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Insider Trading Law and the Ambiguous Quest for Edge

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Black Edge. By *Sheelah Kolhatkar*. New York: Random House. 2017. Pp. xx, 344. $28.

The quest for information in the securities markets bears more than passing similarity to sex: much desired, okay to get it for free, but illegal—and morally condemned—if you are paying for it. Marking the dividing line between getting info gratis and paying for it can be rather murky. Just paying for dinner probably does not count; the bag of cash does. But you have to know that you are paying for it to make it illegal; if you don't know how you happened to get lucky, you are on the right side of the line.

The line between paying and getting something for nothing lurks in the background of *Black Edge*. *Black Edge* is Sheelah Kolhatkar's[1] journalistic account of the investigation by the SEC, FBI, and DOJ into SAC Capital Advisors, the hedge fund managed by Steven A. Cohen, one of Wall Street's most successful traders. Knowing more than others—"edge"—is smart business unless you got the information the wrong way (and you know it), in which case, your edge is the product of criminal fraud, the "Black Edge" of the book's title. The book, although nonfiction, is written in the style of a Grishamesque thriller, minus the dramatic finish. (And, sorry, dear reader, there is no sex.) Indeed, the anticlimactic conclusion is the book's key takeaway from a legal perspective. Cohen, the white whale of the government's investigation, evades criminal prosecution, despite the conviction of a number of lower-level individuals caught up in the government's pursuit of Cohen (p. 294). Cohen's firm, SAC Capital, ultimately pleaded guilty to criminal indictment, paying out $1.8 billion in criminal fines and civil penalties (pp. 258–59). The SEC barred the firm from managing investors' money for a period of two years, but the firm continues to manage Cohen's multibillion-dollar private fortune under the name Point72 Asset Management (pp. 288, 292). Cohen faced no personal sanction, but as the owner of SAC Capital, he took a financial hit from the fine paid by his company, although he remains comfortably a multibillionaire (p. 258). Point72 is poised to return to managing other people's money in 2018.[2]

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1. Staff Writer, the *New Yorker*.

2. Simone Foxman & Katherine Burton, *Steve Cohen's Comeback Begins*, Bloomberg (Sept. 5, 2017, 8:49 AM), http://www.bloomberg.com/news/articles/2017-09-05/steve-cohen-s-comeback-is-said-to-begin-as-marketers-pitch-fund [https://perma.cc/4N2R-R82U].

Kolhatkar is a journalist, not a lawyer, but her book highlights the tension between populism and the rule of law that bedevils the regulation of insider trading. The widely held moral condemnation of insider trading views the crime in black-and-white terms: greed leading to abuse of trust. That moral judgment is animated by a strong populist impulse. In the public mind, insider trading is the signature crime of the wealthy and powerful. The resentment is no doubt exacerbated by the fact that insider trading is associated with speculators. The average person sees the work of professional traders as largely pointless—a zero-sum game. Traders are not producing anything, good or service, but they nonetheless earn enormous sums of money. As a society, we are devoting a lot of resources to promoting liquidity and share-price accuracy—real economic benefits to be sure, but amorphous ones not readily apparent to the public at large. The public's suspicion of the trading class is further fueled by ambitious prosecutors hustling for headlines, who do not miss an opportunity to feature insider trading in well-publicized news conferences.

Despite the politicians' definitive condemnation, the legal prohibition against insider dealing is beset by murky lines, the product of its essentially common law origins. Courts have made it up as they go along because Congress and the SEC have refused to define insider trading by statute or rule. The murkiness of the law, however, also betrays a certain ambivalence in our moral view of insider trading. From an economic perspective, using nonpublic information for trading undermines the liquidity of securities markets. Information asymmetries among traders discourage participation in trading markets, regardless of their source, because the uninformed—"dumb money"—seek to avoid trading with those who know more—"smart money." Our moral intuitions, however, differ sharply based on the source of the information. Few question the use of information found through good fortune (talk of an impending deal overheard in the elevator), while most condemn the use of information divulged in breach of trust—"tipping" in the parlance of insider trading doctrine. But what if the good fortune was promoted by a lot of hard digging? What if the disclosure was "encouraged"? When do investments in digging veer into the prohibited area of paying for information? The law endeavors to distinguish good fortune, even enhanced by honest effort, from the corruption represented by breach of trust. The fluidity with which information passes among participants in the securities markets, however, makes drawing that line treacherous in any given case.

Kolhatkar's account of the pursuit of Cohen and SAC Capital illustrates the fuzzy border defining when use of nonpublic information constitutes insider trading. She also shows the evidentiary challenges that the law poses for prosecutors and the SEC in making their cases. The ambiguity of insider-trading law lurks in the background of how SAC Capital operated. Information can be translated into profit in the securities markets, and SAC Capital invested enormous sums and effort in getting information relevant to its trading decisions. The line between legally and illegally obtained information is a fine one; Kolhatkar never squarely pins down which side of the line Cohen and SAC Capital were on.

In this Review, I will use *Black Edge* to highlight how the law's ambiguities limit the government's reach in pursuing insider trading. In particular, I will focus on how the knowledge requirement for securities fraud casts a shadow over the government's campaign against the hedge fund industry's never-ceasing quest for an informational advantage—"edge," be it white, gray, or black. After setting forth the blurred lines of insider-trading law's approach to the hunt for nonpublic information in Part I, I explore its implications for the government's investigation of Cohen and SAC Capital in Part II. The Review concludes with some thoughts on how insider-trading law may develop going forward.

I. Blurred Lines

The offense of insider trading is based nominally on the prohibition against fraud found in Rule 10b-5 of the Securities Exchange Act,[3] but neither Rule 10b-5 nor its authorizing statute, section 10(b) of the Exchange Act, say anything about insider trading. It is closer to the truth to call the insider trading prohibition a species of common law, albeit one given teeth by the enforcement resources of the federal government. Beginning in the 1960s, the SEC pushed the courts to recognize insider trading as fraud within the broad language of Rule 10b-5.[4] The agency enjoyed considerable success with its agenda in the lower courts, most notably the Second Circuit, the leading intermediate court for the securities law.[5] The government got pushback, however, when the Justice Department deployed the prohibition in a criminal case. That expansion brought the topic of insider trading to the attention of the Supreme Court in *Chiarella v. United States*.[6] *Chiarella* began the process by which the Supreme Court, under the guidance of Justice Lewis F. Powell, Jr. narrowed the scope of insider trading under Rule 10b-5 from the broad prohibition endorsed by the SEC and validated by the Second Circuit to one that more closely tied to common law understandings of fraud.[7] That process culminated in a complex doctrinal thicket, in contrast to the relatively clear prohibitions found in jurisdictions that have prohibited insider trading explicitly by statute. The law of insider trading as it stands now incorporates two principal theories:

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3. 17 C.F.R. § 240.10b-5 (2017).

4. The beginning of the SEC's modern campaign against insider trading is usually traced to an administrative proceeding against a broker-dealer. Cady, Roberts & Co., 40 S.E.C. 907 (1961).

5. *See, e.g.*, SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833 (1968) (recognizing parity-of-information theory of insider trading under Rule 10b-5).

6. 445 U.S. 222 (1980).

7. A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counter-Revolution in the Federal Securities Laws*, 52 Duke L.J. 841 (2003).

1. the classical theory, first recognized by the Supreme Court in *Chiarella*, which holds that a corporate insider (or temporary insider, such as a lawyer or an accountant) commits fraud when he trades with a shareholder without disclosing material, nonpublic information to that shareholder; and
2. the misappropriation theory, which holds that a person who has received material, nonpublic information subject to a duty of trust and confidence commits fraud when he trades on the basis of that information without disclosing his intention to trade to the source of the information.[8]

These theories cover most of the terrain of what would classically be considered insider trading.

More relevant to the investigation in *Black Edge*, insider trading doctrine also reaches outsiders through a prohibition against tipping. Under the Supreme Court's decision in *Dirks v. SEC*, tippees are barred from trading if they know or should know that they have received information from an insider who received a benefit from disclosing the information (such as cash, or an indirect benefit by making a gift of the information to a relative or friend).[9] Either would satisfy *Dirks*'s test: "[W]hether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders."[10] Absent a "direct or indirect personal benefit from the disclosure" received by the tipper, there could be no deception, and therefore, no fraud by either the tipper or the tippee under Rule 10b-5.[11] For the outsider, merely possessing nonpublic information is not enough: "[T]here is no general duty to forgo market transactions 'based on material, nonpublic information.'"[12] Sometimes you just get lucky, and the law is okay with that.

But what counts as a personal benefit? And how much does the recipient of the information need to know about its provenance? These are vital questions for professional traders, who are always looking for an edge, because they cannot make money without one. The ambiguity of the line between lawfully and unlawfully obtained information was the principal battleground in the criminal prosecution and conviction of two peripheral players in the SAC Capital scandal, Todd Newman and Anthony Chiasson. Their subsequent exoneration on appeal by the Second Circuit produced a significant new insider trading precedent.[13]

Newman and Chiasson were two hedge-fund managers who were at the end of extended tipping "chains." Through those chains, the managers received confidential information about impending earnings releases from

8. United States v. O'Hagan, 521 U.S. 642 (1997).

9. 463 U.S. 646 (1983).

10. *Dirks* 463 U.S.. at 662.

11. *Id.* at 667 n.27.

12. *Id.* at 666 n.27 (quoting Chiarella v. United States, 445 U.S. 222, 233 (1980)).

13. United States v. Newman, 773 F.3d 438 (2d Cir. 2014), *abrogated by* Salman v. United States, 137 S. Ct. 420 (2016).

public companies. The key issue in the Second Circuit's controversial *Newman* decision was the quantum of evidence necessary to show that an insider who disclosed confidential information subsequently used for trading received a personal benefit in exchange for the disclosure. The *Newman* court rejected the government's argument—based on the Second Circuit's prior decision in a civil case, *SEC v. Obus*[14]—that it was sufficient that the tippee know, or have reason to know, that the information had been revealed by the tipper in breach of a duty of confidentiality. Instead, the *Newman* court held that "in order to sustain a conviction for insider trading, the Government must prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information *and* that he did so in exchange for a personal benefit."[15] This knowledge requirement for criminal cases was a substantial step up from *Obus*'s negligence standard in civil cases. The court further held that the government must prove that the personal benefit to the tipping insider involved "a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature . . . . this requires evidence of 'a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the [latter].' "[16]

The last bit of the *Newman* court's holding was repudiated by the Supreme Court in *Salman v. United States*, which held that a close family relationship, at least, was sufficient, without any further requirement of a quid pro quo.[17] The Second Circuit has recently eroded the *Newman* decision further in the *Martoma* case, effectively eliminating *Dirks*'s requirement that the gift be to a friend or relative.[18] A gift to anyone for the purpose of trading apparently now counts as a personal benefit to the tipper under insider trading doctrine in the Second Circuit.

Left undisturbed by *Salman* was the *Newman* court's holding that the tippee must know of the personal benefit received by the insider. In a criminal case, the tippee has to know that the tipper disclosed in exchange for a personal benefit.[19] The government did not challenge this aspect of *Newman*, and it remains good law, at least in the Second Circuit.[20] But even that aspect of *Newman* has a limited reach, as *Newman* did not purport to overrule the application of *Obus* in civil enforcement cases brought by the SEC.[21]

14. 693 F.3d 276 (2d Cir. 2012).

15. *Newman*, 773 F.3d at 442.

16. *Id.* at 452 (quoting United States v. Jiau, 734 F.3d 147, 153 (2d Cir. 2013)).

17. Salman v. United States, 137 S. Ct. 420, 428 (2016).

18. United States v. Martoma, 869 F.3d 58 (2d Cir. 2017).

19. *Newman*, 773 F.3d at 442.

20. The First Circuit seems open to the possibility that the *Newman* knowledge standard applies. United States v. Bray, 853 F.3d 18, 28 n.6 (1st Cir. 2017) (citing *Newman*, 773 F.3d at 448–49).

21. *See Newman*, 773 F.3d 438 (discussing exclusively criminal enforcement by the SEC).

I have questioned the reasoning in *Obus* elsewhere,[22] but the Second Circuit has not revisited its holding. For now, negligence suffices in a civil case to show a tippee's state of mind regarding the source of information that has been disclosed in breach of confidence.[23] With Regulation FD's prohibition against selective disclosure of material nonpublic information barring disclosure by executives of public companies,[24] the conclusion that the recipient "should have known" of the breach becomes almost inescapable for a prosecutor. What that conclusion ignores is that Regulation FD is not enforced with much enthusiasm by the SEC.[25] Breaches of confidentiality, perhaps negligent, are not uncommon. For hedge funds and other active traders operating in the Second Circuit, however, the doctrinal gap between *Obus*'s negligence standard and *Newman*'s knowledge standard means substantially different exposures to civil and criminal liability for the same conduct, although both are based on Rule 10b-5. Given this gap, enforcement by the SEC is the more likely threat. The takeaway for traders is that the decision to trade on information of doubtful sourcing may be a business proposition, albeit a risky one, rather than a gamble that invites potential jail time on the downside.

II. The Investigation

A. *Striving for Status*

Black Edge is primarily an account of the investigation into Cohen and SAC Capital. The story is not purely forensic. Kolhatkar focuses throughout on three human emotions that drive the actors in her story: envy, ambition, and fear. All three of these emotions turn, to a greater or lesser extent, on the question of status. The quest for status explains as much, or more, about the characters featured in *Black Edge* than a standard model of *homo economicus* rationally pursuing profit. Particularly poignant is Cohen spending enormous sums to establish himself as an art collector in an effort to distinguish himself from other billionaires—new money aspiring to look like old (pp. 54–56). In the world that Kolhatkar writes about, everyone is trying to get ahead.

Cohen's success in getting ahead—and the envy it generates among his competitors—feeds the investigation. If you are doing better than your rivals, particularly over a long period of time, it is easy for them to conclude that you must be cheating: "No one in the industry understood how Cohen made so much money so consistently; his competitors were envious—and

22. A.C. Pritchard, Dirks *and the Genesis of Personal Benefit*, 68 SMU L. Rev. 857, 869–75 (2015).

23. SEC v. Obus, 693 F.3d 276, 288 (2012).

24. 17 C.F.R. §§ 243.100–.103 (2017).

25. A Westlaw search for Regulation FD reveals litigation releases for nine cases since Regulation FD was adopted in 2000 (through fall 2017).

suspicious."[26] Cohen's competitors were happy to share those suspicions with government investigators,[27] quite transparently hoping that Cohen would receive his comeuppance. Cohen's downfall, of course, would increase their status in the pecking order (and explain why their returns had lagged his for so long).

Ambition drives the actors on the government's side of the investigation. Kolhatkar opens the book with an FBI agent, B.J. Kang, who wants "to take down someone big . . . a significant player in the financial world" (p. x), so he can move up from the penny-ante fraud cases he has been working on (p. 75). The junior SEC attorney assigned to the investigation thinks, "[m]aybe this case was the break he was waiting for" (p. 154). Bigger players in the investigation have bigger ambitions. Preet Bharara, U.S. attorney for the Southern District of New York, is fixated on publicity for his cases (pp. 157–59). He wants to give the voters what they want in the wake of the financial crisis.[28] A good insider trading scandal might also alleviate some of the pressure on higher-ups in the Justice Department, who, along with the SEC, were under heavy criticism for failure to bring cases relating to the financial crisis.[29] In playing the insider trading card, Bharara was following a well-trod path. Rudy Giuliani's shrewd (cynical?) use of perp walks featuring Wall Street fat cats during his time as U.S. attorney in the 1980s catapulted him to mayor of New York and a national political presence.[30] Bharara is not the only prosecutor looking to make a name for himself in *Black Edge*; Kolhatkar notes that the other government lawyers cashed in with partnerships at white-shoe firms after the close of the investigation into SAC Capital (p. 293).

Fear also plays a prominent role in *Black Edge*. The government is scary. When Cohen gets wind of the investigation into his fund, he warns a colleague to "be careful" (p. xv). Kolhatkar suggests this warning is evidence of a guilty mind, but that is not the only inference one could draw. Kolhatkar also shares with us the claim, by Cohen's then wife, that he had cried on her shoulder every night while he was under investigation for insider trading in connection with the takeover of RCA by GE.[31] Being the subject of a criminal investigation may not be as stressful as an indictment or conviction, but

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26. P. xiii; *see also* p. 30 ("Traders at the big firms told each other that Cohen had to be cheating. J.P. Morgan refused to do business with him.").

27. *See* p. 76.

28. *See* p. 157 ("[F]inancial cases were what the public seemed to care the most about at that moment.").

29. P. 139; p. 183 (showing the political pressure brought to bear on the SEC with Senator Charles Grassley demanding explanations for why the agency had not pursued SAC Capital).

30. *See* Joe Nocera, Opinion, *Prosecuting Insider Trading*, N.Y. Times (Dec. 12, 2014), https://www.nytimes.com/2014/12/13/opinion/joe-nocera-prosecuting-insider-trading.html (on file with the *Michigan Law Review*) (drawing parallels between Bharara and Giuliani).

31. P. 70. Cohen's ex-wife was hardly a reliable witness. She was embroiled in litigation with Cohen; she alleged that Cohen had cheated her in the divorce. The RCA investigation lost steam after Cohen pleaded the Fifth when interviewed by the SEC. P. 28.

it is surely close. Given the ambition of the prosecutors and the vagaries of the law explained above—particularly the government's view that the negligent receipt of information can violate Rule 10b-5—the warning to "be careful" seems prudent for anyone in Cohen's position. Regardless of guilt or innocence, an investigation has serious consequences, particularly for someone involved in financial services, even if it does not lead to a prosecution.

The government's ability to strike fear in the hearts of its targets shows up repeatedly in *Black Edge*, most vividly when one of Cohen's traders faints in his driveway when the FBI confronts him about a suspect trade (p. 191). The battle between fear and greed is a constant one in the financial markets, and it comes as no surprise that the threat of indictment tips the balance toward fear. The FBI agents leading the investigation rely heavily on fear to push their investigation forward. Insider trading almost always involves a conspiracy, and the government typically has an attractive offer for the first conspirator to flip—and a threat for those who wait.

In the SAC Capital investigation, the FBI also has an innovation in white-collar forensics, relying on wiretaps to collect direct evidence rather than waiting for one of the targets to flip. The book begins with a wiretapped conversation rewarding the patience of the FBI agent assigned the tedious task of listening in (p. ix). We also see, however, that the tool has its limits, as the FBI opts to tap Cohen's Connecticut home in summertime, rather than his estate in the Hamptons (p. 147–48). The FBI agents were clearly not familiar with the customs of the smart set; technology cannot substitute for knowing the habits of your prey.

B. *Did He Do It?*

Kolhatkar's focus on emotion keeps her story moving, but it distracts from the ultimate question: is Steven Cohen guilty of insider trading? I do not know; *Black Edge* does not provide the answer. Kolhatkar never actually pins down the facts. In fairness, answering that question is asking too much of any author. Kolhatkar has amassed an impressive amount of detail regarding the activities of people in considerable legal jeopardy; they have plenty of reason to not be forthcoming. But in the face of uncertainty, one can ask of Kolhatkar a more evenhanded treatment, rather than a recurring appeal to populist impulse. Kolhatkar clearly sympathizes with the prosecution, who appear to have been more forthcoming with her. (They are not going to jail if they talk!)

Kolhatkar and the government's bête noire is expert networks; she shares an FBI agent's view that "the whole concept of the expert network business model sounded corrupt" (p. 145). Why would traders pay for information unless it was *not* publicly available? Public information is presumed worthless, as the efficient capital market hypothesis tells us that it is already incorporated into the stock price. Valuable information is confidential, the theory goes, so if you are paying something of value for the information, that payment at least raises the question of how the information was obtained.[32] Kolhatkar notes ominously the large sums that SAC Capital paid to one of the expert networks (p. 145). How would the expert network be getting the information other than by paying for it? From the government's perspective, the disclosure of confidential information should raise the presumption that there was a quid pro quo offered in exchange, that is, possessing confidential information should be assumed to be corrupt unless an innocent explanation is proffered.

The government overreaches with this argument.[33] Information sometimes gets out simply because people are careless in restricting access to it. For example, some of the information obtained by traders in *Black Edge* comes from abroad, with company officials following a different set of rules regarding the disclosure of information.[34] But other pieces of information are shared by individuals in the United States within the reach of the SEC and DOJ. How could this information get out without money changing hands? One clue as to how expert networks could obtain valuable information without resorting to bribes is human nature. Confidentiality is not normal, notwithstanding the strictures of Regulation FD; it is ordinary human behavior to talk about what you are doing, including at work. Taciturn individuals are thought to be at least a little odd. People *will* talk. But sometimes financial inducements and human nature are both at play in inducing individuals to ignore confidentiality obligations. Kolhatkar highlights the relationship that one of Cohen's traders, Matthew Martoma, cultivates with a doctor involved in a drug trial. The doctor was being paid by the expert network, but Martoma also reminded the doctor of his son, who had committed suicide (p. 277). Martoma's efforts to ingratiate himself with a lonely old man do not reflect well on Martoma's character, but it is a stretch to call this wheedling corrupt.[35] It's maybe just a bit sleazy.

Kolhatkar and the government also overreach in attempting to put the burden on Cohen to make sure he was not using inside information. She reports the prosecutors prepared a "[m]emo [that] contained example after example of Cohen receiving what seemed to be inside information from his traders and analysts and doing nothing to find out if the information was

32. This speculation ignores the possibility that the expert adds value to publicly available information by more accurately analyzing it. The import of some information may only be fully understood by someone with expertise in the field.

33. A variant of it was proffered by the government when seeking rehearing in *Newman*. Petition of the United States for Rehearing and Rehearing *En Banc*, at 19–20, United States v. Newman, 773 F.3d 438 (7th Cir. 2014) (No. 13-1837(L)). The Seventh Circuit has come close to presuming the intention to make a gift from the fact of disclosure. *See also* SEC v. Maio, 51 F.3d 623, 633 (7th Cir. 1995) ("Absent some legitimate reason for Ferrero's disclosure . . . the inference that Ferrero's disclosure was an improper gift of confidential corporate information is unassailable. After all, he did not have to make any disclosure, so why tell Maio anything?").

34. Pp. 142–43 (detailing information obtained from executives in Taiwan, who were not concerned with U.S. regulators).

35. The doctor was also receiving consulting fees but apparently did not charge a fee for the most damning disclosure that he made to Martoma. *See* United States v. Martoma, 869 F.3d 58, 67 (2d Cir. 2017).

clean" (pp. 237–38). Moreover, "Cohen had never, that the prosecutors found, referred an instance of suspicious trading by an employee to the SEC" (p. 238). But this was the best that the government could muster in its investigation of Cohen: he was not helping them with their campaign against insider trading. The government's attitude reflects the compliance expectation—the feds expect private businesses to help them make their cases. This typical bureaucratic laziness becomes dangerous when the government attempts to attach criminal liability to the failure to be sufficiently helpful to the SEC and DOJ in their vendetta against insider trading.

The government repeatedly falls short when left to its own devices in looking for affirmative evidence of wrongdoing by Cohen. The government is unable to establish that Cohen ever read a critical email that might give prosecutors a smoking gun, despite Kolhatkar's fanciful claim that the email's presence in Cohen's inbox was "practically enough" (pp. 235, 237). And Cohen is even further removed from the source of the information implicated in *Newman*, seven links in a chain of tippees from the insider who disclosed, whereas the defendants in *Newman* were four and five steps removed. That distance from the original source left plenty of room for Cohen's lawyer to argue that "Cohen was too far from the original source of the information, and too ignorant of the circumstances, to be criminally liable for any securities fraud" (p. 242). This argument swayed the government, which grudgingly settled for indicting SAC Capital, based on the conduct of individuals lower down in the food chain, giving up on the quest to indict Cohen individually (p. 244). Ultimately, the SEC concluded that the evidence against Cohen was too tenuous even for a civil case of fraud, leaving the agency's lawyers to scramble for a case based on negligence—failure to supervise—in order to shut down SAC Capital (p. 247). Kolhatkar—and her readers—are left disappointed by Cohen's narrow escape.

Conclusion

For Kolhatkar, the failure to indict Cohen demonstrates the ability of the wealthy and powerful to game the system. The *Newman* decision, which led to the dismissal of the criminal convictions of several of the insider traders with connections to SAC Capital, comes in for special scorn. Channeling the prosecutors, she tells us: "[*Newman*] was yet another measure of vindication for Cohen, essentially legalizing the don't-ask-don't-tell information-gathering model employed at SAC" (p. 291); and "[i]t basically grants permission to trade on material nonpublic information, as long as you don't know too much about where it came from" (p. 292).

Kolhatkar's cheerleading for the prosecution and disdain for the legal barriers that kept Steven Cohen out of jail ignores the other side of the equation: the rule of law. It is no small thing to put an individual away for being on the winning side of a bet in the securities markets. There will always be winners and losers in the securities markets, and the losers will stir envy and resentment against the winners, portraying them as cheaters. We also see in *Black Edge* that government actors have strong incentives to foster sour grapes. Insider trading prosecutions generate headlines that can be converted into future political support and lucrative law firm partnerships. For the agency chiefs, collecting a few scalps from fat cats for insider trading produces the fringe benefit of getting an impatient Congress off their back. The temptations for prosecutors to equate a suspicious pattern of returns with corrupt behavior may be overwhelming and, more troubling, easy for the average juror to swallow.

Putting the government to its proof in showing that the access was corrupt, rather than presuming corruption based on success in trading, protects the innocent. There is surely a cost in allowing some of the guilty to go free, but that is an inevitable consequence of our commitment to due process in criminal justice. The fact that the government's targets happen to be wealthy (or überwealthy in Cohen's case) should not undermine that commitment to fairness.

Black Edge illustrates the gap between what the public expects from the prohibition against insider trading—a level playing field—and what the law currently allows the DOJ and the SEC to pursue. Congress, with the acquiescence of the SEC, has not acted to close that gap. Hedge funds and other professional traders work, quite consciously, in the interstices where money is made. But those interstices are fraught with peril, as a gray edge can look black in the view of motivated prosecutors who believe they can find a sympathetic jury. And the populist impulse underlying the insider trading prohibition ensures that there will be a steady supply of motivated prosecutors. Insider trading enforcement, the more the better, sells in the political sphere.

We have seen that the common law character of the U.S. insider trading prohibition leaves gray areas around the edges of the rule. "Gray edge" is inevitable when the law itself lacks black lines. The SEC has resisted codification, worrying that a statute would create a "road-map to fraud" if not written expansively enough. The SEC's resistance is bolstered by the fact that the financial services industry lobbies against too broad an expansion. Congress has happily gone along with the SEC's reluctance to reduce the insider trading prohibition to statute. Instead, the legislature has intervened only around the edges of insider trading law to create specific statutory penalties[36] and a private right of action.[37] The common theme here is ratcheting up penalties, consistent with an appeal to populism. "We're against greed and corruption!" Congress has also stepped in to correct obvious gaps in the insider trading prohibition developed by the SEC and the courts, such as insider trading in options.[38] Most recently, Congress was shamed into adopting a prohibition against its own members and staff trading on nonpublic

36. Securities Exchange Act of 1934 § 21A, 15 U.S.C. § 78u-1 (2012) (allowing courts to impose three times profits made or losses avoided).

37. *Id.* § 78t-1 (establishing a right of action for contemporaneous traders).

38. *Id.* § 78t(d) (prohibiting trading in options based on material, nonpublic information if trading in the underlying security would be a violation).

information.[39] The SEC has been similarly circumspect in its rulemaking efforts, acting to adopt rules only when necessary to clarify gray areas that had created serious enforcement problems for the agency.[40]

Narrowing the expectations gap between the public's condemnation of insider trading and the law's reach would require a more dramatic intervention. Stamping out all informational advantage, establishing a truly level playing field, requires a prohibition that effectively criminalizes all use of material nonpublic information for trading. Congress has it within its power to enact such a prohibition, and doing so would put traders on notice that any "edge" carries with it the peril of potential imprisonment. The chilling effect of such a prohibition, however, would be significant. All active traders would be at risk of having a jury find that "they should have known" that their informational edge came from a suspect source if their gains are big enough. "It was too good to be true!" Such a rule would move the law from the current fraud standard to a market abuse standard like that found in many foreign jurisdictions.[41]

A half step would be to create a broader civil offense while leaving the criminal prohibition untouched. The Second Circuit has taken a partial step in that direction with the gap between its decisions in *Obus* and *Newman*, discussed above. Going to a pure negligence standard for insider trading would put market participants on notice that any informational advantage carries with it legal consequences. The downside of such a rule is that it would dilute the condemnation implicit in an SEC proceeding. It is also fair to assume that lowering the SEC's burden of proof in insider trading cases would lead the agency to shift more resources to insider trading enforcement at the expense of enforcement targeting other offenses, such as accounting violations and pump-and-dump schemes. Query whether that shift would enhance investor protection.

Under any standard, there would still be ambiguity in some cases about whether the information was public or nonpublic. Nonetheless, a statute would surely alleviate the prosecutorial burden faced by DOJ. It comes at a significant cost, however, because it would reduce the moral condemnation of the criminal law of insider trading.[42] Jail time for corruptly obtaining an

39. *See* Stop Trading on Congressional Knowledge Act of 2012 (STOCK Act), Pub. L. No. 112-105, 126 Stat. 291; Robert Rizzuto, *President Obama Signs Sen. Scott Brown's STOCK Act into Law*, MassLive (Apr. 4, 2012, 12:12 PM), http://www.masslive.com/politics/index.ssf/2012/04/president_obama_signs_sen_scot.html [https://perma.cc/72NZ-DPKX].

40. 17 C.F.R. § 240.10b5-1 (2017) (defining trading "on the basis of" material, nonpublic information); *id.* § 240.10b5-2 (defining duties of trust and confidence for purposes of the misappropriation theory); *see Fast Answers: Insider Trading*, Sec. Exch. Comm'n, (2013), https://www.sec.gov/fast-answers/answersinsiderhtm.html [https://perma.cc/B37J-2ABR] ("The SEC adopted new Rules 10b5-1 and 10b5-2 to resolve two insider trading issues where courts have disagreed.").

41. *See generally* Edward Greene & Olivia Schmid, *Duty-Free Insider Trading?*, 2013 Colum. Bus. L. Rev. 369 (discussing insider trading law in the United Kingdom and the European Union).

42. There might also be some unknown reduction in liquidity as speculators exit the market rather than face the legal risks.

edge is one thing; being put behind bars for being on the right end of a profitable trade is quite another. "Gray edge" is a cost of due process in an insider trading regime premised on the law of fraud.