Legislation and Legitimation:
Congress and Insider Trading in the 1980s

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Abstract

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 legitimize 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.
I. 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’ 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’ relationship to Wall Street and the economy, and of Congress’ response to real or perceived crises in general.

American legal scholars tend to subscribe to what Robert Gordon has referred to as the “evolutionary-functionalist” 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.”1 Evolutionary-functionalists see this not only as a “natural and proper” path, but also as an accurate description of American legal history.

The neoclassical law-and-economics revolution has championed a specific kind of evolutionary functionalism in corporate and securities law. It holds that legal change should be, and for the most part is, a matter of business and economic conditions pushing the law in an economically efficient (i.e., liberal and capitalist) direction. Easterbrook

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1 Robert W. Gordon, *Critical Legal Histories*, 36 STAN. L. REV. 57, 57 (1984). As Gordon points out, “[t]he words "natural" and "proper" stress the normative nature of the theory; deviations from the norm are both atypical and bad.” *Id.*
and Fischel and Roberta Romano advocate especially strong forms of this argument.\textsuperscript{2} Hansmann and Kraakman, two commentators not associated with the neoclassical camp, advanced their own strong version of this argument when they declared that American shareholder capitalism represents the “end of history for corporate law.” American corporate law, in their view, has reached a final, perfected form that other countries can do little more than imitate.

Although social science abandoned this kind of normatively loaded story of social “progress” long ago, legal scholars, and especially corporate legal scholars, have continued to cling to it.\textsuperscript{3} Some commentators may argue that more, less, or different regulation is necessary for optimum efficiency, but most agree to a great extent with the descriptive account and implicitly accept the normative account. Of course, much work has been done to pose alternate explanations for legal change. Mark Roe, for example, has argued that “The modern corporation’s origin lies in technology, economics, and politics.”\textsuperscript{4} According to Roe, American law’s preference for relatively small, decentralized shareholders was at least in part a political response to a cultural bias against concentrated economic power in general and large financial institutions in particular. Roe argues that populist political ideology and the interests of an important constituent group (small financial institutions) coincided, creating enough pressure to push Congress to restrict the role of large financial institutions in corporate finance.


\textsuperscript{3} Gordon, supra note -- at 68.

This article also posits a “political” description of developments in securities law. But while Roe’s analysis focuses on politicians’ responses to the demands of constituents, I focus on a different concern of politicians: institutional self-legitimation—that is, the legitimation of Congress 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. Most legal scholars, as well as many political scientists, view Congress as a frictionless conduit for the implementation of its constituents’ demands. Some see Congress as a conduit for the complex interests of “the public,” while some see it as catering to the wealthy and powerful classes, or to those constituent subgroups (“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:

6 See, e.g., MORTON HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1780-1860 (1977); Gordon, supra note --, at 74-75.
legislators’ considerable autonomy.\(^7\) Richard Fenno famously characterized legislators as rational actors seeking “re-election, influence in the House, and good public policy,” as well as “private gain.”\(^8\) If legislators are viewed as agents, “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,\(^9\) is a form of agency cost. Institutional self-legitimation is one such cost. While this cost is somewhat mitigated by elections, political “markets” are rife with obvious anti-competitive factors: incumbent advantages, financial barriers to entry, the party system, districting rules, and so on.

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 II 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 III 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.\(^10\)

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\(^7\) MAYHEW, supra note --, at 12-13


\(^9\) Other than private gain these goals can of course serve constituents as well, since re-election and influence are necessary to influencing public policy.

\(^10\) In linguistic terminology, “metonymy” is the figurative representation of one concept with the term for another, associated concept. For example, a U.S. Presidential administration is often referred to by the related term “the White House. Thus we might say Congress constructed insider trading as a metonym that stood for America’s economic uncertainty. As we shall see, Congress also contributed to the notion that insider trading was a concept associated with American economic problems.
Part IV presents evidence from the hearings to support this argument. In hearings on insider trading, many legislators suggested that it was the biggest problem on Wall Street. Congressional Democrats tied insider trading to larger policy issues such as hostile takeovers, which they had tried, but failed, to regulate. Having symbolically reduced America’s economic problems to one relatively simple issue, Congress could address the issue in a decisive way to show its authority and competence. Insider trading was a particularly useful symbol. First, it allowed Congress to express disapproval of the excesses of capitalism without criticizing capitalism per se. Second, a law-enforcement problem like insider trading is concrete and dramatic. America’s underlying economic problems were hard to identify and explain, and much harder to solve. Framing the economic situation as a law-enforcement issue allowed Congress to portray itself as the “good guy” against identifiable “bad guys.” Moreover, the reframing gave Congress a problem that was ostensibly amenable to simple solutions: increased penalties and enforcement resources.

II. THE 1980s INSIDER TRADING LEGISLATION

In 1982, the 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 to $100,000. Over

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11 I use the term “law-enforcement problem” rather than “crime” because insider trading is punishable both as a crime and as a civil offense. As will be seen, the 1980s legislation increased both criminal and civil penalties for insider trading.

the next few years, a number of high-profile insider-trading scandals came to light. The cases—most notably those involving Dennis Levine, Ivan Boesky and Michael Milken—suggested that ITSA had been insufficient to deter insider trading. In response, the House held hearings on insider trading in June and July 1986.\footnote{Insider Trading: Hearings Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the H. Comm. on Energy and Commerce, 99th Cong., 2d sess. (1986) (hereinafter H.R. Hr. 99-168).} Insider trading became a central preoccupation of Congressional hearings on the securities markets for the next few years.

Congress passed the Insider Trading and Securities Fraud Enforcement Act (ITSFEA) in October 1988. 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.\footnote{Insider Trading and Securities Fraud Enforcement Act § 21A(b)(1), 15 U.S.C. 78u-1.} 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.\footnote{Insider Trading and Securities Fraud Enforcement Act § 32(a), 15 U.S.C. 78ff. The Sarbanes-Oxley Act of 2002 further raised these penalties to $5 million and 20 years for individuals and $25 million for non-natural persons.} Third, it gave parties that trade in a security contemporaneously with the insider trader a private cause of action against the insider trader.\footnote{Insider Trading and Securities Fraud Enforcement Act § 20A, 15 U.S.C. 78t-1.}

In addition to increasing maximum sanctions, ITSFEA also offered informants a “bounty” in the amount of 10% of civil penalties recovered from insider traders apprehended on the basis of the informant’s information. ITSFEA further required broker-dealers and investment advisers to establish procedures “reasonably designed…to prevent the misuse…of material, nonpublic information.” The law empowered, but did not require, the SEC to establish rules in furtherance of this provision. ITSFEA also
authorized the SEC to conduct investigations in response to a foreign government’s request for assistance. A further provision of ITSFEA directed the SEC to conduct a study to update the landmark 1963 “Special Study” of the securities markets. 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 enacted many of these recommendations in the Securities Enforcement Remedies and Penny Stock Reform Act (the “Remedies Act”). The Remedies Act specifically authorized federal courts to impose civil penalties on securities law violations other than insider trading. But even after the Remedies Act, the potential civil liability for insider trading greatly exceeded, and still exceeds, that for other securities law violations.17

Congressional hearings on the legislation served a major research resource for this article. The institutional characteristics of Congress further undermine the “conduit” theory of Congressional action described 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

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17 The Remedies Act expanded the SEC’s penalty power in insider trading cases and other cases by authorizing it to 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. Although the Remedies Act extended SEC civil monetary penalties to securities law violations other than insider trading, insider trading remained the only violation subject to ITSA’s trebling provision and ITSFEA’s “control person” liability and $1 million maximum fine. (The maximum civil penalty under the Remedies Act was the greater of $100,000 or actual gain.)
two prominent political scientists, “In 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.”18

Congress ostensibly holds hearings to inform the lawmaking process, but they are poorly suited for gathering information.19 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.”20 Furthermore, although witnesses may present differing views, there is rarely interaction among witnesses. Congressional hearings serve purposes other than information gathering, however:

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 performance….21

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. Traditional analyses of legislative history view legislation as an exercise of realpolitik, public choice,

19 DAVIDSON & OLESZEK, supra note --, at 82.
20 Id.
21 Id. at 82-83.
and rational and strategic behavior. Shortly after the passage of ITSFEA a Congressional insider wrote a detailed description of the drafting and passage of ITSFEA. 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 it does not ask how Congress made those determinations. It does not examine the role of Congress in constructing the crisis, or the legitimating and expressive function of the hearings and legislation. This article addresses those issues, focusing on the hearings as rhetorical exercises rather than following the evolving drafts as policy compromises. Admittedly, this approach, too, reveals only one aspect of the legislative process, but it is one that is insufficiently explored.

III. LEGISLATION AND LEGITIMATION

1. 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 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

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captured.\textsuperscript{23} 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 \textit{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.\textsuperscript{24} 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.

American economic uncertainty that began in the 1970s carried on into the 1980s due to foreign competition, economic restructuring, and record inflation and unemployment rates. Hostile takeovers drove the stock market upward, enriching a few, while many observers (rightly or wrongly) blamed them for layoffs. Even though many economic measures had recovered by the mid-1980s, economic fears lingered well into the decade. Indeed, the unprecedented stock market recovery generated some populist resentment, as it preceded the general economic recovery and stock ownership was less widely dispersed than it is at present.

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

\textsuperscript{23} 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”).

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 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.25

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 is not controlled by the economic elite. For a government that is closely identified with capitalism and

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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.”\textsuperscript{26} I do not mean to suggest here that economic elites call all the shots in Washington or that capitalism is an inherently fraudulent system that can be sustained only by political shenanigans. The fact is that government has an interest in maintaining the legitimacy of capitalism and government’s symbiotic relationship with capitalism.\textsuperscript{27}

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. Thomas Reed, a White House assistant for national security affairs, resigned in 1983. He was later indicted on securities fraud charges. In 1984, Deputy Defense Secretary Paul Thayer resigned when the SEC brought insider trading charges against him. Congress passed ITSA that year. Thayer eventually served 19 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 \textit{Wall Street Journal} stock recommendations surfaced in early 1984.\textsuperscript{28} The most infamous scandals—those involving Ivan Boesky and Michael Milken—occurred after the passage of ITSA in 1984, setting the stage for ITSFEA. This

\textsuperscript{27} 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.
may further explain why the Democratically controlled Congress was so interested in insider trading. It may also help explain 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. When Reagan took office in 1980, many expected that the SEC would relax securities enforcement. Reagan’s choice to head the SEC, John Shad, famously declared on taking office that he would come down with “hobnail boots” on insider traders. Shad’s strong statement may have been specifically intended to blunt criticism of the Administration’s deregulatory philosophy. Shad came to the SEC chairmanship with directions to deregulate and to reduce enforcement resources. The Reagan transition team recommended reducing the SEC budget by 30% over three years, and cutting its Enforcement Division from 200 members to 50. The number of SEC staff remained the same from Shad’s arrival in 1981 until 1984, and rose by only about 1% in 1985 and again in 1986.

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

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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. 16, 2002, at A19.
31 See Harvey L. Pitt & Karen L. Shapiro, Securities Regulation By Enforcement: A Look Ahead At the Next Decade, 7 YALE J. REG. 149, 201, (1990) (quoting Final Rept. 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.
the profits from the disputed transaction. He paid no penalty and neither admitted nor denied guilt.  

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.”

2. 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.” 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, however, Congress is better suited to address the particular than the general. Congress nonetheless felt pressure to respond to public anxiety about

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33 The Senate held hearings to investigate the SEC’s handling of the Reed case. Senator D’Amato, Chair of the Banking Committee’s Subcommittee on Securities, concluded that “the SEC staff acted in a wholly professional manner.” Letter from D’Amato to Rep. Timothy Wirth, April 12, 1983, reprinted in H.R. Ser. No. 98-33, at 7 (1983).


the economy. Providing a solution to a complex problem necessarily involves framing
the nature and scope of the problem. The way in which 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. That is, Congress may
reframe a complex, inchoate problem (vague economic uncertainty) as a narrow one it
can address (insider trading), then set out to address it. Thus, members of Congress not
only enjoy autonomy from their constituents’ interests, but also play a hand in shaping
those interests. 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
didn’t 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.”

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.36 Elected representatives
may play a role in shaping constituents’ preferences in addition to simply aggregating

36 See Elizabeth Gerber and John Jackson, Endogenous Political Preferences and the Study of Institutions, 87 AM. POLI. 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.
This type of autonomy is more than an agency cost—it undermines the basic assumptions of the traditional principal-agent model. 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. 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. 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. 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.

### IV. EVIDENCE FROM THE HEARINGS

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37 *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”).

38 See *MAYHEW*, supra note --, at 18.

It is understandably fashionable to credit “the media” for setting the agenda of public discourse. Establishing the extent of this 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” to report on without a construct of that name—primarily a legal and political construct. Most likely, the media and Congress (as well as prosecutors), each having reasons to play up insider trading, acted symbiotically to construct the perception of an epidemic.

39 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.

40 *Cf MAYHEW*, supra note ---, 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.”)
1. 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. Most of the legislators demonstrated an unwavering conviction that such a problem existed. But while the anecdotal evidence was plentiful, the committees and subcommittees holding the hearings neither requested nor received any formal evidence of an insider trading epidemic. Indeed, Congress pressed on despite the fact that the SEC insisted there was no crisis. Congress largely ignored other issues that the SEC identified as more pressing, such as accounting reform—an omission which has certainly came back to haunt us. Congress assumed that insider trading was a major problem, both in terms of the 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.

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 claimed that recent revelations of insider trading had damaged “investor confidence” in 1987 Senate hearings on “Oversight of the Securities and Exchange Commission and the Securities Industry.” Senator D’Amato claimed that “The 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.” Similarly, Donald Marron, Chair & CEO of Paine Webber, argued that “Insider trading abuses undermine confidence in our markets and could potentially drive foreign investors away.” Senator Proxmire 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. Despite this perception, 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. Senator Hecht noted, “We have the highest volume in history and so obviously people still have respect for [the securities] industry.” The strength of the markets in the 1980s contradicts the theory that a perception of widespread insider trading was discouraging investment. Voters did not seem to think insider trading was a major issue in the mid-1980s. 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. Seventy-eight percent

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42 S. Hrg. 100-83 at 13 (1987).
44 S. Hrg. 100-83 at .
45 S. Hrg. 100-83 at 7.
46 Indeed, 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.
of respondents thought most people would trade on an inside tip, and over half said they would trade on a tip.47

The point here is not to determine empirically whether insider trading justified Congressional attention. Given the difficulty of measuring the incidence of insider trading, so we may never know the answer. This uncertainty 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 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.48 Congress too has a great deal of “legislative discretion” akin to prosecutorial discretion. 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.49 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

47 See Pitt & Shapiro, supra note --, at 26 n.325.
48 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 DANIEL R. FISCHEL, PAYBACK (1995). As Fischel notes, many of the convictions in those cases were later overturned. 49 See DAVIDSON & OLESZEK, quoted supra.
problem are largely confined to their opening statements.\(^{50}\) To the extent that witnesses discussed the matter at all, they tended to dispute the idea of an insider trading epidemic. Such testimony does not necessarily 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.\(^{51}\)

Shad was a featured witness at most of the insider trading hearings, but he disputed the extent of the alleged insider trading problem. While Shad portrayed himself to the public as an enforcer (for example, with his “hobnail boots” declaration), he urged moderation to Congress in the hearings.\(^{52}\) 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

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\(^{50}\) For example, Subcommittee Chair Markey opened the final House Hearings on ITSFEA by stating “The war against insider trading must be fought on many fronts.” He also declared that, “During a time when Wall Street has been set aflame with fraudulent activity, those of us in public office will not be seen as fiddling.” H.R. Ser. No. 100-225, at 2.

\(^{51}\) 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. Kaswell, supra note --, 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. at 179.

\(^{52}\) See next paragraph and the discussion of penalties and enforcement, infra.
been trying to understate the corruption in the market in order to reassure investors.\textsuperscript{53} He may also have been motivated in part by loyalty to the budget cuts of the early Reagan years: until December 1986, Shad did not seek increased funding for enforcement, even when the Senate encouraged him to do so.\textsuperscript{54}

Shad did not view enforcement or investor protection as the main goals of the SEC. In the same press conference as the “hobnail boots” comment, he stated that his priority upon taking charge of the SEC would be “improving the capital formation process.”\textsuperscript{55} Reflecting on his most important achievements upon leaving office in 1987, Shad reiterated this theme. 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.” These developments, he argued, “are saving companies, for the benefit of their shareholders, well over a billion dollars a year.”\textsuperscript{56}

Although the SEC had drafted the bill that eventually became ITSA, Shad was cool and matter of fact in his testimony.\textsuperscript{57} He answered questions tersely when asked, declining to join the legislators who fulminated at length about the evil of insider trading. Shad did not even advocate for the bill which his own agency had advanced. Indeed, he seemed to suggest that private-sector resistance to ITSA was more well-considered than

\textsuperscript{53} Donald Langevoort has argued that while the SEC must point out flaws in the market in order to justify its existence, it must at the same time reassure investors in order to keep market participation robust and its own regulatory domain large and important. Langevoort, supra note --.

\textsuperscript{54} See infra Part IV.4. (“Enforcement Resources”).


\textsuperscript{56} Nathaniel C. Nash, \textit{Shad’s View of 6 Busy Years}, N.Y. TIMES, June 24, 1987 at D1.

\textsuperscript{57} Shad’s restrained position contrast 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.” H. REP. 98-355, 98th Cong. 2d sess., at 23, 21 (1983) reprinted in 1984 USCCAN 2274, 2295, 2293. A cover letter accompanying the proposal, signed by Shad, stated that the proposal represented the views of the Commission.
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.”

During the House hearings on ITSA in 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. Shad acknowledged that 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 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 put it in perspective…I believe that it is a very tiny fraction of the billion of dollars in securities that change hands daily.”

58 H.R. Ser. No. 98-33 at 53.
59 H.R. Ser. No. 98-33 at 65.
60 Id.
61 Id. Testifying before the Senate on ITSA, Shad’s chief of enforcement, John Fedders, agreed that insider trading should not be overemphasized: “The goal right now for the enforcement program is not to target it in one area. Insider trading gets enormous publicity because people can understand it and even people in the press can understand it and they can write about it.” The Insider Trading Sanctions Act of 1983 [sic]: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 98th Cong., 2d sess. 66 (1984) (hereinafter S. Hrg. 98-831).
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. John Fedders, the SEC’s chief of enforcement, agreed with Treadway, and said,

> Insider trading has been ballyhooed by the press and made larger than life...Last year it consumed only 8 percent of 250-plus cases that we brought—only 20 cases....there is no way 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—i.e., 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

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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 trading by investment banker Dennis Levine and by the so-called “Yuppie Five.” The Congressmen praised Shad effusively for his purportedly aggressive fight against insider trading.  

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.” He argued that

all 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.

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.” 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.”

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64 H.R. Ser. No. 99–168 at 1 (Wirth), 2 (Rinaldo), 3 (Luken).
65 Id. at 12.
66 Id. at 5.
67 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 states that the increase in tender offers has “given greater visibility, greater opportunity for abuse.” Id. at 44.
68 Id. See also 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
The witnesses’ testimony did not support the legislators’ belief that insider trading was increasing. Gordon Macklin, president of NASD, stated merely that insider trading “undermines the reasonable expectation that all participants in the securities markets play by the same rules.” He said no more about the extent of the problem. John Phelan, head of the New York Stock Exchange, 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, also refused to join the dire chorus about insider trading. Levitt acknowledged evidence of price movement prior to public announcements of takeovers, but argued that it could be caused by legal purchases by acquirers, as well as by professional investors who had deduced the likelihood of takeovers. Thus “one cannot conclude that this activity evidences an epidemic of insider trading.”

Later in 1986, additional hearings were held just after the settlement of the Ivan Boesky case. Representative Ronald Wyden (D-Ore.) asked John Phelan whether Boesky’s insider trading was just “the tip of the iceberg” or an “aberration.” Phelan said he was unable to answer that; 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 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. 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. In both hearings, the testimony of the exchanges and securities firms downplaying the significance of insider trading obviously had a self-serving element. The point, however, is that Congress 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 1987 hearings on insider trading, Senator Donald Riegle (D-Mich) stated that the confirmation of David Ruder as Shad’s successor would hinge upon whether Ruder would be as committed as Shad to battling “the contagion of insider trading.”73 Riegle’s position is typical of the depiction of insider trading as a fundamental economic issue. But Riegle’s suggestion that Shad is a model crusader against insider trading is odd. Over and over again in the hearings, Shad refused to join Congress in its claims of an insider trading crisis, and he was lukewarm at best with respect to legislative proposals. Yet legislators granted him a great deal of deference and even praise. Riegle expressed hope that Ruder would “measure up” to Shad with respect to insider trading, and he

73 Definition of Insider Trading: Hearings before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs, Part 1, 100th Cong., 1st sess. 2 (1987) (hereinafter S. Hrg. 100-155 pt.1)
seems to have gotten his wish: in hearings on ITSFEA, Ruder was as lukewarm as Shad had been. And as with Shad, legislators did not attempt to cast Ruder as the villain, despite his opposition to much of the bill. When asked directly if he supported the bill, Ruder replied, “Not all of it.” The questioner, Representative Howard Nielson (R Utah), then asked if the bill was “salvageable,” to which Ruder unenthusiastically gave a somewhat affirmative response. In Wyden-like fashion, Nielson thanked Ruder and declared himself “encouraged” by this answer.\footnote{H.R. Ser. No. 100-225, at 94 (1988).}

In April 1987, the Senate held a hearing entitled “Improper Activities in the Securities Industry.” The only witnesses were Gary Lynch, 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-Wisc.), chair of the Committee on Banking, Housing, and Urban Affairs, lauded Lynch and Giuliani as “the Ferdinand Pecoras of the 1980’s.”\footnote{Improper Activities in the Securities Industry: Before the S. Comm. on Banking, Housing, and Urban Affairs, 100th Cong. 2 (1987).} The comparison is far-fetched to say the least. Unlike the Pecora hearings, which purported to uncover deep patterns of corruption on Wall Street, the insider trading prosecutions led only to the punishment of individuals. Proxmire’s reference to the Pecora hearings underscores the fact that none of the 1980s insider trading hearings involved documents, investigations, or testimony revealing corrupt practices in the securities industry, as the Pecora hearings had.\footnote{See SELIGMAN, supra note 32, at 20-38 (describing Pecora Hearings).} Pecora investigated and exposed large, established companies and banks as corrupt organizations, while Lynch and Giuliani
prosecuted individual criminals (including proof readers, clerks, word processors, and the like).\textsuperscript{77} Rather than conducting investigation and fact-finding, the hearings start from the presumption that insider trading is a major problem and ask witnesses to agree with that opinion and to speculate about its frequency and economic effects. The hearings on “Improper Activities in the Securities Industry” congratulate Lynch and Giuliani for their completed cases and listen to condemnations of Levine and Boesky issued by members of the financial establishment with no direct knowledge of the conduct.\textsuperscript{78}

Proxmire framed the purpose of the hearings as follows:

Some have argued that we should drop all laws that prohibit insider trading...They would argue that...the Boeskies and the 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.\textsuperscript{79}

Proxmire’s suggestion that there was significant opposition to the prohibition on insider trading is simply false.\textsuperscript{80} A few academics questioned the prohibition of insider trading,\textsuperscript{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

\textsuperscript{77} See, S. Hrg. 100-76, at 19 (1987) (list of cases brought by S.D.N.Y. U.S. Attorney’s office). 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.

\textsuperscript{78} See testimony of Donald Marron, infra.

\textsuperscript{79} S. Hrg. 100-76, at 2 (1987).

\textsuperscript{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, at 18 (1988).

\textsuperscript{81} The only critic mentioned by name in the hearings is Professor Henry Manne, who had written a book in the 1960s defending insider trading profits as a form of compensation for corporate managers who engineer profitable transactions. HENRY MANNE, INSIDER TRADING AND THE STOCK MARKET (1966). Thus his argument would not apply to outside arbitrageurs like “the Boeskies and the 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); 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.
insider trading law.\textsuperscript{82} 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.

\textbf{2. Hostile Takeovers}

Why would Congress participate in \textit{creating} the impression of an insider trading epidemic, rather than accepting the SEC’s denials? 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. Hostile takeovers were perhaps the most potent symbol of the economic woes of the 1980s. They were, rightly or wrongly, popularly blamed for mass layoffs and the loss of American competitiveness. But they were far more complex and politically difficult to address than insider trading. Furthermore, although hostile takeover activity was a major point of populist concern, the Reagan Administration supported it the name of free markets and the expected efficiency gains of a “market for corporate control.” In the face of Republican opposition, Democrats’ attempts to regulate hostile takeovers failed. Insider trading, however, had no defenders. In the insider trading hearings, members of Congress (mainly Democrats) repeatedly overstated and distorted the connection between insider trading and hostile takeovers. In so doing they may have been attempting to portray insider trading legislation as a substitute for hostile takeover regulation, which they were unable to pass into law.

\textsuperscript{82} In later Senate hearings, Sen. Armstrong, in passing, mentioned Manne’s position as worth consideration, though he called it “far-fetched.” S. Hrg. 100-83, (1987).
An obvious irony of politics is that it is easier to reach agreement when less is at stake. A focused campaign against an easy target, insider trading, provided an opportunity for both parties to express concern about economic issues and to show its effectiveness by producing a legislative response. Insider trading regulation was probably more palatable to Republicans than hostile takeover regulation because it did not threaten arguably productive business practices. On the other hand, Democrats portrayed it as a substitute for their failure to pass hostile takeover regulation. In the hearings, Democratic members of Congress repeatedly conflate 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.

In the 1980s, there was a great deal of public anxiety about hostile takeovers. Hostile takeovers were upsetting to labor, the economic establishment, and members of the public who envied wealth. 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 14 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 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.

Although major economic indicators suggest that the recession had ended by the mid-1980s, hostile takeovers remained a major political concern throughout the decade.

83 Fischel, supra note --.
84 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 14 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 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.
Insider trading and takeovers were linked in the public imagination. Business Week’s cover story of April 29, 1985, was titled *Insider Trading: The Wall Street Epidemic Washington Can’t Stop*. Business Week conducted a study of 229 takeover attempts and found that in 72 percent of the cases, target company prices rose before a bid was publicly announced. Prominent insider traders, such as Dennis Levine, Ivan Boesky, and the “Yuppie Five,” were convicted for trading on nonpublic information regarding hostile acquisitions.  

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. This article takes no position on this issue. Justified or not, there was strong anti-takeover sentiment in the popular imagination, from organized labor, and from the financial and industrial establishment. The Reagan White House and the SEC, however, were “ideologically committed to fostering a market for corporate control.” Democrats in Congress tried, and failed, to pass legislation restricting hostile takeovers. In the insider trading hearings, politicians consistently conflated takeovers and insider trading in an apparent attempt to suggest that, by passing laws punishing insider trading, they were striking a blow against hostile takeovers.

Hostile acquirers and many academic commentators justified the hostile takeover movement in large part with the argument that it would unlock shareholder value. This movement in large part with the argument that it would unlock shareholder value. This

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86 Note that the opportunities for profitable insider trading in a hot M&A market are not limited to hostile takeovers. In 1987 Senate hearings, US 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. S. Hrg. 100-76, at --.

87 See testimony of Lawrence Gold, General Counsel, AFL-CIO, S. Hrg. 100-183 at --.


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.” Even John Shad voiced this same skepticism in a June 1984 speech calling for takeover regulation. Treasury Secretary Donald Regan, however, soon stated the White House’s opposition to regulation and argued for the beneficial economic functions of takeovers. Shad did not revisit the issue.

Both parties felt political pressure to respond to hostile takeovers. The Tender Offer Report Act was introduced in the House in 1984. Senator Proxmire introduced the Corporate Productivity Act in 1985, requiring that all takeover attempts be done by tender offers submitted to the target’s board of directors. Multiple takeover regulation bills were introduced in the Senate in 1987. Rather than adopting Secretary Regan’s strong pro-takeover position, Congressional Republicans introduced their own version of tender-offer reform.90 The GOP bill also included some measures designed to fight insider trading.91 Neither the securities industry nor the SEC supported either party’s

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90 H.R. 2668, 100th Cong., 1st sess., 3 Cong. Rec. H4558 (1987). Of course, the introduction of a competing bill could also have been a strategic move designed to derail the passage of legislation.
91 These provisions included SEC funding increases as requested by the Commission and SEC coordination with foreign securities enforcement investigations. See Kaswell, supra, note 24 at 148. Both were passed as part of separate legislation, the latter as part of ITSFEA. A controversial provision would have empowered the SEC to require internal surveillance systems of broker-dealers and self-regulatory organizations (“SROs,” i.e., the exchanges and NASDAQ). This provision met with significant resistance from the industry and the SROs. Id. at 149. The bill also included instructions to the SEC to conduct a comprehensive study of the securities markets, see id., which also found its way into ITSFEA.
proposals, and the parties could not come to agreement on a compromise bill.\textsuperscript{92} None of the proposed takeover regulation bills passed.\textsuperscript{93}

Although the parties could not agree on hostile takeover legislation, they could agree that insider trading was undesirable. Furthermore, tender offer reform lacked the support of the SEC and the White House. Accordingly, 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.\textsuperscript{94} 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 anti-takeover legislation in 1987, Congress passed ITSFEA, insider trading legislation more extensive than that included in the GOP’s anti-takeover bill.

In the 1980s hearings, many Democrats insisted that insider trading and takeovers were “related,” but they never established precisely what that 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 anti-takeover sentiment. Indeed, the Senators who conflated hostile takeovers with insider trading in hearings on insider trading barely

\textsuperscript{92} See Kaswell, \textit{supra} note --- at 147-150.
\textsuperscript{93} Fischel credits the 1987 crash with finally ending attempts at federal anti-takeover legislation. Some observers feared a coming 1929-style crash, 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 FISCHEL, \textit{supra} note -- at 35-39.
\textsuperscript{94} \textit{Id.}
mentioned insider trading in the hearings on anti-takeover bills in 1987. 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 John Shad. In 1983 hearings on ITSA, Shad did not criticize hostile takeovers or directly blame them for insider trading. He did note, however, that hostile takeovers provide especially profitable opportunities for insider trading, especially with the growth of standardized option contracts. After Treasury Secretary Regan expressed the White House’s support for an active corporate control market, Shad told the Senate in 1985 that takeovers were good for the economy because they tended to increase market capitalization. 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.

Although prices often spike prior to takeover announcements, Shad argued that these price increases are “often” the result of legal purchases by prospective acquirers themselves and other parties with legally acquired information. According to Shad,

95 See S. Hrg. 100-183..
96 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.” See H.R. Hrg 99-33 at 19.
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.  

The House held hearings on insider trading in December 1986. The Levine case had settled that spring, and the Boesky case had just settled. In the meantime, 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. Representative Michael Oxley (R-Ohio) was clearly in the minority when he argued in vain that “these are two distinct issues. I trust we will reserve our other hearings to examine the tender offer problem.” Instead, the insider trading hearings 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 causes takeovers. Representative Wyden 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.” Similarly, Representative Florio (D-

\[100\] Id.

\[101\] H.R. Ser. No. 99-179 at 6. Senator Jake Garn (R-Utah) said essentially the same thing in 1987 hearings, and was similarly ignored, in S. Hrg. 100-76, at 9.

\[102\] H.R. Ser. No. 99-179 at 5.
N.J.) stated, “The insider trading scandal has…raised some significant questions about…what in fact is the driving force behind [hostile] takeovers.” 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, thus discouraging the acquisition.

In 1986 hearings on SEC funding, Representative Dingell asked Shad to tell the panel:

what 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.

By implying that takeovers could be regulated by stepping up securities law enforcement, this statement diverted attention from Congress’s failure to pass anti-takeover legislation. Furthermore, it shifted responsibility from Congress to the SEC. Moreover, Dingell referred to hostile takeovers as “related” to insider trading, thus suggesting that Congressional success in producing insider trading legislation constituted a blow against insider trading. Dingell did not, however, explain how takeovers and insider trading were “related.”

The Senate’s 1987 hearings on “Improper Activities in the Securities Industry” were focused on the recent stock-fraud convictions of Ivan Boesky and Dennis Levine by Giuliani and Lynch. Nonetheless, senators introduced the hearings by discussing hostile

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104 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 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.
105 H.R. Ser. No. 99-179 at 90-91 Shad’s response to the question focused on insider trading and did not mention takeovers. Id.
takeovers, characterizing them as an example of “improper activities.” Furthermore, they implied the reverse theory of causation espoused by Wyden and Florio in the 1986 House hearings. Senator Proxmire asked rhetorically,

> How much do we really know about the corporate takeover game and the complex network of information that circulates among investment bankers, 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?¹⁰⁶

Senator Jim Sasser (D-Tenn.) suggested that takeover bids were announced in order to create the “opportunity” for insider trading.¹⁰⁷ Senator 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.”¹⁰⁸ 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.

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

> …the 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.¹⁰⁹

This is a plausible hypothesis about takeovers, and potentially a good policy justification for their regulation. But of course, it has 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

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¹⁰⁶ S. Hrg. 100-76 at 1.
¹⁰⁷ *Id.* at 11-12.
¹⁰⁸ *Id.* at 2.
¹⁰⁹ *Id.* at 3.
with the general nature of “the merger game,” the macroeconomic consequences of takeovers were far beyond the expertise of Giuliani and Lynch.

The Senators’ phrasing and their subsequent statements in the hearing show that they sought testimony not for information, but for confirmation of their preexisting positions. Indeed, despite the senators’ opening statements, very little of the questioning concerned the relationship between takeovers and insider trading—about 3 pages of 80 total pages of testimony and questioning.110 This limited discussion addressed only the uncontroversial fact that impending takeovers (not just 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 include any evidence supporting this idea.

The Senate held hearings in February 1987 on “Oversight of the Securities and Exchange Commission and the Securities Industry.” Although the hearings were about the SEC generally and not insider trading in particular, insider trading and hostile takeovers predictably emerged as a prominent topic. Senator Sasser called for “legislation that shines the light on the stock manipulations that are at the heart of corporate takeovers today.”111 Donald Marron, Chair & CEO of Paine Webber Group, testified that government action was necessary to prevent “the loss of public confidence” caused by insider trading.112 He supported increasing the flow of information to the market, for example, by requiring earlier disclosure of the acquisition of large blocks of a

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110 Id. at 72, 76-77.
111 S. Hrg. 100-83 at 6.
112 Id. at 12. “I reluctantly conclude that Wall Street cannot solve this problem alone,” Marron stated. Id.
LEGISLATION AND LEGITIMATION

stock\textsuperscript{113} and of trades in a stock by the issuing corporation’s directors, officers and major shareholders.\textsuperscript{114} In supporting enhanced disclosure, Marron seemed, unsurprisingly, 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.\textsuperscript{115}

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 unfunded tender offers credibility by publicly stating that it was “highly confident” it could raise the funding, then quickly do so by selling junk bonds.\textsuperscript{116} Marron’s testimony seems to express the financial establishment’s desire to protect its clients in the corporate establishment from hostile takeovers.

Congress considered, but ultimately rejected, a direct and potentially effective method of combating trading based on nonpublic information about takeovers: 13(d) reform. Section 13(d) of the Exchange Act gives the acquirer of 5 percent or more of a stock 10 days to file notice of that fact with the issuer, the exchanges, and the SEC. The

\textsuperscript{113} Such disclosure is governed by section 13(d) of the Securities and Exchange Act of 1934, 15 U.S.C. 78m(d). 13(d) reform is discussed in detail \textit{infra}. Marron also suggested broadening the reach of 13(d) to include not only groups that explicitly agree to obtain 5% or more of and issue, but also “tacit understandings” concerning “concerted or coordinated activities relating to significant acquisitions of stock in publicly held companies.”

\textsuperscript{114} S. Hrg. 100-83 at 12. Such disclosure is governed by section 16(a) of the Securities and Exchange Act of 1934, 15 U.S.C. 78p(a).

\textsuperscript{115} S. Hrg. 100-83 at 14.

opportunity to trade on significant nonpublic information arises during that 10-day
“window.” Requiring earlier disclosure of large positions would limit such opportunities,
while avoiding the legislative difficulties involved in creating a new class of proscribed
conduct. 117

Since the SEC supported 13(d) reform, it could likely have been passed had it
been proposed by itself or linked to ITSFEA. But it appears that Congress pursued 13(d)
reform as a device for regulating takeovers, not for preventing insider trading. Closing
the 10-day window could derail takeovers because early disclosure would raise
acquisition prices and encourage the issuer 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.

Indeed, it was well within Congress’s power to directly prohibit trading on
material information about hostile takeovers, yet it declined to do so. The SEC passed
such a rule, Rule 14e-3, in 1980. However, the Commission’s statutory authority to pass
such a rule was, and remains, unclear. 118 Nonetheless, Congress did not (and still has
not) acted to codify the prohibition. This further supports the theory that Congress was
more concerned about hostile takeovers per se than insider trading on hostile takeover
information. Conversely, the SEC, which openly favored an active takeover market, was

117 As noted above and further discussed below in section IV.4.a. below, securities law did not (and still
does not) clearly define what constitutes illegal “insider trading.” As long as this remains the case,
eliminating opportunities to trade on nonpublic information would seem to be more effective than
increasing penalties.
118 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 §10(b) and the complex case law thereunder. See United States v. O’Hagan, 521 U.S. 642
(1997).
more interested in regulating misconduct in connection with takeovers than in restricting takeovers per se.

In 1980, SEC Chair Harold Williams proposed closing the 13(d) window, apparently to discourage hostile takeovers. In 1983, his successor, John Shad, appointed an Advisory Committee on Tender Offers. The committee stated that it could not be determined whether hostile takeovers were beneficial or harmful to the economy, and recommended a mild reform package that included closing the 13(d) window. 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. Hearings on takeover regulation were held in the 99th and 100th Congresses, but they produced no legislation.

The SEC continued to support 13(d) reform in 1987, when Congress once again considered takeover regulation. 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

119 The historical information in this paragraph is derived from Karmel, supra note --, at 128-29.
120 FISCHEL, supra note --, at 37.
121 Karmel, supra note --, at 129. In 1987, the SEC supported a narrowing of 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.
disclosure re tender offers, and increased the minimum period of time tender offers were required to remain open from 20 days to periods ranging from 30 to 60 days.122

3. 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 expressed 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 regulation, and insider trading regulation in particular, are at least partly motivated by populist resentment of the wealthy.123 Most of these commentators view Congress as responding (if not pandering) to constituents’ own prejudices. But the need to criticize the excesses of capitalism means politicians also have a self-interested motivation to “blame the rich.”

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.124 This hostility wanes in good economic times, but resurfaces in recessions and depressions. According to Roe, the corporate and financial establishment of the 1930s accepted disclosure regulation as the “lesser of the political evils” at a time

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122 These bills, S. 227, S. 678, S. 1323, and S. 1324 (100th Cong., 1st sess.), are reprinted and discussed in S. Hrg. 100-183.
when many people were clamoring for direct government regulation of business and socialism was a real political force.

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 that envy fueled the high profile prosecutions of Michael Milken and Ivan Boesky.\footnote{FISCHEL, supra note --, at 1-8.} According to Fischel, hostility toward business and finance arises not only from bad economic times for average people, but also from extremely prosperous times for the rich. Despite the “trickle-down” 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, LBOs, and other arcane opportunities for great wealth were accessible only to privileged insiders.\footnote{Even among institutional investors, dowdier players like S&Ls did not get into the junk-bond market until it was on the verge of collapse.} Although the Supreme Court has rejected the idea, the prohibition on insider trading has—historically and in the popular imagination—gained support from the perception that unequal access to information about the markets is unfair. Such informational disparities correspond to “inequalities in wealth…and access to human capital in society at large.”\footnote{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 S. CT. REV. 309, 330.).} Jeanne Schroeder has gone so far as to argue that the “misappropriation” theory of insider trading liability can only be explained as an expression of envy of those who enjoy trading advantages over the general public.\footnote{Jeanne L. Schroeder, *Envy and Outsider Trading: The Case of Martha Stewart*, 26 Cardozo L. Rev. 2023, 2027 (2005) (“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.”)}
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 the government concern with white-collar crime in the 1970s was a broad-based, decentralized response to the delegitimization of government authority following the Watergate scandal.\(^\text{129}\) In the immediate post-Watergate era, the Justice Department and the FBI specifically stated numerous times that they focused their efforts on white-collar crime in order to restore confidence in the justice system and the government.\(^\text{130}\) Poveda notes that the FBI’s annual report first began including “white-collar crime” as a subheading in 1974. The first-ever criminal prosecution for insider trading under 10b-5 was brought in 1978,\(^\text{131}\) and a wave of major prosecutions continued throughout the 1980s. Poveda’s theory is also consistent with the SEC’s controversial move in the 1970s, under Commissioner Stanley Sporkin, to take on corporate corruption in addition to its more typically “regulatory” tasks.

Disparity in wealth is endemic to American society, indeed to most societies today. By itself, then, the envy argument is an incomplete explanation 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 answer is that insider trading offered Congress an opportunity to cater to the popular envy of wealth without actually challenging the established economic order. The legitimacy of Democratic

\(^{129}\) TONY G. POVEDA, RETHINKING WHITE-COLLAR CRIME (1994).
\(^{130}\) Id. at 136-37.
\(^{131}\) The Supreme Court eventually overturned the conviction in that case in Chiarella v. U.S., 445 U.S. 222 (1980).
members of Congress required establishing populist credentials without inflaming too
much resistance from the economic establishment. Republicans, conversely, had to show
that their new deregulatory, pro-business 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, it pleased the Wall
Street establishment because it posed no fundamental challenge to the status quo.

Even the high-profile, highly privileged insider trader villains of the 1980s, bond
traders like Michael Milken, arbitrageurs like Ivan Boesky, and investment bankers like
Dennis Levine, came from relatively less privileged roots than the leaders of established
financial houses and corporations. Indeed, although Fischel blames insider trading
prosecutions on a populist bias against wealth *per se*, he further contends that the hostile
takeover battles of the 1980s were at least in a part “a struggle between old money and
new money.” 132 Milken and Boesky, he argues, made their fortunes by attacking the
economic status quo—which included organized labor as well as established financial
houses and industrial corporations. 133 Fischel contends that Milken was the victim of an
“unholy alliance” between the “displaced establishment” and the aforementioned leftist
“rich-haters.” 134 While there is no real evidence of any overt conspiracy, 135 the
aforementioned conflation of insider trading with hostile takeovers in the Congressional
hearings is consistent with this theory. Portraying insider trading regulation as anti-

132 Fischel, supra note 43, at 22.
133 *Id*. at 68, 189. Fischel introduces his book by condemning those who vilify the rich, but here he
distinguishes between “old” and “new” money and vilifies the former.
134 *Id*. at 168.
critique of the Congressional response to hostile takeovers and insider trading is to some degree
undermined by Fischel’s own “angry energy” and “lack of objectivity.” *Id*. 
takeover legislation appealed to the Wall Street establishment as well as to populist sentiment.\(^{136}\)

In fact, insider trading regulation cannot be sincerely portrayed as a populist blow against the wealthy. Like the “white collar crime” movement generally, the insider trading crusades may have resulted in punishments of “average people” more often than powerful elites.\(^{137}\) The legislative reforms arguably did little to hold elites responsible.\(^{138}\) And although a number of high-profile prosecutions involved wealthy traders, many low-level individuals were prosecuted as well. Rudolph Giuliani, as U.S. Attorney for the Southern District of New York, brought a large number of insider trading prosecutions against clerical workers.\(^{139}\) Similarly, the SEC under Shad pursued a “small dollar program” involving small gains, sometimes less than $10,000.\(^{140}\) Furthermore, John Fedders, the SEC’s chief of enforcement under Shad, specifically said he thought upper-

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\(^{136}\) See especially the testimony of Paine Webber executive Donald Marron in S. Hrg. 100-83, discussed supra.


\(^{138}\) ITSA did not impose liability on “control persons”, and when ITSFEA did, it imposed a “knowing or reckless” scienter standard.

\(^{139}\) See S. Hrg. 100-76, at 19 (list of cases). In addition, the 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 with a G.E.D. who had risen to the level of trading assistant at Drexel. JAMES, supra note 115, at 349, 418.

\(^{140}\) Pitt & Shapiro, *supra* note --. In defense of the small dollar program, the SEC argued that enforcement must catch everyone, 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 public, defusing criticism of the SEC as too industry-friendly. *Id.*
level officers would lack the requisite scienter to be vicariously liable for insider trading by their employees.  

Unsurprisingly, the insider trading hearings do not contain explicit reference to resentment of the rich. While politicians may have employed pure anti-capitalist populism at other times in history, that 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. In this context, it is worth considering Schroeder’s argument that “misappropriation” theory is based on envy of individuals’

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141 Pitt & Shapiro, supra note --. Although ITSFEA imposed liability on “control persons” of insider traders, it did so only for control persons who acted “knowingly” or recklessly.

142 Mark Roe, for example, traces suspicion of concentrated financial power to the Jacksonian era. More recently, radical labor and the Socialist Party were significant political forces in the early 20th century.

143 See, e.g., Stephen Koepp, From Pinstripes to Prison Stripes, TIME, March 2, 1987 [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 Yuppies’ 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.”). The “whiz kid” phenomenon recurred, of course, in the dot.com boom of the 1990s.
good fortune (however isolated or fleeting), as distinct from a more systematic
resentment towards the wealthy as a class.\textsuperscript{144} 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.

Senator D’Amato asserted, “The new players in the market have come into a go-
gogo environment. It appears to them that success is measured in the amount you earn—the
ends always justifying the means.”\textsuperscript{145} Representative 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…the young resourceful people.”\textsuperscript{146}
Representative Wirth (D-Colo.) asserted that “a number of people, especially young
people” have been “moving in and taking advantage of” the bull market.\textsuperscript{147} 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….”\textsuperscript{148} Wirth was
apparently referring to Dennis Levine and the so-called “Yuppie Five,” respectively.\textsuperscript{149}

\textsuperscript{144} Jeanne L. Schroeder, \textit{Envy and Outsider Trading: The Case of Martha Stewart}, 26 Cardozo L. Rev.
2023 (2005)
\textsuperscript{145} S. Hrg. 100-83 at 5.
\textsuperscript{146} H.R. Ser. No. 99-168 at 43.
\textsuperscript{147} \textit{Id.} at 59.
\textsuperscript{148} \textit{Id.} at 2.
\textsuperscript{149} The “Yuppie Five” were corporate lawyer Michael David, stockbroker Morton Shapiro, Shapiro’s client
Daniel Silverman, and arbitrage analysts Andrew Solomon and Robert Salsbury, all of whom pleaded
Some legislators specifically argued that the Wall Street establishment had moral standards superior to those of the new financial players. Luken 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.” Similarly, D’Amato 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.” Testifying before the senate Banking Committee, Giuliani cited the “Yuppie Five” defendants as evidence of a failure to teach ethics to young people. George Ball, Chair and CEO of Prudential-Bache Securities, was even more explicit in his defense of the status quo, stating, “[t]hose 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.” Thus while the attack on insider trading may appear to have challenged Wall Street, in fact it can be seen as a defense of the established economic order and a rebuke to “newcomers,” who are portrayed as threatening to jeopardize the status quo by overreaching. This rhetorical approach casts insider traders as disruptivenewcomers and outsiders to an orderly and virtuous establishment—hardly a populist position.

4. Penalties and Enforcement

guilty to insider trading charges in 1986. See Reuters, Guilty Plea in “Yuppie 5” Case, CHI. TRIB., Nov. 27, 1986 at C3.
151 S. Hrg. 100-83 at 5-6.
152 S. Hrg. 100-76 at 54.
Congress insisted that insider trading activity was rampant, and characterized it as a law-enforcement matter. Congress thus reduced America’s complex economic problems to a simplified cops-and-robbers issue. Like the criticism of “new wealth,” transforming inchoate economic dissatisfaction into a law-enforcement problem also had an obvious moralistic component. Focusing on insider trading and portraying it as a law-enforcement issue was useful in that it reframed economic policy as an issue of punishing individual lawbreakers. This transformed a complex set of issues into a simple morality play with an ostensibly simple solution. It also diverted attention away from more intractable economic problems, and thereby blunted fundamental questions about 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. That is, 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 the define the offense on a painfully slow, case-by-case basis.

As noted above, insider trading regulation was justified 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, anti-fraud regulation is itself potentially “fraudulent” in that it suggests that enforcement protects the public from investment risk.\(^{154}\) 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.\(^{155}\) 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. 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. 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 points. As Langevoort points out, a passive diversification philosophy conflicts with our faith in the efforts of active individual investors and investment advisers. And, more importantly in the current context, it also undermines the perception that legislators and regulators can protect investors and are necessary to do so.

ITSFEA created a private cause of action for those who trade contemporaneously with an insider trader. This cause of action, codified as section 20A of the 1934 Act, does little to increase the overall exposure of insider traders, however. A defendant’s total liability exposure under section 20A is limited to his profit gained or loss avoided, and reduced by any disgorgement. There is little incentive to bring suit, as the total

\(^{154}\) Langevoort, *supra* note ---.

\(^{155}\) *Cf.* William Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002) (“The disturbing thing [about the Enron disaster] is that the standing army of civil and criminal enforcers had no deterrent effect.”).
potential recovery is small, to say nothing of the recovery for any individual plaintiff, given the potential number of contemporaneous traders of a publicly traded stock. Section 20A does not create a new class of prohibited conduct, and courts have interpreted it narrowly.\footnote{That is, § 20A seems only to grant standing to private plaintiffs for claims that must otherwise satisfy existing case law regarding private causes of action under Section 10(b) and Rule 10b-5. \textit{See} Jackson Nat'l Life Ins. Co. v. Merrill Lynch & Co., 32 F.3d 697, 703 (2d Cir. 1994).} The subcommittee draft of ITSFEA had included a provision authorizing an additional private right of action for \textit{any} person (not just contemporaneous traders) injured by the acts of an insider trader.\footnote{\textit{See} H.R. Ser. No. 100-225 at 14 (reprinting draft version of ITSA bill).} This provision was deleted in committee deliberations, however, due to fear that it would expand civil liability.\footnote{\textit{See} Kaswell, \textit{supra} note --, at 168-69.} 

Remarkably, while focusing on penalties, Congress \textit{failed to define} the offense it was 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 generic antifraud prohibitions of Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder. The judicial definition was (and remains) notoriously murky. While it seems logically necessary that a definition of the offense should proceed 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 maximum 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 Congressional focus on penalties is typical of its symbolic, theatrical approach to the insider trading issue. Despite lip service to its effect on “investor
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 13(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. As 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.  

Legislators’ focus on penalties is more plausibly explained as an attempt to express outrage at insider trading, which serves the legitimacy purposes explained above. Indeed, the very focus on insider trading as a significant economic issue itself makes the economic dislocations of the 1980s amenable to reframing 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 choice of witnesses is telling. The hearings served little purpose other than to frame

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the insider trading issue as a law enforcement struggle and, moreover, to associate senators with Lynch and Giuliani, the actual participants in that struggle.160

The point here is not to critique ITSA and ITSFEA’s efficacy in addressing insider trading. Rather, the point is that they do not even 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, that it did not need additional powers, and that it did not need additional funding.

a. 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 § 10(b) and Rule 10b-5 had to be a narrow one that satisfied the common-law definition of fraud.161 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

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160 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 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.

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. This may be a form of compromise to defuse disagreement and allow the 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.” 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.” 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. Shad showed more interest in exempting certain kinds of conduct than in creating a broad prohibition: the SEC “urge[s] that the legislative history of the bill cite behavior to which the statute is not intended to apply.” Shad was particularly concerned that an executive who reveals

164 Id.
166 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).
information to outsiders “in order to obtain their advice and assistance for the benefit of his shareholders” not be considered an unlawful “tipper.“168

When ITSA went before the Senate in 1984, Senator D’Amato introduced a competing bill that included ITSA’s trebling provision, but would also have outlawed all trading on material nonpublic information.169 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.170 SEC Chief of Enforcement John Fedders was equivocal, presenting six reasons in favor of a legislative definition of IT and six reasons against.

D’Amato’s broad definition was in direct response to the Supreme Court’s 1980 opinion in United States v. Chiarella. 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 financial printer obtained the names of impending takeover targets by reading takeover announcements during the printing process, before their public dissemination. The government argued that a person who trades in securities without disclosing that fact that he possessed material nonpublic information has committed securities fraud. The Court rejected that argument, however, holding that such a trade does not constitute fraud unless the trader had some independent legal duty to disclose, such as a fiduciary duty to the counterparty.171 This suggested that while existing law prohibited insider trading by corporate insiders (such as officers and directors), who owe

168 Some of the conduct Shad was interested in protecting is now prohibited by SEC Regulation FD, 17 C.F.R. 243.100-243.103. passed in 2000.
169 S. Hrg. 98-831.
fiduciary duty to their shareholders, it did not reach trading by most “outsiders” who possess material nonpublic information. Justices Burger and Stevens believed “outsiders” commit fraud in violation of 10(b) and 10b-5 if they “misappropriate” material nonpublic information, but the majority of the Court did not address this theory, as it had not been presented to the jury below.

The committee report accompanying ITSA defended the failure to define insider trading. According to the report, an explicit definition would be too narrow and create loopholes. Furthermore, existing case law was sufficiently clear. The report supported this latter contention with reference to cases predating *Chiarella*, but remarkably failed to mention *Chiarella*.

In summer 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). Once again, Senator D’Amato 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. That theory was indirectly implicated in *Carpenter v. U.S.*, 175

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173 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 15, reprinted in 1984 USCCAN at 2288.
174 Pitt & Shapiro, *supra* note --, at 227; see S. Hrg. 100-155, pt. 1.
175 “Wrongfully” meant 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 S. 1380, reprinted in S. Hrg. 100-155, pt. 1, at 74 (1987).
which was pending before the Supreme Court in 1987.\textsuperscript{176} \textit{Carpenter} involved charges under mail fraud, not 10b-5, but turned on the idea that the misuse of information for trading purposes constituted fraud.

The Chair of the House Energy & Commerce Committee, John Dingell, opposed ITPA on the ground that a clear proscription would be easier to evade.\textsuperscript{177} The SEC, under David Ruder’s chairmanship, proposed its own, substantially similar, version of ITPA in November 1987.\textsuperscript{178} The perceived need for ITPA soon abated, however, when the Supreme Court decided \textit{Carpenter} late in 1987.\textsuperscript{179} The Court upheld the defendants’ convictions on mail fraud charges and contained no language undermining the misappropriation theory.\textsuperscript{180} ITPA ultimately failed to pass, and ITSFEA, introduced in June 1988, contained no definition.

\textit{b. The SEC’s Restrained Approach to Penalties}

Although the SEC drafted the ITSA legislation, Commission officials gave only lukewarm support to increased penalties. Before ITSA, the only civil sanction for insider

\begin{itemize}
\item \textsuperscript{176} Carpenter v. U.S., 484 U.S. 18 (1987).
\item \textsuperscript{177} Pitt & Shapiro, supra note --, at 227. Pitt himself, then a partner at Fried, Frank, Harris, Shriver & Jacobson and former counsel to the SEC, 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 at 99 (1987). 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. \textit{Id}.
\item \textsuperscript{178} H.R. Ser. No. 100-225 at 50.
\item \textsuperscript{179} See Pitt & Shapiro, supra note --, at 227.
\end{itemize}
trading was disgorgement of trading profits. At the ITSA hearings, Shad stated that he wanted the hearings to inform the public that under existing law, insider traders faced a “host of other sanctions” in addition to disgorgement, including loss of broker-dealer licenses and criminal sanctions, as well as non-legal sanctions, such as “loss of employment, social opprobria [sic], [and] heavy legal fees.”

SEC counsel Dan Goelzer was wary of increasing civil penalties too much, for fear this “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.”

Goelzer took the position that in the secondary liability context, 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. Shad took an even narrower position, stating that the SEC’s recommendation was that trebling should apply only to persons who “actually trade while in possession of material nonpublic information or who tip such information to others who trade.”

“Employers, control persons, and aiders and abettors (other than tippers)” should not be subject to treble damages under the statute, Shad argued. Predictably, issuers, corporate lawyers, and securities firms also favored narrowing secondary liability.

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181 H.R. Ser. No. 98-33 at 60.
182 H.R. Ser. No. 98-33, at 41-42 (reprinting memo from Goelzer to Shad, 4/12/83).
183 ITSEFA later expanded employer’s potential liability by adding control person provisions.
185 Id.
Later, in December 1986 hearings following the Levine and Boesky settlements, Dingell argued that the treble-penalty provision of ITSA was an insufficient deterrent. Larger penalties might be necessary, he argued, due to the “unbelievable greed of some in the marketplace.”

Representative Luken pointed out that ITSA penalties only work as a deterrent if they are really being applied. Between the passage of ITSA in 1984 and summer 1986, the SEC brought 11 cases. It obtained civil penalties in 9 of them, all pursuant to settlements. 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. In the largest and most notorious insider trading case, Dennis Levine’s settlement involved no penalty, requiring only disgorgement of $11 million in profits and cooperation in further investigation, which ultimately yielded little. One defendant, First Boston Corporation, paid a penalty equal to twice the amount of profit. No defendant paid the treble penalty authorized by ITSA.

William J. Anderson, the GAO’s Assistant Comptroller General for General Government Programs, testified that as of Sept. 30, 1986, the full treble damages permitted under ITSA had never been imposed in any case. In fiscal 1985, penalties in excess of disgorgement were imposed in only 2 of 12 civil actions. The penalties imposed were less than the profits disgorged. Penalties were imposed in 15 of 30 actions in 1986. Penalties in those cases ranged from .01 times profits to 2.36 times profits. As a partial explanation, the SEC told GAO that it considers a defendant’s ability to pay when

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188 Id. at 8.
190 Id. at 20.
requesting penalties.\textsuperscript{192} Shad proudly testified that in calendar 1986 as of December 11, SEC civil cases had obtained court orders for $80 million in disgorgements and $54 million in penalties\textsuperscript{193}—note, however, that this aggregate penalty amount is far less than the maximum permitted under the treble damages provision.

After ITSA, Shad did not believe any further insider trading sanctions were necessary. He argued that “ITSA, by supplementing other civil, administrative and criminal sanctions, provides substantial deterrence of insider trading.”\textsuperscript{194} Of course, such a contention is non-falsifiable. Shad also argued that the major cases like 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.\textsuperscript{195}

Shad and his SEC showed no interest in severe punishment of insider trading. Both the Levine and Boesky settlements were criticized at the time as weak.\textsuperscript{196} Dennis Levine was arrested in May 1986, and in early June, he pleaded guilty to four felonies. Levine settled SEC civil charges by agreeing to disgorge $11.6 million in trading profits, a permanent injunction from future securities law violations and a lifetime ban from the securities industry.\textsuperscript{197} In the July 1986 hearings, legislators asked Shad why Levine did not pay any civil penalties under ITSA. At least some of Levine’s trading occurred before the effective date of ITSA, but Shad did not rely on that fact. Rather, he explained by stating that Levine “disgorged $11.6 million and agreed to cooperate in the

\textsuperscript{192} Id. at 33.
\textsuperscript{193} Id. at 54.
\textsuperscript{194} Id. at 63
\textsuperscript{195} Id. at 53.
\textsuperscript{196} See, e.g., JAMES B. STEWART, DEN OF THIEVES 295-96 (1991).
\textsuperscript{197} H.R. Ser. No. 99-168 at 15 (Shad testimony).
Commission’s continuing investigation. He also simultaneously pled guilty to four felony counts.” 198 The Justice Department, which cooperated extensively with the SEC in the Levine investigation, was no more severe. In 1986, Shad told Congress that the maximum penalties Levine faced were 20 years in prison and $610,000 in fines. 199 But when Levine was finally sentenced, he received only 2 years and $362,000 in fines. 200 Luken argued that the practice of giving leniency in exchange for testifying against others undermined the deterrent effect of sanctions. 201

Gary Lynch, the SEC’s head of enforcement, testified that Boesky’s $100 million settlement consisted of a $50 million disgorgement and a $50 million penalty—again, far less than the maximum treble damages. (Boesky also agreed to plead guilty to criminal charges, resulting in a three-year jail sentence. 202) 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.” 203 Moreover, the government promised to withhold the announcement of the settlement so that Boesky could quietly liquidate his positions before their prices crashed. 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:

198 Id.; see also HR Hrg 99-179 at 88 (Lynch testimony).
199 H.R. Ser. No. 99-168 at 15 (Shad testimony).
200 STEWART, supra, at 272.
202 See STEWART, supra, at 289.
although Boesky had nonpublic information, his trading was not illegal because he violated no duty of disclosure, and thus did not violate Rule 10b-5.\textsuperscript{204}

Later in the same hearing, Luken questioned whether Boesky’s fine would really have a deterrent effect. He asked whether the SEC had investigated Boesky’s assets and ability to pay before setting the penalty at $50 million. Lynch evaded the question for a while, but Luken finally demanded a response. Lynch appeared to concede that he had not performed such an investigation: “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.”\textsuperscript{205}

John Shad had been succeeded by David Ruder by the time Congress considered ITSFEA. Ruder did not initially support most of ITSFEA. His testimony in July 1988 was critical of the legislation. 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.”\textsuperscript{206} He also noted that the SEC had already approved New York Stock Exchange rule changes increasing supervisory requirements in member firms.\textsuperscript{207} He stated that this SRO-based approach was “more comprehensive” and thus “more desirable” than ITSFEA’s imposition of control-person liability.\textsuperscript{208}

\textsuperscript{204} \textit{Id.} at 124.
\textsuperscript{205} 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. \textit{Stewart, supra} note --, at 280. Ironically, however, “this big round number” was widely perceived as inadequate.
\textsuperscript{206} H.R. Ser. No. 100-225 at 36.
\textsuperscript{207} \textit{Id.} at 36.
\textsuperscript{208} 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. \textit{Securities Exchange Act of 1934} \S 15(f), 15. U.S.C. 78o(f).
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.\textsuperscript{209} 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 “Draconian.”\textsuperscript{210} 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).\textsuperscript{211} When pressed on his views on the 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.”\textsuperscript{212}

Ruder did support section 6, which authorized SEC to conduct investigations in response to a foreign government’s request for assistance in investigating violations of that country’s securities laws.\textsuperscript{213} Ruder thought this was the most important part ITSFEA, because it would help foreign prosecutions and encourage foreign governments to cooperate with the SEC. Dennis Levine, for example, had done his insider trading through an offshore account, and his scheme was discovered thanks to tips from abroad. Ruder also supported ITPA, the proposed definition of insider trading, which ultimately failed.\textsuperscript{214} He submitted his unenthusiastic written comments on ITSFEA into the record and then invited discussion on other proposed reforms.\textsuperscript{215}

\begin{footnotes}
\item[209] H.R. Ser. No. 100-225 at 42-43.
\item[210] 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.
\item[211] Id. at 47.
\item[212] Id. at 93.
\item[213] Id. at 47-49.
\item[214] Id. at 50. Indeed, in the ITSFEA hearings, Ruder was more interested in ITPA and other reforms than in discussing ITSFEA.
\item[215] Id. at 21.
\end{footnotes}
Other than capping liability in private suits, Congress did not respond to Ruder’s criticisms of ITSFEA. Ruder suddenly changed his position on the bill just before it was passed. When asked about his view of the bill in September 1988, he said “I personally support the bill.” Despite his earlier insistence that increased penalties were unnecessary, he stated, “I think that increases in sanctions in the insider trading area will be helpful and effective in deterring that kind of conduct.”\textsuperscript{216} It is unclear what prompted Ruder’s change in position. Despite his late support, however, note that Congress drafted most provisions of the bill, including its increase in SEC discretion with respect to “control person” penalties, despite Ruder’s opposition.

c. Enforcement Resources

Shad initially opposed Congressional plans to expand the SEC’s budget, particularly in the enforcement area.\textsuperscript{217} He insisted that the SEC could perform its enforcement mission without larger budgets. In the Senate hearings on ITSA, Proxmire asked Shad why he did not seek additional appropriations for enforcement.\textsuperscript{218} Shad responded by stating that the Enforcement Division had brought an increased number of cases in fiscal 1982, despite a reduction in staff, and another increase in 1983 despite no growth in staff.\textsuperscript{219} 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

\textsuperscript{216} Id. at 264.
\textsuperscript{217} At hearings in summer 1986, Shad stated, “the Commission is not here today to request additional resources, at least at this time, or legislation.” H.R. Ser. No. 99-168 at 4.
\textsuperscript{218} S. Hrg. 98-831 at 64.
\textsuperscript{219} Id.
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.220

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 its budget.221 In accordance with the Reagan budget, Shad did not ask Congress for increases in SEC funding.222 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.223 Senators Alan Cranston (C-Calif.), Sasser, and Proxmire, however, showed great interest in enforcement actions, however, asking Shad whether the SEC was being aggressive enough.224 Proxmire asked why Shad was not asking for more money for enforcement. Shad replied that Reagan’s 1986 budget was sufficient.225

This seems 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. This makes sense, as enforcement is much easier for

220 Id. at 65.
224 Id. at 46-48 (Cranston), 48-52 (Sasser), 57-60 (Proxmire).
225 Id. at 70.
politicians to understand, and makes a more dramatic statement to the public about the government’s commitment to imposing discipline on the markets.

*d. Legislative Expansion of Executive Discretion*

Even assuming that increased penalties were an appropriate response to an insider trading “epidemic,” the increase in penalties under ITSA and ITSFEA was 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. The Committee Report on ITSFEA stated that “courts should impose jail terms” for insider trading, and that it “*expects* that raising the ceiling will increase the certainty of substantial prison sentences,” but in fact ITSFEA did nothing to require jail time. Similarly, as Shad himself 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 imposing the maximum penalty will ultimately be made by the judiciary as precedents are established.”

Increasing the range of penalties does not directly increase penalties imposed on wrongdoers; it only increases the discretion of the enforcement agencies that recommend sanctions and the courts that impose them.

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227 *H.R. Ser. No. 99-168 at 19.*
ITSA and ITSFEA further expanded executive power by giving the SEC discretion to exempt “any person or transaction or class of persons or transactions” from their penalty provisions.\(^{228}\) Neither the ITSA nor ITSFEA hearings include consideration of mandatory minimum penalties or other restrictions on SEC discretion. Furthermore, the failure to pass a legislative definition put the definition of insider trading in the hands of SEC rulemaking and the charging decisions of SEC civil enforcers and Justice Department prosecutors (subject, of course, to judicial review).

The fact that Congress “reformed” insider trading law by expanding the discretion of executive agencies is remarkable in light of the clear difference in philosophy between the Democratically-controlled Congress and the Republican Administration. Congress and the SEC sharply disagreed about the scope of the insider trading problem, the appropriateness of harsher penalties and the need for more enforcement resources. This was not a matter of political compromise, in which Congress ceded discretion to a powerful executive. Rather, it was a matter of buck-passing, for ITSA and ITSFEA both gave the SEC power it did not seem to want.

As noted above, the trebling provision of ITSA had never been applied as of 1986. Furthermore, the SEC gave 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 asked Shad whether the SEC should be given increased power to set civil fines. Shad said it was not necessary, because ITSA was sufficient.\(^ {229}\) He repeated the caution expressed in the ITSA hearings—that high penalties might reduce judicial willingness to


\(^{229}\) S. Hrg. 99-129 at 72-73.
go along with SEC penalties, might increase defendants’ willingness to litigate, and that the SEC needed time to see whether ITSA was working.230 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. As noted above, Congress praised Shad and his SEC for their enforcement efforts even as Shad and other Commission officials testified that insider trading was not a significant problem. 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.”231 Congress did not call attention to Shad’s lukewarm attitude toward insider trading enforcement: if it were to do so, it could not justify “passing the buck” to the SEC.

V. CONCLUSION

Most current legal commentary on corporate and securities regulation (such as the wealth of excellent work on Sarbanes-Oxley), 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 is not concerned with the economic effects that securities regulation produces, but with the political motivations that produce it. This inquiry suggests that

230 Id. at 73-74; 90-92. The SEC did, however, want authority to bring administrative proceedings under sec 14 and power under sec 17 to sanction registered transfer agents.

231 ITSFEA §2.
economic regulation is the product of Congress’s concern for its own perpetuation as an institution and not the result of its sober calculations of economic effects.

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. Legislators, speaking and writing for the record, are literally performing to communicate to their colleagues, for the edification of society, and to the voters. While much has been written on the “expressive” function of law, this commentary tends to view law as the expression of public values. But this view necessarily presumes that the legislators (or judges) who make the law are a frictionless conduit of public values. More skeptical views of lawmaking see legislators as bought-and-paid-for conduits not of the public interest, but of “special interests.” Those (such as Richard Fenno) who do consider the autonomy of legislators tend focus on them as classical rational actors seeking individual gain. I suggest that legislators may use their autonomy to legitimate the existing political and economic order. While this theory is consistent with a characterization of politicians as cynical lackeys of capitalism, it is just as consistent with legislators who are sincere believers in the American establishment.
APPENDIX: List of Hearings Cited


