Fairness, Inc.

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The Origins (and Billion-Dollar Bonuses) of Rule 10b-5 as America's Insider Trading Prohibition

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For James and Giovanni, the fairest souls I've ever known …

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Preface

Boundless Equity

Traditionally, the capitalist world accorded insiders the advantage of using their unique position for personal gain. The story tells of the European deputy commander of the national army being allowed to deposit the entirety of the nation's defense budget into his personal account (to live off the daily accumulating interest). When it came to the personal stock trades of corporate managers, the "majority rule" stated that such insiders owed no duty to shareholders to reveal confidential news. Between 1909 and 1933, distinct courts in the American system began acknowledging rare exceptions between buyers and sellers of corporate stock under the "special circumstances" rule.

The Great Depression (b. 1929) tested this nation's economic system and way of life like no challenge before. Wall Street was blamed for the majority of attendant ills. When Franklin Roosevelt took office, a New Deal was ushered in, with an accompanying but unspecific promise of restrictions on access and privilege. The resulting securities laws, in part, presumed certain stock transactions by company insiders to be illegal—under very detailed conditions.

As has been noted countless times, Congress did not then or at any point thereafter define the violation coined "insider trading." Nonetheless, the American insider trading prohibition ("Prohibition")—largely encapsulated within Securities and Exchange Commission[1] Rule 10b-5—has admirably trudged forward and grown to be the unquestioned worldwide standard. It now covers all parties and all trades. It is readily employed by the SEC, the Department of Justice, state regulators, stock exchanges, and private counsel. It is utilized to garner unfathomable monetary awards as decided by judges and juries; in turn, it cowers defendants to settle accusations, culminating in 2014 with an

1. Hereinafter "SEC" or "Commission."

epic $1.8 billion fine against a mammoth hedge fund firm. Such cartoonish recovery raises the question, how did the Rule meant to cabin excesses itself become such a tool for extravagant returns?

I commenced work on my first insider trading investigation in 1989, within 6 months of graduating law school. I was shocked by the lack of statutory guidance. Further, the legal principles emanated solely from the SEC's stockpile of cases from various decades. Within our own regulator, we tried to follow local precedent and remain true to a list of aggravating factors rumored to exist solely within the market surveillance division (the exact list was never shown to me). "Do what you think is fair, and we can prove," I recall being told by superiors.

Years later, as an adjunct law professor, I focused on the sole hint at a statutory standard appearing in a federal securities law: "For the purpose of preventing the unfair use of information ..."[2] With those ten words, the 1934 Congress loosed generations of varied weapons against what has become a notorious economic crime.

Decades later, after serving as a securities arbitrator, full-time academic, compliance counsel, public speaker, and author, I can say that my nascent fears of ill-definition were amply justified. As a cause of action, the whole of Rule 10b-5 contains ever-changing parts. When broken into elements, some of them disappear. In sum, the Prohibition proves most ready to be a hodgepodge response to any perceived inequity—even when the ad hoc response runs counter to the intentions of its creators. To say that this standard is tied more to each generation's notion of fairness than to a persisting rule of law is a tragic understatement; the standard wholly varies with the perceived gravity of the financial privilege in each and every case.

To be sure, the free-form nature of the amorphous regulation has not escaped attention. A highly regarded legal treatise commenced with the sardonic dedication, "For all of those investors who have been protected from a crime that Congress has been unwilling or unable to define."[3] A Circuit Court said the theory supporting cases against those outside the subject corporation made us all "pawns in an overall litigation strategy known only to the SEC."[4] The Supreme

2. Section 16(b) of the Securities Exchange Act, 15 U.S.C. §78p (2012).

3. Ralph C. Ferrara, Donna M. Nagy & Herbert Thomas, Ferrara On Insider Trading and The Wall iii (Law Journal Press 1995).

4. *United States v. Bryan*, 58 F.3d 933, 952–955 (4th Cir. 1995).

Court, which had twice struck down the government's attempt to render inside information contraband, similarly refused the first two attempts to expand the prohibition to non-insiders. Even when ultimately approving the theory by which the government charges "outsiders," the high Court acknowledged that informational disparities among investors are inevitable. Still, between 1961 and the present, the Prohibition has steadfastly traveled upwards to become the pinnacle business regulation in the history of commerce.

The current Book is the story of a single word, a vague Rule, a few dozen people, and a cause memorized by rote. Perhaps the tale is a testament to the persistence of an agency that itself must sing for its supper from Congress on an annual basis. Indeed, the Commission has steadfastly expanded its insider trading arsenal, and the worldwide fear of the unique Prohibition arguably speaks foremost to the ambitious foresight of a bureaucratic goal.

Or maybe the story hinges on the action of Congress, which, when randomly drawn into the scuffle, has consistently empowered an agency and investors to seek higher fines through increased litigation.

But more likely, the Prohibition's raucous journey is a credit to the American judiciary, which, ably availing itself of our common law system, has proven uncannily flexible in bending the equities behind our unique disdain of insider privilege. Boundless Rule 10b-5, the proscription alternatively branded by the Congress that inspired it "a catchall" and later by the highest Court "not a catchall," has more often than not been warmly embraced in the widest of terms by jurists captivated by an undying quest for market equality.

And the enforcement of the Prohibition has most often equated wrong with dollars. Indeed, like the Cold War and the Crusades, efforts at combating insider trading have quite spectacularly launched careers and generated nearly incalculable bounties. When it comes to prosecuting insider trading, it appears that justice is sometimes blind, but it is always richly rewarded.

While many critiques parse the scant 81 words comprising Rule 10b-5, the more challenging analysis of the humble anti-fraud measure expediently drafted nearly 75 years ago may lie in its sole restriction: The claimant party's ability to justifiably invoke *fairness*. From the creation of the modern insider trading prohibition in 1961 through the present time, the *fairness* standard remains the sole discernible predictor in a body of law perennially racing to keep pace with the stock market, thus scattering SEC precedent into that infamous rabbit hole known as "case-by-case basis."

Fairness as contemplated by Congress, the Commission, the experts, or the courts.

Fairness as a lure to attract foreign investors to the highly regulated American markets.

Fairness as measuring rod to compensate the victims of greedy villains.

Fairness as a shibboleth, the recitation of which all but ensures a payday for its pronouncer.

Fairness as a Rorschach test with only one interpretation, should we wish the markets to appear equitable.

Fairness as its own means and end, interpreted on any given day by courts, administrative regulations, private sector guides, government press releases—even in televised docudramas pitting good vs. evil.[5] Ultimately, as this just cause grew, *fairness* towards the insider trader himself has been examined (when he appears to have acted more on serendipity than out of malicious intent). Indeed, like second and third generation photocopies of a favored picture, the fairness standard is now almost unrecognizable in case results.

Accordingly, this Book traces both the unfathomable growth and the consequential earning potential of a rule that transcends its own purpose and language. Indeed, SEC Rule 10b-5 has become the primary calibrant by which the efficacy of regulation is measured, creating estimable careers and fortunes for its best practitioners. The anti-fraud measure historically whipped up by a coterie of practical regulators in 1942 has swelled to premise fines and disgorgements now numbered in the billions. And those billions are shared by government attorneys, prosecutors, the SEC, class action lawyers, nominal plaintiffs, actual victims, educational charities, the Federal budget, and sometimes even whistleblowers (both foreign and domestic).

Ideally, the reader will learn both how the Prohibition developed and how it collaterally grew to become a profit center. Regrettably, as the precedents continue to multiply, the battle against insider trading has been institutionalized to such a degree that significant reform may not be possible.

5. In early 2016, a television program titled "Billions" routinely attracted over a million viewers per episode (and grew to have an open following among lawyers and law students). The fictitious show continues to pit a billionaire hedge fund owner of nefarious means against an overly aggressive federal prosecutor with equally questionable tactics. In one episode, a representative of the prosecutor's office pleaded in vain at a federal court hearing for the survival of an insider trading Complaint, arguing repeatedly for "fairness to the marketplace." *Billions* (Episode 10, "Quality of Life," original air date of March 27, 2016).

Nevertheless, it is ultimately for the fresh eyes of law students to decide if the far reach of this storied measure has been judiciously exercised to the benefit of investors, or if it has simply been opportunistically employed in the name of justice.

The Chinese proverb says, "The best way to predict the future is to invent it." No one could have predicted the various means by which regulatory and private fortunes have been generated by a weapon called *fairness*, but Rule 10b-5 most certainly invented them. The *fairness* standard is either a healthy subordination of law to a worthy Congressional goal or the ledger by which an unnamed but juggernaut corporation generates bonuses for all of its managers. Concomitantly, Rule 10b-5's exponential growth is alternatively a triumph of reason over formality or a cautionary tale of scapegoat profiteering. Either way, when it comes to insider trading, the Rule has essentially functioned as a corporation, garnering billions from (and for) those in its path.

J. Scott Colesanti, LL.M.
February 2018

Using This Book

This Book has a two-fold purpose: 1) Describing in detail the origins of American insider trading law, primarily effectuated through application of Securities and Exchange Commission Rule 10b-5, and 2) Detailing the reasons for the revenue streams therefrom. The Book's three parts deal with, in turn, the history of the Prohibition, its period of greatest challenge, and its current (and cowering) embodiment. In turn, each Chapter strives to meets its goal through 3–5 sections progressing from the people to the law to the result. After every three Chapters, a "Checkpoint" Chapter revisits the lessons of the preceding part while gauging the Prohibition's growth.

Footnotes in each Chapter provide direction to the source of a quote or new assertion. For broader reference, a selected bibliography concludes each Chapter; this listing attempts to both further corroborate the statements in each Chapter and to present a variety of views on the key cases and events discussed therein.

It is impossible to research this field without being struck by the sheer repetition of the term "fairness" by attorneys, policy makers, victims, legislators, and jurists. Accordingly, throughout the Book, the term is highlighted in bold.

Because the role of the lawyer is to offer solutions, the Book concludes with over a dozen short and long-term suggestions for a variation on the status quo.

The accompanying Teacher's Manual offers some additional timely questions and cases, as well as more food for thought.

About the Author

J. Scott Colesanti, LL.M., was the first law clerk to a Chief Hearing Officer of the New York Stock Exchange. He investigated his initial insider trading cases within a year of his law school graduation and subsequently served as the youngest Trial Counsel for the New York Stock Exchange Division of Enforcement during his 10-year tenure.

Professor Colesanti has taught at the law school level for over 17 years. In 2006, while serving as an adjunct, he was selected "Professor of the Year" by the Hofstra Law Review. He has developed and taught 10 courses and has had over 20 articles published by legal journals. His writings are included in treatises on securities law and as expert commentaries to seminal cases.

He has also served within the NYSE Office of the General Counsel, and as a securities industry arbitrator for over a decade. Professor Colesanti has handled appeals before the Securities and Exchange Commission, the Social Security Administration, the EEOC, and the New York State Division of Human Rights.

Professor Colesanti regularly lectures on the Financial Crisis and has lectured/taught abroad on securities fraud and insider trading. He served on the editorial board of the *Journal of Securities Law, Regulation and Compliance,* and is a former contributing co-editor of the *Business Law Professor Blog.* As of August 2017, Professor Colesanti was rated among the top 10% of authors ranked by downloads on the Social Science Research Network. "Fairness, Inc." is his third released book.