(Not) Holding Firms Criminally Responsible for the Reckless Insider Trading of their Employees

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Late in 2013, federal prosecutors announced a plea agreement relating to criminal insider trading charges earlier brought against S.A.C. Capital Advisors, L.P. and certain of its affiliates (“SAC”) under Section 10(b) of the Securities Exchange Act of 1934, as amended (“Section 10(b)”), and Rule 10b-5 adopted by the U.S. Securities and Exchange Commission (“SEC”) under Section 10(b) (“Rule 10b-5”). To be the subject of criminal liability, violations of insider trading prohibitions under Section 10(b) and Rule 10b-5 must be willful. The indictment asserts that SAC actively encouraged the unlawful use of material nonpublic information in the conduct of its business. We may never know the precise facts as to the level of culpability and state of mind of the employees of SAC whose activities founded the indictment. But public portrayals of the firm and its employees focus on intentional misconduct.

Having been exposed in my time as a lawyer and law professor to many instances of insider trading that resulted from reckless behavior, however, I have found myself pondering the possibility—and considering the appropriateness—of corporate criminal liability for insider trading based on reckless employee conduct. Could reckless employee conduct result in a willful violation of Section 10(b) and Rule 10b-5 and, therefore, criminal liability for the firm that employs them? I admittedly am troubled by the possibility. Something just does not seem right about holding someone (even if that someone is a business entity) criminally responsible for the less-than-intentional acts of someone else (even if that someone else is an agent of the business entity against whom criminal enforcement is sought). What about, for example, mens rea in that context?

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7 Although the term “corporate criminal liability” is used throughout for ease of reference, most of what is said in this essay about the potential liability of an employer for employee conduct relates to both corporations and other forms of entity (as well as to principals of sole proprietorships).
This short paper summarizes my observations made in an essay written for a forthcoming edition of the Stetson Law Review (currently in the editorial process) that addresses these concerns. The essay is based on remarks I made at a conference on corporate criminal liability held at the Stetson University College of Law in February 2016. In summarizing, this paper first identifies the potential for corporate criminal liability for the reckless insider trading violations of employees under Section 10(b) and Rule 10b-5, then argues against that liability and suggests ways to eliminate it before concluding. The essay includes significant background information not presented here.

**Problem and Proposed Solutions**

The potential for corporate criminal liability for reckless employee insider trading derives from the possibility that the employee’s reckless trading may be deemed to be a willful violation of the 1934 Act for which the employer is liable under an agency theory—*respondeat superior*. This fact scenario is most likely to occur in a private equity, investment management, or other financial services firm (like SAC). However, other employers—including, for example, personal holding companies and acquisition-minded firms—also may engage in securities trading in the ordinary course of their respective businesses. The criminal liability of an employer for reckless insider trading of an employee rests on vague notions of corporate criminal liability—ill-defined as a matter of policy or theory—layered on top of uncertainties about the availability of criminal liability for reckless insider trading because of the indistinct contours of the requisite element of willfulness. The availability of criminal liability and sanctions in this inherently unstable doctrinal environment strains the credibility of criminal law and weakens its signaling power in the community.

There must be a better way. My idea for that better way is a simple one, although it may not be easily implemented. Given the tendentious nature of criminal liability for reckless insider trading and the questionable footing of corporate criminal liability, I suggest the elimination of corporate criminal liability for reckless employee insider trading violations. In other words, I propose that we take corporate criminal liability off the table altogether when an employee’s asserted violation of Section 10(b) and Rule 10b-5 is reckless, as opposed to a knowing violation of law.

How might this be accomplished? There are a number of options. Another essay prepared for the corporate criminal liability conference at which these ideas were shared argues for the elimination of corporate criminal liability for insider trading based on the type of insider trading at issue. That solution makes infinite

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9 See Anderson, supra note Error! Bookmark not defined., at ___ (noting that “true insider trading and source-employee outsider trading are crimes that cannot be committed by a company. Corporate criminal liability in these circumstances yields
sense based on the analysis forwarded in that essay. This paper, however, takes a more narrow approach to possible solutions consistent with the arguments made here, focusing on bespoke options addressing corporate criminal liability in the specific context of reckless employee insider trading.

Congress or the courts could, for example, clarify that reckless conduct is not, by its nature, willful conduct. A rule or interpretation of this kind would consign enforcement of the employee violation to the civil realm and thus also relegate any derivative (vicarious) liability to civil enforcement. This curative option would easily solve the corporate criminal liability problem identified in this paper.

However, resolving the corporate criminal liability problem in this way also would take away the possibility of criminal enforcement against the individual. The in terrorem or educational effect on an individual of potential criminal liability is different, since the individual, unlike a business entity, may be incarcerated.

[P]rison is the distinctive sanction of the criminal law because it fulfills a pedagogical function that fines do not. Not only are prisons highly visible reminders of the deterrent threat of the law, but the use of imprisonment broadcasts a special communitarian message about the equality of all citizens before the law. . . . Alone, it tells members of an audience who may identify themselves as belonging to very different communities (in terms of wealth, race, etc.) that each is a citizen of the same society, subject to the same duties and punishment. The use of imprisonment can symbolize the equality of all before the law, and thus it affirms the existence of a single community.10

Although the precise communitarian lessons to be learned by employees who engage in reckless insider trading may be difficult to discern given the overall lack of clarity in U.S. insider trading law,11 it may be desirable to retain the threat of

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10 Coffee, supra note Error! Bookmark not defined., at 224.
11 Id. at 237 (“[T]he ‘technicalization’ of crime . . . means that the broad mass of public opinion will never quite understand what the law required or why the behavior was illegal.”).
criminal sanctions as well as civil sanctions for individuals because of the distinctive deterrent and educative functions of incarceration in that context.

The elimination of corporate criminal liability for reckless employee insider trading also could be accomplished by circumscribing corporate criminal liability directly. The U.S. Congress could enact legislation clarifying that such liability is unavailable or the federal judiciary could rule that corporate criminal liability for reckless insider trading by employees is against public policy—or at least not warranted as a matter of public policy. These two options are more narrowly tailored but would require legislative or judicial attention to codifying embedded legal concepts (recklessness among them) that currently are not well defined. The implementation of either approach, therefore, would require significant additional thought and attention not undertaken here. Finally, in the absence of a legislative or judicial response, prosecutorial guidelines could be issued prohibiting corporate criminal prosecutions for reckless employee insider trading. Although this manner of handling the elimination of corporate criminal liability is suboptimal (given that rules memorialized only in guidelines may more easily be changed), a willing Department of Justice could implement efficacious guidelines in a relatively straightforward manner.

Although Congress, the courts, or the Department of Justice may impose restrictions on corporate criminal enforcement for reckless employee insider trading, I (like others who have come before me) understand that a resolution of this kind from these rule-making institutions is unlikely for various reasons. There is, perhaps, one additional, albeit less desirable, alternative: to adjust the imposition of penalties for corporate criminal liability in this context through sentencing guidelines.\(^\text{12}\) This alternative, however, still allows enforcement agents to threaten corporate criminal liability in circumstances where civil liability remedies may adequately serve society’s needs (whether for deterrence, punishment, community education, or something else).

To that end, an important footnote must be left here to assuage the concerns of those who are concerned that eliminating corporate criminal liability for reckless employee insider trading will serve to disincentivize firms from monitoring and guiding employee compliance with insider trading prohibitions. Eradicating corporate criminal liability for reckless insider trading violations would not absolve firms from responsibility for their employees’ wrongful conduct. The potential for tort liability (including public—SEC—actions based on aider and abettor liability for providing substantial assistance to a primary violator with the required scienter\(^\text{13}\)) remains, as does the possibility of statutory civil liabilities. In the insider trading

\(^{12}\) *Id.* at 240-41 (suggesting corporate criminal liability reform through sentencing guidelines).

\(^{13}\) *See, e.g.*, Graham v. SEC, 222 F.3d 994 (D.C. Cir. 2000) (considering aider and abettor liability under Section 10(b) and Rule 10b-5 in connection with a stock-kiting scheme).
area, these statutory bases for civil liability include, for example, potential controlling person liability under Section 20(a) of the 1934 Act ("unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action"). In addition, the SEC has authority to levy civil penalties on employers as controlling persons under Section 21A of the 1934 Act or impose a cease and desist order on an employer that causes and employee's insider trading violation. These potential liabilities and remedies should provide firms with adequate incentives to ensure employee compliance with U.S. insider trading prohibitions.

**CONCLUSION**

This paper challenges and ultimately denounces corporate criminal liability for reckless employee insider trading. The rationale? Underlying doctrinal, policy-based, and theoretical foundations for this type of criminal liability are weak to the extent they exist at all. Public civil liability serves the same objectives as corporate criminal liability—and more—in this context.

The argument offered in this paper exists at the intersection of a number of strains in related scholarship. It is, of course, an argument based in over-criminalization. “Once everything wrongful is made criminal, society’s ability to reserve special condemnation for some forms of misconduct is either lost or simply reduced to a matter of prosecutorial discretion.” However, the paper also contributes to ongoing scholarly conversations about the actual and potential implications of unclear statutory, regulatory, and decisional law, including implications that interact with prosecutorial discretion. The viewpoints of those who read this will undoubtedly be shaped by their positions on these and other issues, some of which may be in conflict.

Ultimately, achievement of the result advocated in this paper may be improbable. Regardless, the ideas presented in the foregoing pages are designed to encourage the consideration of the embedded issues in the described legal setting and in other similar contexts. These certainly provide ample opportunity to start new conversations that may be productive to the development of insider trading law or the law governing corporate criminal liability. I look forward to those conversations.

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17 Coffee, supra note Error! Bookmark not defined., at 201.