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"Getting the Word Out About Fraud: A Theoretical Analysis of Whistle-blowing and Insider Trading"

Jonathan Macey

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Jonathan Macey*

Abstract

The purpose of this Article is to show that insider trading on the basis of certain kinds of negative information is the analytic and functional equivalent to whistleblowing. Both practices are desirable responses to corporate pathologies such as fraud and corruption, and both are generally motivated by the self-interest of the actors. In light of this analysis, it is peculiar that whistleblowing is encouraged and protected, while insider trading on precisely the same information is not only discouraged but criminalized. Whistle-blowing and insider trading on negative information are different from blackmail, which is another activity that is sometimes motivated by information about a third party's illicit conduct. While both whistleblowing and insider trading on "whistleblower information" should be encouraged, blackmail should be prohibited because it impedes rather than facilitates the discovery of fraud and corruption. Finally, despite the theoretical similarities between insider trading and whistleblowing, there are some important practical differences in the way that whistleblowing and insider trading affect markets, indicating that these activities are complements rather than substitutes in the fight against fraud and corruption.

Introduction

Over the past five years, it appears that whistleblowers have become fashionable. Whistleblowers, who traditionally have been considered tattletales and otherwise viewed with suspicion,[1] have recently enjoyed a distinct rise in popularity. As Slate magazine observed not long ago:

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[1] In the past whistleblowing was viewed as radical and vaguely subversive, if not down-right disloyal and unpatriotic. See, e.g., Gerald Vinten, (ed.). Whistleblowing-Subversion or Corporate Citizenship? (1994); Joyce Rothschild, , and Terance D. Miethe. (1994). ''Whistleblowing as Resistance in Modern Work Organizations: The Politics of Revealing Organizational Deception and Abuse,'' in John M. Jermier, David Knights, and Walter R. Nord (eds.), Resistance and Power in Organizations. London: Routledge, pp. 252–273.Frederick A. Elliston, John Keenan, Paula Lockhart, and Jane van Schaick. Whistleblowing: Managing Dissent in the Workplace (1985); Frederick A. Elliston, ''Civil Disobedience and Whistleblowing: A Comparative Appraisal of Two Forms of Dissent.'' Journal of Business Ethics 1, 23–28 (1982); David W. Ewing, Freedom Inside the Organization: Bringing Civil Liberties to the Workplace (1977); Brian Martin, ''Whistleblowing and Nonviolence.'' 24 Peace & Change 15, 15–28. Martin, Brian. (1999).

> In recent years, aided in part by movies like "The Insider," whistleblowers have attained the status of folk heroes. "It's become popular to protect whistleblowers—that's never happened before," says Danielle Brian, executive director of the Project on Government Oversight, a nonprofit public interest group dedicated to exposing governmental corruption and mismanagement that works closely with whistleblowers and that advocates for them. [2]

Time magazine dubbed 2002 "The Year of the Whistleblower," honoring "inside do-gooders who risked their careers"[3] by exposing, among other things, how the FBI let a key terrorism suspect slip through its fingers before the terrorist attacks of September 11, 2001 and how Enron misled investors through phony accounting treatment of off-balance sheet transactions. There is even a "National Whistleblower Center," a non-profit group dedicated to helping whistleblowers in their efforts "to improve environmental protection, nuclear safety, and government and corporate accountability."[4]

Whistleblowers are now thought of as an integral component of the recently re-regulated system of corporate governance that is supposed to result in better monitoring and control of managerial misconduct (agency costs) in large publicly-held corporations.[5] Tip-offs from insiders have been described as "by far the most common method of detecting fraud."[6]

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[2] By Eric Boehlert, The betrayal of the whistleblowers, Salon.com, October 21, 2003.
[3] Id.
[4] National Whistleblower Center website. The primary goal of the Center is to ensure that disclosures about government or industry actions that violate the law or harm the environment are fully heard, and that the whistleblowers who risk their careers to expose wrongdoing are defended. The Center's mission is to strengthen the rights of whistleblowers and to help make their underlying claims.
[5] The centerpiece of the new corporate governance regime is the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 2002 U.S.C.C.A.N. (116 Stat.) 745 to be codified in scattered sections 15 and 18 U.S.C.). This bill contains significant protections for private-sector whistle-blowers, discussed infra TAN XX-XX. Upon signing the bill into law, President George W. Bush observed that "today I sign the most far reaching reforms of American business practices since the time of Franklin Roosevelt. The law says to every dishonest corporate leader: You will be exposed and punished; the era of low standards and false profits is over; no boardroom in America is above the law." Remarks on Signing the Sarbanes-Oxley Act of 2002, 38 Weekly Comp. Pres. Doc. 1283, 1284 (July 20, 2002).
[6] Sarbanes-Oxley, A price worth paying? May 19th 2005, The Economist.com

It is still probably the case that whistleblowing is "a form of organizational dissent,"[7] although the recent positive publicity for whistleblowers suggests that whistleblowing is now viewed with less suspicion, and whistleblowers as less politically motivated and more altruistic than was the case in the past.

The purpose of this Article is to suggest that one particular kind of insider trading—namely insider trading on the basis of information about corporate corruption, corporate fraud or other illegal corporate conduct—and whistleblowing are analytically and functionally indistinguishable as responses to corporate pathologies such as fraud and corruption. This, in turn, explains why whistleblowers are sometimes viewed with suspicion and distrust, rather than with veneration, by not only their colleagues but also by regulators and journalists.

When giant businesses like Enron, Adelphia, or WorldCom are brought to their knees by whistleblowers, innocent people are harmed. The innocent employees, small suppliers, local communities, and philanthropic organizations that depended on these firms suffer as much, if not more, than the firm's largely diversified investor base, and these groups single out the whistleblower as the source of their trouble. Revelations by whistleblowers can be embarrassing to regulators, prosecutors, and others who are supposed to be alert for fraudulent corporate activity.

Conversely, it also is the case that inside traders sometimes have fared surprisingly well in the courts. In particular, in cases where insider trading leads to the same revelations about insipient fraud as whistleblowing would, courts can be remarkably accepting of such trading.

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[7] Brian Martin and Will Rifkin, The Dynamics of Employee Dissent: Whistleblowers and Organizational Jiu-Jitsu, 4 Public Organization Review, 221, 221–238 (2004).

In this Article I advance the theory that both whistleblowing and insider trading are best analyzed as involving rights in the same inchoate intellectual property: valuable information. The issue of whether one has the right to blow the whistle on somebody else, and the issue of whether one has the right to trade on the basis of non-public information ultimately depends on whether the person engaging in the conduct has a rightful property interest in the information he or she is using. If so, then the conduct, whether it is characterized as whistleblowing or as insider trading, should be not only legally-permissible, but affirmatively encouraged. By contrast, in situations where the person doing the trading or the whistleblowing has no legitimate property interest in the information because somebody else has a right to keep the information confidential and/or to use the information as they see fit, the behavior should be illegal.

This Article begins with a definition of whistleblowing and a history of the government's efforts to encourage the practice. Part I also includes an analysis of perhaps the most famous case of whistleblowing: Sherron Watkins and Enron. Part II compares insider trading and whistleblowing. This comparison explains the traditional antipathy and suspicion toward whistleblowers. In Part III, I explore whistleblowing and insider trading as phenomena that often occur together and concurrently. Part IV demonstrates why whistleblowers lack credibility and explains that verifying the assertions of non-trading whistleblowers is likely to be very costly. In Part V, I discuss the implications of a property-rights regime for insider trading and whistleblowing, as well as the legal regimes dealing with each. In this Part, I show how insider trading on negative information, when properly regulated, is a superior substitute for whistleblowing. The argument here is not that inside trading should be generally permitted or that such trading

is universally beneficial to shareholders, companies, or society. Rather, the argument is that the limited and tightly regulated ability to "sell short" can credibly signal to the market that the trader has negative information about a company.[8] Part VI provides a consideration of why, in light of this analysis, we observe such radically-different treatment of whistleblowers and inside traders. In Part VII, I look at the distributional concerns of insider trading and of whistleblowing for the investors of a company, exploring who actually pays for these practices and their effects on the company. Part VIII explains why the private contracting process within firms is not likely to permit the sort of trading advocated here, thereby making it necessary to accomplish the result by regulation rather than by intra-firm contracting. Part IX briefly discusses blackmail as a method for reacting to confidential or secretive information about corporate fraud and compares this reaction to that of whistleblowing and insider trading.

I. Defining Whistleblowing

A whistleblower is an employee or other person in a contractual relationship with a company who reports misconduct to outside firms or institutions, which in turn have the authority to impose sanctions or take other corrective action against the wrong-doers. While some definitions of whistleblowing require that the misconduct be reported to people outside of the organization, others consider reporting misconduct up the chain of command within an organization also to constitute whistleblowing.[9] Where one is

[8] Selling short involves selling shares that one does not own with the intention of profiting by ""covering the short position,"" which entails buying the shares more cheaply in the future when the price declines.

[9] For example, whistleblowing has been defined in one regulation as conduct that involves disclosure of information by an employee or applicant for employment that the employee or applicant reasonably believes evidences: a violation of law, rule or regulation; gross mismanagement, a gross waste of funds, an abuse of authority, or a substantial and specific danger to public health or safety, unless such disclosure is specifically prohibited by law, and if such information is not specifically required by Executive Order to be kept secret in the interest of national defense or the conduct of foreign affairs. . U.S. Department of Transportation, Transportation Security Administration, Interim Policy on Whistleblower Protections for

blowing the whistle against an entire way of doing business or against people at or near the very top of a company, as was the case with Enron, reporting the behavior up the chain of command is not actually whistleblowing. After all, it is hardly whistleblowing to report misconduct to the very people engaged in the misconduct. On the other hand, where the misconduct involved is that committed by public officials, instead of individuals in the private sector, disclosure to those outside the organization may constitute a crime if the information is classified pursuant to administrative action or subject to an executive order of confidentiality.[10]

A. Our Venerable Tradition of Compensating Whistleblowers

The origins of whistleblowing legislation in the United States can be traced to the False Claims Act, enacted in 1863 in order to reduce the incidence of fraud among the suppliers of munitions and other war materials to the Union government during the Civil War.[11] Significantly, the Act authorizes payments to whistleblowers of a percentage of any money recovered or damages won by the government in cases of fraud that the whistleblower's evidence helped expose. The act allows whistleblowers, called "relators," to bring *qui tam* actions on behalf of the government against those alleged to have submitted false claims to the government.[12] As with modern whistleblower statutes, the False Claims Act also provides protection for whistleblowers for wrongful dismissal.

TSA Security Screeners, http://www.osc.gov/documents/tsa/tsa_dir.pdf; See also C. Fred Alford, Whistleblowers: Broken Lives and Organizational Power

[10] See, e.g. U.S. Department of Transportation, Transportation Security Administration, Interim Policy on Whistleblower Protections for TSA Security Screeners, http://www.osc.gov/documents/tsa/tsa_dir.pdf

[11] 31 U.S.C. §3730(h)

[12] "Qui tam" is an abbreviation of the Latin phrase "qui tam pro domino rege quam pro se ipso in hac parte sequitur," which means "who brings action for the king as well as himself." Qui tam actions date back to at least the 14th century.

The False Claims Act was not widely utilized until far-reaching amendments to the Act in 1986 made it an attractive weapon to combat fraud in virtually any program involving federal funds. Although originally intended to deter the submission of fraudulent invoices by defense contractors, the False Claims Act now covers every industry that deals with the federal government, and it is sometimes used even in ordinary commercial contract disputes. The Act provides for whistleblowers to be reinstated to their jobs with seniority, double back pay, interest on back pay, compensation for discriminatory treatment, and legal fees. Additional federal legislation bars reprisals against those who expose government corruption.[13]

Congress adopted further whistleblower protection for public employees in 1989 when it passed the Whistleblower Protection Act. The WPA is an anti-retaliation statute that prohibits the federal government from retaliating against employees who blow the whistle on public sector misconduct and that provides a means of redress for employees. The Office of the Special Counsel and the Merit Systems Protection Board are charged with upholding the WPA. Employees can obtain protection as whistleblowers either by making disclosure to a Special Counsel, the Inspector General of an agency, another employee designated by an agency head to receive such disclosures, or to any other individual or organization.

Thus, employees who work for companies that deal with the government or who are themselves in government jobs have incentives to disregard internal channels, such as the internal audit function, and file whistleblower actions in court. This is true because the so-called *qui tam* provision of the Federal False Claims Act provides for an individual

[13] Harassment and dismissal of and the revelation of widespread waste and fraud in defense contracting led Congress to strengthen the position of whistleblowers in 1989.

with knowledge that someone has filed a false claim involving payment by the government to file a *qui tam* action in court. When such an action is filed, the government takes responsibility for investigating the allegation.

Where the fraud is successfully prosecuted, the whistleblower is eligible to receive a bounty of at least fifteen percent of the final recovery, which for large frauds can amount to tens of millions of dollars merely for having brought a false claim to the government's attention. The burden of proving the false claim must be met by the government: "[t]he whistleblower has to do nothing other than file the *qui tam* action."[14]

Thus, while it is tempting to distinguish whistleblowing from insider trading on the grounds that the motivations of whistleblowers are more "pure," this does not appear to be the case. Here the point is not that insider traders are particularly virtuous. Of course they aren't. Rather the point is that wWhistleblowers are often motivated by the financial returns associated with whistleblowing in the same way that insider traders are motivated by the financial returns associated with trading, Consistent with this intuition, the federal statutes regulating whistleblowing for public corruption are specifically designed to provide economic incentives for whistleblowers. And at least some whistleblowers have profited richly from *qui tam* actions. In the fiscal year 2005, for example, federal whistleblowers were awarded $166 million, up from $108 million in 2004.[15] In one particular case, the various government settlements from the myriad investigations into HealthSouth Corporation's alleged fraud against Medicare and other

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[14] John Figg, ""Whistleblowing,"" Internal Auditor, April 2000, http://www.findarticles.com/p/articles/mi_m4153/is_2_57/ai_63170650/pg_4 (accessed December 12, 2005).

15 November 7, 2005, U.S. Newswire, Justice Department Recovers $1.4 Billion In Fraud & False Claims In Fiscal Year 2005; More Than $15 Billion Since 1986, http://releases.usnewswire.com/GetRelease.asp?id=56318 (accessed December 13, 2005); U.S. Department of Justice Whistleblower statistics, http://www.phillipsandcohen.com/CM/Whistleblowerrewardsstories/DOJ%20stats%20fy2004.pdf

federally-insured health care programs yielded $327 million in fines payable to the U.S. government.[16] Of this amount, $76 million in recoveries was attributable to four *qui tam* law suits. Five relators received $12.6 million for their contributions to the HealthSouth litigation.[17] More generally, recoveries resulting from all *qui tam* and non *qui tam* cases brought under the False Claims Act from 1986 to 2004 total $13.5 billion. Whistleblower rewards for *qui tam* cases exceeded $1.4 billion during this period. .

B. Self-Interested Behavior and Whistleblowing

Even where whistleblowers do not engage in whistleblowing for money, there often are other self-interested motivations behind this ostensibly-altruistic behavior. Disgruntled employees are more likely to engage in whistleblowing than other employees, and revenge is often a common feature in whistleblower cases. Thus, it does not appear possible to distinguish whistleblowing from insider trading by citing differences in the motivations of whistleblowers and inside traders.[18] As noted above, a whistleblower is someone who observes criminal behavior and alerts a competent

[16] The United States alleged that HealthSouth, the nation's largest provider of rehabilitative medicine services, engaged in three major schemes to defraud the government. The first, comprising $170 million of the settlement amount, resolved Health South's alleged false claims for outpatient physical therapy services that were not properly supported by certified plans of care, administered by licensed physical therapists or for one-on-one therapy as represented. Another $65 million resolved claims that HealthSouth engaged in accounting fraud which resulted in over-billing Medicare on hospital cost reports and home office cost statements. The remaining $92 million resolved allegations of billing Medicare for a range of unallowable costs, such as lavish entertainment and travel expenses incurred for HealthSouth's annual administrators' meeting at Disney World, and other claims. Government-initiated claims accounted for $251 million of the settlement amount, with the remaining

[17] In Qui tam cases, brought under the False Claims Act (FCA), private parties, called ""relators"" are permitted to bring law suits in the name of the United States against government contractors and other parties in the name of both the relator and the government,. Under the FCA, the government has the right to intervene in the relator's case. But if the government declines, the relator can still pursue the case. If the relator wins money from the defendant, he is entitled to keep a portion of the recovery, plus his attorneys' fees and other costs.

[18] Although there is a potential financial benefit to whistleblowing, it is generally difficult to demonstrate that such financial benefit the primary motivating factor rather than just a contributing one. By contrast, in the case of insider trading, the primary motivation often is to profit from the inside information. Highlighting wrongdoing may merely be a secondary fringe benefit. It does appear, however, to be naïve to assume that whistleblowers are altruistic or that they as a group have a "moral edge" on inside traders.

authority. The term naturally conjures up images of concerned citizens frantically blowing whistles to thwart muggings and bank robberies on Main Street, USA. [19]

1. Sherron Watkins—A Paradigmatic Whistleblower?

Sherron Watkins, the iconic whistleblower, does not remotely fit the traditional definition and imagery associated with a whistleblower.[20] She did write a memorandum articulating some of her concerns about the "suspicions of accounting improprieties" at Enron. But she gave this document to the company's CEO, Kenneth Lay, now a criminal defendant in various fraud and insider-trading cases related to Enron's collapse. Then, on the basis of Lay's vague assurances that he would look into the wrong-doing, she did nothing, and her memorandum was not made public until congressional investigators released it six weeks after Enron filed for bankruptcy – long after the company and its stock price had collapsed.

Critical to understanding Ms. Watkins' role as a self-interested whistleblower is to understand her objectives in writing the whistleblower letter. To do this, it is necessary to parse the letter that Watkins anonymously e-mailed to Lay. The opening line makes it clear that Watkins' objective is to retain her employment and to protect her pension savings. The Watkins letter begins by asking, "Has Enron become a risky place to work? For those of us who didn't get rich over the last few years, can we afford to stay?"[21] Far from whistleblowing, the letter suggests ways that the company can unwind its problems,

[19] Dan Ackman, ""Sherron Watkins had Whistle But Blew It,"" February 14, 2002. Forbes.com, http://www.forbes.com/2002/02/14/0214watkins.html

[20] Besides being hailed as one of Time Magazine's People of the Year in 2002, a reporter once observed that Watkins ""has been hailed as a whistleblower so often it's starting to sound like part of her name."" Id.

[21] Federal Energy Regulatory Commission Release of e-mails, http://www.itmweb.com/f012002.htm

without the need to notify investors or regulators of the massive improprieties going on in the company. She adds:

> I am incredibly nervous that we will implode in a wave of accounting scandals. My eight years of Enron work history will be worth nothing on my resume, the business world will consider the past successes as nothing but an elaborate accounting hoax.[22]

Moreover, Watkins clearly identified herself with the management team that created the scandal, as much as with the Enron investors who were devastated by the collapse of the company. For example, she expresses concern that unhappy employees were aware of the company's improper accounting practices and could possibly seek revenge on the company by exposing the fraud. Watkins observes that many shareholders "bought (Enron common stock) at $70 and $80 a share looking for $120 a share and now they're at $38 or worse." She also observes that she and other employees "are under too much scrutiny and there are probably one or two disgruntled 'redeployed' employees who know enough about the 'funny' accounting to get us in trouble."[23]

Watkins' letter reveals that she was well aware that the company was engaged in accounting fraud, and that the financial statements of the company did not fully represent to investors and regulators the true condition of the company. For example, Watkins observed, "[W]e have had a lot of smart people looking at this and a lot of accountants including AA & Co. have blessed the accounting treatment. None of that will protect Enron if these transactions are ever disclosed in the bright light of day."[24]

This suggests that Watkins was not only self-interested, but she also realized that there were material accounting issues that had not been disclosed. Rather than disclose

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[22] Id.
[23] Id.
[24] Id.

these issues, she advocated attempting to correct the problems secretly, which she analogized to "robbing [a] bank in one year and trying to pay [the money] back two years later." In other words, the Watkins letter is more consistent with an effort by Watkins to distance herself from the fraud, but to continue to participate in the cover-up, in hopes that the entire mess would somehow blow over and life could return to normal.

Acting in a manner entirely consistent with the model of rational self-interested behavior, Watkins attempts to quantify the risks and rewards of continuing to mask the company's ongoing fraud by assessing the probability of getting caught. She argues that if "the probability of discovery is low enough and the estimated damage too great; then therefore we [should] find a way to quietly and quickly reverse, unwind, write down these positions/transactions."[25] Alternatively, she advises that if "the probability of discovery is too great, the estimated damages to the company too great; therefore, we must quantify [and] develop damage containment plans and disclose."[26] Her biggest concern is detection. She fears that "too many people are looking for a smoking gun,"[27] and she fully understood that Enron was "a crooked company."[28]

2. Analyzing Sherron Watkins' Actions

The point here is not to vilify Sherron Watkins. Rather, the purpose of this detailed review of Sherron Watkins' "whistleblowing" is to emphasize the point that Ms. Watkins did not do anything to expose the ongoing financial irregularities and accounting fraud. It is doubtful that Ms. Watkins properly can be characterized as a whistleblower. As I observed earlier, reporting fraud to the very people engaged in the misbehavior is

[25] Id.
[26] Id.
[27] Id.
[28] Id.

hardly whistleblowing. Even if Ms. Watkins could be thought of as a whistleblower, she must be described as an unsuccessful one.

More importantly, regardless of whether Ms. Watkins' activities technically constitute whistleblowing, it is impossible to describe her motives as being more altruistic or other-regarding than inside traders. Clearly, there were many motivations for her actions, including concerns about self-preservation, her savings, her reputation, and about the undiversified human capital investment she had made in Enron.

The complexity that characterizes Sherron Watkins' motives is probably quite typical. Whatever distinctions one might be able to draw between whistleblowers and inside traders, it is not possible to distinguish these two activities on the basis of the motives of the actors. Since the activities cannot be distinguished on the basis of *motive*, and they cannot be distinguished on the basis of *consequences*, one is left to wonder what fuels our intuition that whistleblowing is desirable while insider trading on the same set of information is so abhorrent.[29]

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[29] Despite the recent surge in popularity, whistleblowers and whistleblowing still face image problems not demonstrably different from the image problems faced by people accused of insider trading. For example, one whistleblower, Jesselyn Radack, a former legal adviser to the Justice Department's Professional Responsibility Advisory Office, observes being called "traitor," "turncoat," and "terrorist sympathizer." She was so described after advising the criminal division of the FBI that any interrogation of "American Taliban" John Walker Lindh outside of the presence of his lawyer would be unethical. The FBI ignored Radack's advice and interrogated Lindh when he did not have the benefit of legal counsel. Later Radack claims a number of e-mails she had written explaining her legal position determining that Lindh had a right to a lawyer while being interrogated had been destroyed after the judge in the Lindh case ordered that all the these documents be turned over to the court. Radack then turned whistleblower, disclosing the existence of the missing e-mails to Newsweek. Radack claims that she believed this was permitted by the Whistleblower Protection Act. Writing about the incident, Radack observes that "[w]histleblowers are stereotyped as disgruntled employees, troublemakers and snitches. The conscientious employee is often portrayed as vengeful, unstable or out for attention. Jesslyn Radack, ""Comment: Whistleblowing: My Story"" The Nation July 4, 2005, posted June 16, 2005, http://www.thenation.com/docprem.mhtml?i=20050704&s=radack (accessed December 12, 2005).
[32]

Most, but not all whistleblowing is tolerated. There is an exception to the general rule favoring whistle-blowing where a whistleblower reveals confidential information that she has a legitimate legal duty not to disclose. But this, as shown below, is precisely the context in which insider trading is illegal.[32] My point is that, as with whistleblowing, insider trading should be prohibited only in cases where whistle-blowing is prohibited, that is, in those cases where the would-be trader has a legitimate legal duty to keep the information confidential and otherwise to refrain from acting on the information.

But, while the legal system ostensibly excoriates inside traders, the law protects whistleblowers from retaliation by their employers by making it illegal for any public company to "discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee" because of any lawful provision of information about suspected fraud.[33]

II. Insider Trading as Whistleblowing

Insider trading involves buying or selling securities (or derivatives, such as puts, calls, or futures) on the basis of material, nonpublic information.[34] In this Article, I am limiting my discussion of insider trading to the narrow context in which such trading occurs in a situation in which whistleblowing could also occur.[35]

In this whistleblowing context, insider trading occurs when the potential whistleblower has bad news about a company. The conduct that replaces the

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[33]. See Table 1 for a catalogue of whistleblower statutes.

[34] It also is possible to trade shares in rival firms on the basis of material inside information. For example, when an employee in a company obtains good (bad) news about her company's prospects, she may sell (buy) shares in rivals, particularly in markets with high levels of concentrations and barriers to entry. See Ian Ayres and Joe Bankman "Substitutes for Insider Trading," 54 Stanford Law Review, 235, 235-294 (2001).

[35] For a broad defense of insider trading as an efficient mechanism for compensating management, see Henry G. Manne, Insider Trading and the Stock Market (1966).

whistleblowing involves selling shares short,[36] selling single-stock futures contracts, and purchasing put options or selling call options – all strategies that permit traders to profit on the basis of price declines.

Insider trading on the basis of information about an on-going fraud necessarily leads to the exposure of that fraud. It is not profitable for an inside trader simply to sell or to sell short shares in the company involved in the fraud without revealing or causing the underlying information to be revealed. While it might seem that mere selling without disclosure might be a profitable strategy for insiders because such selling drives share prices down, this is not the case.[37] In efficient capital markets,[38] transacting in financial assets whether it involves buying or selling, will not affect the underlying values of those assets unless such transactions reveal information. This is because the prices of securities and other financial assets reflect, at any given time, all publicly available information relevant to the price of that asset.

Mere trading does not effect share prices. Rather, trading only effects share prices to the extent that the trading reveals new information about the returns to investors in the underlying asset. For example, the available evidence indicates that evidence that

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[36] Short selling occurs when somebody sells shares that she does not own by first borrowing such shares, and delivering them to the purchaser. The short-seller must, at some point repurchase the shares. The short seller's goal is for the price of the shares being sold to decline so that they can be repurchased at a lower price, thereby enabling the seller to profit from a decline in the price of the stock. A short-seller's profit is the price at which the stock are sold minus the cost of buying the shares plus the commissions and expenses (interest) associated with borrowing the stock until the short position is covered.

[37] Daniel R. Fischel and David J. Ross, "Should the Law Prohibit 'Manipulation' in Financial Markets," 105 Harvard Law Review 503 (1991)

[38] The proposition that stock markets are efficient has been formalized in the well-known "Efficient Capital Markets Hypothesis (ECMH)." For a discussion of the ECMH, which posits that a market is efficient if the prices of the assets traded in that market fully reflect all available information relevant to the pricing decision, see Jonathan Macey, An Introduction to Modern Financial Theory 38 (1998). See also Burton Malkiel, A Random Walk Down Wall Street (8th edition 2004); Burton Malkiel, The Efficient Markets Hypothesis and its Critics, 17 Journal of Economic Perspectives 59-82 (2003) The semi-strong form of the ECMH posits that current securities prices "fully reflect all public knowledge… and that efforts to acquire and analyze this knowledge cannot be expected to produce superior investment results." James H. Lorie, Peter Dodd, and Mary Hamilton Klimpton, The Stock Market: Theories and Evidence 56 (2d ed. 1985).

large block trades adjust rapidly to reflect new information contained in the sale of the block.[39]

Because trades that lack information content will not affect prices, insiders cannot profit merely by selling. In order for prices to adjust, the information must be revealed to other market participants. Insiders will not have extracted all of the gains associated with their whistleblower information prices until adjust such that they fully reflect the information about the fraud that motivated the insiders' trading. Thus, as with whistleblowing, insider trading on whistleblower information must result in the information about a fraud to be revealed. If the information turns out to be unreliable, prices will not adjust, and the insider will lose the transaction costs associated with his investment. These costs can be substantial if the insider is selling short as well as liquidating his current holdings.[40] For this reason, short selling is likely to be a far more credible signal than whistleblowing because the talk involved in whistleblowing is cheap, while the trading involved in short selling is costly to the short seller whose information about the underlying company is erroneous.

Such short selling can create perverse incentives, particularly the incentive that top managers might have to cause harm to their firms in order to make private gains on the following declines in the company's shares. But these perverse incentive effects do

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[39] Larry Dann, David Mayers and Robert Raab, "Trading Rules, Large Blocks, and the Speed of Adjustment," 4 J. Fin. Econ. 3 (1977).

[40] Short selling is so costly that very few shares are actually sold short. See Robert Shiller, "From Efficient Markets to Behavioral Finance," 17 J. Econ. Perspectives 83-104 at 101, (2003). For example studies show that less than two percent of all stocks had short interest of more than five percent of outstanding shares. Patricia Dechow, Amy Hutton, Lisa Muelbroek and Richard Stone, "Short Selling, Fundamental Analysis and Stock Returns," 49 Journal of Financial Economics 283-306 (2001). In addition to the complex tax issues associated with short-selling, traders who sell short must pay daily accruing interest for the shares they borrow in order to deliver to the purchaser of the shares that have been sold short. Also, short sellers generally do not receive interest on the funds received from selling stock short and these funds do not reduce outstanding margin balances. See also SEC Regulation SHO. August 6, 2004, http://www.sec.gov/rules/final/34-50103.pdf 17 CFR Parts 240, 241 and 242, Release No. 34-50103.

not pose a problem in cases where inside trading is done by employees who have no power to affect the strategic decisions of the firm, either because they no longer are employed by the company or because they work in a low-level capacity that does not involve strategic decision-making. For this reason, in my view, regulation should be enacted that permits low-level insiders such as rank-and-file employees to trade on the basis of material non-public information under certain conditions.[41]

As with whistleblowing, insider trading requires that the person engaged in the conduct have a pre-existing relationship with the company. In fact, liability for insider trading requires that there be a pre-existing relationship of trust and confidence that the defendant-insider has breached by trading.[42] To be a whistleblower requires a similar sort of relationship. And, of course, at a bare minimum, both whistleblowing and inside trading require that the whistleblowers and the traders actually have some information not generally known that is of interest to others.

Tying these various strands together, we see that whistleblowers and insiders share the same basic defining characteristics: (a) they are informational intermediaries; (b) they have information not widely known or not already reflected in share prices; and (c) they are in a pre-existing contractual or quasi-contractual relationship with the source of the information.[43] As a descriptive matter, the only meaningful difference between inside traders and whistleblowers lies in how the information possessed is used by the trader or by the whistleblower – that is, whistleblowers talk rather than trade. This distinction may appear vast but, when analyzed realistically, it is far from clear that this is

[41] Trading by employees who have not had any role in the underlying conduct on which the trading is based. This would, presumably, include rank-and-file employees.
[42] Chiarella, Dirks, O'Hagen.
[43] See Table 1.

a difference with much, if any, moral significance. And, as shown below, it also is far from clear that these activities can be distinguished on the basis of their economic impact on third parties.

A. SEC v. Dirks

The starting point for any analysis of the relationship between whistleblowing and insider trading is Dirks v. SEC.[44] This case is interesting for two reasons. First, the case involves the efforts of a failed whistleblower. Raymond Secrist, the Equity Funding employee who provided the tip about the company's fraud to the defendant Ronald Dirks, only resorted to Dirks because his repeated efforts to act as a whistleblower were unsuccessful. Second, Dirks is interesting because it suggests that whistleblowers and inside traders are likely to have similar motivations for their behavior. Whether their underlying motivation is revenge, profit-seeking, or some complex combination of reasons does not appear relevant to our analysis of the social desirability of the attendant behavior.

In Dirks, the Supreme Court examined the insider trading liability of Ronald Dirks, who received valuable information from a disgruntled employee of fraud-ridden Equity Funding Corporation. Dirks then passed the information along to his clients, a group of institutional investors, who in turn traded on the basis of the information in advance of the public disclosure of the fraud.

A brief review of the facts of the case will help our analysis. On March 6, 1973, Raymond Dirks, a securities analyst at the investment bank Hawkins Delafield, received a tip from Ronald Secrist, a disgruntled former officer of Equity Funding of America. Secrist's tip alleged that the assets of Equity Funding, a diversified corporation primarily

[44] 463 U.S. 646 (1983)

engaged in selling life insurance and mutual funds, were vastly overstated as the result of a massive, ongoing series of fraudulent corporate practices. Secrist also told Dirks that he and others had tried to convey his information about the fraud at Equity Funding to various regulatory agencies, including the SEC, the California state securities commissioner, and the Illinois state securities commissioner. None of the agencies followed up on these accusations. Secrist urged Dirks to verify the fraud and to disclose it publicly. Secrist did not attempt to blackmail Equity Funding.

At oral argument in the Supreme Court, the SEC took the position that Dirks' obligation to disclose would not be satisfied by reporting the information to the SEC.[45] In its brief to the Court, the SEC took an inconsistent position, arguing in favor of a "safe harbor" rule under which an investor would satisfy his obligation to disclose by reporting the information to the Commission and then waiting a set period of time before trading.[46] However, as noted by the Court, since no such safe harbor rule was in effect, "persons such as Dirks have no real option other than to refrain from trading."[47]

The prohibition on insider trading was unfortunate in Dirks. If the legal restrictions against insider trading had been successful in deterring Raymond Dirks from acting on the tip he had received from Ronald Secrist, it would have prolonged a massive ongoing fraud. Clearly, prohibiting insider trading would have been inefficient in this context, which is why the Supreme Court rejected the SEC's legal theory and overturned the Commissions sanctions against Raymond Dirks.

B. Lessons from Dirks

[45] Tr. of Oral Arg. 27, at 661, n. 21.
[46] Brief for Respondent 43-44.
[47] 463 U.S. 646, 680.

The Dirks case illustrates that insider trading has at least one clear advantage over whistleblowing: it provides a significantly more credible signal of the veracity of the information. Talk is cheap. When, as is often the case, the whistleblower is a disgruntled employee, people are less inclined to believe the whistleblower's story. This is particularly true in a situation like that of Equity Funding, or Enron, where the corporation is highly-regarded and has significant resources with which to respond to the whistleblower's allegations. In Dirks (and there is no reason to assume that this result should not be generalized), insider trading worked where whistleblowing did not.

The constellation of facts that produced the litigation in Dirks demonstrates that insider trading on negative information has certain decisive advantages over whistleblowing. One such advantage is that insider trading does not require that the person in possession of knowledge of the wrongdoing be able to persuade a government official to take action before the wrongdoing can be confronted. The insider need only convince herself that she is right in her own assessment of the situation. This, of course, means that insider trading on whistleblower information obviates whistleblower's credibility problem.

It is true that in the important subset of cases involving government corruption, whistleblowers can bring their own lawsuits in the form of *qui tam* actions. But litigation is costly and time-consuming, and plaintiffs in *qui tam* actions must confront the bureaucratic hurdles of court procedure, hurdles that need not be confronted by those who simply trade.[48] Thus, at least in some cases, insider trading has the advantage of

48 Under the False Claims Act, the whistleblower first files a lawsuit against the individual or business association charged with defrauding the government under seal. Copies of the complaint must be served on the Department of Justice, along with a written disclosure of all material evidence and information in the whistleblower's possession so that the Federal Government to investigate the claim prior to deciding

involving a faster and more certain pay-off for the insider in possession of whistleblower information than whistleblowing does. This is because, unlike whistleblowers, inside traders do not have to rely on government officials, who are often poorly-motivated or inept, in order to profit from the information they have acquired. Similarly, unlike whistleblowers, inside traders do not have to wait for the litigation process to run its course, which may take years to produce a recovery or settlement.

III. Insider Trading and Whistleblowing: Is the Combination the Norm?

SEC v. Dirks, described in the previous section, involved the simultaneous use of both whistleblowing and insider trading (via tipping) in a very effective manner, where effectiveness is measured by the success in revealing the fraud. The claim that insider trading and whistleblowing are closely linked is bolstered by the extent to which these activities are conducted simultaneously. Insider trading and whistleblowing both require possession of material, non-public information, and both trading and whistleblowing are consistent with the rational self-interest of the people engaging in these activities. Thus it should not be surprising that we observe in cases such as Dirks that these activities are carried on simultaneously.

For example, Sherron Watkins, "the whistleblowing Enron vice president who has been portrayed as a kind of white knight among a cast of self-serving charlatans," engaged in trading on the basis of the information contained in her whistleblower

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whether to intervene. The Department of Justice is then supposed to investigate the case and decide whether to intervene in the lawsuit. While the statute provides for sixty days for the Department of Justice to make up its mind whether to sue, this period can be and often is extended at the request of the government in the court in which the complaint was filed. If the Government declines to intervene, the whistleblower may continue to pursue the litigation on her own. If the Government decides to intervene, the whistleblower receives a slightly smaller percentage of any recovery (if the Government intervenes, the whistleblower is entitled to between 15 to 25 percent of the proceeds of the action or settlement, plus expenses and attorneys' fees. If the Government does not intervene, the whistleblower is entitled to between 25 and 30 percent of the plus expenses and attorneys' fees).

memorandum, and, as a result, was described as being "at risk for having violated insider trading laws."[49] During her congressional testimony about her role in uncovering the financial and accounting fraud at Enron, Watkins revealed that soon after warning that Enron CEO Kenneth Lay that the company was about to "implode in a wave of accounting scandals," she sold a large block of her shares in order to avoid impending losses. That sale violated the current interpretation of SEC Rule 10b-5, the regulation prohibiting insider trading, which makes it illegal to buy or sell securities "while in possession of material, nonpublic information about the security," where doing so involves the breach of a pre-existing duty of trust to maintain the confidentiality of such information.

Of course it is not possible to acquire data on the specific incidences of insider trading by people with whistleblower information since people trading on the basis of material non-public information do not advertise their transactions. However, Sherron Watkins' near incrimination under the laws prohibiting insider trading is not without precedent.

In addition to the Watkins and the Dirks examples, the classic insider trading/whistleblower sequence (and even accusations of blackmail) is reiterated in the example of Ted Beatty at Dynegy, another Houston energy company. Mr. Beatty, angry at Dynegy when he was overlooked for a promotion, resigned from the company. When he left, he took with him incriminating documents that suggested questionable accounting at the company in a transaction called Project Alpha. The information revealed by Mr. Beatty caused several high-ranking Dynegy officers to resign almost immediately and led to the fraud investigations of energy traders at several companies, and also resulted in an

[49] MSNBC, March 8, 2003

SEC suit against Dynegy for securities fraud. Dynegy ultimately suffered the complete collapse of its equity and consented to a $1 million SEC civil fine, selling all of its major assets in order to survive.

Following a pattern of conduct virtually identical to the one followed by Ronald Secrist in the Dirks case, Mr. Beatty tipped his information about Dynegy to another analyst, Jack Pitts, of the New York investment fund, Steadfast Capital. Steadfast, like Raymond Dirks' firm Hawkins Delafield, sold Dynegy's stock short. Shortly before trading, Mr. Pitts, the tippee, wrote an e-mail to his tipper, Mr. Beatty, observing that "any sign of dubious accounting at Dynegy would make investors' fears go crazy and take the stock into a tailspin." Again, a combination of whistleblowing and insider trading led to the exposure of fraud.

IV. Credibility, Pay-offs and Reliance on Other Mechanisms of Corporate Governance

The Dirks case and the Beatty incident both illustrate the parallels between insider trading and whistleblowing where the information being used pertains to fraud or other corporate misconduct. Both insider trading and whistleblowing can be used to expose fraud. In both cases, it appears that trading was more successful than whistleblowing in revealing the fraud. Given the complexity of whistleblowers' motives, their inability to make a credible commitment about the veracity of their information, as well as the necessity for bureaucratic investigation and intervention of the information being disclosed, it is not surprising that whistleblowing is often unsuccessful.

Another important distinction between whistleblowing and insider trading relates to how each of these activities interacts with other institutions of corporate governance and informational gatekeepers, particularly Wall Street industry analysts and the SEC.

Whistleblowing, to be effective, requires that other institutions of corporate governance also function effectively, because whistleblowing is not self-effectuating. Specifically, unlike inside traders, whistleblowers must first convince regulators, financial analysts, or some other corporate governance intermediary of the validity of their claims before their actions can gain traction. Thus, the effectiveness of whistleblowing largely depends in on the integrity and efficacy of these other institutions. In light of the historical unreliability of institutions of corporate governance, the need to rely on these institutions is a serious disadvantage for whistleblowing relative to insider trading. Again, the Dirks case provides a useful illustration of the point.

A. The Failure of External Corporate Governance Mechanisms

Stock market analysts were quite bullish on Equity Funding, the company whose fraud Ronald Secrist was attempting to reveal. Shortly before Equity Funding collapsed, an analyst at the investment banking firm Cowen & Co. issued a report recommending that investors buy Equity Funding "for aggressive accounts."[50] An analyst at Burnham & Co., Inc. opined that Equity Funding was "an excellent value" and rated the Company "a Buy."[51]

Analysts were not only touting Equity Funding, they also engaged in active efforts to defend the stock against Secrists' efforts at whistleblowing. On March 26, 1973, the day before the New York Stock Exchange halted trading in Equity Funding, the analyst at Hayden, Stone, Inc. who was responsible for covering the company circulated a memorandum announcing that "rumors have been circulating which have affected Equity Funding's stock." The analyst reported that his well-regarded investment bank had

[50] http://www.stocksandnews.com/searchresults.asp?Id=1573&adate=2/6/2004
[51] Id.

"checked these rumors, and there appears to be no substance to any of them."[52] It turns out that the analyst had checked with insurance regulators in various states and each one said they had no present intention of conducting any inquiries into Secrist's allegations of fraud at Equity Funding.[53] The SEC showed a similar lack of interest in investigating Equity Funding until investors tipped by Secrist began trading on the information he gave them. Secrist testified that Equity Funding employees who had attempted to notify the SEC of the wrongdoing at the company had been "brushed aside with a comment that that's a ridiculous story." Worse still, whistleblowing employees "also found that the information was sometimes relayed back to Equity Funding, and that "they were placed in personal jeopardy as a result of having gone" to the SEC.[54]

Attempts by Dirks to tip Equity Funding's outside auditors were similarly ineffective. During the course of his investigation of Equity Funding, Dirks met with the company's auditors "in an attempt to spread word of the fraud and bring it to a halt."[55] When Dirks learned that Equity Funding's auditors were about to release certified financial statements for the company, he contacted them and apprised them of the fraud allegations, hoping that they would withhold the release of their report and seek a halt in the trading of the company's securities. Instead, the auditors merely reported Dirks' allegations to management.[56]

Despite the fact that whistleblowers had contacted the SEC and state insurance officials as early as 1971, Equity Funding's Chairman, who was one of the principal architects of the fraud, testified that prior to March 1973, when Secrist's insider trading

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[52] Id.
[53] Id.
[54] Dirks v. SEC.
[55] Id.
[56] Id.

caused Equity Funding's stock price to collapse, he had "received no questions from auditors, state regulatory authorities, or federal regulatory authorities that suggested they suspected there was a fraud at Equity Funding."

B. The Failure of the Media to Expose Corporate Fraud

Journalists often perform no better than regulators in facilitating the efforts of whistleblowers. In fact the rationale given by the Wall Street Journal for declining to write a story about the fraud at Equity Funding usefully reveals a general problem for journalists seeking to publish information tipped by whistleblowers: namely, the lack of a means to verify the credibility of the information being provided by the whistleblower:

> During the entire week that Dirks was in Los Angeles investigating Equity Funding, he was also in touch regularly with William Blundell, the Wall Street Journal's Los Angeles bureau chief. Dirks kept Blundell up to date on the progress of the investigation and badgered him to write a story for the Journal on the allegations of fraud at Equity Funding. Blundell, however, was afraid that publishing such damaging rumors supported only by hearsay from former employees might be libelous, so he declined to write the story. … Dirks provided Blundell with 'the substance of all he knew,' including his 'notes' and the 'names' of all witnesses. Nevertheless, given the 'scope of the fraud,' Blundell doubted that it could have been 'missed by an honest auditor' and discounted the entire allegation.[57]

C. Whistleblowers' Failure to Communicate

The cautious reactions to information provided by whistleblowers are not necessarily a result of sloth or venality on the part of regulators, market analysts, journalists, or others. Rather, the suspicion attached to whistleblowers is justified by the dubious motives that often accompany their actions. For example, Raymond Secrist, the tipper who pointed Raymond Dirks to the Equity Funding fraud, was reported to have

[57] Id.

tipped Dirks because he was "upset over his small Christmas bonus."[58] Similarly, Ted Beatty, the Dynegy tipper, began his whistleblowing because Dynegy failed to give him "the promotion he felt he deserved."[59]

In addition, it is by no means clear that the highly-cautious reactions one often observes in response to whistleblowers' information is a particularly inefficient response to whistleblowing. In order to gauge the efficiency of ignoring whistleblowing, one must compare the costs of ignoring the whistleblowing information with the benefits, which come in the form of conserving resources that otherwise would be wasted in pursuing the false charges of disgruntled employees and other malcontents. The question of whether the costs of such caution in response to whistleblowers' complaints exceed the benefits of investigating the merits of the allegations remains an empirical issue for which data is scarce if not non-existent. One thing that is known, however, is that the cost-benefit calculations associated with ignoring whistleblowers may be different for bureaucrats and financial intermediaries than for society as a whole. Bureaucrats are inherently risk-averse. They benefit little from validating a whistleblower's complaint, and risk a lot if they make a blunder. Thus, bureaucratic incentives may lead to whistleblowers' claims being met with an excess of caution.

Of course, when analysts and other corporate governance intermediaries have incentives to bias their recommendations and analyses in favor of companies and to ignore fraud, whistleblowers will face even greater obstacles in trying to convince people that what they are saying is true. As I have observed in a previous article:

> The problem with the analysts' recommendations is not difficult to grasp. Investment banks pressure the analysts they employ to give positive

[58] http://www.stocksandnews.com/searchresults.asp?Id=1573&adate=2/6/2004
[59] Sapsford and Beckett, supra.

> ratings on companies tracked by issuers, because positive ratings boost stock prices and generate capital for their investment banking clients.[60]

Thus gatekeepers such as stock market analysts and bureaucrats have much to lose and little to gain from crediting whistleblowers' accusations.

D. The Effects of These Failures on Whistleblowing: The Relative Pay-Offs of Whistleblowing and Insider Trading

This analysis reveals a major defect with whistleblowing. Besides providing a more credible signal than whistleblowing, insider trading does not rely on the efficacy of other institutions of corporate governance in order to be effective. As these other corporate governance institutions become more effective, however, the need for whistleblowing itself also declines. This, in turn, indicates that whistleblowing is least effective when it is most needed, which is during times when the basic institutions of corporate governance are not functioning independently or effectively.

Predictably, the market's response to whistleblowing and insider trading reflects the higher value associated with trading than whistleblowing. The Beatty incident at Dynegy and the Dirks case both suggest that the monetary pay-off for trading is higher than the payoff for either whistleblowing or tipping, at least in the private sector, where there are no statutes that provide monetary incentives for whistleblowers. In both cases it appears that the tippees receiving the information and trading on it fared much better than the tippers who provided them with the information and attempted to inform regulators of the problems they had discovered. Mr. Beatty was assured by the people he approached with his information about Dynegy that his assistance in their trading activities "would earn him big money." Subsequent press reports of Mr. Beatty's activities, however,

[60] Jonathan Macey, Efficient Capital Markets, Corporate Disclosure and Enron, 89 Cornell L. Rev. XXX (2003).

reveal that "no such payout has materialized," and that Mr. Beatty is now "unemployed and in financial stress."[61] Raymond Dirks became a celebrity. Ironically, his efforts to cooperate with the SEC led to his being prosecuted by the SEC for insider trading.[62] If he had confined his activities to trading, and had not attempted to inform the SEC of his concerns about Equity Funding, it is likely that he would have avoided prosecution.

V. Insider Trading, Whistleblowing, Property Rights and Law

Insider trading can accomplish the same socially-desirable results as whistleblowing. An important difference between insider trading and whistleblowing is that whistleblowing is strictly-regulated and constrained by the need for whistleblowers to have their claims validated by some sort of public institution like an administrative agency or a prosecutor. This required mediation by an outside organization is a controlling mechanism to ostensibly restrict the flow of frivolous or inappropriate whistleblowing. As shown above, the problem with this process is not so much that it may generate too many whistleblower complaints, but that it may generate too few; and those that are generated are sometimes still inappropriately discounted.

A. The Law of Insider Trading and Its Foundations in Property Rights

By contrast, there is no mediating public institution in place to monitor and control insider trading on whistleblowing information. There are, of course, legal restrictions on insider trading in place, but these restrictions are aimed at eliminating insider trading, and do not have the intention of facilitating insider trading on whistleblower-type information.

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61 Jathon Sapsford and Paul Beckett, Whistleblower Reels From Actions' Fallout, The Wall Street Journal Online, http://www.careerjournal.com/myc/survive/20021217-sapsford.html

[62]October 11, 1973 testimony of Ray Garrett, Jr., Chairman of the SEC Before the United States Senate Subcommittee on HUD, Space Science, Veterans, Committee on Appropriations. http://www.sechistorical.org/collection/papers/1970/1973_1011_Garrett_HUDSSV.pdf

Completely eliminating or even relaxing the rules against insider trading would predictably result in an over-supply of insider trading. Some mechanism or interpretive rule is needed to distinguish among the various sorts of inside (material, non-public) information, and also to permit market participants to determine what sort of information may be utilized in trading and what sort of information must remain confidential.

Current court interpretations of the SEC rules related to insider trading provide a very promising starting point for developing an interpretive rule about when insider trading is appropriate in the whistleblowing context. Here the argument proceeds in three steps. First, the legal prohibition against insider trading does not bar all trading that occurs when one trader has an informational advantage over her counter-party. Rather, the rule requires that trading on the basis of such an informational advantage be the result of a breach of fiduciary duty for it to be illegal.

Second, basing legal responsibility for insider trading on the breach of fiduciary duty serves as a basis for establishing and allocating property rights in non-public information. Information belongs to somebody, usually the company that is the source of the information. Where trading on this information involves the misappropriation (or theft) of such information, a breach of duty occurs. Conversely, trading does not involve the breach of a duty when the trader is not violating the property rights of any other person or entity by trading.

Third, applying the above analysis of fiduciary duties and property rights to trading on the basis of whistleblower information suggests that there is no basis upon which to ban such trading. Information about an on-going fraud or other criminal activity should not be considered the property of the firm that is engaged in the fraud. Trading on

the basis of such information, therefore, should not be considered a breach of fiduciary duty. Put simply, while companies clearly have a valid interest in maintaining the confidentiality of legitimate corporate information, such as their strategic plans, their earnings, their acquisition plans and other activities, they have no valid interest in maintaining the confidentiality of information about fraud or other illegal activities that might be used in whistleblowing.

The rules against insider trading are meant to protect public companies and investors from theft of information that properly belongs to them. Insiders such as executives or directors, and "temporary insiders" such as attorneys, accountants, financial printers, and investment bankers routinely obtain confidential information about a company in the course of their work. The insider trading rules are intended to prevent both these permanent and temporary insiders from abusing their positions of trust by trading in violation of their legal duties of confidentiality.

The Supreme Court clearly articulated the fiduciary underpinnings of insider trading regulations in Chiarella v. United States.[63] The defendant in this case, Vincent Chiarella, was a financial printer whose employer, Pandick Press, was routinely hired by companies seeking to acquire other companies. These acquirers required the services of a printer to manufacture the disclosure documents that would accompany their offers to acquire other companies. Chiarella traded on the basis of his advance knowledge of the information contained in the disclosure documents that he was printing. In so doing, he breached a fiduciary duty not to his trading partners – he owed no fiduciary duties to them – but rather to the bidding firms that were the sources of the information and to his employer, both of whom had relied on Chiarella to keep the information in his possession

[63] 445 U.S. 222, 231 (1980)

confidential. In the court's view, unless Chiarella had a fiduciary obligation requiring him to keep the information he had acquired confidential, his trading did not constitute insider trading despite the fact that he clearly possessed advantageous nonpublic information.[64]

B. Legal Lessons for Trading on Whistleblower Information: Creating Incentives

Here the parallel to whistleblowing is clear. Insider trading is regulated in order to *maintain* the confidentiality of legitimate corporate information. Whistleblowing is encouraged in order to *prevent* information about fraud and corruption from remaining confidential. In both the insider trading context and the whistleblowing context, the key issue is the extent to which the applicable law provides the appropriate incentives for people. In the case of insider trading, the focus is on providing incentives for people to maintain the confidentiality of legitimate corporate information that is meant to be used only for a corporate purpose and not for the private benefit of inside traders. In the case of whistleblowing, the focus is on providing incentives for people to reveal information about wrong-doing.

No rational person would consider the disclosure of some material non-public information about a company's strategic plans to be legitimate whistleblowing. It is, therefore, mysterious why anyone would consider information about an on-going corporate fraud to be bona fide corporate information that a company could legitimately require its employees to keep confidential. Since it seems irrational to prevent people

[64] Chiarella clearly breached a fiduciary duty to his employer, Pandick Press when he traded on information that he had promised, as a condition of his employment, to keep confidential. However, because the government had not presented this theory of liability to the jury, the Court held that Chiarella could not be convicted for trading in breach of a fiduciary relationship of trust and confidence to his Pandick.

from disclosing such information, it also seems irrational to prevent people from trading on the basis of this sort of "whistleblower" information.

From a legal perspective, insider trading is illegal only when such trading is based on material non-public information and the person doing the trading has breached a fiduciary duty by their trading From a property rights perspective, the same inquiries into whether a person owes and has breached fiduciary duties by trading defines and allocates the nature of the property interest in the information being exploited through trading. This is because one cannot owe a fiduciary duty such as a duty to refrain from trading or to keep information confidential unless the person to whom such an obligation is owed enjoys a property interest in such information.

Consistent with this analysis and going back at least to Locke, information acquired through legitimate means, such as one's own labor, is the property of the person who has acquired it.[65] One has a presumptive right to use information acquired in this way.[66] As Hernando De Soto has powerfully illustrated, the economic justifications for clearly defining property rights, as well as for extending such rights to people who have made legitimate acquisitions, is that doing so provides the best set of incentives to maximize the value of such information. As Locke was concerned with the under-utilization of land enclosed by England's landed gentry, De Soto's concern is with what he described as "dead" assets, a term he used to describe the undisclosed and unregistered assets of those operating outside of the highly corrupt, over-bureaucratized formal economies of undeveloped countries.[67]

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[65] John Locke, Two Treatises of Government, ed. Mark Goldie, (London: Everyman 1993).
[66] Alan Strudler, ""Moral Complexity in the Law of Nondisclosure, 45 UCLA L.Rev. 337, 375 (1997).
[67] Hernando de Soto, The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else, 2000; See also Richard Pipes, Property and Freedom 1999. For an extremely useful comparison of the

The implications are clear: failure to allow insider trading on the basis of whistleblower information will lead to the same sort of under-utilization of assets as the failure to legalize property rights in under-developed sectors of the world. Just as in the case of ill-defined property rights in De Soto's native Peru, the failure to recognize the rights of people in possession of corporate whistleblower information to profit from that information will lead to under-utilization of such information and to inefficiency.

Thus, applying this analysis to the legal restrictions on insider trading yields at least three reasons why certain insiders should be permitted to trade on whistleblower information. First, insider trading is only illegal when it involves the breach of a fiduciary duty, and there is no fiduciary duty to maintain the confidentiality of information about an ongoing fraud. Second, from a property rights perspective, a company committing fraud cannot claim a legitimate corporate interest in maintaining the ongoing confidentiality of information relating to its fraud. Finally, applying the sort of economic analysis that De Soto applies in the development context yields the conclusion that insider trading on whistleblower information should be encouraged because, just as it is socially desirable to encourage the efficient utilization of assets in the economy, it is also efficient to encourage activities that will not only lead to the exposure of corporate fraud, but also actually discourage such fraud by raising the probability that it will be exposed.

Still another incentive-based justification for permitting insider trading on the basis of whistleblower information is that doing so is likely to decrease the time required

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work of Locke and de Soto, on which this paragraph draws, see Donald Krueckeberg, ""The Lessons of John Locke or Hernando de Soto: What if Your Dreams Come True?""15 Housing Policy Debate, 1 (2004) (accessible at http://content.knowledgeplex.org/kp2/cache/documents/38182.pdf , accessed January 5, 2006).

for the information to be revealed to the public. Insiders may trade knowing that the information they are using will come out eventually. As long as insider trading is illegal, however, there exists a powerful disincentive to reveal that they are trading. Legitimizing their property rights in whistleblower information by making insider trading on the basis of such information legal would not only have the obvious effect of encouraging more such trading, but it also would encourage traders to disclose or otherwise take steps to make public the information in their possession. This in turn would accelerate the exposure of the fraud and other wrong-doing that was the subject of the trading.

C. What Kind of Information Qualifies as Whistleblower Information?

In addition to limiting the identity of who can trade on whistleblower information, there remains the issue of what sort of information is the proper subject of trading and what is not. Here the analysis is greatly facilitated by analogy to protections afforded to corporate whistleblowers by the Sarbanes-Oxley Act. Sarbanes-Oxley provides protection for information "regarding any conduct which the employee reasonably believes constitutes a violation … of any provision of Federal law relating to fraud against shareholders."[68] Thus, just as not every disclosure by self-proclaimed whistleblowers is protected activity; neither should every trade by an insider be subject to the defense that it involved protected whistleblowing. Nevertheless, the category of protected activity is broad for whistleblowers,[69] and it should be no less broad for inside traders.

[68] 18 U.S.C. § 1514A(a).
[69] Stephen M. Kohn, Michael D. Kohn and David K. Colapinto, Whistleblower Law: A Guide to Legal Protections for Corporate Employees,"" 79 2004.

Whistleblower disclosures to non-governmental agencies including the news media have long been protected by the Department of Labor under statutory provisions that are virtually identical to the provisions protecting whistleblowers in Sarbanes-Oxley.[70] Permitting whistleblowers to communicate in a slightly different way, by trading, seems like a modest extension of this current policy.

Sarbanes-Oxley contains protections for whistleblowers who mistakenly believed that their employers were engaged in illegal conduct. Specifically, an employee's whistleblower disclosures are protected as long as they are based on the employee's "reasonable belief" that the employer has engaged in fraudulent or illegal conduct. Under Sarbanes-Oxley, the employee is under no obligation to show that her allegations are meritorious.[71]

The problem associated with the transmittal of erroneous information pertaining to a corporation's activities is far less acute in the whistleblower context than for insider trading for two reasons. First, where an insider engages in trading on the basis of whistleblower information—regardless of whether that trading consists of short-selling, selling call options, single-stock futures or buying put options—the insider must risk her own capital, betting that there will be a decline in the value of the company's share price when the whistleblower information is revealed. This means that, regardless of whether

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[70] See Gutierrez v. Regents of the University of California, 98-ERA-19, D&O of ARB p. 6, November 13, 2002 (finding that, in addition to contacting members of Congress, communicating with reporters and a public interest organization, leading to the whistleblower being quoted in three ""prominent"" newspapers, were protected activities designed to ""publicly reveal information"" about misconduct was also protected conduct).

[71] The standard was articulated in Halloun v. Intel Corp., 2003-SOX-7, D&O of ALJ, p. 10 (March 4, 2004):

> A belief that an activity was illegal may be reasonable even when subsequent investigation proves a complainant was entirely wrong. The accuracy or falsity of the allegations is immaterial; the plain language of the regulations only requires an objectively reasonable belief that shareholders were being defrauded to trigger the (Sarbanes-Oxley) Act's protections.

Id.

the insider is acting in good faith, it is costly for an insider to trade on the basis of erroneous information, because doing so involves a substantial risk that the insider will suffer trading losses. Second, whistleblowing involves moral hazard problems that do not exist in the insider trading context. Specifically, because it is illegal for employers to retaliate against whistleblowers, employees have an incentive to invent issues about which they can whistle-blow in order to obtain job security that they would not otherwise have. Employers will be reluctant to fire whistleblowers because doing this risks not only civil penalties, but criminal sanctions under Section 1107 of Sarbanes-Oxley.[72]

In addition, Congress, in order to make it "easier for an individual to prove that a whistleblower reprisal has taken place" held that for a whistleblower to obtain relief in the form of reinstatement or damages for alleged retaliation, he need not show that "the whistleblowing was a factor in a personnel action." Indeed, the whistleblower need not even show that the whistleblowing was a substantial motivating or predominant factor in any action taken against him.[73] Instead he need only show a tenuous correlation: merely showing that the official taking the action knew that whistleblowing had taken place and acted within a time period after such whistleblowing that "a reasonable person could conclude that the disclosure was a factor in the personnel action."[74]

The analysis up to this point has demonstrated that there are built-in incentives that limit the extent to which people will engage in insider trading on the basis of erroneous whistleblower information. These safeguards do not similarly constrain

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[72] Section 1107(a) of Sarbanes-Oxley amends 18 U.S.C. Section 1513 to provide that: ""[w]however knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense, shall be fined under this title or imprisoned not more than 10 years, or both.""

[73] Congressional Record S2784 135 (1989)

[74] Id.

whistleblowers. The analysis also indicates that only certain information should be the subject of insider trading. This information, which is the same information that might assist in an investigation of a violation of law, is the sort of information which we should encourage whistleblowers to disclose. The fact that we are able to determine the sort of information that qualifies for whistleblower protection demonstrates that we can also determine the sort of information that is the proper subject for protected insider trading.

However, the analysis here does not yield the conclusion that anybody in possession of material information about an ongoing corporate fraud should be able to trade on such information. As suggested above, the information must have been obtained in some legitimate manner. Thus it is necessary, as Locke puts it, that such property rights be allocated to information and other assets that are the product of one's "honest industry."[75] This suggests that the right to engage in insider trading on the basis of whistleblower information ought not be allocated to people who actually are participating in the fraud, because those who generate or participate in generating information about an on-going fraud have not acquired such information as the result of their 'honest industry,' and are not entitled to profit from exploiting such information.[76] Similarly, from an economic perspective, permitting participants in a fraudulent scheme within a corporation

[75] Locke, supra, Treatise I, ¶ 42, p. 31 ("[J]ustice gives every man a title to the product of his honest industry").

[76] In an interview, Dean Henry Manne, when asked about the corporate scandals at Enron and Global Crossing indicated that insider trading, if permissible, would have prevented these and other frauds, saying, "I don't think the scandals would ever have erupted if we had allowed insider trading . . . because there would be plenty of people in those companies who would know exactly what was going on, and who couldn't resist the temptation to get rich by trading on the information, and the stock market would have reflected those problems months and months earlier than they did under this cockamamie regulatory system we have." See Larry Elder, "Legalize Insider Trading?" http://www.washtimes.com/commentary/20030615-112306-2790r.htm June 15, 2003, accessed December 18, 2005.

to trade on such information could have the undesirable effect of providing additional incentives for miscreants to commit fraud.

VI. Whistleblowers and Insider Trading: Some Differences

Whistleblowing and insider trading are complements, not substitutes. A system that permitted both whistleblowing and insider trading on whistleblowing information would do a better job of ferreting out wrong-doing than a system that permitted only one practice and not the other. The legitimacy of payments to whistleblowers is well-established and uncontroversial. The legitimacy of insider trading is, of course, far more contested.

The previous section has stressed certain advantages that insider-trading has over whistleblowing. Insider trading is self-effectuating. Inside traders receive prompt compensation for revealing corporate fraud. By contrast, private sector whistleblowers are merely protected from retaliation by law. Even in the public sector, where statutes provide for payments for whistleblowers, compensation for whistleblowing is highly uncertain and requires the whistleblower to wait for years, if not decades. However, insider trading on whistleblower information is not without problems of its own. Thus, as discussed below, insider trading will never replace whistleblowing as a device for dealing with corporate wrong-doing.

A. The Need for Public Securities Markets

One problem with insider trading as a corporate governance device is that it is only effective in companies whose shares are publicly-traded. There may be no insider trading opportunities for whistleblowers where the fraud or wrong-doing discovered by the whistleblower took place in government agencies or in privately-held businesses.

However, this shortcoming of insider trading can be easily overstated. First, the observation that it is not possible to engage in insider trading in firms and agencies with no publicly-traded shares does nothing to undermine the argument that insider trading on whistleblower information can be of value in revealing fraud in companies whose shares are publicly-traded. Second, drawing from what Ian Ayres and Joseph Bankman have observed, when insiders cannot trade in their own company's stock, they may be able to use the information to trade instead in the stock of their firm's rivals, suppliers, customers, or the manufacturers of complementary products.[77] Ayres and Bankman refer to this form of trading as trading in stock substitutes. These scholars observe that trading in stock substitutes may be quite profitable, and Heather Tookes has shown that insider trading in competitors often is a more profitable trading strategy for insiders than trading shares in their own firm.[78]

Ayres and Bankman do not consider the possible role of insider trading as a substitute for whistleblowing. Clarifying the law to permit insider trading in stock substitutes would dramatically expand the usefulness of insider trading on whistleblower information. For example, where a municipal worker has information about fraud in the allocation of construction contracts, she could sell stock in the contractor prior to blowing the whistle.[79]

B. <u>The Timing Problem</u>

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[77] See Ian Ayres and Joe Bankman "Substitutes for Insider Trading," supra.

[78] Heather Tookes, ""Information, Trading and Product Market Interactions: Cross-Sectional Implications of Insider Trading"" 2004 Working Paper, on file with author.

[79] Clearly it should be illegal for a government official involved in the investigation or prosecution of activity, either in the public sector or the private sector, to engage in any sort of trading on the basis of that information. The ability to engage in such trading would present a profound moral hazard, as the government official would have incentives to bring cases against innocent companies in order to benefit from stock price movements around the time of the announcement of contemplated regulatory action.

An additional theoretical problem with insider trading is that the ability to engage in insider trading on any sort of information, including (but not limited to) whistleblower information, may create perverse incentives for the person in possession of the whistleblower information to delay revealing the information in order to complete her trading. Legalizing insider trading in material non-public information about corporate fraud, or any other whistleblower information, is inefficient to the extent that such legalization provides incentives for traders to delay disclosure until the point at which the information would otherwise be disclosed.[80]

The question of the extent to which such delays would occur is an empirical one for which no data are available. However, while delays in the disclosure of whistleblower information does represent potential social costs inherent in the proposed regime, there are significant benefits on the other side of the ledger that are very likely to outweigh such costs.

Foremost among these advantages is the fact that permitting insider trading on whistleblower information would lead to the disclosure of information that otherwise would not be divulged at all. Since complete non-disclosure of whistleblower information is clearly worse that a mere delay in disclosure of such information, it is highly probable that the benefits of permitting insider trading on the basis of whistleblower outweigh the costs.

Even if there is a delay in disclosure while insiders trade, this delay must be evaluated in light of the fact that there also is an inevitable delay in disclosure whenever a

[80] Henry Manne has suggested that there is no problem here because insider trading enables investors to receive "virtual" full disclosure in the form of immediate and correct price adjustments. See Henry Manne, “The Case for Insider Trading,” AEI-Brookings Joint Center Policy Matters 03-05, April 2003 http://online.wsj.com/article/SB112778801827952972.html

whistleblower engages in whistleblowing without concomitantly engaging in insider trading. Moreover, as described in more detail below, insider trading tends to push prices in the "correct" direction even before the revelatory disclosures are made. In contrast, when whistleblowing occurs unaccompanied by trading, there may be no change in share values prior to the public disclosure of information.

VII. Who Pays for Whistleblowing and Insider Trading: Fairness Worries and Distributional Issues

The above discussion has presented an analysis favoring allowing insider trading on the basis of whistleblower information from instrumentalist and efficiency perspectives. Insider trading also raises important distributional concerns. In particular, at first blush it might appear that one advantage whistleblowing has over insider trading is that, since its impact is distributed more evenly over a corporation's population of shareholders, it is more "fair" than insider trading.

A. Fairness

At the outset, I wish to emphasize that no claim is being made here that those who trade on the basis of an informational advantage are particularly virtuous. These folks are not heroes. No claim is made that they are. Rather, the claim is simply that those who trade on the basis of inside information about an ongoing corporate fraud cannot be said categorically to be morally inferior to someone like Sherron Watkins who engages in self-serving whistle-blowing. This, of course, is not because those who engage in inside trading are commendable, but rather because those who engage in whistle-blowing are

not. Nevertheless, it is far from clear that insider trading of the sort described here should be banned on fairness grounds.[81]

It is important to recognize at the outset that the traders being discussed here deserve to be able to sell their shares ahead of other shareholders. From a fairness perspective, perhaps the best way to conceptualize the issue is by analogizing the shareholders in a company riddled with fraud to ethical dilemma that confronts the crew of a sinking ship with a grossly insufficient supply of life rafts. Selling shareholders are a bit like crew members who learn about a crisis on board ship in the course of their duties some time before their fellow passengers. Should the crew members be able to use this information to save themselves by securing a place on a life raft before the passengers?

Focusing on the differences between the employees (crew) and the outside investors (passengers) suggests that in the corporate context, the answer to this question generally will be yes. This is because, unlike outside investors, the rank-and-file employees are unable to diversify their investments in the companies in which they work, and thus they suffer disproportionately from the effects of major corporate scandals. In particular, workers, unlike outside investors, have undiversifiable investments in their own human capital. Trading on the basis of inside information related to an on-going corporate fraud that is going to destroy the company at least permits an employee to recoup some of this lost investment.

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[81] Louis Kaplow and Steven Shavell argue that legal policy analysis should be guided by reference to the well being of individuals, and that legal rules should not guided by notions of fairness except to the extent that these fairness notions affect individuals' well-being" Louis Kaplow and Steven Shavell, Fairness Versus Welfare at 27 (2002). Of course, under this approach, one need not address the issues of fairness raised by analytical devices such as Kant's categorical imperative or the veil-of-ignorance construct. Under the Kaplow-Shavell approach, insider trading of the kind I describe in this Article should be encouraged because it unambiguously leads to improvements in the welfare of individuals. However, in this portion of the Article my aim is to show that insider trading of the kind I describe is best characterized as “fair” in Kantian or Rawlsean terms as well as “efficient” in Pareto terms.

When a corporation like Cendant, Enron, and Equity Funding implode, the rank-and-file workers are often the hardest hit. When Enron filed for bankruptcy protection, more than 4500 workers lost their jobs.[82] In the fall of 2001, as the problems at Enron gradually revealed themselves, "the company swiftly collapsed, taking with it the fortunes and retirement savings of thousands of employees."[83] The Enron rank-and-file employees have had a very difficult time securing comparable employment elsewhere, even years after the collapse of the company.[84] In contrast with the executives at the top, who participated in the fraud and made millions, "most former Enron employees who had nothing to do with the fraud at the company," have not fared well at all.[85]

Like 25.6% of companies with 5,000 or more employees, most (60%)[86] of Enron employees had their retirement money undiversified investments in Enron stock,[87]

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[82] Kristen Hays, "Midlevel Enron Corp. Executive Pleads Guilty to Filing False Fax Return," Wednesday, November 27, 2002, http://www.texnews.com/1998/2002/texas/texas_Midlevel_1127.html

[83] Alexei Barrionuevo, "10 Enron Players: Where They Landed After the Fall," The New York Times, January 29, 2006, http://select.nytimes.com/search/restricted/article?res=F0061FF83A5B0C7A8EDDA80894DE404482

[84] Simon Romero, "Hard Times Haunt Enron's Ex-Workers; Few Find Jobs of Equal Stature Years After Company's Collapse" The New York Times, January 25, 2006, http://select.nytimes.com/search/restricted/article?res=F60C17FC3B5B0C768EDDA80894DE404482

[85] Id.

[86] Ari Weinberg, "The Post-Enron 401(k)" Forbes October 20, 2003. http://www.forbes.com/2003/10/20/cx_aw_1020retirement.html; Enron had 11,000 employees in its 401(k) plan, Michael W. Lynch, "Enron's 401(k) Calamity" Reason, December 27, 2001, http://www.reason.com/ml/ml122701.shtml In early 2001, Enron decided to contract out its 401(k) administration to an outside company. This transfer required that Enron's 401(k) accounts be frozen. Thus, for a certain period of time in October and November 2001 employees could not more their retirement funds out of Enron stock. There is a dispute about whether the accounts were frozen for 12 trading days, (from October 26, 2001 through November 12, 2001), as the Company claims, or for a longer period. . One employee has alleged that his account was frozen on September 26, 2001. A separate law suit alleges that accounts were frozen beginning on October 17, 2001. The period when the accounts were frozen, whatever the precise dates actually were, was a time of extreme upheaval at Enron. On October 16, 2001, the Company announced that it had to take a $1.1 billion charge for bad investments. On October 22, the SEC announced an informal investigation into Enron's accounting practices. On October 29, Moody's downgraded their ratings of Enron's debt. On October 31, the SEC announced that its investigation was formal. On November 8, Enron restated its financial results for every year since 1997. On October 26, 1991, the day Enron claims it froze its 401(k) accounts, its stock was trading at $13.81 per share. By the time 401(k) investors could sell again, the stock was at $9.98. Id.

despite the fact that these employees have other alternatives.[88] Like many other public companies, Enron matched pretax 401(k) contributions with its own stock and limited the ability of employees to sell that stock.[89] Given the undiversified nature of employees' investment in Enron stock, and the inability of Enron employees to diversify it does not appear to be unfair to permit these employees to sell and to sell short when in possession of material non-public information about their company. Other investors can avoid the firm-specific risk of an implosion at Enron by holding a diversified portfolio of securities. Workers cannot avoid this risk. The only way for them to mitigate the risk is by trading on the basis of inside information.

Permitting certain rank-and-file insiders to trade on the basis of their informational advantage about the on-going fraud at Enron would be entirely fair. Workers are at a disadvantage relative to other shareholders, because they are unable to diversify their human capital investment in the companies they work for. Rules enabling these people to trade would be consistent with Rawls' idea that legal rights ought to be arranged so that they inure "to the greatest benefit of the least advantaged."[90] Rawls, therefore endorses precisely the sort of involuntary disadvantage that results from insider trading when such disadvantage benefits the worst-off.

Another Rawlsean perspective, the veil of ignorance, generates the same conclusion about the fairness of insider trading. Rawls' methodology for generating

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[87] Corey Rosen, "Questions and Answers about Enron, 401(k)s, and ESOPS," National Center for Employee Ownership, http://www.nceo.org/library/enron.html

[88] Testimony of Douglas Kruse before the House Subcommittee on Employer-Employee Relations of the Committee on Education and the Workforce February 12, 2002 (reporting that "about 70-75% of participants in plans that are heavily invested in employer stock [ESOPs, 401(k) plans, and profit sharing plans] are in companies that also maintain diversified pension [or other retirement] plans"),

[89] Ari Weinberg, "The Post Enron 401(k)," supra.

[90] John Rawls, A Theory of Justice, (1971) at 83, 302; see alsoDaniel Markovits, "How Much Redistribution Should There Be?," 112, Yale Law Journal 2291, 2326-2329 (2003).

principles of justice is to imagine what rules of social ordering rational, self-interested people would choose from behind a veil of ignorance. It seems clear that rational shareholders in large public companies would agree *ex ante* to permit innocent insiders to trade on the basis of whistleblower information. This is true for the reasons discussed in the preceding paragraph regarding the fact that these workers deserve to trade. It is also true because self-interested investors would agree to permit this sort of insider trading because it reduces the probability that fraud will occur in the first place by increasing the probability that such fraud would be found out.

It is undeniable that insider trading, by definition, involves unequal treatment. To the extent that fairness is defined as equal outcomes, then the insider trading I describe, along with all other trading, would be banned. More troubling is the fact that the trading I describe also involves inequality of *opportunity*, because the insiders have access to whistleblower information that is not available to their trading partners. However, as Easterbrook and Fischel ably have explained, in the corporate context at least, fairness does not mean equal treatment because fairness and equality are not the same thing.[91] Fairness, for investors, requires the pursuit of policies that maximize the value of investments *ex ante*.[92] Easterbrook and Fischel illustrate the point as follows: given a choice between two ventures, one that provides a payoff of $10 to every one of a firm's 10 investors, and one that provides a payoff of $40 to five of the ten investors but nothing to the remaining five, a firm's board should choose the latter venture. This is because the total expected (ex ante) return from the latter investment is $200, while the expected return from the former investment is only $100. As Easterbrook and Fischel observe, if

[91] Frank Easterbrook and Daniel R. Fischel, The Economic Structure of Corporate Law, 110 (1991).
[92] *Id*.

unequal distribution is necessary to make the overall returns higher, than the company is *required* to choose inequality.[93] This illustration maps perfectly onto the whistleblower issue. Barring insider trading on whistleblower information would eliminate the inequality that results from the insider's trading on an informational advantage, but it also would eliminate the substantial gains to all investors associated with the *ex ante* reduction in the incidence of fraud. Thus, because shareholders "unanimously prefer legal rules under which the amount of gains is maximized, regardless of how the gains are distributed,"[94] insider trading on the basis of whistleblower information is fair to investors under any coherent notion of the meaning of the term "fair."

Finally, with respect to fairness, I hasten to acknowledge that the "pure" whistleblower (should such a thing exist) is a Good Samaritan.[95] Insiders, on the other hand, decidedly cannot be accurately described as Good Samaritans. Nevertheless, nobody has ever seriously suggested that one is legally required to be a Good Samaritan. The issue, in other words, is not whether insider trading on whistle-blower information should be applauded; the issue is whether the conduct should be considered criminal. At a minimum, this decision should be left to investors themselves, who, after full disclosure, should be allowed to decide for themselves whether they want to invest in a public company that permits insider trading on the basis of whistle-blower information.

B. Distributional Concerns

Intuitively, whistleblowers' impact is uniform across all shareholders, while insiders' trading differentially effects those (buying) shareholders who are unfortunate

[93] *Id*. at 111.
[94] *Id*. at 124.
[95] JJ Thomson, "A Defence of Abortion," 1 Philosophy and Public Affairs 47-66 (1971) (defining a Good Samaritan as "someone who goes out of his way, at some cost to himself to help."

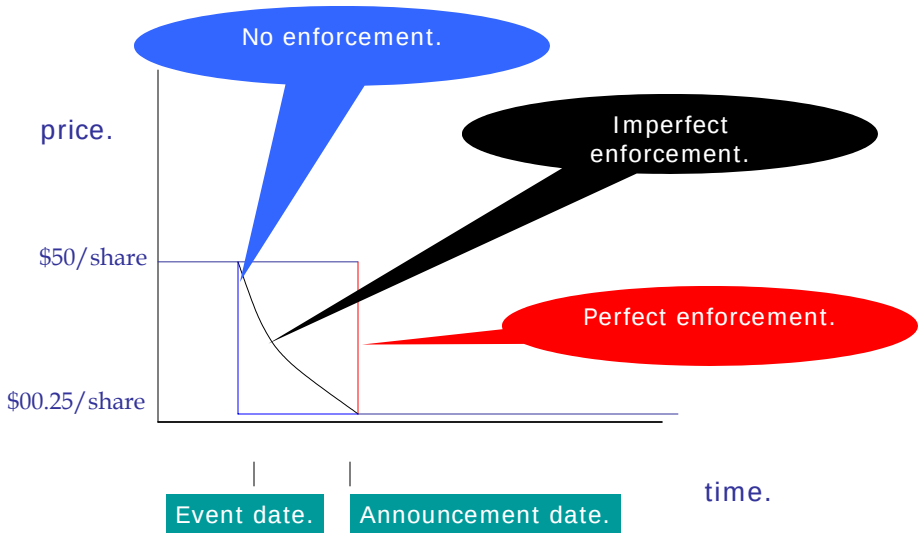
enough to be the counterparties of the insiders who are selling on whistleblower information. However, this intuition is wrong because it falsely assumes that those trading with insiders in possession of whistleblower information are harmed. In fact, the outsiders who are the whistleblower information traders' counterparties likely benefit from the insider trading here. This is because selling by insiders in possession of whistleblower information will, to the extent that it has any effect at all on share prices, drive down those prices, thereby benefiting their counter-parties by driving down their acquisition costs.

The downward pressure on share prices caused by insider trading will benefit ordinary investors, whom I define as investors who do not purport to trade on information not already impounded in share prices, but instead buy and sell shares either to adjust their portfolios or because of changes in patterns of consumption and investment over their life cycle. The critical point here is that such traders are not induced by insider selling to buy: they would have bought anyway. As such, they are made better off, not worse off, by any informed sales by insiders because such sales drive down the price at which the insiders' counterparties are able to buy. The effect of insider trading on true outsiders just described is depicted in the chart below.

The assumption is that, all else being equal, in the absence of any prohibition on insider trading there will be more such trading than there would be otherwise. This greater incidence of insider trading would cause share prices to fall more precipitously than they would fall otherwise. Alternatively, if enforcement of the law is "perfect" in the sense that all inside traders are caught and punished, there will be no such trading, and share prices will adjust only when the fraud or other corporate misconduct that is the

subject of the whistleblowing is revealed to the public, at which time there will be a dramatic drop in share prices. Finally, where there are prohibitions on insider trading on the basis of whistleblower information, but those prohibitions are imperfectly enforced, share prices will respond to insider trading, but less dramatically than they would respond if such trading were condoned.

Distributional Effects of Insider Trading Regulation About Corporate Misconduct



As depicted in the graph, because share prices fall most dramatically when insider trading is permitted, this is the legal regime that most benefits buyers. It is also clear that people who trade prior to the commencement of the fraud are not affected. And, of course, people who trade after the fraud is announced are similarly unaffected by the insiders' trading.

The above discussion of the distributional effects of insider trading on whistleblower information is incomplete because it ignores the real possibility that if insider trading on whistleblower information were permitted, then insiders might delay

exposing an on-going fraud in order to allow themselves time to trade on such information. This possibility, as noted above, also affects the analysis of the efficiency characteristics of trading on whistleblower information. However, from a distributional perspective, it is by no means clear that a delay in revealing an ongoing fraud or other corporate misconduct hurts a company's existing shareholders. Rather, such shareholders benefit as long as the conduct goes undetected, because as long as this is the case, share prices remain high. Shareholders who manage to use any extra time to sell their shares clearly benefit.

It is also the case that if insider trading is illegal and the only avenues that insiders have for dealing with fraud or corporate misconduct are blackmail and whistleblowing, the delay in the release of information about corporate misconduct is likely to be even longer than it will be if insiders are permitted to trade. Most importantly, from both an efficiency standpoint and a distributional standpoint, insider trading on whistleblower information is likely to lead to less corporate misconduct because the possibility that such insider trading will occur increases the probability that corporate fraud will be detected, thereby leading to a reduction in the incidence of such fraud.

This reduction in fraud makes all shareholders better off, whether viewed from a distributional perspective or an efficiency perspective. Thus, while there is some ambiguity about the distributional effects of insider trading on whistleblower information, the argument that insider trading has distributional *benefits* for true outsiders, which is the class of shareholders thought most deserving of protections, is quite compelling.

VIII. Whistleblowing and Insider Trading: Corporate Governance and Contracting Issues

Whistleblowing has long been encouraged as a means to reduce the incidence of fraud against the government. At common law, insider trading was tolerated: managers and other insiders were permitted to trade on the basis of non-public information unless specifically forbidden to do so by contract.[96] Corporate charters are silent both on the issue of insider trading[97] and on the issue of whistleblowing. This is surprising on both counts – it is surprising that corporate charters do not bar trading on inside information, and it also is surprising that corporate charters do not encourage whistleblowing by offering monetary rewards to whistleblowers like the ones provided for in federal whistleblower statues such as the False Claims Act.

However, the foregoing analysis explains both of these phenomena. As for insider trading, the analysis here suggests that it is not in shareholders' interests to bar all sorts of insider trading. Insider trading on whistleblower information should not be banned: indeed it should be encouraged. On the other hand, where insider trading involves the misappropriation of information that is the property of shareholders or the company itself, insider trading must be banned, as is the case where there is insider trading in advance of the announcement of a tender offer or of corporate earnings. Suppose, for example that a corporate officer accepts a bribe in exchange for information that a company was about to repurchase a large block of its own shares at a premium above the current market price. This information is then used by the person paying the bribe to purchase stock in the company, thereby driving up the price that the company

[96] Goodwin v. Agassiz, 283 Mass. 358, 186. N.E. 659 (1933) Comment, ""Insider Trading at Common Law, 51 U. Chi. L. Rev. 838 (1984).
[97] See Carlton & Fischel, The Regulation of Insider Trading, 35 Stanford L.Rev. 857 (1983) noting that corporate charters do not prevent insider trading.

must pay to acquire its own shares.[98] This sequence of events involves the theft of valuable information that is in the nature of a property right.

Current law permits insider trading when, and only when, such trading is consistent with traders' fiduciary duties of care and loyalty to the company. Fiduciary duties are the mechanism employed by the law to identify and allocate property rights in the information that provides the basis for trading. Fiduciary duties therefore replace contractual rules where contracting is too costly. Since insider trading can arise in a widely divergent set of circumstances, and because corporations and their agents do not have perfect foresight and thus are unable to anticipate all future situations in which insider trading might occur, it would be extremely costly to draft a corporate contract that specified with precision what sorts of trading are banned. So instead of trying to specify *ex ante* every possible situation in which insider trading should be banned, we have a rule that prohibits trading that involves breaches of fiduciary duties and theft of intellectual property.

The "contracting cost" explanation of why we do not observe provisions in corporate charters or bylaws barring insider trading does not explain why we do not observe provisions in corporate contracts that specifically permit whistleblowing, providing protections, and authorizing monetary rewards for whistleblowers. One possibility is that venal and corrupt corporate managers prevent these sorts of charter provisions from being implemented because they want to discourage whistleblowers from

[98] cf. FMC Corp. v. Boesky, 573 F. Supp. 242 (N.D. Ill 1987) reversed in part, 852 F.2d. 981 (7th Cir. 1988) on remand, 1989 U.S. Dist. Lexis 13353 (N.D. Ill) (corporation suing arbitrageur for insider trading on information about a corporate recapitalization that would distribute cash to shareholders in exchange for reducing their equity stakes in the company in order to give managers a larger share of the corporation's equity, on the theory that the corporation had to pay more to acquire the shareholders' equity because insider trading drove up the price of the company's shares).

revealing their illegal acts. This explanation is highly unlikely for two reasons. First, while it is undoubtedly the case that there are a few corporate managers who are dishonest, there are many more who are honest. Such managers would be able to signal their integrity by providing job security and bounties for whistleblowers. Thus, it might not be surprising that some firms decide not to provide such protections, but it is quite curious that none did until Sarbanes-Oxley required them to do so.

The Sarbanes-Oxley Act of 2002 contains two sets of provisions addressing issues involving corporate whistleblowers. One set of provisions are the whistleblower procedures mandated by Sarbanes-Oxley Section 301, which requires audit committees to establish internal whistleblowing procedures pursuant to Securities Exchange Act Rule 10A-3. The second set of provisions is contained in Sarbanes-Oxley Section 806, which adds a panoply of whistleblower protections to Title 18 of the U.S. Code.

Rule 10A-3 of the Exchange Act requires the New York Stock Exchange, Nasdaq, and other stock market self-regulatory organizations to compel the audit committees of listed companies to establish formal procedures for responding to whistleblowers' complaints regarding accounting and auditing issues. Audit committees must establish procedures for dealing with both external complaints from any sources and internal complaints from employees. Companies must provide a mechanism for receiving and processing confidential, anonymous submissions by employees of concerns regarding questionable accounting or auditing matters.

Section 806 of Sarbanes-Oxley establishes safeguards for employee whistleblowers who report certain sorts of corporate misconduct. Section 806 provides protections for any employee who either: (a) files, testifies, participates in, or otherwise

assists in any proceeding relating to an alleged violation of the mail, wire, bank, or securities laws; or (b) provides information or assists in an investigation regarding any conduct that the employee "reasonably believes" constitutes a violation of the mail, wire, bank, or securities laws. Employees are protected by Section 806 if they report information to a federal regulatory or law enforcement agency, any member or committee of Congress, any person with supervisory authority over the employee, or any other person who has "the authority to investigate, discover, or terminate misconduct." Additionally, Section 806 prevents employees who file complaints with the Secretary of Labor from being discharged, demoted, suspended, threatened, harassed, or discriminated against as a result of that involvement. Civil remedies for violations of Section 806 include reinstatement, back pay with interest, and attorneys' fees.

Second, it is curious why firms emerging from bankruptcy, firms going public for the first time, or firms whose original financing came from venture capitalists did not try to improve their access to the capital markets and the terms of their initial financing by introducing whistleblower protections such as the ones contained in Sarbanes-Oxley. In all likelihood, such provisions were not adopted by companies because they do not enhance shareholder welfare. It would be an exaggeration to say that providing protections for whistleblowers is devoid of benefits. Rather, the point is simply that it appears likely that companies generally decide on their own not to provide for protections for whistleblowers because the cost of maintaining such provisions outweighs the benefit.

One significant cost of installing whistleblower protections of the kind described in Sarbanes-Oxley is the cost of evaluating a whistleblower complaint. Particularly where bounties are involved, as noted above, there are likely to be several false

complaints for every valid one. The risk of receiving false complaints is compounded when one takes into account the fact that disgruntled former employees, especially those who have been terminated, are likely to bring whistleblower complaints in order to try to obtain reinstatement and/or back-pay.[99] It is also likely that terminated employees will attempt to extract a measure of revenge on former supervisors, particularly those responsible for the employees' termination.[100]

Evidence of concern about false whistleblower complaints is contained in the provisions of Sarbanes-Oxley Act itself, which requires OSHA to dismiss any whistleblower complaint without conducting an investigation unless the complainant can make a "prima facie showing" that his or her whistleblowing activities constituted at least "a contributing factor" in any alleged unfavorable personnel action. Even if the complainant succeeds in making this prima facie showing, Sarbanes-Oxley does not permit OSHA to investigate a whistleblower's complaint "if the employer demonstrates, by clear and convincing evidence, that the employer would have taken the same unfavorable personnel action in the absence of that behavior."

The high costs of investigating a whistleblower's complaints and the problems of false and retaliatory complaints, coupled with what may, in fact, be a low incidence of corporate fraud, make it likely that the costs of whistleblower provisions outweigh the benefits. These costs appear to be the best explanation for why companies did not adopt

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[99] The problem of distinguishing among whistleblower complaints is likely exacerbated by the fact that, whistleblowers often are mavericks who may have personality conflicts with supervisors anyway.

[100] Thus it is not surprising that whistleblowers are viewed with some moral ambiguously: ""[t]o some, whistle blowing is considered to be an ultimate expression of accountability. To others, whistle blowing is the spiteful behavior of disgruntled employees and an act of organizational disloyalty."" American Society for Public Administration, Position Statement on Whistleblowing, available at http://www.iit.edu/departments/csep/codes/coe/aspa-a.html accessed December 12, 2005

whistleblower protections such as the ones mandated by Sarbanes-Oxley before they were required to do so by statute.

IX. Whistleblowing and Insider Trading Are Not Blackmail

Like whistleblowing and insider trading, requests for blackmail payments reflect an effort to traffic in intellectual property. In particular, in all three cases, there is information that somebody wants to conceal, and somebody else wants to bring it to the light of day. Scholars have gone to great lengths to try to explain the harm in blackmail.[101] My goal here is not to add to the existing theories of how blackmail is different from or similar to other crimes.[102] The primary reason that blackmail has posed such an analytical problem for scholars is blackmail involves the combination of two acts: threatening to reveal a secret and demanding money (presumably) to keep the secret, neither of which, standing alone, is illegal.[103] Rather my point is simply that blackmail does not share the benign, welfare-enhancing characteristics that link insider trading and whistleblowing. In particular, whereas whistleblowing and insider trading inevitably lead to the discovery and exposure of pathological behavior, the payment and acceptance of blackmail lead to the continued concealment of the unacceptable behavior. This suggests that blackmail is a less desirable practice than either insider trading or

[101] Henry E. Smith, The Harm in Blackmail, 92 Northwestern L.Rev. 861 (1998); James Lindgren, Unraveling the Paradox of Blackmail, 84 Columbia L. Rev. 670 (1984); Jennifer Gerarda Brown, Blackmail as Private Justice, 241 University of Pennsylvania L. Rev. 1935 (1993).

[102] The primary reason that blackmail has posed such an analytical problem for scholars is that blackmail involves the combination of two acts, threatening to reveal a secret and demanding money in exchange for keeping a secret, neither of which, standing alone, is illegal. Glanville L Williams, Blackmail, 1954 Criminal L. Rev. 79, 163.

[103] Id. at 163.

whistleblowing. While insider trading and effective whistleblowing lead to the exposure of wrong-doing, successful blackmail leads to the continued cover-up of wrong-doing.[104]

Blackmailers are accurately perceived as sleazy and corrupt. Their conduct is clearly illegal. By contrast, whistleblowers are occasionally viewed as brave and altruistic, and inside traders, while viewed somewhat more ambivalently than whistleblowers, seem to hold a position in the moral order somewhere between blackmailers and whistleblowers.

X. Conclusion

Insiders who know or suspect corporate wrongdoing can respond in one of three ways: by whistleblowing, by insider trading, or by blackmailing the wrongdoers. This Article has advanced the argument that insider trading on the basis of information about corporate wrongdoing is more like whistleblowing than it is like blackmail. Unlike blackmail, in order for insider trading on information concerning corporate misconduct to be successful, the information that underlies such trading must be revealed or else the share price of the company engaged in the wrongdoing will not fall and the insider will not profit. By contrast, a successful blackmail strategy will result in a payoff to the blackmailer that will keep the information quiet forever. Thus, insider trading on whistleblower information, like whistleblowing itself, results in the release of information about corporate misconduct.

The argument here is not that all insider trading should be condoned. In fact the opposite is true. The analysis here applies only to a very narrow subset of inside information – information about corporate misconduct that would be the proper cause for

[104] This is not to say that blackmail involves only costs and no benefits. To the extent that the possibility of blackmail deters the undesirable conduct that is the subject of the blackmail, there are benefits. The social costs of blackmail, however, clearly outweigh the private benefits to the blackmail contract.

whistleblowing. Trading on non-public information about legitimate corporate news, whether the news is good or bad, is and should be illegal. The prohibition of this sort of insider trading is efficient because it protects valuable property rights in information. By contrast, corporations and corporate miscreants have no legitimate property-based expectation in keeping information about an ongoing misconduct confidential. Permitting insider trading on the basis of such information would, in a variety of contexts, provide the strongest incentives for people to seek out and expose such corporate wrongdoing.

Table 1

Definition	Whistleblowing	Insider Trading	Blackmail
Pre-existing contractual or quasi-contractual relationship of trust/confidence	Yes	Yes	No
Trading/Whistling/Blackmail demand involves breach of duty	No	No	No
Information becomes reflected in securities prices	Yes	Yes	No
Motivations of Actor	Highly Varied	Highly Varied	Venal
Informational intermediaries	Yes	Yes	No
Actions impose distributional harm	Yes	Yes	No
Actions lead to corrective measures	Yes	Yes	No
De minimus problem	No	Yes	Yes
Verification problem	Yes	No	Yes