Mixed Motives Insider Trading

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ABSTRACT: If you trade securities on the basis of careful research, then you are a brilliant and shrewd investor. If you trade on the basis of a hot tip from your brother-in-law, an investment banker, then you are a criminal. What if you trade for both reasons?

There is no single answer to this question, thanks to a three-way circuit split. Some courts would forgive you because of your lawful trading motives, some would convict you because of your unlawful motives, and some would hand the issue to the jury. Sometimes called the "awareness/use" debate or the "possession/use" debate, the proper treatment of mixed motive traders has occupied dozens of law review articles over the last 30 years.

This Article demonstrates that courts and scholars have so far followed the wrong reasons to the wrong answers. Instead, this Article takes trader motives seriously, drawing on insights and solutions from the broader jurisprudence of mixed motive. This analysis generates a new legal test and demonstrates the test's superiority.

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I. INTRODUCTION

There are scrupulous traders who buy and sell stock for lawful reasons, such as insights gleaned after painstaking financial research.[1] And there are unscrupulous traders whose motivations are unlawful, such as a hot tip from an investment banker brother-in-law.[2] The former earn profits and praise;[3] the latter face punishment and condemnation as "insider traders."[4]

But Jekyll and Hyde were the same man, and some traders have both lawful and unlawful motivations. Investment funds seeking maximum insight will discover both lawful and unlawful "edge."[5] Executives sometimes buy to show support for their company or sell to meet personal expenses—all while company secrets pass over their desks.[6] Human nature is such that we act for many reasons, and this is no less true when great sums of money are at stake. The law must have a plan for sorting the good from the bad, even when people are truly both.

This problem arises frequently.[7] But even if true mixed motives were rare, *alleged* mixed motives are common enough to require courts to craft a rule.

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1. Slater v. A.G. Edwards & Sons, Inc., 719 F.3d 1190, 1199 (10th Cir. 2013) (referencing "the handful of investors who did foresee the collapse and profited handsomely from their uncommon insight" (citing MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010))).

2. Salman v. United States, 137 S. Ct. 420, 423–24, 427–28 (2016).

3. *See* Laidlaw v. Organ, 15 U.S. (2 Wheat.) 178, 193 (1817) (acquitting trader whose knowledge resulted from "rising earlier in the morning, and obtaining by superior diligence and alertness that intelligence by which the price of commodities was regulated").

4. SEC v. Contorinis, 743 F.3d 296, 304–07 (2d Cir. 2014) (affirming disgorgement for "insider trading").

5. *See* SHEELAH KOLHATKAR, BLACK EDGE: INSIDE INFORMATION, DIRTY MONEY, AND THE QUEST TO BRING DOWN THE MOST WANTED MAN ON WALL STREET, at xviii–xix (2017) (discussing the process by which traders seek out informational advantages, which are sometimes called "edge"). For example, investment funds often hire experts to advise them on the science undergirding pharmaceutical research. These experts sometimes go too far and confide secret research results to which they are privy. *See, e.g.*, United States v. Martoma, 894 F.3d 64, 69 (2d Cir. 2017).

6. *E.g.*, *In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1428 (9th Cir. 1994) ("[The trader], moreover, 'sold its shares because it faced a pressing need to service a huge debt incurred from overinvesting in real estate.'" (quoting *In re* Worlds of Wonder Sec. Litig., 814 F. Supp. 850, 872 n.17 (N.D. Cal. 1993))).

7. One hundred-and-twelve insider trading cases cite *United States v. Smith*, 155 F.3d 1051 (9th Cir. 1998), *SEC v. Adler*, 137 F.3d 1325 (11th Cir. 1998), or *United States v. Teicher*, 987 F.2d 112 (2d Cir. 1993), the three principal cases in this domain, though the problem predates this trio. THOMSON REUTERS: WESTLAW EDGE, https://1.next.westlaw.com/Search/Home.html (select only "All Federal" in "Jurisdiction" search settings, then use the search query, "adv: ("155 F.3d 1051" or "137 F.3d 1325" or "987 F.2d 112") & ("insider trading")"); *see also* Allan Horwich, *Possession Versus Use: Is There a Causation Element in the Prohibition on Insider Trading?*, 52 BUS. LAW. 1235, 1236 (1997) ("[T]he issue frequently arises in counseling . . . [corporate executives] who

Forgiving mixed motives lets defendants prolong their trial by concocting a pretextual reason for action.[8] Punishing mixed motives lets prosecutors sustain a case by alleging an ulterior motive even after a defendant has proven her bona fides. A sensible rule for mixed motives trading is required by motion practice that requires courts to accept as true any well-pleaded factual allegations, including as to mental facts.

No statute defines insider trading, let alone makes fine distinctions such as the precise treatment of mixed motive trades,[9] so it falls to courts to decide what to do.[10] Yet, it is no easy task to decide the fate of the mixed motives trader, because both condemnation and toleration have some appeal.[11] A trader who steals a secret and then trades has violated another's trust and taken advantage of the trading partner. But she also trades no differently than a sainted trader who worked hard to lawfully derive the same investment thesis; indeed, she *may well be* that sainted trader too, since some traders perform lawful and unlawful research.

When faced with this dilemma, circuits have split. Trade with mixed motives in the Second Circuit and you are bound for prison;[12] in the Ninth

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may obtain inside information pending completion of a transaction or in the midst of a pre-established trading program.").

8. *See, e.g.*, *Teicher*, 987 F.2d at 117 (describing how defendant fabricated pretextual reasons for buying stock).

9. Insider trading law is generally prosecuted as a violation of SEC Rule 10b-5, which makes manipulative and deceptive conduct a violation of the Securities Exchange Act of 1934. *See* 15 U.S.C. § 78ff(a) (2018) (providing for not more than $5 million in fines, 20 years imprisonment, or both, for any willful violation of the Exchange Act or any rule thereunder). For a discussion of the criminal penalties against insider trading, see generally 2 WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING § 7:2, at 7-9 to 7-18 (2d ed. 2008). *See also* 15 U.S.C. § 78u-1(a)(1) (authorizing SEC to seek civil penalties when a person violates the Exchange "by purchasing or selling a security . . . while in possession of material, nonpublic information"); *id.* § 78u-1(a)(2) (authorizing penalties of up to "three times the profit gained or loss avoided as a result of such unlawful purchase, sale, or communication").

10. *Cf.* Walter J. Blum, *Motive, Intent, and Purpose in Federal Income Taxation*, 34 U. CHI. L. REV. 485, 507 (1967) ("The fact is that some of our statutory rules that apparently classify on a state of mind basis do not indicate what magnitude of the relevant qualifying purpose is sufficient.").

11. *See, e.g.*, Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1639 (1999) ("The choice between *Adler* and *Teicher* is difficult.").

12. *See Teicher*, 987 F.2d at 114 (affirming defendants' convictions of securities fraud); *cf.* SEC v. MacDonald, 699 F.2d 47, 50 (1st Cir. 1983) (en banc) (civil); *In re* Wash. Mut., Inc., 461 B.R. 200 (Bankr. D. Del. 2011), *vacated in part*, No. 08-12229 (MFW), 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012) (bankruptcy). This same result would seem to occur in Australia. *See* CORPS. & MKTS. ADVISORY COMM., INSIDER TRADING REPORT 33 (2003) (recommending "an exemption for informed persons trading pursuant to a pre-existing non-discretionary trading plan. Subject to this limited exception, the insider trading legislation should not have a use requirement or a defence of non-use." (citation omitted)).

Circuit, you can expect acquittal;[13] the Seventh and Eleventh Circuits have adopted an intermediate standard somewhere between.[14]

This controversy has come to be known as the "awareness/use" debate.[15] Some scholars support the pro-government "awareness" standard of the Second Circuit, in which traders may be convicted any time they are aware of or knowingly possess proscribed information.[16] Others prefer the pro-defendant approach of the Ninth Circuit, which convicts only when prosecutors show that the defendant "used" proscribed information to trade differently than she otherwise would have.[17] The former punishes defendants according to their bad reasons for trading; the latter forgives defendants according to their good reasons. Still others urge acceptance of the Seventh and Eleventh Circuits' approach, which sits ambiguously in between.[18]

The lack of consensus regarding mixed motive trading is a result of deficiencies in the proof so far offered. Most analyses veer excessively toward practicality and doctrinalism.[19] Commentators note that the various rules differ in how hard they make life for the prosecutor, and they argue that the different rules fit to varying degrees with guiding authorities.[20] But their arguments are unsatisfying precisely because of their narrowness. We lack a basis for deciding, in the abstract, how practically difficult it should be for prosecutors to convict mixed motives traders until we decide whether such traders ought to be convicted.

The few commentators to invoke bedrock policy justifications—fairness, property, market integrity, incentives—have done so in ways that abstract away from the very facts that make these mixed motive cases so bedeviling. For example, one otherwise careful examination of these issues assumes that traders' lawful reasons for their actions are too flimsy to ever make a difference.[21] But taking this debate seriously means accepting that traders can be strongly motivated by *both* lawful and unlawful reasons.

This Article seeks to resolve the decades-old circuit split by providing a determinate, policy-based argument that takes mixed motives seriously. The core of the argument is an innocuous normative principle: Traders should

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13. *See generally* United States v. Smith, 155 F.3d 1051, 1070 (9th Cir. 1998) (affirming defendant's insider securities trading conviction). This same result would seem to occur in the United Kingdom. *See* Criminal Justice Act 1993, c. 36, § 53(1)(c) (UK).

14. SEC v. Lipson, 278 F.3d 656, 660–62 (7th Cir. 2002); SEC v. Adler, 137 F.3d 1325, 1337–39 (11th Cir. 1998); SEC v. Life Partners Holdings, Inc., 41 F. Supp. 3d 550, 560–61 (W.D. Tex. 2013).

15. *See* discussion *infra* Part III.

16. *See infra* Section II.B.

17. *See infra* Section II.C.

18. *See infra* Section II.D.

19. *See infra* Section III.A.

20. *See infra* Section III.A.3.

21. *See* Jesse M. Fried, *Insider Abstention*, 113 YALE L.J. 455, 484–86 (2003) (discussing the "possession versus use" debates under Rule 10b-5).

not on average be richer or poorer as a result of proscribed inside information. Although modest, this principle has important implications. Crucially, no existing legal test satisfies it.

This Article demonstrates the unacceptability of all the existing mixed motives standards and proposes a new one, which successfully equalizes the profits of insiders and outsiders in most cases and comes close in the remaining cases. The test is a *primary motive* test, under which a trader is liable if and only if her primary reason for trading was unlawful. This approach properly balances the trader's legitimate needs against the policy goals of the law. This test has never been considered by securities scholars and jurists,[22] though it enjoys widespread use in other substantive areas of the law.[23]

This Article proceeds as follows: Part II summarizes the awareness/use circuit split, in which different courts take different approaches to traders who act on the basis of both proscribed information and some other reason. It explains enough insider trading law for readers unfamiliar with the topic.

Part III presents the rationales offered by scholars and jurists in favor of their preferred resolution of the awareness/use debate. This Part reveals the existing debate to be indeterminate. Part IV explains a novel normative principle for use in evaluating candidate insider trading rules and shows the principle to be broadly acceptable according to familiar policy standards. A reader who is pressed for time can easily skip Part III and all but the first page of Part IV.

Part V shows that no existing legal standard is satisfactory. Part VI introduces the primary motive test, demonstrates its virtues, and defends it against criticism.

A word about terminology: No previous project has discussed the awareness/use debate in terms of mixed motives, perhaps because of the assumption that securities law has no role for motive.[24] Yet, it is often fruitful

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22. The closest forbearer of this thought is Donald C. Langevoort, who makes a passing reference to the search for "dominant" motive as a necessary condition for liability for the related but distinct question of mixed motive tipping. DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT, AND PREVENTION § 11.3 (2020). Langevoort was considering mixed motive tipping, in which a trader's source both disclosed the information for an acceptable reason (such as disseminating information to investors) and an unacceptable reason (such as to obtain a personal benefit). *Id.* While mixed motive *tipping* raises some parallel questions as mixed motives *trading*, this Article focuses only on the latter. The questions deserve separate treatment because they implicate different values. Most importantly, it is far from clear whether the animating normative principle of this paper (that insiders should not enjoy different profits than outsiders) has a direct analogue to tippers: It is not immediately clear that tippers should generally be as wealthy as non-tippers, rather than more or less.

23. *See infra* Section VI.A.

24. *See, e.g.*, Dirks v. SEC, 463 U.S. 646, 674 n.10 (1983) (Blackmun, J., dissenting) ("The scienter requirement addresses the intent necessary to support liability; it does not address the motives behind the intent."); *see also* SEC v. Lipson, 278 F.3d 656, 662 (7th Cir. 2002) (arguing that one who offers a defense of good motives "would be like someone who robbed a bank with the intention of giving the money to charity. The noble end would not immunize the ignoble

to describe a familiar problem with unfamiliar terminology. Recharacterized through new language, what seems superficially as a parochial securities law debate can join in conversation with a broader jurisprudential discourse —scholars and jurists have grappled with mixed motives in many domains, from civil rights to tax, for decades.[25] Whether we call it a "motive," a "motivation," a "reason," or something else, people often act under more than one influence. This is a general feature of the human condition with which every area of law must wrestle. Proceeding with the language of "mixed motives" situates this Article in a broader literature and invites readers to consider whether other domains have something to teach.

II. THE LAW OF TRADING FOR TWO REASONS

American law bars trading on the basis of proscribed information.[26] But is a trade "on the basis of" proscribed information when the trader both knew the proscribed information and had some other reason for trading? Two distinct answers have support in scholarship and doctrine, with a third approach seemingly nested somewhere in between. This Part introduces these competing rules after a brief note about what reasons for trading are lawful or unlawful.

A. REASONS FOR TRADING

There are two types of reasons to trade, both of which come in a lawful and unlawful variety. One type of reason concerns access to information. A trader who knows more about an asset is in a good position to profit. For example, Texas Gulf Sulphur Company ("TGS") discovered vast quantities of valuable minerals in Canada in 1959, but tried to keep the discovery a secret so they could buy the surrounding land cheaply.[27] TGS executives likewise bought their company's stock and saw it rapidly appreciate once the good fortune was publicized.[28]

Unlawful information trading is often called "insider" trading. It involves trading on the basis of information acquired or used in breach of a duty of

means of achieving that end from legal punishment."). This objection is problematic even on the terms internal to securities law. *See Dirks*, 463 U.S. at 663 n.23 ("[M]otivation is not irrelevant to the issue of scienter."). In particular, it is hard to imagine imposing criminal sanctions without due consideration of motive. A related concern is that juries may ignore subtle distinctions between one motive rule and another. Such skepticism dampens the importance of the awareness/use debate, but it does not undermine this Article's analysis of the relative merits of the standards debated. This Article does not offer a concerted defense of motive in insider trading law. It simply shows what motive rule works best.

25. *See generally* Andrew Verstein, *The Jurisprudence of Mixed Motives*, 127 YALE L.J. 1106 (2018) [hereinafter Verstein, *Mixed Motives*] (discussing areas of law that consider mixed motives in varying ways).

26. *See* Salman v. United States, 137 S. Ct. 420, 426–28 (2016).

27. SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 843–47 (2d Cir. 1968) (en banc).

28. *See id.* at 851.

trust or confidence. Secrets lifted from a corporation are off limits if the trader agreed explicitly or implicitly not to use those secrets,[29] or if the trader occupies a fiduciary role at the entity (an officer, director, or trusted agent such as a lawyer),[30] or if the trader knows that a fiduciary breached his duties in sharing the secrets—especially by selling secrets in exchange for a personal benefit.[31] For example, the TGS executives violated the law by buying TGS stock because they were duty bound to keep the company's secrets and to refrain from using those secrets to take advantage of selling shareholders.[32]

Lawful information trading involves using superior information that does not meet any of the conditions for proscription. Most centrally, American law leaves ample room for investors and analysts to research assets.[33] For example, the investment firm Muddy Waters conducts multi-year, trans-continental investigations of companies it suspects to be overvalued.[34] It has frequently discovered fraud, bet against the company, and then disclosed its results.[35] Research can be aggressive—counting cars in parking lots using satellite photos[36] or interviewing disgruntled former employees[37]—as long it does not cross the line and become unlawful information.[38]

Other reasons for trading do not involve information pertinent to the value of the asset; they are instead personal and idiosyncratic. For example, an executive may need to sell stock to finance a loan to his child's business.[39] Or a CEO may buy her company's shares to show that she is confident in its

29. *See generally* United States v. O'Hagan, 521 U.S. 642 (1997) (holding that a breach of fiduciary duty that reveals confidential information amounts to insider trading).

30. Chiarella v. United States, 445 U.S. 222, 226–30 (1980).

31. Dirks v. SEC, 463 U.S. 646, 654–61 (1983).

32. *See Tex. Gulf Sulphur Co.*, 401 F.2d at 848–53.

33. *See Chiarella*, 445 U.S. at 233 (rejecting general equality of information principle); *see also* Zohar Goshen & Gideon Parchomovsky, *On Insider Trading, Markets, and "Negative" Property Rights in Information*, 87 VA. L. REV. 1229, 1246–53 (2001) (explaining the role of researchers in improving stock market efficiency). *See generally* Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1 (1978) (describing contract law's general tendency to allow informed trading).

34. *See infra* notes 162–67 and accompanying text.

35. *See infra* notes 162–67 and accompanying text.

36. Eamon Javers, *New Big Brother: Market-Moving Satellite Images*, CNBC (Sept. 13, 2013, 4:33 PM), https://www.cnbc.com/2010/08/16/new-big-brother-marketmoving-satellite-images.html [https://perma.cc/37HM-3MF7].

37. Dirks v. SEC, 463 U.S. 646, 648–49 (1983).

38. *See supra* notes 29–32 and accompanying text.

39. *See* SEC v. Adler, 137 F.3d 1325, 1328 (11th Cir. 1998).

future.[40] Or an investor may sell or short a company's shares to indicate skepticism about the company.[41]

Unlawful uninformed trading is called market manipulation. It involves the deliberate creation of market congestion or confusion.[42] Market manipulation is not the focus of this Article. The non-manipulative reasons to trade without information can be called "idiosyncratic" trading, because they have to do with the trader's idiosyncratic needs rather than information about the asset. Figure 1 summarizes the reasons for trading and their legality.

Figure 1. Reasons for Trading

	Lawful	**Unlawful**
Informed	Permitted Information	Proscribed Information
Uninformed	Idiosyncratic	Manipulative

It is unlawful to insider trade, which is to trade on the basis of proscribed information. It is lawful to make lawfully informed trades or trades for idiosyncratic reasons. The following Sections address the competing rules for traders with both a lawful and an unlawful reason to trade.

B. THE "AWARENESS" STANDARD

The first decision to extensively address the possible treatment of a mixed motive insider trader was *United States v. Teicher*, some 25 years ago.[43] In *Teicher*, a lawyer at a white shoe law firm and an investment banker leaked their clients' confidential mergers and acquisitions plans to the defendants.[44] With

40. *See, e.g.*, Ed Lin, *5 CEOs Who Are Buying Their Companies' Stock*, BARRON'S (May 27, 2019, 7:00 AM), https://www.barrons.com/articles/ceos-of-macys-centurylink-and-3-others-bough-up-their-companys-stock-51558721615 [https://perma.cc/5WMD-VTYG] (describing a CEO's nearly $500,000 purchase of stock at a time that the stock was down 33 percent, along with a statement: "My continued investment, through stock purchases, represents my belief in the value of the business."); *see also* Marion Crain, *Managing Identity: Buying Into the Brand at Work*, 95 IOWA L. REV. 1179, 1241 (2010) (describing employee purchases of stock to signal loyalty). Investment banks also buy shares of the companies they underwrite in order to "stabilize" the stock. Brent J. Horton, *Spotify's Direct Listing: Is It A Recipe for Gatekeeper Failure?*, 72 SMU L. REV. 177, 205–06 (2019) (describing Morgan Stanley's stabilization of Facebook stock, which had declined 11 percent from the IPO price).

41. *See, e.g.*, Liz Moyer, *Five Years After Brawl with Icahn, Ackman Exits Losing Bet Against Herbalife*, CNBC (Mar. 1, 2018, 2:37 PM), https://www.cnbc.com/2018/02/28/ackman-exits-bet-against-herbalife.html [https://perma.cc/Q9H9-W9NX] (describing how an activist investor skeptical of Herbalife took a large short position in it).

42. *See generally* Andrew Verstein, *Benchmark Manipulation*, 56 B.C. L. REV. 215 (2015) (discussing how it is possible to manipulate benchmarks of price).

43. United States v. Teicher, 987 F.2d 112, 112 (2d Cir. 1993).

44. *Id.* at 114–16.

such information, it was easy for the defendants to profitably buy stock and call options on the target companies, the value of which would invariably rise.[45] These tips plainly constituted proscribed information.

However, these tips may not have been the defendants' only reason for action. One defendant argued that he had done "fundamentals" research that confirmed the value of the stock, concluded that the stock was undervalued due to the cloud of tobacco litigation, and also heard of rumors—including some published in the *Wall Street Journal*—hinting at the very same transactions his friend put him onto.[46]

The traders argued that their mixed motives exonerated them.[47] They argued that there is a violation only "where it can be proven that the trading was *causally connected* to the misappropriated information and hence, was proven *not* to have been conducted on an independent and proper basis."[48] They essentially wanted a "but-for" standard, where proscribed information is only problematic if it is a but-for cause of the trade.[49]

The Second Circuit instead upheld their conviction, holding that a trader can be convicted *without any proof of use* of proscribed information, so long as they were in "knowing possession" of it.[50] *Teicher*, therefore, stands for a pro-government standard in which mixed motive traders are judged by their worst reasons for trading. If a trader was aware of information that would motivate a trade, they are liable for insider trading, even if other needs and knowledge overdetermined the trade.[51]

C. THE "USE" STANDARD

The Ninth Circuit took the other horn in *United States v. Smith*.[52] In that case, an executive (Smith) sold all of his shares after learning about a problem

45. *Id.* at 115–16.

46. *Id.* at 117. These rumors would have been lawful to trade on. The defendant had other reasons, though all struck the court (and most readers) as pretextual.

47. Specifically, they argued that their verdict should be overturned because of a flawed jury instruction "that the defendants could be found guilty of securities fraud based upon the mere possession of fraudulently obtained material nonpublic information without regard to whether this information was the actual cause of the sale or purchase of securities." *Id.* at 119.

48. *Id.* (quoting the defendants-appellants).

49. *See* Verstein, *Mixed Motives*, *supra* note 25, at 1137–39 (defining the but-for standard as one that imposes liability if the defendant would not have been motivated to act had her proscribed motives not been present).

50. In this Article, I join others in equating "knowing possession" and "awareness" standards as the set of standards that do not require use of the information. I do not address arguments that these two formulations may be subtly different. *Accord* 3 ALAN R. BROMBERG, LEWIS D. LOWENFELS & MICHAEL J. SULLIVAN, BROMBERG AND LOWENFELS ON SECURITIES FRAUD § 6:249, at 6-695 to 6-700 (2d ed. 2020) ("The 'knowing possession' test may lie somewhere between mere possession and active use, but so close to the former that it is not readily distinguishable.").

51. The test was therefore an "any motive" test, where even the smallest illegal reason will tarnish the action. *See* Verstein, *Mixed Motives*, *supra* note 25, at 1141–43.

52. United States v. Smith, 155 F.3d 1051, 1069–70 (9th Cir. 1998).

at his company.[53] In terms of lawful motives, Smith argued that he pieced together fragments of "soft" information,[54] each morsel of which would have been immaterial as a matter of law.[55] Thus *even if* he used proscribed information, his lawful research could have given him a similar, independent, and lawful motive for trading. Like the *Teicher* defendants, Smith argued the jury should have been told to convict only if the proscribed information caused him to trade differently than he otherwise would have, meaning the prosecution must disprove the existence of his allegedly lawful motive.[56]

The Ninth Circuit agreed.[57] *Smith*, therefore, stands at the opposite extreme from *Teicher*. The pro-defendant *Smith* standard requires the government both to *prove* knowing possession of proscribed knowledge and to *disprove* the existence of any lawful alternative reason for action. Put bluntly, mixed motive defendants lose on *Teicher* and win on *Smith*.

D. THE INTERMEDIATE RULE

The Eleventh Circuit struck an ambiguous intermediate rule in *SEC v. Adler*.[58] In that case, several corporate executives sold stock in the days before their company disclosed a devastating loss of sales.[59] The defendants clearly had access to material, non-public information about the company's prospects, but each defendant argued they had other reasons for their trades.[60] In particular, one executive argued that he sold his stock to raise money for his son's business.[61]

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53. *Id.* at 1053.

54. *Id.* at 1054–55. "The line between 'soft' and 'hard' information is not a bright one." *Id.* at 1064 n.22. The term "soft information" usually connotes speculative or unreliable information, such as earnings projections.

55. Appellant's Reply Brief at *19–21, United States v. Smith, 155 F.3d 1051 (9th Cir. 1998) (No. 97-50137), 1997 WL 33550179.

56. *Id.* at 24–25.

57. *See Smith*, 155 F.3d at 1066–70. This holding was no comfort to Smith though. The Ninth Circuit held that the district court had thoroughly found that the illegal information was used and causally affected Smith's trading decisions. *Id.* at 1069–70.

58. *See generally* SEC v. Adler, 137 F.3d 1325 (11th Cir. 1998) (holding that merely knowing insider information does not amount to per se insider trading). It was also intermediate in time, coming before *Smith*, but after *Teicher*. There are hints of the standard prior to this case, *e.g.*, Dura-Bilt Corp. v. Chase Manhattan Corp., 89 F.R.D. 87, 95 (S.D.N.Y. 1981) ("Defendants' reliance on inside information, if not otherwise shown by the facts, may be inferred from a showing of defendants' possession of the information . . . ."), but there is no attempt to argue for it. *Smith*, for its part, reserved the question of whether *Adler*'s burden shifting approach may be appropriate in civil cases. McClelland v. Gronwaldt, 155 F.3d 507, 516 n.27 (5th Cir. 1998), *overruled by* Arana v. Ochsner Health Plan, 338 F.3d 433 (5th Cir. 2003).

59. *Adler*, 137 F.3d at 1327–30.

60. *Id.*

61. *Id.* at 1328. The father's excuse looked plausible. He had documented his desire to trade many months before executing it, he executed it almost immediately once he was freed from a 120-day lock-up that barred trading, and he only sold a portion of his stock. *Id.* at 1328–29.

The district court freed the trading father, holding as a matter of law that a trader with sufficient lawful motives for trading does not "use" the illicit information he merely possesses, and that use is required.[62] The district court, therefore, used a test from *Smith*.[63] The Court of Appeals reversed, concluding that only a jury could resolve the question of use, but accepted that use was required.[64] However, for a twist, the court permitted an instruction that the jury should *infer* that a trader who possessed information also used it. Specifically, the court stated, "[W]hen an insider trades while in possession of material nonpublic information, a strong inference arises that such information was used by the insider in trading."[65] Thus, the defendant is liable if that inference goes unaddressed. However, the defendant can rebut the inference by demonstrating that she did not use the information in deciding to trade.

The Eleventh Circuit's test resembles *Teicher* in that it puts pressure on the defendant: The mere possibility of a lawful reason for trading is no defense.[66] However, the test resembles *Smith* in that it acquits a defendant who is shown to have had a sufficient, independent, lawful motive—a defendant is forgiven according to their lawful motive.[67]

It is difficult to say as a functional matter whether *Adler* collapses into *Teicher* or *Smith*. However, it is plausible that *Adler* is really just a variant on *Smith*, since bona fide mixed motives act as a defense. The difference from *Smith*, in that the defendant bears the burden of proving a lawful motive rather than the government having the burden of disproving it, appears to be trivial. A later Seventh Circuit case applying *Adler* held that the defendant had carried "his burden of production" by merely "present[ing] some evidence" asserting that he had a lawful motive.[68] If that is all it takes to overcome the inference of unlawful trading, then there is little sunlight between *Adler* and *Smith*.[69] This Article assumes that *Adler* is a version of *Smith* and, thus, that there are really just two salient rules.[70]

Other lawful reasons were less plausible: because a broker told the defendant to diversify his portfolio and because of the presidential election. *Id.* at 1330.

62. *See* SEC v. Adler, No. CV 94-PT-2018-S, 1995 WL 822672, at *2 (N.D. Ala. Oct. 26, 1995), *rev'd*, 137 F.3d 1325 (11th Cir. 1998).

63. *See supra* Section II.C.

64. *Adler*, 137 F.3d at 1342.

65. *Id.* at 1337.

66. *See supra* Section II.B.

67. *See supra* Section II.C.

68. SEC v. Lipson, 278 F.3d 656, 661 (7th Cir. 2002).

69. *E.g.*, United States v. Henke, 222 F.3d 633, 635–36 (9th Cir. 2000) (per curiam) (affirming jury verdict where argument for use was weak but without a suggestion that the trial court was wrong to let the jury deliberate on the issue).

70. *Accord* Fried, *supra* note 21, at 485 (treating the *Adler* approach of the Seventh Circuit and Eleventh Circuit as relevantly similar to the *Smith* approach of the Ninth Circuit).

E. SUBSEQUENT DEVELOPMENTS

In the aftermath of these three cases, the SEC in 2000 endorsed a form of the Second Circuit's "awareness" standard from *Teicher*.[71] Since that endorsement, *Teicher* has become understandably prominent, but some jurists and scholars remain committed to the other approaches.[72] Importantly, each approach has been followed by numerous courts in both civil[73] and criminal cases,[74] even after the SEC's rule. Accordingly, the circuit split remains alive and in need of discussion. This Article examines the considerations invoked by each side in the following Section.

III. EVALUATIVE PRINCIPLES

A deep scholarly literature debates insider trading law, from the highest-level questions of whether to prohibit insider trading restrictions at all,[75] down to subtler debates—such as whether "high frequency trading" constitutes a form of insider trading.[76] Whatever the status of other insider trading debates, 30 years of debating awareness/use has not led to a satisfying consensus.

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71. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,737 (Aug. 24, 2000) (codified at 17 C.F.R. pts. 240, 243, 249) ("[A] purchase or sale of a security . . . is 'on the basis of' material nonpublic information . . . if the person making the purchase or sale *was aware of* [rather than 'used'] the material nonpublic information when the person made the purchase or sale." (emphasis added)); *id.* at 51,727 ("[T]he goals of insider trading prohibitions—protecting investors and the integrity of securities markets—are best accomplished by a standard closer to the 'knowing possession' standard than to the 'use' standard.").

72. *E.g.*, ARNOLD S. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 § 66.02[a][iii][D] (1981) (arguing against awareness approach); Horwich, *supra* note 7, at 1268 (arguing for use); BROMBERG ET AL., *supra* note 50, § 6:258, at 6-717 to 6-725 (arguing for an *Adler*-type intermediate test).

73. For a smattering of examples, see SEC v. Bauer, 723 F.3d 758, 776–77 (7th Cir. 2013) (applying *Adler*); SEC v. Ginsburg, 362 F.3d 1292, 1297–98 (11th Cir. 2004) (applying *Adler*); United States v. Dombrowski, No. 14 CR 41, 2014 WL 3454320, at *2 (N.D. Ill. July 15, 2014) (applying *Teicher*); SEC v. Life Partners Holdings, Inc., 41 F. Supp. 3d 550, 560–61 (W.D. Tex. 2013) (applying *Adler*); *In re* Countrywide Fin. Corp. Sec. Litig., 588 F. Supp. 2d 1132, 1203 (C.D. Cal. 2008) (applying *Smith*); and SEC v. Blackman, No. 3:99-1072, 2000 WL 868770, at *10 (M.D. Tenn. May 26, 2000) (applying *Teicher*). *Cf. In re* Wash. Mut., Inc., 461 B.R. 200, 265 (Bankr. D. Del. 2011) (applying *Teicher* in bankruptcy).

74. United States v. Anderson, 533 F.3d 623, 628–29 (8th Cir. 2008) (applying *Smith*); United States v. Royer, 549 F.3d 886, 899 (2d Cir. 2008) (applying *Teicher*); United States v. Jun Ying, No. 1:18-CR-74-AT, 2018 WL 6322308, at *5 (N.D. Ga. Dec. 4, 2018) (applying *Adler*); United States v. Nacchio, No. 05–cr–00545–EWN, 2006 WL 8439745, at *8 (D. Colo. Aug. 25, 2006) (applying *Teicher*); United States v. Causey, No. H-04-025-SS, 2005 WL 3560632, at *4 –5 (S.D. Tex. Dec. 29, 2005) (applying *Adler*).

75. For the seminal argument urging legalization, see generally HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966).

76. *Compare* MICHAEL LEWIS, FLASH BOYS 99–102 (2014) (characterizing high frequency trading as a form of front-running), *with* Merritt B. Fox, Lawrence R. Glosten & Gabriel V. Rauterberg, *Informed Trading and Its Regulation*, 43 J. CORP. L. 817, 827–28 (2018) (offering a qualified defense of high-speed traders), *and* Kevin S. Haeberle & M. Todd Henderson, *Making*

The relevant literature has taken two forms, neither of which persuasively resolves the problem of mixed motives trading. Most of the discussion has been "doctrinal," in the sense that it accepts the basic premises of the existing law and attempts to make it work out more effectively. I discuss the doctrinal arguments as they have been developed in Section III.A. In Section III.B, I introduce and apply the existing policy literature. This literature has been only superficially applied to the awareness/use debate, perhaps because it is too general to provide concrete answers to subtle questions.

A. DOCTRINAL CONSIDERATIONS

This Section outlines the "doctrinal" arguments that have been deployed in the awareness/use debate so far. I refer to them as "doctrinal" because they take compatibility with existing insider trading law and practice to be a *per se* good. These are largely arguments initially crafted by advocates in particular cases, who want to win, and subsequently addressed by courts and doctrinally focused commentators. And like many arguments deployed in advocacy, they persist because both sides can make a good point.

1. Authority

Courts addressing mixed motive defendants are constrained by statutes, the precedents of higher courts, and administrative rules. Partisans on both sides of the awareness/use debate have invoked all three sources of law in support of their positions.

First, although no statute prohibits or defines insider trading, Congress has occasionally legislated changes to the insider trading law as produced by courts and the SEC. In 1984 and 1988, Congress amended the Securities Exchange Act of 1934 to impose penalties for "purchasing or selling a security or security-based swap agreement *while in possession* of material, nonpublic information."[77] This language, combined with statutory history,[78] seems to support an awareness standard.[79] However, some courts and commentators construe this language to create a necessary, but not sufficient, condition for liability—leaving open the possibility that Congress wished to preserve a use standard.[80]

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a Market for Corporate Disclosure, 35 YALE J. ON REGUL. 383, 402 (2018) (urging greater exemption from insider trading law for a form of "announcement trading").

77. 15 U.S.C. § 78u-1(a)(1) (2018) (emphasis added); *id.* § 78t-1(a) (emphasis added).

78. *See* LANGEVOORT, *supra* note 22, § 3.13 (discussing Congressional hearings).

79. *Id.*; *see also* Donald C. Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273, 1290 (1984) ("[A] discussion in the course of the House hearings suggests that the drafters were aware of precisely what they were doing.").

80. *See, e.g.*, SEC v. Adler, 137 F.3d 1325, 1337 (11th Cir. 1998); Horwich, *supra* note 7, at 1254–58; Donna M. Nagy, *The "Possession vs. Use" Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never Be Golden*, 67 U. CIN. L. REV. 1129, 1153–54 (1999); Note, *A Critique of the Insider Trading Sanctions Act of 1984*, 71 VA. L. REV. 455, 496–97 (1985).

Second, the Supreme Court is capable of overruling the mixed motives circuit split, and some analysts have argued that it has already done so.[81] Some commentators read *United States v. O'Hagan*, decided four years after *Teicher*, as a rebuke to the awareness standard.[82] *O'Hagan* repeatedly discussed the "use" of information as necessary to violate the law.[83] But the Court did not elaborate on what "use" meant, nor did it cite *Teicher*, despite ample reason to do so: The Eighth Circuit opinion under consideration in *O'Hagan* discussed mixed motives and cited *Teicher*.[84] If the Supreme Court truly meant to resolve this issue, it would have called attention to this discussion and cited the relevant case.[85]

Third, the SEC promulgates the rules under which insider trading is prohibited and has some power to set the terms of the prohibition.[86] Some courts have deemed the debate resolved by the SEC's promulgation of Rule 10b5-1, which seemingly endorses *Teicher*'s awareness standard.[87] However, others have questioned the SEC's authority to determine the scope of substantive liability for insider trading in light of existing Supreme Court precedent,[88] particularly for criminal matters.[89]

Others have questioned whether the SEC has in fact endorsed the awareness standard. Rule 10b5-1, which contains the claimed endorsement, also states "[t]he law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5, and Rule 10b5-1 does not modify the scope of insider trading law in any other respect."[90] Several courts have reasoned

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81. Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83, 145 (2002) ("Not unlike many academics, [*Adler* and *Teicher*] approached the relevant Supreme Court decisions as an innerantist [sic] approaches Holy Writ.").

82. *See, e.g.*, *Adler*, 137 F.3d at 1338 (reading *United States v. O'Hagan*, 521 U.S. 642 (1997) in this manner).

83. *E.g.*, *O'Hagan*, 521 U.S. at 656 ("[T]he fiduciary's fraud is consummated . . . when, without disclosure to his principal, he uses the information in purchasing or selling securities.").

84. *See generally id.* (refraining from citing *Teicher*).

85. Subsequent decisions have likewise avoided the question. *See* Salman v. United States, 137 S. Ct. 420, 427–28 (2016) (refraining from citing *Adler*, *Smith*, and *Teicher*).

86. *See* Securities Exchange Act of 1934, ch. 404, § 10(b), 48 Stat. 881, 891 (codified at 15 U.S.C. § 78j(b) (2018)) (authorizing the SEC to promulgate rules proscribing fraud).

87. *See, e.g.*, United States v. Dombrowski, No. 14 CR 41, 2014 WL 3454320, at *2 (N.D. Ill. July 15, 2014) (extending *Chevron* deference to Rule 10b5-1 in a mixed motives insider trading case); SEC v. Moshayedi, No. SACV 12–01179 JVS (ANx), 2013 WL 12172131, at *14 (C.D. Cal. Sept. 23, 2013) ("[B]ecause the SEC subsequently promulgated a rule interpreting the phrase 'on the basis of,' the Court defers to the SEC's definition."); *cf. Adler*, 137 F.3d at 1339 (implying the SEC had authority to overrule its mixed motive rule if it promulgated an appropriate rule).

88. *E.g.*, 2 HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES LAW HANDBOOK § 33:21 (2000) ("The . . . rulemaking . . . appears questionable."); Carol B. Swanson, *Insider Trading Madness: Rule 10b5-1 and the Death of Scienter*, 52 U. KAN. L. REV. 147, 204 (2003) ("[T]he SEC may well have exceed its authority.").

89. *See infra* notes 104–10 and accompanying text.

90. 17 C.F.R. § 240.10b5-1 (2020).

from this language that the SEC merely established awareness as a necessary condition for conviction, but did not establish any new sufficient conditions.[91] Since Rule 10b5-1 sets a low awareness standard for conviction, it does not force courts to abandon the higher use standard.[92]

2. Doctrinal Structure

Insider trading is an offense with elements,[93] including *scienter* (an appropriately bad state of mind)[94] and a *connection* between fraud and the sale or purchase of a security.[95] Some courts and commentators have reasoned that the solution to the awareness/use debate may be implied by whatever element it is part of.[96] Unfortunately, there is no agreement about which element that is.[97]

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91. *E.g.*, United States v. Jun Ying, No. 1:18-CR-74-AT, 2018 WL 6322308, at *5 n.10 (N.D. Ga. Dec. 4, 2018) (applying *Adler* and reasoning that it is the law of the Circuit that controls, while "Rule 10b5-1 does not modify the scope of insider trading law" (quoting 17 C.F.R. § 240.10b5-1)); *accord* Fried v. Stiefel Lab'ys, Inc., 814 F.3d 1288, 1295 (11th Cir. 2016).

92. Even prior to 10b5-1, the SEC promulgated Rule 14e-3 prohibiting insider trading in tender offers. In doing so, it endorsed the awareness standard. 15 U.S.C. § 78n(e) (2018); 17 C.F.R. § 240.14e-3 (2020). The rule has only two knowledge requirements: (1) "knows or has reason to know [the information] is nonpublic and" (2) "knows or has reason to know [the information] has been acquired . . . from" the bidder, the target or certain of their affiliates or associates. 17 C.F.R. § 240.14e-3. There is no requirement of use. The Supreme Court subsequently blessed this rule. United States v. O'Hagan, 521 U.S. 642, 676 (1997). Unfortunately, the mixed motive rule for 14e-3 sends only an ambiguous lesson for the vast majority of insider cases brought under 10b-5. The fact that the SEC promulgated, and the Court blessed, an awareness standard in one domain may imply a *different* standard elsewhere, where the rule has different language and the Court has not intervened; or it may mean that the *same* standard applies elsewhere—lest the mixed motives standards differ depending on whether the defendant traded on a tender offer or not. *Cf.* Harald S. Bloomenthal & Samuel Wolff, *View from the Ninth Circuit*—United States v. Smith—*Rule 10b-5*, *in* 1E GOING PUBLIC AND THE PUBLIC CORPORATION § 20:27 (2020) (noting the possibility that the knowing possession standard may prevail any time the SEC pushes on § 17(a) since it does not require scienter).

93. Stoneridge Inv. Partners, LLC v. Sci.-Atlanta, Inc., 552 U.S. 148, 157 (2008) (listing the elements for a typical private action).

94. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

95. *See* SEC v. Zandford, 535 U.S. 813, 825 (2002) (requiring only that the transactions and breach of duty "coincide"). Merely defrauding someone out of money and then buying securities is not a violation of 10b-5. The fraud and the purchase or sale must "coincide" with one another. *Id.* at 822.

96. Still other elements have been considered as host to the awareness/use debate. *See, e.g.*, *In re* Countrywide Fin. Corp. Sec. Litig., 588 F. Supp. 2d 1132, 1202–03 (C.D. Cal. 2008) (considering mixed motives as a matter of loss causation).

97. Nor is it clear that scienter and "in connection with" are the only two options. Some commentators have insisted upon a standalone "causation" element to which the awareness/use debate must be applied. This tends to lead them to endorse a use standard. *See generally* Horwich, *supra* note 7, at 1268–76 (demonstrating this is problematic because the SEC and DOJ are not required to establish causation, evidenced by the fact that there are no criminal law cases cited in favor of his causation argument). To the degree courts have considered causation in light of the awareness/use debate, they have rejected the use standard. *See* United States v. Rajaratnam, 719 F.3d 139, 158–60 (2d Cir. 2013) (computing gains "caused" by the defendants' insider

Smith endorsed a use standard on the theory that this debate is about scienter, since motives are ultimately mental states, and only the pro-defendant use rule ensures a bad mental state.[98] The notion is that someone with perfectly lawful reasons for action is not a willful lawbreaker, and any unlawful motives are causally inert stray thoughts.[99] Only those whose unlawful mental state actually changed their conduct possessed a sufficiently culpable mental state for punishment.[100]

Courts endorsing the awareness standard have tended to minimize the importance of scienter and instead localize the debate as part of the "in connection with" element.[101] Analyzing the debate under this element tends to lead to the more pro-government awareness standard, because courts have construed this element capaciously.[102]

With arguments on both sides, and no guiding authority, it is no surprise that many courts and commentators have abandoned the idea that the answer lies in doctrinal structure.[103]

3. Burden of Proof

If defendants can escape or delay liability by adducing a real or pretextual lawful reason for action, which prosecutors must then labor to disprove, law enforcement will become much more challenging. Both sides of the debate have adverted to the practical difficulty prosecutors face under a use test. This

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trading according to an awareness standard, including even gains the defendant would have enjoyed had the inside information been absent); *accord* United States v. Martoma, 48 F. Supp. 3d 555, 568–70 (S.D.N.Y. 2014), *aff'd*, 894 F.3d 64 (2d Cir. 2017). What is more, assuming that the debate is best understood as one of causation would not itself answer the question of what legal rule is best. It is an error to assume that a motive of reason only caused an action if it was a but-for cause of the action. *See* Andrew Verstein, *The Failure of Mixed-Motives Jurisprudence*, 86 U. CHI. L. REV. 725, 754–62 (2019).

98. United States v. Smith, 155 F.3d 1051, 1068 n.25 (9th Cir. 1998) ("In fact, a knowing-possession standard would, we think, go a long way toward making insider trading a strict liability crime . . . . [A]ny construction of Rule 10b-5 that de facto eliminates the mens rea requirement should be disfavored."); SEC v. Adler, 137 F.3d 1325, 1337–39 (11th Cir. 1998). Recall that most commentary treats "knowing possession" and awareness as the same.

99. Marvin G. Pickholz, Peter J. Henning & Jason R. Pickholz, *Section 10(b) and Rule 10b-5—Insider Trading—"On the basis of," in* 21 SECURITIES CRIMES § 7:28 (2019) ("The 'use versus possession' issue is one aspect of proving *scienter* and, in a criminal prosecution, the willfulness for a violation.").

100. This reasoning is debatable. A trader with good and bad intentions *has* bad intentions.

101. *See* United States v. Teicher, 987 F.2d 112, 120 (2d Cir. 1993). *Contra Adler*, 137 F.3d at 1335 n.24 (rejecting the relevance of "in connection with").

102. Yet this conclusion is contestable. Is a knowledge or intention truly in connection with an action if the action would have occurred even had the knowledge or intention been absent?

103. *See In re* Countrywide Fin. Corp. Sec. Litig., 588 F. Supp. 2d 1132, 1202–03 (C.D. Cal. 2008) (concluding that the same test arises under each element considered); BLOOMENTHAL & WOLFF, *supra* note 88, § 33:21 ("In the last analysis, the real argument may be over whether the issue is framed as one of causation or one of scienter and whether they are so intertwined that they cannot be considered separately.").

argument figured prominently in *Teicher*, the touchstone for the awareness standard.[104] Although some courts minimize the challenges a use standard poses for prosecutors,[105] commentators have largely agreed that, as compared to a use standard, the awareness standard makes life easier for prosecutors and harder for defendants.[106]

However, the ease of prosecution under the awareness standard is a bug, not a feature, according to many observers, because it violates due process norms. *Smith* rejected both *Teicher*'s awareness standard and *Adler*'s intermediate standard in which use is required but may be inferred, reasoning that those standards inappropriately shifted the burden of prosecution onto a criminal defendant.[107]

For their part, those favorable to the awareness standard have tended to minimize the extent to which the awareness standard actually shifts any burden onto defendants.[108] As the *Teicher* court explained, "Unlike a loaded

104. *Teicher*, 987 F.2d at 121 ("As a matter of policy then, a requirement of a causal connection between the information and the trade could frustrate attempts to distinguish between legitimate trades and those conducted in connection with inside information." (citing 7 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3505 (3d ed. 1991))); *see also Insider Trading: Hearings Before the Subcomm. on Telecomms. and Fin. of the H. Comm. on Energy and Commerce*, 100th Cong. 64 (1988) (SEC Chairman endorsing awareness standard).

105. United States v. Smith, 155 F.3d 1051, 1069 (9th Cir. 1998) ("The difficulties, however, are by no means insuperable. . . . Any number of types of circumstantial evidence might be relevant to the causation issue.").

106. LOSS & SELIGMAN, *supra* note 104, at 3504–05 (concluding, after brief analysis, that "[t]he very difficulty of establishing actual use of inside information points to possession as the test").

107. *Smith*, 155 F.3d at 1069; *accord* United States v. Heron, 525 F. Supp. 2d 729, 739–40 (E.D. Pa. 2007) (holding that Rule 10b5-1 is inappropriate in criminal cases because it shifts the burden of proof), *rev'd*, 323 F. App'x 150 (3d Cir. 2009). *Adler* sympathized with Smith but permitted a pro-government inference because the case concerned a civil violation where the norms did not need to be so favorable to the defendant. *Adler*, 137 F.3d at 1336–37. Others have joined in expressing this conclusion. *See, e.g.*, Horwich, *supra* note 7, at 1277; Hui Huang, *The Insider Trading "Possession Versus Use" Debate: An International Analysis*, 34 SEC. REGUL. L.J. 130, 136–37 (2006) (noting due process concerns raised by a conclusive presumption); David W. Jolly, *Knowing Possession vs. Actual Use: Due Process and Social Costs in Civil Insider Trading Actions*, 8 GEO. MASON L. REV. 233, 251–53 (1999); Stuart Sinai, *A Challenge to the Validity of Rule 10b5-1*, 30 SEC. REGUL. L.J. 261, 277–83 (2002).

108. DANIEL J. FETTERMAN & MARK P. GOODMAN, DEFENDING CORPORATIONS AND INDIVIDUALS IN GOVERNMENT INVESTIGATIONS § 15:15 ("[T]he "use" standard is not difficult to satisfy. . . ."). It is for this reason that many prosecutors decline to ask for an "awareness" jury instruction even in circuits that would allow one. *See* Steven R. Glaser & Raymond Bilderbeck, *Use vs. Possession in Insider Trading Cases*, N.Y. L.J. (July 9, 2012, 12:00 AM), https://www.law.com/newyorklawjournal/almID/1202562088687 [https://perma.cc/NVM7-VLHL] (first quoting Jury Instructions, United States v. Goffer, 756 F. Supp. 2d 588 (S.D.N.Y. 2011) (No. 10-cr-0056); and then quoting Jury Instructions, United States v. Rajaratnam, 802 F. Supp. 2d 491 (S.D.N.Y 2011) (No. 09-cr-1184)); Audrey Strauss, *Recent Insider Trading Jury Charges: 'Possession' vs. 'Use,'* N.Y. L.J. (July 7, 2011, 12:00 AM), https://www.law.com/newyorklawjournal/almID/1202499494707 [https://perma.cc/47SC-LG2G] (quoting Transcript of Record, United States v. Contorinis, No. 09-1083 (S.D.N.Y Oct. 4, 2010)) (noting the government needed to prove that

weapon which may stand ready but unused, material information cannot lay idle in the human brain."[109] If awareness by its nature entails use, then prosecutors really do carry their burden when they show awareness and there is no undue "shift" to the defendant.[110]

4. Fiduciary Principles

Violations of Rule 10b-5 generally require that the trader breach a duty, often a fiduciary duty.[111] Courts and scholars have invoked fiduciary law to answer the question of mixed motives insider trading. Unfortunately, both use and awareness fit plausibly within fiduciary principles.

On the one hand, a fiduciary betrays its principal by taking the principal's property and using it without permission, or by obtaining benefits they would not have gotten without their trusted position.[112] This would suggest a "use" standard.[113] A fiduciary who merely "knowingly possesses" the principal's property, but does not (mis)use it and does not enrich herself above the gains she would otherwise have obtained, does not seem to harm the principal or help herself.

Other courts have found fiduciary support for the awareness standard:

> [A] "knowing possession" standard comports with the oft-quoted maxim that one with a fiduciary or similar duty to hold material nonpublic information in confidence must either "disclose or abstain" with regard to trading. When the fiduciary is an insider who is not in a position to make a public announcement, the fiduciary must abstain.[114]

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the material, nonpublic information was "a factor in the decision to buy or sell; it need not be the only consideration").

109. *Teicher*, 987 F.2d at 120.

110. *Cf.* United States v. Nacchio, 519 F.3d 1140, 1168 (10th Cir. 2008) (assuming without deciding that 10b5-1 is lawful), *vacated in part*, United States v. Nacchio, 555 F.3d 1234 (10th Cir. 2009) (en banc).

111. *See* Salman v. United States, 137 S. Ct. 420, 423 (2016) ("[T]his Court explained that a tippee's liability for trading on inside information hinges on whether the tipper breached a fiduciary duty by disclosing the information.").

112. *Cf. Adler*, 137 F.3d at 1333–34 (focusing on the tipper-tippee context, but the reasoning remains the same in context of fiduciary duties).

113. *See* Horwich, *supra* note 7, at 1237–38 (describing theories that apply "to information taken wrongfully from one source for use in trading in the securities of *another* company"); *see also* Bryan C. Smith, *Possession Versus Use: Reconciling the Letter and the Spirit of Insider Trading Regulation Under Rule 10b-5*, 35 CAL. W. L. REV. 371, 371 (1999) ("[T]he Ninth Circuit has recently endorsed a causation standard requiring proof of actual use of inside information for a violation of Rule 10b-5.").

114. *Teicher*, 987 F.2d at 120 (citation omitted); *see also* Nagy, *supra* note 80, at 1141–44, 1165–1200 (describing the "disclose or abstain" rule and how it has played out in federal courts); Lacey S. Calhoun, *Moving Toward a Clearer Definition of Insider Trading: Why Adoption of the Possession Standard Protects Investors*, 32 U. MICH. J.L. REFORM 1119, 1138–41 (1999).

Donna Nagy argues at length that fiduciary principles in securities law require fiduciaries to disclose all material information they possess before transacting with a beneficiary.[115] A fiduciary simply cannot keep secrets she knows that the beneficiary would like to know while she transacts, even if the fiduciary would have taken the same acts if the fiduciary did not know the information.[116] The key question is not whether the fiduciary would have acted differently but for the information—it is whether the trusting beneficiary would have acted differently. The deal is that the trading fiduciary must be candid about everything she is aware that the trusting party would wish to know.

One reason that fiduciary principles have failed to resolve the debate is that they would, at best, only resolve half of it. Classical insiders such as directors and officers are subject to fiduciary duties when they buy stock,[117] and could have their mixed motive standard derived from such duties. But they have no fiduciary relationship to their victim when they insider trade in bonds,[118] or the stock of competitors.[119] Therefore, reliance on fiduciary principles would leave many cases without an answer.

B. POLICY CONSIDERATIONS

An extensive literature normatively analyzes the regulation of insider trading. Four rationales are often discussed. Advocates tend to claim that these theories are imminent in and justify the existing body of law. This Section briefly introduces the four rationales, noting the limited extent to which the existing literature has or has not applied these rationales to the awareness/use debate. As with doctrinal considerations, these policies are largely indeterminate in their prescriptions.

1. Incentives

Insider trading can distort incentives, increasing costs for firms and society.[120] For example, trading may distract employees, who divert their attention to trading opportunities rather than business opportunities.[121] Managers may push the firm to take more risks, or to reduce the quality of periodic disclosures,[122] in order to multiply the opportunities for the insider

115. Nagy, *supra* note 80, at 1160–62.

116. *Id.*

117. Chiarella v. United States, 445 U.S. 222, 227–30 (1980).

118. STEPHEN M. BAINBRIDGE, INSIDER TRADING LAW AND POLICY 79–81 (2014).

119. Ian Ayres & Joe Bankman, *Substitutes for Insider Trading*, 54 STAN. L. REV. 235, 241–43, 253 (2001).

120. Incentive arguments are not only directed to executives. Goshen & Parchomovsky, *supra* note 33, at 1260–61 (arguing that insider trading negatively affects outsiders' incentives to research firms).

121. James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L.J. 628, 633–34, 645–46, 649–53.

122. Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1054–55 (1982) ("Subordinates would stall the upward flow

to trade ahead of a wild price swing.[123] The act of trading might spill the beans on an employer's proprietary secrets.[124] Indeed, even selecting a career with access to secrets is a kind of incentive distortion.[125]

Jesse Fried argues that a "use" standard creates bad incentives because it encourages agents to strategically abstain from trading.[126] By buying whenever inside information confirms their existing plans but abstaining whenever the inside information contradicts their existing plans, insiders profit from information without using it to trade.[127] And thus, such agents are subject to many of the bad incentives discussed above.[128] For example, the wilder the stock price, the more times they can strategically abstain. Fried then concludes that the alternative "awareness" standard "is likely to improve [managers'] incentives."[129]

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of critical information to maximize their opportunities for financial gain."); Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1437 (1967); *cf.* Jesse M. Fried, *Insider Signaling and Insider Trading with Repurchase Tender Offers*, 67 U. CHI. L. REV. 421, 425 n.18 (2000) ("The prospect of insider trading profits can . . . encourage insiders to invest in projects that are difficult for outsiders to assess, whether these projects are otherwise desirable or not, in order to increase the information asymmetry between themselves and public shareholders . . . ."). *But see* Stephen M. Bainbridge, *Insider Trading*, *in* 3 ENCYCLOPEDIA OF LAW AND ECONOMICS 772, 787–88 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000) (arguing that delay is unlikely).

123. Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 332 (arguing that insider trading may lead to excess volatility); Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 149 (1982) ("[T]he temptation of profit might actually encourage an insider to act against the corporation's interest."). *But see* Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 874–76 (1983) (arguing risk-averse managers need such incentives, and their team dynamics limit how far things can go without a leak).

124. *See* James D. Cox, *Seeking an Objective for Regulating Insider Trading Through* Texas Gulf Sulphur, 71 SMU L. REV. 697, 706–08 (2018). For example, when mining executives buy their company's shares en masse, it may hint to other prospectors where they should dig to find valuable minerals. Andrew Verstein, *Insider Trading in Commodities Markets*, 102 VA. L. REV. 447, 490–91 (2016).

125. Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443, 478 (2001) (pointing out that individuals might opt to become an executive in order to acquire information).

126. Fried, *supra* note 21, at 486.

127. Steven R. Salbu, *Tipper Credibility, Noninformational Tippee Trading, and Abstention from Trading: An Analysis of Gaps in the Insider Trading Laws*, 68 WASH. L. REV. 307, 333–34 (1993); Levmore, *supra* note 123, at 119; Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1503 n.53 (1999); Boyd Kimball Dyer, *Economic Analysis, Insider Trading, and Game Markets*, 1992 UTAH L. REV. 1, 23–24. Although American law bars some insider trading, it permits nearly all forms of abstention, including abstentions that are informed by proscribed information.

128. *See supra* text accompanying notes 120–27.

129. Fried, *supra* note 21, at 481. Fried is commenting on how abstention will improve incentives, but he is considering incentives under an awareness regime, which he explicitly advocates for. *Id.* at 484–86.

Yet an "awareness" standard can also undermine agent incentives. An awareness standard means that it is frequently illegal for a trader to undertake her preferred trade because she has become aware of inside information.[130] Traders who wish to preserve their freedom to trade may take inefficient steps to avoid information that would "taint" them and remove valuable trading options.[131] And those steps precisely parallel the steps taken by would-be insider traders. Just as the desire for inside information may cause agents to increase a firm's risk, the desire to avoid inside information may lead a trader to tamp down on a firm's risks. Just as the desire for inside information may cause agents to excessively oppose public disclosure of the company's information, the desire to avoid informational advantages may cause the agent to excessively urge public disclosure of the company's information. And just as the desire for inside information can excessively encourage people to pursue careers that give them access to the information, the desire to avoid inside information can excessively curtail interest in such careers.

These risks are not speculative, especially once one widens the frame to include non-executive traders. Consider Larry Ellison, the billionaire founder of Oracle and early investor in numerous other technology companies. Ellison has frequently served on the board of companies he funds. His involvement brings insight, connections, and reputation to the firms he joins. Yet in joining firms, he exposes himself to liability under an awareness standard: What he learns at any one company may make it illegal to buy or sell shares at any other company.[132] If a strict mixed motive rule makes it appreciably more burdensome for Ellison to contribute to multiple companies, he may contribute to fewer of them.

It is an empirical question whether the incentive costs of an awareness standard are smaller or greater than the costs Fried identifies of the use standard.[133] One can speculate, but the matter has never been studied.[134]

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130. An agent can preserve this freedom by documenting a trading plan and invoking the 10b5-1 affirmative defense. But this solution is not perfect. First, some traders will worry about legal risk even in light of this plan—it is, after all only an affirmative defense; the government can prevail if it shows that the trader nevertheless used the information or that the plan was not entered into "in good faith" at a time that the trader possessed no material non-public information. Second, some traders may want to retain their freedom to trade without putting anything into a restrictive plan. Third, some traders may so often possess material non-public information that they can never (or only rarely) initiate a written trading plan.

131. *See generally* Andrew Verstein, *Insider Tainting: Strategic Tipping of Material Nonpublic Information*, 112 NW. U. L. REV. 725 (2018) [hereinafter Verstein, *Strategic Tipping*] (describing how some have strategically used insider trading as a weapon).

132. Ellison has in fact frequently been accused of insider trading. *E.g.*, Jonathan D. Glater, *Oracle's Chief in Agreement to Settle Insider Trading Lawsuit*, N.Y. TIMES (Sept. 12, 2005), https://www.nytimes.com/2005/09/12/technology/oracles-chief-in-agreement-to-settle-insider-trading-lawsuit.html [https://perma.cc/SER2-723L].

133. *See supra* notes 126–29 and accompanying text.

134. *See infra* Parts V and VI (making some effort to answer these questions).

2. Property

Another theory undergirding insider trading regulation is a property rights theory. On this account, entities own the information they generate, and insider trading law amounts to a species of intellectual property law.[135]

The property rights theory might support a use standard, based on the rationale that traders do not steal someone's intellectual property unless they do something with it that the owner disallows.[136] As one piece put it, "[w]here the company has consented to the insider's access to this information as part of his or her job, there is no illicit use unless the information is used in an unconsented manner."[137]

Of course, the key question in the property rights theory is what use a firm should be presumed to have allowed.[138] It is perfectly consistent with the property theory that a firm might insist that its information be accessed only by individuals who refrain from trading while aware of the information. There is some evidence that firms actually prefer such limits: Netflix bars all trading except trading specifically authorized by the Chief Compliance Officer and trading during specific windows of time.[139] The high degree of restriction seems to hint at an awareness standard. For the firms that do not make things clear,[140] we are left with the question of whether to presume they would want an awareness or use standard—which, to some degree, moves the question back to agent incentives.[141]

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135. Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9, 30–37 (1984); Richard J. Morgan, *Insider Trading and the Infringement of Property Rights*, 48 OHIO ST. L.J. 79, 94–95 (1987).

136. *See generally* Stacey L. Dogan, *Beyond Trademark Use*, 8 J. ON TELECOMMS. & HIGH TECH. L. 135 (advocating for the adoption of the "trademark use doctrine" to determine intermediary trademark liability).

137. Smith, *supra* note 113, at 383.

138. STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 603–05 (2002).

139. NETFLIX, INSIDER TRADING POLICY 2 (2020), https://s22.q4cdn.com/959853165/files/doc_downloads/governance_docs/Insider-Trading-Policy-MASTER.pdf [https://perma.cc/SE24-MZLX]. Of course, any such statement must be read in light of the background legal environment. Firms craft their insider trading policy knowing about the circuit split on mixed motives trading and knowing the SEC's belief in an awareness standard.

140. In some firms, the answer is ambiguous. *See, e.g.*, *Code of Business Conduct and Ethics*, AMAZON, https://ir.aboutamazon.com/corporate-governance/documents-charters/code-business-conduct-and-ethics [https://perma.cc/T6AZ-XD4P] (banning trades "based on material nonpublic information").

141. *See supra* Section III.B.1; *see infra* Section IV.B.1.

3. Fairness

Fairness and equality have long held sway as aspirations for insider trading law[142] and to some degree, of existing law.[143] *Teicher* reasoned that this principle supported an awareness standard: "[O]ne who trades while knowingly possessing material inside information has an informational advantage over other traders."[144] *Smith* instead derived a use standard from the same principles:

> The persons with whom a hypothetical insider trades are not at a "disadvantage" at all provided the insider does not "use" the information to which he is privy. That is to say, if the insider merely possesses and does not use, the two parties are trading on a level playing field; if the insider merely possesses and does not use, *both* individuals are "making their decisions on the basis of incomplete information." It is the insider's use, not his possession, that gives rise to an informational advantage and the requisite intent to defraud.[145]

Others have argued that a use standard would in fact strike most people as unfair.[146]

It should not be surprising that there are opposing views on whether an insider has an unfair informational advantage, given the difficulty in pinning down a precise sense of what fairness means. Difficult in any domain, securities law occupies an abstract and complex domain (trading markets) with peculiar economic and normative premises. For example, it has long been argued that insider trading is not unfair because it does not leave retail investors worse off on average.[147] Whatever the prospects for a fairness-based

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142. Levmore, *supra* note 123, at 119. *See generally* Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375 (1999) (discussing moral and other non-economic critiques of insider trading law).

143. The fairness rationale fits naturally with Rule 14e-3, which provides an almost unconditional ban on profitable trading on the eve of a tender offer. *See, e.g.*, Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1198 (1995) (asserting that Rule 14e-3 represents an "effort to revive the [*Texas Gulf Sulphur*] equal access to information rule"); Thomas W. Joo, *The Worst Test of Truth: The "Marketplace of Ideas" as Faulty Metaphor*, 89 TUL. L. REV. 383, 430 (2014) (stating, in the context of Rule 14e-3, "that the SEC . . . views equalization . . . as an important aspect of market health"); Steve Thel, *Statutory Findings and Insider Trading Regulation*, 50 VAND. L. REV. 1091, 1101 (1997) (describing the promulgation of Rule 14e-3 as "adoption of a principle of equal access to information").

144. United States v. Teicher, 987 F.2d 112, 120 (2d Cir. 1993).

145. United States v. Smith, 155 F.3d 1051, 1068 (9th Cir. 1998).

146. *See* Karen Schoen, *Insider Trading: The "Possession Versus Use" Debate*, 148 U. PA. L. REV. 239, 282 (1999) (describing how investors may view "such trading as unfair").

147. *See* Merritt B. Fox & Kevin S. Haeberle, *Evaluating Stock-Trading Practices and Their Regulation*, 42 J. CORP. L. 887, 909–12 (2017); Kenneth E. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 807–09 (1980); Easterbrook, *supra* note 123, at 329–30. *Compare* William K.S. Wang, *Stock Market Insider Trading: Victims, Violators and Remedies—Including an Analogy to Fraud in the Sale of a Used Car with a Generic Defect*, 45 VILL. L. REV. 27, 46–49 (2000) (emphasizing the loss of a particular victim), *with* John P. Anderson, *What's the*

account of insider trading, it does not obviously offer better support to either an awareness or use standard.

4. Market Integrity

A well-functioning market is highly liquid, meaning that trading is easy and cheap.[148] Insider trading law is often supported by advocates of market integrity because they see insider trading as injurious to liquidity. Insider trading can injure market integrity and liquidity in one of two ways.

First, the sense of unfairness may discourage retail investors from investing and trading as readily.[149] A key goal of the Securities Acts was to encourage retail investors to place their trust in public markets after the stock market crash of 1929.[150] Some commentators have argued that a use standard will strike retail investors as unfair, and thus discourage their participation.[151] However, it is notoriously difficult to verify assertions about what investors will find unfair or what will discourage their participation.[152] Perhaps investors are not bothered that individuals trade while aware of proscribed information, so long as they do not use it.

A second version of the liquidity argument focuses on sophisticated "market makers" who become more cautious when informed trading is widespread.[153] Market makers charge a per-trade fee, in the form of a bid-ask

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Harm in Issuer-Licensed Insider Trading?, 69 U. MIA. L. REV. 795, 802–06 (2015) (disputing Wang's analysis).

148. Fox et al., *supra* note 76, at 833–35.

149. Fox & Haeberle, *supra* note 147, at 912–13. *But see* John P. Anderson, *Insider Trading and the Myth of Market Confidence*, 56 WASH. U. J.L. & POL'Y 1, 5–12 (2018) (questioning this assumption).

150. S. REP. NO. 73-22, at 2982–83 (1933).

151. Schoen, *supra* note 146, at 282 ("[I]nvestors are likely to *perceive* such trading as unfair, believing that a trader possessing inside information cannot escape the influence of such information. And to the extent that the insider trading prohibition is based on the belief that investors will not participate in a market that they perceive to be unfair, it is investors' *perceptions* that are relevant in determining what conduct should be prohibited.").

152. *See generally* Anderson, *supra* note 149 (challenging assumptions about investors' views of fairness).

153. *See* Lawrence R. Glosten & Paul R. Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. FIN. ECON. 71, 72–77 (1985); Albert S. Kyle, *Continuous Auctions and Insider Trading*, 53 ECONOMETRICA 1315, 1324 (1985); *see also* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 488 (1970) (discussing liquidity of durable goods); Walter Bagehot, *The Only Game in Town*, 27 FIN. ANALYSTS J. 12, 13–14 (1971) (discussing the role of market makers in providing liquidity); Goshen & Parchomovsky, *supra* note 33, at 1251 ("It is widely agreed that insider trading diminishes liquidity. This view is based on a theoretical model that suggests that market makers will offset the risk of trading against insiders by increasing the bid-ask spread."); Krawiec, *supra* note 125, at 469–70 (discussing the mixed evidence on how insider trading affects liquidity); John C. Coffee, Jr., *Is Selective Disclosure Now Lawful?*, 218 N.Y. L.J. 5, 5–6 (July 31, 1997) (suggesting that impaired disclosure affects market efficiency).

spread.[154] The spread widens as a function of losses to informed traders.[155] Unlike investor morale, market-maker reactions are subject both to clear economic models and social science research, making their invocation somewhat less speculative. However, no research has yet looked at the question of the relationship between bid-ask spreads and mixed motive insider trading rules.

IV. A NEW PRINCIPLE

Although some scholars have attempted to fit the awareness/use debate to the policies undergirding insider trading regulation, no sustained effort has yet succeeded. If familiar policies have proven unappealing or indeterminate, but we don't wish to abandon normative analysis, then we will need a new normative principle. In this Part, I propose one. Section IV.A describes the principle. Section IV.B shows that the principle is consistent with existing policy rationales for insider trading.

A. THE EQUAL PROFITS PRINCIPLE

The extensive literature on insider trading has not reached a consensus on the best justification for insider trading restrictions, much less the proper contours of the law. This Article neither attempts to settle those debates, nor to simply assume the truth of one perspective for the purposes of argument. Instead, this Section sets out an intermediate, mid-level normative principle by which to evaluate variations on the law. This principle is ecumenical, intuitively plausible, and broadly compatible with all normative positions.

The principle is also intermediate in the sense that it is mostly internal to the law. It seeks to explain, justify, and marginally improve existing insider trading law. Perhaps some fundamental change is required to the law, such as rapid decriminalization or removal of the "personal benefit test."[156] This principle is not meant to support or resist such changes. Instead, it is meant to decide the awareness/use debate that arises under the existing law.[157]

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154. Laura Nyantung Beny, *Do Insider Trading Laws Matter? Some Preliminary Comparative Evidence*, 7 AM. L. & ECON. REV. 144, 148 (2005).

155. A market integrity and liquidity perspective focused on market makers is sometimes called the adverse selection theory or a microstructure approach. *See* Stanislav Dolgopolov, *Insider Trading and the Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market Making*, 33 CAP. U. L. REV. 83, 148 (2004); Nicholas L. Georgakopoulos, *Insider Trading as a Transactional Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation*, 26 CONN. L. REV. 1, 6–7 (1993); Fox et al., *supra* note 76, at 822; Andrew Verstein, *Crypto Assets and Insider Trading Law's Domain*, 105 IOWA L. REV. 1, 7 (2019).

156. *See supra* note 31 and accompanying text.

157. There is a persistent debate in securities enforcement about how closely criminal law may match civil law. *See generally* Samuel W. Buell, *What is Securities Fraud?*, 61 DUKE L.J. 511 (2011) (discussing whether scienter requirements should differ). This Article does not take a position in that debate: It simply identifies a new and desirable motive standard.

The principle is this: *Two traders alike in all respects except for their knowledge of proscribed information should enjoy the same expected profits from trading.*

To put it another way, a trader who frequently learns proscribed information should not experience greater returns as a result, nor should she be poorer on average for proximity to secrets. By contrast, traders rich in permitted information should be richer for it.[158] Importantly, equal profits from unlawful information are better than less-than-equal profits (losses).

The equal profits principle is attractive in light of familiar policy rationales. It improves incentives for agents and third parties who sometimes have access to proscribed information. It optimally protects principles' property rights. It meets plausible standards of fairness, and it clearly benefits market integrity. The next Section explains the rationale behind this principle in greater detail, with particular emphasis on why equal profits are more desirable than zero or negative profits for the insider.

B. COMPATIBILITY WITH FAMILIAR POLICIES

1. Incentives

If illicit trading profits make bad agents, limiting illicit trading profits to zero should restore good incentives. Indeed, as long as any positive profits exist for trading on the basis of proscribed information, traders will seek to generate and use proscribed information, with all the incentive problems it creates. Only an equal profits rule will cause agents to properly disregard the temptations of proscribed information.

It may seem that we should not stop at equal profits, but should actually demand less-than-equal profits for those with proscribed information. But this is harmful on an incentives rationale. All the worries that caused us to worry about positive profits from proscribed information apply (albeit in reverse) when negative profits are imposed.

For example, one incentive problem employees face when profits are positive is that they may cause the corporation to take excessive risks, since each risk gives them a chance to trade opportunistically before the market learns the truth. But traders would cause the corporation to be excessively cautious on a negative expected profits rule, since extra risks generate information that tends to constrain them and lower expected trading profits. Executives who can profit from proscribed information may be distracted as they spend time trying to acquire it rather than working, but executives who suffer losses from proscribed information will be distracted in trying to avoid access to proscribed information and they will be encouraged to remain ignorant, which is not good for effective work.

To the degree that we worry about excessive entry to the jobs and industries with access to proscribed information, we would worry about

158. *Cf.* Fried, *supra* note 21, at 486 (using similar reasoning to reach differing conclusions).

excessive exit from such industries if expected profits were negative.[159] It is better for everyone if agents do not regard proscribed information as either a perk or a pitfall.

Relatedly, a rule with zero expected profits from proscribed information protects executives' incentives to hold their company's stock.[160] When executives trade with proscribed information, it is likely a trade in their own company's stock. Under a negative expected profits rule, executives would regard stock ownership as a costly affair; their purchases and sales would be taxed by the legal rule, and they would find it better to sit on the sidelines. A zero expected profits rule makes it cheap for executives to take an incentive aligning position in their company's stock.

Incentives matter for outsiders of the firm too. Those who research stocks for a living invest great sums of money into learning permitted information and developing lawful reasons to trade. Under a positive profit rule, they would divert their attention toward illegal information. Under a negative profits rule, they would take costly steps to avoid information that might be proscribed.

For example, Muddy Waters takes an intensely forensic approach to investigating companies, oftentimes interviewing current and former employees.[161] In doing so, they uncover lawful information that is privately and socially valuable. But there is also a risk that any given investigator will overstep the law and obtain proscribed information: They may confer a personal benefit upon their source in exchange for the duty-breaching disclosure, they may receive a tip that they know was misappropriated from the source, or they may instinctively (but wrongly) assure an employee confidentiality in the search for the truth about an issuer. Some amount of such misbehavior may be a natural result of intense research. We do not want the law to encourage hedge funds to break the law in these ways, but we also do not want the law to judge a long-term investigative project by its single worst moment.

To make this more concrete, consider Muddy Waters' recent tussle with Luckin Coffee, a NASDAQ-listed Chinese chain. Investigators devoted 11,260

159. *See supra* note 132 and accompanying text (describing possible reluctance of a prized investor-director, Larry Ellison).

160. Encouraging executive stock ownership is thought to help align their interests with that of shareholders. Mark Anson, Theodore White, William McGrew & Bridgette Butler, *Aligning the Interests of Agents and Owners: An Empirical Examination of Executive Compensation*, IVEY BUS. J. (May –June 2004), https://iveybusinessjournal.com/publication/aligning-the-interests-of-agents-and-owners-an-empirical-examination-of-executive-compensation [https://perma.cc/U2ST-3UFN]. Executives who cannot trade will demand more stock in compensation for the illiquidity. M. Todd Henderson, *Implicit Compensation* 10 (Univ. of Chi. L. Sch. Chi. Unbound, Working Paper No. 521, 2010).

161. *See supra* notes 34–38 and accompanying text.

hours to in-store observations of Luckin Coffee shops.[162] They had 92 full-time employees just sitting in coffee shops watching sales, and another 1,418 part-time staff on the job.[163] They physically examined over 25,000 receipts and over 11,000 hours of video footage.[164] These observations revealed sales so low that Luckin's official figures had to be a lie.[165] The investigators shared their work with Muddy Waters, which publicized it—forcing the company to admit that it had engaged in widespread fraud.[166] The discovery was socially valuable, and it required costly investigation, but the investigators likely recouped the cost, as the stock dropped more than 80 percent.[167]

If the law severely penalizes investors like Muddy Waters for trading after such a discovery, such investors will take steps to minimize exposure from such discoveries. They may tether their employees with extensive compliance programs or disallow aggressive but legal investigation. They may tell traders to disable their email or cell phones in the period leading up to a planned trade, to minimize the chance their network delivers proscribed information.[168] They may discourage investigations as extensive as the Luckin investigation, since each hour in the store is an hour in which an employee could lie to the personnel and become a misappropriator. To tamp down on proscribed information, investigators will tamp down on information.

If the trader's expected profits from research are taxed by the chance discovery of proscribed information, the trader will conduct less research at the margin, which is not optimal. If valuable research is rendered less useful *ex post* when proscribed information is acquired, the benefit of such research *ex ante* falls, and less of it will be funded. A trader will trade less often and at less accurate prices, harming price accuracy and market integrity.

It is far better if unlawful information neither helped nor hurt investigators' progress. Only an equal profits principle properly makes traders indifferent to proscribed information.

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162. The facts are slightly convoluted: The report was actually written by anonymous investigators who may or may not have been coordinating with Muddy Waters.

163. GMT RESEARCH, LUCKIN COFFEE: FRAUD + FUNDAMENTALLY BROKEN BUSINESS 1, https://cdn.gmtresearch.com/public-ckfinder/Short-sellers/Unknown%20author/Luckin%20Coffee_Anonymous.pdf [https://perma.cc/7YXL-8H5R].

164. *Id.*

165. *Id.*

166. Amelia Lucas, *Shares of China's Luckin Coffee Plummet 80% After Investigation Finds COO Fabricated Sales*, CNBC (Apr. 2, 2020, 11:31 AM), https://www.cnbc.com/2020/04/02/luckin-coffee-stock-plummets-after-investigation-finds-coo-fabricated-sales.html [https://perma.cc/G9JC-L9KK].

167. *Luckin Coffee Inc. (LKNCY)*, YAHOO! FIN., https://finance.yahoo.com/quote/LKNCY/history?period1=1585612800&period2=1585958400&interval=1d&filter=history&frequency=1d&includeAdjustedClose=true [https://perma.cc/X5RV-JJTQ].

168. As another example, recall that the analysist in *Dirks* obtained secrets from a disgruntled employee. Dirks v. SEC, 463 U.S. 646, 648, 652 (1983). Although this research was lawful, a rational hedge fund might discourage such research if it posed any chance of scuttling an otherwise valuable multi-year investment thesis.

2. Property

The equal profits principle is compatible with a property account in three ways. First, the equal profits principle removes on average any incentive the agent may have to take the principal's property, since doing so does not, on average, yield any profits. Second, it defers to the property account on what reasons count as proscribed.[169] Recall that the principle allows a trader to make positive profits based on their lawful reasons but not their unlawful ones. The principle is itself neutral on what counts as unlawful information. If the property account holds that certain information belongs to the principal, it is easy for the equal profits principle to designate that information as disallowed for profit.

Third, the equal profits principle concerns itself with rules, rather than case-by-case efficiency or fairness evaluations.[170] Property rights collapse if one views disputes discretely. Why can a stranger not enter my house and warm her hands by my fire? How is exclusion efficient or fair? The institution of property only makes sense if we back up a step: Is it legitimate for anyone to have a locked door, and did I come to be one of those people through a legitimate process? Likewise, the equal profits principle does not fixate on eliminating advantages in any given trade; it merely seeks a net reduction of profits to zero. The institution serves our goals, even if we may spot instances that bother us.

3. Fairness

The meaning of fairness and equality are controversial. But it has occurred to many commentators that insider trading is unfair because the insider appropriates gains from her unequally informed counterparty. An investor who is induced to trade by the insider's offer misses the chance to profit as the insider will: The insider's profits come, in a very obvious sense, from her trading partner.[171] The transaction is zero sum and that leads the trading partner to regret the trade.

If the zero-sum quality of insider trading goes to its unfairness, then an equal profits principle is a good curative. Investors' losses on account of others using proscribed information will average zero, since insiders' gains from possession of such information will average zero.[172]

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169. *See supra* notes 113–16 and accompanying text.

170. Goshen & Parchomovsky, *supra* note 33, at 1255.

171. *See* Wang, *supra* note 147, at 46–48 (emphasizing the loss of a particular victim). *But see* Anderson, *supra* note 147, at 796–97 (disputing Wang's analysis).

172. One caveat is that an insider who does not make extraordinary profits on average may be able to make a killing on some particular trade (even if the gains are offset by large losses on another trade); their counterparties on those profitable trades may complain of unfairness. If the losses are not randomly distributed, certain counterparties may find that they lose on some transactions and do not enjoy any offsetting gains on other transactions, implicating fairness and incentive concerns.

Moreover, fairness accounts usually take some account of the character of the informed trader. Indeed, fairness often inclines us to reward individuals who work to develop an informational advantage.[173] Allowing traders to keep the profits of their permitted information is consistent with a fairness account. Thus, fairness supports an equal profits principle rather than a negative profits principle, since equal profits permits the trader to keep their gains from permitted information. A negative profits principle would tax traders who plan to trade on the basis of permitted information.

4. Market Integrity

Market integrity asks whether a particular practice harms liquidity, without offsetting benefits to price accuracy. The equal profits principle has a salutary effect on liquidity, while making appropriate allowances for price accuracy.

Nevertheless, popular distaste for insider trading is almost certainly based on the sense that insiders amass terrific wealth by abusing their position. A rule that reduces expected profits from proscribed information to zero, equalizing the treatment of those with and without proscribed information, is well positioned to protect market liquidity against popular backlash.[174] At the same time, the equal profits principle permits trading gains for those with lawful reasons for action, vindicating the sense that hard work can pay off.

The equal profits principle enhances liquidity. This is because insider trading profits cause market makers to increase bid ask spreads—which harms liquidity—to offset their losses to inside traders. When the insiders' gain is reduced to zero by the equal profits principle, the risk to market makers disappears, and so they will narrow spreads, thereby enhancing liquidity.[175]

The equal profits principle also makes appropriate allowance for price accuracy. American law's baseline is to permit informed trading in order to spur research and promulgation of information.[176] The equal profits principle limits profits from proscribed information, so it stands alongside the other policy rationales as representing a tradeoff between accurate prices and other goals. But, it allows traders to profit from their permitted information and thereby encourages them to trade in ways that promote price accuracy.

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173. Laidlaw v. Organ, 15 U.S. (2 Wheat.) 178, 193 (1817) (finding no fraud had been perpetrated by insider trading, "unless rising earlier in the morning, and obtaining by superior diligence and alertness that intelligence by which the price of commodities was regulated, be such").

174. *See* John P. Anderson, *Greed, Envy, and the Criminalization of Insider Trading*, 2014 UTAH L. REV. 1, 9–12.

175. *See supra* notes 153–55 and accompanying text.

176. *See* Fox et al., *supra* note 76, at 821–25.

V. EVALUATING THE EXISTING TESTS

This Part evaluates the awareness and use test under the equal profits principle. Motives and reasons are easy things to misunderstand or mischaracterize, so Section V.A moves slowly in setting up a model and a descriptive framework for presenting it. Section V.B uses the model to show the infirmity of both legal standards endorsed by courts and scholars.

A. MODELING THE TESTS

The model in this Section assumes three periods. First, a trader is endowed with some combination of reasons (some lawful, some unlawful) for trading. Second, the trader makes her preferred trade (buy, sell, or abstain) subject to the relevant legal constraints. Third, the trader enjoys payoffs (positive, zero, or negative) from the trades she selected. This Section sets out those building blocks.

1. Preferred Trades

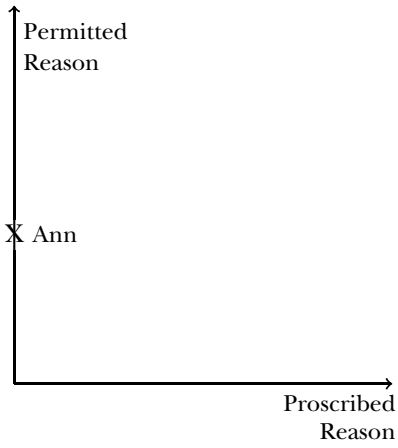
Traders buy and sell securities in response to reasons, and we can think of the direction and strength of such reasons numerically.[177] A positive value would indicate a reason to buy and a negative value would indicate a reason to sell. A strong reason would be a very large absolute value.[178]

A person's lawful reasons can be placed on the Y axis and their proscribed reasons can locate them on the X axis. For example, we could imagine that Ann has scrupulously researched a stock and decided to buy it. We can think of her having a positive lawful reason to trade and no other reason. Therefore, she would sit right on the Y axis of a figure depicting her motives for trading, as Figure 2 displays.

177. The values need not be exact nor is it essential that beliefs *really* be quantifiable. In most cases, there is some clarity and insight from getting even an impressionistic sense of the sign and magnitude. In particular, it is often possible and useful to ascertain how reasons compare to one another. Do two reasons point in the same direction, reinforcing each other, or are they in tension? If the latter, which one prevails? Does a trader buy in light of powerful good news about the stock? Or does she sell despite the good news because of even stronger countervailing discoveries?

178. Insider trading law may be inconsistent on whether it takes stock of subjective or objective reasons. When applying the use test, courts often seem to care about whether the trader was subjectively influenced by proscribed information. When applying an awareness test, courts seem to take an objective perspective—if the information is the sort that would motivate most traders, it is no defense that *this* trader wasn't motivated by it. This model is compatible with both subjective and objective motives.

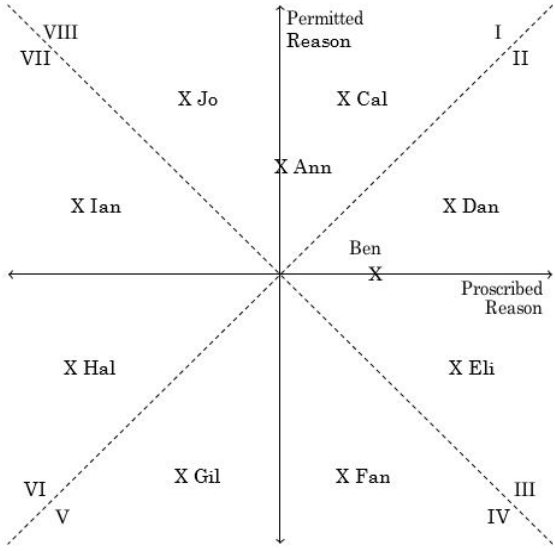
Figure 2. Ann's Motive



This depiction of Ann's trading motives invites thinking about other possible combinations. Some traders' only reasons to trade concern proscribed information; such a trader would be placed directly on the X axis. Other traders have both lawful and unlawful reasons for action. If both reasons support buying the stock, they will appear somewhere in the space to the right of Ann's placement. But if either reason cautions against buying, or even urges selling, then we will need a larger domain in which to display the results. Figure 3 extends the axis to make room for more traders.

With Figure 3 we can observe traders such as Cal, with two independent reasons to buy the stock, and Hal, with two independent reasons to sell it. Cal and Hal are the sort of traders who are at the heart of mixed motives insider trading cases. But they are not the only sort of traders who may act with more than one motive.

Figure 3. Trading Domains



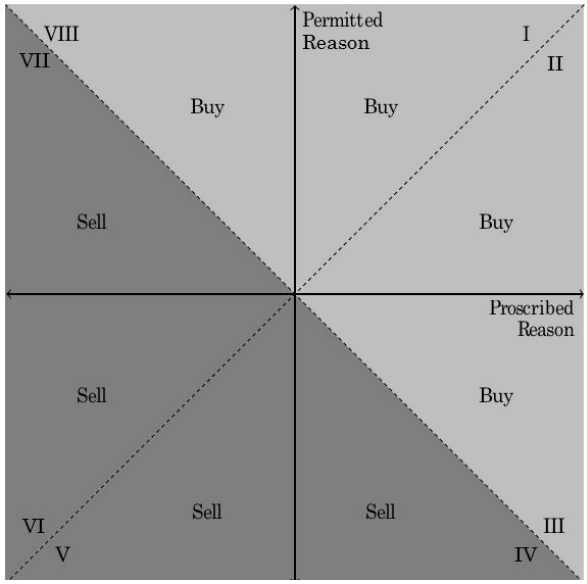
We can also observe traders like Ian and Jo, who sit in the upper left-hand quadrant because they have both a lawful reason to buy the stock and an unlawful reason to sell the stock. A dotted line separates them to indicate an important difference between them: For Ian, the unlawful reason is his more important reason and for Jo, the opposite is true.

We can think of Ian as someone who has researched the fundamentals of a company and deemed it undervalued but has also surreptitiously learned that the company's most important drug will be rejected by the FDA. Ian has a reason to buy and a reason to sell, but the latter swamps the former. If Ian were free to act, he would probably set his fundamental analysis aside and dump the shares. Jo is in the inverse position. Whatever makes her bullish on the stock is more compelling than the worrying, but tenuous, reason to sell.

How someone prefers to trade is, in part, a function of her reasons. A trader will tend to buy when her reasons to buy are greater than her reasons to sell, and vice versa.

Figure 4 depicts a trader's preferred trades in light of their reasons. In fact, it is how such a trader *would* trade if unconstrained by law.

Figure 4. Preferred Trades



Domain I, which contained Cal, is one where all reasons pointed toward buying and the trader, accordingly, prefers to buy. Domain VII contains traders like Ian, whose lawful reasons to buy are swamped by their unlawful reasons to sell, and who would accordingly sell.

Notice also that in domain IV, the trader has inside information urging a purchase, but the unconstrained trader nevertheless sells. There will indeed be times in which lawful reasons are sufficiently compelling that a trader would like to sell despite having some proscribed insight urging a purchase. What it means for there to be two reasons is that the reasons might not always point in the same direction and that the ultimate result is not preordained; it instead depends on the relative strength of the reasons.

2. Preference Frequency

A trader in domain III will prefer to buy a stock. What are the odds that her combination of reasons will place her there? The answer depends on the relative occurrence of her reasons for action.

If she more frequently has lawful reasons to buy than sell, she will more often find herself somewhere in domains I, II, VII, and VIII. If she more frequently has unlawful reasons to buy than sell, she will more often find herself somewhere in domains I, II, III, and IV. If her lawful reasons to buy tend to be weaker than her unlawful reasons to buy, she will find herself more often in domain II than domain I.

The actual distribution requires assumptions, so we now make three. First, we assume that the stock will go up in value.[179] Second, we assume that unlawful reasons are correlated with the future value of the stock. Thus, since the stock is going to go up in value, a trader with unlawful motives will tend to have positive unlawful motives, placing them to the right of the origin. For the purposes of exposition, we assume normal distribution, with an 80 percent chance that the signal is correct.[180] Third, we assume that the presence or absence of correlation for the lawful motives depends on the nature of those motives. Traders with personal or idiosyncratic reasons for action are just as likely to have reasons to buy or sell. These lawful reasons, such as a need for cash or a need to demonstrate commitment and confidence in a company, are unlikely to correlate strongly with the future price of an asset. Thus, the Y value is a random variable, positive half of the time and negative half of the time. By contrast, traders with lawful information on which to trade will have more positive placements on the Y axis than negative. Such a trader has a valuable signal that will, all things being equal, tend to lead them to profits. As with the proscribed information, the model assumes 80 percent accuracy and a normal distribution as to strength.

179. This is unrealistic; the stock will go up only half the time. But this analysis gives us the correct results for those half of the cases. And everything in the model works in parallel for the sale cases. The correlations biasing results toward buying would simply bias things toward sale in those cases.

180. This assumption matches the accuracy enjoyed by an insider trading ring prosecuted in *SEC v. Zavodchikov*, No. 16-845, 2019 WL 3451501 (D.N.J. July 31, 2019). Out of 837 trades made with proscribed information, 77 percent of the trades resulted in a positive net profit. Complaint at ¶ 144, SEC v. Ieremenko (D.N.J. filed Jan. 15, 2019) (No. 19-cv-505), https://www.sec.gov/litigation/complaints/2019/comp-pr2019-1.pdf [https://perma.cc/57CW-7ES6].

Figure 5. Idiosyncratic Trading Distribution

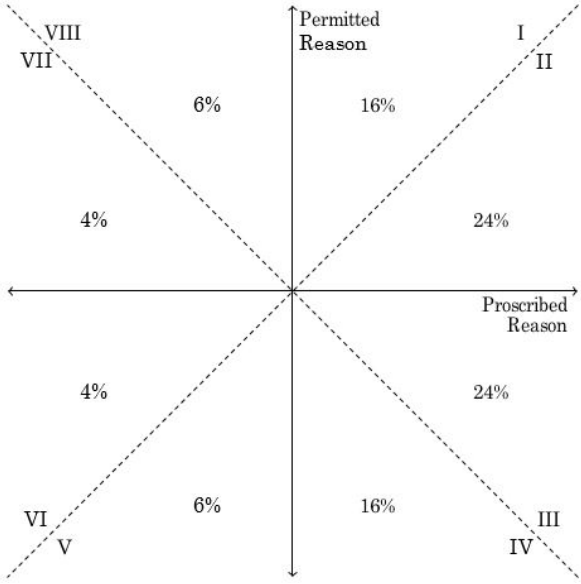


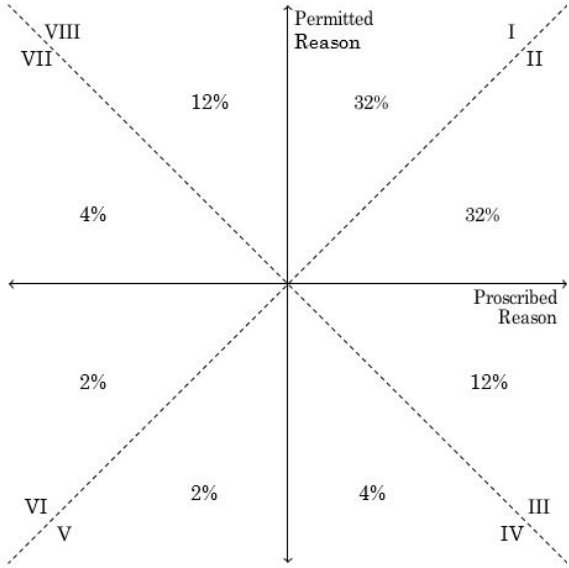
Figure 5 depicts plausible probabilities for the first type of trader, whose lawful information is idiosyncratic rather than informed.[181]

Figure 6 then displays the resulting distributions when a trader possesses both lawful and unlawful information.[182]

181. On our assumptions, 80 percent of the outcomes must reside in domains I, II, III, and IV, because these are the domains in which the proscribed information urges the correct trading strategy. The results above the X axis should mirror those below it, because any given unlawful reason is equally likely to be paired with a lawful reason as an unlawful one. Domain II is more likely than domain I given the bias of unlawful reasons toward the truth in these cases. In the 20 percent of cases where the proscribed reason erroneously favors sale (domains V, VI, VII, VIII), it is more likely that the proscribed reason will be smaller than the lawful reason. That is because the strength of the reasons are normally distributed with a bias to the right of the origin, so the negative proscribed reasons tend to be among the weaker reasons. Hence domain VII is less likely than domain VIII and domain VI is less likely than domain V.

182. In 64 percent of cases, both lawful and unlawful information are correct, as indicated in domains I and II. Since they are both 80 percent accurate, the Figure reports equal chances (32 percent) of either one being larger. Likewise, there is a four percent chance that both 80 percent accurate signals are incorrect (domains VI and VI). The odds that the lawful information is accurate and the unlawful information is incorrect are 16 percent. (0.8*0.2=0.16). This result resides in domains VII and VIII, but domains VII and VIII are not equally likely. Since the strength of the reasons are normally distributed with a bias to positive values, the erroneous proscribed reasons will tend to be weaker than the accurate lawful reasons, and the latter will more often be larger. Hence domain VIII has a larger percentage associated with it than domain VII. The precise difference (here four and 12 percent) depends on the assumptions about the distribution of strength. The results in the paper hold without qualification as long as there is any non-uniform distribution.

Figure 6. Informed Trading Distribution



3. Modeling Trading Payoffs

A trader's expected profits from any given instance of mixed motives is a function of the trades she can be expected to make and the payoff from the trades. The previous Section indicated the probability of various trades. Here, we introduce assumptions about payoffs. Specifically, the model assumes a trader who trades "correctly" in light of the future stock price enjoys a profit of $100.[183] One who trades wrongly suffers a "profit" of negative $100. An abstainer gains zero.[184] Thus, a trader who buys in period two will enjoy a profit of $100 if the stock "goes up" in value.

A trader's *expected* profits from any given instance of mixed motives is the product of the payoffs in each case (here, $100, 0 or -$100) multiplied by the

183. The actual return would be a function of both the amount invested and the appreciation of the asset. Still, $100 has the nice property of multiplying cleanly with percentages to yield round dollar values. Importantly, the model assumes that the intensity of reason does not affect the calculation of payoff amounts. This simplifying assumption is reasonable. United States v. Rajaratnam, No. 09 Cr. 1184(RJH), 2012 WL 362031, at *6 (S.D.N.Y. Jan. 31, 2012) ("An insider and a lawful investor who purchase stock at the same time will earn the same profit. The difference between them is not how each has affected the stock but what each knows about the company issuing it." (footnote omitted)).

184. In reality, an abstainer would enjoy the market rate of return, or whatever return yielded by their actual alternative investment strategy. We can treat "zero" as standing in for that alternative opportunity.

chance of each outcome. Whether they buy is a function of what they prefer, and how often this occurs is a function of information correlation.

Thus, an idiosyncratic trader who lacked lawful information, but who always traded in accord with the sum of her reasons would make $40 in expected profit: 70 percent of the time she buys profitably, either because her stronger reason points toward buying (domains III and VIII) or because both of her reasons point toward buying (domains I and II). Thirty percent of the time she sells at a loss.

A lawfully informed trader who always followed the balance of her reasons would do even better, because she would more often have reasons to buy. She would buy in the same domains (I, II, III, and VIII) but those would arise 88 percent of the time. They arise more often because her lawful information causes her to more often have positive Y values. Only 12 percent of the time would she wrongly decide to sell the stock.

Figure 7 shows the expected payoffs ($76) to a trader who took full advantage of their proscribed information in mixed motive cases.

Figure 7. Expected Payoffs

	I	II	III	IV	V	VI	VII	VIII	Total
Idiosyncratic Trader	$16	$24	$24	-$16	-$6	-$4	-$4	$6	$40
Informed Trader	$32	$32	$12	-$4	-$2	-$2	-$4	$12	$76

4. Permitted Trades

In reality, traders are not free to take full account of their unlawful reasons for trading. This Section considers trading under legal constraints. We have already seen the trading patterns of an unconstrained trader, who can trade precisely as her preferences dictate.[185] Here, we consider three salient constraints: (1) naïve trading; (2) use trading; and (3) awareness trading.

i. Naïve Trading

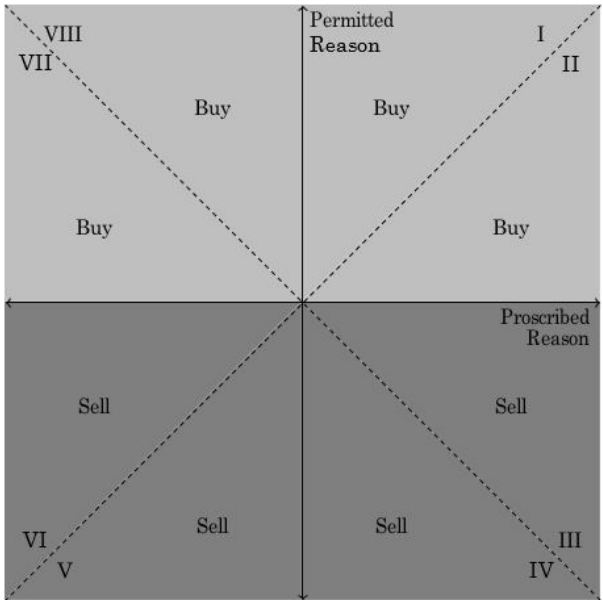
First, consider a legal requirement to trade "naïvely." A naïve trader takes no account of her illegal reasons for action. She buys and sells precisely as she would if she had only lawful reasons.[186] The naïve trader is important because

185. *See supra* Figure 4.

186. The law plausibly requires naïve trading for traders who have subjected themselves to a Rule 10b5-1(c) trading plan. These plans are written plans, undertaken in good faith and prior to having any inside information. Once a plan is in place the trader is generally permitted to trade (even if subsequent inside information would have otherwise rendered the trade unlawful), but one also *must* trade (even if subsequent changes in one's lawful reasons would make the trade irrational).

she serves as the baseline for comparison when applying the equal profits principle. A trader who takes no account of proscribed information behaves exactly as does a trader with no proscribed information—an outsider, like you and me. The trades of a naïve trader are depicted in Figure 8.

Figure 8. Naïve Trading



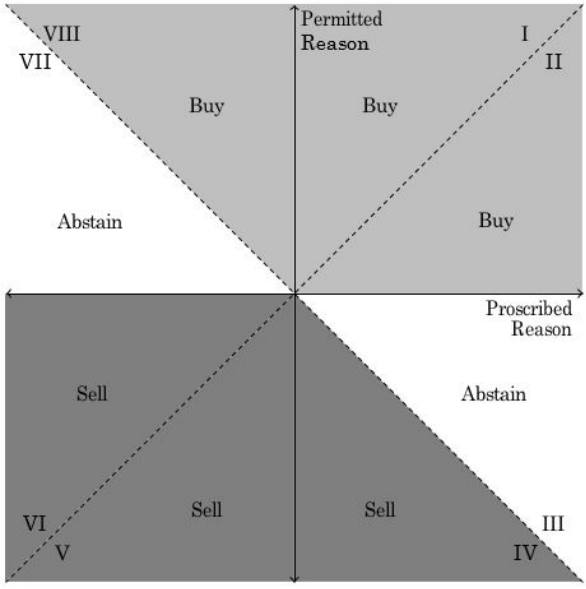
Like the unconstrained trader from Figure 4, a naïve trader buys in domains I, II, and VIII. She sells in domains IV, V, and VI. Her behavior differs in domain III because she sells instead of buys. The naïve trader sells because her lawful reasons urge a sale. Her unlawful reasons strongly counsel buying, which she would indeed undertake if unconstrained. Unfortunately for the naïve trader, she is not permitted to take stock of those reasons. Likewise, in domain VII, the naïve trader would sell if permitted to consider all the reasons at her disposal, but the naïve trading rule demands instead a purchase in keeping with her lawful reason for action.

ii. Use Trading

Second, consider a trader subject to a "use" rule. The use rule, advocated by the Ninth Circuit in *Smith*, bars trading only if the trader used proscribed information.[187] In particular, trades that would have been undertaken solely on the basis of lawful information are not prohibited.

187. *See supra* Section II.C.

Figure 9. "Use" Trading



Such a rule constrains the trading behavior, as displayed by Figure 9. In particular, it forces her to abstain in domain III. There, she has a weak lawful reason to sell and a strong unlawful reason to buy. She would like to buy, but such a purchase would obviously be the fruit of illegal information; left only to her lawful motives, she would not be buying. Because the inside information would be necessary for her to buy, she is barred from buying.

However, she need not actually sell as the naïve trader would. The law permits an insider to abstain.[188] Therefore, the trader will abstain in domain III, acting differently than both the unconstrained and the naïve trader.

She also opts to sell in domain IV and buy in domain VIII for the same reason that the unconstrained trader did: Her lawful reasons seemed more compelling than her relatively weak unlawful reasons. Even insiders will sometimes opt to disregard their inside information in the face of compelling lawful information or idiosyncratic need pointing the other direction.

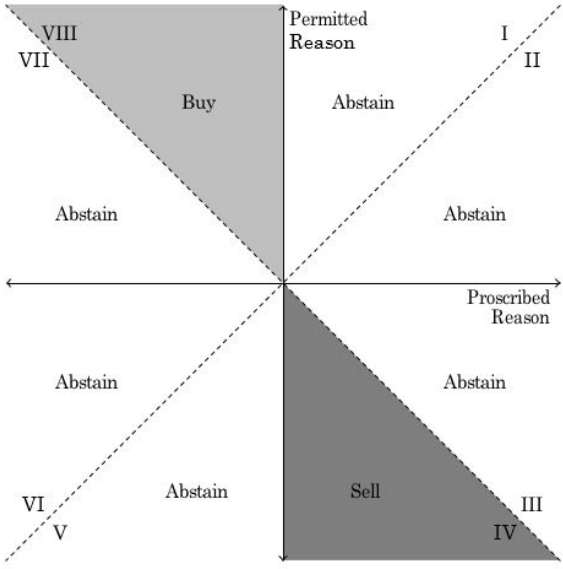
iii. Awareness Trading

The third legal constraint for present purposes is the Second Circuit's "awareness" standard from *Teicher*, which prohibits trading not just while

188. Several scholars have noted this point and considered it problematic. *See, e.g.*, Salbu, *supra* note 127, at 333–34; Levmore, *supra* note 123, at 119; Prakash, *supra* note 127, at 1491, 1503 n.53; Dyer, *supra* note 127, at 23–24. *But see* Fried, *supra* note 122, at 455–59 (defending abstentions).

using proscribed information, but even while aware of it.[189] This standard proves highly restrictive of trading, more so than either the use standard or —perhaps surprisingly—the trading pattern of the naïve trader. Figure 10 displays the decisions taken by a trader subject to an awareness standard.

Figure 10. "Awareness" Trading



Under the awareness standard, a trader abstains in domains III and VII, taking advantage of her superior information to avoid purchasing (selling) in a case where the balance of her reasons consider it unwise. And in domains IV and VIII, she again sells (buys) when proscribed information urged the opposite, because her lawful information was more compelling. The important differences occur in domains I, II, V, and VI, where the trader is precluded from trading. She is prohibited from trading because she is aware of information supporting the trade.[190] Her independent lawful reasons do not grant her permission to trade under this test.

189. *See supra* Section II.B.

190. The awareness standard could be construed to bar such a sale, since the trader *is* aware of proscribed information. However, the SEC and DOJ have never prosecuted an individual for trading with information that disconfirms their trade. And there are plainly cases where the government could have prosecuted such an individual for such a trade and opted not to do so. SEC v. Obus, 693 F.3d 276, 293 (2d Cir. 2012) ("[Government declines to prosecute defendant insofar as] Obus sold back some of the SunSource shares before the Allied deal was publicly announced."). *Obus* was decided under *Teicher*'s awareness standard. *See id.* at 285, 293.

B. COMPARING RESULTS

Each legal constraint will result in different decisions. Figure 11 displays a chart of the trader's decisions based on the standard applied.

Figure 11. Three Trading Behaviors

	I	II	III	IV	V	VI	VII	VIII
Naïve	Buy	Buy	Sell	Sell	Sell	Sell	Buy	Buy
Use	Buy	Buy	Abst.	Sell	Sell	Sell	Abst.	Buy
Aware	Abst.	Abst.	Abst.	Sell	Abst.	Abst.	Abst.	Buy

Traders subject to different trading rules also understandably enjoy different trading profits, though the precise result depends on whether the trader's lawful reasons are informational or idiosyncratic.

1. Idiosyncratic Traders

Figure 12 denotes the profitability of an idiosyncratic trader under each legal constraint, as explained at length below.

Figure 12. Idiosyncratic Trading Payoffs

	I	II	III	IV	V	VI	VII	VIII	Total
Naïve	$16	$24	-$24	-$16	-$6	-$4	$4	$6	$0
Use	$16	$24	0	-$16	-$6	-$4	0	$6	$20
Aware	0	0	0	-$16	0	0	0	$6	-$10

The naïve trader trades in every instance, sometimes profitably and sometimes not. She trades based on need, whim, expressive intent, and the like. Such reasons will often precede profitable changes in stock price (as in domains I and II), but on average the trader cannot outperform the market by trading in light of only the market's information. The net result is a wash. Her unlawful reasons go unconsidered so they do not alter the trading conduct.

The idiosyncratic use trader outperforms the naïve trader. She does so because she is able to trade profitably in domains I, II and VIII alongside the naïve trader, and she follows the naïve trader into error in domains IV, V, and VI. But she abstains in domain III, avoiding a substantial loss and improving her expected return. (she also abstains in domain VII, missing out on an unexpected gain).

The idiosyncratic awareness trader *underperforms* the naïve trader. She does so because she can only trade in two instances, but these two instances do not occur with equal frequency. Domain IV occurs quite often, making it a costlier error than the rather rare (but profitable) trade in domain VIII.[191]

Thus, neither the use test nor the awareness test match the naïve trader and neither satisfies the equal profits principle. One test unfairly and inefficiently allows the insider to profit, and the other penalizes them excessively.

2. Informed Traders

The payoffs are different if the trader's lawful reasons are informational, as shown by Figure 13.

Figure 13. Lawfully Informed Trade Payoffs

	I	II	III	IV	V	VI	VII	VIII	Total
Naïve	$32	$32	-$12	-$4	-$2	-$2	$4	$12	$60
Use	$32	$32	0	-$4	-$2	-$2	0	$12	$68
Aware	0	0	0	-$4	0	0	0	$12	$8

Though the naïve trader still trades in every instance, she tends to gain more than she loses. Her net return is a positive $60, reflecting the fact that an informed trader, who trades in accord with her useful information, will tend to profit. Eighty percent of the time she buys a rising stock (in domains I, II, VII and VIII). Twenty percent of the time (in domains III, IV, V, and VI) she sells it for a loss.

The informed use trader does better than the naïve trader, even though she trades in fewer instances. In domain III, the informed use trader abstains. She thereby avoids the losses suffered by the naïve trader in almost a quarter of the mixed motives cases. However, in domain VII she follows the counsel of her unlawful information to abstain. This ends up being a mistake, since the stock does appreciate, but it happens only rarely. The two abstentions only partially offset one another, leading to a modestly superior return compared to the naïve trader.

The informed awareness trader does very poorly. She only opts to trade in domains IV and VIII. In the former case, she heeds her erroneous lawful information to sell a rising stock. In the latter, she buys despite countervailing unlawful information, relying instead on her strong lawful optimistic research.

191. The awareness trader *will* enjoy equal profits to the naïve trader if assumptions are modified to ensure that VIII is just as likely as IV, rather than being less likely. But unless those outcomes are precisely matched in all cases, awareness will still disappoint in some cases.

As with the idiosyncratic trader who has no lawful information, the lawfully informed trader likewise fits poorly with both existing tests. Again, the use standard leaves her with more money than is optimal, and the awareness standard with less. Neither result is fully satisfactory.

3. Taking Stock

Neither test employed by courts satisfies the equal profits principle. The use test rewards traders for their possession of proscribed information and the awareness test penalizes them. This result is true regardless of the nature of the traders' lawful reason for action.

This diagnosis differs from Professor Fried's important analysis of these same issues.[192] He concluded that the awareness standard succeeds in equalizing the return of the insider and the naïve trader.[193] There are three explanations for Fried's differing conclusion.

First, he assumes traders always trade in accord with their unlawful information.[194] In other words, he assumes that traders would buy in domain IV rather than sell. While there is intuitive appeal to the idea that inside information will swamp other reasons for trading, such a notion amounts to denying the difficulty of mixed motive cases. Mixed motive trading means that traders have lawful motives that can sometimes matter. If they matter, they sometimes urge action even in the face of obstacles, such as countervailing inside information.

Second, Fried does not consider the nature of lawful reasons to differentiate between informed and idiosyncratic trading. His model assumes the trader is an executive, the sort of trader who is unlikely to have lawful information—what an executive knows about her company, she learned at work.[195] And for such a trader, the awareness standard comes close to being satisfactory. That is because idiosyncratic traders have no natural tendency to trade profitably, so it does them little harm when the law bars them from trading (as Fried's preferred standard forces them to do).[196] The cost to traders from forced abstention runs much higher if the trader has already invested in valuable, lawful information. The high cost of the awareness standard becomes more apparent when one considers lawfully informed traders, such as sophisticated investor Larry Ellison or an investment fund like Muddy Waters.[197] As Figure 13 showed, the awareness standard bars trading in the most profitable quartile of motives, a truly devastating loss. Such a

192. *See generally* Fried, *supra* note 21 (discussing insider information and its impact on the market).

193. *Id.* at 491–92.

194. *See id.* at 468 (describing a model in which trades are a function of only "two factors: (1) the nonpublic information, if any, CEO receives . . . and (2) the legal restrictions").

195. *Id.* (assuming an ABC executive who may trade ABC stock).

196. *Id.* at 457–58.

197. *See supra* notes 34–38, 132, 162–67 and accompanying text.

motive standard strongly discourages trading by those who can research lawful information if there is any risk of developing proscribed information too.

Third, Fried seems to take for granted that the solution must be one of the two standards already on the table. What else could courts select, anyway, if not use or awareness? It turns out there is a third option—which has the salutary effect of satisfying the equal profits principle when applied to idiosyncratic traders. It is to that third standard we now turn.

VI. A NEW TEST

The equal profits principle reveals both the use and awareness standards to be unacceptable. This Part introduces and defends a new test. Section VI.A introduces the new test. Section VI.B shows its substantial satisfaction of the equal profits principle. Section VI.C then attempts to reconcile the new test with the existing doctrinal and policy goals discussed in Part III to show that the results are acceptable even to partisans of particular approaches to insider trading law or the awareness/use debate. Section VI.D considers some strategic responses by traders and their information sources ("tippers") to show that they do not upset the conclusions.

A. THE PRIMARY MOTIVE TEST

The primary motive test is a test that permits an action undertaken with two motives so long as the lawful motive predominates; if the unlawful motive predominates then the act is unlawful.[198] Such a test has never been considered in securities law, but it is far from novel in the jurisprudence of mixed motives more broadly. Any comparative analysis would quickly discover this option, which is widespread in other domains. The test has been used for decades in numerous legal domains such as tax law,[199] constitutional law,[200]

198. The rule can be constructed with a tie going to the defendant or otherwise. Nothing in this analysis stipulates how to handle the rare case when two reasons are of precisely equal force. It can be constructed so that the prosecution or plaintiff bears the full burden of proof, or the test can be applied as an affirmative defense (practically putting the burden of proof onto the defendant) after the prosecutor has established mere awareness of the proscribed information. Again, this Article sets aside that important question; its analysis is compatible with either resolution.

199. *See* United States v. Generes, 405 U.S. 93, 103–04 (1972); *accord* B.B. Rider Corp. v. Comm'r, 725 F.2d 945, 948 (3d Cir. 1984) ("Mixed motives are not uncommon, and the critical question is which of the taxpayer's motives is dominant.").

200. Cook v. LaMarque, 593 F.3d 810, 815–16 (9th Cir. 2010) (jury selection); Miller v. Johnson, 515 U.S. 900, 916 (1995) (redistricting); McCreary County v. ACLU, 545 U.S. 844, 859–61 (2005) (establishment clause).

tort,[201] landlord/tenant,[202] property,[203] corporate law,[204] antitrust,[205] and bankruptcy.[206]

In the insider trading context, the test would permit a trader to buy a stock so long as she has a lawful motive for the action that is stronger or more compelling than her unlawful motive. This task is inherently comparative. It means that the same piece of material, non-public information might authorize trading by one trader and not another. It means that a single trader's right to trade on the basis of a morsel of proscribed information may change over time, as her lawful motives change.

Under this framework, an executive who has an urgent need for cash is permitted to sell a few shares even if she recently saw the company's slightly disappointing earnings, as can an investment fund that has devoted thousands of employee-hours to determining that the company is a fraud.[207] But a trader who has a vague desire to rebalance her portfolio should not buy security X for now, if she has corruptly procured information that it will be a tender offer target. Ultimately, the primary motive test involves balancing the interests at stake.

Let us consider what trading ultimately takes place under the primary motive test, analyzing it as we did the use and awareness tests. Figure 14 displays what decisions a trader would make under the primary motive test.

201. *See* RESTATEMENT (SECOND) OF TORTS § 668 & cmts. (AM. L. INST. 1977) (outlining the test for malicious prosecution in tort).

202. *E.g.*, MICH. COMP. LAWS ANN. § 600.5720(1)(a) (West 2020) (forbidding eviction "primarily as a penalty").

203. *See* Obolensky v. Trombley, 115 A.3d 1016, 1023–25 (Vt. 2015) (concerning the construction of a "spite-fence" to be used as punishment in a property boundary dispute).

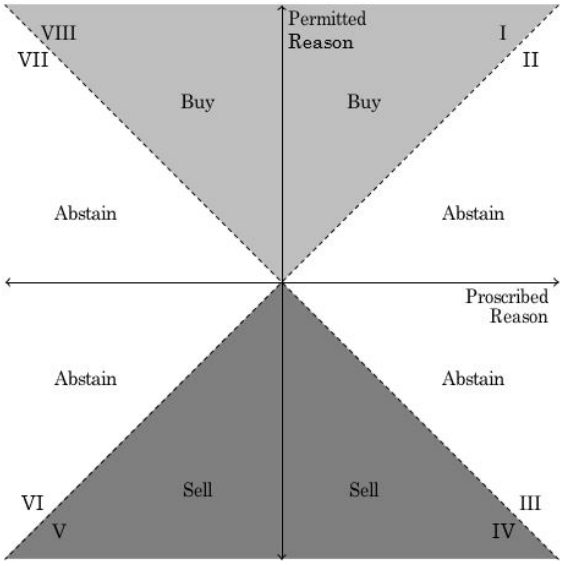
204. *See* Cheff v. Mathes, 199 A.2d 548, 554 (Del. 1964) (analyzing the primary motive test in a shareholder derivative suit, with the business judgment rule as a controlling consideration).

205. *E.g.*, NAACP v. Claiborne Hardware Co., 458 U.S. 886, 914 (1982) (using a primary purpose test in a boycott case).

206. *In re* Schneider, 417 B.R. 907, 915 (Bankr. N.D. Ill. 2009) ("If the primary motivation for the transfer is based on fraudulent intent, other motivations may be urged, but they are irrelevant.").

207. *See supra* notes 162–67 and accompanying text.

Figure 14. Primary Trading



As Figure 14 displays, the primary motive test constrains traders somewhat differently than the use and awareness tests. Unlike the use test, the primary motive test bars buying in domain II and selling in domain VI, where a trader's unlawful motive predominates over her lawful motive. Unlike the awareness test, the primary motive test permits buying in domains I and V, because lawful motive predominate there over unlawful ones. Under any of these tests, the trader can and will trade in domains IV and VIII, and the trader declines to trade in domains III and VII. The overall effect is moderate, leading to strictly less trading than the use test and strictly more trading than the awareness test.

Figure 15 summarizes the trades of the primary motive-constrained trader.

Figure 15. Primary Trading By Domain

	I	**II**	**III**	**IV**	**V**	**VI**	**VII**	**VIII**
Primary	Buy	Abst.	Abst.	Sell	Sell	Abst.	Abst.	Buy

With a firm grasp of how the test shapes behavior, we can turn next to how it shapes profits.

B. SATISFYING THE EQUAL PROFITS PRINCIPLE

This subpart shows that the primary motive test is an unqualified success in equalizing profits for the typical (idiosyncratic) insider trader, such as

corporate executives, and a qualified success in doing so for lawfully informed traders, such as research-heavy hedge funds.

As we did in Part III, we can extrapolate expected profits from a trader's likely trades under the primary motive test. Figure 16 then demonstrates the payoffs from those trades for both informed and idiosyncratic traders.

Figure 16. Trading Payoffs Under Primary Motive Test

	I	II	III	IV	V	VI	VII	VIII	Total
Idiosyncratic	$16	0	0	-$16	-$6	0	0	$6	$0
Informed	$32	0	0	-$4	-$2	0	0	$12	$38

As Figures 15 and 16 indicate, a trader subject to the primary motive test profitably buys in domain I because she has several reasons advising the purchase and the primary one is lawful. This trade is authorized in a way that the awareness test would have prohibited, and this accounts somewhat for her superior profits relative to trading under an awareness test, which prohibits such trading.

In domain II, the trader abstains. She does so because her two reasons both convince her that abstention beats selling, and because buying is prohibited. Buying is prohibited because her predominant motive is unlawful. Her inability to buy in this domain partially explains her lower profits relative to the use test, which permits such trading.

In domain III, the trader opts to abstain, because her primary (indeed, sole) reason for selling is unlawful, and buying is unattractive given how weak are her reasons for doing so. She lawfully avoids a loss, as she does on both the use and awareness tests.

The trader sells in domain IV, making a loss. She does so because her lawful reason to sell is more compelling than her unlawful reason to buy, and because the test does not preclude the trade. She likewise trades in domain V, making a loss, for the same reason.

In VI, the trader has ample reason to sell, but she settles for abstention. In retrospect, this will look like a wise decision, because it avoids a loss. The same is true in VII, where the trader would like to sell, but settles instead for abstention. Finally, in VIII, the trader buys profitably, despite inside information counseling a sale, on the basis of lawful information.

These results are best understood in comparison to the naïve trader baseline and the other two legal tests, as displayed by Figure 17.

Figure 17. Comparing the Rules

	Idiosyncratic	**Informed**
Naïve	$0	$60
Use	$20	$68
Aware	-$10	-$10
Primary	$0	$38

When lawful motives are idiosyncratic, the primary motive standard results in zero net profits, the same as the naïve trader. *The primary motive test therefore satisfies the equal profits principle, where no other legal test succeeds.* It is superior to both the "use" and "awareness" tests for the prototypical insider trading case, where a corporate insider or their tippee takes advantage of misappropriated information.

Regardless of the nature of the trader's lawful motives, the awareness test disappoints. For traders with and without lawfully acquired information, the awareness test results in negative profits. For the idiosyncratic trader, this undesirable result is contrasted to the full success of the primary motive test.

The diagnosis is more complex for lawfully informed traders, though the overall result is ultimately the same. The primary motive test and the awareness test both deliver negative profits relative to the naïve trader. Neither fully satisfies the equal profits principle. But the primary motive test dominates the awareness test by providing an incorrect profit level with the same sign but a lesser magnitude.[208] Essentially, the awareness test always makes the same mistakes as the primary motive test, but with worse results. One conclusion follows resoundingly: The awareness test—endorsed by the SEC, Second Circuit Court of Appeals, and many prominent scholars—should not be used.[209]

One reason for this result is that the primary motive test differs from the awareness test only when the benefits of the awareness test are small (domain V) and its costs are large (domain I). Both rules could cause the loss of valuable research, but the primary motive rule permits traders to still trade on valuable research if it is costly, significant, or important research. Only when the inside information predominates over the research does the primary motive test bar trading. That will still render some research useless, but the risk is lessened.

208. This result is robust against all plausible numerical assumptions. The awareness and primary motive tests have payoffs in all domains except for I and V. For the awareness test those two domains have payoffs of zero, because the trader does not trade. For the primary motive trader, the domains have a positive expected value as long as gains from I exceed losses from V. That is assured as long as proscribed information is *at all* correlated with future stock prices.

209. *See supra* Sections II.B, II.E.

The primary motive rule does not strictly dominate the use rule because neither is perfect and qualitatively different: One promises too much profit to informed traders and the other promises too little. When two rules differ but neither is wholly better, reasonable minds may differ on the right rule. Nevertheless, the balance of reasons supports the primary motive rule.

First, if positive profits for proscribed information remain, the system continues to encourage and reward traders to seek out proscribed information. Traders with a lawful motive can use it as a shield to go look for otherwise unlawful tips. A negative profits rule also distorts incentives, but the magnitude is probably not symmetric. If the law leaves a profitable opportunity available, traders will mobilize to maximally appropriate it —there could be entire hedge funds specialized in laundering proscribed information through the appropriate mixture of lawful motives.

The downside of a less-than-equal profits principle is that otherwise law-abiding citizens, some of whom want to pursue lawful research, will face challenges. But this downside can be mitigated in many cases by 10b5-1(c) trading plans.[210] These plans constitute an SEC-sanctioned affirmative defense to mixed motive traders who document a written trading plan, entered into in good faith, and at the time lack material, non-public information.[211] The availability of this option gives some traders with negative expected profits a way to opt into a different legal treatment in which their expected profits may be higher: At the time they have lawful reasons for action, they can lock in their trading plans, which they can still undertake if they later discover proscribed information, thus offsetting expected losses from abstention. The solution is not perfect, since traders surrender their discretion under such plans. They lose their ability to respond to changing needs and new lawful information. But the availability of 10b5-1 permits a pressure valve that reduces the costs of a negative profits rule.[212]

A third principle militating in favor of the primary motive test is its success in addressing the idiosyncratic traders, noted above.[213] It is likely that the majority of insider trading cases are idiosyncratic traders, given that all corporate fiduciaries have access to proscribed information, but lawful

210. 17 C.F.R. § 240.10b5-1(c) (2020). It is an interesting question to ask what motive rule should apply to the creation of such a plan. Must the trader be free of all proscribed information, as is typically assumed? Or is should a trader be permitted to implement a trading plan when in possession of proscribed information, so long as it is not primary? The better argument is probably for the more constraining rule, permitting the plan only when the insider lacks any proscribed information. The alternative risks excessively strategic exploitation. But making that case requires a through explanation of how 17 C.F.R. § 240.10b5-1(c) plans work and fail, which is beyond the scope of this Article.

211. *Id.*

212. *Cf.* John P. Anderson, *Undoing a Deal with the Devil: Some Challenges for Congress's Proposed Reform of Insider Trading Plans*, 13 VA. L. & BUS. REV. 303, 304–06 (2019) (explaining the requirements and effects of the Rule 10b5-1(c) Trading Plan and affirmative defenses legislation).

213. *See supra* Section V.B.1.

informational advantages are rare and are not inherently paired with proscribed information. The idiosyncratic trader is plainly the focus of nearly all scholarly analysis on this topic. The primary motive test's success in resolving those many cases helps compensate for its merely satisfactory performance in the case of informed mixed motive traders; the use test has no such compensation.[214] The primary motive standard therefore provides a better foundation.[215]

Although the use test appears to differ by a smaller number from the ideal ($8 above instead of $22 below), it would be unwise to prefer it on this basis. The precise numerical outputs are sensitive to assumptions about hard-to-verify facts. The use test deviates by more than $8 if we assume a stronger correlation between proscribed information and future stock price.[216] The primary motive test differs by less than $22 if we assume a weaker correlation between lawful information and future stock price.[217]

No rule fully satisfies the equal profits principle, and their flaws are not fully commensurate, but the primary motive test's sometimes-negative profits seem preferable to the use test's always-positive profits.

C. ACCEPTABILITY OF THE PRIMARY MOTIVE TEST

The primary motive test has so far been derived from background policy considerations, but it is also compatible with the doctrinal considerations

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214. It is possible to consider a compound rule, in which the primary motive standard would be used when traders lack lawful information and the use test would be deployed when they have lawful information. There is no principled problem with a compound test apart from its complexity and that it might lead defendants to characterize their reasons as informational to take advantage of a more protective test.

Another alternative rule would involve a continuous liability regime. For example, a trader with two equally strong motives would be liable for half of her trading profits, one with much stronger unlawful motives would owe 90 percent of her trading profits. Continuous rules move the difficulty of a factfinder weighing motives from the liability stage to the damages stage. They do less to chill defendant conduct near the borderline. *See generally* Saul Levmore, *Probabilistic Disclosures for Corporate and Other Law*, THEORETICAL INQUIRES IN L. (2019) (discussing the usefulness of continuous disclosure, even when the law shies away from it). Whether a continuous liability rule would be better is an interesting question, but it is beyond the scope of this paper, which takes for granted the law's current commitment to discontinuous liability.

215. Someone who places an extremely high value on encouraging lawful research, such that any negative profits are unacceptable, may still prefer the use test.

216. The naïve trader and the use trader differ only in their payoffs from domain III (where the naïve trader suffers a loss that the use trader avoids) and domain VII (where the naïve trader enjoys a gain the use trader misses). The use trader's superior returns grow if domain III becomes more common or domain VII becomes less common—both of which occur if proscribed information becomes more reliable.

217. The naïve trader and the primary motive trade differ only in domains II and VII (where the naïve trader profits) and domains II and VI (where the naïve trader loses). Therefore, the primary motive trader's inferior performance gets closer to equality if domains II or VII become less common, or if domains III or VI become more common—each of which occur if lawful information becomes less reliable.

most important to lawyers and jurists actually handling these cases. It is broadly consistent with existing legal authority, it fits various doctrinal formulations, it imposes only workable and fair practical burdens on the parties, and it is consistent with familiar fiduciary principles. The underlying reason the primary motive test is so compatible with doctrinal considerations is because of its ability to balance, something that sets it apart from the use and awareness tests.

1. Authority

Although novel, the primary motive rule is not entirely without support in existing doctrine. Many courts have used vague language in describing their reasoning or holding, which is not easily squared with either the awareness or use standard, but which can be read as a precursor to the primary motive standard.

For example, although the SEC has long championed an awareness standard,[218] its first statements advocating for that standard included language that could support a primary motive test. In that case, the majority of the Commission held that the proscribed information must be a factor in the investment decision of the defendant,[219] and the concurring opinion called it "[a] motivating factor, and not just a factor, in the decision to effect the transaction."[220] Whether something is a factor suggests more than mere awareness, but less than but-for causation. Whether something is a motivating factor likewise demands more than mere awareness, and requires consideration of what other factors were in play. Arguably, only the primary factor among many factors is the motivating factor.

United States v. Smith, the patron saint of the use test, itself deviated from the language of use: "It is enough if the government proves that such inside information was a significant factor in [the] defendant's decision to sell or sell short PDA stock."[221] Information can be significant even if it is not used, and vice versa. By contrast, whether information is "significant" is arguably a comparative exercise: Information is significant in part if it is important relative to other information. A comparative exercise is the heart of a primary motive test.

In other areas of law, courts have explicitly equated such language with a primary motive test. For example, courts conducting *Batson* hearings in the Ninth Circuit use a primary motive test when deciding whether race has

218. *See supra* Section II.E.

219. *In re* Invs. Mgmt. Co., Release No. 9267, 44 SEC Docket 633, 646 (July 17, 1971).

220. *Id.* at 650 (Smith, Comm'r, concurring).

221. United States v. Smith, 155 F.3d 1051, 1066 (9th Cir. 1998); SEC v. Adler, 137 F.3d 1325, 1337 (11th Cir. 1998) (adopting the "use test"); *accord* United States v. Anderson, 533 F.3d 623, 630 (8th Cir. 2008) (quoting *Smith*, 155 F.3d at 1070 n.28); United States v. Heron, 525 F. Supp. 2d 729, 748 (E.D. Pa. 2007) (endorsing "significant" factor test), *rev'd on other grounds*, 323 F. App'x 150 (3d Cir. 2009).

played an unlawful role in jury selection, and they refer to the test as a "substantial factor" test.[222] It is not unreasonable that *Smith*'s language could be construed to allow for the superior primary motive test.

Indeed, several scholars have (perhaps inadvertently) characterized *Smith* as a primary motive test, suggesting some compatibility of the new test with the existing doctrine. For example, Bromberg and Lowenfels characterized *Smith*'s use test when they stated:

> By approving the trial court's instruction that the MNPI [material, non-public information] need not be the sole cause of the trade, the appeal court leaves ample room for defendant's evidence that reasons other than the MNPI were the dominant cause of the trade. Thus the fact finder must decide whether the MNPI was a significant cause; if not, there is no violation.[223]

Paraphrasing *Smith* as a "dominant" cause test clearly prefigures a primary motive test since dominant and primary are near synonyms. Likewise, discussion of "significant" causes suggests a need for comparison of relative importance. Bromberg and Lowenfels go on to make an inherently comparative summary of *Smith*'s use rule: "If the MNPI was significant but other reasons were more significant, there is no violation."[224]

The point is not that the primary motive test is in fact the rule from *Smith*, *Teicher*, or *Adler*; rather, the point is that there is sufficient room in the doctrine for a court to locate a primary motive test without flouting compelling authorities.

2. Doctrinal Structure

Whether we conceive of mixed motives as a matter of scienter or "in connection with," either element is compatible with a primary motive standard. The "in connection with" element is capacious and compatible with a variety of motive structures.[225] Many areas of law recognize mens rea as satisfied when a primary motive has been established.[226] Primary motive stands on no worse footing than the existing rules in terms of conformity with doctrinal structure.

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222. Cook v. LaMarque, 593 F.3d 810, 815 (9th Cir. 2010); *see also* Verstein, *Mixed Motives*, *supra* note 25, at 1149–50 (referencing how *Cook v. LaMarque* "laid out a 'substantial part' standard for *Batson* challenges").

223. BROMBERG ET AL., *supra* note 50, § 6:258, at 6-723.

224. *Id.*

225. *See* SEC v. Zandford, 535 U.S. 813, 825 (2002) (requiring only that the transactions and breach of duty "coincide").

226. *See, e.g.*, RESTATEMENT (SECOND) OF TORTS § 668 & cmt. c (AM. L. INST. 1977) (malicious prosecution); NAACP v. Claiborne Hardware Co., 458 U.S. 886, 914 (1982) (using a primary purpose test in a boycott case).

3. Burden of Proof

A primary motive standard causes both plaintiff and defendant to share the potential challenges of proof.[227] The defendant prevails if the government does not produce a plausible illegal motive sufficient to overcome proffered lawful motives, but the government is not compelled to root out and discredit every hint of lawful motive.[228] This distribution of burden seems to comport with notions of fair play, as evidenced by its widespread use for decades in numerous other areas of law where the stakes are no lower.[229]

The primary motive test requires a fact finder to compare the strengths of motives. This may seem difficult, but it relieves the factfinder of a comparably difficult task required by the use standard: predicting, counterfactually, how a trader would have traded had they not received the proscribed information. That prediction is required under the use test to determine if the information was used. Such predictive reasoning is not easy to do—it requires assessing how compelling the lawful motives were, and the trader's own trading tendencies.

By contrast, the primary motive standard is a comparative exercise: The jury must figure out whether one of these reasons loomed larger for the defendant than the other. A comparative exercise is strictly easier than a counterfactual exercise. First, comparison is amenable to multiple forms of proof. For example, the jury might be shown that the defendant sent a flurry of emails focused on one motive, but no emails supporting the latter motive. This would be powerful proof under a primary motive test, but it is not powerful proof under a use standard because a motive could be a sufficient reason for action even if it is not firmly documented and did not occupy much discussion at the time.

Whenever counterfactual reasoning (as in the use test) is easier for juries to perform than comparative reasoning, it is possible to concert the comparative exercise into a counterfactual exercise. The jury can be instructed to imagine that the stated unlawful information was the opposite of the information that was actually acquired. If the information is that a tender offer is being planned, the jury should imagine that an announced

227. Nothing in the model presented stipulates who should formally bear the burden of proving motive predominance. Rule of law norms may suggest that the prosecution to bear this burden in at least criminal cases. Or perhaps it is acceptable to structure the test as an awareness standard with an affirmative defense of primary motive available to the defendant, which functionally shifts the burden to the defendant. The former seems more appropriate given that the primary motive test tends to press negative profits onto lawfully informed traders—the government bearing the burden would partially compensate for this loss.

228. The test can be modified further without losing its integrity if it deemed unacceptably challenging for the government to even establish predominance. Instead, the government's burden could be to establish mere awareness (or knowing possession), whereupon the defendant can offer an affirmative defense of primarily lawful motives.

229. *See supra* notes 199–206 and accompanying text.

tender offer is being cancelled; if the information is that earnings will be higher than expected, the jury should imagine that the earnings were lower than expected. And then the jury must ask whether—under this counterfactual—the defendant would still have traded. The jury will find that the trade would still have occurred if the lawful motive was stronger than the unlawful motive; otherwise, the inverted unlawful information would have successfully discouraged the trade. Doing so restructures a comparative exercise into a counterfactual akin to a use test, but it preserves the logic of comparison. Because a primary motive test can be converted to a use test when and only when a use test is more workable, a primary motive test is always as workable as the use test.

Under any test, the defendant can generate a pretextual reason, or the government can insist upon a bad motive that isn't there, but the primary motive standard tends to make both errors harder because the credibility and strength of the fictitious motive must grow with the potency of the real motive.

Consider first the risk of pretextual false-negatives, in which the trader lies to justify a suspicious trade. The primary motive test makes this lie harder precisely when it really counts, when one really wants to insider trade. For example, ImClone learned in late 2001 that its bet-the-company drug would be rejected by the FDA.[230] We know now that the stock price would drop 90 percent once this news was fully digested by the public.[231] Prior to the disclosure, though, Marth Stewart sold her shares after being tipped off. Stewart offered a mixed motive defense, claiming that she had long planned to sell out if the shares dipped below $60.[232] This reason was likely pretextual, but a use test would have let Stewart draw out her case and potentially win; her pretext need not be plausible compared to something else—it simply needs to be adequate, viewed in isolation, to justify her trade. And who is to say that limiting her losses after a two percent decline is an inadequate reason for action? The use standard exonerates whenever the trader had *any* sufficient lawful reason to trade: The same barely-sufficient motive will serve to exonerate a small insider trade and a gigantic heist.[233]

230. Constance L. Hays & Patrick McGeehan, *A Closer Look at Martha Stewart's Trades*, N.Y. TIMES (July 15, 2002), https://www.nytimes.com/2002/07/15/business/a-closer-look-at-martha-stewart-s-trades.html [https://perma.cc/3NQ2-G6W2].

231. Reuters, *The Rise and Fall of ImClone Systems*, FOX NEWS (Jan. 13, 2015), https://www.foxnews.com/story/the-rise-and-fall-of-imclone-systems [https://perma.cc/D6FZ-6DP5] (describing the decline in price from $75.45 to $6.55).

232. United States v. Stewart, 305 F. Supp. 2d 368, 370–71 (S.D.N.Y. 2004). Martha Stewart was not convicted of insider trading and it is not clear that she would have been; she may not have breached any duty in trading. However, for the purposes of the example, I assume that she would have violated the law if she had used the tip.

233. The fact that the primary motive test is harder on liars than the use standard does not suggest that it violates norms of fair play by shifting too much difficulty to defendants. For defendants who actually have a lawful motive for action, the burden of showing it is not greater

By contrast, on the primary motive test, Stewart would have had no serious chance of success. She would have to show a more compelling reason to trade than the impending 90 percent drop in value, which is hard to fictitiously invent on the fly; her vague desire to sell if the stock dipped by two percent probably wouldn't cut it. It is harder to fabricate big pretextual lawful reasons than small pretextual lawful reasons, so the primary motive test makes pretextual defenses weaker.[234]

The primary motive test is also robust against false-positives, which are convictions despite the genuine absence of bad motives. When a trader has an urgent lawful reason to trade, she finds it easier to prevail on a primary motive test over the government's alleged bad motive. For example, investigators of Luckin Coffee built an investment thesis over many months, with dozens of employees employing lawful research techniques.[235] These efforts serve ballast for short sellers, such as Muddy Waters, against any implication of impropriety.[236]

It is challenging to craft rules that are both practical and fair, but the primary motive test does well at both by responsively incorporating the proofs that seem most important.

4. Fiduciary Principles

According to *Adler*, a mixed motive rule that reflects fiduciary principles should turn in part on whether the agent enriches itself by virtue of its conduct.[237] *Adler* rejected the awareness standard because the court reasoned that a trader does not enrich itself by trading while merely knowing the principal's information if the trader does not use it.[238]

Whatever the ultimate merits of *Adler*'s fiduciary focus, it is applied too narrowly. An agent who does not profit by knowing the principal's information *in a particular trade* may still obtain improper benefits over the course of a series of trades. The proper fiduciary principle would seek to systematically reduce to zero any secret gains obtained by the agent, rather than myopically focusing on particular transactions. The equal profits

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for large motives than small ones. If anything, those with strong lawful reasons will find it easier to demonstrate their rationales than those with middling lawful reasons.

234. *See* Verstein, *Mixed Motives*, *supra* note 25, at 1134–36. It is for this reason that sage scholars of tax law urged its use in that domain. *See generally* Blum, *supra* note 10 (advocating for the primary motive test under its "primary purpose" name).

235. *See supra* notes 162–67 and accompanying text.

236. Strictly speaking, the use test provides better protection to traders, though the difference is likely small. Traders will still try to show that their lawful motives were primary even if non-primary motives could operate as a defense. Both the use and primary motive test stand leagues better than the awareness test in protecting genuine lawfully motived trading.

237. SEC v. Adler, 137 F.3d 1325, 1333–34, 1338 (11th Cir. 1998); *accord* Dirks v. SEC, 463 U.S. 646, 662 (1983) ("Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.").

238. *See Adler*, 137 F.3d at 1338–39.

principle comports with fiduciary principles by eliminating secret profits to agents, and the test that comes out of that principle—the primary motive test—stands on good fiduciary grounds as a result.

5. The Underlying Strength of the Primary Motive Test

At a high level, the *use* and the *awareness* test both embody important insights, while being blinkered to others. The *use* test properly recognizes that traders like Muddy Waters and Larry Ellison have legitimate interests in trading, and that it would be bad to disable them if tainted with a single spore of proscribed information.[239] But the use test goes too far in imposing *no* duties at all on a trader who has a minimal lawful motive. It plainly should matter that Martha Stewart was smuggled a game-changing head start about ImClone's stock (even if she really would have sold her shares based on a two percent decline in value).[240] Or, to take another example, Senator Richard Burr of North Carolina unloaded between $628,000 and $1.72 million worth of stock after learning in confidential Intelligence Committee briefings that the COVID-19 pandemic was likely to be much worse than widely believed.[241] Burr asserts that he would have sold anyway, on the basis of cable news coverage suggesting the Coronavirus could be quite harmful.[242] The use test would absolve Burr, but that goes too far. Being a Senator who swims in national secrets can legitimately impose *some* limits on one's day-trading. The awareness test is blinkered the other way: Intent upon stopping Stewart or Burr, the awareness test goes too far and endangers Larry Ellison and Muddy Waters.

Both the use and awareness tests fail because they both single out a single interest—the government's or the trader's—without any regard to the other. The primary motive test excels because it is a true balancing test, designed to account for both of the legitimate interests at stake. Its openness to the relevant facts is why it scores so well in terms of doctrinal and policy considerations. Of course, its openness might also leave it subject to opportunistic gaming, a subject we turn to next.

D. STRATEGIC DISCLOSURES

The model vindicating the primary motive test assumes that information is distributed randomly (either with or without a bias) and that traders prohibited from trading cannot somehow restore their trading rights. This

239. *See supra* notes 34–38, 132, 159–68 and accompanying text.

240. *See infra* Section VI.C.3.

241. Eric Lipton, Nicholas Fandos, Sharon LaFraniere & Julian E. Barnes, *Stock Sales by Senator Richard Burr Ignite Political Uproar*, N.Y. TIMES (Mar. 21, 2020), https://www.nytimes.com/2020/03/20/us/politics/coronavirus-richard-burr-insider-trading.html [https://perma.cc/FK3M-B68T].

242. *See* Richard Burr (@SenatorBurr), TWITTER (Mar. 20, 2020, 9:28 AM), https://twitter.com/SenatorBurr/status/1241008837479542786.

Section considers strategies by which information might be non-randomly distributed, for example an ally feeding the trader only secrets that improve their trading rights, or a barred trader restoring her trading rights through disclosure. The goal of this inquiry is to see whether the primary motive test remains the best test in the face of strategic responses. As this Section displays, it does.[243]

1. By a Friendly Tipper

The information an insider obtains will not be random if her tipper curates the secrets conveyed. Withholding information in cases where it is problematic could alter the payoffs to the various rules. A trader subject to the primary motive test is forbidden from trading in domain II because the trader's primary reason to trade is unlawful. If a friendly tipper withheld the illicit information in such a case, the trader would have only a single, lawful reason for action and could profitably trade in domain II. The primary motive test would then fail the equal profits principle for idiosyncratic traders.

The importance of this possibility is probably not great. First, aggressive use of friendly tipping causes the expected profit of all three candidate standards (primary, use, and awareness) to converge.[244] The primary motive standard's relative virtues—being close to equal profits and erring on the side of too little profit—remain all the way up to that limit, and it never becomes worse than the other tests. In short, strategic tipping at most dampens the benefits of the primary motive test without ever eliminating them.

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243. This Section does not discuss the most obvious strategic option for traders: setting up a number of 10b5-1(c) trading plans, and then opportunistically cancelling them whenever inside information reveals that abstaining is more profitable. The SEC has stated that canceling a plan while in possession with material, non-public information does not violate the law. *Exchange Act Rules: Questions and Answers of General Applicability*, SEC (Mar. 31, 2020), https://www.sec.gov/divisions/corpfin/guidance/exchangeactrules-interps.htm [https://perma.cc/96CU-QTAB]. This Article does not address this tactic because the tactic is usable regardless of the trader's motive rule and nothing in this Article makes the problem worse. Whether this tactic should be prevented, and how, is beyond the scope of this Article.

244. For idiosyncratic primary motive traders, adding profits to domain II would raise profits by $24 (to $24 in total). Because the tipper cannot see the future, she would also withhold tips that would push the trader from domain V to domain VI. That change allows the trader to trade and make a $4 loss. So the expected gain rises to $20. That is the same value as the use standard. For informed trading, the introduction of domains II and VI adds $32 and -$2 respectively. That pushes the expected return from $38 to $68.

For idiosyncratic awareness traders, idiosyncratic returns begin as -$10. Strategic tipping could preserve the trader's trades in domains I ($16), II ($24), V (-$6), and VI (-$4) for a total increase of $30. The expected gain therefore rises to $20. For informed awareness traders, expected profits begin as $8. Strategic tipping preserves trading in domains I ($32), II ($32), V (-$2), and VI (-$2). That adds $60 to arrive at $68.

Those values ($20 for idiosyncratic and $68 for informed) are the same returns a trader obtains under the use standard, with or without strategic tipping (since the strategic tipper cannot withhold tips to improve the use trader's returns).

Second, this strategy requires the friendly tipper to be able to anticipate the strength and magnitude of the trader's existing lawful motive for action. Without this information, the tipper does not know whether to withhold a tip that might otherwise help the trader to avoid a costly loss. It will often be unrealistic for a tipper to plumb the level of the trader's lawful interest in the trade. The tipper could ask prior to disclosure, but such a conversation may be incriminating if discovered by prosecutors. Nor is a trader likely to answer candidly if the trader's lawful reason for trading is lawful information, because disclosing the reason tempts betrayal: A tipper who knows the nature of the tippee-trader's reason for trading might go ahead and trade on the basis of that information. A faux tipper could use offers of strategic tipping as a means to extract trading plans from the trader, who would accordingly relate to such offers with skepticism.

2. By the Trader

It may appear that the trader can simply disclose proscribed information she has discovered in order to regain her right to trade.[245] This may seem to alter the analysis above in both the primary motive test (domains II and VI) and the awareness test (domains I, II, III, IV), by converting forced abstentions into permitted purchases. It may be taken to cause the primary motive test to fail the equal profits principle, by generating profits in domain II for the idiosyncratic trader under the primary motive test, or it may be taken to redeem the awareness test for the informed trader by generating gains sufficient to offset its losses.

There are several reasons to reject this reasoning. First, by disclosing the inside information, the trader will cause the price of the security to change (here, rise) prior to her purchase. The trader will still enjoy zero or low gains in those domains because their purchase will be at the post-appreciation price. Disclosing the information is not really an alternative to abstention, since "abstention" really is "abstention until information comes to light." Disclosure is just the decision to bring the information to light.

Moreover, disclosure carries legal risks, too. Fiduciaries, such as executives, are not at liberty to just disclose their company's secrets.[246] The same is true of outsiders who have assumed a duty of confidentiality. Moreover, if the information turns out to be false, or if the disclosing trader does not publicize it with perfect accuracy, the trader might herself be accused of making an actionable misstatement.[247]

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245. The trader could disclose in a recognized public forum, such as a newspaper like the *Wall Street Journal*, or through some regulatory filing. For example, the SEC requires anyone making a tender offer to file a Schedule TO containing numerous disclosures. 17 C.F.R. § 240.14d-3 (2020) (requiring tender offeror to file Schedule TO); Schedule TO, 17 C.F.R. § 240.14d-100.

246. *See* s*upra* note 30.

247. *See* 17 C.F.R. § 240.10b-5 ("It shall be unlawful . . . [t]o make any untrue statement of a material fact . . . in connection with the purchase or sale of any security.").

Even if the law allowed the trader to disclose, doing so will still leave her worse off than if she had never learned the proscribed information. The choice to disclose reveals information about the disclosing trader: To opt for disclosure, the trader suggests that she has found a trading opportunity with respect to this stock apart from the one disclosed. Otherwise, why would she disclose rather than abstain? If she discloses the proscribed information, she also hints at remaining undisclosed information.

For example, a would-be acquirer might obtain proscribed earnings information.[248] If she discloses those earnings to the world, it will signal that she wishes to buy the company, and had that wish apart from the now-disclosed earnings. This will lead other traders to draw inferences or engage in additional research. Does the trader know that one of the company's drugs has been approved or a lawsuit settled? Careful observers (like competitors and arbitragers) will read the tea leaves. They may not know exactly what motivates the trader to disclose, but they will sometimes be able to make inferences. If Muddy Waters discloses that it was given information about an upcoming stock offering, it will be easy to infer that it has independent reasons to sell its stock.

Even if it is difficult to determine from the context what direction the trader's own prior trading interest is, other traders will react to the signal that there is an informed trader about to act. Some traders may engage in further research about the security, knowing now that there is some useful information to be discovered. Market-makers may simply become cautious, widening bid-ask spreads. Regardless, prophylactic disclosure still signals interest and implies information.

To be sure, an idiosyncratic trader does not have any lawful informational advantage. However, third parties do not know the trader's private information and the chance that she might have information will cause the reactions just mentioned, along with the negative consequences for the trader. She bears the cost of being a revealed informed trader even though she is not one.[249]

VII. CONCLUSION

This Article argued that the existing literature on mixed motives insider trading followed the wrong reasoning to the wrong conclusions. Most of the commentary is too deeply internal to insider trading doctrine to give clear and policy-justified solutions. The little scholarship that overcomes that

248. On the downsides of learning inside information, see generally Verstein, *Strategic Tipping*, *supra* note 131.

249. A large idiosyncratic trader, such as a short-seller who is buying to cover her position, might be subject to front-running and exploitation even though she is technically an idiosyncratic trader. Third parties who observe disclosures can infer that the discloser had some reason to want to regain their trading rights and can quickly buy shares with the plan of reselling them to the trader at a profit.

problem faces the different problem of not taking seriously enough the fact that mixed motives traders have more than one motive. In particular, the existing literature treats all lawful reasons alike and treats each as basically inconsequential.

Taking mixed motives seriously means considering whether the right answer to the debate might lie outside of securities law, elsewhere in the jurisprudence of mixed motives. The best legal rule may not be "awareness" or "use," but instead the primary motive test used in many substantive areas of law. The primary motive test has a salutary balancing feature that affords traders a measure of freedom while respecting the law's goals.