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The More You Gain, the More You Lose: Sentencing Insider Trading Under the U.S. Sentencing Guidelines

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NOTES

THE MORE YOU GAIN, THE MORE YOU LOSE: SENTENCING INSIDER TRADING UNDER THE U.S. SENTENCING GUIDELINES

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Insider trading defendants are sentenced under the general economic crime provisions of the U.S. Sentencing Guidelines. These provisions provide a chart, which prescribes a gradually increasing offense level based on "the gain resulting from the offense." Only two circuit courts have yet to define "gain" for sentencing purposes, resulting in a split in methodology. Due to the tremendous weight the Guidelines place on the amount of "gain" when calculating a sentence, the potential result of using different methodologies to calculate "gain" is the difference between freedom and years of incarceration.

This Note examines the problems involved with both of the methods of calculating "gain" for sentencing purposes applied by the circuits. This Note proposes a reexamination and restructuring of the Guidelines' economic crime provisions in order to focus the determination of a defendant's sentence away from an unstable monetary figure and toward other factors that truly reflect the culpability of the defendant. This Note argues that a complete restructuring of the economic crime provisions is required to fulfill the original objectives upon which the Guidelines were created.

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INTRODUCTION

Imagine three corporate executives who share the same positive, material, nonpublic information about the future of their corporation. Based on this information, all three buy 1000 shares of stock at five dollars per share, costing them $5000 each. The positive information is publicized four weeks later. After the fifth week, the market has absorbed the information and it is reflected in the stock price, which is now fifteen dollars per share. On this day, Officer A sells his 1000 shares, making $10,000. Officer B retains his shares until three months later, when the stock price has risen to fifty dollars per share. Officer B pockets $45,000. Officer C was not so lucky; the market crashes six months later, the stock price drops to two dollars per share, and Officer C sustains a loss.[1]

All three executives have committed the same crime: they each purchased "a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence,"[2] in violation of federal law.[3] However, based on one interpretation of the U.S. Sentencing Guidelines (Guidelines), all three executives would be recommended for a different prison sentence. This is due to the operation of section 2B1.1 of the Guidelines, which prescribes increasing the total offense level based on "the gain resulting from the offense."[4] If one were to consider "gain" for this purpose as the pocketed gains that each executive made on his purchase and subsequent sale of stock, Officer A would be sentenced based on a $10,000 gain (resulting in a Guideline sentence of six to twelve months);[5] Officer B would be sentenced based on a $45,000 gain (Guideline sentence of fifteen to twenty-one months);[6] Officer C would be sentenced at the base level (Guideline sentence of no imprisonment to six months).[7]

1. Hypothetical situation adapted from *United States v. Mooney*, 425 F.3d 1093, 1107 (8th Cir. 2005) (en banc) (Bright, J., dissenting).
2. 17 C.F.R. § 240.10b5-1(a) (2010).
3. 15 U.S.C. § 78j(b) (2006).
4. U.S. SENTENCING GUIDELINES MANUAL §§ 2B1.1, 2B1.4 (2009).
5. *Id.* §§ 2B1.1, 2B1.4, 5A (assuming these defendants are in Criminal History Category I).
6. *Id.*
7. *Id.*

However, the intuition of most people would be that this result is unjust. As all three executives committed the same offense, their respective sentences should reflect their individual culpability, not their luck.[8] Alternatively, a different approach calculates the "gain resulting from the offense" by using the stock price at the time the market absorbed the effects of the positive, now public information, which was fifteen dollars per share.[9] Since all three executives purchased stock at the same price, their Guideline sentences would be equal.[10] This method has been termed the "market absorption" method and has only recently been adopted by a circuit court as a viable method to calculate insider trading gain.[11]

Although the above, over-simplified hypothetical appears to have an easy solution, in reality, reaching a precise date of market absorption can be both complicated and unreliable. Therefore, both methods described have flaws that could result in sentences that do not fully reflect the defendant's culpability. Since, in the current Guidelines, the "gain" amount carries the greatest weight, relative to other factors, in determining a sentence,[12] the resulting sentences are based frequently on a flawed figure. Thus, the method for deriving "gain", as well as the weight "gain" has in determining the sentence, are both issues of import. The two calculation methods that have emerged out of the circuits have created a conflict, further exacerbating the unpredictability of insider trading sentencing.[13]

This Note examines the methods of interpreting the insider trading provision of the Guidelines and the motives behind the creation of these provisions. Part I of this Note outlines the historical background of insider trading and sentencing law. Part II describes the current circuit split concerning the issue of interpreting "gain" under the applicable Guidelines provisions. Part III of this Note summarizes the problems involved with each of the methods applied by the circuits and proposes a reexamination of the Guidelines' economic crime provisions in order to focus the determination of a defendant's sentence away from a monetary figure—"gain"—and towards a reflection of the true culpability of the defendant. Part III argues that a complete restructuring of the economic crime provisions is required to fulfill the original objectives upon which the Guidelines were created.

I. THE DEVELOPMENT OF INSIDER TRADING AND SENTENCING LAW

Part I of this Note highlights the important developments in both securities fraud jurisprudence and white collar sentencing law. Because

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8. *See* 18 U.S.C. § 3553(a) (2006) (mandating that "[t]he court shall impose a sentence sufficient, but not greater than necessary"); *id.* § 3553(a)(6) (mandating that the sentencing court shall consider "the need to avoid unwarranted sentence disparities among defendants with similar records who have been found guilty of similar conduct").

9. *See infra* Parts II.A.2, II.A.4, II.B.2.

10. *See* USSG §§ 2B1.1, 2B1.4, 5A.

11. *See* United States v. Nacchio, 573 F.3d 1062, 1085–87 (10th Cir. 2009).

12. *See* USSG § 2B1.4.

13. *See infra* Part II.

understanding the nature of the offense and its consequences to the public is crucial to shaping an appropriate sentencing policy, Part I.A discusses the development of the criminalization of securities fraud and insider trading as well as briefly summarizes the effects such offenses have on the public. Part I.B outlines the development and philosophy behind federal sentencing law. Finally, Part I.C investigates the legislative history behind the current statutory prohibitions penalizing securities fraud in order to highlight that political, as opposed to philosophical, reasons underlie the current state of white collar sentencing.

A. Securities Fraud & Insider Trading Jurisprudence

1. The Origins of Securities Law: Common Law Fraud

The common law doctrine of fraud, on which all further statutory law is based, required proof of five elements: 1) a false statement of 2) material fact 3) made with the intention to deceive 4) upon which one reasonably relied and 5) which caused injury.[14]

Under common law, the elements of fraud are easily met when a defendant makes a false statement. However, the application is less clear in a case of omission—nondisclosure of a material fact. The unlawful conduct in question in any insider trading case is the nondisclosure of inside information about the future value of the stock in question.[15] However, at common law, people were expected to bargain for information.[16] Therefore, sellers or buyers of stock were not required to divulge any positive or negative information they possessed that might change what the other party considered to be a fair price for the stock. The only instance where a seller was required to deal with full and fair disclosure was in contracts between trustees and beneficiaries.[17]

State courts attempted to apply the trustee-beneficiary duty to directors and officers of corporations in several ways. Initially, a director's only duty was to his corporation and, therefore, he did not owe a duty of disclosure to those with whom he traded in the market.[18] A minority of courts found that a director had a duty to disclose all material information when he traded with shareholders in his company's stock.[19] Finally, an intermediate rule articulated in *Strong v. Repide*[20] was adopted. The *Strong* Court found that a director must either disclose material information or refrain from trading in face-to-face transactions only where "special facts" exist.[21]

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14. WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 615 (3d ed., 2009).
15. *See infra* notes 56–58 and accompanying text.
16. *See id.* at 616.
17. *See id.*
18. *See id.*
19. *See id.*
20. 213 U.S. 419 (1909).
21. *Id.* at 431. In *Strong*, the defendant who purchased stock from a shareholder of the company was not only a director, but he was also engaged in negotiations leading to the sale of the company's lands to the government at a price which he knew would greatly enhance

Today, common law fraud actions are rare.[22] In an open market where traders are rarely involved in direct face-to-face transactions, insider trading is practically never penalized under common law.[23] Insider trading is now almost exclusively litigated under the federal securities laws that developed out of the common law doctrines.[24]

2. Federal Statutory Authority: The Securities Act of 1933 & the Securities Exchange Act of 1934

The Securities Act of 1933 (1933 Act)[25] was enacted after the Great Depression and subsequent market collapse.[26] The main remedy of the 1933 Act was disclosure.[27] The 1933 Act forced the "registering" of public offerings and securities with a governing body, later commissioned as the Securities and Exchange Commission (SEC).[28] The 1933 Act required that any material information concerning securities offered on a public market must be ascertainable by investors, and prohibited deceit, misrepresentations, and other fraud in the sale of securities to the public.[29]

In 1934, Congress held hearings to address the concerns about trading practices of "unscrupulous market manipulators"[30] after noticing the adverse effects false and misleading information had on markets.[31]

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the value of the stock. *Id.* at 431–32. The Court found that the director was acting as an agent of the shareholders to receive the best available price for their benefit and that he was in the unique position to know the true value of the company. *Id.* at 432. The Court stressed that it was due to these "special facts," not solely to the fact that the defendant was a director of the company, that a duty to disclose the information he held about the value of the stock existed. *Id.* at 431–32; *see* ALLEN ET AL., *supra* note 14, at 616.

22. *See* ALLEN ET AL., *supra* note 14, at 620 ("[A]lmost all litigation of officer and director liability for trading in a company's securities—from the late 1940s to today—has been in the federal courts.").

23. *See, e.g.*, Freeman v. Decio, 584 F.2d 186, 196 (7th Cir. 1978) (en banc) (finding that Indiana law does not allow a derivative suit against corporate officers and directors for trading corporate stock on the basis of material inside information). *But see* Diamond v. Oreamuno, 248 N.E.2d 910, 912–13 (N.Y. 1969) (holding that under New York law, officers will be liable to the corporation if they trade based on information gleaned solely by virtue of their position as officers before disclosing information to the shareholders). *See also* HENRY MANNE, INSIDER TRADING AND THE STOCK MARKET 17–26 (1966) (discussing the evolution of common law rules). State fiduciary duty law is still applied in two situations: when a corporation brings a claim against an officer, director, or employee for the profits made by trading on information gleaned through his corporate duties; and when shareholders challenges the quality of the disclosures that the corporation makes to them. *See* ALLEN ET AL., *supra* note 14, at 620.

24. *See supra* note 22 and accompanying text.

25. 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2006)).

26. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 3 (5th ed. 2006).

27. *See id.*

28. *See id.*

29. *See id.* at 3–5.

30. *Id.* at 5–6 (describing, as one example of corruption, the practice of "stock pools," that is devices used by brokers and dealers to create a false appearance of trading activity intended to induce innocent investors to enter into the market based on these manipulated price and volume changes).

31. *See id.* at 6.

Furthermore, Congress found it inherently unfair that corporate insiders took advantage of the access they had to confidential information to make a personal profit.[32] These hearings resulted in the enactment of the Securities Exchange Act of 1934 (1934 Act).[33] The 1934 Act created the SEC[34] and delegated broad authority to the SEC to regulate all matters of trading in securities.[35] It is under the 1934 Act that SEC Rules are promulgated.[36]

The 1933 Act and the 1934 Act clearly attempt to prohibit fraud and encourage dissemination of information related to the trading of securities.[37] However, neither in these acts nor in other legislation has Congress ever defined the offense of "insider trading."[38] In fact, there is debate regarding whether insider trading should be regulated at all.[39] Over time courts have applied several statutes to the regulation of insider trading. Initially, the 1934 Act sought to regulate the trading of insiders by forcing full disclosure by issuers through reporting obligations.[40] Additionally, Section 16 of the 1934 Act contains a requirement for specific insiders to report certain types of transactions.[41] When these reporting requirements proved inadequate to prevent insiders from abusing confidential information for personal benefit,[42] the general antifraud section of the 1934 Act, Section 10,[43] and corresponding SEC Rule 10b-5[44] were targeted for proscribing insider trading.[45] This rule, derived from Section 10(b) of the

32. *See id.* It is interesting to note that the motivations behind the statutory development of securities fraud were to protect ignorant stockholders from manipulation, while today our laws work under the assumption that markets are dominated by sophisticated and resourceful investors. *See id.*; *infra* Part I.A.5.i.

33. 48 Stat. 881 (codified at 15 U.S.C. §§ 78a–78nn (2006)).

34. Securities Exchange Act of 1934 (1934 Act) § 4(a), 15 U.S.C. § 78d(a) (2006); *see* COX ET AL., *supra* note 26, at 6.

35. Securities Exchange Act of 1934 § 4(b), 15 U.S.C. § 78d (2006); *see* COX ET AL., *supra* note 26, at 6.

36. *See* 17 C.F.R. § 240.0-1 (2010) ("[T]he rules and regulations in this part [are] prescribed by the Commission pursuant to Title I of the Securities Exchange Act of 1934 . . . .").

37. *See supra* notes 25–36 and accompanying text.

38. *See* COX ET AL., *supra* note 26, at 879; William K.S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1224 (1981) ("No federal provision expressly prohibits the general practice of trading on nonpublic information . . . .").

39. *See, e.g.*, ALLEN ET AL., *supra* note 14, at 690 ("[T]he academic debate has ventured even farther afield from popular sentiment by focusing on whether insider trading ought to be regulated at all."); COX ET AL., *supra* note 26, at 880 ("Some economics-oriented legal scholars remain convinced that insider trading regulation is both unnecessary and counterproductive . . . ."); *see also* MANNE, *supra* note 23, at 138–41 (1966) (arguing that insider trading is a key tool of compensation for entrepreneurs and corporate insiders). *But cf. id.* at 147–58 (summarizing the arguments against using insider trading as compensation); Wang, *supra* note 38, at 1225 ("It is unlikely that inside trading is an incentive, much less an essential one, for top corporate executives."). The debate concerning whether insider trading should not be regulated is outside the scope of this Note.

40. *See* COX ET AL., *supra* note 26, at 879.

41. Securities Exchange Act of 1934 § 16, 15 U.S.C. § 78p (2006).

42. *See* COX ET AL., *supra* note 26, at 879.

43. Securities Exchange Act of 1934 § 10, 15 U.S.C. § 78j (2006).

44. 17 C.F.R. § 240.10b-5 (2010).

45. *See* COX ET AL., *supra* note 26, at 879.

1934 Act, is the government's most frequently used tool to regulate insider trading.[46]

3. The Elements of Rule 10b-5

Rule 10b-5 is promulgated under Section 10(b) of the 1934 Act,[47] which is the general antifraud section of the 1934 Act.[48] Rule 10b-5 is based on the common law fraud doctrine.[49] Rule 10b-5 expanded the common law doctrine into the open market in two landmark cases: In re *Cady, Roberts & Co.*[50] and *SEC v. Texas Gulf Sulphur Co.*[51] Both cases articulated that insider trading is an actionable offense because the assumed unequal access to information is inherently unfair.[52]

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46. *See, e.g.*, Chiarella v. United States, 445 U.S. 222, 230 (1980) ("Thus, administrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure."); *see also* Matthew R. King, *Securities Fraud*, 46 AM. CRIM. L. REV. 1027, 1057 n.174 (2009) ("Currently, § 10(b) and Rule 10b-5 are the Government's primary means of regulating insider trading."). Other statutes and rules that are applicable to insider trading under certain circumstances include Securities & Exchange Commission (SEC) Rule 14(e)-3, 17 C.F.R. § 240.14e-3, which prohibits trading during tender offers; the federal mail fraud statute, 18 U.S.C. § 1341 (2006); and § 16(b) of the 1934 Act, 15 U.S.C. § 78p(b) (2006), which requires certain insiders to disgorge any short-swing profits. *See* William K. S. Wang, *Recent Developments in the Federal Law Regulating Stock Market Inside Trading*, 6 CORP. L. REV. 291 (1983), *as reprinted in* CONTEMPORARY ISSUES IN SECURITIES REGULATION 59, 59 (Mark I. Steinberg ed., 1988). The statutory authority outside of § 10(b) and Rule 10b-5 are beyond the scope of this Note.

47. Section 10 states in part:

> It shall be unlawful for any person, directly or indirectly, by the use of . . . any facility of any national securities exchange . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j.

48. *See, e.g.*, *Chiarella*, 445 U.S. at 234–35 ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud."); *see also* COX ET AL., *supra* note 26, at 879.

49. Rule 10b-5 states in part:

> It shall be unlawful for any person . . . by the use of . . . any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5; *see supra* note 14 and accompanying text.

50. Exchange Act Release No. 6,668, 40 SEC Docket 907 (Nov. 8, 1961).

51. 401 F.2d 833 (2d Cir. 1968) (en banc).

52. *Id.* at 848 (describing that this unfairness frustrates "the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information"); *Cady, Roberts*, 40 SEC Docket at 912 (describing the obligation to disclose material facts as resting "on two principal elements; first, the existence

Since Rule 10b-5 prohibits "deceit" in the trading of securities, the elements of Rule 10b-5 are in line with those of common law fraud.[53] Rule 10b-5 requires: (1) a misstatement or omission (2) of material fact (3) with scienter[54] (4) in connection with the purchase or sale of a security (5) upon which the plaintiff reasonably relied and (6) that the plaintiff's reliance proximately caused his or her injury.[55] Over time, courts have found liability under the Rule to be consistent with the common law fraud requirements.

a. When Is Omission Unlawful? Finding a Duty to Disclose

Rule 10b-5 differed from the common law by including "omission" as an actionable offense under federal law.[56] A duty to disclose (or abstain from trading with) material information was difficult to establish at common law in the absence of either a trustee-beneficiary relationship or the existence of "special facts."[57] With 10b-5 liability now extended to cover an omission of material facts, federal courts grappled with developing a theory under which to find a duty to disclose.[58]

i. The Equal Access Theory

Initially, the SEC and the courts both adopted the aggressive position that mere possession of relevant, material, nonpublic information gave rise to a duty to disclose or abstain from trading.[59] This theory was called the "equal access theory" and operated under the assumption that "all traders owe a duty to the market to disclose or refrain from trading on nonpublic corporate information."[60] However, the equal access theory was too far removed from the strict common law requirement of an affirmative duty to disclose and was subsequently rejected by courts.[61]

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of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing") (footnotes omitted); *see also* COX ET AL., *supra* note 26, at 880.

53. *See supra* note 14 and accompanying text.

54. "Scienter" is "an 'intent to deceive, manipulate, or defraud' by the defendant." King, *supra* note 46, at 1036 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976)). After several cases grappled with the definition of what mental state was required to be liable under Rule 10b-5, the SEC adopted Rule 10b5-1 and defined trading "on the basis of" inside information as whether or not the trader was "aware" of the information. 17 C.F.R. § 240.10b5-1(b).

55. 17 C.F.R. § 240.10b-5.

56. *Id.*

57. *See supra* notes 16–22 and accompanying text.

58. *See* ALLEN ET AL., *supra* note 14, at 632.

59. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc); *In re* Cady, Roberts & Co., Exchange Act Release No. 6,668, 40 SEC Docket 907, 911, 913 (Nov. 8, 1961).

60. ALLEN ET AL., *supra* note 14, at 646; *see supra* note 52 and accompanying text.

61. *See, e.g.*, Chiarella v. United States, 445 U.S. 222, 227–28 (1980) (rejecting the equal access theory).

ii. The Fiduciary Duty Theory

The courts next attempted to isolate a preexisting relationship between insiders and other traders to support the analogy to the common law recognition of the trustee-beneficiary relationship.[62] The U.S. Supreme Court, in *Chiarella v. United States*,[63] rejected the equal access theory and found it necessary that the insider breach a fiduciary duty in trading on the inside information in order to find Rule 10b-5 liability.[64] In so holding, the Court established the "fiduciary duty theory" (or the "classical theory").[65] In *Chiarella*, the Court overturned the criminal conviction of a financial printer who had traded on confidential knowledge of pending takeover bids that he had gained via his employment.[66] The Court ruled that the printer did not breach a disclosure duty by trading on the nonpublic information.[67] Since the printer had learned information from the documents of the takeover bidders—and not the target company—he lacked a relationship with, and therefore a fiduciary duty to, the shareholders of the target companies.[68] If instead Chiarella had used the knowledge to trade on the shares of the company by which he was employed, the fiduciary duty requirement would have been fulfilled.[69]

The Court extended the fiduciary duty theory to "tippees" and "tippers" in *Dirks v. SEC*.[70] In *Dirks*, a former employee exposed a company's ongoing fraud to a securities analyst, Dirks, who then informed his own clients of the fraud without successfully alerting the public.[71] The Court found that although Dirks himself did not have a fiduciary relationship with the shareholders of the company with whom he traded, the fiduciary duty of the employee who "tipped" him could be applied to Dirks in certain circumstances.[72] In *Dirks*, the Court reasoned that since the employee, the

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62. *See supra* notes 16–17 and accompanying text.
63. 445 U.S. 222 (1980).
64. *Id.* at 233 ("We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information. Formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties, should not be undertaken absent some explicit evidence of congressional intent."); *see* ALLEN ET AL., *supra* note 14, at 632–33.
65. *Chiarella*, 445 U.S. at 228 ("[O]ne who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.'") (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)); *see* ALLEN ET AL., *supra* note 14, at 632–33.
66. *Chiarella*, 445 U.S. at 224.
67. *Id.* at 233.
68. *See id.* at 232–33; ALLEN ET AL., *supra* note 14, at 647–48.
69. *See* ALLEN ET AL., *supra* note 14, at 647–48.
70. 463 U.S. 646, 660 (1983).
71. *Id.* at 648–50.
72. *Id.* at 660 ("[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.").

"tipper", had not personally benefited from the "tippee's" trading, there was no tipper violation of Rule 10b-5 and thus no violation to pass on to the tippee.[73]

iii. The Misappropriation Theory

The courts eventually found that the fiduciary duty theory alone did not enable them to find liability in all appropriate situations.[74] *Chiarella*, for example, appeared to be a clear case where liability could have been found under a slightly modified duty to disclose.[75] The lower courts responded to *Chiarella* by proposing the "misappropriation theory" to reach company outsiders who trade illicitly on confidential information.[76] The theory holds that the deceitful misappropriation of market-sensitive information is itself a fraud on the source of the information and is therefore a violation of Rule 10b-5.[77]

In *United States v. O'Hagan*,[78] the Supreme Court also adopted the more far-reaching theory. O'Hagan was a partner at a law firm involved in a possible tender offer[79] by Grand Metropolitan for the stock of Pillsbury Company.[80] Although O'Hagan did not work on the account himself, he began to purchase call options for Pillsbury stock after his firm began representing Grand Metropolitan.[81] Once the tender offer was made public, O'Hagan exercised his options and was rewarded with a $4.3 million profit.[82]

The Supreme Court adopted the misappropriation theory and held that a defendant is liable under Rule 10b-5 "when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[83] The Court felt that this theory built on, and did not replace, the fiduciary duty theory outlined in *Chiarella*.[84] In this

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73. *Id.* at 662 ("Absent some personal gain, there has been no breach of duty to stockholders.").

74. *See infra* note 76.

75. *See supra* note 69 and accompanying text.

76. *See, e.g.*, United States v. Chestman, 947 F.2d 551, 566 (2d Cir. 1991); SEC v. Cherif, 933 F.2d 403, 410 (7th Cir. 1991) (en banc); SEC v. Clark, 915 F.2d 439, 453 (9th Cir. 1990).

77. *See, e.g.*, *Chestman*, 947 F.2d at 566 (citing United States v. Carpenter, 791 F.2d 1024, 1032 (2d Cir. 1986)) ("Focusing on the language 'fraud or deceit upon *any* person', we have held that the predicate act of fraud may be perpetrated on the source of the nonpublic information, even though the source may be unaffiliated with the buyer or seller of securities."); *Carpenter*, 791 F.2d at 1032 (2d Cir. 1986) (confirming that the breach of trust may be made upon the source of the information and not the buyer or seller of the security in order to find liability under Rule 10b-5).

78. 521 U.S. 642 (1997).

79. A "tender offer" is an offer to all shareholders of a corporation to purchase their shares at a premium over market price. ALLEN ET AL., *supra* note 14, at 433. The objective of a tender offer is to obtain a controlling share of the corporation. *Id.*

80. *O'Hagan*, 521 U.S. at 647.

81. *Id.*

82. *Id.* at 648.

83. *Id.* at 652.

84. *Id.* at 652–53 ("The two theories are complementary . . . . The classical theory targets a corporate insider's breach of duty to shareholders with whom the insider transacts;

case, the duty owed by O'Hagan was not as one standing in a fiduciary relationship to shareholders of Pillsbury, but instead as one bound to the expectation of confidentiality of his law firm and its client, Grand Metropolitan.[85]

A number of cases attempted to define relationships that trigger the duty to disclose or abstain from trading under the misappropriation theory.[86] In response, the SEC adopted Rule 10b5-2, stating that a duty of trust and confidence exists for purposes of the misappropriation theory whenever: (1) a person agrees to maintain information in confidence, (2) a history, pattern or practice of keeping information confidential exists, or (3) the information is shared by a family member, unless the defendant can show that there was no expectation to keep the information confidential.[87]

Examining the misappropriation theory and its limits uncovers what courts view to be the harm from insider trading—the unfairness caused by the breach of trust between parties.[88] Since liability under 10b-5 requires finding "deception," the misappropriator would need to breach a duty of trust to the source of the information and, therefore, make the transactions without informing the source of his intention to profit from the confidential information.[89] This ignores that the trade's effect on the market would be the same regardless of whether the trader informed his source that he planned to use the information in this manner.[90] The same result would occur if the source authorized the trader to use the information.[91] These examples illustrate that the breach of trust between parties is the main concern driving insider trading prohibition.

b. Satisfying the Duty to Abstain or Disclose

When is it appropriate for an inside trader to begin trading on his inside information? Should he wait until there has been a public announcement, or is it sufficient to wait until a substantial number of investors have access to the information, by a leak of the information or a release to a portion of investors?[92] The SEC in In re *Faberge, Inc.*[93] suggested a "public access" approach: information must be disclosed "in a manner calculated to reach

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the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate 'outsider' in breach of a duty owed not to a trading party, but to the source of the information.").

85. *Id.* at 653 n.5.

86. *See, e.g.*, United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991) (holding that a husband-wife relationship was not fiduciary per se as to give rise to a duty to respect confidential information); United States v. Carpenter, 791 F.2d 1024, 1035 (2d Cir. 1986) (finding liability when a journalist for the *Wall Street Journal* traded with advance knowledge that a stock would get a good review in a later column due to the misappropriation of information from the source, the *Journal*).

87. 17 C.F.R. § 240.10b5-2 (2010); *see* COX ET AL., *supra* note 26, at 897–98.

88. *See infra* Part I.A.5.b.

89. *See supra* note 49 and accompanying text.

90. *See* COX ET AL., *supra* note 26, at 898.

91. *See id.*

92. *See id.* at 885.

93. Exchange Act Release No. 10,174, 45 SEC Docket 249 (May 25, 1973).

the securities market place in general through recognized channels of distribution, and public investors must be afforded a reasonable waiting period to react to the information."[94] The U.S. Court of Appeals for the Second Circuit in *United States v. Libera*[95] found the appropriate approach to be whether the material information has been fully impounded into market price, on the assumption that the opportunity for wrongful profit has passed.[96] These cases bear on the determination of what point in time an insider trading defendant's conduct ceases to be illegal.[97]

4. Loss Causation and Damages: Calculating the Harm Done

To find liability under Rule 10b-5, a false statement or omission "must both 'cause' the plaintiff to enter the transaction and 'cause' the plaintiff's loss."[98] Losses that are caused by the insider's transaction are actionable. However, factors other than omission, such as general market factors, should not be recoverable as damages.[99]

In *Dura Pharmaceuticals, Inc. v. Broudo*,[100] the Supreme Court put a limit on the type of damages that could be recovered from a false statement or omission. Dura made false public statements concerning the likelihood of Food and Drug Administration (FDA) approval of a new asthmatic spray device, revealing later that the FDA would not approve the device.[101] Once the true information was revealed, Dura's share price temporarily fell but almost fully recovered within a week.[102]

The U.S. Court of Appeals for the Ninth Circuit found liability, requiring only a "pleading that the price at the time of purchase was overstated."[103] The Supreme Court unanimously reversed.[104] Justice Breyer, writing for the Court, rejected the Ninth Circuit's "inflated purchase price" approach to causation of loss.[105] The Court reasoned that the fact that the stock price was inflated by false statements at the time of purchase was insufficient to establish that the false statements actually caused a loss on sales after truthful disclosure.[106] The Court indicated that the variations of the stock market do not themselves cause fraud-related economic loss.[107] Therefore, the damages that the plaintiff could recover were only those that the

94. *Id.* at 255.
95. 989 F.2d 596 (2d Cir. 1993).
96. *Id.* at 601.
97. *Cf. infra* notes 396–407 and accompanying text (discussing the *Nacchio* court's examination of the possible portion of insider gains that is "lawful"); *infra* Part III.A (discussing the problems with using gain to measure culpability).
98. *See* ALLEN ET AL., *supra* note 14, at 685.
99. *Id.*; *see infra* Part III.A.
100. 544 U.S. 336 (2005).
101. *Id.* at 339.
102. *Id.*
103. Broudo v. Dura Pharm., Inc., 339 F.3d 933, 938 (9th Cir. 2003), *rev'd*, 544 U.S. 336 (2005).
104. *Dura*, 544 U.S. at 338.
105. *Id.* at 345.
106. *Id.* at 342–43.
107. *Id.*

defendant's illegal conduct caused, which ceased once the market absorbed the truthful information.[108]

Although *Dura* spoke to loss causation and damages in a civil false statement case, courts have applied the same reasoning in criminal prosecutions because it sheds light on the point at which damage is done, and therefore liability will end—when truthful disclosure cuts off the loss causation.[109] Once courts determine the point at which loss causation has ceased, how courts actually calculate damages in a civil proceeding can also be extremely helpful in determining a sentence under the Guidelines, due to the similar calculations of a plaintiff's damages and of the insider's "gain" under the Guidelines.[110] Examining civil damages calculations can be used as guidance in calculating a sentence under the Guidelines.[111]

The majority method to calculate damages used by civil courts is the "disgorgement method."[112] The primary purposes of this remedy are to deprive a defendant of "ill-gotten gains"[113] and to prevent unjust enrichment.[114] The U.S. Court of Appeals for the First Circuit in *SEC v. MacDonald*[115] examined whether a defendant should be required to disgorge the entire profits from the sale of securities purchased on the basis of insider knowledge or only "an amount representing the increased value of the shares at a reasonable time after public dissemination of the information," determining that the district court should analyze the market absorption date to provide an appropriate disgorgement amount.[116]

The *MacDonald* court found that any increase in the value of stock after the public dissemination of the information could not be attributable to any illegal conduct of the defendant.[117] Although acknowledging previous holdings recognizing that any windfall of a rise in stock price should be for the benefit of the defrauded and not the fraudulent party,[118] the court also recognized that "[t]here are, of course, limits to this principle."[119] The

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108. *See id.*

109. *See, e.g.*, United States v. Nacchio, 573 F.3d 1062, 1078 (10th Cir. 2009); United States v. Rutkoske, 506 F.3d 170, 179 (2d Cir. 2007); United States v. Olis, 429 F.3d 540, 546 (5th Cir. 2005) ("The civil damage measure should be the backdrop for criminal responsibility both because it furnishes the standard of compensable injury for securities fraud victims and because it is attuned to stock market complexities."); *infra* notes 410–14 and accompanying text; Part III.A.

110. *See infra* notes 413–15 and accompanying text.

111. *See, e.g.*, *Nacchio*, 573 F.3d at 1077–80 (relying on civil cases, and specifically the disgorgement method of calculating damages, to formulate a method to calculate "gain" for the purposes of sentencing).

112. *See, e.g*, SEC v. Calvo, 378 F.3d 1211, 1217 (11th Cir. 2004) (upholding the district court's plan to distribute disgorged funds absent abuse of discretion); *see* King, *supra* note 46, at 1084.

113. *Calvo*, 378 F.3d at 1217.

114. *See, e.g.*, SEC v. Banner Fund Int'l, 211 F.3d 602, 617 (D.C. Cir. 2000) (finding that disgorgement is an equitable remedy to prevent unjust enrichment).

115. 699 F.2d 47 (1st Cir. 1983).

116. *Id.* at 52–55.

117. *Id.* at 52.

118. *Id.* at 53 (quoting Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir. 1965)).

119. *Id.* (quoting *Janigan*, 344 F.2d at 787).

court found that "the defrauded sellers can recover only those accretions occurring up to a reasonable time after they discovered the truth."[120] Additionally, the court noted that any other method would result in inequitable results to similarly situated defendants.[121]

The court then determined that there should be a "cut-off date," at which point subsequent profits or losses are considered unrelated to the inside trading and, therefore, should not be applied to the disgorgement amount.[122] The court also looked to *Texas Gulf* for guidance in determining when this "cut-off date" should be.[123] In examining *Texas Gulf*, the Court found that the period for dissemination and "digestion" of the information into the market could be reasonably found to be no longer than one day.[124] The *MacDonald* court noted that in the case of the stock with which MacDonald was dealing, "the market itself may be the best indicator of how long it took for the investing public to learn of, and react to, the disclosed facts."[125] At first disclosure the stock price increased; once investors stopped reacting to the good news, the stock price leveled off, even if only temporarily.[126] The court found this price behavior to be evidence of the time at which the market ceased reacting to the illegal conduct.[127] The disgorgement measure of damages has since become the standard measure of damages in both SEC actions and private action litigation.[128]

5. Theoretical Underpinnings: Who Is Harmed by Insider Trading?

In order to comprehend how insider trading harms society, as well as individuals, it is necessary to consider the economic theories underlying how markets function when there is trading of insider information.

a. Efficient Capital Market Hypothesis and Its Critiques

One of the core working hypotheses of modern financial economics is the Efficient Capital Market Hypothesis (ECMH).[129] Although how markets

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120. *Id.* The court went on to explain that "[w]hen a fraudulent buyer has reached the point of his full gain from the fraud, viz., the market price a reasonable time after the undisclosed information has become public, any consequence of a subsequent decision, be it to sell or retain the stock, is *res inter alios*, not causally related to the fraud." *Id.* at 54.

121. *Id.* at 54 ("[T]o charge one class of insiders more than others who had committed precisely the same fraudulent act does not seem to us to meet any definition of 'equitable.'").

122. *Id.; see also* SEC v. Shapiro, 494 F.2d 1301, 1309 (2d Cir. 1974) ("Once public disclosure is made and all investors are trading on an equal footing, the violater should take the risks of the market himself.").

123. *MacDonald*, 699 F.2d at 54.

124. *Id.* (citing to and discussing SEC v. Texas Gulf Sulphur Co., 312 F. Supp. 77 (S.D.N.Y. 1970), *modified on other grounds*, 446 F.2d 1301 (2d Cir. 1971)).

125. *Id.* at 55.

126. *Id.*

127. *Id.*

128. *See, e.g.*, Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980); *see* ALLEN ET AL., *supra* note 14, at 689.

129. *See* ALLEN ET AL., *supra* note 14, at 130. The Efficient Capital Market Hypothesis (ECMH) was introduced by Eugene F. Fama, in his article *Efficient Capital Markets: A*

function has never been truly agreed upon and continues to be studied, securities fraud analysts as well as courts rely on the ECMH as the main assumption when attempting to calculate the cause-and-effect "loss" or "gain" attributed to a particular fraud.[130] The ECMH postulates that prices of stock on the market reflect all material information available to the public and that this information is quickly assimilated into stock prices.[131]

The ECMH focuses on the relationship between stock price and information.[132] A price is established in an efficient market if the price that exists for the security is what it would be if everyone had the same information about that security.[133] Not every investor has the same opinion about the value of the stock, but an efficient market will be the result of all investors' collective decisions, which are based on the same information.[134] The ECMH also holds that material information is rapidly absorbed into the market and the price quickly reflects that information upon its public dissemination.[135] For this to be true, the ECMH assumes that sophisticated investors exist who do the required research and trade, so that the information is introduced into the market.[136]

Although at one point the ECMH was thought to be unassailable,[137] the theory has been under attack, especially recently, for not properly anticipating volatility in the market unrelated to the stock's intrinsic price.[138] Market behaviors such as "bubbles" and other evidence of "herd" behavior have brought the ECMH's ability to explain stock prices into question.[139] Evidence that has been offered to question the ECMH includes

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Review of Theory and Empirical Work, 25 J. FIN. 383 (1970) [hereinafter Fama, *Efficient Capital Markets*], which he followed with *Efficient Capital Markets: II*, 46 J. FIN. 1575 (1991).

130. *See* COX ET AL., *supra* note 26, at 95 ("[M]any doctrines and SEC regulations are premised on the efficient market hypothesis."); *id.* at 105 ("[T]he efficient market hypothesis is the intellectual framework within which current disclosure policies are formulated and their operation assessed."); *infra* Part I.A.5.b.

131. Fama, *Efficient Capital Markets*, *supra* note 129, at 383–84; *see* ALLEN ET AL., *supra* note 14, at 130, 683.

132. Fama, *Efficient Capital Markets*, *supra* note 129, at 388; *see* COX ET AL., *supra* note 26, at 105.

133. Fama, *Efficient Capital Markets*, *supra* note 129, at 387; *see* COX ET AL., *supra* note 26, at 105–06.

134. *See* COX ET AL., *supra* note 26, at 106.

135. *Id.*

136. *Id.* at 107.

137. In 1978, Professor Michael Jensen wrote: "I believe there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis." Michael C. Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95, 95 (1978).

138. *See, e.g.*, Robert M. Daines & Jon D. Hanson, *The Corporate Law Paradox: The Case for Restructuring Corporate Law*, 103 YALE L.J. 577, 614 (1992) ("Legal scholars familiar with current financial economics literature agree that there is now reason to doubt the efficiency of [securities] markets."); Ronald H. Gilson & Reinier Kraakman, *The Mechanisms of Market Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715 (2003); Donald Langevoort, *Taming the Animal Spirits of Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 141 (2002) ("If far from dead, market efficiency is at least more contestable than ever."); *see* COX ET AL., *supra* note 26, at 110–15.

139. A recent *N.Y. Times Magazine* article by economist Paul Krugman attacked economists' general reliance on the ECMH and blamed this reliance for the recent economic

stock analyst strategies that actually count on "fads and fashions" when predicting future stock behavior, representing a belief that stocks are in fact mispriced.[140] Furthermore, the volume of trading and the volatility of stock prices indicate that prices do not reflect the intrinsic value at any given moment.[141] Many argue that this behavior is more consistent with the view that stock prices are determined significantly by investor reaction rather than on the actual financial information related to the security.[142] Originally dismissed, economist John Maynard Keynes felt that stock prices reflected a collective strategy by investors to assess what the "crowd" would do, rather than to assess what the value of the stock was based on the company's assets or future financial performance.[143] Some commentators are once again embracing Keynes' ideas.[144]

Some scholars point to a relatively new theory, behavioral finance, to raise questions about the ECMH.[145] The theory suggests that "noise traders," whose trades are motivated by behavioral biases as opposed to rational expectations about intrinsic value, influence prices.[146] Though the ECMH is not discredited, it stands qualified by research supporting the view that markets are "noisy".[147] Although the assertion that stock prices react quickly to publicly available information is not refuted, "[w]hat remains in doubt is how often, and for what duration, stock prices might move out of line with fundamental values."[148] This uncertainty makes it difficult to calculate "gain" and "loss" precisely and consistently.[149]

b. Who Is Harmed?

Understanding the harm caused by insider trading is crucial in deciding how an insider trading defendant should be penalized.[150] Because determining the culpability of each particular defendant is necessary to

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collapse. Paul Krugman, *How Did Economists Get It So Wrong?*, N.Y. TIMES MAGAZINE, Sept. 6, 2009, at 36, 43 ("The spread of the current financial crisis seemed almost like an object lesson in the perils of financial instability.").

140. *See* COX ET AL., *supra* note 26, at 111.

141. *Id.*

142. *Id.*

143. JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY 147–64 (1936); *see* COX ET AL., *supra* note 26, at 112.

144. *See, e.g.*, Krugman, *supra* note 139, at 36, 43; *see also* John Cassidy, *Letter from Chicago: After the Blowup*, NEW YORKER, Jan. 11, 2010, at 28 (examining the recent change in economic attitude toward a Keynesian ideology by interviewing, among others, Judge Richard A. Posner, a leader in the Chicago School of economics, now a reformed "Keynesian").

145. *See, e.g.*, Krugman, *supra* note 139, at 36, 42–43; Larry E. Ribstein, *Fraud on a Noisy Market*, 10 LEWIS & CLARK L. REV. 137, 139–41 (2006).

146. Ribstein, *supra* note 145, at 141; *see* COX ET AL., *supra* note 26, at 110–13; *see infra* notes 438–44 and accompanying text.

147. COX ET AL., *supra* note 26, at 113.

148. *Id.*

149. *See infra* text accompanying note 445.

150. Determining the harm caused will help to determine culpability of the defendant. *See* STANTON WHEELER ET AL., SITTING IN JUDGMENT: THE SENTENCING OF WHITE-COLLAR CRIMINALS 20 (1988).

dispensing sentences that are uniform and not arbitrary, it is important to understand both the practical effects, as well as the degree of harm caused by the fraud itself.

With the ECMH as a strict assumption in determining insider trading effects, a theoretical understanding can be reached on how insider trading harms participants in the market. The first conception of why insider trading is harmful is that it is "unfair" and undermines public confidence in the market.[151] Since market prices supposedly reflect all publicly available information, undisclosed information should not be used to privately assess the stock's true value.[152] Allowing insider trading can impede corporate decision making, and tempt insiders to delay public disclosure of valuable information.[153]

But what is the direct, measurable harm attributed to the crime? The first conception of harm is the idea articulated in *Cady, Roberts* and *Texas Gulf Sulphur*: 10b-5 is intended to level the playing field of those trading in securities.[154] The focus of the equal access theory is the "inherent unfairness," discussed in *Cady, Roberts*, involved in an insider taking advantage of the information that is unavailable to those with whom he is trading.[155] The injured party under this theory is the individual trader who was taken advantage of by the insider.[156] The policy being furthered is that traders have a "justifiable expectation . . . that all investors . . . have relatively equal access to material information."[157] Although the equal access theory is no longer a viable method on which to predicate a duty to disclose,[158] the idea of underlying unfairness has survived in subsequent insider trading jurisprudence.[159]

Putting aside the idea that profiting from an informational advantage is inherently harmful to other traders, the practical effect of insider trading on the market provides additional reasoning to regulate such conduct. Those opposed to the regulation of insider trading, namely Henry Manne, have argued that the only effect inside trading has on the market is to move the market in the right direction, reflecting the most accurate information.[160] If this is true, all other traders actually receive a better, more informed price

151. *See, e.g.*, Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 344 (1979) (quoting *In re* Cady, Roberts & Co., Exchange Act Release No. 6,668, 40 SEC Docket 907, 912 (Nov. 8, 1961)); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 858 (1983).

152. *See supra* notes 132–35 and accompanying text.

153. *See* Carlton & Fischel, *supra* note 151, at 858.

154. *See supra* note 52 and accompanying text.

155. *See supra* Part I.A.3.a.i.

156. *See* Kenneth E. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 804 (1980).

157. *Id.* at 806.

158. *See supra* notes 61, 64 and accompanying text.

159. *See supra* Parts I.A.3.a.ii–iii (summarizing the development of the "fiduciary duty" and "misappropriation" theories, both founded on an assumption that profiting from the use of confidential information is unfair to the source of that information, and to other traders).

160. MANNE, *supra* note 23, at 77–110; *see* Scott, *supra* note 156, at 807.

than if the insider had stayed out of the market.[161] Essentially, insiders are correcting the market price by selling their information to other traders.[162] Therefore, assuming markets are efficient, insider trading will lead to more informed prices and may actually increase investor confidence as well as the efficiency of the market.[163]

However, there are others who may be harmed by the insider trading besides the party directly transacting with the insider. An example featuring a corporation with very few shareholders who interact in face-to-face transactions demonstrates this harm. Suppose that the president of a corporation knows adverse material information about the corporation.[164] The president, betting that the stock price will decrease at disclosure, is interested in selling his shares.[165] However, an unknowledgeable stockholder also desires to sell his shares at the market price, eleven dollars per share.[166] The president is willing to sell his shares at ten dollars per share, and therefore the president preempts the other shareholder's sale.[167] When the bad news is disclosed, the shareholder is stuck with his shares that are now worth only eight dollars per share. He is made worse off by the insider's trading.[168]

Similar harm occurs when the president has good news.[169] He will buy shares at a higher price than market value, knowing that the price will increase when the news is disclosed.[170] Therefore, he preempts other traders who desire to buy at market price, depriving them of the opportunity to profit when the good news is disclosed.[171] He also induces current shareholders, who would not have sold but for the insider's offer, to sell their stock at the higher price.[172] These shareholders have also been deprived the opportunity to profit from the disclosure.[173]

Analogous harm also occurs in the public stock market. When a large insider purchase increases the stock price, it induces current shareholders to sell, missing the opportunity to profit off the inevitable price increase.[174] Similar effects happen when a large insider sale decreases the price.[175] This large sale preempts other sellers who were willing to sell at the higher

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161. MANNE, *supra* note 23, at 77–110; *see* Scott, *supra* note 156, at 807.

162. *See* Scott, *supra* note 156, at 808.

163. *See* ALLEN ET AL., *supra* note 14, at 691–92; Carlton & Fischel, *supra* note 151, at 885.

164. This example is taken from Wang, *supra* note 38, at 1222–24.

165. *Id.* This practice is sometimes referred to as "loss avoidance": the insider sells anticipating that once the information is disclosed, it will result in a lower stock price. *See* United States v. Nacchio, 573 F.3d 1062, 1077 n.12 (10th Cir. 2009).

166. Wang, *supra* note 38, at 1222–24.

167. *Id.*

168. *Id.*

169. *Id.*

170. *Id.*

171. *Id.*

172. *Id.* at 1235–36.

173. *Id.* at 1236.

174. *Id.* at 1235–37.

175. *Id.*

market price.[176] These shareholders keep their shares, and are deprived of the opportunity to sell before the stock price decreases.[177]

B. The U.S. Sentencing Guidelines: History and Application

The development of securities fraud case law has shaped courts' understanding of the harm caused by insider trading and other white collar offenses and how these offenders should be penalized. This section explores the creation of the Guidelines, how they currently punish white collar defendants, and the motivations behind how their methodology came to be.

1. The Creation of the Sentencing Guidelines and Its Commission

a. The Sentencing Reform Act of 1984

Originally, federal sentencing was completely discretionary; there were no guidelines or procedures to adhere to except statutory mandatory maximum or, in some cases, minimum sentences.[178] In 1984, Congress passed the Sentencing Reform Act (SRA), drastically reforming the federal sentencing process.[179] Judge Marvin E. Frankel of the U.S. District Court for the Southern District of New York was one of the leaders of this reform movement.[180] Judge Frankel noted that the result of the current system of unguided sentences by judges was "a wild array of sentencing judgments without any semblance of the consistency demanded by the ideal of equal justice."[181] Judge Frankel found that the fate of a defendant was far too dependent on the judge that the defendant was assigned to for sentencing.[182] Judge Frankel and others urged for a system of guidance so that all similarly situated defendants would be fairly sentenced.[183]

With these goals in mind, the SRA established the U.S. Sentencing Commission (Commission) to create the Guidelines,[184] defined the goals of

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176. *Id.*

177. *Id.*

178. *See* MARVIN E. FRANKEL, CRIMINAL SENTENCES: LAW WITHOUT ORDER 5–6 (1973).

179. Pub. L. No. 98-473, Title II, 98 Stat. 1987 (1984) (codified as amended in scattered sections of 18 U.S.C.; 28 U.S.C.A §§ 991–998 (2006)); *see also* Michael S. Tunink, Comment, *A New Role for the United States Sentencing Commission in Post-*Booker *Sentencing: Reflecting Judicial Practice*, 40 ARIZ. ST. L.J. 1429, 1431 (2008) ("In 1984, Congress passed the SRA in response to criticisms of the uncertainty and lack of uniformity in the discretionary sentencing system.").

180. *See generally* FRANKEL, *supra* note 178 (noting his concern with the inconsistent sentences imposed by federal judges at that time).

181. *Id.* at 7.

182. *See id.* at 6 ("It is even an illicit form of qualification to insert a parenthetical 'depending upon the judge' . . . . For that goes, after all, to the very core of the evil our principles denounce. We claim . . . to have a government of laws, not men.").

183. *See* KATE STITH & JOSÉ A. CABRANES, FEAR OF JUDGING: SENTENCING GUIDELINES IN THE FEDERAL COURTS 104 (1998) ("Reduction of 'unwarranted sentencing disparities' was a—probably *the*—goal of the Sentencing Reform Act of 1984."); Tunink, *supra* note 179, at 1431–32.

184. 28 U.S.C. § 991 (2006).

punishment,[185] and provided appellate review of sentences departing from the Guidelines.[186] The SRA promoted the development of the Guidelines in order to further the basic purposes of criminal punishment, which the Act defined to be deterrence, incapacitation, just punishment, and rehabilitation.[187] The SRA delegated broad authority to the Commission to review federal sentencing.[188]

b. The Role of the Sentencing Commission

The Commission is an independent agency in the judicial branch.[189] Its principal purpose is to establish sentencing policies and practices for the federal courts that will "assure the ends of justice by promulgating detailed guidelines prescribing the appropriate sentences for offenders convicted of federal crimes."[190]

There were three main reasons for Congress to create an ongoing, independent Commission.[191] The first was to create a committee of experts who would draft reasonable sentencing rules based on their experience.[192] Second, since Congress knew that the first version of sentencing rules would not be perfect, the Commission also needed to monitor, evaluate, and modify the rules over time.[193] The Commission itself describes this process as "evolutionary. It expects, and the governing statute [the SRA] anticipates, that continuing research, experience, and analysis will result in modifications and revisions to the guidelines through submission of amendments to Congress."[194] Finally, Congress realized that the creation of reasonable sentencing rules were dependent on the source of these rules being insulated from political pressures.[195]

2. Sentencing Insider Trading Under the Guidelines

The SRA contains congressional directives as to how the sentencing ranges should be determined, the most important of which directs the Commission to create categories of offense behavior and offender characteristics.[196] The Guidelines calculation has several steps and is based on a "point" calculation system.[197] These points will calculate a defendant's total "Offense Level" (up to forty-three levels) and "Criminal

185. 18 U.S.C. § 3553(a) (2006).
186. *Id.* § 3742, *invalidated by* United States v. Booker, 543 U.S. 220 (2005).
187. 18 U.S.C. § 3553(a)(2).
188. U.S. SENTENCING GUIDELINES MANUAL §§ 1A1.1–1.2 (2009).
189. *Id.*
190. *Id.*
191. *See* Frank O. Bowman, III, *Pour Encourager les Autres? The Curious History and Distressing Implications of the Criminal Provisions of the Sarbanes-Oxley Act and the Sentencing Guidelines Amendments That Followed*, 1 OHIO ST. J. CRIM. L. 373, 379 (2004).
192. *See id.*
193. *See id.*
194. USSG § 1A1.2.
195. *See* Bowman, *supra* note 191, at 379–80.
196. 28 U.S.C. § 994(b)(2) (2006); *see* USSG § 1A1.2.
197. *See generally* USSG §§ 2–5.j

History Category" (up to six categories).[198] The intersection of the total offense level and criminal history category as designated by a sentencing chart[199] will give the range of months indicating the defendant's potential sentence. Where the Guidelines call for imprisonment, the range must be narrow.[200]

a. Approach in Drafting Sections 2B1.1 & 2B1.4: The Loss Chart

The original approach to providing sentencing ranges for offenses was empirical and historical as opposed to philosophical.[201] Instead of being guided by the purposes of punishment and attempting to draft penalties reflecting those purposes, the Commission reproduced the sentencing patterns that emerged pre-Guidelines.[202] In the case of economic crimes, however, the Commission diverted somewhat from this historical practice.[203] The Commission did not focus heavily on the factors that had historically been important to judges in sentencing economic crimes; instead, the Commission consciously increased the severity of sentences for certain economic crimes to above pre-Guideline levels.[204] Before the Guidelines, many white collar criminals were given probation—a result that the Commission felt was not a sufficient deterrent to future economic criminals.[205] Consequently, the Commission made sure that white collar criminals would be given a "short but definite period of confinement" instead of probation.[206] Therefore, the Commission identified one factor as the most relevant in sentencing white collar criminals: the amount of monetary "loss" or "gain" resulting from the offense.[207]

This heavy reliance on "loss" and "gain" resulted in extreme sentences.[208] In attempting to avoid giving probation, courts have given white collar defendants severe sentences for their crimes.[209] Judge Jed S.

198. *See id.* §§ 1B1.1, 5A.

199. *Id.* § 5A.

200. 28 U.S.C. § 994(b)(2); *see* USSG § 1A1.2 ("[T]he maximum of the range cannot exceed the minimum by more than the greater of 25 percent of the minimum or six months.").

201. *See* Bowman, *supra* note 191, at 385.

202. *See id.*

203. *See id.*

204. *See id.*

205. *See id.*; *see also* John Hagan & Ilene Nagel Bernstein, *The Sentence Bargaining of Upperworld and Underworld Crime in Ten Federal District Courts*, 13 LAW & SOC'Y REV. 467, 475 (1979) (quoting a U.S. Attorney in one district who stated that almost all white collar criminals would receive probation if not for plea bargaining).

206. Steven Breyer, *The Federal Sentencing Guidelines and the Key Compromises Upon Which They Rest*, 17 HOFSTRA L. REV. 1, 22 (1988).

207. *See*, Bowman, *supra* note 191, at 386.

208. *See id.*; *see also* Ellen S. Podgor, *Throwing Away the Key*, 116 YALE L.J. POCKET PART 279, 279 (2007), http://thepocketpart.org/2007/02/21/podgor.html (arguing that sentences imposed upon white collar criminals are inappropriately severe).

209. *E.g.*, Ken Belson, *WorldCom Head Is Given 25 Years for Huge Fraud*, N.Y. TIMES, July 14, 2005, at A1 (announcing the twenty-five year prison sentence imposed on WorldCom CEO Bernard Ebbers); Robert Farzad, *Jail Terms for 2 at Top of Adelphia*, N.Y. TIMES, June 21, 2005, at C1 (announcing the sentences of two officials of Adelphia

Rakoff of the Southern District of New York spoke out at the sentencing hearing of a defendant about his feeling that the "loss" chart resulted in an unreasonable sentence for the defendant:

> What drove the Government's calculation in this case, more than any other single factor, was the inordinate emphasis that the Sentencing Guidelines place in fraud cases on the amount of actual or intended financial loss. As many have noted, the Sentencing Guidelines, because of their arithmetic approach and also in an effort to appear "objective," tend to place great weight on putatively measurable quantities . . . without, however, explaining why it is appropriate to accord such huge weight to such factors. . . . Since successful public companies typically issue millions of publicly traded shares . . . the precipitous decline in stock price that typically accompanies a revelation of fraud generates a multiplier effect that may lead to guideline offense levels that are, quite literally, off the chart.[210]

Scholars join Judge Rakoff in his feeling that the Guidelines result in extreme sentences that may or may not be related to the defendant's culpability.[211]

Chapter 2B prescribes the sentences for offenders of "Basic Economic Offenses" based on this "loss"-focused approach.[212] The Chapter Two provision that prescribes the sentence for insider trading offenders is 2B1.4.[213] The section is quite sparse, including only a "base offense level" and an instruction to apply additional offense levels based on a "loss" chart found in 2B1.1.[214] Section 2B1.1 prescribes progressively greater increases to the offense level based on the relevant amount of loss (or, in insider trading cases, "gain").[215] The loss chart includes categories for loss starting at $5000 up to $400 million.[216] The increase in offense level according to this chart could be anywhere between two levels and thirty levels.[217] The result of this calculation, assuming the defendant is in criminal history

Communications Corporation: eighty-year-old John Rigas was sentenced to fifteen years, and his son Timothy Rigas was sentenced to twenty years).

210. United States v. Adelson, 441 F. Supp. 2d 506, 509 (S.D.N.Y. 2006) (citing STITH & CABRANES, *supra* note 183, at 69). The "chart" that Judge Rakoff referred to is the "loss" chart included in 2B1.1 of the Guidelines.

211. *See, e.g.*, STITH & CABRANES, *supra* note 183, at 97–98; Podgor, *supra* note 208, at 279.

212. U.S. SENTENCING GUIDELINES MANUAL § 2B (2009).

213. Before November 2001, insider trading fell under section 2F1.1, and many cases refer to this section as section 2F1.1. As of November 2001, section 2F1.1 was deleted and its provisions were combined with section 2B1.4. *See* King, *supra* note 46, at 1093 n.442.

214. USSG § 2B1.4.

215. *Id.* § 2B1.1.

216. *Id.* § 2B1.1(b)(1).

217. *Id.*

category I (as many white collar defendants are),[218] could be a sentence difference of up to twenty-four years.[219]

The commentary of 2B1.4 is vague:

> This guideline applies to certain violations of Rule 10b-5 that are commonly referred to as "insider trading". Insider trading is treated essentially as a sophisticated fraud. Because the victims and their losses are difficult if not impossible to identify, the gain, *i.e.*, the total increase in value realized through trading in securities by the defendant and persons acting in concert with the defendant or to whom the defendant provided inside information, is employed instead of the victims' losses.[220]

The interpretation of the phrase "total increase in value" has been contested in the courts.[221] The commentary in 2B1.1 attempts to give further guidance on how to calculate gain: "The court shall use the gain that resulted from the offense . . . ."[222] The courts have looked to both areas of the commentary for guidance in calculating "gain."[223]

The method of calculating loss or gain under 2B1.1 is highly dispositive in determining a sentence, regardless of statutory maximums that are included in some of the statutes under which insider trading is prosecuted.[224] This is due to the way that the Guidelines handle multiple counts of conviction, by grouping offenses.[225] If the Guidelines prescribe a life sentence, the court will stack the maximum sentences for each count of conviction.[226] Therefore, the Guideline sentence reached by calculating "gain" is almost always imposed, regardless of statutory maximums. The method of calculating "gain" under this section of the Guidelines is the

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218. *See* U.S. SENTENCING COMMISSION'S SOURCEBOOK OF FEDERAL SENTENCING STATISTICS, tbl. 14 (2009), *available at* http://www.ussc.gov/ANNRPT/2009/Table14.pdf (showing that for defendants sentenced under the category of "fraud" in 2009, 64.4%—2883 out of a total of 4480—were sentenced under criminal history category I).

219. USSG § 5A (assuming criminal history category I, comparing the high end of the sentencing range at offense level 38—prescribing a range of 235–239 months—with the low end of the sentencing range at offense level 8—prescribing a range of 0–6 months).

220. *Id.* § 2B1.4 cmt. n.1.

221. *See infra* Part II.

222. USSG § 2B1.1 cmt. n.3(B).

223. *See infra* Parts II.A, II.B.

224. *See infra* notes 225–26 and accompanying text.

225. *See, e.g.*, United States v. Evans, 352 F.3d 65, 71 (2d Cir. 2003) ("Thus, where multiple convictions are involved, Sentencing Guidelines § 5G1.2(d) ordinarily requires a district court to impose consecutive statutory maximum sentences to the extent necessary to fashion a sentence within the range of 'total punishment' set forth by the Sentencing Guidelines.") (citing USSG § 5G1.2(d) (2000), which, in the most current version, USSG § 5G1.2(d) (2009), reads that "[i]f the sentence imposed on the count carrying the highest statutory maximum is less than the total punishment, then the sentence imposed on one or more of the other counts shall run consecutively, but only to the extent necessary to produce a combined sentence equal to the total punishment. In all other respects, sentences on all counts shall run concurrently, except to the extent otherwise required by law").

226. For an example of how the court will stack these individual statutory maximums to result in a sentence, see Diana B. Henriques, *Madoff, Apologizing, Is Given 150 Years*, N.Y. TIMES, June 30, 2009, at A1, which includes a chart displaying the statutory maximums that were added to come to a final sentence of 150 years when the Guidelines prescribed a life sentence.

resulting conflict discussed in Part II of this Note. The U.S. Court of Appeals for the Eighth Circuit, in *United States v. Mooney*,[227] interprets the 2B1.4 instruction to mean that the defendant should be sentenced based on the net profit achieved through all trading of inside information.[228] Alternatively, the U.S. Court of Appeals for the Tenth Circuit, in *United States v. Nacchio*,[229] finds that the "gain resulting from the offense" should be cut off at the point at which disclosure has caused the market to absorb the information and therefore cuts off any unlawful gains.[230] The two methods can often lead to very different sentences for the same defendant.

b. The Incremental Approach

The "loss" chart is unique in the Guidelines in that it takes a precise incremental approach to determining culpability.[231] This is an approach that has been criticized for being complex and rigid.[232] Judge Jon O. Newman of the Second Circuit recently attacked the loss chart at Public Hearings held by the Commission.[233] Judge Newman takes issue with the loss chart's premise that "every minute increment of offense conduct must result in a minute increment of punishment."[234] His theory is that there is no relevant difference related to culpability between a burglar who steals $4000 and one who steals $6000, depending only on what amount is available for theft.[235]

Judge Newman postulates that the Guidelines have taken this approach because continuity is preferable to large "cliffs" of categories.[236] In other words, one continuous curve increasing the sentence of a defendant gradually is preferable to two or three levels with large gaps of loss amount

227. 425 F.3d 1093, 1102 (8th Cir. 2005) (en banc).

228. *Id.* at 1100; *see infra* notes 346–52 and accompanying text.

229. 573 F.3d 1062, 1085–87 (10th Cir. 2009).

230. *Id.* at 1072; *see infra* notes 393–94 and accompanying text.

231. *See* U.S SENTENCING GUIDELINES MANUAL § 2B1.1(b)(1) (2009). The only other area of the Guidelines that prescribes progressively higher total offense level additions by a measurable quantity is the drug weight tables. *Compare id.* § 2B1.1(b)(1), *with id.* § 2D1.1(c).

232. *See, e.g.*, United States v. Dallas, 229 F.3d 105, 107 (2d Cir. 2000) (Newman, J.) (citing United States v. Martinez-Rios, 143 F.3d 662, 670 (2d Cir. 1998) (Newman, J.)) (discussing the drug weight tables, describing the approach as an attempt to reflect the concept of "incremental immorality"); *supra* notes 209–10 and accompanying text.

233. *U.S. Sentencing Commission Public Hearing Testimony and Transcripts* (2009) (statement of Judge Jon O. Newman, U.S. Court of Appeals for the Second Circuit), [hereinafter *J. Newman Testimony*], *available at* http://www.ussc.gov/AGENDAS/20090709/Newman_testimony.pdf.

234. *Id.* at 5.

235. *Id.* ("The distinction [between $4,000 and $6,000] makes very little sense. . . . [N]o criminal wakes up in the morning and decides that he is going to steal $4,000 but not $6,000. He might make a conscious decision to rob a convenience store rather than a bank, but once inside the convenience store, he opens the till and takes what is there. The fortuity of whether the till contains $4000 or $6000 should not result in added punishment.").

236. *Id.* at 9.

separating each.[237] Judge Newman claims that although this method "is a statistician's dream . . . it is a sentencing judge's nightmare."[238]

Judge Newman points out that one of the many "unfortunate consequences" of this incremental approach is that it "create[s] an illusion of precision that is divorced from reality."[239] Requiring judges to find a precise number and sentence a defendant mainly based on that number gives the perception that each defendant has been sentenced accordingly compared to other defendants with different amounts of loss or gain.[240] Judge Newman claims that "in reality there are so many variables in determining losses and so many problems in gathering evidence that the loss figures used for determining punishment in many cases will at best only approximate the true (and often unknowable) loss amounts."[241]

Other commentators agree that determining the "loss" or "gain" amount in a securities fraud or insider trading case is not an exact science, and in fact many other factors, unrelated to a defendant's criminal activity, may add to the rise or fall of a stock price.[242] It is for this reason that reaching a precise figure to satisfy the Guidelines calculation may be an unattainable goal.[243]

3. Post-*Booker*: Do the Guidelines Still Matter?

Although the Guidelines are no longer mandatory, they still play an important role in determining the sentence of a defendant. This section briefly discusses the successful constitutional attack on the Guidelines and their role in sentencing today.

In *United States v. Booker*,[244] the Court held that the Guidelines are a violation of the Sixth Amendment's right to a trial by jury.[245] In *Booker*, the district court had imposed a sentence greater than the original Guidelines sentence because of the post-trial finding by the court that the defendant had been in possession of additional grams of crack and had obstructed justice.[246] The Supreme Court reversed, holding that all facts used to impose a sentence must be proven to a jury beyond a reasonable doubt.[247] In the first of a two-part plurality opinion, Justice John Paul Stevens reasoned that, because the Guidelines were mandatory, they had the

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237. *Id.* at 7–8.
238. *Id.* at 8.
239. *Id.* at 7.
240. *Id.*
241. *Id.*
242. *See, e.g.*, Holman W. Jenkins, Jr., Editorial, *Should the Stock Market Be the Sentencing Judge?*, WALL ST. J., Mar. 31, 2004, at A15.
243. *See id.*
244. 543 U.S. 220 (2005).
245. *Id.* at 223. The Sixth Amendment holds in part that: "In all criminal prosecutions, the accused shall enjoy the right to a speedy and public trial, by an impartial jury of the State and district wherein the crime shall have been committed . . . ." U.S. CONST. amend. VI.
246. *Booker*, 543 U.S. at 227.
247. *Id.* at 230–31 (citing Ring v. Arizona, 536 U.S. 584 (2002)); *see* U.S. CONST. amend. VI (defining a defendant's right to trial by jury).

"force and effect of laws" and therefore implicated the Sixth Amendment.[248]

In the second part of the opinion, Justice Breyer discussed the remedy for the Sixth Amendment violation, which was to sever and excise the parts of the SRA that made the Guidelines mandatory, thus making them "effectively advisory."[249] The remainder of the statute kept appellate review in place under a reasonableness standard.[250]

Although advisory, the Guidelines calculation is still procedurally required before imposing a sentence.[251] A procedural error warranting reversal of a sentence on appeal is "failing to calculate (or improperly calculating) the Guidelines range."[252] The SRA still requires every federal sentencing judge to start the process of selecting a sentence by determining the Guidelines calculation.[253] Only after making that calculation may the judge exercise discretion.[254] It follows that, although not mandatory on district courts, the interpretation of the Guidelines is still a dispositive matter of law for convicted defendants.

Additionally, departing from the Guidelines, although permissible, must be justified either under Chapter Five of the Guidelines or 18 U.S.C. Section 3553(a).[255] First, if a particular case presents especially atypical features, the Guidelines allow the court to grant a departure and sentence outside the prescribed range under Chapter Five.[256] The SRA permits a court to depart from the Guidelines sentence only when it finds "an aggravating or mitigating circumstance of a kind, or to a degree, not adequately taken into consideration by the Sentencing Commission in formulating the guidelines that should result in a sentence different from that described."[257] However, Chapter Five lists several factors that the court may not take into account as grounds for departure (e.g., race, sex, national origin, creed, religion, socio-economic status, lack of guidance as a

248. *Booker*, 543 U.S. at 233–34.

249. *Id.* at 245.

250. *Id.* at 260–62.

251. Gall v. United States, 552 U.S. 38, 51 (2007).

252. *Id.*

253. 18 U.S.C. § 3553(a) (2006). Section 3553(a) states in part:

> The court, in determining the particular sentence to be imposed, shall consider . . .
>
> (4) the kinds of sentence and the sentencing range established for—
>
> (A) the applicable category of offense committed by the applicable category of defendant as set forth in the guidelines—
>
> (i) issued by the Sentencing Commission pursuant to section 994(a)(1) of title 28, United States Code . . . .

Id.

254. *See, e.g.*, *J. Newman Testimony*, *supra* note 233, at 2 ("As a result, the Guidelines continue to exert a major influence on all federal sentences. For all judges, they are at least the beginning of the sentencing process. For some, they are the end of the process.").

255. 18 U.S.C. § 3553(a) (describing factors that a court must consider when sentencing a defendant); U.S. SENTENCING GUIDELINES MANUAL § 1A2 (2009); *see id.* § 5K2.0 (identifying "Grounds for Departure").

256. USSG § 1A2. *See generally id.* § 5K (listing all possible instances to award a departure).

257. 18 U.S.C. § 3553(b).

youth, drug or alcohol dependence or abuse, coercion and duress, post-sentencing rehabilitative efforts).[258] Therefore, the instances where a Chapter Five departure is permissible are limited.

A court is also entitled to consider factors enumerated in 18 U.S.C. Section 3553(a) in order to impose a sentence that is "sufficient, but not greater than necessary."[259] Section 3553(a) is written with the purposes of punishment and the goals of our criminal justice system in mind.[260] Every court must consider the Section 3553(a) factors when determining a sentence, whether it is within or outside the Guidelines-prescribed sentence.[261] These factors are extremely broad, and may be interpreted to include an unlimited number of considerations.[262] Therefore, a large gap is created between the standard for imposing a Guideline departure (found in U.S.S.G. Section 5) and the standard for imposing a non-Guideline sentence (justified by 18 U.S.C. § 3553(a) factors).[263] It is for this reason that the Commission is much more rigorous in analyzing the rates of non-Guideline sentences within a district than it is in analyzing the Guidelines departures. Therefore, 18 U.S.C. § 3553(a) departures are applied sparingly.[264]

When looking specifically at fraud offenses, statistics confirm the continuing importance of, and dependence on, the Guidelines for sentencing.[265] The statistical reports provided by the Commission provide information by offense of all non-Guidelines sentences nationally.[266] The

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258. USSG § 5K2.0(d)(1). Notably, the Commission has recently proposed an amendment to the Guidelines that provide that these certain offender characteristics "may be relevant in determining whether a sentence outside the applicable guideline range is warranted." USSG §§ 5H1.1, 1.3, 1.4 (Proposed Amendments Apr. 30, 2010), *available at* http://www.ussc.gov/2010guid/finalamend10.pdf. It remains to be seen what effect this amendment will have on the percentage of departures in future sentences. *See* Douglas A. Berman, *U.S. Sentencing Commission Posts Full Text of its Significant New Guideline Amendments*, SENTENCING L. & POL'Y. (Apr. 30, 2010, 11:56 AM), http://sentencing.typepad.com/sentencing_law_and_policy/2010/04/us-sentencing-commission-posts-full-text-of-its-significant-new-guideline-amendments.html.

259. 18 U.S.C. § 3553(a).

260. *See id.*

261. *See, e.g.*, United States v. Fernandez, 443 F.3d 19, 26 (2d Cir. 2006) ("[A] sentence will satisfy the requirements of *Booker* and the Sixth Amendment if the sentencing judge (1) calculates the relevant Guidelines range, including any applicable departure under the Guidelines system; (2) considers the calculated Guidelines range, along with the other § 3553(a) factors; and (3) imposes a reasonable sentence.") (citing United States v. Crosby, 397 F.3d 103, 113 (2d Cir. 2005)).

262. *See* 18 U.S.C. § 3553(a) (listing among the factors to be considered such broad categories as: "the nature and circumstances of the offense and the history and characteristics of the defendant"; "the need to avoid unwarranted sentence disparities among defendants with similar records who have been found guilty of similar conduct"; "the need . . . to reflect the seriousness of the offense"; the need to deter others from similar conduct; and other similar factors).

263. *See supra* notes 255–62 and accompanying text.

264. *See* U.S. SENTENCING COMMISSION'S SOURCEBOOK OF FEDERAL SENTENCING STATISTICS, tbl. 27 (2009), *available at* http://www.ussc.gov/ANNRPT/2009/Table27.pdf (indicating that the percentage of total above or below range sentences is approximately 14% nationally for all crimes).

265. *See id.*

266. *E.g.*, *id.*

relevant inquiry is on non-government sponsored departures.[267] In 2009, the percentage of total cases in which a judge awarded a discretionary non-Guidelines sentence totaled only 19.5% of fraud convictions.[268] Therefore, the Guidelines are still important in determining the actual sentence given.

C. The Development of White Collar Criminal Penalties: Legislative History and Current Events

The legislative history of the white collar Guidelines provisions demonstrates the power Congress had in affecting the evolution of sentencing policy. Since the Guidelines are meant to be shaped by an independent Commission insulated from political pressures,[269] the review by Congress of the Guidelines[270] and their directives to the Commission create a philosophical tension. An examination of the history of the white collar provisions of the Guidelines illuminates this tension.

The first Guidelines were enacted in 1987, including a "loss" chart for economic crimes.[271] During the next nine years, the "loss" chart was modified almost annually.[272] Each amendment tended to increase the sentence ranges and make the Guidelines more and more complex.[273] Even with these amendments, the U.S. Department of Justice (DOJ) and other organizations still debated whether the current sentencing regime was strong enough.[274] They felt that sentences for the white collar criminal on the higher end of the spectrum remained too low and did not reflect the seriousness of the offense.[275] The result of this debate was a five-year collaborative effort to reform these portions of the Guidelines.[276] This collaboration produced the 2001 Economic Crime Package of Guideline amendments.[277] One of these amendments was to modify the "loss" chart

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267. Government sponsored departures are given for cooperation or other circumstances. *See* U.S. SENTENCING GUIDELINES MANUAL § 5K1.1 (2009) (awarding government sponsored departures for "Substantial Assistance"); *id.* § 5K3.1 (awarding government sponsored departures for "Early Disposition" of certain crimes in certain fast track districts). Since a judge is not applying his or her discretion in sentencing under a government sponsored departure, these numbers are not indicative in showing how judges use the Guidelines to sentence.

268. U.S. SENTENCING COMMISSION'S SOURCEBOOK OF FEDERAL SENTENCING STATISTICS, tbl. 27 (2009), *available at* http://www.ussc.gov/ANNRPT/2009/Table27.pdf (applying the categories "Above Range w/ *Booker*," "Remaining Above Range," "Below Range w/ *Booker*," and "Remaining Below Range").

269. *See supra* note 195 and accompanying text.

270. *See supra* note 194 and accompanying text.

271. *See* Bowman, *supra* note 191, at 378.

272. *See id.*

273. *See id.*

274. *See id.* at 387–88.

275. *See id.*

276. *See id.* at 388.

277. *See id. See generally* Frank O. Bowman III, *The 2001 Federal Economic Crime Sentencing Reforms: An Analysis and Legislative History*, 35 IND. L. REV. 5 (2001) (summarizing the collaborative efforts that produced the 2001 Economic Crime Package, and the amendments included within the package).

to increase total offense level enhancements.[278] Other amendments included an extended definition of "loss" as well as modification to some specific offense characteristics.[279]

Although the amendments encompassed in the 2001 Economic Crime Package were agreed upon by all interested parties,[280] the events of 2001 and 2002 changed the attitude of the political community drastically. On December 2, 2001, Enron became the largest company to declare bankruptcy after fabricating profits with help from accounting firm Arthur Anderson.[281] Later, dozens of other companies also showed strong evidence of reporting violations.[282] In 2002, WorldCom's CEO and CFO were found to have overstated earnings, and the company surpassed Enron to become the largest company to declare bankruptcy.[283] CEO Bernard Ebbers was later sentenced to twenty-five years in prison as a result.[284] These troubling economic circumstances had severe effects on the American economy; America had become "a nation of investors whose dreams of retirement for themselves and education for their children are intertwined with the fate of the stock of the corporations."[285] Losses to investors and employees of these corporations were in the billions.[286] Furthermore, investor confidence in these institutions was severely undermined.[287] After these events, there was heavy pressure on Congress to restore confidence in the health and trustworthiness of the stock market.[288]

During 2002, the Senate and the Bush administration focused on drafting both criminal and civil responses to the corporate scandals.[289] On June 19, 2002, then-Senator Joseph R. Biden scheduled a series of congressional hearings exploring the topic entitled "Are We Really Getting Tough on White Collar Crime?"[290] All participants reached the consensus that investigative and prosecutorial responses, not increased sentences, were

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278. *See* Bowman, *supra* note 191, at 388. *Compare* U.S. SENTENCING GUIDELINES MANUAL § 2B1.1 (2000), *with* USSG § 2B1.1 (2001).

279. *See* Bowman, *supra* note 191, at 389. *Compare* USSG § 2B1.1 cmt. n.2 (2000), *with* USSG § 2B1.1 cmt. n.2 (2001).

280. *See* Bowman, *supra* note 191, at 390.

281. *See* COX ET AL., *supra* note 26, at 9; Rebecca Smith, *Enron Files for Chapter 11 Bankruptcy, Sues Dynegy: Proceeding Is Biggest Ever in the U.S., With Assets of Just Under $50 Billion*, WALL ST. J., Dec. 3, 2001, at A3.

282. *See* COX ET AL., *supra* note 26, at 9–10.

283. *See id.* at 10; Peter J. Henning, *White Collar Sentences After* Booker*: Was the Sentencing of Bernie Ebbers Too Harsh?*, 37 MCGEORGE L. REV. 757, 759 (2006); *supra* note 209.

284. *See* Henning, *supra* note 283, at 757; *see also supra* note 209.

285. Bowman, *supra* note 191, at 392.

286. *See id.*; Smith, *supra* note 281.

287. *See* Bowman, *supra* note 191, at 392.

288. *See, e.g.*, 148 CONG. REC. 5498 (2002) (comments of Rep. Kanjorski & Rep. Oxley); *see also* Bowman, *supra* note 191, at 393.

289. *See* Bowman, *supra* note 191, at 393.

290. *Penalties for White Collar Crime: Are We Really Getting Tough on White Collar Crime?: Hearing Before the Subcomm. on Crime and Drugs of the Sen. Judiciary Comm.*, 107th Cong. (2002), *reprinted in part in* 15 FED. SENT'G REP. 234 (2003).

needed going forward.[291] However, on July 9, 2002, President George W. Bush gave a speech in New York City calling for "tough new criminal penalties for corporate fraud."[292] Although the DOJ had only recently expressed its satisfaction with the Guideline amendments enacted as part of the 2001 Economic Crime Package, Congress responded to the President's speech by immediately pushing for new legislation.[293] Republicans and Democrats competed to offer the toughest proposals for white collar criminal legislation.[294]

The resulting legislation was the Sarbanes-Oxley Act of 2002 (SOX).[295] SOX created new substantive offenses and increased statutory maximum sentences for existing economic crimes.[296] Most importantly, SOX also included specific and general directives to the Commission.[297] Specifically, the Commission had 180 days to enact the requested amendments to the Guidelines.[298] SOX section 805 required the Commission to increase sentences for crimes involving fraud and obstruction of justice, with specific reference to 2B1.1;[299] SOX section 905 and section 1104 more generally asked the Commission to review the severity of the sentences for certain types of economic crimes.[300] Further, SOX section 905(a) insisted that the "Commission shall review and, as appropriate, amend the Federal Sentencing Guidelines . . . consider[ing] the extent to which the guidelines and policy statements . . . are adequate in view of the statutory increases in penalties contained in [SOX]."[301] The Commission was left with these directives to interpret and implement in order to enhance the sentences for white collar crimes.[302]

Within the required 180 days, the Commission released on January 25, 2003 a supplement to the 2002 Guidelines.[303] The supplement included a modified "loss" chart in 2B1.1.[304] Compared with the "loss" chart from the

291. *See id.* at 237; Bowman, *supra* note 191, at 395.

292. Dan Collins, *Text of Bush Speech on Business Crime: President Promises Action Against Corporate Criminals*, CBSNEWS (July 9, 2002), http://www.cbsnews.com/stories/2002/07/09/national/main514592.shtml; *see* Bowman, *supra* note 191, at 398.

293. *See* Bowman, *supra* note 191, at 400.

294. *See id.*

295. Sarbanes–Oxley Act of 2002 (SOX), Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, 29 U.S.C.).

296. *See* Bowman, *supra* note 191, at 403–05.

297. SOX §§ 805, 905, 1104; *see* Bowman, *supra* note 191, at 405.

298. *See* SOX §§ 805(b), 905(c), 1104(c).

299. *See id.* § 805(a).

300. *See id.* §§ 905, 1104; *see also* Bowman, *supra* note 191, at 409.

301. SOX § 905(a).

302. *See* Bowman, *supra* note 191, at 411 (stating that the SOX directives "raised the fundamental questions of whether Congress wanted the Commission to exercise its independent, expert judgment in incorporating [SOX] into existing sentencing law, and of whether, and if so to what degree, Congress was prepared to defer to the Commission's judgment.").

303. U.S. SENTENCING GUIDELINES MANUAL, *Supplement to the 2002 Federal Sentencing Guidelines Manual*, *available at* http://www.ussc.gov/2002suppa/2002supp.htm.

304. *See id.* § 2B1.1.

2002 Guidelines,[305] the modified loss chart raised the number of offense levels based on "loss." This emergency-modified "loss" chart remains the current version of 2B1.1.[306]

In March 2003, the Commission held public hearings to debate the new amendments, as well as other proposed amendments to the 2003 Guidelines.[307] The DOJ continued to insist on higher sentences, threatening to go to Congress with requests for "draconian" mandatory sentences.[308] Although resistant to further increases, the Commission acquiesced to the DOJ as a compromise preferable to legislation proscribing mandatory sentences.[309] The 2003 Guidelines, released on November 1, 2003, increased the base offense level of 2B1.1 offenses from 6 to 7.[310] Few meaningful modifications have been made to the economic crime provisions since these critical political events.[311]

Often due to the circumstances under which the "loss" chart has evolved, many have criticized the white collar provisions of the Guidelines for prescribing sentences that are too extreme.[312] The "loss" chart in 2B1.1 is now the most determinate factor in sentencing a white collar defendant.[313] Since the difference in amount of "loss" or "gain" could mean the difference between a life sentence and only a few months in prison, defendants often vigorously contest the Government's finding of amount of "loss" or "gain." As a result, courts have struggled to define a competent method to calculate "loss" or "gain," especially when that loss or gain is based on a change in a public stock price. Part II examines the methods that two circuit courts have adopted for calculating "gain" in an insider trading case.

II. APPLYING THE GUIDELINES TO INSIDER TRADING: HOW COURTS CALCULATE "GAIN" UNDER SECTION 2B1.4

Part II of this Note examines the methods used by two circuit courts to calculate the amount of "gain" attributed to an insider trading defendant's conduct in order to determine the appropriate Guideline sentence under 2B1.4 and 2B1.1. Before 2009, the Eighth Circuit determined "gain" by calculating the net profit made by the defendant on the purchase and subsequent sale of the stocks in question.[314] Part II.A of this Note examines the Eighth Circuit's reasoning and opinion. In July 2009, the

305. *See* USSG § 2B1.1 (2002).
306. *Compare id.*, *with* USSG § 2B1.1 (2009).
307. *See* Bowman, *supra* note 191, at 431.
308. Bowman, *supra* note 191, at 431.
309. *See* Bowman, *supra* note 191, at 431.
310. *Compare* USSG § 2B1.1 (2002), *with* USSG § 2B1.1 (2003).
311. *Compare* USSG §§ 2B1.1, 2B1.4 (2003), *with* USSG §§ 2B1.1, 2B1.4 (2009).
312. *See, e.g.*, Podgor, *supra* note 208; Jenkins, *supra* note 242, at A15; *supra* notes 209–10 and accompanying text.
313. *See* USSG §§ 2B1.1, 2B1.4 (2009); *supra* Part I.A.2.a.
314. United States v. Mooney, 425 F.3d 1093, 1102 (8th Cir. 2005) (en banc).

Tenth Circuit created a split among the circuits[315] when the court reversed the sentence of an insider trading defendant and ordered the district court to calculate "gain" using a method that would instead reflect the point in time when the market absorbed the inside information.[316] This decision was only the second instance in which a circuit addressed the calculation of "gain" since 2005.[317] Part II.B further draws out the reasoning of the Tenth Circuit, as well as examines the district court's treatment of the "market absorption" method on remand.

A. United States v. Mooney*: The Net Profit Approach*

1. Background

In 2005, the Eighth Circuit was the first circuit court to address the definition of calculating "gain" under U.S.S.G. section 2B1.4 and section 2B1.1 in the sentencing of Michael Alan Mooney.[318] Mooney was convicted of eight counts of mail fraud, five counts of money laundering, and four counts of securities fraud.[319] Mooney was the former vice president of underwriting for United Healthcare Corporation (United).[320] In early 1995, Mooney was involved in negotiations entered into by United and MetraHealth (Metra), a privately owned company, in an effort by United to acquire Metra.[321] Success of the deal would have resulted in United becoming the largest health care services company in the United States.[322] During the negotiations, Mooney attended due diligence-related confidential meetings on behalf of United.[323] During these meetings, Mooney and others looked through Metra's confidential financial records and projections.[324] United's corporate counsel informed all participants that they were not to trade in stock during the due diligence period and that they were to protect the secrecy of the proceedings.[325]

Ignoring this instruction from corporate counsel, Mooney contacted his stockbroker to sell United common stock and to use the proceeds to purchase call options[326] in United stock, giving him the right to buy shares

315. *See* Douglas A. Berman, *Tenth Circuit Reverses Nacchio's Sentence While Thoughtfully Discussing Federal Fraud Sentencing*, SENT'G. L. & POL'Y. (July 31, 2009, 12:03 PM), http://sentencing.typepad.com/sentencing_law_and_policy/2009/07/tenth-circuit-reverses-nacchios-sentence-while-thoughtfully-discussing-federal-fraud-sentencing-.html.

316. United States v. Nacchio, 573 F.3d 1062, 1086 (10th Cir. 2009).

317. *Mooney*, 425 F.3d 1093; *see also Nacchio*, 573 F.3d at 1069 ("*United States v. Mooney* appears to be the only circuit decision squarely deciding the issue of gain under the insider trading sentencing guideline . . . .").

318. *Mooney*, 425 F.3d 1093.

319. *Id.* at 1095.

320. *Id.*

321. *Id.*

322. *Id.*

323. *Id.* at 1096.

324. *Id.*

325. *Id.*

326. An option is a type of derivative, which is a financial instrument whose value depends on the price of some underlying instrument. *See* COX ET AL., *supra* note 26, at 103.

of stock at a price of thirty-five dollars per share.[327] On June 22, 1995, the *Wall Street Journal* reported speculation about United's acquisition of Metra,[328] and a few days later on June 26, United publicly announced its agreement to acquire Metra.[329] The stock price rose as follows: on June 20 (before the announcements) the stock traded at $40.125 per share; by July 15 the price was $44.50 per share; by October 5 the price was over $49.00 per share.[330] Mooney subsequently exercised his call options on July 14, October 4 and October 5, netting a total profit of $274,199.46.[331]

In response to Mooney's aggressive purchases of United call options prior to the announcements, the SEC began an investigation into his trading activities.[332] On August 2, 1999, the SEC filed a civil action against Mooney, alleging that he had purchased call options while in possession of material nonpublic information regarding the proposed merger.[333] The SEC's civil action was stayed when he was indicted on criminal charges.[334]

At his criminal proceedings, Mooney was found guilty by a jury on all counts.[335] Mooney was sentenced on August 21, 2002 under the then-mandatory Guidelines.[336] After determining the base offense level by grouping the offenses of mail fraud, securities fraud, and money laundering, the court then determined the additional levels to be attributed to his illegal "gain" from the offense.[337] The district court found the gain from the insider trading to be $274,199.46 under 2B1.4.[338] The court determined

"*Options* are rights to buy or sell securities from or to another at some predetermined price and date. (*Call options* are the rights to buy; *put options* are rights to sell.)." *Id.* Options are risk-shifting devices that can allow the purchaser to increase the risk and thus increase the opportunity for profit. *Id.*

327. *Mooney*, 425 F.3d at 1096.

328. Leslie Scism & Ron Winslow, *United Healthcare in Talks to Purchase MetraHealth*, WALL ST. J., June 22, 1995, at A3; *see Mooney*, 425 F.3d at 1096–97.

329. *Mooney*, 425 F.3d at 1097.

330. *Id.*

331. *Id.* at 1096 n.2.

332. *Id.* at 1097.

333. *Id.*

334. *Id.*

335. *Id.*

336. *Id.* The district court decided to apply the 1994 Guidelines as opposed to the 2002 Guidelines "[b]ecause the federal sentencing guidelines in effect in 2002 would have resulted in a higher sentencing range for the amount of gain found to have resulted from his offenses." *Id.* Due to this decision, the court added two additional levels to the base offense level representing a gain between $200,000 and $350,000 in illegal proceeds. *Id.* at 1098; *see* U.S. SENTENCING GUIDELINES MANUAL § 2S1.1(b)(2)(C) (1994). If Mooney had been sentenced under the current Guidelines, his total offense level increase based on a gain of $274,199.46 would have been instead an increase of twelve levels. *See* USSG § 2B1.1 (2009). The applicable provision of section 2B1.4 "is identical in both versions except for the use of gender neutral language in 2002," and therefore the discussion interpreting "gain" under this section is relevant under the current Guidelines as well. *Mooney*, 425 F.3d at 1097. *Compare* USSG § 2F1.2 (1994), *with* USSG § 2B1.4 (2002), *with* USSG § 2B1.4 (2009).

337. *Mooney*, 425 F.3d at 1097; *see supra* note 336.

338. *See Mooney*, 425 F.3d at 1098; USSG § 2B1.4 (1994).

that the final total offense level was 21, which increased his sentence range to 37–46 months.[339] He was sentenced to 42 months.[340]

2. Mooney's Argument to Re-sentence Using the Market Absorption Method

On appeal, Mooney argued that the gain from his insider trading was much less than what the district court had found.[341] Mooney argued that his "gain" for the purposes of sentencing should not be determined by the actual proceeds of his sale of the options but instead by the market absorption approach based on the disgorgement method used in civil insider trading cases.[342] Mooney's argument was that the market would have reasonably absorbed his inside information by June 28, 2005, two days after United announced its Metra acquisition, and that the information would have reflected the true value of his call options on that date.[343] If this were the case, his gain would have been measured at $50,467.47, changing his sentencing range to 24–30 months.[344] Mooney argued that his later sales of call options should not be considered in calculating gain since the later gains were a result of normal market fluctuations of the market and independent of any inside information he possessed.[345]

3. Majority Opinion

The court began its inquiry[346] by examining the plain language of 2B1.4 describing "the gain resulting from the offense."[347] The court found the phrase to be "simple and straightforward. The guideline refers to the defendant's gain, not to market gain, and it ties gain to the defendant's

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339. *Mooney*, 425 F.3d at 1098; USSG § 5A.

340. *Mooney*, 425 F.3d at 1098. If Mooney had been sentenced under the current Guidelines using the net profit calculation approach taken by the court, the total offense level would have been 31, and the range prescribed by the Guidelines would have been 108–135 months. USSG § 5A (2009); *see supra* note 336.

341. Reply Brief and Supplemental Addendum of Appellant at 1, United States v. Mooney, 425 F.3d 1093 (8th Cir. 2005) (No. 02-3388).

342. *Id.* ("As of June 28, 2003, everyone in the market had the same information as Mr. Mooney and was on the same footing as he. Any increase in value of the securities after June 28 was due to ordinary market forces, and not due to Mr. Mooney's alleged information advantage."); *see also id.* at 2–4 (arguing that the calculation method and reasoning in *SEC v. MacDonald*, 699 F.2d 47 (1st Cir. 1983) (en banc), should be applied in this criminal case); *supra* notes 112–21 and accompanying text.

343. *Mooney*, 425 F.3d at 1098–99.

344. *Id.* at 1099. Under the current Guidelines, this "gain" figure would have led to an increase in total offense level of six levels, equaling a total offense level of 25. USSG § 2B1.1. Therefore, a sentence based on the market absorption method under the current Guidelines would have been 57–71 months. *Id.* § 5A. Thus, under the current Guidelines, the difference in sentence based on net profit versus the market absorption method for Mooney would have been more than fifty months, or over four years. *See supra* note 340.

345. Reply Brief and Supplemental Addendum of Appellant, *supra* note 341, at 1–2.

346. *Mooney*, 425 F.3d at 1099 ("In interpreting the guidelines, we start with the plain language of the guideline itself.") (citing United States v. Gonzalez-Lopez, 335 F.3d 793, 797 (8th Cir. 2003)).

347. USSG § 2B1.4 (2002).

offense."[348] In order for Mooney's theory to be adopted, the court maintained, the language would have to include reference to the "market value" or some other indication that the value in the market was dispositive in calculating gain.[349] The court went next in its analysis to the commentary to 2B1.4 in order to strengthen its argument.[350] The court pointed to the area of the commentary indicating that "[b]ecause the victims and their losses are difficult if not impossible to identify, *the gain, i.e., the total increase in value realized through trading in securities by the defendant*" is used to calculate gain.[351] The court found the "total increase in value realized" language to be clearly referring to the in-pocket gains resulting from trading in securities.[352]

Furthermore, the court specifically rejected using victims' losses as a proxy for a gain calculation.[353] In the court's opinion, using a market absorption method would be an attempt at estimating the harm caused to a trader of United stock during the time that Mooney traded based on his material, nonpublic information and would therefore be "inappropriate in the criminal context."[354]

The court also rejected Mooney's argument that the civil law disgorgement method should apply to his sentencing calculation.[355] The court found that had the Commission intended for civil remedies to be applied in the context of sentencing, there would be support for this inference in the Guidelines or the commentary.[356] Furthermore, the court noted a greater need for clear rules in the criminal context, as opposed to the more extensive fact-finding associated with civil cases.[357]

Finding bright line rules to be preferable to a complex system of calculation, the court rejected Mooney's reliance on *MacDonald*.[358] The court strongly felt that "[i]mprecise standards" are inappropriate to apply to a criminal case.[359] Because the interpretation that the district court had applied to 2B1.4 provides courts a "simple, accurate, and predictable rule," the court adopted this net profit approach as the applicable test in the Eighth Circuit.[360]

348. *Mooney*, 425 F.3d at 1099.

349. *Id.*

350. *Id.* ("The official commentary to § 2B1.4 makes the meaning of the guideline very clear.").

351. *Id.* (quoting USSG § 2B1.4 cmt. background).

352. *Id.*

353. *Id.* at 1100.

354. *Id.* at 1101.

355. *Id.* ("Mooney's civil law theory should not be substituted for the guidance of the commentary, and he cites no support in the guidelines or in judicial decisions for incorporating a civil law standard into the interpretation of a sentencing guideline.").

356. *See id.* at 1099.

357. *Id.* at 1101.

358. *Id.* ("Imprecise standards are particularly inappropriate in the criminal context, and Mooney's approach would be especially difficult in this case . . . . The focus in § 2B1.4 on the increase in value realized by the defendant's trades provides a simple, accurate, and predictable rule for judges to apply . . . .").

359. *Id.*

360. *Id.*

4. Dissenting Opinion

Judge Myron H. Bright issued a strong dissent and was the first circuit judge to insist on an application of the market absorption rule.[361] Judge Bright first attacked the majority's interpretation of the plain language of the Guidelines, specifically the interpretation of the phrase "gain resulting from the offense."[362] Rather than focusing on the "resulting" language as the majority did, Judge Bright instead focused on the language "from the offense," insisting that the court must first determine "what 'the offense' is."[363] Judge Bright insisted that simply focusing on the "gain" of the defendant would translate to all the defendant's stock gains over the lifespan of the defendant's trading activity.[364] This conclusion, reasoned Judge Bright, cannot stand.[365]

The "offense" in the particular case of Mooney was not the purchase of the stock itself but Mooney's "*use of a manipulative or deceptive contrivance in connection with* the purchase."[366] Therefore, the offense is not the purchase and sale of the security but instead the "deception" used to profit from the purchases and subsequent sales.[367] In essence, Judge Bright attempted to sever the "gain" into total gain (or net profit) and gain attributed only to the "deception" and therefore to the offense itself.[368] This gain attributed to the deception "stops when the deception stops, though there may be later gain (or loss) as the stock market gyrates along, unmolested by any deception."[369]

Judge Bright further explained that the majority's interpretation of the language of 2B1.4 would be inconsistent with the overall goals of punishment furthered by the Commission and required by statute.[370] One of the main motivations behind the SRA and the Guidelines themselves was to further uniformity of the sentences of similarly situated defendants.[371] With that in mind, Judge Bright concluded that the majority's interpretation would result in unequal sentences for defendants who had committed the

361. *Id.* at 1105 (Bright, J., dissenting).
362. *Id.* at 1105–06.
363. *Id.* at 1105.
364. *Id.* at 1105 n.9.
365. *Id.* at 1105.
366. *Id.* at 1106 (quoting 15 U.S.C. § 78j(b) (2002) and 17 C.F.R. § 240.10b-5 (2002), the Rule under which Mooney was convicted); *see also supra* Part I.A.3.a (discussing the theories upon which to find a breach of a duty in order to satisfy the "deception" requirement of Rule 10b-5).
367. *Mooney*, 426 F.3d at 1106 (Bright, J., dissenting).
368. *Id.*
369. *Id.*
370. *Id.* at 1107 ("It is unreasonable to apply the Guidelines in a way that would lead to such disparate sentences for similarly situated defendants whose real conduct was identical. Such an application would create a through-the-looking-glass inversion of the Guidelines—advising unequal sentences for identical crimes—defeating the chief purpose of the Guidelines.") (discussing United States v. Booker, 543 U.S. 220 (2005)).
371. *Id.*

same crime, thus contravening the purposes of the SRA.[372] Since it would be unreasonable to apply the Guidelines in a manner that would lead to disparate sentences, Judge Bright concluded that the majority's interpretation was erroneous.[373]

Finally, Judge Bright found the disgorgement remedy applied in the civil case *Dura* to be highly persuasive in the criminal context.[374] Judge Bright concluded that since the Supreme Court had recognized in a civil context that certain "ups and downs" of the market do not affect the amount of loss to a victim of deception caused by the fraud, that "obvious concept" should apply even more strongly in a criminal case when imposing a sentence of incarceration.[375] Therefore, Judge Bright concluded that isolating the precise gain caused by criminal activity was crucial to determining the appropriate sentence.[376]

Although the majority did not agree, Judge Bright's and Mooney's arguments were reconsidered in 2009 by the Tenth Circuit in *United States v. Nacchio*.[377]

B. United States v. Nacchio*: The Market Absorption Method*

1. Background

Joseph Nacchio was the former CEO of Qwest Communications International, Inc.[378] During the second quarter of 2001, Nacchio entered into an automatic sales plan to exercise 10,000 options a day at a minimum price of thirty-eight dollars per share or higher.[379] During this time, Nacchio possessed information that Qwest's first and second quarter earnings reports were inflated, and that there was a legitimate risk that Qwest would not meet its year-end projections.[380] However, Nacchio continued exercising his options without disclosing this information through May 2001, when the stock price dropped below thirty-eight dollars per share and remained there, thus ending Nacchio's trading activity.[381] In July 2001, Qwest issued a press release reporting the financial results for the second quarter, and, in August 2001, disclosed the magnitude of the non-recurring revenue and how it would affect future projections.[382]

372. *Id.* Also, see *supra* notes 1–7 and accompanying text for a similar hypothetical as the one offered by Judge Bright to demonstrate the lack of uniformity in the majority's method.

373. *Mooney*, 425 F.3d at 1107 (Bright, J., dissenting).

374. *Id.* at 1108 (discussing Dura Pharm., Inc. v. Broudo, 544 U.S. 336 (2005)); *see also supra* notes 100–08 and accompanying text.

375. *Mooney*, 425 F.3d at 1108 (Bright, J., dissenting).

376. *See id.*; *see also supra* notes 100–08 and accompanying text.

377. 573 F.3d 1062 (10th Cir. 2009).

378. *Id.* at 1064.

379. *Id.* at 1065.

380. *Id.* at 1064. Specifically, the government alleged that Nacchio was aware of the fact that Qwest was making projections based heavily on IRU sales (indefeasible rights of use), which are nonrecurring sources of revenue. *Id.* at 1064 & n.1.

381. *Id.* at 1065.

382. *Id.* at 1066.

Nacchio was subsequently charged and convicted of nineteen counts of insider trading covering the trades made during April and May 2001.[383]

The U.S. District Court for the District of Colorado sentenced Nacchio to 72 months.[384] Nacchio's sentence was enhanced pursuant to the loss chart in 2F1.1 of the Guidelines.[385] At trial, there was no dispute that the gross proceeds from the relevant stock sales were approximately $52 million;[386] subtracting costs and other fees and taxes, Nacchio's net profit from the trading totaled approximately $28 million, resulting in a Guidelines range of 63–78 months.[387] The court specifically rejected Nacchio's argument to apply the "market absorption" approach to calculate the illegal "gain," caused directly by his deception.[388]

The Tenth Circuit reviewed the sentence of Nacchio, comparing the district court's gain calculation and Nacchio's requested market absorption method.[389] The court first analyzed the discussion in *Mooney*, noting it as the only circuit decision to have addressed the precise issue before the court.[390] The court summarized the "net profit" approach applied in *Mooney* as well as the Eighth Circuit's reluctance to apply the civil law approach for calculating "gain" in a criminal context.[391] The court also discussed Judge Bright's dissenting opinion, which it found convincing.[392]

2. Majority Opinion

The Tenth Circuit rejected the district court's and the *Mooney* court's interpretation of the Guidelines, and determined the approach district courts should follow: 1) the district court should take into account that the offense is not the sale and purchase of the shares itself but rather the "deception intertwined with the sales" due to the possession of nonpublic, material

383. *Id.*

384. *Id.* at 1069.

385. *Id.* at 1067–69 (describing the district court's calculation of gain). Nacchio was sentenced under the 2000 Guidelines. The 2000 Guidelines sentenced insider trading under 2F1.2. *See* U.S. SENTENCING GUIDELINES MANUAL § 2F1.2 (2000). This section has subsequently been deleted and replaced by 2B1.4. *Compare* USSG § 2F1.2 (2000), *with* USSG § 2B1.4 (2009). Additionally, the loss table used to sentence insider trading in the 2000 Guidelines was in 2F1.1. *See* USSG § 2F1.1 (2000). For the purposes of this discussion, there is no material difference between how the 2000 Guidelines and the current Guidelines' insider trading provisions function. *Compare* USSG § 2F1.1 (2000), *with* USSG § 2B1.1 (2009).

386. *Nacchio*, 573 F.3d at 1067–68.

387. *Id.* at 1068–69. The government claimed that taxes should not be included in the calculation and insisted that Nacchio's "gain" for the purposes of sentencing was $44.6 million. *Id.* Nacchio submitted an event study (an economic study that focuses on the reaction of the market to the disclosed information, see *infra* note 480) that claimed that the maximum portion of Nacchio's sales proceeds that would be attributable to inside information was only 3.52% of the $52 million, or $1.8 million total. *Id.* at 1068. The court rejected both of these calculations. *Id.*

388. *Id.* at 1069.

389. *See id.* at 1067–69.

390. *Id.* at 1069.

391. *Id.* at 1069–70.

392. *Id.* at 1070–71.

information and 2) with that in mind, the district court should compute the "gain" for sentencing purposes based on the gain "resulting from that deception."[393] The court went on to explain that district courts, in attempting to base the "gain" calculation only on the deception involved, should use the civil disgorgement remedy as guidance in sentencing criminal insider trading defendants.[394]

Like the Eighth Circuit in *Mooney*, the *Nacchio* court first examined the plain language of the Guidelines and corresponding commentary for support of its approach.[395] The court relied heavily on Judge Bright's dissent in *Mooney* to analyze the meaning of the phrase "the gain resulting from the offense."[396] The court concluded that, based on the language from the commentary of the Guidelines, both "knowledge and deception" are necessary to have committed insider trading.[397] The court felt that the logical conclusion was necessarily that "any gain associated with lawful trading should not be considered gain as used to increase a prison sentence."[398]

Further, the court looked to section 1B of the Guidelines for general application guidance.[399] This section specifies that to be convicted under the relevant statute the "offense" includes all "relevant conduct."[400] "Relevant conduct" is defined as "all acts and omissions committed . . . *that occurred during the commission of* the offense of conviction."[401] All of this commentary led the court to believe that Nacchio could not be sentenced based on the total profit gained through exercising his options but instead only on the "gain" attributed to the nondisclosure of the negative information.[402]

The court also relied heavily on *Dura* and *MacDonald* to address the "tangle of factors affecting price" that also influences the calculation of a defendant's sentence.[403] Similarly, in the criminal context, the court cited *United States v. Olis*,[404] a U.S. Court of Appeals for the Fifth Circuit decision recognizing that stock price movements based on other factors should not be included in loss determination for accounting fraud.[405] The *Olis* court highlighted "thorough analyses grounded in economic reality" as the method required to determine loss.[406] The *Olis* court reasoned that the intrinsic value decline of stock should be determined to calculate the

393. *Id.* at 1072.
394. *Id.*
395. *Id.* at 1072–73.
396. *Id.* (quoting U.S. SENTENCING GUIDELINES MANUAL § 2F1.2 (2000)).
397. *Id.* at 1072.
398. *Id.*
399. *Id.* at 1073; *see also* USSG § 1B1.1 cmt. n.1(*l*).
400. *Nacchio*, 573 F.3d at 1073; *see also* USSG § 1B1.1 cmt. n.1(*l*).
401. *Nacchio*, 573 F.3d at 1073 (quoting USSG § 1B1.3(a)(1)).
402. *Id.*
403. *Id.* at 1074 (quoting Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 343 (2005)); *see also supra* notes 100–08 and accompanying text.
404. 429 F.3d 540 (5th Cir. 2005).
405. *Nacchio*, 573 F.3d at 1075 (citing *Olis*, 429 F.3d at 549).
406. *Olis*, 429 F.3d at 547.

sentence, and the district court's approach had not taken into account "the impact of extrinsic factors" on the resulting price of the stock.[407]

The Tenth Circuit acknowledged that a "net profit" approach would result in a simple and easily applicable standard to apply in every case.[408] However, the court also noted "a critical objective of federal sentencing is the imposition of punishment on the defendant that reflects his or her culpability for the criminal offense (rather than for the unrelated gyrations of the market)."[409] In fact, since the defendant's freedom is at stake in addition to the amount of forfeiture he must surrender, the court agreed with the Second Circuit in *United States v. Rutkoske*[410] that the considerations of the civil sphere are "at least as strong[]" in the criminal context.[411] Therefore, the court felt that it was appropriate, if not even more important, in criminal cases to calculate gain by first examining the "movement of a stock's price after the relevant information is made public."[412]

The court next qualified its approach by noting that although it is inappropriate to rely on strategies used in the civil sphere to determine the damages of victims, the disgorgement method is designed not only to compensate victims, but also to deprive the defendant of unjust enrichment from his crime.[413] In this sense, the court found that the civil disgorgement method is appropriate to use as guidance in the context of sentencing.[414] The court instructed the district court on remand to focus on the same factors and analysis applied in civil disgorgement cases, such as *MacDonald*, which would apply the market absorption method argued by Nacchio.[415]

The court concluded with a discussion about the policy considerations that must be taken into account when sentencing.[416] The court held that the market absorption approach is consistent with the central goals of sentencing in that "it endeavors to hold the defendant accountable for the portion of the increased value of the stock that is related to his or her criminally culpable conduct. Consequently, it militates against the creation of unwarranted sentencing disparities among similarly situated defendants."[417] From a policy perspective, the court opined, a sentencing approach that focuses on a defendant's culpability and attempts to avoid

407. *Id.* at 548–49.
408. *Nacchio*, 573 F.3d at 1077.
409. *Id.* at 1077 (citing 18 U.S.C. § 3553(a) (2006) ("sufficient, but not greater than necessary")).
410. 506 F.3d 170 (2d Cir. 2007).
411. *Nacchio*, 573 F.3d at 1078 (citing *Rutkoske*, 506 F.3d at 179).
412. *Id.* at 1079 (citing SEC v. Patel, 61 F.3d 137, 140 (2d Cir. 1995)).
413. *Nacchio*, 573 F.3d at 1079–80.
414. *Id.* at 1080.
415. *Id.* at 1078–80 & 1080 n.15.
416. *Id.* at 1080–86.
417. *Id.* at 1080; *see also* 18 U.S.C. § 3553(a) (2006).

interference from the unrelated market forces "narrow[s] the zone of unpredictability in sentencing."[418]

3. Resentencing

Nacchio was resentenced on June 24, 2010 in the District of Colorado.[419] The court reduced Nacchio's 72-month sentence by only two months.[420] The court acknowledged the directive of the Tenth Circuit to "consider a different measure of loss, a measure of loss that correlates to the measure of disgorgement that is used in civil securities fraud cases."[421] For purposes of calculating this figure, the court characterized "loss" and "gain" as "exactly [the] same thing."[422] Both parties presented expert witness testimony in the form of two event studies[423] to recommend to the court a "loss" or "gain" figure. The government's expert proffered a study that attributed 45%–65% of the total drop in value of Qwest's stock to the revelation of Nacchio's information that he possessed when trading, which resulted in a "gain" figure of $23 to $32 million.[424] Nacchio's expert, Professor Daniel R. Fischel, repeated his testimony from Nacchio's previous sentencing hearing, concluding that Nacchio's use of inside information either caused no loss in value of Qwest stock, or only 3.52% of the total drop, resulting in a "gain" or "loss" figure of $1.8 million.[425]

Importantly, the court noted that both experts agreed "that their studies did not and could not perfectly reflect market responsiveness to the information. They referred to their inability to precisely measure as a reflection of inherent inefficiencies in the market."[426] The court also acknowledged the difficultly in the "methodology to be absolutely precise where there is no single, discrete fact that is known to the insider and is later revealed on a discrete day," not unlike Nacchio's situation, which the court and government expert described as "being revealed in dribs and drabs over a period of time."[427]

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418. *Nacchio*, 573 F.3d at 1082. The court acknowledged also, however, that even the disgorgement approach adopted cannot insulate itself completely from "chance market forces." *Id.* at 1082 n.18.

419. Transcript of Sentencing Hearing, United States v. Nacchio, No. 05-cr-00545-MSK (D. Colo. June 24, 2010); *see also* Douglas A. Berman, *Much Ado About Two Months in the Resentencing of Former Qwest Chief Joe Nacchio*, SENT'G. L. & POL'Y. (June 24, 2010, 5:25 PM), http://sentencing.typepad.com/sentencing_law_and_policy/2010/06/much-ado-about-two-months-in-the-resentencing-of-former-qwest-chief-joe-nacchio.html; *Judge Cuts Nacchio's Sentence by 2 Months, Forfeitures by $7 Million*, DENVERPOST.COM (June 24, 2010, 11:31 PM), http://www.denverpost.com/business/ci_15368168?source=pkg.

420. Transcript of Sentencing Hearing, *supra* note 419, at 44.

421. *Id.* at 12.

422. *Id.* at 13 ("What we're looking at is the difference in value between what Mr. Nacchio recovered from the sale of his stock . . . and what an investor ultimately in possession of the same information would have been able to recover for the same stock.").

423. *See supra* note 387.

424. Transcript of Sentencing Hearing, *supra* note 419, at 15.

425. *Id.*

426. *Id.* at 17.

427. *Id.*

Ultimately, the court picked one expert's testimony—the government's—over the other, determining the "gain" amount to be between $23 and $32 million,[428] as compared to the original figure of $28 million.[429] The resulting Guidelines range was, therefore, no different than the original sentencing range.[430] For resentencing, the court decided to use the "midpoint" in the Guidelines range, which would be 70 and a half months, rounding down to 70 months.[431] Therefore, for Nacchio, the victory of obtaining a favorable method for resentencing was short lived, as the government's expert testimony triumphed again.

III. THE COMMISSION SHOULD REEXAMINE THE IMPACT OF "GAIN" AND RESTRUCTURE SECTION 2B1.4 AND SECTION 2B1.1

The decisions of *Mooney* and *Nacchio* demonstrate that the Guidelines' emphasis on "gain" results in sentencing proceedings that are not in line with our current legal system's goals regarding sentencing.[432] Not only do these decisions exhibit the large discrepancies in sentences imposed on similar defendants,[433] but they also illustrate the vagueness of the Guidelines' instructions on how courts should calculate this figure.[434] These differences cannot stand if the Guidelines are going to satisfy the goals upon which they were conceived.[435]

Part III.A of this Note argues that "loss" or "gain" should not be the determinative factor in calculating a sentence because it is based on an imprecise and contestable figure that is affected by many factors and not always directly related to culpability. Part III.B argues that other factors should play an equally important role in sentencing, and the "loss" chart in 2B1.1 should be restructured. Part III.B also proposes that the Commission use the market absorption method adopted by the *Nacchio* court to instruct users of the Guidelines on how to calculate "gain." Part III.C argues that the proposed amendments are in line with the role the Commission is expected to play in the development of sentencing law.

A. The Current Guidelines Put Undue Emphasis on "Gain"

As the current Guidelines are written, the most dispositive element in sentencing—"gain"—is a figure that is neither precise nor related to culpability.[436] Market imperfections cause the validity of any calculation based on a stock price to be called into question.[437]

428. *Id.* at 26; *see also id.* at 20 ("I credit [the government expert's] opinion more greatly than I credit Professor Fischel.").

429. *See supra* note 387.

430. *See supra* note 387 and accompanying text.

431. Transcript of Sentencing Hearing, *supra* note 419, at 44.

432. *See supra* notes 187, 259–60 and accompanying text; Part II.

433. *See, e.g.*, *supra* notes 340, 344 (comparing Mooney's potential sentences based on the net profit versus the market absposrtion method under the current Guidelines).

434. *See supra* Part II.

435. *See supra* notes 191–95 and accompanying text.

436. *See supra* notes 232–43 and accompanying text.

437. *See supra* notes 138–49, 403–07 and accompanying text.

As articulated in many cases, the market factors that affect price are not easily identified.[438] If the defendant's "gain" from the sale or purchase of the security on the basis of inside information is the sole determinative factor in sentencing, then the imprecise operation of the stock market has been unfairly allowed to determine a defendant's sentence.[439] Furthermore, the theories on which courts rely to determine the harm of insider trading are not precise enough to be the basis of a sentence.[440] The ECMH is a core tenant on which the harm of insider trading is based.[441] However, the ECMH, especially recently, has been under attack.[442] If factors not directly related to the security in question affect price in addition to the public information available as behavioral finance postures,[443] then the effect of inside trading in the market and on individual market traders could be less than originally thought.[444]

Additionally, since even economists cannot precisely predict market fluctuations, courts certainly should not be required to digest complex economic studies in order to reach such a precise and important figure.[445] Since courts are not equipped to continually evaluate economic theory, the ability of courts to come to a precise figure representing "loss" or "gain" is extremely difficult.[446] In the criminal context, when different calculations can result in a sentencing disparity of many years, the current Guidelines require a figure that is as precise as possible.[447] This precision is a standard that current methodologies cannot realistically reach.

Further, the defendant cannot predict the precise rise and fall of stock prices; therefore, a precise incremental "loss" or "gain" chart is not necessary to indicate the defendant's state of mind when committing the crime.[448] A better proxy for determining the defendant's intent and the seriousness of the offense would be a chart that contains fewer increments and separate amounts that truly represent large-scale fraud from small-scale

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438. *See, e.g.*, *supra* notes 100–08 (discussing Dura Pharm., Inc. v. Broudo, 544 U.S. 336 (2005)); *supra* notes 403–07 (discussing United States v. Nacchio, 573 F.3d 1062 (10th Cir. 2009) and United States v. Olis, 429 F.3d 540 (5th Cir. 2005)).

439. *See supra* notes 210–11 and accompanying text.

440. *See supra* notes 138–48 and accompanying text.

441. *See supra* notes 129–31 and accompanying text.

442. *See supra* notes 138–49 and accompanying text.

443. *See supra* notes 142, 145–48 and accompanying text.

444. *See, e.g.*, Jenkins, *supra* note 242, at A15 ("Let's think back to lachrymose news stories discussing the sufferings of Enron shareholders, which confidently insisted that fraud had cost them $50 billion in stock losses. That number is still cited by prosecutors, politicians and pressies, though it's based on a brief, outlandish spike in the company's stock price during the Internet bubble.").

445. *See, e.g.*, *J. Newman Testimony*, *supra* note 233, at 6 ("The excessive segmentation of these monetary loss tables . . . requires sentencing judges to do detailed fact-finding, far beyond what is needed to select an appropriate sentence.").

446. *See* Basic Inc. v. Levinson, 485 U.S. 224, 253 (1988) (White, J., concurring in part, dissenting in part) ("But with no staff economists, no experts schooled in the [ECMH], no ability to test the validity of empirical market studies, we are not well equipped to embrace novel constructions of a statute based on contemporary microeconomic theory.").

447. *See supra* notes 231, 409–12 and accompanying text.

448. *See* Bowman, *supra* note 277, at 38–41 (discussing how loss does indicate culpability); *supra* note 235 and accompanying text.

fraud.[449] Similar to Judge Newman's burglar who decides to rob a convenience store and takes whatever is there, an inside trader will trade on the information he possesses, taking a guess at how the stock market will reward him.[450] Whether he gains $20,000 or $100,000 is not truly within his control.[451] Therefore, the current chart that contains sixteen increments of monetary amounts and corresponding total offense level additions is not an appropriate indicator of the defendant's true culpability.[452]

B. The Guidelines Should Be Amended to Reflect the Importance of "Gain" and Other Factors

1. Other Factors Should Carry Proportionate Weight

The economic crimes provisions of the original Guidelines were unique in that these sections failed to replicate previous sentencing patterns of actual judges.[453] However, if the Commission had undertaken this exercise to create white collar provisions, it most likely would have discovered several other factors that federal judges considered when sentencing white collar defendants.[454]

According to one study, prior to the Guidelines judges imposed an appropriate sentence based on three important concepts: the sentence should reflect the harm done,[455] offenders should be sentenced differently according to the blameworthiness of their actions,[456] and the consequences of every sentence to society should be considered.[457]

Keeping these norms in mind when sentencing white collar defendants, judges considered not only financial loss but also the "spread" of the events over time and place, the nature of the victim, and the presence and nature of any violation of trust.[458] As one of many, this study may guide the Commission in utilizing other factors for determining an appropriate sentencing range for an insider trading defendant. For example, duration of the offense is one factor that should be included by the Commission in

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449. *See* WHEELER ET AL., *supra* note 150, at 66–67; *J. Newman Testimony*, *supra* note 233, at 4–5 ("I fully recognize, as do all sentencing regimes, that seriousness of the offense should be considered a basis for increasing a sentence . . . stealing one million dollars is properly punished more severely than stealing one hundred dollars. The issue is not whether seriousness of the offense should increase severity of the sentence. The issue is whether every minute increment of offense conduct must result in a minute increment of punishment.").

450. *See supra* note 235 and accompanying text.

451. *See id.*

452. *See* U.S. SENTENCING GUIDELINES MANUAL § 2B1.1(b)(1) (2009).

453. *See supra* notes 201–07 and accompanying text.

454. *See generally* WHEELER ET AL., *supra* note 150 (documenting a study done before the first Guidelines were enacted, and interviewing federal judges for their sentencing philosophies).

455. *Id.* at 20.

456. *Id.*

457. *Id.* at 22.

458. *Id.* at 66.

considering the defendant's role in the offense.[459] Duration of the offense is an indirect indicator of the degree of planning and deliberateness that has gone into the conduct, therefore providing insight into the defendant's intent and state of mind.[460]

Moreover, further examination into the harm caused by the offense can lead the Commission to additional factors upon which to base a sentence.[461] Insider trading law has always primarily been concerned with, and in fact requires, a breach of trust or breach of fiduciary duty.[462] As a result, the breach of this trust should be at the center of any insider trading sentencing proceeding. In order to determine the degree of this breach for sentencing purposes, many factors could be analyzed, such as the level of sophistication of the crime, the deceit involved, the effort made to uncover the information or extract the information from the source, and the effort made to conceal the deception.[463]

Additionally, the possibility of recidivism by the defendant should be considered.[464] Although deterring future crimes by others is an important concern in sentencing white collar criminals,[465] the possibility of future criminal acts by the same offender is most often not a threat.[466] These criminals have been forced to give up the positions of power that gave them the opportunity to commit fraud, and the subsequent public disgrace of a criminal conviction leaves these individuals with little incentive or opportunity to commit fraud again.[467] Additionally, the old age of many defendants results in functional life sentences.[468] Surely the deterrence of future crimes by others can be achieved without such extreme sentences based only on the "loss" or "gain" amount.

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459. *Id.* at 69.

460. *Id.* at 70 ("Duration obtains its importance from its use as a proxy for the repetitive and patterned nature of the offense on the one hand, the deliberate, calculating nature of the offender on the other.").

461. *See supra* note 455 and accompanying text.

462. *See supra* Part I.A.3.a.

463. *See* Bowman, *supra* note 277, at 21.

464. *See* 18 U.S.C. § 3553(a)(2)(C) (2006) (requiring the court to consider the need for the sentence to "protect the public from further crimes of the defendant").

465. *See* WHEELER ET AL., *supra* note 150, at 22 ("[I]n white-collar cases, general deterrence is a most relevant consequence.").

466. *See* Podgor, *supra* note 208, at 284.

467. *See, e.g.*, *id.* Podgor goes on to argue:

> Unlike violent criminals, white-collar offenders are removed from the positions of authority that enabled them to commit crimes in the first place . . . . His criminal acts were specific to his business career. And like so many white-collar offenders, his removal from power meant that he was no longer dangerous to society. It is unlikely that he will be returning as a CEO of a major company ever again.

Id.

468. *See, e.g.*, Henning, *supra* note 283, at 762 (outlining several examples of defendants receiving what amounts to life sentences as discussed in Ebbers' sentencing); *supra* notes 209, 226 and accompanying text.

2. The Section 2B1.1 "Loss" Chart Should Be Restructured

In addition to other factors, "gain" should also be examined to determine the culpability and sentence of an insider trading defendant.[469] The scale of the loss or gain caused by the offense is important to determine the mindset of the defendant.[470] However, this factor should not be so critical as to potentially increase a sentence from six months to 360 months.[471] The level additions imposed due to "gain" should be proportionate to those based on the other factors.[472] It is unjust that the 2B1.1 chart can increase a defendant's total offense level by thirty levels,[473] when other factors—e.g., role in the offense, acceptance of responsibility—can only increase or decrease the offense level by two or four levels.[474]

In addition to considering the weight that each factor plays in sentencing, the Commission should also examine the sentences prescribed for other crimes, including state offenses such as violent crimes, in order to restructure the Guidelines for fairer sentencing of white collar criminals.[475] There is no other area of the Guidelines that prescribes life sentences to first-time, non-violent or non-drug related offenders.[476] The white collar provisions are unique in this respect, and therefore the Commission should consider whether these comparative sentences truly reflect societal values.[477]

3. Section 2B1.4 Should Include Instructions from the Commission to Calculate Gain Using the Tenth Circuit's Market Absorption Method

In addition to restructuring the 2B1.1 chart, the calculation of "gain" should be clearly defined in the Guidelines.[478] Instructions from the Commission concerning a "gain" calculation method are necessary.[479]

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469. *See* WHEELER ET AL., *supra* note 150, at 20, 66–68; Bowman, *supra* note 277, at 38–39 (arguing that "loss" in a white collar criminal case is a good indication of the mental state of the defendant).

470. *See* Bowman, *supra* note 277, at 38–39.

471. *See* U.S. SENTENCING GUIDELINES MANUAL §§ 2B1.1(b)(1), 5A (2009).

472. *But see* Bowman, *supra* note 277, at 40–41 (arguing that the weight placed on "loss" in sentencing is appropriate as compared to other factors).

473. *See* USSG §§ 2B1.1(b)(1), 5A.

474. *See, e.g.*, USSG § 3B1.1–1.3 (allowing for a maximum of four additional total offense levels depending on the role in the offense); USSG § 3C1.1 (allowing for two additional total offense levels for obstruction of justice); USSG § 3E (allowing for a two-level reduction for acceptance of responsibility).

475. *Accord* Podgor, *supra* note 208, at 281–84 (comparing white collar offenses and sentences to violent crimes).

476. *See generally* USSG § 5A.

477. *Accord* Podgor, *supra* note 208, at 281–84.

478. *See* USSG § 2B1.4 cmt. background.

479. *See* STITH & CABRANES, *supra* note 183, at 97–98 ("[T]he Commission has gone out of its way to make it clear that it alone will determine the scope and application of concepts employed in the Sentencing Guidelines . . . . The Commission deliberately employed minute quantitative distinctions in the Guidelines precisely in order to minimize the opportunity for sentencing judges to make discretionary choices."); *supra* notes 189–95 and accompanying text.

Specific instructions will allow courts and parties to a criminal prosecution to have a consistent and predictable method on which to base their findings. Clear instructions will also obviate the need to compile event studies and stage complex arguments supporting one method over another.[480] Most importantly, instructions will help reduce unwarranted sentencing disparities by mandating that courts apply the same procedure to determine "gain."[481]

If the Commission does define a "gain" calculation method, it should chose to adopt the market absorption method embraced by the *Nacchio* court.[482] The market absorption method truly identifies the harm of insider trading.[483] Using the difference in price between the time of the insider's trade and at the time at which the market absorbs the information better represents the opportunity for profit missed by the trader who was preempted or the loss incurred by the trader who was induced to trade.[484] Using any other figure is illogical. After the trading on the inside information has been finalized, no more harm to the market, or to other traders, is caused since the information has been disclosed.[485]

Furthermore, the civil sphere already embraces this method for determining SEC penalties and private damages.[486] The *Nacchio* court pointed out that the Second Circuit has, in previous cases, employed reasoning from civil cases to determine loss causation in criminal cases.[487] Mooney's brief also argued that there exists a "longstanding practice" of applying civil law analysis to criminal cases.[488] Mooney argued that the language being analyzed in civil insider trading cases and criminal insider

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480. *See, e.g.*, United States v. Nacchio, 573 F.3d 1062, 1068 (10th Cir. 2009) (summarizing the event study compiled by University of Chicago economist, Professor Daniel R. Fischel). An event study is an economic study that looks to how the price of the stock changes after the fraud was disclosed. *See id.* at 1068 n.7 (citing United States v. Grabske, 260 F. Supp. 2d 866, 867 (N.D. Cal. 2002); Kevin P. McCormick, *Untangling the Capricious Effects of Market Loss in Securities Fraud Sentencing*, 82 TUL. L. REV. 1145, 1163–79 (2008)).

481. *See* 18 U.S.C. § 3553(a)(6) (2006) (mandating the duty to avoid disparities in sentences among similarly situated defendants).

482. *See supra* notes 393, 415 and accompanying text.

483. *See supra* Part I.A.3.b (discussing the point at which insider trading is no longer illegal); Part I.A.4 (discussing loss causation and the calculation of damages); notes 164–77 and accompanying text.

484. *See supra* notes 164–77 and accompanying text.

485. *See supra* note Part I.A.3.b; Part I.A.4; notes 164–77 and accompanying text.

486. *See supra* notes 112–28 and accompanying text.

487. United States v. Nacchio, 573 F.3d 1062, 1078 (10th Cir. 2009) (citing United States v. Rutkoske, 506 F.3d 170, 179 (2d Cir. 2007)); *see also* United States v. Ebbers, 458 F.3d 110, 128 (2d Cir. 2006).

488. Reply Brief and Supplemental Addendum of Appellant, *supra* note 341, at 3 ("There is a longstanding practice of applying civil law when analyzing criminal matters concerning § 10b and Rule 10b-5, the provisions at issue here.") (citing Chiarella v. United States, 445 U.S. 222 (1980) (applying civil interpretations of Rule 10b-5 in a criminal case); United States v. Boyer, 694 F.2d 58, 60 (3d Cir. 1982); United States v. Charnay, 537 F.2d 341, 348 (9th Cir. 1976) (holding Rule 10b-5 allows civil law precedents interpreting the rule to be applicable in criminal prosecutions)).

trading cases is equivalent and, therefore, that civil authorities are both "enlightening and cogent."[489]

Finally, although not a perfect system, the market absorption method should be used in favor of a method that results in harsher sentences.[490] Simplicity of method should not be preferred to a more complicated method that will accurately impose a sentence that is "sufficient, but not greater than necessary" as required by the SRA.[491]

C. Amending the Guidelines Is in Line with the Expected Role of the Commission and the Goals of Sentencing

1. The Commission Should Be Insulated from Political Pressures

The purpose of creating the Commission as an independent agency in the judicial branch was to insulate the Guidelines' development from political pressures.[492] The development of the white collar provisions of the Guidelines was arguably not insulated from such pressures.[493] The Commission originally attempted to perform objective analysis when it collaborated with other parties to produce the 2001 Economic Crime Package.[494] However, the subsequent SOX legislation and amendment of the Guidelines in response to congressional pressures was inappropriate.[495] Because of the role that strict congressional directives played in the development of the white collar provisions, the Commission should reassess these areas of the Guidelines divorced from these directives.

The Commission has recognized this problem in the past and responded correctly to it. The crack-cocaine issue is another area in which the Commission was attacked for responding to congressional directives. The result of the 100-to-1 weight ratio created by the Anti-Drug Abuse Act of 1986 (1986 Act) was that a defendant dealing five grams of crack received the same mandatory minimum sentence as a defendant dealing 500 grams of powder cocaine.[496] The Guidelines used weight tables for drugs that were very similar to the chart used in white collar provisions.[497] The

489. *Id.* at 4.

490. *See supra* notes 410–12 and accompanying text; *see also* Podgor, *supra* note 208, at 279 (accusing the current Guidelines of producing "draconian" sentences for white collar criminals).

491. 18 U.S.C. § 3553(a) (2006); *see also supra* notes 414–18.

492. *See supra* note 195 and accompanying text.

493. *See supra* Part I.C.

494. *See supra* notes 274–80 and accompanying text.

495. *See supra* notes 281–311 and accompanying text; *see also* Podgor, *supra* note 208, at 282–83 ("[T]he sentiment is clearly to have tough federal sentencing Guidelines that satisfy the public's wish that the government get 'tough on crime.' The very thought that those who are privileged might receive a relatively lenient sentence horrifies a public with no tolerance for lawbreakers. Legislators answerable to this public look for ways to ratchet up sentences to display their support of victims' rights and to ensure that those who benefit from opportunity are held to a higher standard.").

496. 21 U.S.C. §§ 841(b)(1)(A)(ii)–(iii), (B)(ii)–(iii) (2006).

497. *See J. Newman Testimony*, *supra* note 233, at 5–6; *supra* note 231 and accompanying text.

weight tables for crack and cocaine were highly disproportionate, and the Commission offered no empirical evidence supporting this disparity.[498] It was clear that the Commission was basing the Guidelines on the standards set in the 1986 Act.[499]

The Commission later determined that the crack-powder sentencing disparity is generally unwarranted.[500] Based on additional research, the Commission concluded that the disparity "fail[ed] to meet the sentencing objectives set forth by Congress in both the Sentencing Reform Act and the 1986 Act."[501] The Commission attempted in several ways to remedy the problem. In 1995, the Commission proposed amendments to the Guidelines that would have replaced the 100-to-1 ratio with a 1-to-1 ratio.[502] Congress rejected the amendments.[503] In response, the Commission issued reports in 1997 and 2002 recommending that Congress change the weight ratio to 5-to-1 and then "at least" 20-to-1, respectively.[504] Neither proposal prompted congressional action.[505] Finally in 2007, the Commission again urged Congress to amend the 1986 Act and also adopted an ameliorating change in the Guidelines.[506] The amendment reduced the base offense level associated with each quantity of crack by two levels.[507] This change resulted in crack offenses yielding sentences that are between two and five times longer than sentences for equal amounts of powder.[508]

The lesson learned from the crack-cocaine disparity is that the Commission is expected to perform its own individual research and analysis, divorced from congressional pressures, in order to define reasonable sentences.[509] When the Commission based the crack-cocaine provisions of the Guidelines around a congressional act, the result was a widespread consensus that the Guidelines were unreasonable.[510] In response, the Commission appropriately reevaluated these portions to better reflect the goals of sentencing as required by the SRA and made legitimate

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498. *See* Ellis Cose, *Closing the Gap*, NEWSWEEK, July 20, 2009, at 25 ("Why are the penalties for crack and powder so disparate? Largely because legislators were told—and believed—that small-time crack dealers were somehow on a par with big-time powder dealers . . . . There was also the notion that crack was a freakish demon drug—that it was many times more addictive, a trigger for violence, and infinitely more dangerous than powder in virtually every way. Those ideas turned out to be either false or overstated.").

499. *See* Kimbrough v. United States, 552 U.S. 85, 96 (2007).

500. *See* Cose, *supra* note 498 ("Since 1995 the Sentencing Commission has been trying to set things straight—partly because the law makes no sense . . . .").

501. *Kimbrough*, 552 U.S. at 97 (quoting a report issued by the Commission in 2002).

502. *Id.*

503. *Id.* at 99.

504. *See id.*

505. *See id.*

506. U.S. SENTENCING COMM'N, REPORT TO THE CONGRESS: COCAINE AND FEDERAL SENTENCING POLICY (May 2007), *available at* http://www.ussc.gov/r_congress/cocaine2007.pdf.

507. *See Kimbrough*, 552 U.S. at 100.

508. U.S. SENTENCING GUIDELINES MANUAL §§ 2D1.1(c), 5A (2009).

509. *See supra* notes 193–95 and accompanying text.

510. *See supra* notes 496–501 and accompanying text.

changes in sentencing policy.[511] The Commission can and should perform this same exercise with the 2B1.1 chart and the insider trading provisions.

2. The SRA Requires the Commission to Consider the Purposes of Sentencing

"[S]ufficient, but not greater than necessary"[512] should be the phrase that guides the Commission's determination of sentences.[513] The Commission should be concerned not only with producing precise Guidelines for sentencing similarly situated defendants but also with erring on the side of leniency in order to satisfy the statutory requirement of imposing a sentence that is sufficient, but not greater than necessary.[514]

Furthermore, sentencing disparities among similarly situated defendants were one of the most important motivations behind creating the Guidelines and a Commission.[515] Therefore, any area of the Guidelines that results in widely varied sentences should be reexamined. The 2B1.1 chart is one such area that needs to be reexamined for this purpose.[516] Restructuring the chart and creating precise instructions on how to calculate "loss" or "gain" will bring the Guidelines closer to satisfying the original goals on which they were conceived.[517]

CONCLUSION

The circuit split created by the conflicting interpretations of sections 2B1.1 and 2B1.4 of the Guidelines showcases one of the major difficulties courts face when sentencing the perpetrators of complex white collar fraud. As examined by this Note, and demonstrated by the district court on remand in *Nacchio*, a defendant's sentence will be largely determined by the winner of a battle of expert witnesses posturing a figure based on theories that are inexact at best. The Commission is in the unique position to resolve this major issue in white collar sentencing policy. By reexamining the white collar provisions of the Guidelines and considering the original purposes of creating a uniform system of federal sentencing, the Commission is capable of bringing courts one step closer to uniform and predictable sentencing of white collar offenders.

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511. *See supra* notes 500–08 and accompanying text.
512. 18 U.S.C. § 3553(a) (2006).
513. *See supra* note 259 and accompanying text.
514. *See supra* notes 416–18 and accompanying text.
515. *See supra* notes 181–83 and accompanying text.
516. *See* Henning, *supra* note 283, at 771 ("To the extent that a discussion of disparity has any meaning, for economic crimes . . . the calculation of the amount of loss will be one likely source of inconsistency. Such calculation is the primary driver of sentences for these offenses. Because judges have the sole authority to determine the loss under the now-advisory Sentencing Guidelines, that determination may engender differences in sentencing based on how a judge decides the loss caused by the crime or whether other factors result in not following the loss table in determining the final sentence. With the greater discretion provided by *Booker*, trial courts may be able to play with the numbers, or simply ignore them, in determining the sentence that will be reviewed only for its reasonableness.").
517. *See supra* notes 190-95 and accompanying text.