Investigations of the H. Comm. on Energy and Commerce, 99th Cong. (1986)* [hereinafter H.R. Ser. No. 99-179].

73. *Id.* at 192.

74. *Id.* at 158.

75. S. Hrg. 100-76, *supra* note 43, at 2.

76. See SELIGMAN, *supra* note 33, at 20-38 (describing Pecora Hearings).

77. Giuliani and Lynch maintained that they would uncover a large-scale criminal conspiracy thanks to Levine and Boesky's cooperation (negotiated as part of their plea bargains). No such conspiracy was ever found, however.

their completed cases and listened to condemnations of Levine and Boesky issued by members of the financial establishment who had no direct knowledge of the conduct.⁷⁸

The emptiness of the proceedings was clear from Proxmire's opening statement about the purpose of the hearings:

Some have argued that we should drop all laws that prohibit insider trading They would argue that . . . the Boeskies and Levines . . . deserve every penny they can steal.

So you [Lynch and Giuliani] tell us, if you get a chance, why we, as Members of the Congress, should be concerned with insider trading . . . and does insider trading, in fact, demean and damage the capital markets of our country?⁷⁹

Proxmire's suggestion that there was significant opposition to the prohibition on insider trading is simply false.⁸⁰ A few academics had questioned the prohibition of insider trading,⁸¹ but none of them testified at any of the hearings or enjoyed a prominent place in the public debate at the time. No politicians or regulators had suggested any rollback of insider trading law. As for Proxmire's question of whether insider trading affects the capital markets, this is an empirical issue as to which two law-enforcement officials basking in praise for successful insider trading prosecutions are hardly the most qualified or impartial sources.

B. Hostile Takeovers

Why would Congress participate in *creating* the impression of an insider trading epidemic, despite the lack of evidence and resistance from the SEC? America's multiple, inchoate economic uncertainties could not be denied. Congress needed a relatively simple and manageable problem to serve as a proxy for those anxieties and an opportunity for Congress to respond to them. In the public discourse of the 1980s, hostile takeovers often filled this role. They were, rightly or wrongly, popularly blamed for mass layoffs and the loss of American competitiveness.⁸² Hostile takeovers were

78. See Hrg. 100-83, *supra* note 43, at 11-23 (testimony of Donald Marron, Chairman and CEO of Paine Webber Group).

79. S. Hrg. 100-76, *supra* note 43, at 2.

80. Nonetheless, in the final hearings on ITSFEA, Rep. Rinaldo similarly took the opportunity to "disagree with those few critics who argue there is no problem with insider trading, that it is really only a victimless crime." H.R. Ser. No. 100-225, *supra* note 43, at 18.

81. The only critic mentioned by name in the hearings is Professor Henry Manne, whose famous writings in the 1960s defended insider trading profits as a form of compensation for corporate managers who engineer profitable transactions. See HENRY MANNE, *INSIDER TRADING AND THE STOCK MARKET* 131-45 (1966). His compensation argument would not apply to outside arbitrageurs like "the Boeskies and Levines." Other examples of academic critiques of insider trading regulation at the time included Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983) and Michael Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1 (1980), but it is not clear whether Proxmire or other members of Congress were aware of these works.

82. Like hostile-takeover legislation, Congress had difficulty passing legislative protection against layoffs. The 100th Congress passed plant-closing legislation (WARN) on August 4, 1988, some fourteen years after the first plant-closing bill was introduced. See Richard W. McHugh, *Fair Warning or Foul? An Analysis of the Worker Adjustment and Retraining*

upsetting to labor, the economic establishment, and members of the public who envied wealth.⁸³ But they were far more complex and politically difficult to address than insider trading. In 1986, Dingell told the *New York Times* that a House subcommittee had been trying for four years to produce hostile takeover regulations, but "could not overcome the technical and substantive questions It is difficult in terms of showing that the action taken actually deals with the problem and does some good."⁸⁴

Furthermore, although hostile takeover activity was a major point of popular concern, the Reagan administration supported it in the name of free markets and the expected efficiency gains of a competitive "market for corporate control." In the face of Republican opposition, Democrats' attempts to regulate hostile takeovers failed. Although major economic indicators suggest that the recession had ended by the mid-1980s, hostile takeovers remained a major political concern throughout the decade. Indeed, despite congressional failure to do so, several states enacted antitakeover legislation throughout the 1980s and even into the 1990s.⁸⁵

Unlike hostile takeovers, insider trading had no defenders in Washington.⁸⁶ In the hearings, Democratic members of Congress repeatedly conflated insider trading with hostile takeovers. They appear to have been suggesting to constituents that insider trading laws would impede hostile takeovers despite the failure of attempts to pass actual takeover regulation. Knowing this to be unlikely, Republicans who favored the corporate-control market had no reason to object. A focused campaign against an easy target, insider trading, provided an opportunity for both parties to express concern about economic issues and to demonstrate their effectiveness by producing a legislative response.

The hostile takeover wave of the 1980s has been criticized for destroying American businesses and jobs and defended as part of a salutary streamlining of bloated American industry.⁸⁷ This article takes no position on this issue. Justified or not, there was strong anti-takeover sentiment in the popular imagination, from organized labor,⁸⁸

Notification (WARN) Act in Practice, 14 BERKELEY J. EMP. & LAB. L. 1 (1993). Its primary provision was a requirement of advance notice of plant closings. It did not otherwise limit closings or provide for compensation to workers. WARN created private causes of action for workers against employers who violated the notice requirement, but did not provide for government enforcement of the requirement. *See id.* at 25–26.

83. *See* FISCHER, *supra* note 27, at 22–28.

84. Jonathan Fuerbringer, *Congress Weighs Takeover Curbs in Effort to Stem Insider Trading*, N.Y. TIMES, Nov. 23, 1986, at 1.

85. *See, e.g.*, Lyman Johnson & David Millon, *Missing the Point About State Takeover Statutes*, 87 MICH. L. REV. 846, 850 (1989) (noting that Delaware, the leading corporate law jurisdiction, passed an antitakeover "business combinations" statute in 1988); Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 27–28 (1992) (noting that between 1983 and 1992, twenty-nine states passed so-called "other constituencies statutes" that gave managers discretion to reject hostile takeover bids).

86. As noted above, insider-trading regulation had some critics in academia. *See supra* note 81.

87. The former position is articulated in, for example, Andrei Shleifer & Lawrence Summers, *Breach of Trust in Hostile Takeovers*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33, 35 (Alan J. Auerbach ed., 1988); the latter is advanced in, for example, Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1953–57 (1991).

88. *See Regulating Hostile Corporate Takeovers: Hearings on S. 227, S. 678, S. 1264, S. 1323, and S. 1324 Before the S. Comm. on Banking, Housing, and Urban Affairs*, 100th Cong.

and from the financial and industrial establishment.⁸⁹ The Reagan White House and the SEC, however, were “ideologically committed to fostering a market for corporate control.”⁹⁰ Hostile acquirers and many academic commentators justified the hostile takeover movement in large part with the argument that it would unlock shareholder value. This approach explicitly placed stock prices ahead of employee welfare and other measures of a corporation’s social utility. Both the normative argument that privileged shareholder value and the descriptive argument that hostile takeovers served that norm were extremely controversial at the time. The public and many politicians in the 1980s tended to dismiss the focus on share price as an immoral or disingenuous justification for the greed of “corporate raiders.”

Both parties felt political pressure to respond to hostile takeovers. The Tender Offer Report Act was introduced in the House in 1984.⁹¹ Senator Proxmire (D-Wis.) introduced the unsuccessful Corporate Productivity Act in 1985, requiring that all takeover attempts be made via tender offers submitted to the target’s board of directors.⁹² Multiple takeover regulation bills were introduced in the Senate in 1987.⁹³ Rather than adopting the White House’s strong protakeover position, congressional Republicans introduced their own version of tender offer reform.⁹⁴ The GOP bill also included some measures designed to fight insider trading.⁹⁵ Neither the securities industry nor the SEC supported either party’s proposals, and the parties could not come to agreement on a compromise bill.⁹⁶ None of the proposed takeover regulation bills passed.⁹⁷

243–49(1987) [hereinafter S. Hrg. 100-183] (testimony of Laurence Gold, General Counsel, AFL-CIO).

89. See S. Hrg. 100-83, *supra* note 43, at 11–23 (testimony of Donald Marron, Chairman and CEO of Paine Webber Group).

90. Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 131 (1998).

91. See *id.* at 129.

92. S. 706, 99th Cong. (1985).

93. These bills, discussed in S. Hrg. 100-183, *supra* note 92, included S.227 (“To amend the Securities Exchange Act of 1934 to Impose Additional Restraints on Corporate Tender Offers, and for Other Purposes”); S.1264 (“To Place a Moratorium on Hostile Foreign Takeovers”); and S. 1324 (“To amend the Securities Exchange Act of 1934 to Provide for More Effective Disclosure and to Curb Abuses with Respect to Accumulations of Stock and the Conduct of Tender Offers”).

94. H.R. 2668, 100th Cong. (1987). Of course, the introduction of a competing bill could also have been a strategic move designed to derail the passage of legislation.

95. The bill would have authorized the SEC to cooperate with foreign securities enforcement investigations and to pass rules requiring broker-dealers and self-regulatory organizations (“SROs,” i.e., the exchanges and NASDAQ) to impose internal surveillance systems; it also would have instructed the Commission to conduct a comprehensive study of the securities markets. See Kaswell, *supra*, note 15, at 148–49. These provisions were later enacted as part of ITSFEA. The GOP bill also would have authorized SEC funding increases as requested by the Commission; this was passed as part of separate legislation. See *id.* at 148 & n.17.

96. See *id.* at 147–150. Anne Khademian argues that an SEC endorsement “would have provided the necessary push for [anti-takeover] legislation.” KHADEMIAN, *supra* note 54, at 186.

97. FISCHEL, *supra* note 27, at 36. Fischel credits the 1987 crash with finally ending attempts at federal anti-takeover legislation. Some observers feared a coming 1929-style crash,

Although the parties could not agree on hostile takeover legislation, they could agree that insider trading was undesirable. The administration had apparently chosen to respond to the excesses of the hostile takeover market indirectly through insider trading prosecutions of prominent takeover artists like Milken and Boesky rather than through tender offer regulation.⁹⁸ Furthermore, as argued above, the Republican party had to respond to legitimacy concerns raised by its deregulatory agenda, not to mention the Thayer and Reed insider trading scandals. Thus insider trading laws, particularly ITSFEA in 1988, may have been in part a compromise attempt between Democrats and Republicans to suggest that they were taking *some* economic action in response to hostile takeovers. This tail came to wag the dog: after the failure of antitakeover legislation in 1987, Congress passed ITSFEA, which included most of the insider trading provisions from the GOP anti-takeover bill in addition to control-person liability and increases in maximum penalties.

Insider trading and takeovers were linked in the public imagination. Most of the notorious insider traders, such as Dennis Levine, Ivan Boesky, and the “Yuppie Five,” were convicted for trading on nonpublic information regarding hostile acquisitions.⁹⁹ A 1985 *Business Week* cover story on the insider trading “epidemic” conducted a study of 229 takeover attempts and found that in 72% of the cases, target company prices rose before a bid was publicly announced.¹⁰⁰ The article implied that this was due to insider trading, although such increases could be due to lawful trades by acquirors or speculators.¹⁰¹

In the 1980s hearings, many Democrats insisted that insider trading and takeovers were “related,” but they never clearly stated what the relationship was. The conflation raises questions about the extent to which insider trading was the true concern of Congress. The evidence suggests that the insider trading hearings and legislation were at least in part an expression of displaced antitakeover sentiment. Indeed, the senators who conflated hostile takeovers with insider trading in hearings on insider trading barely mentioned insider trading in the hearings on antitakeover bills in 1987.¹⁰² Instead, they focused on the arguments that hostile takeovers destroy healthy companies and cost jobs.

As with the question of the insider trading “epidemic,” Congress did not seek evidence of a link between hostile takeovers and insider trading. And as with the “epidemic” question, Congress ignored the conflicting views of SEC Chair John Shad. In 1983 hearings on ITSA, Shad did not criticize hostile takeovers or directly blame them for insider trading, but he did note that hostile takeovers provide especially

and some blamed the specter of antitakeover legislation for the crash. Congress lost its stomach for regulation for fear of catching blame for harming financial markets further. *See id.* at 35–39.

98. *See id.*

99. Note that the opportunities for profitable insider trading in an active mergers and acquisitions market are not created solely by hostile takeovers. In 1987 Senate hearings, U.S. Attorney Rudolph Giuliani submitted a list of what appear to be insider trades, or suspected insider trades, by Levine, Boesky, Martin Siegel, Ilan Reich, and Marcel Katz. The vast majority of them involved *friendly* takeovers, not hostile ones. *See* S. Hrg. 100-76, *supra* note 43, at 29–35.

100. Jeffrey M. Laderman, *The Epidemic of Insider Trading: The SEC Is Fighting a Losing Battle to Halt Stock-Market Abuses*, *BUS. WK.*, Apr. 29, 1985, at 78, 79.

101. *Cf.* H.R. Ser. No. 99-168, *supra* note 45, at 179–203 (testimony of Arthur Levitt), 7–27 (testimony of John Shad).

102. *See generally* S. Hrg. 100-183, *supra* note 88.

profitable opportunities for insider trading,¹⁰³ especially with the growth of standardized option contracts.¹⁰⁴ In a June 1984 speech, Shad had criticized leveraged buyouts for saddling American corporations with excessive debt.¹⁰⁵ In 1985, however, after Treasury Secretary Regan expressed the White House's support for an active corporate control market, Shad told the Senate that takeovers were good for the economy because they tended to increase market capitalization.¹⁰⁶ He also expressed faith in the market to judge the value of junk bonds, which were often used to finance takeovers and thus considered part of the perceived takeover problem.¹⁰⁷

Although prices often rise prior to takeover announcements, Shad argued in 1986 House hearings that these spikes are "often" the result of legal purchases by prospective acquirers themselves and other parties with legally acquired information.¹⁰⁸ According to Shad,

it is not difficult for securities analysts, risk arbitrageurs, speculators and a wide variety of others to identify probable takeover candidates If you wanted my opinion, I believe that the legitimate reasons, plus rumors and speculations that the market has always had in enormous quantity, far exceed the amount of insider trading prior to public announcement.¹⁰⁹

When the House held hearings on insider trading in December 1986, the Boesky case had just settled, and the Levine case had settled that spring. The SEC and Justice Department continued to investigate Michael Milken, who had close professional ties to Boesky and whose junk bond empire dominated the financing of hostile takeovers. These individuals, like so many of the prominent insider traders of the 1980s, were convicted or suspected of trading on information about takeovers. Thus they intensified the popular association of insider trading with hostile takeovers.

103. In a written statement, included in the hearing record, Shad wrote: "The large number of mergers and tender offers has been an important factor in the increased incidence of insider trading because the reaction of the market to the announcement is predictable Thus, persons with advance knowledge of a proposed tender offer or merger announcement have an opportunity to obtain substantial profits in a short period of time without great risk of loss." H.R. Ser. No. 98-33, *supra* note 4, at 19. John Phelan, head of the NYSE, offered a similar explanation in 1986 hearings. See H.R. Ser. No. 99-179, *supra* note 72, at 164.

104. In his written statement, Shad pointed out that standardized option contracts reduced the capital one had to put at risk in order to trade on inside information, because buying options is cheaper than buying the underlying stock. Furthermore, "once a tender offer or merger is announced, the value of an option contract tends to increase at a much greater percentage than the rise in the price of the stock." H.R. Ser. No. 98-33, *supra* note 4, at 20.

105. Mark Potts, *Big Investors' Merger Role Questioned*, WASH. POST, June 8, 1984, at E1. Shad further stated, "The theory that contested [i.e., hostile] takeovers discipline incompetent managements is of limited veracity." *Id.*

106. *Reauthorizations for the Securities and Exchange Commission, 1986-88: Hearing on S. 919 Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs, 99th Cong. 45-46 (1985)* [hereinafter S. Hrg. 99-129] (statement of John S.R. Shad, SEC Chairman).

107. *Id.*

108. H.R. Ser. No. 99-168, *supra* note 45, at 11, 39.

109. *Id.* at 39.

In 1987 hearings on "The SEC and Insider Trading," Representative Michael Oxley (R-Ohio) argued that insider trading and hostile takeovers "[were] two distinct issues."¹¹⁰ Oxley was clearly in the minority, as hearings nominally devoted to insider trading became a forum for criticizing hostile takeovers. As Shad pointed out, the hostile takeover wave created unprecedented opportunities to make immense profits by trading on nonpublic information. But many members of Congress reversed the relationship, suggesting that insider trading caused takeovers. Representative Wyden (D-Or.) asked, "Would the whole phenomenon of what Mr. Boesky so poetically calls 'merger mania' have gathered steam without widespread use of insider trading? It seems very, very unlikely."¹¹¹ Similarly, Representative Florio (D-N.J.) stated, "The insider trading scandal has . . . raised some significant questions about . . . what in fact is the driving force behind [hostile] takeovers."¹¹² This reverse theory—that insider trading is indispensable to takeovers—makes little sense. Indeed, trading on leaked information about a planned takeover bid can trigger an increase in the target's price, thereby discouraging the acquisition.¹¹³

In 1986 hearings on SEC funding, Representative Dingell (D-Mich.) asked Shad to tell the panel:

[w]hat will be the level of enforcement that you will need to properly deal with not only the insider trading questions, but the other related questions of takeovers and mergers . . . because it appears very much to the Chair that these are related matters and may perhaps be simply different portions of the same apple.¹¹⁴

Shad's response to the question focused on insider trading and did not mention takeovers. By implying that the SEC could regulate takeovers by stepping up securities law enforcement, politicians diverted attention from their failure to pass antitakeover legislation and shifted responsibility from Congress to the SEC. Moreover, Dingell referred to hostile takeovers as "related" to insider trading, suggesting that congressional success in producing insider trading legislation constituted a blow against hostile takeovers. Dingell did not explain, however, *how* takeovers and insider trading were "related."

The Senate held hearings in February 1987 on "Oversight of the Securities and Exchange Commission and the Securities Industry."¹¹⁵ Although the hearings concerned the SEC generally, and not insider trading in particular, insider trading and hostile takeovers predictably emerged as a prominent topic. Senator Sasser (D-Tenn.)

110. H.R. Ser. No. 99-179, *supra* note 72, at 6. Senator Jake Garn (R-Utah) used exactly the same language in 1987 Senate hearings and was similarly ignored. S. Hrg. 100-76, *supra* note 43, at 9.

111. H.R. Ser. No. 99-179, *supra* note 72, at 5.

112. *Id.* at 9.

113. It is conceivable (though unlikely, given the costs and risks involved) that a takeover bid could be a bluff designed to drive up the target's share price and create the opportunity for secret trading profits. But a bluffer could more easily (and legally) make money through greenmail than insider trading. Moreover, this fanciful scenario only makes sense if no takeover were ever intended, and thus it lends no support to the theory that insider trading is intimately linked to takeovers.

114. H.R. Ser. No. 99-179, *supra* note 72, at 90-91.

115. S. Hrg. 100-83, *supra* note 43.

called for “legislation that shines the light on the stock manipulations that are at the heart of corporate takeovers today.”¹¹⁶ Donald Marron, Chairman and CEO of Paine Webber Group, testified that government action was necessary to prevent “the loss of public confidence” caused by insider trading.¹¹⁷ He supported increasing the flow of information to the market, for example, by requiring earlier disclosure of the acquisition of large blocks of a stock¹¹⁸ and of trades in a stock by the issuing corporation’s directors, officers, and major shareholders.¹¹⁹ In supporting enhanced disclosure, Marron unsurprisingly seemed more concerned with impeding *takeovers*, not with limiting *insider trading* based on takeover information. This is particularly evident in the following statement:

Attempts should be made to achieve more balanced rules between target companies and buyers to help reduce the abuses that are being experienced in [tender offers]. For example, more diligent consideration should be given to the elimination of so-called greenmail and to the creation of rules that would require the full financing of tender offers before they happen.¹²⁰

The full financing proposal has no apparent connection to insider trading. Rather, it appears to be aimed at Michael Milken’s aggressive method of financing takeovers by relatively small acquirers. Commercial and investment banks were loath to finance hostile takeovers. Drexel, however, would give credibility to unfunded tender offers by announcing “that it was ‘highly confident’ it would raise the money promised in a takeover bid” and then quickly raise the funds by selling junk bonds.¹²¹ Marron’s testimony seemed to express the financial establishment’s desire to protect its corporate clients from hostile takeovers.

In the Senate’s 1987 hearings on “Improper Activities in the Securities Industry,” testimony focused on the successful stock-fraud prosecutions of Ivan Boesky and Dennis Levine by Giuliani and Lynch.¹²² Nonetheless, senators introduced the hearings by implying that hostile takeovers constitute “improper activities.” They also implied the reverse theory of causation espoused by Wyden and Florio in the 1986 House hearings. Senator Proxmire (D-Wis.) asked rhetorically,

How much do we really know about the corporate takeover game and the complex network of information that circulates among investment bankers,

116. *Id.* at 6.

117. *Id.* “I reluctantly conclude that Wall Street cannot solve this problem alone,” Marron stated. *Id.* at 12.

118. *Id.* Such disclosure is governed by section 13(d) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78m(d) (2000 & Supp. II 2002). Section 13(d) reform is discussed in detail *infra* text accompanying notes 128–136. Marron also suggested broadening the reach of 13(d) to include not only groups that explicitly agree to obtain five percent or more of an issue, but also “tacit understandings” concerning “concerted or coordinated activities relating to significant acquisitions of stock in publicly held companies.” S. Hrg. 100-83, *supra* note 43, at 12.

119. *See id.* at 12. Such disclosure is governed by section 16(a) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78p(a) (2000 & Supp. II 2002).

120. S. Hrg. 100-83, *supra* note 43, at 14.

121. STEWART, *supra* note 27, at 114–15.

122. S. Hrg. 100-76, *supra* note 43.

takeover lawyers, corporate raiders, arbitrageurs, stock brokers, junk bond investors and public relations specialists?

Is insider trading central to the takeover process, or is it merely an isolated abuse?¹²³

Senator Jim Sasser (D-Tenn.) suggested that takeover bids were announced in order to create the “opportunity” for insider trading.¹²⁴ Senator John Heinz (R-Pa.) stated, “I am most interested in what our witnesses have to say, because what this committee needs to do is determine whether there is something inherently corrupting in the merger game and the way it is played.”¹²⁵ The only witnesses at the hearing, however, were Giuliani and Lynch, enforcement officials unlikely to be qualified to evaluate “the merger game” as a whole.

Senator Heinz indicated that his real concern was takeovers per se, and not their relationship to insider trading:

[T]he fast bucks are being made at the expense, I fear, of America’s competitiveness, because every fast buck used in a takeover battle, ending up as debt on a balance sheet of an acquirer, is a buck that cannot go into research or development or long-term planning or productivity enhancement.¹²⁶

This is a plausible hypothesis about takeovers, and potentially a good policy justification for their regulation. But, takeovers have nothing to do with insider trading, or the hearings at hand. The hearings did not discuss whether the takeover wave had resulted in a misallocation of resources or whether insider trading had anything to do with it. As with the general nature of “the merger game,” the macroeconomic consequences of takeovers extended far beyond the expertise of Giuliani and Lynch.

The senators’ phrasing and subsequent statements during the hearing shows that they had no interest in gathering evidence about the relationship between takeovers and insider trading. Despite the opening statements, very little of the questioning concerned this topic—about three pages of eighty total pages of testimony and questioning.¹²⁷ This limited discussion addressed only the uncontroversial fact that impending takeovers (friendly as well as hostile ones) create the opportunity to make unusually large amounts of money from inside information. It did not explore the implausible theory that insider trading causes hostile takeovers. Indeed, despite the repeated, unsupported statements of representatives and senators, none of the hearings produced (or sought) any evidence supporting this idea.

Congress considered, but ultimately rejected, a direct and potentially effective method to combat trading based on nonpublic information about takeovers: section 13(d) reform. Section 13(d) of the Securities and Exchange Act gives the acquirer of five percent or more of a stock ten days to file notice of that fact with the issuer, the exchanges, and the SEC.¹²⁸ The opportunity to trade on significant nonpublic information arises during that ten-day window. Requiring earlier disclosure of large

123. *Id.* at 1.

124. *Id.* at 11–12.

125. *Id.* at 2.

126. *Id.* at 3.

127. *See id.* at 72, 76–77.

128. Exchange Act § 13(d)(1), 15 U.S.C. § 78m(d)(1) (2000).

positions would limit such opportunities, while avoiding the legislative difficulties involved in creating a new class of proscribed conduct. As noted above and further discussed below, securities law did not (and still does not) clearly define illegal "insider trading." Eliminating opportunities to trade on nonpublic information would seem to be a more effective prevention measure than increasing penalties for a poorly defined offense. However, increased penalties are more dramatic and easier to explain than disclosure regulations.

Because the SEC supported it, Congress likely could have passed 13(d) reform by itself or linked to ITSFEA. But it appears that Congress pursued 13(d) reform as a device to regulate takeovers, not to prevent insider trading. Closing the ten-day window could derail takeovers because early disclosure would raise acquisition prices and enable the target to institute takeover defenses. 13(d) reform came before Congress as part of a package of hostile takeover regulation, and when hostile takeover regulation failed, 13(d) reform failed with it. This framing of 13(d) reform is consistent with the argument advanced above that Congress was more concerned with takeovers than with insider trading in connection with takeovers.

In 1980, SEC Chairman Harold Williams proposed closing the 13(d) window, apparently to discourage hostile takeovers.¹²⁹ In 1983, his successor, John Shad, appointed a Blue Ribbon Advisory Committee on Tender Offers. The committee pronounced itself unable to determine whether hostile takeovers were beneficial or harmful to the economy, but nonetheless recommended a mild reform package that included closing the 13(d) window.¹³⁰ The proposed Tender Offer Report Act, reported by the House Energy and Commerce Committee in 1984, would have closed the window, but would have also placed further requirements on bidders. For example, the bill would have increased the length of time tender offers were required to remain open, and bidders would have to file an impact statement. The Reagan administration and the SEC saw the bill as too restrictive and opposed it.¹³¹ Hearings on takeover regulation were held in the 99th and 100th Congresses, but they produced no legislation.¹³²

The SEC continued to support 13(d) reform in 1987 when Congress once again considered takeover regulation.¹³³ But as in 1984, 13(d) reform was coupled with additional takeover restrictions that alienated the SEC and the White House and doomed the entire package. The takeover bills considered by Congress in 1987 would have, in slightly different ways, closed or narrowed the 13(d) window, increased required disclosure for tender offers, and increased the minimum period of time tender offers were required to remain open from twenty days to periods ranging from thirty to sixty days.¹³⁴

129. Karmel, *supra* note 90, at 128–29.

130. FISCHER, *supra* note 27, at 37.

131. Karmel, *supra* note 90, at 129.

132. S. Hrg. 100-183, *supra* note 88; *Impact of Corporate Takeovers: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 99th Cong. (1985).

133. Karmel, *supra* note 90, at 129. In 1987, the SEC supported narrowing the window from ten days to five: "The SEC's rationale for this proposal was that it would promote prompt disclosure without unduly inhibiting the ability of market participants to trade freely. There was no mention of curbing insider trading in the tender offer arena." *Id.* (citation omitted).

134. These bills are reprinted and discussed in S. Hrg. 100-183, *supra* note 88.

It was in fact well within Congress's power to directly prohibit trading on material information about hostile takeovers, yet it declined to do so. Prior to Shad's chairmanship, the SEC passed such a rule in 1980.¹³⁵ However, the Commission's statutory authority to pass such a rule was, and remains, unclear.¹³⁶ Nonetheless, Congress did not (and still has not) acted to codify the prohibition. This inaction further supports the theory that Congress was more concerned about hostile takeovers per se than about insider trading on hostile takeover information. Conversely, the SEC openly favored an active takeover market and was more interested in regulating misconduct in connection with takeovers than in restricting takeovers per se.

C. Moralism, Envy, and "New Money"

The choice of insider trading as a symbol translated economic issues into a moral conflict in which the government clearly held the high ground. With its crusade against insider trading, Congress could express moral disapproval of certain business figures without raising questions about capitalism itself or the government's interdependent relationship with it. It was no accident that Congress presented wealthy and powerful individuals as the "bad guys" in insider trading. Many scholars have argued that financial and, particularly, insider trading regulations are at least partly motivated by populist resentment of the wealthy.¹³⁷ Politicians may take up this banner to curry favor with constituents or to express sincerely held beliefs about holding the wealthy accountable.¹³⁸

But politicians also have a third motivation to blame the rich: the need to distance themselves and the institutions of government from the excesses of capitalism. Mark Roe has argued that the development of the U.S. financial regulatory regime has been heavily influenced by a culturally embedded suspicion of concentrated economic power.¹³⁹ This hostility wanes in good economic times, but resurfaces in times of economic uncertainty. In the 1930s, for example, many people were clamoring for direct government regulation of business, and socialism was a real political force. According to Roe, the corporate and financial establishment of the 1930s thus accepted relatively moderate disclosure regulation under the Securities Acts as the "lesser of the political evils."

Daniel Fischel has argued that the popular view of the 1980s as the "decade of greed" is an expression of populist envy of the rich. Further, he has vociferously argued that such envy fueled the high-profile prosecutions of Michael Milken and Ivan Boesky.¹⁴⁰ According to Fischel, hostility toward the worlds of business and finance arises not only from bad economic times for average people, but also from extremely

135. 17 C.F.R. § 240.14e-3 (2001).

136. The issue did not come before the Supreme Court until 1997, when the Court specifically declined to decide whether the SEC had statutory authority to prohibit under 14e-3 insider trading not already prohibited by section 10(b) and the complex case law thereunder. *United States v. O'Hagan*, 521 U.S. 642, 676 n.22 (1997).

137. See e.g., FISCHEL, *supra* note 27, at 1–8; ROE, *supra* note 22; Coates, *supra* note 36; Jeanne L. Schroeder, *Envy and Outsider Trading: The Case of Martha Stewart*, 26 CARDOZO L. REV. 2023 (2005).

138. See Langevoort, *supra* note 23, at 1328–30.

139. See ROE, *supra* note 22.

140. FISCHEL, *supra* note 27, at 1–8.

prosperous times for the rich. Despite the “trickle-down economics” rhetoric of the 1980s and the eventual economic recovery, the majority of the public was excluded from the great wealth of the stock market boom. Junk bonds, leveraged buyouts, and other arcane opportunities for great wealth were accessible only to privileged insiders.¹⁴¹ Although the Supreme Court has rejected the idea,¹⁴² the perception that unequal access to market information is fraudulent has—historically and in the popular imagination—lent support to a prohibition on insider trading. Such informational disparities correspond to “inequalities in wealth . . . and access to human capital in society at large”¹⁴³ Jeanne Schroeder has gone so far as to argue that the misappropriation theory of insider trading liability is an expression of envy of those who enjoy trading advantages over the general public.¹⁴⁴

ITSA and ITSFEA were part of a larger legal preoccupation with insider trading that included increased prosecutorial action. The rise of insider trading prosecutions may have been due to changing prosecutorial priorities as much as to changing patterns of criminal behavior. Tony Poveda has argued that governmental concern with white-collar crime in the 1970s was a broad-based, decentralized response to the delegitimization of governmental authority following the Watergate scandal.¹⁴⁵ In the early post-Watergate era, the Justice Department and the FBI “explicitly linked [their] responses to white-collar crime as an attempt to restore trust and confidence in the criminal justice system as well as governmental and economic institutions.”¹⁴⁶ Poveda notes that the FBI’s annual report first included “white-collar crime” as a subheading in 1974.¹⁴⁷ The first-ever criminal prosecution for insider trading under SEC Rule 10b-5 was brought in 1978,¹⁴⁸ and a wave of major prosecutions continued throughout the 1980s.¹⁴⁹ Poveda’s theory is also consistent with the SEC’s controversial 1970s move

141. Even among institutional investors, dowdier players like savings and loans did not get into the junk-bond market until it was on the verge of collapse.

142. See *Chiarella v. United States*, 445 U.S. 222, 233 (1980) (“This reasoning suffers from two defects. First not every instance of financial unfairness constitutes fraudulent activity. . . . Second, the element required to make silence fraudulent—a duty to disclose—is absent in this case.”).

143. Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information*, 95 NW. U.L. REV. 443, 477 (2001) (citing Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 330).

144. See Schroeder, *supra* note 137, at 2027 (“The misappropriation theory [accepted by the Supreme Court in *U.S. v. O’Hagan*, 521 U.S. 642 (1997)] . . . involves the resentment by the investment public that other persons have the good fortune to enjoy something to which the public has no right—non-public information obtained from third party sources who are the legally recognized owners of the information.”) (alteration added).

145. See PAVEDA, *supra* note 20.

146. *Id.* at 137–38 (alteration added).

147. *Id.* at 135.

148. The Supreme Court eventually overturned that conviction in *Chiarella*, 445 U.S. 222 (2000).

149. PAVEDA, *supra* note 20, at 136.

under Director of Enforcement Stanley Sporkin to take on corporate corruption in addition to its more typical regulatory tasks.¹⁵⁰

Disparity in wealth is endemic to American society, indeed, to most societies today. By itself, then, the envy argument is incomplete because it fails to explain why this populist sentiment resulted in insider trading legislation and not other legislative changes, such as progressive taxation. Part of the full explanation is that insider trading legislation offered Congress an opportunity to cater to the popular envy of wealth without actually challenging the established economic order. The legitimacy of congressional Democrats required establishing populist credentials without inflaming too much resistance from the economic establishment. Republicans, conversely, had to show that their new deregulatory, probusiness approach would not include a free pass for abusive practices. Insider trading regulation pleased populists by addressing the excesses of a small set of wealthy individuals. At the same time, the regulations pleased the Wall Street establishment because they posed no fundamental challenge to the status quo.

Although Congress presented insider trading regulation as a blow to the wealthy and powerful, this characterization becomes unconvincing upon closer examination. The high-profile, highly privileged insider trading villains of the 1980s—bond traders like Michael Milken, arbitrageurs like Ivan Boesky, and investment bankers like Dennis Levine—were certainly wealthy. But they were, relatively speaking, *arrivistes*, challengers to the entrenched structure of wealth and power dominated by the leaders of established financial houses and corporations. Daniel Fischel contends that the hostile takeover battles of the 1980s were at least in part “a struggle between old money and new money.”¹⁵¹ Milken and Boesky, he argues, were vilified because their involvement in financing and speculating on hostile takeovers challenged the established order—which included organized labor as well as established financial houses and industrial corporations—and also angered leftist “rich-haters.”¹⁵² While there is no evidence of any overt conspiracy, the aforementioned concern with hostile takeovers in the congressional hearings is consistent with Fischel’s theory. Congress’s portrayal of insider trading regulation as antitakeover legislation¹⁵³ appealed to the Wall Street establishment as well as to populist sentiment.

Indeed, the legislative reforms arguably did little to hold elites responsible: ITSA did not impose liability on control persons, and when ITSFEA later did, it held them to a more forgiving reckless or knowing standard of scienter.¹⁵⁴ John Fedders, John Shad’s SEC enforcement chief, publicly stated his belief that upper-level officers would lack the requisite scienter to be vicariously liable for insider trading by their employees.¹⁵⁵ Like the white-collar crime movement generally, the insider trading crusades may have punished average people more often than powerful elites.¹⁵⁶ The

150. See KHADEMIAN, *supra* note 54, at 167 (“[P]erhaps more than any other representative of the agency, Sporkin had been closely identified with SEC activism throughout the 1970s . . .”).

151. FISCHEL, *supra* note 27, at 22.

152. *Id.* at 68.

153. See *supra* notes 119–26 and accompanying text.

154. See ITSFEA § 3(a), *supra* note 5.

155. Pitt & Shapiro, *supra* note 32, at 201 n.222.

156. Poveda, *supra* note 25, at 247 (finding that studies confirm “the vast majority of offenders who are arrested for certain designated ‘white-collar crime’ statutes . . . are

SEC under Shad pursued a “small dollar program” involving gains, in some cases, of less than \$10,000.¹⁵⁷ A list of insider trading prosecutions brought by Rudolph Giuliani, as U.S. Attorney for the Southern District of New York, includes many against clerical workers, such as proofreaders, clerks, and word-processing operators; the list also includes a cabdriver and a police officer.¹⁵⁸ Giuliani’s lengthy, high-profile investigation of Drexel Burnham Lambert, Michael Milken’s firm, led to the imprisonment of only one person other than Milken: Lisa Ann Jones, a former teenage runaway and high-school dropout who had become a trading assistant at Drexel.¹⁵⁹

Unsurprisingly, the insider trading hearings do not contain any explicit references to resentment of the rich. While American politicians may have employed pure anti-capitalist populism at other times in history,¹⁶⁰ it has not been a viable strategy since at least the dawn of the Cold War. Government’s symbiotic relationship with capitalism and wealth meant it could not attack the wealthy per se. And in the insider trading hearings, Congress did not. It reserved its moral critique for “new money”: young, newly wealthy individuals, whom legislators and witnesses accused of lacking discipline and ethics. The hearings thus reflected populist resentment against those who quickly obtained wealth and then acted in an unseemly way. The hearings did not challenge the established order under which certain individuals and institutions traditionally controlled wealth quietly. Indeed, members of the Wall Street establishment joined in the condemnation of “new money.”

Popular culture in the 1980s was fascinated with the “yuppies” who rose from obscurity to make immense, rapid fortunes in the financial markets; it also delighted in the eventual downfall of some of them.¹⁶¹ In this context, it is worth considering Jeanne

overwhelmingly not elite offenders”); Daniel C. Richman, *Federal Criminal Law, Congressional Delegation, and Enforcement Discretion*, 46 UCLA L. REV. 757, 788 n.143 (1999) (“There is reason to believe that much of the white-collar initiative [in the late 1970s and early 1980s] simply expanded punitive responses to members of the lower middle and middle classes.” (quoting JOACHIM J. SAVELSBERG & PETER BRÜHL, *CONSTRUCTING WHITE-COLLAR CRIME: RATIONALITIES, COMMUNICATION, POWER* 147–48 (1994))) (alteration in original).

157. Pitt & Shapiro, *supra* note 32, at 210–12. In defense of the small dollar program, the SEC argued that enforcement must reach even small violators, and that some violators deliberately made small profits to evade prosecution. *Id.* Pitt and Shapiro suggest that the SEC actively sought out insider trading cases because they went over well with Congress and the media, defusing criticism of the SEC as too industry-friendly. *See id.*

158. S. Hrg. 100-76, *supra* note 43, at 15–28.

159. Ronald Sullivan, *Insider Jail Terms Set Aside*, N.Y. TIMES, Sept. 9, 1992, at D16; *see also* STEWART, *supra* note 27, at 349–50, 418.

160. Mark Roe, for example, traces suspicion of concentrated financial power to the Jacksonian era. ROE, *supra* note 22, at 58–59. More recently, radical labor and the Socialist Party were significant populist forces in the early 20th century.

161. *See, e.g.*, Stephen Koepp, *From Pinstripes to Prison Stripes*, TIME, Mar. 2, 1987, at 48, available at <http://www.time.com/time/archive/preview/0,10987,146057,00.html> (referring to insider trader Martin Siegel, “only 38,” as a “former Kidder, Peabody merger whiz kid” and noting insider trading charges recently filed against a 34-year-old lawyer); Michael White, *The Yuppie Five’s New York Adventures Thicken the Plot for London after Big Bang*, THE GUARDIAN (London) August 26, 1986 (“The fact is that bright young things who 20 years ago used to want to become brain surgeons, President of the United States or Chief Justice ... are nowadays heading for the investment banks.... explaining that law is all very well but Wall Street is where the action is, not to mention the bucks.”). A variation on the love-hate view of “whiz kids” recurred in the dot.com boom of the 1990s.

Schroeder's argument that insider trading law derives in part from envy of individuals' good fortune (however isolated or fleeting), as distinct from a categorical resentment toward the wealthy as a class.¹⁶² There is some anecdotal reflection of this cultural trope in the hearings. Legislators and witnesses show particular disdain for those who gain wealth quickly at a relatively young age. They identify this new wealth with corruption and imply that traditional economic elites have superior moral sense. This suggests that envy of wealth is particularly intense with respect to "new money." It is also consistent with Fischel's argument that the charge against insider trading and hostile takeovers was driven (or at least cheered on) by the Wall Street establishment.

In one hearing, Senator D'Amato (R-N.Y.) asserted, "The new players in the market have come into a go-go environment. It appears to them that success is measured in the amount you earn—the ends always justifying the means."¹⁶³ Representative Thomas Luken (D-Ohio) suggested that the 1980s saw new kinds of players committing insider trading, "a 23-year-old stock broker or a 27-year-old lawyer, rather than a CEO."¹⁶⁴ Representative Timothy Wirth (D-Colo.) asserted that "a number of people, particularly young people" have been "moving in and taking advantage of" the bull market.¹⁶⁵ He found it "especially disturbing . . . that a 33-year old alleged whiz kid earning over \$1 million a year believed he had to steal another \$12 million. It is equally disturbing to see five young men in their twenties using stolen information to line their own pockets . . ."¹⁶⁶ Wirth was apparently referring to Dennis Levine and the so-called "Yuppie Five," respectively.

Some legislators specifically argued that the Wall Street establishment had moral standards superior to those of the new financial players. Representative Luken (D-Ohio) stated that "[t]he traditional image of the conservative staid, sometimes stony investment banker, has been replaced by the young, sharp, highly paid MBA who may not have been exposed to the business ethics or traditions of the past."¹⁶⁷ Similarly, Senator D'Amato (R-N.Y.) called on the securities industry and corporate law firms to "imbue some sense of morality and ethics into their young executives and associates. . . . It appears to them that success is measured in the amount you earn—the ends always justifying the means."¹⁶⁸ Testifying before the Senate Banking Committee, Giuliani cited the "Yuppie Five" defendants as evidence of a failure to teach ethics to young people.¹⁶⁹ George Ball, Chair and CEO of Prudential-Bache Securities, was even more explicit in his defense of the status quo, stating, "Those 26 year olds just have not been around long enough" to appreciate "what they owed [sic] to the preservation of the integrity of that system."¹⁷⁰ Thus while the attack on insider trading may appear to have challenged Wall Street, in fact it can be seen as a defense of an orderly and virtuous pre-established economic order and a rebuke to disruptive

162. See Jeanne L. Schroeder, *Envy and Outsider Trading: The Case of Martha Stewart*, 26 CARDOZO L. REV. 2023 (2005). Schroeder applies this argument only to the "misappropriation" theory of insider trading.

163. S. Hrg. 100-83, *supra* note 43, at 6.

164. H.R. Ser. No. 99-168, *supra* note 45, at 43.

165. *Id.* at 59.

166. *Id.* at 2.

167. H.R. Ser. No. 99-179, *supra* note 72, at 7.

168. S. Hrg. 100-83, *supra* note 43, at 5-6.

169. S. Hrg. 100-76, *supra* note 43, at 54.

170. H.R. Ser. No. 99-168, *supra* note 45, at 60.

“newcomers,” who are portrayed as threatening to jeopardize the status quo by overreaching.

D. Penalties and Enforcement

Consistent with its emphasis on isolated individual wrongdoers, Congress treated insider trading as a law-enforcement matter rather than a market-regulation one. Like the criticism of “new wealth,” transforming inchoate economic dissatisfaction into a law-enforcement problem also had an obvious moralistic component. It reframed economic policy as an issue of punishing individual lawbreakers, thus transforming a complex set of issues into a simple cops-and-robbers story. FN? This diverted attention away from more intractable economic problems, and thereby blunted fundamental questions about congressional efficacy, the self-regulatory securities law regime, and the market-based economic system generally.

Furthermore, when insider trading is characterized as a law-enforcement issue, it is ostensibly amenable to solution by relatively simple legislative means—increased enforcement and stricter penalties. This is not true of more complex economic issues like hostile takeovers or America’s loss of global industrial competitiveness. Nor is it true of more complex depictions of insider trading. Insider trading is not necessarily a law-enforcement issue. It may be viewed as a matter of imperfections in the flow of information to the markets, or the law’s failure to clearly define permissible and impermissible trading activity. But legislative solutions to those kinds of problems are much more difficult, both technically and politically. Congress failed to pass a definition of “insider trading” (and to this day still has not done so). Instead, it left it to the courts to define the offense on a painfully slow, case-by-case basis.¹⁷¹

As noted above, Congress justified insider trading regulation in part by the supposed need to restore investor confidence. A policy emphasis on penalties and enforcement can create *excessive* investor confidence, however. As Donald Langevoort has argued, antifraud regulation is itself potentially misleading in that it suggests that enforcement protects the public from investment risk.¹⁷² Penalties and enforcement do not necessarily reduce the incidence of fraud. Moreover, they cannot eliminate it, so some risk of fraud must be accepted as an inevitable agency cost of investing.¹⁷³ Moreover, even assuming that enforcement reduces fraud, investors are constantly exposed to other, more significant forms of risk—most obviously, the risk of market downturns.

171. The primary Supreme Court cases have been *Chiarella v. U.S.*, 445 U.S. 222 (1980), *Dirks v. SEC*, 463 U.S. 646 (1983), and *U.S. v. O’Hagan*, 521 U.S. 643 (1997). The cases are summarized and critiqued in Richard W. Painter, Kimberly D. Krawiec & Cynthia A. Williams, *Don’t Ask, Just Tell: Insider Trading After U.S. v. O’Hagan*, 84 VA. L. REV. 153, 161–88 (1998).

172. Langevoort, *supra* note 21, at 1139–40 (“The rhetoric of securities regulation—much of it generated by the Securities and Exchange Commission (SEC)—trumpets our commitment and success in creating strong marketplace integrity, inviting deep investor trust in the transparency of the corporate system. The reality is also different here, as Enron and similar cases show.”).

173. Cf. William Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1288 (2002) (“The disturbing thing [about the Enron disaster] is that the system’s standing army of civil and criminal enforcers had no deterrent effect.”).

Portfolio diversification has far more power than anti-fraud measures to mitigate exposure to fraud or any other risk. Indeed, diversification can reduce risk even if the root causes of risk (including but not limited to fraud) go unaddressed.¹⁷⁴ The regulatory regime, however, makes no attempt to educate investors about these basic points. Indeed, its focus on financial disclosure and anti-fraud enforcement can obscure these truths. Langevoort argues that legislators and regulators nonetheless emphasize anti-fraud measures, rather than passive diversification, to create the impression that they are protecting investors. The congressional focus on insider trading is consistent with Langevoort's argument. That Congress was more interested in show than a coherent law-enforcement approach is supported by the fact that ITSA and ITSFEA increased penalties for "insider trading" without defining the offense they were punishing. The federal securities acts have never defined the offense known as "insider trading." Indeed, federal law has no general rule against trading on nonpublic information. The offense has been constructed by federal court opinions under the broad, generic anti-fraud prohibition of Section 10(b) of the 1934 Act and the similarly broad SEC Rule 10b-5 promulgated thereunder.¹⁷⁵ Neither 10(b) nor 10b-5 even mention insider trading specifically. As defined by case law, insider trading and its relationship to "fraud" under 10(b) and 10b-5 were (and remain) notoriously murky. While it seems logically necessary that a definition of the offense should precede a discussion of the penalties it entails, the definitional issue proved too technically and politically difficult. Congress nonetheless pushed ahead with the politically easier task of increasing maximum penalties. Increasing these penalties presented a tough face to the public while passing actual responsibility for action from Congress to the courts, the SEC, and the Justice Department.

The emphasis on penalties is typical of Congress's symbolic, theatrical approach to the insider trading issue. Despite lip service to its effect on "investor confidence," Congress framed insider trading as an issue of immorality and punishment—of good versus evil. It could just as well have been framed as, for example, a failure of preventive measures (such as market surveillance or the I3(d) window), or even as a type of conduct that is problematic but marginal. The hearings assume that additional deterrence is needed, but there is no attempt to calculate the deterrent value of any specific penalty amounts or structures. Indeed, the deterrent effect of penalties is unavoidably speculative, as we can never know for certain how much crime does *not* occur due to penalty laws. Dan Kahan has argued:

We will rarely have reliable information on the probability of conviction, average psychic gains, elasticity of demand, and like variables, the measurement of which depends on seemingly intractable empirical problems. Our confidence in the information we do have on these facts will nearly always be less than the confidence we have in the relative expressive reprehensibility of diverse wrongs Consequently, . . . the raw expressive judgments that inform our consequentialist theory of value are much more likely to dominate the cost-benefit axioms of deterrence than vice-versa.¹⁷⁶

174. Langevoort, *supra* note 21, at 1164–67.

175. See Pitt & Shapiro, *supra* note 32, at 202–03.

176. Dan Kahan, *The Secret Ambition of Deterrence*, 113 HARV. L. REV. 413, 427–28 (1998).

Legislators' focus on penalties is more plausibly explained not as a reasoned deterrence strategy, but as an attempt to express outrage at insider trading.¹⁷⁷ This expression also serves an instrumental purpose: self-legitimation. The focus on insider trading as a significant economic issue made Congressional action easier by reframing the complex economic dislocations of the 1980s as issues of identifiable villains, rather than as inevitable consequences of capitalism and the business cycle. This is symbolized by the 1987 Senate hearings in which Lynch and Giuliani, the victorious enforcement agents of the Boesky and Levine cases, were the only witnesses. Even assuming that insider trading was an issue important enough to merit yet another hearing, the hearings served little purpose other than to frame the insider trading issue as a law-enforcement struggle and, moreover, to associate senators with Lynch and Giuliani, the actual participants in that struggle.¹⁷⁸

ITSA and ITSFEA do not seem genuinely intended to address insider trading so much as to create the *impression* of addressing it while avoiding politically difficult action. The emphasis on law enforcement and penalties had great rhetorical power in that it reframed vague economic anxieties as narrowly focused conflicts with identifiable human villains. Furthermore, the law-enforcement approach relieved Congress of immediate responsibility for solving economic problems and passed it on to the agencies. This strategy resulted in the odd phenomenon of Congress insisting that there was an insider trading epidemic and offering the SEC more power and resources to combat it, while the SEC insisted that there was no significant problem and that it did not need additional powers or funding.

1. The Failure to Define "Insider Trading"

In two major cases in the early 1980s, the Supreme Court handed victories to defendants, holding that a judge-made definition of insider trading based on Section 10(b) and Rule 10b-5 had to be a narrow one that satisfied the common-law definition of fraud.¹⁷⁹ The Supreme Court decisions invited Congress to clarify the definition of the offense, but Congress failed to do so. Indeed, the fundamental ambiguity of "insider trading" may have been one of the reasons Congress chose it as its proxy for the economic fears of the 1980s.

When Congress faces conflicting demands from different interest groups, it may prefer legislative ambiguity, leaving interpretation to the courts or administrative agencies.¹⁸⁰ This may be a form of compromise to defuse disagreement and allow the

177. See *supra* note 23 and accompanying text.

178. Admittedly, Giuliani at one point offered some plausible anecdotal evidence that penalties work as a deterrent. He argued that evidence (including wiretaps) collected in his investigations suggested that would-be insider traders weigh the potential consequences against the potential gain, and thus higher penalties will deter some violations. S. Hrg. 100-76, *supra* note 43, at 50. Thus he called for higher maximum criminal sentences and jail time as the "general rule." *Id.* at 51-52. But this (limited) policy discussion was the exception rather than the rule in the hearings.

179. See *SEC v. Dirks*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980).

180. See Joseph A. Grundfest & A.C. Pritchard, *Statutes with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 STAN. L. REV. 627 (2002).

passage of legislation. It also allows individual legislators to avoid displeasing one of the conflicting interest groups: "the legislator will be able to assure each group that it won, and then will be able to blame a court or agency if subsequent developments belie that assurance."¹⁸¹ As with the increase in maximum penalties, the appeal of "passing the buck" may help explain the failure to adopt a definition.

The issue of definition came up in the ITSA hearings, but Shad declined to discuss the definition or other matters regarding insider trading regulation generally. He said the bill submitted by the SEC was "very specifically addressed to the treble damage proposal."¹⁸² In a written memo accompanying his testimony, Shad stated that the SEC opposed a definition because the case law was sufficiently clear and a new legislative definition would just create more grounds for litigation.¹⁸³ Shad showed more interest in exempting certain kinds of conduct than in creating a broad prohibition¹⁸⁴: the SEC "urge[s] that the legislative history of the bill cite behavior to which the statute is not intended to apply."¹⁸⁵ Shad was particularly concerned that an executive who reveals information to outsiders "in order to obtain their advice and assistance for the benefit of his corporation's shareholders" not be considered an unlawful "tipper."¹⁸⁶

When ITSA went before the Senate in 1984, Senator D'Amato (R-N.Y.) introduced an alternative version bill that included ITSA's trebling provision, but would also have outlawed all trading on material nonpublic information.¹⁸⁷ Shad took no position on D'Amato's bill, stating that the Commission needed time to look at it and compare it to existing law.¹⁸⁸ SEC Chief of Enforcement John Fedders was equivocal, presenting six reasons in favor of a legislative definition of IT and six reasons against.¹⁸⁹

D'Amato's broad definition was in direct response to the Supreme Court's 1980 opinion in *United States v. Chiarella*.¹⁹⁰ In the absence of a legislative definition of "insider trading," the SEC and the Justice Department typically pursue the offense under the generic anti-fraud provisions of Section 10(b) of the 1934 Act and Rule 10b-5. In *Chiarella*, a criminal case, a financial printer obtained the names of impending takeover targets by reading takeover announcements during the printing process, before their public dissemination. The Justice Department argued that a person who trades in securities without disclosing the fact that he possessed material nonpublic information has committed securities fraud. The Court rejected that argument, holding that such a trade does not constitute fraud unless the trader had some independent legal

181. William Eskridge, Jr., *Politics Without Romance: Implications of Public Choice Theory for Statutory Interpretation*, 74 VA. L. REV. 275, 288 (1988).

182. See H.R. Ser. No. 98-33, *supra* note 4, at 53.

183. See *id.* at 91-104 (reprinting letter from Shad to Rep. Wirth dated June 29, 1983).

184. In contrast, SEC Counsel Dan Goelzer testified that the "range of potential conduct" is so broad that a narrow legislative definition might end up permitting certain kinds of trading that should be prohibited. *Id.* at 50; see *id.* at 41-42 (reprinting memo from Goelzer to Shad dated April 12, 1983).

185. See *id.* at 91-104, 98 n.* (reprinting letter from Shad to Rep. Wirth dated June 29, 1983).

186. *Id.* Some of the conduct Shad was interested in protecting is now prohibited by SEC regulation FD, 17 C.F.R. §§ 243.100-.103 (2000).

187. S. Hrg. 98-831, *supra* note 62, at 3, 8-10

188. See *id.* at 13.

189. See *id.* at 35-37.

190. 445 U.S. 222 (1980).

duty to disclose, such as a fiduciary duty to the counterparty.¹⁹¹ The Department of Justice also advanced an alternative “misappropriation” theory: the printer had violated a duty, and thus violated Rule 10b-5, by misappropriating the takeover information from his clients. The Court did not address this theory on the ground that it had not been put before the jury at trial.¹⁹² *Chiarella* suggested that while the existing law of securities fraud prohibited insider trading by corporate insiders (such as officers and directors) who owe fiduciary duty to their shareholders, it did not reach trading by most “outsiders” who possess material nonpublic information.

Despite *Chiarella* and a subsequent case, *SEC v. Dirks*,¹⁹³ which further underscored the role of fiduciary duty, the committee report accompanying ITSA defended the legislation’s failure to define insider trading. According to the report, an explicit definition would be too narrow and create loopholes. Furthermore, the report argued, existing case law was sufficiently clear.¹⁹⁴ The report supported this latter contention with reference to cases predating *Chiarella* but remarkably failed to mention *Chiarella*.¹⁹⁵

In the summer of 1987, in reaction to the wave of insider trading scandals, Congress again considered a legislative definition of insider trading: S. 1380, the Insider Trading Proscriptions Act (ITPA).¹⁹⁶ Once again, Senator D’Amato (R-N.Y.) was the primary sponsor of the bill. It would have prohibited the use of information that had been “used or obtained wrongfully” to trade in securities. Like the 1984 proposal, the proposed definition was independent of §10(b) and Rule 10b-5, but it was narrower than the earlier proposal. The ITPA definition was specifically constructed to codify the misappropriation theory of insider trading liability.¹⁹⁷ That theory was indirectly implicated in *Carpenter v. U.S.*,¹⁹⁸ which was pending before the Supreme Court in 1987. *Carpenter* involved charges under mail fraud, not Rule 10b-5, but turned on the idea that the misappropriation of information for trading purposes constituted fraud.

Representative John Dingell (D-Mich.), Chair of the House Energy & Commerce Committee and a key crusader against insider trading, opposed ITPA. Like the authors of the ITSA committee report, he argued that a clear proscription would be easier to evade.¹⁹⁹ Nonetheless, the SEC under David Ruder’s chairmanship proposed its own

191. *See id.* at 228.

192. *See id.* at 237 n.21.

193. 463 U.S. 646 (1983).

194. *See* H. REP. NO. 98-355, 98th Cong. 2d sess., at 13–14 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2286–87.

195. The report argued that *Dirks* would not affect insider trading enforcement because it involved “unique facts,” but “direct[ed]” the SEC to monitor the effects of *Dirks* for at least two years and report back to the committee each year. *Id.* at 14–15, *reprinted in* 1984 U.S.C.C.A.N. at 2287–88.

196. Pitt & Shapiro, *supra* note 32, at 227.

197. ITPA defined “wrongfully” to mean that the obtaining of the info or its use would constitute “theft, conversion, misappropriation or breach of any fiduciary, contractual, employment, personal or other relationship of trust and confidence.” *See Definition of Insider Trading: Hearings Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 100th Cong. 74 (1987) [hereinafter S. Hrg. 100-155 pt.1].

198. 484 U.S. 19 (1987).

199. Pitt & Shapiro, *supra* note 32, at 227. Pitt himself, then a partner at Fried, Frank, Harris, Shriver & Jacobson and former counsel to the SEC, and later the SEC chair under

substantially similar version of ITPA in November 1987.²⁰⁰ The perceived need for ITPA soon abated, however, when the Supreme Court decided *Carpenter* late in 1987.²⁰¹ The Court's opinion upheld the defendants' convictions on mail fraud charges and, although it made no holding with respect to the misappropriation theory, it did not question it.²⁰² Thus, regardless of the uncertain status of misappropriation under Rule 10b-5, it appeared regulators could continue to address it through mail fraud law. ITPA ultimately failed to pass, and ITSFEA, introduced in June 1988, contained no definition of insider trading and failed to address the misappropriation question.

2. The SEC's Restrained Approach to Penalties and Enforcement

As noted above, John Shad and other Republican SEC officials gave only lukewarm support to ITSA's increased penalties. Before ITSA, SEC civil enforcement actions could pursue only disgorgement of trading profits and injunctions against future violations.²⁰³ At the ITSA hearings, Shad stated that he wanted to correct what he believed to be a misperception that the consequences of insider trading were limited to disgorgement. Shad seemed to protest too much when he insisted that insider traders faced a "host of other sanctions" under existing law. Other than the fact that broker-dealers might lose their licenses, he named no other consequences of SEC civil charges. Rather, he pointed to criminal sanctions, which of course require a separate criminal investigation, prosecution, and conviction. He also rather lamely and obviously pointed to nonlegal consequences such as "loss of employment, social opprobria [sic], [and] heavy legal fees."²⁰⁴

SEC counsel Dan Goelzer was wary of increasing civil penalties too much, for fear that doing so "might change the character of the Commission's enforcement program, inhibit settlements of the Commission's enforcement actions and cause the judiciary to be less receptive to Commission actions designed to protect the investing public."²⁰⁵ In the secondary liability context, Goelzer argued that the trebling provision should apply narrowly: an employer should face treble damages only if liable for aiding and abetting, and not merely on the basis of *respondeat superior*.²⁰⁶

Shad took an even narrower position on secondary liability, stating that the SEC's recommendation was that trebling should apply only to persons who "actually trade

George W. Bush, testified before the Senate in 1987. He gave a list of recommendations that included legislative clarification of the definition of insider trading. S. Hrg. 100-83, *supra* note 43, at 99. He focused on clear standards, not enforcement or surveillance, in both accounting standards and IT. His testimony expressed concern primarily for predictability and ease of compliance for market actors, not for prevention or detection of misconduct. *See id.*

200. H.R. Ser. No. 100-225, *supra* note 43, at 50.

201. *See Pitt & Shapiro, supra* note 32, at 227.

202. *See Carpenter*, 484 U.S. 19; Pitt & Shapiro, *supra* note 32, at 227. *Carpenter* involved deliberate leaks of upcoming *Wall Street Journal* stock recommendations. The conviction was on mail fraud charges, not securities fraud. The Supreme Court finally upheld a version of the misappropriation theory a decade later in *United States v. O'Hagan*, 521 U.S. 642 (1997).

203. *See* Carole B. Silver, *Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984*, 1985 DUKE L.J. 960, 960 (1985).

204. H.R. Ser. No. 98-33, *supra* note 4, at 60.

205. *Id.* at 41-42 (reprinting memo from Goelzer to Shad, dated April 12, 1983).

206. The adoption of ITSFEA expanded employers' potential liability by adding control-person provisions. *See supra* note 5 and accompanying text.

while in possession of material nonpublic information or who tip such information to others who trade.”²⁰⁷ “Employers, control persons, and aiders and abettors (other than tipsters)” should not be subject to treble damages under the statute, Shad argued.²⁰⁸ Predictably, issuers, corporate lawyers, and securities firms also went on record in favor of narrowing secondary liability.²⁰⁹

In the 1986 hearings following the Levine and Boesky settlements, Representative Dingell (D-Mich.) argued that the treble-penalty provision of ITSA was an insufficient deterrent.²¹⁰ Shad disagreed. He argued that the major cases like those against Levine and Boesky had triggered a number of SEC investigations into related activity, and it would be “premature” to consider additional insider trading laws while those investigations were in progress.²¹¹ Furthermore, he argued that “ITSA, by supplementing other civil, administrative and criminal sanctions, provides substantial deterrence of insider trading.”²¹² As noted above, such contentions about deterrence are nonfalsifiable.

As Representative Luken (D-Ohio) pointed out in the 1986 hearing, however, penalties only work as a deterrent if they are really being applied.²¹³ This was not the case with ITSA. According to William J. Anderson, the Government Accountability Office’s (GAO) Assistant Comptroller General for General Government Programs, the treble civil damages authorized by ITSA in 1984 had never been imposed in any case as of September 30, 1986.²¹⁴ From the passage of ITSA in 1984 to the summer of 1986, the SEC brought eleven civil enforcement cases. Defendants paid monetary sanctions in nine of them, all pursuant to settlements.²¹⁵ According to Shad, “most of the defendants” in these cases were required to disgorge their profits and pay a penalty equal to the amount of profit.²¹⁶ Penalties in excess of disgorgement were imposed in only two SEC civil cases in fiscal year 1985.²¹⁷ The aggregate penalties imposed in fiscal year 1985 were less than the aggregate profits disgorged. In 1986, penalties were imposed in fifteen of thirty actions.²¹⁸ Penalties in those cases ranged from 0.01 times profits to 2.36 times profits. In a report to the GAO, the SEC explained that penalties

207. H.R. Ser. No. 98-33, *supra* note 4, at 91–104 (1983) (reprinting letter from Shad to Wirth, dated June 29, 1983).

208. *Id.*

209. *See, e.g., id.* at 222, 224 (1983) (reprinting letter from Saul S. Cohen, Securities Industry Association to John Fedders, dated Jan. 25, 1983); S. Hrg. 98-831, *supra* note 62, at 84–85 (testimony of David Brodsky, Chairman, ABA Section on Litigation, Subcommittee on SEC Enforcement Procedures and partner, Schulte Roth & Zabel).

210. *See* H.R. Ser. No. 99-179, *supra* note 72, at 2–4.

211. *Id.* at 53.

212. *Id.* at 63.

213. *Id.* at 8.

214. *Id.* at 33.

215. *See* H.R. Ser. No. 99-168, *supra* note 45, at 20 (statement of John Shad, Chairman, SEC).

216. *Id.* at 19.

217. *See* H.R. Ser. No. 99-179, *supra* note 72, at 33 (statement of William J. Anderson, Assistant Comptroller General, GAO).

218. *Id.*

did not approach the maximum because it considered a defendant's ability to pay when requesting penalties.²¹⁹

In the most high-profile cases of the day, the SEC reached settlements with Dennis Levine and Ivan Boesky. However, SEC settlements were criticized as weak.²²⁰ In the July 1986 hearings, legislators asked Shad why the Levine settlement had not imposed any civil penalties, as authorized by ITSA. Shad responded by listing the terms of the settlement: Levine had "disgorged \$11.6 million and agreed to cooperate in the Commission's continuing investigation. He also simultaneously pled guilty to four felony counts."²²¹ Levine's disgorgement of \$11.6 million sounds far less impressive in light of the fact that the SEC believed his insider-trading profits totaled \$12.6 million.²²² Furthermore, his cooperation yielded little valuable information. Levine's criminal guilty pleas also generated lenient sanctions. Shad told Congress in 1986 that the maximum criminal penalties Levine faced were twenty years in prison and \$610,000 in fines.²²³ But when Levine was finally sentenced, he received only two years and \$362,000 in fines.²²⁴ Luken argued that the government's practice of giving leniency in exchange for testifying against others undermined the deterrent effect of sanctions.²²⁵

According to Gary Lynch, the SEC's head of enforcement, Boesky's \$100 million settlement consisted of a \$50 million disgorgement and a \$50 million penalty—again, far less than the maximum treble damages.²²⁶ Boesky also agreed to plead guilty to criminal charges, resulting in a three-year jail sentence.²²⁷ Part of Boesky's settlement with the SEC and federal prosecutors barred Boesky from association with a broker-dealer—but the bar was stayed "to permit an orderly transfer of control of Boesky's current businesses."²²⁸ Moreover, the government promised to withhold the announcement of the settlement so that Boesky could quietly liquidate his positions before their prices crashed.²²⁹ In effect, the government's settlement terms enabled him to avoid enormous losses by trading on material nonpublic information—the news of his own guilty plea and settlement. In response to that issue, Shad pointed out that the SEC did not want to roil the markets. He also invoked the Supreme Court's narrow definition of insider trading: although Boesky had nonpublic information, his trading

219. *See id.*

220. *See, e.g.,* STEWART, *supra* note 27, at 268, 295–97.

221. H.R. Ser. No. 99-168, *supra* note 45, at 20 (statement of John Shad, Chairman, SEC). Levine also agreed to a permanent injunction from future securities law violations and a lifetime ban from the securities industry. *See id.* at 15, 20.

222. *See* H.R. Ser. No. 99-179, *supra* note 72, at 87 (statement of Gary Lynch, Director, SEC Division of Enforcement).

223. H.R. Ser. No. 99-168, *supra* note 45, at 15 (statement of John Shad, Chairman, SEC).

224. STEWART, *supra* note 27, at 273.

225. *See* H.R. Ser. No. 99-179, *supra* note 72, at 8 (statement of Ron Wyden, Member, H. Subcommittee on Oversight and Investigations).

226. *See id.* at 89 (statement of Gary Lynch, Director, SEC Division of Enforcement).

227. STEWART, *supra* note 27, at 360.

228. H.R. Ser. No. 99-179, *supra* note 72, at 88 (statement of Gary Lynch, Director, SEC Division of Enforcement).

229. *See* STEWART, *supra* note 27, at 289.

was not illegal because he violated no duty to disclose, and thus did not violate Rule 10b-5.²³⁰

Later in the same hearing, Luken questioned whether Boesky's fine would really have a deterrent effect in light of his immense wealth. Luken asked whether the SEC had investigated Boesky's assets and ability to pay before setting the penalty at \$50 million.²³¹ After evading the question for a while, Lynch appeared to concede that he had not performed such an investigation, stating: "It was our judgment that we ought to settle the matter and get on about our business, [get] him as a cooperating witness and try to clean up some of the abuses."²³² According to journalist James Stewart, the government attorneys who negotiated Boesky's settlement had set the sum of disgorgement and penalty at \$100 million because they saw it as "a big round number" that would "dazzle the public," particularly in comparison to the SEC's \$105 million annual budget at the time.²³³ Ironically, "this big round number" was widely perceived as inadequate.

Since ITSA's treble fines had never been imposed, it would seem Congress should either adopt a wait-and-see approach or attempt to insure that the SEC pursued harsher penalties and courts imposed them. But surprisingly, Congress did neither—instead, in ITSFEA it further increased the *maximum* penalty, even though it was clear the SEC had no interest in enforcing the existing maximum. Congress gave enforcement power and resources to the SEC even though John Shad made clear he did not view enforcement or investor protection as the agency's main goals. Although the press gave a great deal of coverage to his "hobnail boots" comment, Shad stated that his priority upon taking charge of the SEC would be "improving the capital formation process."²³⁴ Upon leaving office in 1987, Shad believed he had been true to that goal. When asked to comment on his most important achievements, he did not even mention enforcement or insider trading. Instead, he called integrated disclosure and shelf registration "two of the most important improvements in the securities laws since they were enacted in 1933 and 1934," because they generated "well over a billion dollars a year" in savings for corporations and their shareholders.²³⁵

Shad's successor, David Ruder, was similarly unenthusiastic about insider trading enforcement, yet received similar deference from Congress. During the 1987 hearings, Senator Donald Riegle (D-Mich.) stated that Ruder's confirmation as chair would hinge upon whether he would be as committed as Shad to battling "the contagion of insider trading."²³⁶ Riegle's suggestion that Shad is a model crusader against insider trading is odd in light of Shad's performance.

Ruder had taken office by the time Congress considered ITSFEA. Riegle had expressed hope that Ruder would "measure up" to Shad with respect to insider

230. See H.R. Ser. No. 99-179, *supra* note 72, at 122 (statement of Gary Lynch, Director, SEC Division of Enforcement).

231. See *id.* at 113–14.

232. *Id.* at 115.

233. STEWART, *supra* note 27, at 280.

234. See Kenneth A. Noble, *SEC Chief Plans Insider Trade Curb*, N.Y. TIMES, Oct. 26, 1981, at D1.

235. Nathaniel C. Nash, *Shad's View of 6 Busy Years*, N.Y. TIMES, June 24, 1987, at D1.

236. See S. Hrg. 100-155 pt.1, *supra* note 197, at 2 (statement of Sen. Donald Riegle, Chairman, Subcommittee on Securities).

trading,²³⁷ and he seems to have gotten his wish: in the hearings, Ruder was as lukewarm as Shad had been. His testimony in July 1988 was critical of the bill. He was ambivalent about extending ITSA's trebling provision to "control persons" of insider traders because he believed that "[e]xisting incentives in this area are already substantial."²³⁸ He also noted that the SEC had already approved NYSE rule changes increasing supervisory requirements in member firms.²³⁹ He stated that this SRO-based approach was "more comprehensive" and thus "more desirable" than ITSFEA's imposition of control-person liability.²⁴⁰

Ruder also expressed concern that ITSFEA's private cause of action for contemporaneous traders might place excessive liability on defendants, since exposure would derive from arbitrary factors like trading volume.²⁴¹ At the time of the hearing, the committee print of the bill placed no cap on total damages in a private action. Ruder argued that this uncapped liability was potentially "[d]raconian."²⁴² Ruder also argued that ITSFEA's proposed increase in criminal monetary penalties was unnecessary, and that the existing five-year maximum jail term was the most important criminal penalty (ITSFEA increased the maximum to ten years).²⁴³ When pressed on his views on ITSFEA's bounty provision, Ruder said he had "always been troubled by the bounty concept" because he opposed paying people "for doing what they already should be doing."²⁴⁴

Ruder initially voiced support only for section 6 of ITSFEA, which authorized the SEC to conduct investigations in response to a foreign government's request for assistance in investigating violations of that country's securities laws.²⁴⁵ Ruder thought this was the most important part of ITSFEA because it would not only help foreign prosecutions but also encourage foreign governments to cooperate with the SEC.²⁴⁶ Ruder submitted his unenthusiastic written comments on ITSFEA into the record and then invited discussion on other proposed reforms.²⁴⁷ Indeed, in the ITSFEA hearings, Ruder was more interested in discussing ITPA (which he supported) and other reforms than in discussing ITSFEA.²⁴⁸

237. *See id.* at 3.

238. H.R. Ser. No. 100-225, *supra* note 43, at 36 (statement of David S. Ruder, Chairman, SEC).

239. *See id.*

240. Despite Ruder's skepticism of control-person liability and his preference for SRO rulemaking, ITSFEA empowered, but did not require, the SEC to make rules with respect to internal surveillance systems of broker-dealers and investment advisers. *See* ITSFEA § 3, *supra* note 5.

241. *See* H.R. Ser. No. 100-225, *supra* note 43, at 42-43 (statement of David S. Ruder, Chairman, SEC).

242. *See id.* at 98. As noted above, the bill as passed limited total exposure in private actions to the insider trader's actual profit gained or loss avoided.

243. *See id.* at 44.

244. *Id.* at 93.

245. *See id.* at 47-49. ITSFEA § 6 is codified at 15 U.S.C. § 78c(a).

246. *See id.* at 49. Dennis Levine, for example, had done his insider trading through an offshore account, and his scheme was discovered thanks to tips from abroad. *See* STEWART, *supra* note 27.

247. H.R. Ser. No. 100-225, *supra* note 43, at 21 (statement of David S. Ruder, Chairman, SEC).

248. *See id.* at 50.

As with Shad, legislators did not attempt to cast Ruder as the villain, despite his opposition to so much of the bill. When asked directly if he supported the bill, Ruder replied, "Not all of it."²⁴⁹ The questioner, Howard Nielson (R-Utah), then asked if the bill was "salvageable," to which Ruder unenthusiastically gave a guardedly affirmative response. Nielson thanked Ruder and declared himself "encouraged" by this answer. Other than capping liability in private suits, Congress did not respond to Ruder's criticisms of ITSFEA. As it had done with ITSA when Shad was SEC Chair, Congress drafted and advanced a bill increasing SEC discretion despite the Chair's lack of enthusiasm.²⁵⁰

3. Enforcement Resources

Shad initially opposed congressional plans to expand the SEC's budget, particularly in the enforcement area.²⁵¹ He insisted that the SEC could perform its enforcement mission without larger budgets. In the Senate hearings on ITSA, Senator Proxmire (D-Wis.) asked Shad why he did not seek additional appropriations for enforcement.²⁵² Shad suggested the funding was unnecessary, stating that the Enforcement Division had brought an increased number of cases in fiscal year 1982, despite a reduction in staff, and another increase in 1983 despite no growth in staff.²⁵³ Shad acknowledged that there was always the possibility of undetected violations that could be prosecuted with more resources, but he expressed less concern about under-enforcement than about cost-benefit analysis in an era of budget deficits. He also stated, as he had in the House hearings, that no law-enforcement agency can ever know how many violations are going undetected.²⁵⁴

In 1985, when the SEC requested authorizations before the Senate Appropriations Committee, SEC representatives mentioned ITSA in passing as an achievement to be proud of, but did not mention insider trading enforcement as a justification for the SEC budget.²⁵⁵ In fact, in accordance with the 1986 Reagan budget, Shad did not ask Congress for increases in SEC funding.²⁵⁶ In 1986, congressional Democrats ordered a GAO study of SEC effectiveness, which contradicted Shad's insistence that the SEC

249. *Id.* at 94.

250. In fact, Ruder did a sudden about-face and endorsed the bill just before it was passed. *See id.* at 264. Whatever the reason for his last-minute reversal, Ruder's support cannot justify ITSA's increase in SEC discretion over penalties, since those provisions were drafted and advanced through Congress without his support.

251. At hearings in summer 1986, Shad stated, "[T]he Commission is not here today to request additional resources, at least at this time, or legislation." H.R. Ser. No. 99-168, *supra* note 45, at 4 (statement of John Shad, Chairman, SEC).

252. *See* S. Hrg. 98-831, *supra* note 62, at 64.

253. *See id.*

254. *Id.* at 65.

255. *See* S. Hrg. 99-129, *supra* note 106, at 19-20 (statement of John Shad, Chairman, SEC). Instead, Shad's testimony focused on the recent failures of government securities dealers, raising questions about whether closer regulation was needed, and also on the pending deregulation of financial services that would increase the number of institutions subject to SEC regulation. *See id.* at 15-36.

256. Proxmire asked why Shad was not asking for more money for enforcement. Shad replied that Reagan's 1986 budget was sufficient. *See id.* at 70.

was pursuing more enforcement actions despite limited resources.²⁵⁷ Only after the report was released did Shad change his position and ask Congress for increased SEC funding.²⁵⁸

The differences between Shad and the Democratic Congress seem to belie the conventional wisdom that Democrats favor regulatory approaches to securities law while Republicans favor deregulation and stiffer enforcement of the most egregious conduct. Rather, *agency chief* Shad (a Republican) seems more interested in regulation while these *politicians* (all Democrats) seem more interested in enforcement. Consistent with the assumptions of this Article, the contrast might be explained on the grounds that enforcement is much easier for politicians to understand and communicate to constituents, and makes a more dramatic statement to the public about the government's commitment to imposing discipline on the markets. Furthermore, as will be discussed in the following section, enforcement legislation shifts ultimate responsibility from Congress to the executive branch if the law fails to stop the misconduct at issue.

4. Legislative Expansion of Executive Discretion

The Democratic Congress and the Republican SEC sharply disagreed about the scope of the insider trading problem, the appropriateness of harsher penalties and the need for more enforcement resources. Yet Congress increased the SEC's discretion over civil penalties. This was not a power-sharing compromise settling a dispute between the branches of government. Rather, it appears to have been a case of buck-passing, in which Congress sought to escape responsibility by foisting onto the SEC powers the agency did not want and was unlikely to use.

Not only were increased penalties a questionable response to a questionable insider trading "epidemic," but the increased penalties under ITSA and ITSFEA were more apparent than real. The treble-damages provision of ITSA did not include any mandatory increases in penalties. Rather, it only increased the *maximum* civil sanction, authorizing courts to award up to three times profits as a penalty. ITSFEA expanded this discretion to the control person context. Similarly, ITSA and ITSFEA sequentially raised maximum criminal fines, but not minima. As Shad pointed out to Congress:

ITSA does not require that a civil penalty be imposed in every case, nor does it provide specific criteria to be used in determining the amount of the penalty to be imposed . . . The determination of those facts and circumstances which justify

257. See KHADEMIAN, *supra* note 54, at 175. According to a senior House staff member, Chairman Dingell (D-Mich.), of the House Energy and Commerce Committee, had called for the GAO study specifically to counter Shad's claims that the agency was thriving despite budget constraints. *See id.*

258. See Bruce Ingersol & Steve Swartz, *Shad is Seeking Biggest SEC Budget Rise in 50 Years to Bolster Enforcement Effort*, WALL ST. J., Dec. 8, 1986, at A5 (speaking at a press conference held at the Securities Industry Association's annual meeting on December 5, 1986). In a 1986 hearing, Dingell declared himself "delighted" by Shad's change of heart. *See* H.R. Ser. No. 99-179, *supra* note 72, at 4 (statement of John D. Dingell, Chairman, H. Subcommittee on Oversight and Investigations).

imposing the maximum penalty will ultimately be made by the judiciary as precedents are established.²⁵⁹

The House Report on ITSFEA stated that “courts *should* impose jail terms” for insider trading, and that the Energy and Commerce Committee “*expects* that raising the ceiling will increase the certainty of substantial prison sentences.”²⁶⁰ But the committee cited no basis for this expectation. ITSA had not produced long prison terms, and ITSFEA did not require jail time. Increasing the range of penalties does not directly increase penalties imposed on wrongdoers or even the likelihood that a penalty will be imposed; it only increases the discretion of the enforcement agencies that recommend sanctions and the courts that impose them.

ITSA also expanded executive power by giving the SEC discretion to exempt “any class of persons or transactions” from the statutory penalty provisions.²⁶¹ ITSFEA extended that discretion to permit exemptions in individual cases as well.²⁶² Neither the ITSA nor ITSFEA hearings include consideration of mandatory minimum penalties or other restrictions on SEC or court discretion. Furthermore, the failure to pass a legislative definition put the definition of insider trading in the hands of SEC rulemakers and the charging decisions of SEC civil enforcers and Justice Department prosecutors (subject, of course, to judicial review).

As noted above, the trebling provision of ITSA had never been applied as of 1986. Furthermore, the SEC had given only grudging support to ITSA, the Commission’s own bill, and refused to support ITSFEA until the eleventh hour. After ITSA, the SEC did not seek any further discretion in penalty matters. In 1985 hearings, Senator Proxmire (D-Wis.) asked Shad whether the SEC should be given increased power to set civil fines. Shad said it was not necessary, because ITSA was sufficient.²⁶³ He repeated the caution expressed in the ITSA hearings—that high penalties might reduce judicial willingness to go along with SEC penalties, might increase defendants’ willingness to litigate, and that the SEC needed time to see whether ITSA was working.²⁶⁴ Despite all this, Congress followed ITSA with ITSFEA, extending treble penalties, and the concomitant executive discretion, to the control-person context.

Congress’s continued failure to define the offense put the direction of the “war” on insider trading even further out of congressional control and more squarely in the hands of the SEC, the Justice Department, and the courts.²⁶⁵ Congress not only gave

259. See H.R. Ser. No. 99-168, *supra* note 45, at 19 (statement of John Shad, Chairman, SEC).

260. H.R. REP. NO. 100-910, at 23 (1988), *as reprinted in* 1988 U.S.C.C.A.N. 6043, 6060 (emphasis added).

261. See ITSA, Pub. L. No. 98-376, § 2, 98 Stat. 1264, 1264 (1984), *repealed by* ITSFEA § 3, *supra* note 5.

262. The new language allowed the SEC to exempt “*any person or transaction or class of persons or transactions.*” ITSFEA § 3, *supra* note 5 (emphasis added).

263. See S. Hrg. 99-129, *supra* note 106, at 72–74 (statement of John Shad, Chairman, SEC).

264. See *id.* at 73–74, 90–92. The SEC did, however, want authority to bring administrative proceedings under section 14 and power under section 17 to sanction registered transfer agents.

265. ITSFEA added an additional nominal sanction by creating a private cause of action against insider trading. See ITSFEA § 5, *supra* note 5. Like the penalty provisions, a private cause of action delegates power and responsibility—in this context, to plaintiffs and courts.

the SEC greater discretion, it explicitly praised Shad and the SEC for their enforcement efforts even as Shad and other Commission officials testified against the insider trading crusade. Indeed, Congress seemed to protest too much when it included in ITSFEA's preamble a statement that the SEC had been enforcing the existing rules against insider trading "vigorously, effectively, and fairly."²⁶⁶ This generosity toward the SEC contrasts with the partisan bickering between the Democrat-controlled Congress and the SEC in the 1980s. Some former SEC officials and congressional staffers claim Democratic lawmakers sought every opportunity to embarrass the SEC and the Reagan White House.²⁶⁷ Calling attention to Shad's lukewarm attitude toward insider trading enforcement seems an ideal opportunity of this type, especially in light of the Reed and Thayer scandals. Yet Democratic Congress members did not criticize Shad on this score, perhaps because if they had, they could not justify "passing the buck" to the SEC.

CONCLUSION

Most current legal commentary on corporate and securities regulation (such as the wealth of recent work on the Sarbanes-Oxley Act) focuses on whether a regulatory approach succeeded, or will succeed, in improving economic welfare (however that may be defined). The focus of this Article is very different. Focusing on the front end rather than the back, it looks not at the economic effects that securities regulation produces, but at the political motivations that produce securities regulation.

American legal scholars tend to subscribe to what Robert Gordon has referred to as the "evolutionary-functional" account of legal change: "that the natural and proper evolution of a society . . . is towards the type of liberal capitalism seen in the advanced Western nations . . . and that the natural and proper function of a legal system is to facilitate such an evolution."²⁶⁸ The dominant normative view in the corporate and securities law academy fits this description. It holds that business and economic conditions should push legal change in an "economically efficient" direction, and that market capitalism is the surest route to efficiency. Many scholars further believe as a descriptive matter that American corporate law has been evolving in this manner. Roberta Romano, for example, argues that competition among the states has pushed

Furthermore, § 20A does little to directly increase the overall exposure of insider traders. Section 20A does not create a new class of prohibited conduct, and courts have interpreted it narrowly. *See, e.g.,* Jackson Nat'l Life Ins. Co. v. Merrill Lynch & Co., 32 F.3d 697, 703 (2d Cir. 1994). In addition, plaintiff standing is limited to those who trade contemporaneously with an insider trader. A draft provision of ITSFEA defining standing more broadly was rejected in committee for fear of expanding civil liability. H.R. Ser. No. 100-225, *supra* note 43, at 14; Kaswell, *supra* note 15, at 168-69 (explaining rejection of draft version). Moreover, there is little incentive to bring suit. A defendant's total liability exposure under section 20A is limited to his profit gained or loss avoided, and reduced by any disgorgement, ITSFEA § 5(b)(1)-(2), *supra* note 5; this total liability will potentially be divided among all contemporaneous traders in the stock.

266. *See* ITSFEA § 2, *supra* note 5.

267. *See* KHADEMIAN, *supra* note 54, at 179-82.

268. Robert W. Gordon, *Critical Legal Histories*, 36 STAN. L. REV. 57, 59 (1984). As Gordon points out, "The words 'natural' and 'proper' stress the normative nature of the theory; deviations from the norm are both atypical and bad." *Id.*

them (and Delaware in particular) to produce efficient corporate law.²⁶⁹ Henry Hansmann and Reinier Kraakman made a similar argument on the global level when they declared that American shareholder capitalism represents “the end of history for corporate law.”²⁷⁰ American corporate law, in their view, has reached a final, perfected form that allocates resources efficiently by making shareholder wealth its explicit focus. This Article suggests that economic regulation may be the product of Congress’s concern for its own perpetuation as an institution and not the result of its sober calculations of economic effects. This calls into question the belief that law “evolves” in an efficient direction.

Lawmaking is a process as well as a product. Legal commentators tend to focus on the product. Legal scholarship’s traditional bias toward judge-made law over legislation exacerbates this tendency, since the process of writing judicial opinions is largely inaccessible to scholars. The recorded process of legislation shows lawmakers communicating with their colleagues and with the public. While much has been written on the “expressive” function of law, this commentary tends to view law as communicating “public” values, suggesting that the legislators and judges who make the law are passive mouthpieces of a monolithic public ideology. More skeptical views of lawmaking see legislators as bought-and-paid-for conduits of “special interests,” but as passive nonetheless.

Those who do consider the autonomy of legislators tend to focus on them as classical rational actors seeking narrowly defined personal gain. But legislators may also use their autonomy to legitimate the existing political and economic order more broadly. While this may materially benefit politicians (and “special interests”), it may also be the product of sincere ideological commitments. Although this Article views insider trading legislation as self-legitimizing, this does not necessarily mean it was entirely self-serving. There are obvious potential public benefits to encouraging faith in the system. The notion that our elected officials aim to convince us as well as serve us, however, underscores the tension between self-governing and obedience in a representative democracy.

269. See ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993).

270. See Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 *GEO. L.J.* 439, 439 (2001).

APPENDIX: LIST OF HEARINGS CITED

- Insider Trading Sanctions and SEC Enforcement Legislation: Hearings on H.R. 559 Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce, 98th Cong., 1st sess. (1983) (H.R. Ser. No. 98-33).*
- The Insider Trading Sanctions Act of 1983: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 98th Cong., 2d sess. (1984) (S. Hrg. 98-831).*
- Reauthorizations for the Securities and Exchange Commission, 1986-88: Hearing on S. 919 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 99th Cong., 1st sess. (1985) (S. Hrg. 99-129).*
- Insider Trading: Hearings Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce, 99th Cong., 2d sess. (1986) (H.R. Ser. No. 99-168).*
- SEC and Insider Trading: Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce, 99th Cong., 2d sess. (1986) (H.R. Ser. No. 99-179).*
- Improper Activities in the Securities Industry: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st sess. (1987) (S.Hrg. 100-76).*
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- Definition of Insider Trading: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, Part 1, 100th Cong., 1st sess. (1987) (S. Hrg. 100-155 pt.1).*
- Regulating Hostile Corporate Takeovers: Hearing on S. 227, S. 678, S. 1264, S. 1323, and S. 1324 Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st sess. (1987) (S. Hrg. 100-183).*
- Insider Trading: Hearing Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, 100th Cong., 2d sess. (1988) (H.R. Ser. No.100-225).*