Title

What Governmental Insider Trading Teaches Us About Corporate Insider Trading

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I. INTRODUCTION

There has been much academic debate about whether corporate insider trading should be banned. As Stephen Bainbridge recounts in the Introduction to this volume, that debate was sparked by Henry Manne's influential 1966 book, *Insider Trading and the Stock Market*.[1] Manne contended that corporate insider trading should be deregulated because the benefits to both society and the firm whose stock was traded outweighed the costs. He provided two basic rationales. First, Manne argued that corporate insider trading has the effect of moving securities prices toward the level that they would have reached had the inside information been made public. This increase in price accuracy helps allocate capital to its most productive uses.

Secondly, and more provocatively, Manne argued that corporate insider trading was "the most appropriate device for compensating entrepreneurs in large corporations."[2] Unlike ordinary managers whose service is easy to monitor and "can be purchased like any commodity in the marketplace," it is difficult to ascertain the value of an entrepreneur's services in the form of a predetermined salary. Instead, Manne argued, insider trading provides a means by which companies can compensate entrepreneurs for the value of their innovations. Securities prices tend to rise immediately following the public disclosure of the relevant innovation. Because such price increases roughly reflect the value of the innovation to the firm's business, insider trading enables entrepreneurs to recover a portion of the value of their innovative activity. And ultimately, according to Manne, society has a strong economic interest in incentivizing entrepreneurial innovations.

These claims have been thoroughly disputed,[3] and Manne himself has acknowledged difficulties with the second rationale, the compensation justification.[4] But my focus in this chapter is on an important but little-noticed distinction that Manne drew in his argument between *corporate* insider trading, which he defended, and *governmental* insider trading,[5] which he rejected. In his 1966 book, Manne explained that the compensation-

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[1] Henry G. Manne, Insider Trading and the Stock Market (1966).
[2] Id. at 192.
[3] See, e.g., Robert A. Prentice & Dain C. Donelson, Insider Trading as a Signaling Device, 47 Am. Bus. L. J. 1 (2010).
[4] See Henry G. Manne, Insider Trading: Hayek, Virtual Markets, and the Dog that Did Not Bark, 31 J. Corp. L. 167, 173–74 (2005).
[5] By "governmental insider trading," I refer to the practice of government officials, including members of Congress, trading on material nonpublic information in breach of their fiduciary duties. As I have argued elsewhere, members of Congress should be recognized as fiduciaries for purposes of federal insider trading law. See Sung Hui Kim, The Last Temptation of Congress:

for-innovation argument does not generally apply to government officials because "[v]ery often the government official's news will have been reported to him rather than developed by him or anyone in government."[6] Moreover, Manne argued that to the extent that a government official is responsible for innovations, those "innovations may injure a corporation economically as frequently as they benefit it."[7]And Manne could identify no "social, economic, or political interest in rewarding government officials simply for benefitting or injuring particular companies." In addition, allowing governmental insider trading might incentivize government officials to skew governmental processes to increase trading profits rather than serve the public interest. Finally, Manne warned against "the ease with which inside information can be utilized as a payoff device," which he identified as "the principal evil inherent in government insider trading." More than four decades later, Manne stood steadfast by his criticism of governmental insider trading. Manne stated *inter alia*:

> We do not want [government officials] to receive extra compensation or outside compensation for doing their jobs. And, of course, all too frequently their access to this information is merely another form of bribe, and that sure as hell is not legal.[8]

If even Manne, the most vocal defender of corporate insider trading, rejects governmental insider trading, it should not be surprising that there has been little academic or policy defense of the practice. Indeed, apart from Todd Henderson and Larry Ribstein, who urged, "Let members of Congress trade!,"[9] most academic commentators have expressed normative outrage at such actions.[10] To be sure, there has been a descriptive debate about whether certain forms of governmental insider trading, such as those made by members of Congress, violate existing federal securities law,[11] but there has been almost no normative debate about its impropriety.

Legislator Insider Trading and the Fiduciary Norm against Corruption, 98 Cornell L. Rev. (forthcoming 2013) [hereinafter Kim, Legislator Insider Trading].

6 Id. at 193. Of course, the same could be said of corporate insider trading, since the vast majority of insider trading is done by employees who have not created the valuable information. See Prentice & Donelson, supra note 3, at 4.

7 Of course, the same could be said of corporate insider trading, as insiders can benefit as much from bad news as good news. See id.

8 See e-mail from Henry Manne to Pro.Con.org, procon.org (June 29, 2008), http://insider-trading.procon.org/view.source.php?sourceID=006015.

9 M. Todd Henderson & Larry Ribstein, Let Members of Congress Trade!, politico.com (Dec. 1, 2011), http://www.politico.com/news/stories/1211/69601.html (last visited Nov. 19, 2012).

10 See note 11 infra.

11 Until Congress voted to formally ban congressional insider trading on March 22, 2012, many commentators believed that federal insider trading doctrine did not reach members of Congress. See, e.g., Stephen M. Bainbridge, Insider Trading Inside the Beltway, 36 J. Corp. L. 281, 285 (2011); Richard W. Painter, Getting the Government America Deserves: How Ethics Reform Can Make a Difference 163 (2009); Insider Trading and Congressional Accountability: Hearing Before the Comm. on S. Homeland Sec. & Gov't Affairs, 112th Cong. (Dec. 1, 2011) (statement of John C. Coffee Jr., Professor of Law). But see Donna Nagy, Insider Trading, Congressional Officials, and Duties of Entrustment, 91 B. U. L. Rev. 1105 (2011); Jonathan R. Macey & Maureen O'Hara, Regulation and Scholarship: Constant Companions or Occasional Bedfellows? 26 Yale J. Reg. 89, 107 (2009); Insider Trading and Congressional Accountability: Hearing Before the Comm. on

In this chapter, I unpack this normative consensus against governmental insider trading, with emphasis on congressional insider trading. Specifically, I argue that governmental insider trading should be seen as normatively problematic because it amounts to public corruption.[12] Indeed, Manne himself nodded to such an understanding by using words such as "payoff device" and "bribe" to describe the practice. It may seem pointless to tease out justifications for a conclusion that almost no one rejects, but there is a valuable payoff. When we examine more deeply the reasons why *public* corruption is problematic, we see that analogous reasons apply also to corruption in the *private* sector. And as I explain, just as governmental insider trading should be viewed as a form of public corruption, corporate insider trading should be viewed as a form of private corruption.

Although my argument applies generally to governmental insider trading, I focus on congressional insider trading because this type of governmental insider trading has received the widest public and scholarly attention. Section II briefly summarizes the evidence of governmental insider trading, with emphasis on recent empirical studies about trades made by members of Congress. Section III argues that governmental insider trading should be seen as a form of public corruption,[13] whose harms I articulate in section IV. Section V points out that as governmental insider trading should be seen as a form of public corruption, corporate insider trading should be seen as a form of private corruption with analogous harms. Thus, if one rejects governmental insider trading, one has good reason to reject corporate insider trading as well. Section VI concludes.

II. THE EVIDENCE OF GOVERNMENTAL INSIDER TRADING

Governmental insider trading has been around since the founding of the Republic. In 1789, Alexander Hamilton, the first U.S. Secretary of Treasury, announced that the new American federal government would assume the Revolutionary war debts of states and the Continental Congress at face value. Prior to the announcement, the Assistant Secretary of Treasury, William Duer, leaked this information to speculators who invested on their own and on Duer's behalf in the debt certificates of southern states, which were then selling at a fraction of their face value.[14] As summed up by Charles Geisst, "Duer had

S. Homeland Sec. & Gov't Affairs, 112th Cong. (Dec. 1, 2011) (statement of Donald C. Langevoort, Professor of Law); Kim, Legislator Insider Trading, supra note 5.

[12] Bainbridge, supra note 11, at 282 (arguing that permitting congressional insider trading "opens the door to corruption").

[13] Section III is in large parts duplicative of Part III.B of Kim, Legislator Insider Trading, supra note 5.

[14] Contemporaries faulted Duer at the time for driving the speculation. See Robert F. Jones, William Duer and the Business of Government in the Era of the American Revolution, 32 William & Mary Quarterly 393, 409 (1975); Cathy Matson, Public Vices, Private Benefit: William Duer and His Circle, 1776–1792, in New York and the Rise of American Capitalism: Economic Development and the Social and Political History of an American State, 1780–1870 (eds. William Pencak & Conrad Edick Wright), 72, 96 (1989); Edgar S. Maclay, ed., The Journal of William Maclay, United States Senator from Pennsylvania 1789–1791, vii, 175 (1965).

the distinction of being the first individual to use knowledge gained from his official position to become entangled in speculative trading; in effect, he was the first inside trader."[15]

William Duer may have been the first governmental insider trader but he wasn't the last. There have since been numerous suspicious cases,[16] but until 1995, evidence of governmental insider trading remained anecdotal. In 1995, Gregory Boller, a professor of marketing at the University of Memphis, investigated a random sample of 111 members of Congress from the Senate and the House of Representatives who purchased common stock from 1991 to 1993.[17] Boller found that 25 percent of the members sampled "showed stock transactions that directly coincided with legislative activity." For example, Senator Lloyd Bentsen (Democrat, Texas) had purchased stock in a dairy processor and sold it 10 months later—just days before the Justice Department began investigating the company for rigging bids to sell milk in public schools. Boller's more systematic research raised suspicions.

Indeed, it caught the eye of Alan Ziobrowski and his collaborators,[18] who analyzed all known senatorial stock market transactions between 1993 and 1998 and published their groundbreaking study in the *Journal of Financial and Quantitative Analysis*.[19] After poring through hundreds of pages of opaque and unaudited financial disclosure reports and using a calendar-time portfolio analysis, the researchers found that portfolios reconstructing approximately 6,000 reported common stock trades of U.S. senators outperformed the market by approximately 10 percent per year. By contrast, U.S. households performed on average worse than the market by −1.4 percent during the same period.

Perhaps Senators are just better educated and more financially savvy than the average household. But interestingly, Senators outperformed even corporate insiders, who beat the market by only 7 percent, and hedge funds, which beat the market by between 7 and 8 percent. Interestingly, political party affiliation did not predict returns in a statistically significant manner, but seniority did. Abnormally high returns were more common among the more junior Senators.

The study also produced evidence of uncanny timing. The "prices of common stocks bought by Senators tended to stagnate prior to purchase, soar after purchase, and then stagnate again after sale."[20] The authors concluded that "it seems clear that Senators have

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15 Charles R. Geisst, Wall Street: A History: From Its Beginnings to the Fall of Enron 12 (2004). In response to the bond speculation, Congress enacted the Treasury Act of 1789, which prohibited and still prohibits certain officials from purchasing and disposing of state or federal government securities. Richard W. Painter, Bailouts: An Essay on Conflicts of Interest and Ethics when Government Pays the Tab, 41 McGeorge L. Rev. 131, 151 (2009).

16 See, e.g., Bud W. Jerke, Cashing In On Capitol Hill: Insider Trading and the Use of Political Intelligence for Profit, 158 U. Pa. L. Rev. 1451 (2010).

17 Gregory Boller, Taking Stock in Congress, by Joy Ward, Mother Jones (Sept./Oct. 1995 issue).

18 Megan McArdle, Capitol Gains: Are Members of Congress Guilty of Insider Trading—and Does It Matter?, theatlantic.com (Nov. 2011), http://www.theatlantic.com/magazine/archive/2011/11/capitol-gains/8692/ (last visited Nov. 19, 2012).

19 See Alan J. Ziobrowski et al., Abnormal Returns from the Common Stock Investments of the U.S. Senate, 39 J. Fin. & Quantitative Analysis 661 (2004) [hereinafter, Ziobrowski et al., Senate Study].

20 Matthew Barbabella et al., Insider Trading in Congress: The Need for Regulation, 9 J. Bus. & Sec. L. 199, 205 (2009) (interpreting the Ziobrowski study's findings).

demonstrated a definite informational advantage over other investors although the specific source(s) and nature of that information remain unknown."[21]

In 2011, the same research team turned its sights onto the House and examined 16,000 common stock trades made by approximately 300 members of the House of Representatives from 1985 to 2001.[22] The study found that a portfolio reconstructing these trades beat the market by over 6 percent annually—not as good as the Senators, but still abnormally high. The authors speculated that the smaller returns might arise from the fact that House members wield relatively less influence and thus may have less access to critical inside information.

In contrast to the Senate, political party affiliation mattered in the House: Democratic members enjoyed statistically significant better returns than Republicans. As a possible explanation, the authors pointed out that Democrats controlled the House for 10 of the 17 years covered in the study and were perhaps more entrenched in the House leadership and thus were more capable of exploiting the reins of power. And, as in the Senate, the most junior Representatives reliably outperformed their more senior colleagues. The authors speculated that this seniority effect could be caused by the fact that junior members tend to be in more financially precarious situations and accordingly are more motivated to trade on confidential information.

A third study, conducted by Andrew Eggers and Jens Hainmueller, complicates the picture. They reconstructed the portfolios of 453 members of Congress during a different and shorter time frame—between 2004 and 2008.[23] They found that many individual members generally did not beat the market. Indeed, their research suggested that Congress actually underperformed the market by 2 to 3 percent annually. It is not clear why their findings differ from the previous studies. Eggers and Hainmueller offer some explanations, including the possibility that members had changed their trading practices over time (e.g., moved more of their assets into qualified blind trusts) in response to increased scrutiny. (Even Ziobrowski's Senate study noted that for the years 1997 and 1998, Senators did not outperform the market—perhaps as a reaction to the bad publicity from Boller's research.[24]) Eggers and Hainmueller also speculate that perhaps the bull market of the 1990s provided more profit-making opportunities than the "relatively moribund and finally panic-stricken market" of the mid-2000s. It is also possible that members simply stopped reporting their incriminating transactions once they realized that academics and the media were watching them. After all, the disclosure reports are unaudited. Finally, it is always possible that one of the studies is wrong. Ziobrowski et al. have not released their full data set, and the Eggers–Hainmueller study has not been published in a peer-reviewed journal.[25]

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21 Ziobrowski et al., Senate Study, supra note 19, at 676.

22 Alan J. Ziobrowski et al., Abnormal Returns From the Common Stock Investments of Members of the U.S. House of Representatives, 13 Business and Politics 1 (2011) [hereinafter, Ziobrowski et al., House Study].

23 Andrew Eggers & Jens Hainmueller, Political Investing: The Common Stock Investments of Members of Congress, 2004–2008, http://www.gsb.stanford.edu/facseminars/events/political_economy/documents/pe_10_10_hainmueller.pdf (last visited Nov. 19, 2012). The study analyzed 48,309 trades in 2,581 different stocks. Id.

24 Ziobrowski et al., Senate Study, supra note 19, at 676.

25 McArdle, supra note 18.

That said, even Eggers and Hainmueller's study—which found that members of Congress did not generally beat the market—discovered that members' investments in firms headquartered in their districts outperformed the market by about 4.5 percent per year. This finding is intriguing since, as the authors note, no research in recent decades has suggested that individual investors or money managers can outperform the market by investing in local companies. Also, members performed as well as the market with respect to investments in companies that contributed money to the member's election campaigns or lobbied the member's committee. In other words, members' investments in politically connected companies outperformed the rest of their investments. As a result, Eggers and Hainmueller conclude that "members of Congress seem to benefit as investors from knowledge of companies to which they are politically connected (and particularly those headquartered in their districts), but they seem not to invest enough in these connected companies to make up for the mediocre performance of the rest of their portfolios."[26]

In sum, what can we conclude about congressional insider trading based on these studies? According to the Efficient Capital Markets Hypothesis, a version of which has been supported by a wide body of empirical evidence, the "market incorporates all new information pertinent to stock values very quickly, with the result that future stock price changes and investment returns are unpredictable, rendering it impossible for investors to devise strategies based on available information that will consistently produce abnormal returns."[27] As a result, it should be extremely difficult to outperform the market unless one trades with an informational advantage over other investors. Corporate insiders, who normally have access to material information that is not generally available to the investing public, enjoy significant abnormal returns.[28] Apparently, so do members of Congress, especially regarding firms that are headquartered in their districts. All of this strongly suggests that members of Congress are trading with an informational advantage.

Given the foregoing evidence that some governmental insider trading may be taking place, one might ask what the big deal is? In other words, why is it wrong? I answer that question in the next two sections. In Section III, I argue that governmental insider trading can and should be seen as a form of public corruption. In Section IV, I describe why public corruption in the form of governmental insider trading is wrong by articulating its harms.

III. GOVERNMENTAL INSIDER TRADING AS PUBLIC CORRUPTION

As Justice Stewart said of obscenity, people seem to know public corruption when they see it, but it's hard to define.[29] One source of difficulty lies in the fact that what counts

[26] Eggers & Hainmueller, supra note 23, at 4.

[27] Ziobrowski et al., House Study, supra note 22, at 4.

[28] See, e.g., Jeffrey Jaffe, Special Information and Insider Trading, 47 J. of Business 410 (1974); Dan Givoly & Dan Palmon, Insider Trading and Exploitation of Inside Information: Some Empirical Evidence, 58 J. Bus. 69 (1985); H.N. Seyhun, Insiders' Profits, Costs of Trading, and Market Efficiency, 16 J. Fin. Econ. 189 (1986).

[29] See, e.g., Michael A. Genovese, Presidential Corruption: A Longitudinal Analysis, 136, in Corruption and American Politics (eds. Michael A. Genovese & Victoria Farrar-Myers) (2011)

as corruption is historically contingent. For example, it is today uncontroversial to say that a legislator accepting a bribe is corrupt. But in the nineteenth century, members of Congress openly accepted payments from companies lobbying to obstruct or advance particular legislation. For instance, Daniel Webster was on a retainer from the Bank of the United States to represent the bank's interests, and he unabashedly sent written reminders to replenish his bank account.[30] Bribing members of Congress was not formally banned until 1853. And even after the ban, members went undisciplined until public outrage erupted over the Credit Mobilier bribery scandal in the 1870s, which impelled Congress merely to censure the guilty members.[31] Not until more than a century later, in 1980, did the House finally expel a member for bribery.[32]

Also, what counts as corruption is culturally contingent.[33] Societies maintain different political systems with differing notions of accountability, cultivate different institutions of power with varying degrees of maturity and legitimacy, negotiate different boundaries between public and private domains, and draw on diverse relationships between power and wealth. Accordingly, societies necessarily experience corruption in diverse ways, making it difficult to define both precisely and universally. As summed up by John Kleinig and William C. Heffernan:

> Even if we confine ourselves to what we now familiarly speak of as public corruption, it soon becomes clear that what "we" consider to be corrupt is often contentiously so. One group's perquisite is another's corruption; one group's tradition of patronage is another's nepotism; one group's campaign contribution is another's bribery; one group's just rectification is another's misappropriation. Both historically and cross-culturally, instantiations of corruption have been contested, not only with respect to their identity but also, in certain instances, with respect to their undesirability.[34]

("[T]here is no commonly accepted definition of what constitutes corruption"); Michael Johnston, The Definitions Debate: Old Conflicts in New Guises, 12, in The Political Economy of Corruption (ed. Arvind K. Jain) (2001) ("No one has ever devised a universally satisfying 'one-line definition' of corruption"); Nathaniel Persily & Kelli Lammie, Perceptions of Corruption and Campaign Finance: When Public Opinion Determines Constitutional Law, 153 U. Pa. L. Rev. 119, 126–27 (2004) (noting that corruption means different things to the different Supreme Court Justices).

[30] Daniel Webster, who served in the House and Senate and as Secretary of State, once reminded the President of the Bank of the United States, "If it be wished that my relation to the Bank be continued, it may be well to send me the usual retainers." Richard Allan Baker, The History of Congressional Ethics, in Representation and Responsibility: Exploring Legislative Ethics 8 (eds. Bruce Jennings & Daniel Callahan) (1985).

[31] Dennis F. Thompson, Ethics in Congress: From Individual to Institutional Corruption 2 (1995).

[32] The House voted unanimously to expel Michael J. "Ozzie" Myers, a Pennsylvania Democrat who accepted bribes in an undercover ABSCAM investigation. This was the House's first expulsion for corruption. Id. at 105, note 14. Four years earlier, the House had failed to expel Andrew J. Hinshaw, a California Republican, who had been convicted of accepting a bribe. Id. at 2.

[33] See Jens C. Andvig & Odd-Helge Fjeldstad, Corruption: A Review of Contemporary Research 46 (2001) ("[W]hat is seen as corruption varies from one country to another"). That said, as Klitgaard notes, "Over a wide range of 'corrupt' activities, there is little argument that they are wrong and socially harmful," even across societies. Robert Klitgaard, Controlling Corruption 4 (1987).

[34] John Kleinig & William C. Heffernan, The Corruptibility of Corruption, in Private and Public Corruption 3 (eds. William C. Heffernan & John Kleinig) (2004).

Moreover, even within a single society at a particular moment in time, there will be disagreement about what counts as "corrupt." For example, it has been well documented that elites and the public differ in what they regard as corrupt.[35] Also, an analysis of National Election Study surveys reveals that factors such as race, education, and income affect the likelihood that a respondent will perceive the government to be corrupt.[36]

Given such contingencies and controversies, my goal is not to proffer and defend some best definition of public corruption, which would attempt to specify a strict set of necessary and sufficient conditions that capture all instances of what people regard as corruption with no over- or under-inclusiveness. Indeed, the cognitive science of categories casts serious doubt on the success of any such project.[37] Instead, I offer something more modest, a definition that draws on rough consensus in the political science literature, jibes with general lay understandings, and performs useful analytic work in the narrow context of insider trading.

I start with the "classical" understanding of public corruption in political science. As Dennis Thompson explains:

> In the tradition of political theory, corruption is a disease of the body politic. Like a virus invading the physical body, hostile forces spread through the political body, enfeebling the spirit of the laws and undermining the principles of the regime. The form the virus takes depends on the form of government it attacks. In regimes of a more popular cast, such as republics and democracies, the virus shows itself as private interests. Its agents are greedy individuals, contentious factions, and mass movements that seek to control collective authority for their own purposes. *The essence of corruption in this conception is the pollution of the public by the private*.[38]

Thus, the classical understanding of public corruption is grounded in the notion that private interests somehow taint the public good.

More modern definitions of corruption build on this understanding but tend to drop the organic metaphors of disease, degeneration, or decay. They also tend to replace substance with procedure—the notion of substantive public good is replaced by the democratic process, which purifies private interests into legitimate public purposes.[39]

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[35] Matthew J. Streb & April K. Clark, The Public and Political Corruption 281, in Corruption and American Politics (eds. Michael A. Genovese & Victoria Farrar-Myers) (2011) (describing the perception gap in the views of the elites versus the public on corruption).

[36] These factors, however, are less predictive than a respondent's political attitudes. See Persily & Lammie, supra note 29, at 153–67.

[37] Since the 1970s, advances in the fields of cognitive psychology, cognitive linguistics, artificial intelligence, and anthropology have provided a persuasive account of how humans categorize people, things, and abstract concepts. Such an account discounts the role of deductive reasoning from abstracted principles. See, generally, George Lakoff, Women, Fire, and Dangerous Things: What Categories Reveal About the Mind (1987). For a specific exploration of these insights onto the legal profession, see Sung Hui Kim, Lawyer Exceptionalism in the Gatekeeping Wars, 63 SMU L. Rev. 73, 95–111 (2010). See also Daniel H. Lowenstein, Campaign Contributions and Corruption: Comments on Strauss and Cain, 1995 U. Chi. Legal F. 163, 164 (1995) (". . . concepts such as corruption cannot be applied satisfactorily to political life by deduction from general theoretical propositions").

[38] Thompson, supra note 31, at 28 (emphasis added).

[39] Id. at 28 (noting that the modern conception of corruption retains the notion of the "pollution of the public by the private" but replaces the "consensus on the public good" with the "democratic process").

Under most modern definitions, corruption involves an abuse of trust occasioned by an improper commingling of one's public role and private gain in derogation of predetermined democratic processes—essentially, an act that disrespects the sacred border between public and private. At minimum, there seems to be an academic consensus that public corruption entails an "abuse of public roles or resources for private benefit."[40] In short, public corruption is the use of public office for private gain.[41] Reflecting this simple core understanding, the very first page of the House Ethics Manual commands that members, officers, and employees of the House "should not in any way use their office for private gain."[42]

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[40] Michael Johnston, Democracy without Politics? Hidden Costs of Corruption and Reform in America, 16, in Corruption and American Politics (eds. Michael A. Genovese & Victoria Farrar-Myers) (2011).

[41] See, e.g., Mark E. Warren, Political Corruption as Duplicitous Corruption, 37 Political Science and Politics 803 (2006) (noting the "received conception of political corruption" as "the abuse of public office for private gain"); Joseph S. Nye, Corruption and Political Development: A Cost–Benefit Analysis, 61 Amer. Pol. Sci. Rev. 417, 419 (1967) ("Corruption is behavior which deviates from the formal duties of a public role because of private-regarding (personal, close family, private clique) pecuniary or status gains; or violates rules against the exercise of certain types of private-regarding influence"); Susan Rose-Ackerman, Corruption and Government: Causes, Consequences, and Reform 91 (1999) (defining corruption as the "misuse of public power for private gain"); Thompson, supra note 31, at 7 (noting that all forms of corruption involve the "improper use of public office for private purposes"); Kleinig & Heffernan, supra note 34, at 3 ("If there is an orthodox account of corruption, it is that it consists in the improper use of public office for private gain"); Transparency International Corruption Perceptions Index 2011, transparency.org (June 26, 2012), http://cpi.transparency.org/cpi2011/in_detail/#myAnchor1 (last visited Nov. 19, 2012) (defining corruption as "the abuse of entrusted power for private gain"); World Bank Institute Control of Corruption Index, info.worldbank.org (June 26, 2011), http://info.worldbank.org/governance/wgi/pdf/cc.pdf (last visited Nov. 19, 2012) (noting that "Control of corruption captures perceptions to the extent to which public power is exercised for private gain . . .").

Two definitional issues are worth noting. First, many of the above cited definitions emphasize "misuse" (or "abuse") of public office for private gain. That, of course, raises the question of what counts as "misuse" versus acceptable "use." The same concern can be alternatively reframed as involving the distinction between "private gain" (which is improper) versus acceptable "gain," e.g., one's standard salary. For simplicity's sake, I would rather locate the disapprobation inherent in the term "misuse" in the term "*private* gain." As such, I define corruption simply as the *use* of public office for private gain.

Secondly, the definition of corruption that I have adopted is a narrow one—what political scientists categorize as *individual* corruption. But political scientists also refer to a broader *institutional* (or systemic form of) corruption. See, e.g., Thompson, supra note 31, at 25 (distinguishing individual and institutional corruption); Michael A. Genovese, The Politics of Corruption and the Corruption of Politics, 3, in Corruption and American Politics (eds. Michael A. Genovese & Victoria Farrar-Myers) (2011) (distinguishing individual and systemic corruption). With institutional/systemic corruption, public office is used not so much for private gain, such as lining one's pockets, but for political gain, such as furthering one's ideological causes, political party's fate, or even personal political ambitions. Trying to draw a bright line between institutional corruption and hardball politics is difficult. Thankfully, governmental insider trading falls squarely in the more easily defined category of individual corruption. For purposes of my analysis, I mean to emphasize private gain that is supererogatory and economic in nature. See discussion accompanying notes 43–47 infra.

[42] H. Comm. on Standards of Official Conduct, 110th Cong., House Ethics Manual 1 (2008), ethics.house.gov, http://ethics.house.gov/Media/PDF/2008_House_Ethics_Manual.pdf (last visited Nov. 19, 2012).

A. Private Gain

Since at least Cicero, it has been "beyond debate that officials of the government are relied upon to act for the public interest not their own enrichment."[43] But not all forms of personal enrichment are dubious. After all, members are not required to make a vow of poverty before holding office. Indeed, the Founders endorsed the idea that members of Congress should be paid salaries on the view that being independently wealthy should not be a qualification for elected office.[44] Therefore, the notion of private gain must recognize that some forms of personal gain[45] are necessary or incidental to performing one's political role.

As proposed by Andrew Stark, "private gain" signifies that the public officials are enjoying the gain in question *outside* of their official roles. The "modifier *private* suggests a kind of gain—a trip on a corporate jet, attending an association meeting at a resort, an all-expense paid trip to a charity event—that does not, or ought not, or need not, redound to the official as part of his or her job."[46] Thus, private gain is a form of personal gain that is *supererogatory*—neither part of the explicit compensation allocated to the public official nor culturally viewed as an acceptable or unavoidable perquisite of the role.[47] Consequently, "[i]f the official's responsibilities required the official to board the corporate aircraft, or be present at the association meeting, or attend the charity event, then there would be no 'private' gain, just the exercise of office."[48]

B. From Public Office

It is not enough, however, that the gain be private. It must also somehow flow from the official's *public office*. In other words, there must be a proximate causal nexus between the public role and the private enrichment. At minimum it must be shown that she would never have received the invitation to ride the corporate jet, attend the association meeting at the resort, or participate in the all-expenses paid charity event *but for* her official public role. If the causal nexus is absent, the official's conduct is not improper because the opportunity did not flow from her public role. For example, if the official can demonstrate that prior to becoming a public official she had routinely received the same invitation to

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43 John T. Noonan, Jr., Bribes, 704 (1984).

44 Thompson, supra note 31, at 50; The Records of the Federal Convention of 1787, vol. 1, 219 (ed. Max Farrand) (1966).

45 By "personal gain," I mean to include gain that not only directly benefits the official in question but also inures to the official's family, relatives, or friends.

46 Andrew Stark, Conflict of Interest in American Public Life 76 (2000) (defining the term "private gain from public office").

47 Certain longstanding perquisites of congressional office would not ordinarily constitute "private gain" because they serve an important political function. For example, the purpose of the franking privilege is to aid communication with constituents. However, if the franking privilege is misused by members to assist in reelection efforts, it would amount to "private gain" under this definition. See Thompson, supra note 31, at 30, 73. Also, certain non-economic forms of personal gain, such as enhanced prestige or increased name recognition, are unavoidable consequences of holding office and thus unobjectionable.

48 Stark, supra note 46 at 76.

attend the all-expenses paid charity event, the causal link would arguably be severed and the private gain would not be viewed as improper.[49] In addition, the official must have somehow intended to receive the gain in question in order for her conduct to be deemed improper. This is merely to acknowledge that inadvertent or accidental accruals of private gain can hardly be regarded as "corrupt."

Applying this basic definition, we can see why congressional insider trading can be described as corruption. First, such trading is private gain—a clear act of supererogatory financial gain. Profits earned from insider trading are not part of the explicit compensation allocated to members. Also, there is nothing in the job description of members of Congress or in the nature of their legislative tasks that requires them to use their own personal funds to trade in any stocks, let alone based on information gleaned through their work in Congress. Further, near unanimous public opinion against congressional insider trading strongly suggests that such trading is not culturally viewed as one of the acceptable or unavoidable perquisites of their jobs.[50] Moreover, no member has publicly defended this practice. In fact, when members are directly confronted by the press with allegations of insider trading, they react defensively and evasively.[51] Secondly, such trading opportunities flow from their public office, i.e., they would not have such lucrative trading opportunities *but for* the information gained by virtue of their office. Thus, congressional insider trading fits squarely within the definition of public corruption—the use of public office for private gain.

IV. THE HARMS OF PUBLIC CORRUPTION

Even if, as a descriptive matter, governmental insider trading can be characterized as a form of public corruption, a skeptic might press the ultimate normative question: what's wrong with corruption? George Washington Plunkitt, the notorious New York state Senator and Tammany Hall politician, made just this challenge in a colorful speech back in 1905:

> Everybody is talkin' these days about Tammany men growin' rich on graft, but nobody thinks of drawin' the distinction between honest graft and dishonest graft. There's all the difference in the world between the two. Yes, many of our men have grown rich in politics. I have myself. I've made a big fortune out of the game, and I'm gettin' richer every day, but I've not gone in for dishonest graft—blackmailin' gamblers, saloonkeepers, disorderly people, etc.— and neither has any of the men who have made big fortunes in politics. There's an honest graft, and I'm an example of how it works. I might sum up the whole thing by sayin': "I seen my opportunities and took 'em.". . .

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49 See id.

50 A recent public opinion poll reports that the "vast majority of Americans (86%) believe insider trading laws should be enforced against members of Congress." See New Judicial Watch—Harris Interactive Poll Sends Warning to Washington Politicians, judicialwatch.org (Jan. 20, 2012), http://www.judicialwatch.org/press-room/weekly-updates/new-poll-and-stealing-democracy/ (last visited Nov. 19, 2012).

51 See, e.g., Confronting Pelosi on Insider Trading, cbsnews.com (June 17, 2012, 3:55 pm), http://www.cbsnews.com/8301-504803_162-57323518-10391709/confronting-pelosi-on-insider-trading/?tag=segementExtraScroller;housing (last visited Nov. 19, 2012).

> I'll tell you of one case. They were goin' to fix up a big park, no matter where. I got on to it, and went lookin' about for land in that neighborhood.
>
> I could get nothin' at a bargain but a big piece of swamp, but I took it fast enough and held onto it. What turned out was just what I counted on. They couldn't make the park complete without Plunkitt's swamp, and they had to pay a good price for it. Anything dishonest in that?[52]

Plunkitt's defense of "honest graft" is refreshingly candid but ultimately unpersuasive. After all, but for Plunkitt's actions, the government could have bought that swamp for the "bargain" price that Plunkitt originally got it for. Instead, the government had no choice but to pay Plunkitt's higher, hold-out price, and thus suffered direct financial harm.

That said, in some cases, the financial harm to the government or to the general public is not so clear. For example, one common defense asserted by the bribe taker is that there is no victim.[53] Indeed, as already mentioned, Henry Manne has defended *corporate* insider trading on the grounds that it actually—on net—benefits investors.[54] The same defense has been made of congressional insider trading.[55] But such defenses (of corporate and congressional insider trading) understand harm too narrowly. Even if no primary harm to the government or other investors can be identified in the form of clear, direct, financial costs, tolerating public corruption in the form of governmental insider trading produces three distinct secondary harms captured by the terms temptation, distraction, and legitimacy.[56]

A. Temptation Costs

Public corruption in the form of governmental insider trading tempts public officials into bad decision making. To make this claim, I have to offer some baseline of what counts, by contrast, as good governmental decision making. Keeping our focus on legislators, here is a thin account: legislative decision making should be driven by the merits of the underlying policy and be responsive to the interests of the Representative's constituents. This is a thin account in that I am specifying neither what counts as the "merits" nor how one goes about deciding them. Moreover, I am not specifying what it means to be "responsive"—whether a Representative acts on the basis of his own or his constituents' conception of their interests—which turns on whether one embraces a trustee or

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52 William L. Riordan, Plunkitt of Tammany Hall: A Series of Very Plain Talks on Very Practical Politics (1993, 1905), reprinted in William Safire, Safire's New Political Dictionary: The Definitive Guide to the New Language of Politics (under entry "Honest Graft") 334 (1993).

53 Omar Azfar et al., The Causes and Consequences of Corruption, 573 Annals Am. Acad. Pol. & Soc. Sci. 42, 47 (2001).

54 Manne, supra note 1. See also Hsiu-Kwang Wu, An Economist Looks at Section 16 of the Securities Exchange Act of 1984, 68 Colum. L. Rev. 260 (1968). But see William K.S. Wang, Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom under SEC Rule 10b-5?, 54 S. Cal. L. Rev. 1217, 1235 (1981).

55 See Henderson & Ribstein, supra note 9.

56 This is not to say that governmental insider trading is normatively problematic for consequentialist reasons only. There may also be deontological objections to the practice, which may not be well captured by terms such as "costs" or "harms."

delegate theory of representation.[57] Nor do I specify who counts as the Representative's "constituents," whether the relevant constituency is the Representative's electoral district or the public-at-large. That said, even under this minimalist account, deciding on the basis of one's private financial self-interest and ignoring or discounting the public's interest cannot be deemed a decision "on the merits" or one that is "responsive" to one's constituents.

Edmund Burke, who championed the trustee theory of representation, put this well in a speech in which he explained his role as a member of Parliament:

> Certainly, gentlemen, it ought to be the happiness and glory of a representative to live in the strictest union, the closest correspondence, and the most unreserved communication with his constituents. Their wishes ought to have great weight with him; their opinion, high respect; their business, unremitted attention. It is his duty to sacrifice his repose, his pleasures, his satisfactions, to theirs; and above all, ever, and in all cases, to prefer their interest to his own.[58]

According to Burke, it is neither indifference nor impartiality but sacrificing personal interests in favor of the constituents' interests that defines the essence of good legislative representation.

Now, what happens when we inject substantial financial temptation in the form of stock market trades based on information that few others have? Legislators are likely to succumb to this temptation and make decisions that they would not have made but for their financial self-interest. By definition, this deviation is bad because it departs from a decision based on the merits responsive to one's constituents.[59]

Moreover, when members base their legislative decisions on what maximizes their financial self-interest and not on what maximizes the public's welfare, they are invariably distorting government spending priorities and misallocating the financial resources of the federal government. For example, suppose that the Chair of the House Appropriations Committee believes that a particular military vehicle, manufactured by a small publicly traded corporation, is ultimately unsuitable for the Defense Department's purposes. But it is a close call because there is no obviously better alternative in the marketplace. Suppose further that this member's four children, who are each one year apart in age, will soon be attending college. If he advocates strongly in favor of the military vehicle, there is a good chance that the expenditure will be approved. And if he also purchases stock in advance, he stands to gain a hefty profit, which could help pay for tuition. Because of his personal financial situation, this member will be sorely tempted to advocate in favor of the military expenditure, notwithstanding his understanding of the merits. Such a decision risks a serious misallocation of government resources.[60] And it is not just that

[57] The distinction between delegates and trustees in political theory is based on the "reasons for their decisions—whether they decide according to expressed preferences of the persons they represent [(delegate theory)], or according to representatives' judgments about the interests of the persons they represent [(trustee theory)]." Thompson, supra note 1, at 99–100.

[58] Edmund Burke, Speeches at Mr. Burke's Arrival at Bristol, and at the Conclusion of the Poll, in The Works of the Right Honourable Edmund Burke 438, 446–47 (ed. Henry G. Bohn) (1954).

[59] Members should not be beholden to influences that are decidedly irrelevant to the process of legislative deliberation. Thompson, supra note 31, at 20.

[60] Indeed, studies indicate that corrupt procurements often lead to the diversion of government contracts toward suppliers of substandard quality, sometimes at higher prices and sometimes

legislators will be tempted to cast a bad *vote*. Temptation costs are likely to pervade all forms of legislative work, such as making phone calls, setting agendas, giving speeches, subpoenaing witnesses, asking questions in hearings, and so on. Indeed, entrepreneurial legislators might more proactively[61] try to hustle up trading opportunities by redirecting research resources, reorganizing their offices, and rewriting the rules of legislative ethics.[62]

True, financial temptation will not always change a legislator's behavior. Even in the case of outright bribery, one could imagine a situation in which the bribe does not actually lead to a bad decision. For example, suppose that, for a particular environmentally conscious member of Congress, a good decision—i.e., one based on the merits responsive to his constituents—would be to favor some carbon emissions cap on automobiles. Even if there were no bribe, he would vote in its favor. But he happens to be bribed to do so by an electronic car battery company, which would benefit from the legislation. Since the member would have voted in favor of the emissions cap regardless of the bribe, one could say that there was no consequential harm.[63] In a similar vein, apologists for corruption point out that bribes may occasionally lead to efficient outcomes.[64]

But this is ivory tower thinking. Yes, it is possible that isolated cases of bribery or other forms of corruption could fit into this scenario. But we will generally lack the evidence to be certain. In reality, perfect information is not available. There is often nothing in the nature of legislative acts (e.g., a vote in favor of or against proposed legislation) that provides obvious evidence of financially self-interested motivation. Take, for example, the investments of Representative Ron Paul (Republican, Texas). According to his financial disclosure for the year 2010, Paul owned $1.6 million to $3.5 million in gold-mining stocks, as well as a stake in three bear-market funds—funds designed to perform well when the S&P 500 and Nasdaq perform poorly. Previous disclosures from 1994 to 2002 reported that Paul held "semi-numismatic" coins worth

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for inappropriate technologies. Tanja Rabl, Private Corruption and its Actors: Insights into the Subjective Decision Making Processes 64 (2008). Also, empirical work has found high levels of corruption to be associated with underinvestment in education (which provides fewer opportunities for bribery) and overinvestment in public infrastructure. Rose-Ackerman, supra note 41, at 2–3 (summarizing findings).

61 For example, with respect to bribery, economic research indicates that once bribery becomes pervasive in a society, government officials do not remain passive recipients of cash but rather become active extortionists of fees. Klitgaard, supra note 33, at 41–42. Citizens, too, increasingly "invest their energies in the pursuit of illicit favors . . ." Id. at 44.

62 Cf. Susan Rose-Ackerman, Corruption: Greed, Culture, and the State, 120 Yale L. J. Online 125, 135 (2010) (describing the potential effects of unchecked corruption).

63 Under federal law, acceptance of a bribe is illegal, regardless of whether the official's conduct was actually influenced. See, e.g., U.S. v. Valle, 538 F.3d 341, 346 (2008); U.S. v. Quinn, 359 F.3d 666, 675 (2004).

64 For reviews of arguments maintaining that corruption may occasionally be socially beneficial, see Rabl, supra note 60, at 64; Rose-Ackerman, supra note 41, at 21; Klitgaard, supra note 33, at 30–36. For critiques of such arguments, see Rose-Ackerman, supra note 41, at 26; Klitgaard, supra note 33, at 36 (concluding that corruption's "positive effects . . . were seldom encountered").

between $100,000 and $250,000, and over the past 16 years Paul has invested heavily in gold-mining stocks.[65]

Paul's policy positions as a legislator are remarkably consistent with his financial positions. Since December 2010, Paul has been the Chairman of the House Subcommittee on Domestic Monetary Policy.[66] In 2011, he voted against House Speaker John Boehner's plan to raise the nation's $14.3 trillion spending cap in an effort to avoid a default on U.S. debt.[67] And, since at least 1981, Paul has advocated returning the U.S. to the gold standard and for years has advocated abolishing the Federal Reserve Board.[68] A few years ago, Paul even told the *New York Times*, "We will go back to the gold standard, even if it takes the near-destruction of the dollar to get there."[69]

Were Paul's legislative judgments distorted by his financial investments?[70] Or did Paul simply put his money where his mouth is—which is why his investments track his policy convictions? How could we know? It is precisely the impossibility of ascertaining Paul's true motivations—whether he voted *because of*, *regardless of*, or *despite* private gain—that is the problem.

It is not just that third parties might not know what Paul's motivations are. Paul himself might not know since he, like everyone else, lacks introspective access into the more subtle yet pervasive causes of his own behavior.[71] Although we all want to believe that we are rational and deliberate authors of our own conduct, cognitive psychology teaches that our mental processes "operate to a great extent without our conscious awareness"[72] and much of our behavior is influenced by forces whose impact we tend to systematically dis-

65 Jim McTague, Candidate of Doom and Gloom, online.barrons.com (Aug. 20, 2011), http://online.barrons.com/article/SB50001424052702303822904576516114289723344.html (last visited Nov. 19, 2012).

66 Paul Appointed Chairman of Domestic Monetary Policy Subcommittee, paul.house.gov (Dec. 9, 2010), http://paul.house.gov/index.php?option=com_content&view=article&id=1806:paul-appointed-chairman-of-domestic-monetary-policy-subcommittee&catid=32:2010-press-releases (last visited Nov. 19, 2012).

67 McTague, supra note 65.

68 Ron Paul, End the Fed (2009).

69 Annie Lowrey, End the Fed? Actually, Maybe Not., slate.com (Feb. 9, 2011), http://www.slate.com/articles/business/moneybox/2011/02/end_the_fed_actually_maybe_not.2.html (last visited Nov. 19, 2012).

70 To clarify, I am not asserting that Paul's legislative judgments are, as a factual matter, distorted by his investments. As noted by Stark, "The problem, though, is that we cannot directly peer into an officeholder's mental state as she comes to judgment, cannot gauge the extent to which she remained admirably impervious to—or else was all-too-fallibly mindful of—her own interests. Since no law could effectively forbid officials from becoming judgmentally impaired by their own interests . . . conflict-of-interest regulation instead prohibits the holding of certain kinds of interest altogether." Stark, supra note 46, at 4.

71 See Richard E. Nisbett & Timothy DeCamp Wilson, Telling More than We Can Know: Verbal Reports on Mental Processes, 84 Psychol. Rev. 231 (1977); Timothy DeCamp Wilson & Richard E. Nisbett, The Accuracy of Verbal Reports About the Effects of Stimuli on Evaluations and Behavior, 41 Soc. Psychol. 118 (1978). See also Daniel Hays Lowenstein, On Campaign Finance Reform: The Root of All Evil is Deeply Rooted, 18 Hofstra L. Rev. 301, 325 (1989) (making a similar point with respect to the influence of campaign contributions).

72 Sung Hui Kim, The Banality of Fraud: Re-situating the Inside Counsel as Gatekeeper, 74 Fordham L. Rev. 983, 1026 (2005) [hereinafter Kim, Banality].

count.[73] And prominent among those pervasive, unconscious influences is the motivation of financial self-interest.[74]

Given this evidentiary uncertainty, *ex post* determination of whether some legislative decision making was altered by the potential for private gain will be costly, nearly impossible. Thus, it makes sense to adopt an *ex ante* prophylactic rule to prevent the temptation in the first place. In addition, a prophylactic ban on trading on material nonpublic information can be justified on accountability grounds. As Dennis Thompson has argued, citizens "have the right to insist, as the price of trust in a democracy, that officials not give reason to doubt their trustworthiness."[75] As a result, officials have a "responsibility not only to act for the right reasons but also to provide reasonable assurances that they are doing so" and "avoid acting under conditions that give rise to a reasonable belief of wrongdoing."[76]

B. Distraction Costs

Temptation to pursue one's financial self-interest, which potentially misallocates the government's financial resources, is not the only harm that can arise from public corruption. Another harm is the distraction occasioned by the excessive pursuit of private gain—in effect, the misallocation of a legislator's time. Consider, for instance, that Senator Kerry (Democrat, Massachusetts) and his wife completed 111 transactions (103 of which were buys) of pharmaceutical and health insurance companies in 2003 while the prescription drug benefit of the Medicare program was being debated in Congress.[77] Or consider that Congressman Jim Moran (Democrat, Virginia), a member of the Appropriations Committee, sold shares in *90* different companies on September 17, 2008—one day after members of Congress were briefed about the Administration's plan to bail out AIG.[78] The staggering volume of such trading activity raises a genuine question about whether these legislators are devoting sufficient attention and focus to perform their jobs competently. The distraction costs of corruption have been amply documented in numerous case studies, which observe that energies of corrupt bureaucrats are channeled toward the pursuit of "corrupt business interests, leaving behind what is their expected primary work."[79]

C. Legitimacy Costs

Finally, public corruption may generate another type of harm—one that is not localized but more systemic in nature and thus difficult to quantify. If citizens widely perceive

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[73] See Don A. Moore & George Loewenstein, Self-Interest, Automaticity, and the Psychology of Conflict of Interest, 17 Soc. Just. Res. 189 (2004).

[74] See Kim, Banality, supra note 72, 1027–29. See also Lowenstein, supra note 71, at 324 (noting that "an individual whose own self-interest is at stake finds it difficult to view a situation dispassionately and objectively").

[75] Thompson, supra note 31, at 126.

[76] Id. at 23, 126.

[77] John Kerry, Financial Disclosure, 2003; Peter Schweizer, Throw Them All Out 17, 19 (2011).

[78] James Moran, Financial Disclosure, 2009; Schweizer, supra note 77, at 33.

[79] Klitgaard, supra note 33, at 38.

that legislators are not acting independently in the sense that they are making decisions to further their own financial self-interest, then the legitimacy of the legislature may be further undermined. This erosion of legitimacy may, in turn, translate into less citizen compliance with the law. By "legitimacy," I mean the property that a governmental authority, rule, or decision holds when the "relevant public regards it as justified, appropriate, or otherwise deserving of support for reasons beyond fear of sanctions or mere hope for personal reward."[80] A government that is perceived as sociologically legitimate is signified by an "active belief by [its] citizens, whether warranted or not, that particular claims to authority deserve respect or obedience for reasons not restricted to self-interest."[81]

Tom Tyler's groundbreaking 1990 panel study on legal compliance offers strong evidence to support the argument that when citizens believe that legal authorities violate norms of procedural fairness, the legitimacy of those legal authorities erodes, and citizens become less compliant with laws.[82] Using data collected from a random sample of 1,575 respondents and a subsequent random subset of 804 respondents, Tyler examined respondents' actual experiences with the police and courts, including changes in perceived legitimacy resulting from such experiences.[83] Because legitimacy is an abstract concept that is difficult to measure, Tyler identified two proxies that would serve as indirect measures or indicators of legitimacy: (1) citizens' self-reports of their perceived obligation to obey the law (irrespective of their personal views about whether the law was wrong or right); and (2) their general affective orientation toward legal authorities, i.e., the police and the courts. Tyler found that each indicator of legitimacy influenced citizens' actual compliance with the laws.[84]

But what then determined whether a person would have high or low indicators of legitimacy? Tyler found that a crucial determinant was the perceived fairness of the procedures that legal authorities followed, independent of the actual substantive outcome of those procedures.[85] Among the various factors relevant to common perceptions of procedural fairness were the honesty of the decision maker (whether the official was motivated to be just) and the decision maker's reliance on objective information to reach decisions.[86] To summarize, then, Tyler demonstrated that perceptions of procedural fairness predict indicators of legitimacy (measured as felt obligations to obey laws and as affective regard to legal authorities), which in turn predicts behavioral compliance.

Tyler made similar findings in subsequent research examining the legitimacy of members of Congress. Using both experimental and survey methodologies, Tyler found that citizens' judgments about the procedural fairness of congressional decision making independently influenced the legitimacy of members of Congress, as measured by respondents' proactive willingness to vote for political leaders, perceived obligations to

80 Richard H. Fallon, Jr., Legitimacy and the Constitution, 118 Harv. L. Rev. 1787, 1795 (2005).
81 Id.
82 See Tom R. Tyler, Why People Obey the Law 64 (1990).
83 Tyler, supra note 82, at 8–13.
84 Id. at 47, 62.
85 Id. at 102. Tyler generally refers to the fairness of the procedures followed as "procedural justice."
86 Id. at 164.

follow federal laws, and attitudinal support for authorities.[87] Citizens regarded legislators' honesty in their decision making, reliance on relevant information to reach decisions, and general trustworthiness as important components of procedural fairness.[88] In sum, Tyler's research shows that if citizens perceive that legal authorities, including the police, courts, and congressional Representatives, are making decisions based on unfair procedures, then citizens are less likely to (1) accept those decisions; (2) regard those authorities as being legitimate; and (3) feel obligations to obey the laws. These findings are broadly consistent with empirical studies reporting cynicism, apathy, and regime instability in those developing countries that report widespread public perception of corruption.[89] What can we reasonably infer from this line of research? Insider trading by members of Congress and other government officials will be viewed by citizens as procedurally unfair—dishonest and corrupt. Casual empiricism, in the form of a review of public comments posted in response to on-line news reports of congressional insider trading, supports this hypothesis. Those comments condemn the practice of congressional insider trading as an "outrage" and "the very essence of corruption," denounce legislators-traders as "crooks [who] are taking advantage of their jobs to become richer" and "criminals," and urge that they be "prosecuted for betraying the public trust . . . and outright theft."[90] It should be no surprise, then, that the vast majority of Americans believe that insider trading laws should be enforced against legislators.[91] According to Tyler's research, to the extent that public perception of unfairness is widespread and endures, the legitimacy of Congress would erode, decreasing overall legal compliance. I do not want to overstate the point because, given today's cynical political climate, the government is probably viewed as procedurally unfair for myriad other reasons besides insider trading. That said, the fact that incremental harms to legitimacy are difficult to quantify should not lead one to dismiss the damage to governmental legitimacy as insignificant.

In sum, governmental insider trading constitutes public corruption, the use of public office for private gain. This is normatively problematic because it incurs temptation, distraction, and legitimacy costs.

V. CORPORATE INSIDER TRADING AS PRIVATE CORRUPTION

Above I posited a plausible definition of public corruption—the use of public office for private gain—and articulated its various harms. But corruption is not constrained to the public sphere. As noted by John Kleinig and William C. Heffernan, "[c]orruption is not

[87] Tom R. Tyler, Governing Amid Diversity: The Effect of Fair Decisionmaking Procedures on the Legitimacy of Government, 28 Law & Soc'y Rev. 809, 828 (1994).

[88] Id. at 824.

[89] Klitgaard, supra note 33, at 45.

[90] See Insider: The Road to the Stock Act, cbsnews.com (June 17, 2012, 4:00 pm), http://www.cbsnews.com/video/watch/?id=7411992n&tag=component.0;topnews (last visited Nov. 19, 2012); Confronting Pelosi on Insider Trading, supra note 51 (comments on Sixty Minutes' report on governmental insider trading).

[91] See supra note 50.

the exclusive failing of public officers; there may also be personal corruption, corrupt institutions, and corrupt cultures."[92] Even the *Oxford English Dictionary* refers to corruption within a "public corporation" in one of nine definitions listed for "corruption."[93] Indeed, there is no reason to think that the secondary harms associated with public corruption in terms of temptation, distraction, and legitimacy are unique to the public sector. For example, the misappropriation of funds is improper for the same reason regardless of whether the misappropriator is a public official or private citizen.[94] Assuming that corruption also afflicts the private sector, how would we define it? Unfortunately, defining "private corruption" is even more elusive than defining "public corruption." Unlike public corruption, private corruption has received almost no academic attention.[95] But here finally comes some of the payoff of examining corporate insider trading by way of governmental insider trading. We can craft a definition of private corruption by making minor modifications to our definition of public corruption (the use of public office for private gain).

Since we are addressing the private sphere, there is no "public office," but there is the position of being a fiduciary. Also, since we are exclusively in the private sphere, the term "private gain" fails to distinguish between the fiduciary's financial self-interest and that of the firm. Accordingly, a term such as "personal gain" can help distinguish between the two. By making these twin substitutions, we can define private corruption as the use of a fiduciary position for personal gain.[96]

Just as governmental insider trading could be seen as public corruption defined as the use of public office for private gain, corporate insider trading can be seen as private corruption defined as the use of one's fiduciary position for personal gain. First, such trading is a personal, self-serving, out-of-role activity undertaken by corporate insiders. There is nothing in the job description of officers or directors that requires them to use confidential information that they have gathered through their positions to employ personal funds to trade in securities. Nor are profits generated from insider trading generally regarded as an acceptable perquisite of executive status.[97] Secondly, such trading opportunities flow from their fiduciary position, i.e., they would not have such lucrative trading opportunities *but for* the information gained by virtue of their corporate positions.

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[92] Kleinig & Heffernan, supra note 41, at 3.

[93] The sixth definition of "corruption" states: "Perversion or destruction of integrity in the discharge of public duties by bribery or favour; the use or existence of corrupt practices, *esp.* in a state, public corporation, etc." Oxford English Dictionary 974 (2nd ed. 1989).

[94] Thompson, supra note 31, at 53.

[95] See Rabl, supra note 60, at 18 (noting that "private corruption, that is, corruption in and between companies, is still a neglected topic").

[96] For private corruption, "personal gain" is gain that not only directly benefits the fiduciary in question but also inures to the fiduciary's family, relatives, or friends.

[97] A Business Week poll conducted in 1986 reported that 52 percent believed that insider trading should continue to be illegal. William A. Kelly, Jr. et al., Regulation of Insider Trading: Rethinking SEC Policy Rules, 7 Cato Journal 441 (1987). While this result does not seem like a serious indictment, more recent public reaction to the Martha Stewart scandal suggests that insider trading continues to be unpopular. See Alexandre Padilla, How Do We Think About Insider Trading? An Economist's Perspective on the Insider Trading Debate and its Impact, 4 J. L. Econ. & Pol'y 239, 253–54 (2008).

As already discussed, skeptics such as Henry Manne would retort, what's wrong with that? I maintain that private corruption in the form of corporate insider trading is harmful for the same types of reason that public corruption in the form of governmental insider trading is harmful. As noted, governmental insider trading is harmful because it tempts government officials, including members of Congress, into bad policymaking; distracts them from their tasks; and threatens to erode the legitimacy of government, including the legislative process. Analogously, corporate insider trading is harmful because it tempts corporate managers into bad decision making (i.e., making corporate decisions based on what maximizes the manager's own financial interests rather than the interests of the corporation); distracts them from their fiduciary tasks; and threatens to erode corporate legitimacy.

A. Temptation Costs

First, the opportunity to profit from corporate insider trading tempts managers into making corporate decisions based not on the primary goal of enhancing corporate value[98] but rather on the goal of generating insider trading profits. These temptations can take myriad forms. Managers will be tempted to delay transmission of information to superiors until after the trade has been made; prematurely disclose information to the public once the trade has been made; select particular accounting practices in an effort to affect share prices and maximize insider returns; structure transactions in ways that maximize opportunities for keeping information secret; and select projects based not so much on their likely contribution to long-term corporate value but on their potential to produce dramatic price movements from which insiders can profit handsomely.[99]

Importantly, the temptation to introduce volatility into the share price is largely indifferent to the direction of the price movements.[100] After all, one can profit just as easily and as much from destroying corporate value and short selling as one can from increasing corporate value. To be sure, destroying corporate value may get an insider fired. However, in many cases the manager already expects to exit (regardless of the trading opportunity). To the extent that there are "last period agency costs,"[101] the manager may want to secure for himself a covert severance package on the way out, especially if destroying corporate value is easier than enhancing it (as it undoubtedly is).

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[98] In this chapter, I do not revisit the longstanding debate over the proper purpose of the corporation. See, e.g., Adolf A. Berle, Corporate Powers as Powers in Trust, 44 Harv. L. Rev. 1049 (1931); E. Merrick Dodd, For Whom Are Corporate Managers Trustees? 45 Harv. L. Rev. 1148 (1932). Suffice it to say that neither a shareholder- nor stakeholder-oriented view of corporate purposes would obviously endorse the practice of insider trading.

[99] Stephen M. Bainbridge, Insider Trading, in III Encyclopedia of Law and Economics 772, 788–90 (eds. Boudewin Bouckaert & Gerrit De Geest) (2000).

[100] James D. Cox, Insider Trading and Contracting: A Response to the "Chicago School," 1986 Duke L. J. 628, 651–52 (1986); Saul Levmore, Securities and Secrets: Insider Trading and the Law of Contracts, 68 Va. L. Rev. 117, 149 (1982).

[101] "Last period agency costs" occur when agents fear themselves to be in their last period of employment. Jennifer H. Arlen & William J. Carney, Vicarious Liability for Fraud on Securities Markets: Theory and Evidence, 1992 U. Ill. L. Rev. 691 (1992).

The opportunity to profit from corporate insider trading thus risks a serious misallocation of the corporation's financial resources. Instead of corporate value being the primary benchmark, the element of self-enrichment will distort corporate decision making. As Saul Levmore has written, "Overinvestment might develop in certain industries (or in exploration itself) and underinvestment in others, as insiders guide their firms into enterprises that generate 'events' that might be capitalized upon by traders in the stock market who have early access to the relevant information."[102] Moreover, if corporate insider trading goes unchecked by law, insiders will be tempted to reorganize their offices, rewrite corporate codes of conduct, and structure their activities in ways to generate larger insider trading profits.

At least one court has explicitly acknowledged that corporate insider trading generates just these temptation costs. In the 1969 case of *Diamond v. Oreamuno*,[103] a case of first impression for the New York Court of Appeals, shareholders filed a derivative action against the officers and directors of the company to account for gains generated from trades in the company's stock based on material nonpublic information "acquired by them solely by virtue of their positions" relating to an anticipated change in the company's earnings.[104] In rejecting the defendants' argument that damages must be specifically pleaded in order to state a claim based on a breach of fiduciary duty, the court noted that "unlike an ordinary tort or contract case," an action based on a breach of fiduciary duty "is not merely to *compensate* the plaintiff for wrongs committed by the defendant but, as this court declared many years ago . . ., 'to prevent them, by removing from agents and trustees all inducement to attempt dealing for their own benefit in matters which they have undertaken for others, or to which their agency or trust relates.'"[105]

Thus, the *Diamond* court allowed a breach of fiduciary duty claim for corporate insider trading to proceed based on the recognition that corporate fiduciaries should avoid "inducements" or temptations that compromise their ability to deal in matters relating to their trust. In highlighting the inchoate nature of the harms to be avoided, the court supported adopting an *ex ante* prophylactic ban on insider trading as a means of preventing temptations in the first place.

B. Distraction Costs

Secondly, corporate insider trading may generate nontrivial distraction costs by "invit[ing] managers to devote some significant portion of the time and attention that they might otherwise devote to running the business to identifying trading profit opportunities."[106] Victor Brudney and Robert Clark warned about distraction costs but in a different context—relating to a fiduciary's misappropriation of corporate opportunities:

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[102] Levmore, supra note 100, at 149.

[103] 24 N.Y.2d 494, 248 N.E.2d 910 (N.Y. 1969).

[104] 24 N.Y.2d 496. The defendants knew that, as a result of increased expenses, their net earnings would decline significantly. Prior to the release of that information, they sold stock, avoiding a loss of $800,000. 24 N.Y.2d 497.

[105] 24 N.Y.2d 498–99 (citations omitted).

[106] Donald C. Langevoort, Insider Trading: Regulation, Enforcement & Prevention, § 1:4 (2011).

> The duties of the executives of a public corporation normally require full-time application of their managerial talents and energies and leave no room for active participation in the development or operation of other businesses. Correspondingly, their compensation arrangements are such that neither equity nor efficiency requires them to be allowed to take covert indirect compensation as they see fit.[107]

I do not want to overstate my case. The distraction costs posed by corporate insider trading are probably less than the distraction costs posed by misappropriating corporate opportunities. After all, the misappropriation and exploitation of a corporate opportunity should consume a significant amount of the insider's time. By contrast, an inside trade can be executed via a few text messages to one's broker. Similarly, the distraction costs posed by *corporate* insider trading may be less than the distraction costs posed by *governmental* insider trading. In many cases of governmental insider trading, the material nonpublic information will impact the stock prices of *multiple* issuers, e.g., various companies in a particular industry that may be impacted by proposed legislation. A member of Congress researching potential trades may thus be forced to research multiple companies in industries that are unfamiliar. By contrast, most (but not all) cases of corporate insider trading will involve information that impacts the stock prices of a single familiar issuer—the corporation for whom the corporate insider works. That said, the fact that distraction costs in some other context may be relatively large does not mean that the distraction costs in this context are absolutely small or trivial.

C. Legitimacy Costs

Thirdly, corporate insider trading may undermine the legitimacy of corporate officials (and, derivatively, the corporation) in the eyes of public investors. As we learned above, perceptions of unfairness undermine the legitimacy of legal and political authorities. But what about the legitimacy of corporate authorities? Although "legitimacy" is normally used to refer to legal and political authorities, the concept can usefully be applied to the private sector. After all, corporate authorities can also command or lack the respect, support, and trust of the consuming or investing public. One need only be reminded of the rankings of "The Best & Worst Boards"[108] to understand that corporate authorities are judged not merely on shareholder returns but on perceptions of "good" or "bad" governance quality—criteria often associated with legal and political authorities. Unfortunately, there appears to be no empirical research that specifically examines the link between insider trading and corporate legitimacy.

However, one can draw inferences from studies building on Tyler's research and linking *employees'* fairness perceptions to their attitudinal support for corporate managers. For example, Roger Folger and Mary Konovsky conducted a survey of 217 first-line employees of a private manufacturing plant and found that employees' perceptions about the fairness of procedures used to determine pay raises positively correlated with their

[107] Victor Brudney & Robert Charles Clark, A New Look at Corporate Opportunities, 94 Harv. L. Rev. 997, 1003 (1981).

[108] See The Best & Worst Boards, businessweek.com (Oct. 7, 2002), http://www.businessweek.com/magazine/content/02_40/b3802001.htm (last visited Nov. 19, 2012).

organizational commitment and trust in their supervisors, independent of the substantive outcome of their pay raises.[109] Also, Brockner et al. conducted a study of 150 employees of a financial services organization and found that employees' perceptions about the fairness of the decision rule adopted to determine lay-offs positively correlated with employees' organizational commitment.[110] Both studies adopted similar definitions of "organizational commitment" as including (1) a belief in or identification with the organization's goals or values; (2) a willingness to expend extra effort on the organization's behalf; and (3) an intention to remain with the organization.[111] In short, these studies suggest that attitudinal support for corporate authorities can erode as a function of the perceived fairness of corporate actions and decisions.

All of this begs the question: is corporate insider trading viewed as "unfair"? Justice Blackmun declared as much in his dissent in *Chiarella* and called insider trading "inherently unfair."[112] But commentators in the law and economics tradition have dismissed such claims as fuzzy, or in Manne's words "puerile."[113]

Of course, the fact that some elite academics dismiss unfairness arguments says little about how ordinary investors feel. The investing public is likely to view profits obtained through insider trading as a form of undeserved gain—an advantage accrued not through effort, ingenuity, or risk taking but through special access. And, in the case of insider trading by corporate insiders under the classical theory, this sense of unfairness is compounded by the fact that investors necessarily rely on corporate managers to produce information on which to assess corporate value. Just imagine the reaction if the viewing public found out that the host of the Jeopardy! quiz show was feeding clues to a friend contestant who just happened to trounce all his competitors. Or what if it was discovered that an Iron Chef competitor—tasked to create multiple delectable dishes all based on some "secret ingredient" that is dramatically revealed at the show's start—had known the secret all along, because of intimate access to the show's producer? Would there be a public relations disaster? Certainly. Would such outrage be dismissed as infantile jealousy of adept competitors? I doubt it. The point here is not to defend such reactions on grounds that would satisfy a moral philosopher but simply to predict the brute fact of public outcry.

Finally, beyond undermining the legitimacy of a single firm, if corporate insider trading is viewed as rampant and unchecked by law, the legitimacy of the entire U.S.

109 Roger Folger & Mary A. Konovsky, Effects of Procedural and Distributive Justice on Reactions to Pay Raise Decisions, 32 Acad. of Management J. 115, 125 (1989).

110 Joel Brockner, Tom R. Tyler, & Rochelle Cooper-Schneider, The Influence of Prior Commitment to an Institution on Reactions to Perceived Unfairness: The Higher They Are, the Harder They Fall, 37 Admin. Sci. Q. 241, 248–49 (1992).

111 Id. at 244; Folger & Konovsky, supra note 109, at 119 (referring to Organizational Commitment Questionnaire of Mowday et al.).

112 Chiarella v. US, 445 U.S. 222 at 248 (Blackmun J. dissenting).

113 Manne, supra note 4, at 182, note 60. As a result, unfairness claims have been mostly eclipsed by the popular property rights theory, which holds that the federal insider trading prohibition is most easily justified as a means of protecting property rights in information. See Jonathan R. Macey, From Fairness to Contract: The New Direction of the Rules Against Insider Trading, 13 Hofstra L. Rev. 9 (1984); Stephen M. Bainbridge, Insider Trading Under the Restatement of the Law Governing Lawyers, 19 J. Corp. L., 1 (1993).

securities markets may be put at risk. If the securities markets are viewed as rigged, then investors may lose confidence and refuse to participate in the markets, even if investing in publicly traded stocks would be the most profitable long-run investment strategy. Some evidence for this concern comes from the well-known "ultimatum games." These experiments demonstrate that people will often refuse to participate in what they perceive as an unfair transaction even if participating would further their financial self-interest.[114] In addition, some comparative empirical evidence suggests that nations with stricter insider trading laws enjoy lower costs of capital and more liquid securities markets,[115] indicating a possible inverse relationship between insider trading and investor confidence. Such loss of investor confidence would threaten the depth and liquidity of the markets. Indeed, this "investor confidence" rationale was specifically endorsed by the Supreme Court in *O'Hagan* to justify its extension of federal insider trading doctrine to include misappropriation theory.[116]

To be sure, this fear has been dismissed as just a bogeyman. For example, the much publicized insider trading scandals of the mid-1980s and subsequent robustness of the U.S. securities markets have been cited as evidence that insider trading does not seriously threaten investor confidence.[117] Of course, one could read the available evidence differently and emphasize the impact of the vigorous prosecution of insider traders and the swift passage of the Insider Trading and Securities Fraud Enforcement Act of 1988. On this interpretation, while investors were on notice that insider trading was common,[118] investors were also put on notice that—like other serious crimes—violations would be severely prosecuted.

VI. CONCLUSION

Commentators have correctly described federal insider trading doctrine as anomalous, odd, and incongruous.[119] But we should not be surprised by doctrinal incoherence when the very nature of the harms to be avoided is inchoate and systemic and therefore difficult to precisely define, locate, and quantify. The courts have responded to these complexities

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[114] See, e.g., Matthew Rabin, Incorporating Fairness into Game Theory and Economics, 83 Am. Econ. Rev. 1281 (1993); Colin Camerer & Richard H. Thaler, Anomalies: Ultimatums, Dictators and Manners, 9 J. Econ. Persp. 209 (1995).

[115] Robert A. Prentice, The Inevitability of a Strong SEC, 91 Cornell L. Rev. 775, 831, note 347 (2006); Utpal Bhattacharya & Hazem Daouk, The World Price of Insider Trading, 57 J. Fin. 75, 97 (2002); Laura Nyantung Beny, Insider Trading Laws and Stock Markets Around the World: An Empirical Contribution to the Theoretical Law and Economics Debate, 32 J. Corp. L. 237 (2007).

[116] U.S. v. O'Hagan, 521 U.S. 642, 658 (1997) (citations omitted) (noting that misappropriation theory is "well tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence").

[117] Critics argue that these scandals had "put all investors on notice that insider trading is a common securities violation." Bainbridge, supra note 99, at 786.

[118] See Padilla, supra note 97, at 253–54 (2008) (citing results of public opinion poll taken in the wake of the 1986 insider trading scandals, reporting that 69 percent of respondents believed that insider trading was common).

[119] Bainbridge, Introduction to this *Handbook*.

by incrementally expanding federal insider trading doctrine to encompass temporary insiders, tippers, tippees, and even fiduciaries of firms not connected with the proscribed trades. This gradual expansion can be seen as judicial gropings to restrain a form of private corruption that, if left unchecked, could undermine investor confidence in the securities markets. The Supreme Court seemed to recognize that insider trading can generate these more systemic harms in *U.S. v. O'Hagan*:

> If the market is thought to be systematically populated with . . . transactors [trading on the basis of misappropriated information] some investors will refrain from dealing altogether, and others will incur costs to avoid dealing with such transactors or *corruptly* to overcome their unerodable informational advantages.[120]

In my view, understanding corporate insider trading as a form of private sector corruption helps explain why it is normatively problematic and should be proscribed. This insight about corruption came via a careful examination of governmental insider trading. Henry Manne was right. There is no good reason to tolerate governmental insider trading, given temptation, distraction, and legitimacy costs. But Manne was also wrong—since the same holds true for corporate insider trading.

[120] O'Hagan, supra note 116, at 658 (quoting Victor Brudney, Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws, 93 Harv. L. Rev. 322, 356 (1979) (emphasis added).