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What's the Harm in Issuer-Licensed Insider Trading?

John P. Anderson

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SYMPOSIA

What's the Harm in Issuer-Licensed Insider Trading?

JOHN P. ANDERSON*

There is growing support for the claim that issuer-licensed insider trading (when the insider's firm approves the trade in advance and has disclosed that it permits such trading pursuant to published guidelines) is economically efficient and morally harmless. But for the last thirty-five years, many scholars and the U.S. Supreme Court have relied on Professor William Wang's "Law of Conservation of Securities" to rebut claims that insider trading can be victimless. This law is purported to show that every act of insider trading, even those licensed by the issuer, causes an identifiable harm to someone. This article argues that the Law of Conservation of Securities is not helpful to answering the moral question of whether insider trading is a victimless crime because it either proves too much or too little. It either proves that all profitable trades (or profitable trade omissions) in advance of firms' material disclosures are morally impermissible (an absurdity), or it tells us nothing at all about the moral permissibility of such trades. Of course, once the Law of Conservation of Securities is neutralized, other moral criticisms of issuer-licensed insider trading that rely on this law also fail. Professor Leo Katz's claim that morality does not permit one to consent to a system that openly allows issuer-licensed insider trading is offered as one example of an argument that fails once considered in light of a proper understanding of the Law of Conservation of Securities.

I. INTRODUCTION	796
II. WHY THERE IS NOTHING WRONG WITH ISSUER-LICENSED INSIDER TRADING ...	797
III. INSIDER TRADING HARM AND THE LAW OF CONSERVATION OF SECURITIES	802
IV. WHY THE LAW OF CONSERVATION OF SECURITIES PROVES TOO MUCH OR TOO LITTLE	803

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V. CONSEQUENCES FOR OTHER ARGUMENTS AGAINST ISSUER-LICENSED INSIDER TRADING 806

VI. CONCLUSION 810

I. INTRODUCTION

I have argued elsewhere that insider trading is morally harmless where the issuer approves the trade in advance and has disclosed that it permits such trading pursuant to published guidelines.¹ I have also suggested that reforming the law to permit such issuer-licensed insider trading “would result in a more rational, efficient, and just insider trading enforcement regime.”² A common objection to my claim that issuer-licensed insider trading is harmless is that this argument fails to account for Professor William K.S. Wang’s “Law of Conservation of Securities.”³ According to Professor Wang and others,⁴ the Law of Conservation of Securities proves that each act of insider trading inflicts harm on some definite victim, regardless of whether the trade was approved by the issuer.⁵

In what follows, I will show that the Law of the Conservation of Securities is not helpful to a moral analysis of insider trading because it either proves that all profitable trades (or profitable omissions) in advance of a material disclosure are morally impermissible (an absurdity), or it tells us nothing at all about the moral permissibility of such trades.⁶ Of course, once the Law of Conservation of Securities is neu-

1. See John P. Anderson, *Greed, Envy, and the Criminalization of Insider Trading*, 2014 UTAH L. REV. 1, 27–43 (2014) [hereinafter Anderson, *Criminalization of Insider Trading*].

2. See John P. Anderson, *Anticipating a Sea Change for Insider Trading Law: From Trading Plan Crisis to Rational Reform*, 2015 UTAH L. REV. 339, 380 (2015) [hereinafter Anderson, *Anticipating a Sea Change*].

3. See, e.g., WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING § 3.3.5 (3d ed. 2010); William K.S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1234–35 (1981) [hereinafter Wang, *Material Nonpublic Information*]; William K.S. Wang, *Stock Market Insider Trading: Victims, Violators and Remedies—Including an Analogy to Fraud in the Sale of a Used Car with a Generic Defect*, 45 VILL. L. REV. 27, 27–41, 63–65 (2000) [hereinafter Wang, *Stock Market Insider Trading*].

4. See, e.g., Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 120 n.107, 123 nn.122–24 (1984); Sung Hui Kim, *Insider Trading as Private Corruption*, 61 UCLA L. REV. 928, 948 (2014) (“William Wang has provided a compelling articulation of what the harm [of insider trading] is and who the victims are.”). See also *infra* note 42.

5. See Wang, *Material Nonpublic Information*, *supra* note 3, at 1234–35; Wang, *Stock Market Insider Trading*, *supra* note 3, at 29 (observing that when an insider makes a purchase or sale prior to the public disclosure of a material event, some unidentified member of the public has either more or less shares at the time of the disclosure than they otherwise would have, and “[t]hat someone is worse off because of the insider trade”).

6. Cf. Anderson, *Criminalization of Insider Trading*, *supra* note 1, at 37 (noting that some arguments regarding the morality of insider trading focus on the fact that it is illegal, and arguing

tralized, other moral criticisms of issuer-licensed insider trading that rely upon this law also fail. Professor Leo Katz's argument that morality does not permit one to consent to a system that openly allows issuer-licensed insider trading offers one example.⁷ I conclude by explaining why Professor Katz's challenge to issuer-licensed insider trading fails when considered in light of a proper understanding of the Law of Conservation of Securities. But first, I shall briefly summarize my principal arguments for why issuer-licensed insider trading is morally harmless and should not be criminalized.⁸

II. WHY THERE IS NOTHING WRONG WITH ISSUER-LICENSED INSIDER TRADING

In analyzing the morality of insider trading, it is crucial to first posit a legal regime that does not proscribe any form of insider trading. This ensures that the moral permissibility of insider trading can be tested independent of any social expectations arising solely from the fact that the conduct is illegal.⁹ Next, it is helpful to divide the conduct currently proscribed in the United States under the classical theory of insider trading¹⁰ into two subcategories of trading that would be permitted under this posited regime—"issuer-proscribed" and "issuer-licensed" insider trading. In the United States, a corporate insider incurs insider trading liability if she seeks to benefit by trading (or tipping others who trade) in

that the legality of insider trading is not the proper focus point for discussing the morality of insider trading).

7. See generally Leo Katz, *Crime, Consent, and Insider Trading*, 5 J. CONTEMP. LEGAL ISSUES 217 (1994).

8. For a more complete exposition of these arguments, see Anderson, *Criminalization of Insider Trading*, *supra* note 1.

9. Some have argued that the wrong in insider trading can be traced to the fact that it violates established market regulations. For example, Professor Stuart Green has suggested that insider trading is wrongful because it cheats the established regulatory system. The insider breaks the preestablished rules of the cooperative scheme in order to take advantage of others' compliance. STUART P. GREEN, *LYING, CHEATING, AND STEALING: A MORAL THEORY OF WHITE-COLLAR CRIME* 235–40 (2006). Such arguments are not helpful when the question posed is whether insider trading should be regulated in the first place. See Anderson, *Criminalization of Insider Trading*, *supra* note 1, at 27. By positing a regime that does not proscribe insider trading, we avoid this problem.

10. The current insider-trading jurisprudence has divided insider-trading liability under Section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b) (2012), into two broad theories: the classical theory and the misappropriation theory. See *United States v. O'Hagan*, 521 U.S. 642, 651–52 (1997). The misappropriation theory applies to corporate outsiders. A corporate outsider incurs misappropriation liability when she improperly obtains material nonpublic information and, unbeknownst to the source, seeks to benefit by trading (or by tipping others who trade) on this information. See *id.* at 652. There is no need to discuss the misappropriation theory further here because the focus of this article is on trading by true insiders. For a discussion of the classical theory, see Anderson, *Criminalization of Insider Trading*, *supra* note 1, at 18–20.

shares of her own company based on material nonpublic information.¹¹ The following analysis distinguishes this conduct still further based on whether the issuer has approved the trading or whether the issuer has not approved the trading:

Issuer-proscribed Insider Trading: Insider trades on material nonpublic information [despite the fact] that the insider has promised—or otherwise undertaken pursuant to company policy (express or implied)—not to trade on such information.¹²

Issuer-licensed Insider Trading: Insider trades on material nonpublic information with the firm's approval. (It is presumed that the issuer's policy allowing insider trading is disclosed to the investing public.)¹³

The following arguments demonstrate that issuer-proscribed insider trading is morally harmful and would not be permitted under either utilitarian or deontological moral theories, while issuer-licensed insider trading is morally harmless and, therefore, permissible under both of these theories.¹⁴

Utilitarianism identifies the rightness or wrongness of an act by its results. When the question is whether a type of conduct—such as issuer-proscribed insider trading—should be criminalized, then the utilitarian typically asks if, all things being equal, universal compliance with a rule proscribing the relevant conduct would yield as good or better a state of affairs than a rule permitting that conduct.¹⁵ This calculus must, of course, include the costs of enforcement and compliance.¹⁶ If a rule proscribing the conduct would yield a better state of affairs, then the utilitarian concludes that morality dictates criminalization of the conduct.¹⁷

The consequences of insider trading continue to be hotly debated.¹⁸ Those who suggest that insider trading results in a net benefit to society typically argue that it increases price accuracy,¹⁹ provides real-time

11. See *Chiarella v. United States*, 445 U.S. 222, 228 (1980).

12. See Anderson, *Anticipating a Sea Change*, *supra* note 2, at 379.

13. See *id.* (manuscript at 76–77); see also Anderson, *Criminalization of Insider Trading*, *supra* note 1, at 27–28.

14. The following analysis is limited to testing issuer-licensed insider trading under the moral theories of utilitarianism and deontology because these are the two principal moral theories informing Anglo-American jurisprudence. For a broader treatment (which assesses insider trading through the lens of virtue theory as well), see Anderson, *Criminalization of Insider Trading*, *supra* note 1, at 27–54.

15. This is the principle of rule utilitarianism. See, e.g., J.J.C. SMART & BERNARD WILLIAMS, *UTILITARIANISM FOR & AGAINST* 9 (1973) (“Rule-utilitarianism is the view that the rightness or wrongness of an action is to be judged by the goodness and badness of the consequences of a rule that everyone should perform the action in like circumstances.”).

16. See Anderson, *Criminalization of Insider Trading*, *supra* note 1, at 31–32.

17. See *id.* at 31–32.

18. See *id.* at 7–17.

19. See, e.g., Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35

information to the markets,²⁰ has a market-smoothing effect,²¹ and offers an efficient means of compensation.²² Those who argue insider trading imposes a net harm to society typically claim that it increases the bid-ask spread set by market makers²³ and that it undermines investor confidence in the markets²⁴ (both of which in turn increase the cost of capital to firms).²⁵

Interestingly, by giving separate treatment to issuer-proscribed and issuer-licensed insider trading, the utilitarian's question seems to answer itself. For we can assume that, in making the determination of whether to license insider trading in any given instance, the issuer will weigh the potential costs against the potential benefits to the firm. If the issuer determines that the costs will outweigh the benefits under the circumstances, then the issuer will not license the trading (and vice versa). If insiders were permitted to trade despite the issuer's prohibition, then a net cost to issuers would be expected. In addition, permitting such trading "would undermine the [socially beneficial] practice of promise making in the corporate context" (and in general).²⁶ These considerations are decisive in condemning issuer-proscribed insider trading and warranting its criminalization (or at least its regulation).²⁷

But these considerations are just as decisive in favor of adopting a rule that permits issuer-licensed insider trading under the utilitarian framework. For where insider trading is issuer-licensed, the firm's own calculus reflects that such trading will result in a net benefit for the firm.

STAN. L. REV. 857, 868 (1983) ("If insiders trade, the share price will move closer to what it would have been had the information been disclosed.").

20. See, e.g., *id.* ("Through insider trading, a firm can convey information it could not feasibly announce publicly because an announcement would destroy the value of the information, would be too expensive, not believable, or—owing to the uncertainty of the information—would subject the firm to massive damage liability if it turned out ex post to be incorrect."); see also Henry Manne, *The Case for Insider Trading*, WALL ST. J. (Mar. 17, 2003), <http://people.wku.edu/indudeep.chhachhi/519files/519hout/Instr0303.pdf>; Anderson, *Criminalization of Insider Trading*, *supra* note 1, at 14–15.

21. See, e.g., Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 574 (1970); see also Anderson, *Criminalization of Insider Trading*, *supra* note 1, at 15.

22. See, e.g., Henry G. Manne, *Entrepreneurship, Compensation, and the Corporation*, 14 Q.J. AUSTRIAN ECON. 3, 17–18 (2011); Carlton & Fischel, *supra* note 19, at 861–66; see also Anderson, *Criminalization of Insider Trading*, *supra* note 1, at 16–17.

23. See, e.g., Stanislav Dolgoplov, *Insider Trading and the Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market Making*, 33 CAP. U. L. REV. 83, 100–05 (2004); see also Anderson, *Criminalization of Insider Trading*, *supra* note 1, at 9–12.

24. See, e.g., *United States v. O'Hagan*, 521 U.S. 642, 658 (1997) ("Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law.").

25. See Dolgoplov, *supra* note 23, at 100–01.

26. See Anderson, *Criminalization of Insider Trading*, *supra* note 1, at 29.

27. See *id.* at 29–30.

Moreover, such trading does not generate any of the disutility associated with the breaking of a promise.²⁸ Additionally, to the extent issuer-licensed insider trading would benefit the firm (and therefore its shareholders), the practice should reinforce confidence in the markets rather than undermine it.²⁹

Deontological moral theory is duty-based.³⁰ As such, the deontologist does not judge the moral quality of an act by the goodness or badness of its consequences (as the utilitarian would), but by the motive behind the act, and whether that motive complies with moral law. Deontology is often described as absolutist because it holds that there are certain things one should never do, “though the heavens fall.”³¹ In the debate over whether insider trading should be criminalized, it is often suggested that even if the overall consequences of insider trading are beneficial to the markets and society as a whole, it should nevertheless be criminalized because “it’s just not right!”³² Such objections are driven by deontological intuitions.

Perhaps the most recognized articulation of a deontological moral theory is found in the “end-in-oneself” formulation of Immanuel Kant’s categorical imperative: “Act so that you treat humanity . . . always as an end and never as a means only.”³³ In other words, one should never use others for purposes they themselves would reject.

One need not look further than the promise the insider makes not to trade on the firm’s material nonpublic information to conclude that issuer-proscribed insider trading violates Kant’s categorical imperative. Such trading necessarily treats the promisee (the firm) solely as the means to an end (use of the company’s material nonpublic information for trading profits) that the promisee has expressly rejected.³⁴ If an

28. *Id.* at 30–31. The argument is only made stronger when the significant costs that are incurred by issuers in order to comply with insider trading regulations are taken into account. See generally Joan Macleod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 AM. U. L. REV. 1131, 1172–80 (2003); see also John P. Anderson, *Solving the Paradox of Insider Trading Compliance*, 88 TEMP. L. REV. (forthcoming 2016), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2586185 [hereinafter Anderson, *Paradox of Insider Trading Compliance*].

29. See Anderson, *Criminalization of Insider Trading*, *supra* note 1, at 41–42.

30. In fact the word “deontology” finds its origins in the Greek words *deon* (duty) and *logos* (the science of). PETER A. ANGELES, *DICTIONARY OF PHILOSOPHY* 60 (1981).

31. See 2 *ENCYCLOPEDIA OF PHILOSOPHY* 343 (Paul Edwards ed., 1972).

32. I am reminded of Henry Manne’s frequently-cited example of a student who objected to his economic justification for the legalization of insider trading by stomping her foot and saying “it’s just not right!” HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 15 n.42 (1966).

33. *IMMANUEL KANT, FOUNDATIONS OF THE METAPHYSICS OF MORALS* 46 (Lewis White Beck trans., 2d ed. 1990).

34. See Anderson, *Criminalization of Insider Trading*, *supra* note 1, at 35.

issuer publicly affirms that it does not allow its insiders to trade on material nonpublic information, then issuer-proscribed insider trading also treats other traders in that firm's shares as mere means because they have presumably priced its shares based on the expectation that such trading is not permitted.³⁵

The moral landscape is dramatically different, however, when one engages in issuer-licensed insider trading. Such trading does not deceive or violate a promise to the firm; indeed, the firm has licensed the trade. And there is no deception of others who trade in the firm's shares because the issuer has disclosed that it allows its employees to trade based on material nonpublic information when it is in the firm's interest to do so. As a result of this disclosure, market participants are free to demand a correspondingly lower price for the issuer's shares or to refuse to trade in the firm's stock altogether.³⁶ If they choose to trade in the firm's shares at market price, they do so with the understanding that their counterparty may have an information advantage.³⁷ All interested parties to the issuer-licensed insider's trading are therefore "treated as . . . 'end[s]-in-themselves' and not as . . . mere means."³⁸

For these reasons (and others too lengthy to develop here³⁹), I am convinced that issuer-licensed insider trading within the parameters defined above is morally harmless, victimless, and should not therefore be criminalized. But have I missed something? Professor Wang argues that the Law of Conservation of Securities proves that even issuer-licensed insider trading has victims.⁴⁰ And Professor Katz suggests that any defense of issuer-licensed insider trading is a non-starter because the market participants' right against insider trading is inalienable.⁴¹ In what

35. See *id.* at 35; see also Anderson, *Anticipating a Sea Change*, *supra* note 2, at 385.

36. See Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1515–20 (1999) (arguing that disclosure of general intent to allow trading on the firm's material nonpublic information is sufficient to avoid deception); see also Anderson, *Criminalization of Insider Trading*, *supra* note 1, at 36–40.

37. See Anderson, *Criminalization of Insider Trading*, *supra* note 1, at 39–40.

38. *Id.* at 40.

39. See *id.* at 40–54 (offering arguments based on considerations of fairness and virtue theory that provide further support for the conclusion that issuer-licensed insider trading should not be criminalized); see also Anderson, *Anticipating a Sea Change*, *supra* note 2, at 388 (suggesting that legalization of issuer-licensed insider trading can "improve the current [insider] trading enforcement regime in terms of justice, clarity, efficiency, and coherence"); Anderson, *Paradox of Insider Trading Compliance*, *supra* note 28 (suggesting that legalization of issuer-licensed insider trading would lead to increased shareholder value by significantly reducing compliance and other related costs).

40. See Wang, *Stock Market Insider Trading*, *supra* note 3, at 29 ("[E]ach act of stock market insider trading has specific victims."). According to Professor Wang, the "victims are those who would be better off, but for the act of insider trading," as opposed to the "nondisclosure" that accompanies the insider trade. See *id.*

41. See Katz, *supra* note 7, at 226.

remains, I explain why these claims are mistaken.

III. INSIDER TRADING HARM AND THE LAW OF CONSERVATION OF SECURITIES

In *United States v. O'Hagan*, the Supreme Court relied on a frequently cited argument by Professor Wang to support the claim that every act of insider trading causes an identifiable harm to *someone*.⁴² The argument proceeds as follows.

If an insider trader purchases shares based on material nonpublic information, then she will have more of the relevant issuer's shares at the time the information is disseminated. Consequently, assuming the number of that issuer's outstanding shares remains constant,⁴³ someone else must have *fewer* shares at the time of dissemination.⁴⁴ Those who have fewer shares at the time of dissemination were either induced (to sell) or preempted (from buying) by the insider's trading.⁴⁵ These individuals were therefore made worse off as a result of the insider's trade.⁴⁶ If an insider sells shares on the basis of material nonpublic information, then someone else (the induced buyer or the preempted seller) ends up with *more* shares at the time of dissemination and is thereby made worse off.⁴⁷ "Paraphrasing the law of conservation of mass-energy," Professor Wang refers to "this phenomenon [as] the [L]aw of [C]onservation of [S]ecurities."⁴⁸

The Law of Conservation of Securities purports to demonstrate that each act of insider trading has specific victims, those who "were either preempted [from acting] or induced [to act] by the insider trading."⁴⁹ Professor Wang admits that, as a practical matter, the actual identity of

42. See 521 U.S. 642, 656 (1997). In fact, the Court cites to Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 120–21 & n.107 (1984), but the cited language expressly relies on Professor Wang's argument in *Material Nonpublic Information*, *supra* note 3, at 1234–35.

43. See Wang, *Stock Market Insider Trading*, *supra* note 3, at 29. Note that Professor Wang's argument does not depend on this assumption, but it simplifies its explication. See WANG & STEINBERG, *supra* note 3, § 3.3.8 ("The 'Law of Conservation of Securities' is easier to understand with th[is] . . . assumption[]. Relaxing [this assumption], however, does not alter the conclusions.").

44. WANG & STEINBERG, *supra* note 3, § 3.3.8; see also Wang, *Stock Market Insider Trading*, *supra* note 3, at 29.

45. WANG & STEINBERG, *supra* note 3, § 3.3.8; see also Wang, *Stock Market Insider Trading*, *supra* note 3, at 29–30.

46. See WANG & STEINBERG, *supra* note 3, § 3.3.6; see also Wang, *Stock Market Insider Trading*, *supra* note 3, at 29.

47. Wang, *Stock Market Insider Trading*, *supra* note 3, at 29.

48. *Id.*

49. *Id.* at 29–30.

these “victims” can almost never be determined;⁵⁰ but this does nothing to diminish the fact that they exist.⁵¹

Thus, at a minimum, Professor Wang claims that the Law of Conservation of Securities disposes of the argument that insider trading (like, say, marijuana or pornography use) should not be regulated because it is a “victimless crime.”⁵² He freely admits that the mere fact that insider trading has victims does not settle the question of how it should be regulated.⁵³ Nevertheless, he observes, “society is more likely to regulate insider trading strictly if,” as the Law of the Conservation of Securities demonstrates, “it has victims.”⁵⁴

IV. WHY THE LAW OF CONSERVATION OF SECURITIES PROVES TOO MUCH OR TOO LITTLE

It turns out that the Law of Conservation of Securities does nothing to answer the question of whether insider trading is a “victimless crime.” It either proves too much or nothing at all.

To begin, application of the Law of Conservation of Securities finds a harm or victim in *every* profitable market trade in advance of a material disclosure, not just those based on material nonpublic information.⁵⁵ Imagine Timmy, a college student, buys a new iPhone and loves it so much that he decides to buy ten shares in Apple Inc. The next day, Apple publicly introduces its much-anticipated iWatch. Shares in Apple immediately climb fifteen percent. The Law of Conservation of Securities tells us that Timmy’s purchase of Apple shares harmed or victimized whoever was induced to sell or preempted from buying as a result of Timmy’s trade. But the resulting “harm” or “victimization” has no moral import. It simply reflects the trivial truth that *someone* is always

50. See WANG & STEINBERG, *supra* note 3, § 3.3.7. To identify the victims of an insider trade, one would have to compare the universe in which the insider trade was made to the universe in which it was not made. But “it is almost never possible to describe the universe that would have existed had there been no insider trade.” *Id.* In some rare cases, however, one might be able to identify the victim of an inside trade of a large block of shares. *See id.*

51. It should be noted, however, that the impact of insider trading will almost always be minimal. As Stephen Bainbridge points out, “any gains siphoned off by insiders with respect to a particular stock are likely to be an immaterial percentage of the gains contemporaneously earned by the class of investors as a whole.” STEPHEN M. BAINBRIDGE, *INSIDER TRADING LAW AND POLICY* 197 (2014). For example, “[I]n *Texas Gulf Sulphur*, [401 F.2d 833 (2d Cir. 1968),] trading by insiders amounted to less than 10% of the trading activity in Texas Gulf Sulphur stock and, of course, a vastly smaller percentage of trading activity in the class of securities with comparable betas.” *Id.* at 197–98.

52. See Wang, *Stock Market Insider Trading*, *supra* note 3, at 28.

53. *Id.* at 29.

54. *Id.*

55. Recall that Professor Wang focuses on the act of the trade itself, and not the unequal access to information. *See supra* note 40.

made worse off (in this limited sense) as a result of *any* profitable trade prior to an unanticipated public announcement of material information.

Moreover, it is not just that the Law of Conservation of Securities finds some harm in every profitable trade prior to an unanticipated material disclosure; it identifies the same harm in every profitable trade *omission*.⁵⁶ Continuing with the example above, every Apple shareholder at the time of dissemination was, per the Law of Conservation of Securities, the *but-for* cause of harm to the persons who would have purchased those shareholders' stock had they sold prior to dissemination. Given that there are about six billion outstanding shares of Apple,⁵⁷ this amounts to a significant amount of harms and victims.⁵⁸

Professor Wang seems aware of this odd result, but he fails to appreciate its significance for his thesis. He observes that “[c]learly, society will not impose liability on traders who *unknowingly*, fortuitously make advantageous trades prior to public disclosure. Therefore, causing harm under the law of conservation of securities is not *sufficient* in itself to impose liability.”⁵⁹ But this acknowledgment misses the point. It is not just that the trivial “harm” identified by the Law of Conservation of Securities is not a *sufficient* condition for liability; once it is understood that *every* profitable securities trade (or omission) in advance of a material disclosure results in the same harm, it becomes clear that this law is simply *irrelevant* when assessing the moral permissibility of—or the appropriateness of imposing liability for—insider trading.

It does no good to suggest, as Professor Wang seems to,⁶⁰ that the Law of Conservation of Securities identifies the harm but that only *knowing* or *intentional* inflictions of the harm are wrongful and therefore worthy of regulation. For all *unknowing* traders—i.e., those who fail to possess material nonpublic information—still trade with the clear *intent* to inflict precisely the harm identified by the Law of Conservation of Securities on others, which is only to say that they aim to profit by their trades.⁶¹ And to claim that aiming to profit by trading is morally blame-

56. A logical consequence of the Law of Conservation of Securities' but-for reasoning is that profitable trading omissions (or abstentions) will always make *someone* worse off by relegating whoever would have been the counterparty to the omitted trade to the sidelines. See Wang, *Stock Market Insider Trading*, *supra* note 3, at 28–30.

57. See APPLE INC., 2014 ANNUAL REPORT (FORM 10-K) 24 (Oct. 27, 2014), available at <https://www.sec.gov/Archives/edgar/data/320193/000119312514383437/d783162d10k.htm>.

58. Of course it would likely send the stock price into free fall if all of these Apple shareholders sold their holdings prior to dissemination. This does not, however, diminish the fact that the Law of Conservation of Securities tells us that each such omission makes *someone* worse off by relegating that person to the sidelines at the time the good news is disclosed. See Wang, *Stock Market Insider Trading*, *supra* note 3, at 28–30.

59. *Id.* at 36.

60. See *id.*

61. See, e.g., *Basic Inc. v. Levinson*, 485 U.S. 224, 256 (1988) (White, J., concurring in part

worthy is to suggest that all (or virtually all) market participation is wrongful.

In addition, even when an insider knowingly trades on material nonpublic information, the Law of Conservation of Securities only tells us that *someone* will be made worse off as a result of the trade, it does not tell us *who* that person (or those persons) will be.⁶² The person made worse off could be another insider trader who was preempted.⁶³ Is the preempted insider “harmed” or “victimized” in any morally relevant sense of these terms? Certainly not. In fact, if we assume *arguendo* that there is something inherently wrong with insider trading, then we must conclude that this trade actually preempted the other insider from perpetrating a moral wrong. By analogy, there are many wrongs arguably associated with smoking a joint, for example, but it has never been suggested that smoking a joint is wrong because it prevented someone else from smoking it. Consequently, even on Professor Wang’s own terms, it cannot be said that his Law of Conservation of Securities demonstrates that *every* act of insider trading harms some victim.

In light of these considerations, it is misleading to label the preempted or induced traders identified by the Law of Conservation of Securities as “victims” of insider trading. The preempted or induced traders identified by that law are made worse off by *all* profitable trades or omissions in advance of a material disclosure—regardless of whether they are based on material nonpublic information. Moreover, virtually every time someone trades (or chooses not to trade) on the open market, they *intend* to inflict precisely this “harm” and create just such “victims.” For these and other reasons offered above, the induced or preempted traders identified by the Law of Conservation of Securities are not “victims” within the meaning of that term as availed by scholars in the debate over whether insider trading is a victimless crime.⁶⁴ At the

and dissenting in part) (noting that many investors trade precisely because they are of the opinion that the stock price does not reflect the corporation’s actual worth); Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 852 n.6 (1992) (“Economists have long wondered about the efficiency paradox—that the existence of a high degree of efficiency depends on a critical mass of persons believing that it is worthwhile to try to beat the market, notwithstanding the model’s teachings.”); see also Anderson, *Criminalization of Insider Trading*, *supra* note 1, at 37.

62. See WANG & STEINBERG, *supra* note 3, § 3.3.7.

63. See *id.* § 3.3.6.

64. I have to think that Wang must be aware that his use of the term “victim” is something of an equivocation. For example, contrast the “victims” or “harms” identified by the Law of Conservation of Securities with the candidate harms Wang identifies in the debate over whether pornography is victimless: e.g., that it “increases sex crimes” such as rape, or that it humiliates and “undermines respect for women.” Wang, *Stock Market Insider Trading*, *supra* note 3, at 28. Increasing sex crimes is socially detrimental conduct that, on its own, can distinguish morally permissible conduct from morally impermissible conduct. Trading at a profit (and thereby denying

end of the day, Professor Wang's law fails to tell us anything about the moral quality of an act of insider trading. Consequently, the Law of Conservation of Securities fails to shed any light on the question of whether issuer-licensed insider trading is a wrong that warrants criminalization.⁶⁵

V. CONSEQUENCES FOR OTHER ARGUMENTS AGAINST ISSUER-LICENSED INSIDER TRADING

The conclusion that the Law of Conservation of Securities is morally irrelevant can be employed to test other arguments that issuer-licensed insider trading is morally impermissible. For example, Professor Leo Katz relies on Wang's law to support his claim that persons cannot consent to a system that openly permits issuer-licensed insider trading.⁶⁶

Professor Katz follows Professor Wang in identifying the "victims" of insider trading as those who were induced or preempted by such trading.⁶⁷ He argues that since, *ceteris paribus*, shareholders or potential shareholders have a right not to be harmed or victimized, the question is whether one's right against such victimization can be traded or contracted away. In other words, "[w]e generally think that you *can* consent to a wrong and that it is no longer a wrong when you do. Consent to a theft and it becomes a gift. Consent to a rape and it becomes plain sex."⁶⁸ Can shareholders or potential shareholders consent (even if only tacitly) to issuer-licensed insider trading and thereby cleanse it of any moral blame? Professor Katz argues they cannot.

"[I]magine that [a] company, recognizing the economic benefits of insider trading,"⁶⁹ openly adopts a policy permitting its insiders to trade where doing so is deemed beneficial to the firm. The company even posts the following disclosure in all its advertisements and filings: "THIS COMPANY BELIEVES IN LETTING ITS INSIDERS TRADE ON THE BASIS OF INSIDE INFORMATION. IF THIS BOTHERS

someone else of the opportunity to trade at a profit) cannot, on its own, distinguish morally permissible conduct from morally impermissible conduct.

65. Professor Bainbridge makes a similar point: "To justify a ban on insider trading, you need a basis for asserting that it is inappropriate, undesirable, or immoral for those gains to be reaped by insiders. The law of conservation of securities does not, standing alone, provide such a basis." BAINBRIDGE, *supra* note 51, at 198.

66. See Katz, *supra* note 7, at 218.

67. See *id.* ("After all, the insiders did get richer. That money must have come out of somebody's pocket—his victim's. But whose pocket? Which victim? Well, if not the person who sold the stock, then the person who would have bought the stock if the insider had not bought it.").

68. *Id.* at 234.

69. *Id.* at 219.

YOU, DON'T BUY OUR STOCK.”⁷⁰ Professor Katz suggests that, even with this disclosure, insider trading would be morally impermissible based on the following argument.

Relying on the Law of Conservation of Securities, Katz assumes that (1) the harm done by insider trading is that it permits insiders to profit at the expense of those who are preempted or induced by the insider's trade.⁷¹ (2) The victims of insider trading have a right not to be harmed by such trades (and the state has a corresponding duty to protect them against such harm).⁷² (3) Not every moral claim can be alienated or exchanged for something else. For example, we all have a right to protection by the state from reckless and intentional assaults.⁷³ The law should not permit someone to waive that right in exchange for some liquidated damages remedy (or some other benefit) because the state's duty is to protect its citizens from harm by assault, not to guarantee a “certain amount of utility” to each citizen.⁷⁴ The victim's consent does not cleanse a reckless assault of its wrongfulness, nor does it affect the state's duty to protect. Thus, Professor Katz concludes that (4) similar to reckless assault, one cannot alienate oneself from one's right against being victimized by insider trading. This is true even if one makes a voluntary and calculated decision to trade in the shares of a firm that has made the disclosure quoted above in order to take advantage of “the pecuniary advantages that flow from investing in a company that allows insider trading.”⁷⁵

The flaw in this argument is evident. First, considered from the standpoint of moral wrongdoing, the “victim” identified by the Law of Conservation of Securities bears no resemblance to the victim of an intentional or reckless assault. Recall that the Law of Conservation of Securities purports that *every* profitable trade or omission made in advance of a material disclosure creates “victims.”⁷⁶ But, while the wrongfulness of any assault is self-evident, no one would suggest that *all* profitable trades or omissions made in advance of a material disclosure are wrongful; and certainly no one suggests that market participants possess an inalienable right against all such profitable trades. In short, at a minimum, Professor Katz's argument outlined above fails to appreciate that the Law of Conservation of Securities is egregiously overinclusive as a criterion for identifying the moral permissibility of trading.

70. *Id.*

71. *See id.* at 218.

72. *See id.* at 226.

73. *See id.* at 224.

74. *See id.*

75. *Id.* at 226.

76. *See supra* Part IV.

Second, imagine the practical consequences of recognizing an inalienable right to government protection from the purported “harm” identified by the Law of Conservation of Securities. The only way to protect against all profitable trades or omissions in advance of market-moving events would be to close the markets. To avoid this absurdity, it must be admitted that the Law of Conservation of Securities—considered in isolation—offers no barrier to shareholders and potential shareholders consenting to issuer-licensed insider trading.⁷⁷ In sum, even if Professor Katz is correct that there are some wrongs that consent cannot cleanse,⁷⁸ without more, the mere inducement or preemption identified by the Law of Conservation of Securities does not rank among them.

In fairness, Professor Katz does not describe the situation precisely as I have. When expressly addressing the case of issuer-licensed insider trading, he offers the following hypothetical:

Bertram and Cuthbert are both entrepreneurs. One day Bertram who has not yet done any business with Cuthbert asks to invest in a company Cuthbert happens to be running. Cuthbert is a bit reluctant to let him. The reason, he explains to Bertram, is that he is often seized by the urge to purchase additional stock in his own company from other investors but is apt not to tell them certain material facts that have triggered such an impulse in him (like the discovery of an oilfield), facts that would probably affect their decision to sell. In other words, he is worried that he might go so far as to buy stock from Bertram, which the latter if he had knowledge of all the facts would not consent to sell him. He, Cuthbert, would then be guilty of defrauding someone to whom he owes a fiduciary obligation. Bertram declares that he is willing to shoulder that risk. . . . Cuthbert makes a proposal. It provides that in case Cuthbert should recklessly purchase stock from Bertram without disclosing a material fact, the latter waives his right to complain about fraud. Nevertheless, just to make sure that Cuthbert still makes a good faith effort to watch his step, he shall in such cases be liable to Bertram for a specified sum of damages, let us say \$1,000.⁷⁹

Assume that Cuthbert subsequently agrees to purchase shares from Bertram over dinner one night without disclosing nonpublic information that Cuthbert estimates has a seventy percent chance of being material. Professor Katz argues that Bertram should still be able to press charges against Cuthbert despite their agreement because one’s right against being defrauded is inalienable and cannot be exchanged for some liqui-

77. As noted *supra* Part IV, even Professor Wang admits that the Law of Conservation of Securities is overinclusive as a criterion for moral permissibility or regulation. See Wang, *Stock Market Insider Trading*, *supra* note 3, at 36.

78. See *supra* text accompanying notes 73–74.

79. Katz, *supra* note 7, at 225.

dated damage clause.⁸⁰ Now, “[r]eplace the dinner table with the stock exchange and the \$1,000 fee with the pecuniary advantages that flow from investing in a company that allows insider trading and you have the canonical case.”⁸¹ But there is a crucial, and somewhat obvious, asymmetry between Katz’s hypothetical and a market that openly allows for issuer-licensed insider trading.

Recall the disclosure that Professor Katz imagines an issuer permitting insider trading might make: “THIS COMPANY BELIEVES IN LETTING ITS INSIDERS TRADE ON THE BASIS OF INSIDE INFORMATION. IF THIS BOTHERS YOU, DON’T BUY OUR STOCK.”⁸² These terms bear little resemblance to the hypothetical agreement between Bertram and Cuthbert. In the latter agreement, Bertram exacts from Cuthbert the promise not to trade on material nonpublic information and includes a liquidated damages clause in the event that he does.⁸³ In other words, when Cuthbert trades with Bertram based on material nonpublic information, he breaches the terms of his contractual relationship. Professor Katz therefore builds the fraud into his hypothetical.

But imagine Cuthbert negotiated a clause in his contract with Bertram that expressly grants Cuthbert the right to make trades in his company’s shares based on material nonpublic information. Assume also that Bertram agreed to this clause because he is aware of “the pecuniary advantages that flow from investing in a company that allows insider trading.”⁸⁴ This revision changes the circumstances dramatically. There would no longer be any basis for the claim that Cuthbert fraudulently deceived Bertram in the subsequent trade. In short, when Cuthbert makes the disclosure Professor Katz himself suggests that a firm permitting insider trading would make, the fraud (and therefore the moral wrong) falls away. And once the fraud falls away, so too does any claim that Bertram retains an inalienable right against Cuthbert’s trade. The result is that once Professor Katz’s example is modified to achieve true symmetry with issuer-licensed insider trading, it helps to illustrate the moral permissibility of such trading, not refute it.

80. *Id.* at 226.

81. *Id.* In other words, Professor Katz is suggesting that just like the \$1,000 liquidated damages clause does not exculpate the wrong in Cuthbert’s fraud (and therefore cannot deprive Bertram of his right to legal protection against that fraud), neither do the pecuniary benefits that flow from issuer-licensed insider trading to shareholders (e.g., improved price accuracy, delivery of real-time information to the markets, market-smoothing effect, efficient compensation of firm executives, etc.) exculpate the wrong inherent in such trading nor absolve the state of its duty to protect shareholders against it.

82. *Id.* at 219.

83. *See id.* at 225.

84. *Id.* at 226.

In sum, Professor Katz's argument that traders cannot consent to insider trading is fallacious for one of the following two reasons: (1) It relies on a misunderstanding of the "harm" identified by the Law of Conservation of Securities; or (2) it mischaracterizes the relationship between the issuer that openly permits insider trading and its shareholders, or its potential shareholders, to assume the fraud—and consequent inalienability—that must be proven.

VI. CONCLUSION

The Law of Conservation of Securities either proves too much or too little. It either shows that every profitable trade or omission prior to a material disclosure results in a harm or victimization that should be considered in determining whether criminal liability is warranted—which is a fantastic claim—or it identifies a trivial truth that is not helpful in addressing the question of whether issuer-licensed insider trading is wrong or should be regulated. This law is therefore a non-factor in analyzing the moral permissibility of issuer-licensed insider trading. Neutralizing the Law of Conservation of Securities in turn has consequences for other arguments against issuer-licensed insider trading that rely upon it. The failure of Professor Katz's inalienability argument provides an example.

In sum, I have offered a number of arguments for the conclusion that issuer-licensed insider trading is morally permissible and should not be criminalized. Perhaps these arguments are mistaken; but if they are, it is not because they fail to account for some harm or victim identified by Professor Wang's Law of Conservation of Securities, nor is it because Professor Katz has shown that all traders hold an inalienable right against issuer-licensed insider trading.