INVESTOR'S BUSINESS DAILY®

Supreme Court's Wasted Chance On Insider Trading

Thaya Brook Knight

December 13, 2016

Last week the Supreme Court **issued** its first insider-trading opinion in 20 years and in the process entirely wasted an opportunity. While we may know a little more about whether a certain act constitutes insider trading, we have no more insight into why insider trading is illegal in the first place.

The Supreme Court has **told** us that it's its job to "say what the law is." Apparently the judiciary believes this role extends to making law as well, given that judges, not Congress, made insider trading explicitly illegal under the federal securities laws. If the judiciary is going to tread on the legislature's toes in this way (and if the legislature is going to let them), they should at least do the job well.

But insider-trading law is a murky, squishy mess. And the Supreme Court's ruling in Salman v. U.S. makes no attempt to fix it.

The question before the court was whether it was still insider trading if the insider got nothing in return for giving the information to the outsider who traded. The court ruled that no exchange is required: Giving information as a gift is still insider trading.

Fine, but there is nothing in the decision that event hints at the deeper question about why we criminalize this behavior at all. Without knowing the answer, we not only have a crime that we cannot justify, we have no guiding principle to help in determining what the contours of this crime should be. And that is what has led to the murkiness that characterizes this area of law.

Insider-trading law has always walked a blurry line. On the one hand, it strikes many as fundamentally unfair if some people get information and are able to trade on it more quickly (and therefore to greater advantage) than other people. On the other hand, information is the lifeblood of the capital markets and any restriction on the flow of information **reduces the effectiveness** of the markets themselves. Recognizing this tension has led the courts to logically inconsistent outcomes, resulting in a crime that is difficult for individuals to understand and therefore avoid committing.

The principal arguments in favor of criminalizing insider trading are that it creates an unfair advantage for insiders and their friends, and that it constitutes a theft of company information. But neither theory has been consistently implemented in the courts.

If establishing perfect fairness in access to information were the goal, the courts could have made any trading on nonpublic material information illegal.

But the **Supreme Court** has expressly **rejected** this approach precisely because of the value of accurate information in the proper functioning of the capital markets. If a person overhears information in an elevator, that person can freely trade on the information even if it is nonpublic and even though that person clearly has an advantage over others in the market. Because this trade is legal under our existing case law, it seems illogical to say that the purpose of insider-trading law is to prevent uneven access to information.

As for the argument that insider trading is essentially theft of company information, it also suffers from logical inconsistencies. In the case of theft, the law considers only whether a person took something from another person without permission; what happened to the item later is immaterial.

But insider trading only criminalizes using the information to trade, not any noncompany use of the information. In Salman v. U.S., for example, the insider at one point disclosed information for the purpose of helping to research treatment choices for his dying father. That disclosure, the court suggested, did not trigger insider trading liability.

While a person helping his sick father is certainly sympathetic, the law would not permit him to steal medicine for his father. If insider trading is simply a form of theft, the purpose behind the disclosure should not matter as long as it was not for business purposes. Since the law does in fact require a connection to trading, it cannot be simply that insider trading is illegal because it is theft of information.

After Salman, we know that if the insider gives the information as a gift, that constitutes insider trading (ponder for a moment the difficulties of establishing either that the disclosure was or was not intended as a "gift").

But why? Who is the victim and why does insider trading do harm? It is unfortunate that we have a situation in which the courts are making policy at all. But since the courts have stepped into this mess and created this crime, they need to take full responsibility for their creation and explain why these actions are criminal.

Knight *is associate director of financial regulation studies at the Cato Institute.*