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TABLE OF CONTENTS

Articles

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REGULATORY INNOVATION AND PERMISSION TO FAIL: THE CASE OF SUPTECH

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The recent U.S. Supreme Court decision West Virginia v. EPA has cast a pall over the discretion of administrative agencies at a very inopportune time. The private sector is currently adopting new technologies at a rapid pace, and as regulated industries become more technologically complex, administrative agencies must innovate technological tools of their own in order to keep up. Agencies will increasingly struggle to do their jobs without that innovation, but the private sector is afforded something that is both critical to the innovation process, and often denied to administrative agencies: "permission to fail." Without some grace for the inevitable stumbles that come with developing new technological solutions, regulatory agencies will increasingly be unable to discharge their statutory mandates, resulting in failures of in-action that could harm the public interest.

To illustrate this point, this Article uses "suptech" case studies drawn from the world of financial regulation. After articulating both the necessity and pitfalls of suptech, this Article argues that we need to extend permission to fail to administrative agencies when similar failures are recognized as a necessary part of the private sector innovation process. This Article argues that "permission to fail" cannot be a purely legal construct, and so it seeks to spur an interdisciplinary debate about how to construct both law and public opinion in a way that allows the regulatory state to develop the technological tools it needs to respond to technological developments in regulated industries.

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"[A] paramount dread of government officials is newsworthy failure. Old programs may be inadequate, but their familiarity insulates them from much media attention. [W]hen new initiatives fail, however—and inevitably a large percentage do – they become highly newsworthy, and the focus is typically: who is to blame?"

–Alan A. Altshuler[1]

INTRODUCTION

The technological sophistication of private industry is increasing at a rapid pace. As a result, private economic activity is often happening too quickly, and in ways that are too complicated, for traditional regulatory tools to address the harms of that activity. Regulatory agencies are increasingly finding that to fulfil their statutory mandates, they need to increase their own technological sophistication and that, sometimes, they will need to develop innovative technological tools of their own.[2] This Article argues that regulatory agencies' technological innovation is becoming a defensive necessity but will inevitably involve some failures. In the private sector, failure is seen as critical to the innovation process and is expected. Regulatory agencies also need to be extended this "permission to fail" in their innovation attempts or else they will be condemned to committing failures of inaction and the public will suffer the consequences.

To be sure, some technological innovation is already occurring in regulatory agencies. While these agencies are often caricatured as backward and stodgy, that caricature does not fully reflect the reality of what is occurring the administrative state. To give just a few examples:

> [T]he National Oceanic and Atmospheric Administration is using AI to refine high-impact weather tracking systems to improve decision-making in real-time. The Transportation Security Administration is exploring the use of image recognition to screen pas-

1. ALAN A. ALTSHULER, PUBLIC INNOVATION AND POLITICAL INCENTIVES 1 (1997), https://ash.harvard.edu/files/ash/files/2595.pdf?m=1618943267.

2. "[A]gencies will find it harder to realize gains in accuracy and efficiency with less sophisticated tools. This result also underscores AI's potential to widen, not narrow, the public-private technology gap." DAVID FREEMAN ENGSTROM ET AL., GOVERNMENT BY ALGORITHM: ARTIFICIAL INTELLIGENCE IN FEDERAL ADMINISTRATIVE AGENCIES 7 (2020).

> senger luggage for explosive devices. The Centers for Medicare and Medicaid Services is developing AI-based tools to predict health care fraud. And the Department of Housing and Urban Development deployed a prototype chatbot to enable citizens to acquire information about rental assistance, agency programs, and civil rights complaint procedures.[3]

This Article will focus, in particular, on the technological innovations being developed by financial regulatory agencies in order to promote financial stability and to protect consumers and investors. These tools are collectively referred to as "suptech" (a portmanteau of "supervisory technology") and rely heavily on advances in artificial intelligence (including natural language processing and machine learning technologies). Financial regulators are also exploring the potential for suptech tools based on technologies like APIs, distributed ledgers, and cloud computing,[4] but as this Article will argue, more suptech tools are needed.

Within financial regulatory agencies, suptech innovation has sometimes received less attention than other new regulatory tools like "innovation hubs" and "regulatory sandboxes" (which are designed to nurture technological innovation by the private sector but are limited in their ability to promote core financial regulatory goals like financial stability and consumer protection).[5] In a world of scarce regulatory resources, the public would benefit if regulatory agencies focused their efforts on developing their own technologies to further their own regulatory goals, rather than hoping those goals will be incidentally advanced through private sector innovation.[6] Innovation hubs and regulatory sandboxes have become increasingly popular with financial regulatory agencies around the world, though—perhaps because they lend innovative cachet to the agency without requiring the agency to put too much on the line. Suptech innovation, conversely, entails significant potential for failure on the part of the agency.

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3. *Id.* at 16.
4. *See infra* Part II.
5. *See* Hilary J. Allen, *Experimental Strategies for Regulating FinTech*, 3 J.L. & INNOVATION 1, 25 (2020).
6. *Id.* at 26.

In the private sector, there is a much higher tolerance for failure: venture capitalists, for example, expect the bulk of the investments in their portfolio to fail.[7] When it comes to the public sector, though, it is challenging to "persuade the media and the public that it is acceptable, in certain contexts and under certain conditions, to spend public money on things that turn out to be failures."[8] Researchers from the Bank for International Settlements have identified "concerns among financial authorities about the uncertain value and risks of suptech" as one of the primary impediments to suptech innovation.[9] A survey conducted by the Financial Stability Board on suptech innovation similarly found that "the risk reported to be of greatest concern was around resourcing, followed by concerns around cyber risk, reputational risk and data quality issues."[10] To enable financial regulatory agencies to better pursue public regulatory goals like consumer and investor protection and financial stability, they need more "permission to fail" to loosen constraints on their technological innovation. This permission to fail is only becoming more critical as the U.S. Supreme Court pushes in the other direction, embracing the "major questions doctrine" in a way that is likely to limit discretion in the administrative state.[11]

As this Article will explore, "permission to fail" is a multifaceted concept. First, a baseline understanding of the kinds of failures that are more or less tolerable is necessary. We then need to consider the types of permission structures that will permit the tolerable failures but punish the intolerable ones. Developing both the baseline understanding and the necessary permission structures will necessarily be an interdisciplinary effort: administrative law doctrines are relevant, but the law alone cannot construct and protect permission to fail. A broader interdisciplinary debate among lawyers, sociologists,

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7. ROBERT RHEE, CORPORATE FINANCE 647 (2016).

8. Christopher Pollitt, *Innovation in the Public Sector: An Introductory Overview, in* INNOVATION IN THE PUBLIC SECTOR 35, 39 (Victor Bekkers et al. eds., 2011).

9. SIMONE DI CASTRI ET AL., FIN. STABILITY INST., FSI INSIGHTS ON POLICY IMPLEMENTATION NO. 19: THE SUPTECH GENERATIONS 14 (2019).

10. FIN. STABILITY BD., THE USE OF SUPERVISORY AND REGULATORY TECHNOLOGY BY AUTHORITIES AND REGULATED INSTITUTIONS 1 (Oct. 9, 2020), https://www.fsb.org/wp-content/uploads/P091020.pdf.

11. *See infra* notes 297–300 and accompanying text.

political scientists, technology ethicists, and others is needed to flesh out permission to fail. This Article identifies such need and provides a starting point for the debate.

When it comes to legal reform, the most obvious administrative law change that needs to occur is to free regulatory innovation processes from having to comply with strict quantified cost-benefit analysis requirements. These kinds of requirements can render unacceptable the failures of efficiency and effectiveness that are necessary for innovation: trial and error, cost overruns, and abandoning failed projects are all hallmarks of the innovation process (whether conducted in the private or public sector).[12] However, some failures should not be so readily excused. While the law should not concern itself too much with suptech solutions that never go live, for those that do go live, scrutiny is needed to ensure that the technology has been consciously designed to avoid failures of equity, legitimacy, and credibility.

Recent administrative law literature has focused, in particular, on the equity, legitimacy, and credibility of machine learning algorithms used in the administrative state. These algorithms have been described as "black boxes" (in the sense that "even knowing the inputs and the algorithm's results, the algorithm's human creator cannot necessarily fully explain, especially in terms of cause and effect, how the algorithm reached those results")[13] and scholars are grappling with how administrative law can ensure that the use of machine learning conforms to our expectations of democratic accountability.[14] This Article will engage with this and other literature on how to make technology more accountable, but while these types of legal reforms will help shore up the legitimacy and credibility of regulatory agencies engaging in technological innovation,

12. *See* Wouter van Acker, *An Introduction into Public Sector Innovation - Definitions, Typologies, and an Overview of the Literature* 17 (KU Leuven Pub. Governance Inst., Working Paper, 2018).

13. Bernard W. Bell, *Replacing Bureaucrats with Automated Sorcerers?*, 150 DAEDALUS 89, 90 (2021).

14. *See, e.g., id.*; Cary Coglianese, *Administrative Law in the Automated State*, 150 DAEDALUS 104 (2021); Cary Coglianese & David Lehr, *Regulating by Robot: Administrative Decision Making in the Machine-Learning Era*, 105 GEO. L.J. 1147 (2017); Rory Van Loo, *Rise of the Digital Regulator*, 66 DUKE L.J. 1267 (2017); David Freeman Engstrom & Daniel E. Ho, *Algorithmic Accountability in the Administrative State*, 37 YALE J. ON REG. 800 (2020).

more affirmative messaging is also needed on the topic of regulatory innovation. Regulators need to publicize and celebrate their innovation processes, not just individual successes. They also need to stress that failures of inaction are also failures and that in some circumstances, regulators will not be able to discharge their regulatory mandates without developing technological tools of their own. These narratives can help create permission to fail.

The rest of this Article will proceed as follows. Part I will explore the need for regulatory innovation in more detail before engaging with literature on the constraints that could inhibit this kind of public sector innovation. As Part II will make clear, these constraints are not absolute: there are many examples of suptech innovation in progress but there are also areas where innovations are needed but not being pursued, potentially because of regulators' fear of failure. Part II therefore considers some ways in which suptech innovations could indeed go wrong, categorizing potential failures into failures of effectiveness, efficiency, equity, legitimacy, and credibility. Part III begins the conversation about which failures should and should not be excused and then considers the types of legal reforms and extra-legal strategies needed to excuse the excusable failures and hold agencies accountable for non-excusable failures. Notwithstanding its focus on financial regulation and suptech, this Article's discussion of regulatory innovation and permission to fail in Parts I and III should resonate with any regulatory agency that is struggling to oversee a technologically sophisticated industry.

I.
REGULATORY INNOVATION

A. *The Need for Regulatory Innovation*

Regulatory agencies face many challenges—and, to be clear from the outset, not all of these challenges can be addressed by technological tools. In some contexts, choosing to regulate through non-technological means will be more effective[15] (for example, in some situations, the best response may be for the regulator to adopt rules that limit or even ban the

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15. *See* Deirdre K. Mulligan & Kenneth A. Bamberger, *Saving Governance-By-Design*, 106 CALIF. L. REV. 697, 745 (2018).

use of the industry's new technology). However, technology can sometimes be an important part of the regulator's response; indeed, sometimes technology *must* be part of that response.[16] Regulators' resources are inevitably limited, and technological tools are often pursued for their ability to allow regulators to do more with less (there is particular interest in automating the more mundane aspects of regulatory tasks, allowing regulators to spend more time on the more judgment-based aspects of their agency's work).[17] More critically, though, if a regulated industry is developing its own new technologies at a rapid pace, regulators who fail to innovate in response may ultimately find that their lack of technological capacity has caused them to lose control of that industry, unable to ever catch up.[18] As one regulator from the UK's Financial Conduct Authority recently put it, "We realized that if we held still, we would be accelerating backwards."[19]

For example, if an industry wants to use technology to speed something up to the point where human intervention is impossible, the relevant regulatory agency will need technology of its own if it wants to retain the power to intervene. Or if industry participants start using machine learning algorithms that make decisions after being trained on huge datasets, regulators will often want to scrutinize those datasets—but regulators may not be able to do this in any meaningful way unless they develop their own machine learning tools capable of processing that much data.[20] Ultimately, given the increasing

16. *See* Jo Ann Barefoot, The Case for Placing AI at the Heart of Digitally Robust Financial Regulation, Ctr. on Regul. & Mkts. at Brookings (May 24, 2022), https://www.brookings.edu/research/the-case-for-placing-ai-at-the-heart-of-digitally-robust-financial-regulation/ (arguing that some regulatory functions can no longer be discharged without new technology and suggesting some creative ideas about the types of suptech tools that are needed).

17. *See* Carol A. Heimer & Elsinore Kuo, *Subterranean Successes: Durable Regulation and Regulatory Endowments*, 15 Regul. & Governance S63, S64–65 (2021).

18. *See* Jo Ann Barefoot, A Regtech Manifesto: Redesigning Financial Regulation for the Digital Age 9–10 (2020), https://regulationinnovation.org/regtech-manifesto.

19. *Id.*

20. Coglianese & Lehr, *supra* note 14, at 1,153 ("[W]ith the private sector increasingly relying on algorithms to make faster, more precise decisions, the increased speed and complexity of economic activity in the machine-learning era surely demands that government agencies keep pace and make

technological sophistication of the financial industry, trying to regulate without *any* technological tools will be the regulatory equivalent of bringing a knife to a gun fight—regulatory innovation may become a defensive necessity. A regulatory agency's failure to innovate as the industry innovates around it could ultimately become an irremediable failure of inaction, permanently compromising the public goals of the regulatory state. Time is therefore of the essence in developing those technological tools. Time is also of the essence because regulators' technological tools will be more impactful (and have fewer unintended consequences) if they are developed alongside the technologies the industry is developing, rather than trying to influence and integrate with technologies that are already "fully-baked."[21]

Before going any further, it is helpful to clarify how the terms "innovation," "regulation," and "regulatory innovation" will be used in this Article, as all are susceptible to multiple meanings. When trying to define innovation, people often default to discussions of whether a particular innovation is "disruptive", in the sense of being a "process by which a product or service takes root initially in simple applications at the bottom of a market and then relentlessly moves up market, eventually displacing established competitors"[22] (this approach to defining innovation relies heavily on economist Joseph Schumpeter's work on innovation as a force of "creative destruction" that propels economic growth).[23] However, this approach to defining innovation has its limitations—for example, it largely elides the possibility of rent-seeking innovations by incumbents.[24] More relevantly to this Article, this definitional approach is particularly inadequate when we are dealing with innovations by the public sector.

use of the same analytic tools in order to regulate the private sector more effectively.").

21. *See* HILARY J. ALLEN, DRIVERLESS FINANCE: FINTECH'S IMPACT ON FINANCIAL STABILITY 161 (2022).

22. *Key Concepts: Disruptive Innovation,* CLAYTON CHRISTENSEN, http://claytonchristensen.com/key-concepts.

23. JOSEPH SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY (Taylor & Francis 2010) (1942).

24. *See* Dan Awrey, *Complexity, Innovation and the Regulation of Modern Markets*, 2 HARV. BUS. L. REV. 235, 263–65 (2012).

Often, public sector innovations aren't trying to increase profits or displace private sector competitors—the creations or changes involved in public sector innovation may be pursued with the intention of promoting public goals.[25] A more goal-neutral description of innovation as a "dynamic process through which problems and challenges are defined, new and creative ideas are developed, and new solutions are selected and implemented"[26] would do a better job of encompassing public sector innovation. This kind of definition covers breakthroughs like DARPA and the internet, but it is also broad enough to encompass public sector innovations designed to improve how the state regulates private sector activity. But of course, "regulation" can also mean different things in different contexts. In this Article, I use the term "regulation" to describe the rule-making, supervisory, and enforcement functions of public regulatory agencies (although regulation can certainly be defined much more expansively than that, to incorporate rules and norms enforced by other bodies).[27]

Given how many interpretations there are of "regulation" and "innovation", it should not be surprising that the composite term "regulatory innovation" is also susceptible to many different meanings.[28] I use the term in a reasonably narrow and novel way, to refer to the development of new and creative technologies—either by regulatory agencies or by third-party vendors acting at the behest of those agencies—in order to respond to evolving challenges in their rule-making, supervi-

25. *See* van Acker, *supra* note 12, at 5.

26. Eva Sørensen & Jacob Torfing, *Introduction: Collaborative Innovation in the Public Sector*, 17 INNOVATION J.: PUB. SECTOR INNOVATION J. 1, 4 (2012).

27. *See generally* Matthew D. Adler, *Regulatory Theory, in* A COMPANION TO PHILOSOPHY OF LAW AND LEGAL THEORY 590, 591–92 (Dennis Patterson ed., 2d ed. 2010) (providing an overview of what can be construed as "regulation").

28. *See generally* REGULATORY INNOVATION: A COMPARATIVE ANALYSIS (Julia Black, Martin Lodge & Mark Thatcher eds., 2005). The term "regulatory innovation" is sometimes used to describe innovations in regulatory administration. These kinds of innovations (which would include regulatory sandboxes and innovation hubs) utilize existing regulatory tools like informal guidance and rule-making – often to accommodate the industry they regulate. *Id.* Cristie Ford observes that "sometimes we are left with the sense that "regulatory innovations" have been aimed primarily at making regulation more flexible, less burdensome, cheaper, and more efficient, not for everyone's sake but the sake of certain private sector actors and their innovative efforts." CRISTIE FORD, INNOVATION AND THE STATE 2 (2017).

sory, and enforcement functions. This kind of regulatory innovation faces many constraints, though, including: "lack of competition, risk-avoidance, short-termism, rule-obsession," its overall "publicness," and the resource constraints that public sector bodies often face (which make public innovation harder even as they make efficiency-enhancing innovation more necessary).[29] The next Part will elaborate on these constraints.

B. *Constraints on Regulatory Information*

1. *Lack of Competition*

Public sector bodies are often assumed to occupy a monopoly position, and to therefore lack the pressures to innovate that can arise in competitive markets.[30] It is interesting to consider this assumption in the context of US financial regulatory agencies, given that there is in fact a long history of competition between some of these agencies.

Because the United States provides banks with the option of choosing either a state or a federal bank charter, banks can effectively choose their own federal regulator from among the OCC (which oversees nationally chartered banks), the FDIC (which oversees state-chartered banks that don't choose to become members of the Federal Reserve System), and the Federal Reserve (which oversees state-chartered banks that do).[31] And that doesn't even include the option to become a credit union instead of a bank (which results in supervision by the NCUA).[32] There is also a degree of regulatory competition between these banking agencies and other financial regulators, with financial institutions sometimes structuring their product offerings to fit into the regulatory regimes administered by the SEC or CFTC, even though those products are the functional equivalents of banking products.[33] The SEC and the CFTC also have their own history of turf wars.[34]

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29. van Acker, *supra* note 12, at 16.

30. *See id.*

31. *See* RICHARD SCOTT CARNELL ET AL., THE LAW OF FINANCIAL INSTITUTIONS 86–91 (7th ed. 2021).

32. *Id.* at 87.

33. MICHAEL S. BARR ET AL., FINANCIAL REGULATION: LAW AND POLICY 23 (1st ed. 2016).

34. For background on historic turf wars between the agencies, see John D. Benson, *Ending the Turf Wars: Support for a CFTC/SEC Consolidation*, 36

This fractured system of regulatory supervision has many critics, but when defenses are mustered in favor of the U.S. system, they often fall under the banner of "regulatory competition."[35] The essence of this line of defense is that by allowing financial institutions to choose their regulator, all regulators are forced to be more efficient and to refrain from implementing unduly burdensome regulation.[36] Detractors of regulatory competition, however, criticize it as a "race to the bottom," where agencies compete to be the most lax in order to attract private sector "clients."[37] This dynamic may be manifesting in the various regulatory sandboxes and innovation hubs adopted by fintech-specific units of financial regulators in recent years.[38] These regulatory programs seem to focus primarily on facilitating private sector innovation. While this could ultimately further an agency's core regulatory goals, it is a very indirect and incomplete way to do so.[39]

In short, while U.S. financial regulatory agencies do face some competition, such competition may have led them to innovate in ways not directly linked to furthering their mandates. It is therefore worth considering whether competition is really needed to inspire public sector innovation—the rich history of public sector innovation suggests that competition is not the only driver of innovation.[40] As one innovation scholar put it, "it is important to qualify the unrestrained priority some studies give to commercial contexts and to the false belief that only competitive markets can fuel innovation . . . . There is no reason for public servants to feel any sense of inferiority when considering the record of public sector innovation."[41] Com-

VILL. L. REV. 1175 (1991). A new turf war also seems to be erupting over jurisdiction over crypto. Nikhilesh De, *State of Crypto: SEC vs. CFTC*, COINDESK (Aug. 31, 2021, 10:31 AM), https://www.coindesk.com/policy/2021/08/31/state-of-crypto-sec-vs-cftc.

35. CARNELL ET AL., *supra* note 31, at 93.

36. *Id.* at 97.

37. Hilary J. Allen, *Sandbox Boundaries*, 2 VAND. J. ENT. & TECH. L. 299, 309 (2020).

38. *Id.* at 312; *see also* Hilary J. Allen, *Experimental Strategies for Regulating Fintech*, 3 J. L. & INNOVATION 1, 25 (2020).

39. Allen, *Experimental Strategies for Regulating Fintech*, *supra* note 38, at 26.

40. For more on the successes of public sector innovation, see MARIANA MAZZUCATO, THE ENTREPRENEURIAL STATE: DEBUNKING PUBLIC VS. PRIVATE SECTOR MYTHS (2013).

41. Pollitt, supra note 8, at 38.

petitive pressures may often be the driver of innovation when the only goal is increased profit, but different public-minded goals can also inspire innovation. While government agencies can get into a rut,[42] that rut can be disrupted by finding ways to generate excitement about, and a passionate commitment to, regulatory goals.[43]

2. *Publicness and Short-Termism*

Lack of competition may not significantly constrain suptech innovation, but other constraints may have more bite. One challenge that financial regulatory agencies face is that they typically have multiple statutory mandates, chosen from the following menu of public ends: consumer protection, investor protection, market efficiency, financial stability, competition, and the prevention of crime.[44] Agencies therefore have to balance multiple goals, each of which is individually more difficult and multi-faceted than the profit motive that drives most private sector innovation, while at the same time upholding democratic values of equity, legitimacy, and credibility.[45] Coglianese has described this predicament as an instruction to "surf the crest of a treacherous wave, but then leaving it up to the regulator how to stand up on the surfboard and do all the balancing and adjusting needed to stay afloat."[46]

Without a single quantifiable yardstick like profitability, it can be hard to measure the success of public sector innovation.[47] Some suptech innovations seem to be "win-wins"—particularly the use of big data analytics to track fraud and money laundering, which improve efficiency for the financial industry while, at the same time, enabling regulators to crack down on financial crimes and improve market integrity.[48] Often, though, suptech innovations designed to protect consumers, investors, or the stability of the financial system will have the

42. ALTSHULER, supra note 1, at 1.
43. Hilary J. Allen, *Resurrecting the OFR*, 47 J. CORP. L. 1, 45 (2021).
44. JOHN ARMOUR ET AL., PRINCIPLES OF FINANCIAL REGULATION, 62–69 (2016).
45. For a discussion of the private and public sector values that inform the innovation process, see van Acker, *supra* note 12, at 16.
46. Cary Coglianese, *The Challenge of Regulatory Excellence*, *in* ACHIEVING REGULATORY EXCELLENCE 1, 6 (Cary Coglianese ed., 2017).
47. ALTSHULER, *supra* note 1, at 1.
48. ALLEN, *supra* note 21, at 160.

potential to make the delivery of financial services less efficient, or create regulatory barriers to entry for new market participants. Conflicting mandates can make it hard to measure the success of innovation and, yet, public sector bodies are often asked to demonstrate the success of their innovations.

Many public sector bodies must answer to the electorate every few years which makes it difficult to engage in long-term projects that may not deliver results for several years. This regularly scheduled public scrutiny can discourage the type of risk-taking that could only pay off in the long term.[49] Fortunately, financial regulatory agencies (particularly the banking agencies) tend to have a degree of insulation from this short-termist scrutiny. In the United States, structures that promote this independence include, for example, limitations on the President's ability to remove agency leadership, or a funding source that is not dependent on legislative approval.[50] Outside of the United States, different kinds of structures have been adopted to promote agency independence, but they all share the aim to "reduce the influence of the executive" in the hope that the agencies "would be less vulnerable to the influence of interest groups than politicians, who seek these groups' support in order to secure reelection."[51]

This independence can lessen constraints on innovation posed both by short-termism and by disagreements on how to prioritize public goals, but financial regulatory agencies are not completely insulated from public scrutiny (nor should they be in a democratic society).[52] Even the most independent regulatory agencies need to regularly report to and publicly

49. van Acker, *supra* note 12, at 17.

50. Stavros Gadinis, *From Independence to Politics in Financial Regulation*, 101 CALIF. L. REV. 327, 337 (2013).

51. *Id.*

52. Furthermore, the preference for financial regulatory agency independence is not as strong as it once was. As Gadinis has observed, "[t]he financial crisis of 2007–08 prompted policy makers worldwide to establish new regulatory mechanisms designed to monitor financial institutions more thoroughly and to facilitate intervention in case of emergency . . . . Instead of independent banking regulators, postcrisis reformers assigned the new powers to politically controlled officials, typically high-ranking executive officers such as treasury secretaries and finance ministers." *Id.* at 332.

testify before elected government officials.[53] Some, like the SEC and the CFTC, must regularly request funding from elected government officials.[54] The constraints of short-termism and publicness, therefore, apply to financial regulatory agencies too, at least to some degree.

3. *Rule-Obsession and Risk-Aversion*

Regulatory agencies are often described as rule-obsessed and risk-averse (which fits with the caricature of government as a stodgy Kafkaesque bureaucracy),[55] and these traits make some sense in the face of significant public scrutiny. Innovation requires a high tolerance for experimentation, uncertainty, and failure, though. If "rules and procedures become ends in themselves"[56] in an effort to avoid affirmatively taking risks, then innovation will be stymied, and failures of inaction are likely to increase.

Strategies developed in the private sector that embrace the risks inherent in the innovation process (like the use of techsprints and agile workflows) can and have been adapted for use by financial regulatory agencies, creating an avenue for departing from normal procedures.[57] For example, in France, the financial regulator ACPR established an "intrapreneurship" program that "aims to encourage staff members to suggest or lead innovative projects to improve ACPR's tools and processes. . . . Bank of France's 'Le Lab' leads the design of

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53. For a discussion of the accountability mechanisms in place for one independent agency, the Federal Reserve, see *Is the Federal Reserve Accountable to Anyone?*, BD. OF GOVERNORS OF THE FED. RSRV. SYS., https://www.federalreserve.gov/faqs/about_12798.htm Sep. 4. 2019).

54. For an illustration of how the SEC and the CFTC funding process can be politicized, see *Systemic Risk Council, Prompt, Full Funding of the SEC and CFTC Is Essential to Reducing Systemic Risk*, PEW, (Dec. 7, 2012), https://www.pewtrusts.org/en/about/news-room/press-releases-and-statements/2012/12/07/prompt-full-funding-of-the-sec-and-cftc-is-essential-to-reducing-systemic-risk.

55. "Given the prevailing "CYA" attitude of most government workers (who have decades of *not* being rewarded for creativity), innovation will not come easily." Daniel C. Esty, *Regulatory Excellence: Lessons from Theory and Practice, in* ACHIEVING REGULATORY EXCELLENCE, *supra* note 46, at 141.

56. van Acker, *supra* note 12, at 18.

57. *See* DI CASTRI ET AL., *supra* note 9, at 8; *see also* FIN. STABILITY BD., *supra* note 10, at 11 (providing another example of private sector innovations being adapted by financial regulatory agencies).

selected projects, and brings on board a dedicated sponsor, an external coach and IT support."[58] The European Central Bank has also pursued suptech experimentation, with a Suptech Virtual Lab. The United States has few dedicated suptech incubators (programs like LabCFTC at the CFTC are primarily designed to assist the development of private sector fintech innovations, rather than promoting suptech experimentation)[59] but the FDIC has sought to collaborate with the financial industry on developing new reporting technologies.[60]

Adopting these kinds of strategies are not a panacea, but they can start to erode the barriers to innovation that can be found in rule-obsessed and risk-averse agency cultures. These strategies can also make it easier to hire innovative minds: people with an innovative streak may be more attracted to a workplace that prioritizes and facilitates experimentation.[61] This can alleviate some of the resource constraints limiting innovation within regulatory agencies, which this Article discusses next.

4. *Resource Constraints*

Limitations on resources (by which I mean time, money, and personnel) can also limit innovation and significantly impede suptech experimentation.[62] Limitations on resources can also limit innovation more indirectly: when resources are scarce, expending those resources on innovative projects takes on a greater degree of risk and the fear of wasting scarce resources on innovation may result in those resources being allocated for other purposes. A survey conducted by the Financial Stability Board on suptech innovation found that "the risk reported to be of greatest concern was around resourcing."[63]

58. *See* FIN. STABILITY BD., *supra* note 10, at 13.

59. Hilary J. Allen, *Experimental Strategies for Regulating FinTech*, 3 J.L. & INNOVATION 1, 22, 26 (2020).

60. *See* FIN. STABILITY BD., *supra* note 10, at 14.

61. *See* Colleen M. Baker, *Entrepreneurial Regulatory Legal Strategy: The Case of Cannabis*, 57 AM. BUS. L.J. 913, 947 (2020).

62. Resource constraints and the "limited product offering for suptech solutions from a small pool of specialised technology vendors" were identified by researchers from the Bank for International Settlements as problems for suptech innovation. DI CASTRI ET AL., *supra* note 9, at 14.

63. FIN. STABILITY BD., *supra* note 10, at 1.

One of the challenges of suptech innovation is that it requires expertise beyond that which is typically possessed by financial regulatory agencies. Financial regulatory agencies are predominantly staffed with lawyers, economists, and accountants, rather than software engineers or data scientists.[64] Developing suptech solutions in-house will remain challenging unless the agencies make a concerted effort to hire a broader cross-section of personnel. Innovative employees may be discouraged from joining a regulatory body with a stodgy, bureaucratic reputation so the constraints of rule-obsession and risk-aversion may contribute to resource constraints as well (a possible Catch-22 for regulatory innovation). These problems are not intractable: for example, financial regulatory agencies around the world are building more data science capacity to assist with internal suptech development and deployment.[65] Nonetheless, the expertise deficit will not be fixed quickly, and so regulators may need to enlist outside help to develop suptech solutions in the near-term.

Outsourcing the development of suptech is only an option, though, if there is someone to outsource to. Currently, very few commercial technology vendors specialize in suptech solutions, and so many regulators are keeping their suptech development in-house.[66] Even when a suitable third-party vendor is identified, the quality of the technology developed depends on the regulator's budget and its ability to monitor the vendor's programming process, the latter of which still requires some in-house technological expertise. The possibility that technology vendors could facilitate regulatory arbitrage also remains a concern: to maximize profits, vendors may leverage their suptech work by providing related tools to private firms who can pay more, possibly even skewing the suptech tools in a way that favors the vendor's private sector clients.[67]

64. Saule T. Omarova, *Technology vs Technocracy: FinTech as a Regulatory Challenge*, 6 J. FIN. REGUL. 75, 101 (2020). Regarding the limited data science skills of banking supervisors more specifically, see KENTON BEERMAN ET AL., FIN. STABILITY INST., FSI INSIGHTS ON POLICY IMPLEMENTATION NO. 37: SUPTECH TOOLS FOR PRUDENTIAL SUPERVISION AND THEIR USE DURING THE PANDEMIC 2 (2021).

65. *See* BEERMAN ET AL., *supra* note 64, at 12.

66. *See* FIN. STABILITY BD., *supra* note 10, at 15.

67. *See* Luca Enriques, *Financial Supervisors and RegTech: Four Roles and Four Challenges*, 53 REVUE TRIMESTRIELLE DE DROIT FINANCIER (2017) (Fr.).

Arbitrage concerns will be reduced if a regulatory agency outsources to or partners with an academic institution (rather than a for-profit business), but regulatory personnel still need enough expertise to monitor the development of the tool to ensure that it is fit for its intended purpose.

Limited resources are not just constraints on the initial development of suptech tools; they also constrain the ongoing use of those tools. On the one hand, suptech tools will fail if the frontline staff at the regulatory agency do not possess the skills needed to use the tools at all.[68] At the opposite end of the spectrum, overuse (in the sense of too much deference to these tools) can also prove problematic: without the resources needed to properly interrogate the technology behind the suptech tools, there is a greater risk that so-called "automation bias" will lead to bad outcomes. Automation bias refers to the demonstrated tendency of humans to defer unquestioningly to technologically generated outputs, which are often viewed as more correct and legitimate than any output a human could produce.[69] Those without technological expertise of their own may be more likely to defer to suptech—many regulatory bodies are aware of this possibility and have raised concerns about overreliance on suptech tools.[70] The balance between overreliance and underuse can be managed to some degree with "explicit policies that acknowledge the tensions between, and outline the respective roles of, supervisory judgment and suptech tool outputs,"[71] but mistakes are still likely to be made.

Another resource constraint that suptech innovation faces is "the inertia inherent in legacy IT systems."[72] Many regulatory agencies may find it costly to start from scratch with digitally native systems, and thus resort to building new suptech technologies atop of old legacy systems (that will, in turn, interact with regulated entities' legacy systems).[73] Unfortunately,

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68. *See* FIN. STABILITY BD., *supra* note 10, at 12.

69. For a discussion of automation bias, see Linda J. Skitka et al., *Accountability and Automation Bias,* 52 INT'L J. HUM.–COMPUTER STUD. 701 (2000).

70. FIN. STABILITY BD., *supra* note 10, at 2.

71. BEERMAN ET AL., *supra* note 64, at 2.

72. DI CASTRI ET AL., *supra* note 9, at 14.

73. *See* JUAN CARLOS CRISANTO ET AL., FIN. STABILITY INST., FSI INSIGHTS ON POLICY IMPLEMENTATION NO. 29: FROM DATA REPORTING TO DATA-SHARING: HOW FAR CAN SUPTECH AND OTHER INNOVATIONS CHALLENGE THE STATUS QUO OF REGULATORY REPORTING? 18 (2020).

building new tech on top of legacy systems is particularly likely to produce glitches,[74] the fear of which might discourage suptech innovation.

Ultimately, many of the constraints discussed in this Part boil down to fear of failure and while such fear does not prevent regulatory innovation outright, it can hinder and complicate innovation. The next Part will use case studies drawn from the world of financial regulation to highlight areas where agencies are engaging in suptech innovation and suggest areas where more suptech innovation is needed.

II.
THE BEGINNINGS OF SUPTECH INNOVATION

This Part will look at a number of real-world examples of innovation by financial regulators (as well as where there is room to do more).[75] These kinds of innovations are often described by the catch-all phrase "suptech"—"the use of technology for regulatory, supervisory and oversight purposes."[76] Just like the term "fintech" that inspired it, suptech is an umbrella term for many different innovations and technologies, rather than a unified or coherent phenomenon.[77] It encompasses tools that rely on technologies like APIs, cloud computing, and distributed ledgers—but advances in artificial intelligence technologies have been the primary driving force behind suptech experimentation so far.[78]

A recent report submitted to the Administrative Conference of the United States sought to catalogue the use of artificial intelligence technologies by federal administrative agen-

74. SAMUEL ARBESMAN, OVERCOMPLICATED: TECHNOLOGY AT THE LIMITS OF COMPREHENSION 39–40 (2016).

75. Many of the case studies used in this article involve suptech innovations being developed in the United States, but where international financial regulatory bodies have pursued suptech strategies more aggressively, I will sometimes talk about foreign suptech.

76. *BIS Innovation Hub Work on Suptech and Regtech*, BANK FOR INT'L SETTLEMENTS, https://www.bis.org/about/bisih/topics/suptech_regtech.htm (last visited Dec. 28, 2022).

77. For a discussion of the definitional issues associated with "fintech," see ALLEN, *supra* note 21, at 8.

78. FIN. STABILITY BD., supra note 10, at 1 ("Artificial intelligence applications were the most commonly deployed SupTech tool and were expected to remain so into the future.").

cies.[79] Through research conducted in 2019, the report concluded that nearly half of all non-military federal regulatory agencies had planned, trialed, or adopted some kind of artificial intelligence application,[80] and that over half of those applications were being or had been designed in-house.[81] The report identified financial regulation as one of the top three policy areas for agency use of artificial intelligence.[82]

In 2019, suptech innovation really began to take off among financial regulators globally,[83] with a particular focus on machine learning. "Machine learning" describes a type of artificial intelligence where a computer algorithm is trained to devise its own decision-making rules from the correlations it observes in the data sets provided to it; the algorithm can then follow those rules in executing an assigned task.[84] Machine learning technology can be roughly divided into supervised and unsupervised forms, with the latter being asked to find patterns among data that have not been previously classified or labeled, whereas supervised algorithms are trained to answer a predetermined question by looking at data prepared by a data scientist.[85] Once a machine learning algorithm is trained, the humans who use the algorithm must determine how much deference to give it. Humans can remain "in the loop," where "human oversight is active and involved, with the human retaining full control and the artificial intelligence only providing recommendations or input."[86] Alternatively, humans can delegate more control to the machine learning algorithm: where humans are "out of the loop" they cannot override the algorithm's decision-making, and when humans

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79. ENGSTROM ET AL., *supra* note 2.

80. *Id.* at 16.

81. *Id.* at 18.

82. *Id.* at 17.

83. DI CASTRI ET AL., *supra* note 9, at 1.

84. For background on machine learning, see David Lehr & Paul Ohm, *Playing with the Data: What Legal Scholars Should Learn about Machine Learning*, 51 U.C. DAVIS L. REV. 653 (2017).

85. Bell, *supra* note 13, at 90.

86. Infocomm Media Development Authority (IMDA) & Personal Data Protection Commission Singapore (PDPC), MODEL ARTIFICIAL INTELLIGENCE GOVERNANCE FRAMEWORK 30 (2d ed. 2020), https://www.pdpc.gov.sg/-/media/files/pdpc/pdf-files/resource-for-organisation/ai/sgmodelaigov-framework2.pdf.

are "over the loop" they allow the algorithm to operate on its own but retain the ability to override the algorithm.[87]

An important subset of machine learning-type artificial intelligence is natural language processing, or "NLP." Computers are not well equipped to process text written by and for humans, but "NLP endeavors to bridge this divide by enabling a computer to analyze what a user *said* . . . and process what the user *meant*."[88] As with other forms of machine learning, the NLP algorithm seeks to find patterns or correlations in data (in this case, the data takes the form of written text).[89] Armed with these patterns, the NLP algorithm can be used "to comb through an astonishing array of materials to quickly find, summari[z]e, classify and present relevant information for further review,"[90] which has obvious appeal for regulators.

There is also interest in suptech applications enabled by application programming interfaces ("APIs"), cloud computing, and distributed ledger technology.[91] APIs allow different types of software to communicate with one another, facilitating increased interoperability.[92] Cloud computing technologies could allow agencies to store more data more cheaply (on a network of servers) than they could on their own local servers.[93] Cloud computing could also provide protective redundancy to data storage: if one server in the network fails, data will continue to be available so long as the other servers in the cloud can pick up the slack. Distributed ledger technology also allows data to be stored in multiple places, creating some redundancies (a distributed ledger is essentially a database that is hosted by multiple computers or "nodes," and its integrity is maintained by some form of consensus mechanism among the nodes that governs when changes to the ledger can be

87. *Id.*

88. Peng Lai "Perry" Li, *Natural Language Processing*, 1 GEO. L. TECH. REV. 98, 98 (2016); *see also* DIRK BROEDERS & JERMY PRENIO, FIN. STABILITY INST., FSI INSIGHTS ON POLICY IMPLEMENTATION NO. 9: INNOVATIVE TECHNOLOGY IN FINANCIAL SUPERVISION (SUPTECH) — THE EXPERIENCE OF EARLY USERS 25–26 (2018).

89. Li, *supra* note 88, at 99.

90. BEERMAN ET AL., *supra* note 64, at 2.

91. FIN. STABILITY BD., *supra* note 10, at 27.

92. FIN. STABILITY BD., *FinTech and Market Structure in Financial Services: Market Developments and Potential Financial Stability Implications* 6 (Feb. 14, 2019), https://www.fsb.org/wp-content/uploads/P140219.pdf.

93. *Id.*

made).[94] When "records of all financial transactions are stored in a distributed ledger," regulators can be "given access to the relevant records in the distributed ledger and simply extract the information needed."[95]

The remainder of this Part will look at more specific suptech applications of these technologies.

A. *Innovation in Rulemaking*

One area of suptech experimentation relates to the format of the regulations themselves. Currently, computers cannot easily read most regulations. That doesn't mean that it's impossible for computers to help process these regulations, but natural language processing techniques are required.[96] Some regulators, however, are exploring how regulatory text can be converted into machine-readable data[97] to make it easier for computers to read regulations without NLP.[98]

Machine-readable regulations have strong appeal for private sector institutions, which would like to be able to automate regulatory compliance.[99] Complying with regulations read and executed by a computer would be faster, require fewer employees, and increase certainty that compliance requirements have in fact been satisfied.[100] Machine-readable regulations might also appeal to resource-strapped administrative agencies, who could presumably spend less time examining firms to determine regulatory compliance.

There is particular interest in enshrining *reporting requirements* in machine-readable form.[101] Reporting requirements form the backbone of many financial regulatory regimes and help regulators detect activities as varied as money laundering, discrimination in the provision of credit, market manipulation

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94. Primavera Del Filippi & Aaron Wright, BLOCKCHAIN AND THE LAW 2 (2018) (describing how blockchain, a type of distributed ledger, operates).

95. CRISANTO ET AL., *supra* note 73, at 9.

96. Patrick A. McLaughlin & Walter Stover, *Drafting X2RL: A Semantic Regulatory Machine-Readable Format*, MIT COMPUTATIONAL LAW REPORT, 3 (May 14, 2021), https://law.mit.edu/pub/draftingx2rl/release/2.

97. BROEDERS & PRENIO, *supra* note 88, at 9.

98. McLaughlin & Stover, *supra* note 96.

99. BAREFOOT, *supra* note 18, at 61.

100. Marc Gilman, *Where Is Suptech Heading?* TECHCRUNCH (Jul. 13, 2021), https://techcrunch.com/2021/07/13/where-is-suptech-heading/.

101. CRISANTO ET AL., *supra* note 73, at 14, 16.

by traders, and unsafe and unsound management of risks at banks. Different regulators have jurisdiction over different concerns, and so financial institutions currently need to collate their data into the different forms required by the different regulators, and then deliver or "push" the report to the relevant regulator (usually through a web portal).[102] Because it takes time to collate these reports, most reporting does not occur on a real-time basis. One possible benefit of making reporting rules machine-readable is that it might eliminate this time lag, allowing regulators to receive data reports from regulated firms in close-to-real-time.[103]

Although at least one U.S. regulator has argued that " 'digitizing the rulebook' for machine-readability should be the top priority of every regulator,"[104] there has been limited experimentation on this front by U.S. financial regulatory agencies. The U.K.'s Financial Conduct Authority ("FCA") and the Bank of England, however, have been more aggressive in seeking to develop machine-readable (and machine-executable) regulations in the context of regulatory reporting requirements. Their joint Digital Regulatory Reporting or "DRR" initiative kicked off with a November 2016 techsprint,[105] followed by another techsprint in November 2017.[106] The FCA and Bank of England are now several years into the project, which has involved pilots with several large banks.[107] These pilots have explored the feasibility of using distributed ledger technology to exchange data, as well as APIs that "pull" data from regulated firms in accordance with the machine-readable rules.[108]

The FCA and Bank of England hope that "DRR will potentially allow firms to automatically supply data requested by the regulators, thereby reducing the cost of collection, improving data quality and reducing the burden of data supply on the

102. *Id.* at 9.
103. *Id.*
104. BAREFOOT, *supra* note 18, at 62.
105. Otherwise known as a "hackathon", a techsprint brings together a cross-section of personnel from the private sector to collaborate on finding a technological solution. *See id.* at 77–79.
106. Digit. Regul. Reporting, *Digital Regulatory Reporting: Phase 2 Viability Assessment* 8 (Jan. 7, 2020), https://www.fca.org.uk/publication/discussion/digital-regulatory-reporting-pilot-phase-2-viability-assessment.pdf.
107. *Id.* at 3.
108. *Id.* at 17.

industry."[109] A progress report from January 2020 identified the goals of the project more specifically:

> "A DRR approach would require the regulator to publish a digital (machine-executable) version of their regulatory rules. Ideally, the production of these digital rules from the current natural language version of the rules would be automated, making the subsequent component of the approach (standardi[z]ing the description and identification of data) easier."[110]

However, these goals are still far from realized. The FCA and Bank of England believe that the "best way to pursue the DRR vision is in small, incremental steps which prove valuable to all each time."[111] One of the greatest challenges in developing machine-readable and executable regulations relating to reporting requirements is that they will only work if there are common data standards, so that different institutions refer to and store their data in the exact same ways (which is not currently the case).[112] The FCA and the Bank of England are therefore considering how to get "all stakeholders to align on definitions, interpretation and ongoing implementation of rules and data definitions in the same way."[113]

B. *Innovation in Supervision*

Making rules is only the first part of the regulatory process. Then comes the hard work of monitoring compliance with those rules. As Peter Conti-Brown and Sean Vanatta recently described it: "If regulation sets the rules of the road, supervision is the process that ensures obedience to these rules (and sometimes to norms that exist outside these rules entirely) . . . . Supervision is the mostly secret process of man-

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109. Bank of England, *FCA and Bank of England announce proposals for data reforms across the UK financial sector* (Jan. 7, 2020), https://www.bankofengland.co.uk/news/2020/January/fca-and-boe-announce-proposals-for-data-reforms-across-the-uk-financial-sector.

110. Digit. Regul. Reporting, *supra* note 106, at 4.

111. *Id.* at 38.

112. FIN. STABILITY BD., *supra* note 10, at 18, 20.

113. *Digital Regulatory Reporting*, FIN. CONDUCT AUTH. (Oct. 14, 2020), https://www.fca.org.uk/innovation/regtech/digital-regulatory-reporting.

aging the public and private responsibilities over the risks that the financial system generates."[114]

If supervisory activities reveal that the rules are not being followed, then regulatory agencies will need to respond. The response will vary depending on the context. Sometimes, the regulator and regulated entity will collaborate to achieve the desired outcome; other times, the regulator may take more coercive enforcement action.[115]

This Section will roughly disaggregate suptech applications into those performing the supervisory activities of reporting, surveillance, and analysis (all of which could lead to enforcement actions). While this is not a perfect categorization of suptech streams (there is no generally agreed upon categorization, and the streams identified here will inevitably overlap with one another) it is a helpful way of organizing our discussion about the suptech experimentation that is, and should be, occurring.

1. *Suptech Experimentation and Tools: In Progress*

With financial institutions required to report more (and more granular) data in response to post-2008 regulatory requirements, regulators are finding themselves overwhelmed as they seek to review the data they receive.[116] The use of suptech to improve regulatory reporting, surveillance, and analysis is therefore an obvious use case for suptech.[117] As one proponent of suptech put it, the aspiration is that:

> "Regulators will be able to aggregate and analyze all this data for each regulated entity and, importantly, across the industry. They will also be able to combine

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114. Peter Conti-Brown & Sean Vanatta, *Focus on Bank Supervision, Not Just Bank Regulation,* BROOKINGS (Nov. 2, 2021), https://www.brookings.edu/research/we-must-focus-on-bank-supervision/.

115. Regarding banking supervision more specifically, see CARNELL ET AL., supra note 31, at 313–33. Regarding supervision more broadly, see IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE (1992).

116. "Post-crisis regulatory reforms have led to an upsurge in reporting requirements. This increases the need for efficient and effective monitoring to benefit from the resulting boost in data availability." BROEDERS & PRENIO, *supra* note 88, at 3.

117. "The most common 'use cases' reported by authorities for SupTech tools were in the areas of regulatory reporting and data management." FIN. STABILITY BD., *supra* note 10, at 1.

> it with external big data reflecting trends and risks. Using artificial intelligence (AI) and its branches in machine learning (ML) and Natural Language Processing (NLP), they will be able to find system-wide patterns that may signal compliance failings or emerging problems, at a very early stage before widespread harm can occur and before major liability accumulates to the industry. They will also be able to find valuable bits of information that would otherwise have been hidden like needles in haystacks."[118]

a. Reporting

We have already discussed reporting innovations in the United Kingdom, in the context of machine-readable regulations.[119] In the United States, the FDIC is exploring technological innovations in reporting with the ultimate goal of eliminating the periodic "call reports" it currently receives from banks: it has kicked off a "rapid prototyping competition," with technology firms competing to develop "an innovative new approach to financial reporting, particularly for community banks."[120]

Perhaps the most familiar U.S. suptech innovation in the area of reporting, though, actually predates the term "suptech." In 2009, the SEC mandated the use of machine-readable XBRL data in many regulatory filings.[121] Making regulatory filings machine readable allows computers to easily process the standardized items in the disclosure, and "allows for aggregation, comparison, and large-scale statistical analysis that is less costly and more timely for data users than if the information were reported in an unstructured format."[122] Still, the SEC has not fundamentally changed the way it receives re-

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118. BAREFOOT, *supra* note 18, at 30.

119. *See supra* Section II.A.

120. Fed. Deposit Ins. Corp., *FDIC Selects 14 Companies in Tech Sprint to Modernize Bank Financial Reporting* (Oct. 14, 2020), https://www.fdic.gov/news/press-releases/2020/pr20109.html.

121. Michael S. Piwowar, *Remarks at the 2018 RegTech Data Summit - Old Fields, New Corn: Innovation in Technology and Law* (Mar. 7, 2018), https://www.sec.gov/news/speech/piwowar-old-fields-new-corn-innovation-technology-law.

122. *Id.*

ports: they are still uploaded through the SEC's EDGAR web portal.[123]

Regulators increasingly want to access and analyze increased volumes and new types of data not accommodated by email, web portals, or other traditional methods of submitting reports to regulators.[124] In response, some regulators outside the United States are pursuing APIs that can "ferry large volumes of data directly between databases without human intervention, thereby overcoming the size limitations of file transfer via email or web portals as well as cutting down on time-consuming and error-prone manual submission."[125] Some regulators have also expressed interest in using distributed ledgers for reporting purposes: Australia's financial intelligence unit "AUSTRAC" has experimented with using a distributed ledger and associated smart contracts to automate the reporting of certain transactions.[126]

The "holy grail" for regulatory reporting seems to be a "pull" approach where regulators are able to pull data directly from regulated firms as and when needed: this eliminates costs for regulated entities (because they no longer have to compile reports for regulators) and also eliminates the possibility of human reporting errors by the industry.[127] It may also minimize opportunities for private sector entities to arbitrage reporting regulations (by which I mean satisfying the letter of the regulations, but not their spirit, by providing less information than the regulatory agencies need to fully discharge their functions).[128] However, pull approaches must be handled carefully, so that regulators do not go on fishing expeditions for information to which they have no legal right (an issue we will return to later).[129]

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123. SEC, EDGAR, https://www.sec.gov/edgar/searchedgar/companysearch.

124. DI CASTRI ET AL., *supra* note 9, at 4.

125. *Id.* at 4–5.

126. Yogita Khatri, *Australian Regulator Trials Blockchain to Automate Transaction Reporting*, COINDESK (Feb. 25, 2019, 5:00 AM), https://www.coindesk.com/markets/2019/02/25/australian-regulator-trials-blockchain-to-automate-transaction-reporting/.

127. BROEDERS & PRENIO, *supra* note 88, at 6–7; *see also* FIN. STABILITY BD., *supra* note 10, at 33.

128. For further discussion of regulatory arbitrage, see Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227 (2010).

129. *See infra* Section II.C.4.

b. Surveillance

In addition to using technology to improve reporting, there has been significant interest in using technology to surveil financial markets on a continuous, real-time basis (particularly as regulators find that fintech innovations are facilitating new forms of money laundering and fraud).[130] The hope is that this kind of surveillance will allow regulators to detect and respond to activities like fraud, market manipulation, and money laundering in real-time, which is an improvement over the status quo where regulators can usually only respond with enforcement actions after the fact. This kind of surveillance certainly uses reported data, but also uses data obtained from various other sources using "web-scraping, chatbots, text mining and others to fetch data on demand or as a continuous stream."[131]

There is a particular interest in using technology to improve surveillance of financial crime. Several regulators around the world have invested significantly in developing suptech innovations to detect money laundering and the financing of terrorism,[132] with some authorities "exploring the use of non-traditional sources of information (e.g., newspaper articles [and] social media) and integrating them with traditional information to come up with richer analyses."[133] There isn't much publicly available information about financial regulatory bodies in the United States engaging in this kind of suptech innovation, but "FinCEN," the U.S. financial intelligence unit, is encouraging the private sector to innovate in the realm of anti-money laundering compliance[134] (this kind of compliance-related private sector innovation is often referred

130. DI CASTRI ET AL., *supra* note 9, at 11.

131. *Id.* at 12.

132. FIN. STABILITY BD., *supra* note 10, at 5.

133. RODRIGO COELHO ET AL., *Suptech applications for anti-money laundering*, BANK FOR INTERNATIONAL SETTLEMENTS FINANCIAL STABILITY INSTITUTE INSIGHTS ON POLICY IMPLEMENTATION NO. 18, 1 (Aug. 2019).

134. Board of Governors of the Federal Reserve System et al., *Joint Statement on Innovative Efforts to Combat Money Laundering and Terrorist Financing* (Dec. 3, 2018), https://www.fincen.gov/sites/default/files/2018-12/Joint%20Statement%20on%20Innovation%20Statement%20(Final%2011-30-18)_508.pdf.

to as "regtech").[135] Recently, FinCEN partnered with the FDIC on a techsprint related to digital means of identifying people involved in financial transactions.[136]

In addition, the SEC has had some success with using artificial intelligence to detect insider trading activity in the securities markets. The SEC developed "ARTEMIS" (which stands for "Advanced Relational Trading Enforcement Metric Investigation System") and ATLAS (the "Abnormal Trading and Link Analysis System"), with ARTEMIS designed to identify serial cheaters and ATLAS seeking to find first-time cheaters.[137] In ARTEMIS, machine learning helps determine whether a flagged trader's trading behavior is consistent with their own previous trading behavior, or if the behavior is an outlier. With ATLAS, machine learning compares a flagged trader's trading behavior to the behavior of other flagged traders.[138] In both instances, the machine learning algorithm is trained using so-called "bluesheet" data, which are trading records for a specified time period provided by selected broker-dealers in response to requests from the SEC.[139]

Broader market surveillance—in the sense of trying to get a sense of *all* market interactions, not just instances of nefarious behavior—is a bigger challenge.[140] The SEC has experienced significant setbacks in developing its Consolidated Audit Trail ("CAT"): the ambition was for the CAT to maintain a timestamped record of every bid, offer, and completed trade

135. For an explanation of the various meanings of the term "regtech," *see* Enriques, *supra* note 67, at 53.

136. FDITech, *Measuring the Effectiveness of Digital Identity Proofing for Digital Financial Services*, FDIC, https://www.fdic.gov/fditech/techsprints/measuring-effectiveness.html?source=govdelivery&utm_medium=email&utm_source=Govdelivery (last visited Jan. 2, 2023).

137. ENGSTROM ET AL., *supra* note 2, at 23–24.

138. *Id.* at 23–25. For a discussion of SEC enforcement actions aided by these technological tools, see Charles Riely & Danielle Muniz, *What Securities Pros Need To Know About SEC Data Analytics*, LAW360 (Jun. 7, 2019, 2:19 PM), https://jenner.com/system/assets/publications/19013/original/What%20Securities%20Pros%20Need%20To%20Know%20About%20SEC%20Data%20Analytics.pdf?1560358438.

139. ENGSTROM ET AL., *supra* note 2, at 24.

140. FIN. STABILITY BD., *supra* note 10, at 27. This type of market surveillance is harder because it tends to "rely on large data volumes and a combination of diverse regulatory, market intelligence and market data." *Id.*

of equity stocks and options,[141] but more than a decade after the project was first launched, it is still not fully operational.[142]

c. Analysis

The U.S. Consumer Financial Protection Bureau ("CFPB") also carries out market surveillance, through its online complaints portal.[143] The volume of complaints submitted has proved challenging for the CFPB to process, but suptech innovations can be used to analyze data once it has been amassed: the CFPB "deploys [natural language processing] to automatically analyze text to categorize narratives, identify trends, and predict consumer harm."[144] More specifically, "the CFPB is deploying contextual [natural language processing] tools to categorize complaints via topic modeling."[145] The results are then made publicly available for use by outside researchers.[146]

Analysis can also be assisted by machine learning technology designed to seek out anomalies in the data.[147] For example, some financial intelligence units use machine learning to reduce the number of false-positive suspicious transaction reports received[148] (due to the volume of transaction reports received, the potential efficiency gains are enormous).[149] As another example, in order to help detect fraud in regular corporate filings, the SEC uses "a machine learning tool that helps identify which filers might be engaged in suspect earnings management." Specifically, "[t]he" tool is trained on a histori-

141. David A. Wishnick, *Reengineering Financial Market Infrastructure*, 105 MINN. L. REV. 2379, 2434 (2021).

142. *See* Chairman Jay Clayton, *Statement on Status of the Consolidated Audit Trail*, U.S. SEC. AND EXCH. COMM'N (Nov. 14, 2017), https://www.sec.gov/news/public-statement/statement-status-consolidated-audit-trail-chairman-jay-clayton (explaining that the SEC adopted the rule requiring the creation of CAT in 2012); *Timeline*, CATNMSPLAN, https://www.catnmsplan.com/timeline (last visited Feb. 19, 2023) (displaying a timeline that shows CAT is incomplete as of early 2023).

143. *See* CONSUMER FIN. PROT. BUREAU, https://www.consumerfinance.gov/complaint/ (last visited Jan. 2, 2023).

144. ENGSTROM ET AL., *supra* note 2, at 61.

145. *Id.* at 62.

146. Gilman, *supra* note 100.

147. DI CASTRI ET AL., *supra* note 9, at 5.

148. COELHO ET AL., *supra* note 133, at 3–4.

149. *Id.* at 2.

cal dataset of past issuer filings and uses a [type of machine learning algorithm known as a] random forest model to predict possible misconduct using indicators such as earnings restatements and past enforcement actions."[150] A human remains in the loop, though, as staff from the SEC's Division of Enforcement look at the results of this machine learning tool in the context of other indicators as well.[151]

So far, we have discussed suptech innovations by market regulators (like the SEC and the CFPB) and by financial intelligence units (like FinCEN). However, we have not yet looked at prudential regulation, which is designed to keep individual financial institutions like banks (as well as the financial system as a whole) "safe and sound."[152] Like their colleagues in other regulatory agencies, prudential regulators have also begun to look to suptech to enhance their analysis (as well as reporting and surveillance) functions—and this accelerated during the pandemic as traditional forms of prudential supervision (like on-site examinations) became practically impossible due to lockdown restrictions.[153]

For example, the Federal Reserve turned to natural language processing during the COVID-19 pandemic to help it "identify emerging trends" in documents submitted by regulated banks.[154] It developed a tool called "LEX" that "automates risk annotation of documents, allowing for text analysis, document summari[z]ation and analytics" and was "particularly good at finding "unknown unknowns", discovering many sentences that may have been missed by examiners, including via the summari[z]ation tool, which has become increasingly effective at capturing the essence of a document or part of a document."[155]

As with market surveillance, prudential regulators aren't just applying their natural language processing tools to data submitted directly by banks—they are also considering a broader range of unstructured data sources[156] and relying

150. ENGSTROM ET AL., *supra* note 2, at 23.
151. *Id.* at 27.
152. CARNELL ET AL., *supra* note 31, at 242.
153. BEERMAN ET AL., *supra* note 64, at 1.
154. FIN. STABILITY BD., *supra* note 10, at 57.
155. BEERMAN ET AL., *supra* note 64, at 19.
156. Unstructured data sources may include "internal bank-generated reports, board and committee minutes, newspaper articles, social media chat-

upon natural language processing for "text analysis, text summari[z]ation and information classification" to process the data from those sources.[157] So far, natural language processing has been particularly useful in assessing the quality of bank assets (an important indicator of the bank's health) and the quality of the bank's management and governance.[158]

2. *Suptech Experimentation and Tools: Possibilities*

As just discussed, while suptech experimentation for prudential purposes was slow to start, the COVID-19 pandemic inspired an uptick in suptech innovation as it relates to *micro*prudential regulation (meaning regulation designed to manage the solvency and liquidity risks of individual financial institutions).[159] The rules-based nature of microprudential regulation has allowed authorities "to codify some of the simpler checks and validations on structured data returns previously done manually, thus allowing supervisors to focus on higher value tasks."[160] *Macro*prudential regulation, on the other hand, considers how the risk management strategies of individual institutions might interact to cause systemic problems that undermine the stability of the financial system as a whole.[161] This is a "higher value task" that does not lend itself easily to hard and fast rules. It is, therefore, not particularly surprising that suptech innovation relating to systemic risks and financial stability remains limited.[162]

That is not to say that experimentation with macroprudential suptech is nonexistent. For example, the Bank of Italy has considered using machine learning to "analy[z]e real estate ads in a popular online portal to forecast housing prices and inflation,"[163] "authorities such as a Federal

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ter, audited financial statements, other company filings and analyst research reports." *Id.* at 11.

157. *Id.*

158. *Id.* at 2.

159. FIN. STABILITY BD., *supra* note 10, at 27; BEERMAN ET AL., *supra* note 64, at 1.

160. *Id.*

161. Samuel G. Hanson et al., *A Macroprudential Approach to Financial Regulation*, 25 J. ECON. PERSP. 3, 3 (2011) (defining a macroprudential approach as one which "recognizes the importance of general equilibrium effects, and seeks to safeguard the financial system as a whole").

162. FIN. STABILITY BD., *supra* note 10, at 27.

163. DI CASTRI ET AL., *supra* note 9, at 14.

Reserve Bank and the Bank of England are developing NLP solutions to parse large amounts of documents to identify trends. . . . [and] [t]he ECB is exploring the use of market sentiment analysis for enhanced risk monitoring."[164] More generally, there is significant interest in "visualization" technology (like dashboards) that make it easy for regulators to slice and dice data, drill down into it, or zoom out for a broader view.[165] This kind of data visualization could prove to be enormously helpful in detecting "how different developments fit together and where the unseen risks might be hidden,"[166] making long-term trends for financial stability more visible.[167] As we have already discussed, regulators are also interested in using innovative technologies to shift financial regulation from an often lagging exercise that can only respond once harm has occurred, to a real-time activity that allows for intervention to proactively prevent harm.[168] However, real-time reporting and analysis will have limited impact if regulators lack the tools needed to *respond* in real-time to the identified problems.

I have previously argued that creative suptech tools are needed that enable financial regulators to intervene, when necessary, to preserve financial stability, and that these creative tools are becoming increasingly necessary as the financial industry adopts artificial intelligence, cloud, and distributed ledger technologies.[169] For example, if the "decentralized finance" or "DeFi" industry becomes integrated with the more established financial industry, then financial regulators will have to figure out how to respond to financial stability risks associated with the technologies that DeFi relies on. These include decentralized distributed ledgers and the smart contracts and cryptoassets that run on those ledgers, "recreat[ing]

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164. FIN. STABILITY BD., *supra* note 10, at 26.
165. DI CASTRI ET AL., *supra* note 9, at 13.
166. Martin Hellwig, *Financial Stability and Monetary Policy 20 (Max Planck Inst. or Rsch. on Collective Goods*, Working Paper No. 2015/10, 2015), https://www.coll.mpg.de/pdf_dat/2015_10online.pdf.
167. BAREFOOT, *supra* note 18, at 34.
168. "For authorities, the use of SupTech could improve oversight, surveillance and analytical capabilities, and generate real time indicators of risk to support forward looking, judgement based, supervision and policymaking." FIN. STABILITY BD., *supra* note 10, at 1.
169. ALLEN, *supra* note 21, at 160–61.

traditional financial instruments and generat[ing] new ones."[170] Smart contracts are computer programs that are designed to be self-executing and self-enforcing, meaning there are few opportunities to halt their operation even if it would be in the best interests of the parties (or financial stability) to do so.[171] One way to pause smart contract execution might be to develop new types of circuit breakers that take the form of a regulator-maintained "oracle" (in smart contract-speak, "oracle" is used to describe an external data source consulted by the smart contract).[172] Any smart contract used to create a financial product could be required to check in with an oracle before executing; regulators could then use the oracle to block execution when necessary to preserve financial stability.

New operational risks are also a significant concern as the financial industry becomes increasingly technologically complex. Although operational problems have thus far generally been considered something for financial institutions to manage internally, I have argued previously that operational problems at individual financial institutions may interact in ways that cause problems for the stability of the financial system as a whole.[173] To my knowledge, there has not been any focus on real-time reporting of major technological outages and similar operational failures. This is needed. And, again, once a problem is identified, real-time intervention will be needed, perhaps in the form of circuit breakers "that prevent a financial service provider from rerouting or transferring transactions to another provider or system, if regulators determine that that alternative could be compromised by the overload."[174]

C. *Potential Failures*

As we think about suptech innovation, we shouldn't just consider its potential benefits—we should also think about how it can go wrong. In his edited volume *Regulatory Excellence*, Cary Coglianese discusses several outcomes that denote regula-

170. Kevin Werbach, *DeFi Is the Next Frontier for FinTech Regulation*, REGUL. REV. (Apr. 28, 2021), https://www.theregreview.org/2021/04/28/werbach-defi-next-frontier-fintech-regulation.

171. ALLEN, *supra* note 21, at 98.

172. *Id.* at 188.

173. *See* Hilary J. Allen, *Payments Failure*, 62 B.C.L. REV. 453 (2021).

174. ALLEN, *supra* note 21, at 180.

tory success: effectiveness, cost-effectiveness, efficiency, equity, legitimacy, credibility, and trustworthiness.[175] The flip side, of course, is that failure to achieve these kinds of outcomes can be interpreted as regulatory failure. This Section will use these outcomes (or lack thereof) to organize a discussion of possible suptech failures.

1. *Failures of Effectiveness*

A failure of effectiveness is the most obvious type of suptech failure. The technology will not always succeed in achieving the outcomes it was developed for, and there are infinite ways in which this could happen. This Section will use several case studies from the previous Section as illustrative examples.

a. Machine Learning and SEC Enforcement Failures

Machine learning suffers from the so-called "garbage in, garbage out" problem, meaning that if the data used to train the algorithm is flawed, its decision-making will also be flawed[176] (and "[d]ata quality, reliability and completeness" issues may be a particular problem for new types of unstructured data, like social media data).[177] Decision-making based on problematic data could be wrong *entirely*, or it could have a disproportionately negative impact in some instances while working reasonably well the rest of the time. For example, the SEC's ARTEMIS and ATLAS algorithms (which seek to detect insider trading) are not trained using *all* available trading data. Instead, they are trained using "bluesheet data" collected in connection with the SEC's enforcement activities.[178] This data is not representative of the much wider universe of trading data out there and, instead, "reflects SEC staff judgments about the likelihood of market misconduct in each case. . . . As a result, the types of misconduct and entities targeted will reflect the assumptions, heuristics, and biases of enforcement staff."[179] The technology could therefore be very good at detecting the types of insider trading that the SEC expects but

175. Coglianese, *supra* note 46, at 11.
176. ALLEN, *supra* note 21, at 55.
177. BEERMAN ET AL., *supra* note 64, at 12.
178. See *supra* note 139 and accompanying text.
179. ENGSTROM ET AL., *supra* note 2, at 25.

may miss more creative forms of insider trading that SEC enforcement staff do not anticipate.

This problem could theoretically be addressed by training the machine learning algorithm with more comprehensive market data, but the SEC's attempts to develop a CAT to provide it with a record of *all* trading activity have faced many obstacles (an issue we will return to shortly).[180] Furthermore, a supervised machine learning algorithm would not be able to learn directly from such a large volume of market data; an unsupervised learning algorithm would first need to be applied to compress the available data into a useable form by identifying relevant variables for the supervised algorithm to learn from.[181] This creates more opportunities for technological failure, however, as decisions about which data to focus on and which to discard are delegated to an algorithm.[182]

In addition to its ARTEMIS and ATLAS tools, the SEC also uses a machine learning tool to review corporate filings that is "trained on a historical dataset of past issuer filings . . . to predict possible misconduct using indicators such as earnings restatements and past enforcement actions."[183] Another concern about relying on historical datasets to train regulatory tools is that, inevitably, industry participants will start to learn the types of misconduct that trigger the algorithm and change their behavior accordingly. Once this happens, a historical dataset will no longer be predictive of future misconduct. Some financial regulatory agencies have already expressed concerns that "their use of suptech might lead to market participants adjusting their behavior in order to 'game' the technology."[184] As regulated financial institutions might figure out "which signals create warnings or alerts in a SupTech monitoring system," they may try to avoid them.[185]

b. Circuit Breakers

In some circumstances, regulators may need to automate their emergency tools (like circuit breakers)—human re-

180. *See infra* Section II.C.2.
181. ALLEN, *supra* note 21, at 57–58.
182. *Id.*
183. ENGSTROM ET AL., *supra* note 2, at 10.
184. BROEDERS & PRENIO, *supra* note 88, at 2.
185. FIN. STABILITY BD., *supra* note 10, at 10.

sponse times may be too slow to shut down fully automated transactions before harm is transmitted to the broader financial system.[186] The efficacy of any automated adjudications of when to deploy circuit breakers will depend, however, on the quality of data available.[187] Unfortunately, if the circuit breaker has been created for the purpose of protecting financial stability, there are severe limitations on the data available to train the regulators' machine learning algorithms on when to activate the circuit breaker. As Rama Cont, the chair of mathematical finance at Imperial College London, said:

> "[w]e are not in a big data situation really . . . . The only situation where we are really strong with data is consumer loans, credit cards and so on. We only have one market history, so is the pattern which led to Lehman the same which leads to the fall of bank X the next time?"[188]

And it is not just limitations in the raw data that could limit the efficacy of automated adjudications in determining when to intervene: training a machine learning algorithm is a much more involved and judgment-dependent process than many people appreciate.

With a supervised machine learning algorithm, human data scientists are responsible for selecting the data (including weeding out outliers), dividing it into training and testing data, labeling the features in the data that the algorithm should study, and tuning the operations of the algorithm during the training process (the ability to tune is dependent on the type of machine learning algorithm selected, which is another choice that will influence how the algorithm will ultimately operate).[189] As they go through these steps, data scientists strive to avoid "overfitting" (a situation where the machine learning algorithm constructs a decision-making matrix that explains every single idiosyncrasy of the training data, but can-

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186. *See supra* notes 168–72 and accompanying text.

187. For more on "adjudicating by algorithm", see Coglianese & Lehr, *supra* note 14, at 1,170 (providing the example of a "pipeline safety machine-learning system that automatically issues shut-off orders when the system forecasts a heightened risk").

188. Nazneen Sherif, *Academics Warn Against Overuse of Machine Learning*, RISK.NET (Mar. 15, 2017), https://www.risk.net/risk-management/4120236/academics-warn-against-overuse-of-machine-learning.

189. Lehr & Ohm, *supra* note 84.

not respond to new data that does not display those exact idiosyncrasies).[190] However, avoiding overfitting involves deemphasizing low-probability events, which are the very events that any financial stability-oriented circuit breakers strive to protect against.[191]

There is therefore a risk that circuit breakers will fail to kick in when they are needed; negative consequences can also flow when circuit breakers *do* kick in:

> Inability to trade on the suspended market may create a frenzy of trading elsewhere, and this other trading will likely affect prices of equities and linked financial products once trading resumes. . . . [I]nvestors may be trapped in positions they wish to offload . . . . [and] traders with the quickest access to information will be the first to know when the halt in trading is ended, effectively allowing them to set a price that may be detrimental to other, longer-term investors when trading resumes.[192]

Deploying an unwarranted circuit breaker could therefore be considered a failure, just as it would be a failure if a circuit breaker was not deployed when needed.

c. Machine-Readable Rulemaking and Reporting Failures

A significant amount of suptech experimentation has focused on automating regulatory reporting, and many believe that machine-readable rules (and perhaps even machine-readable legislation) are critical to that process.[193] Projects to develop machine-readable law have the facially laudable goal of making the law more predictable and easier to understand and comply with: Australia's CSIRO (a government agency responsible for scientific research), for example, has recommended that national legislation be published in machine-readable code, "a move CSIRO suggests will boost the adoption of new regulatory technology across the economy, improv-

190. *Id.* at 684.

191. "[W]hen it comes to financial stability, unlikely events with catastrophic ramifications are exactly what we are worried about." ALLEN, *supra* note 21, at 27.

192. Hilary J. Allen, *The SEC as Financial Stability Regulator*, 43 J. CORP. L. 715, 748 (2018).

193. *See supra* Section I.A.

ing compliance while reducing costs."[194] However, critics of this recommendation have observed that written laws are always incomplete and that the circumstances in which they operate are always evolving. As such, there will always be a need for discretion and flexibility.[195]

An anticipated need to embody law in code may discourage legislators and regulators from including necessary nuances in the laws they adopt.[196] Instead, machine readable regulations will be easier to implement when rules are detailed and prescriptive, and this may encourage regulators to adopt these kinds of rules even when a different strategy might be better suited to managing the problem at hand.[197] Principles-based regulation, for example, may be needed to deal with the rapid technological changes occurring in the financial industry because, unlike static rules, a principles-based approach gives "regulators an umbrella framework under which they could flexibly deploy new types of regulatory strategies as new technologies arose."[198] In this context, adopting detailed machine readable rules to the exclusion of principles-based regulation may result in less effective regulation.

d. Prudential Supervision Failures

As we just explored, there is often a need for significant nuance in regulatory drafting. Agencies developing machine-readable regulation must *try* to ensure that the machine-readable version "still captures all the potential ambiguity of the

194. James Eyers, *CSIRO Says Laws Should be Published in Code*, AUSTRALIAN FIN. REV. (Jan. 16, 2020, 11:30 AM), https://www.afr.com/companies/financial-services/laws-should-be-published-in-code-so-computers-can-read-them-csiro-20200115-p53rlu.

195. Joe McIntyre, *CSIRO Wants Our Laws Turned into Computer Code. Here's Why That's a Bad Idea*, THE CONVERSATION (Jan. 19, 2020, 10:03 PM), https://theconversation.com/csiro-wants-our-laws-turned-into-computer-code-heres-why-thats-a-bad-idea-130131.

196. Mulligan & Bamberger, *supra* note 15, at 719.

197. Attempts to "technologize" principles-based regulation (by delegating decisions about what will satisfy the relevant principles to machine learning models) would face all of the same limitations of machine learning already discussed in this Article and would presumably require a significant "human-in-the-loop" presence to be effective.

198. ALLEN, *supra* note 21, at 173. For background on the merits of rules versus principles more generally, see Julia Black et al., *Making a Success of Principles-Based Regulation*, 1 L. & FIN. MKT. REV. 191 (2007).

original"[199]—but it is likely impossible to capture every ambiguity.[200] As such, machine-readable regulation will inevitably be incomplete. Any automated reporting system based on machine-readable regulation is, therefore, likely to result in reporting that is both over- and underinclusive—and the data that the agency receives will ultimately shape how the agency operates.[201] If the data is collected for prudential regulatory purposes, for example, regulators may be distracted or overwhelmed by superfluous data that provides little information about where risks are developing, while at the same time missing information that could be crucial to a big picture analysis of developing risks in the financial system. Overreliance on suptech could therefore train regulators' focus on "the risk that can be measured, rather than the risk that matters."[202]

There is also the question of how regulators should process the voluminous amounts of data they receive. If prudential regulators rely too heavily on natural language processing technology to review reports, their review may be incomplete. Text written for human consumption has so many dimensions that natural language processing often entails taking steps to reduce the complexity of the data:[203] these steps are ultimately judgment calls that reflect a data scientist's views on the importance (or unimportance) of certain elements of the text. For example, the steps taken may include "filtering out very common or uncommon words; dropping numbers, punctuation, or proper names; and restricting attention to a set of features such as words or phrases that are likely to be especially diag-

199. Harry Eddis et al., *What is digital regulatory reporting and why should you care?*, LINKLATERS (Jun. 19, 2018), https://www.linklaters.com/en-us/insights/blogs/fintechlinks/2018/june/what-is-digital-regulatory-reporting-and-why-should-you-care.

200. Usha Rodrigues similarly argues that smart contracting on a blockchain departs in a fundamental way from contract law because it provides no place for the law to step in to supply default rules. Usha Rodrigues, *Law and the Blockchain*, 104 IOWA L. REV. 679, 682 (2019).

201. ENGSTROM ET AL., *supra* note 2, at 63.

202. FIN. STABILITY BD., *supra* note 10, at 3.

203. "A sample of thirty-word Twitter messages that use only the one thousand most common words in the English language, for example, has roughly as many dimensions as there are atoms in the universe." Matthew Gentzkow, Bryan Kelly & Matt Taddy, *Text as Data*, 57 J. ECON. LITERATURE 535, 535 (2019).

nostic."[204] However, if the data scientist excludes elements from the analysis that actually carry important meaning, then the natural language processing analysis will be faulty as a result of these flawed assumptions. While these can be checked to some degree by human oversight,[205] that human oversight limits the efficiency gained from adopting the natural language processing techniques in the first place. Given the volume of material that regulators must review, it seems inevitable that some data points will be missed.

2. *Failures of Efficiency*

The previous Section discussed some ways in which suptech innovations may fail to fully deliver on their intended outcomes. Even imperfect innovations, though, may still be superior to the status quo: sometimes regulatory success is relative. This type of relative regulatory success is sometimes described as "cost-effectiveness" ("achieving a specific level of a desired outcome . . . at a low cost") or "efficiency" ("balancing problem reduction with other concerns, such as costs, so as to achieve an optimal level of reduction in the problem").[206] Regulatory failures can be relative too: a suptech technology may ultimately succeed in some respects, but the development costs may be hard to justify in light of the improvements offered. Or a suptech innovation may be said to have failed if it reallocates some of the costs of regulation that are currently being borne by the financial industry and shifts them to the regulator.[207]

One illustration of a potential efficiency failure is the SEC's CAT which, while it may not ultimately turn out to be a failure, was mired in difficulties for a decade. The impetus for CAT's creation was the Flash Crash of 2010 (an episode of extreme price movements in the stock market triggered by the interactions of algorithms selecting and executing trades).[208] As former SEC Commissioner Kara Stein articulated it:

204. *Id.* at 536.
205. *Id.* at 555–56.
206. Coglianese, *supra* note 46, at 11.
207. The UK's Financial Conduct Authority and Bank of England have noted that as part of their DRR project, "the regulator would be responsible for the function of "Writing Digital Regulation" that is currently carried out by firms or vendors." Digit. Regul. Reporting, *supra* note 106, at 25.
208. For more on the Flash Crash, see Allen, *supra* note 192, at 737–38.

> "The Flash Crash and other events in our markets demonstrate the need for CAT. Only through a consolidated audit trail can we truly know what is happening in our marketplace, with trading activity cascading across multiple trading venues and asset classes. The linkages, complexity, and fragmentation of our markets outstrip the current ability to monitor, analyze, and interpret market events. Only through CAT can we develop regulations that are truly driven by facts. Only through CAT can regulators appropriately survey our high-speed and high-volume marketplace."[209]

The CAT's potential utility as a suptech tool is clear but achieving that potential has proved difficult. In 2012, the SEC adopted Rule 613, which required self-regulatory organizations (like the Financial Industry Regulatory Authority or "FINRA") to submit a plan for SEC approval pertaining to the creation, implementation, and maintenance of a CAT.[210] However, the self-regulatory organizations struggled to find a technology vendor to develop the CAT: in 2017, the SEC ultimately blessed the bid from the vendor Thesys.[211] Thesys vastly underestimated the costs and time needed to complete the project, though, and problems with the CAT's development quickly began to snowball.[212] The project experienced repeated delays, partly as a result of the project's having "too many cooks" (with it being unclear who among Thesys, its subcontractor Sapient, the SEC, or the self-regulatory organizations, was ultimately responsibility for the project).[213] To address these coordination problems, the SEC hired Manisha Kimmel in 2019 to be a

209. Kara M. Stein, Comm'r, U.S. Sec. and Exch. Comm'n, The Dominance of Data and the Need for New Tools: Remarks at the SIFMA Operations Conference (Apr. 14, 2015).
210. 17 C.F.R. § 242.613 (2012).
211. James Rundle & Anthony Malakian, *CAT's Tale: How Thesys, the SROs and the SEC Mishandled the Consolidated Audit Trail,* WATERSTECHNOLOGY (Feb. 14, 2019), https://perma.cc/SB44-AWSL.
212. *Id.*
213. *Id.*

"CAT tsar."[214] Two days after she was hired, Thesys was fired as a vendor and ultimately replaced with FINRA.[215]

The CAT's rollout was further delayed as a result of COVID-19,[216] with full customer and account reporting not coming online until July 2022.[217] The CAT may turn out to be enormously useful, but at least in the present moment, it does not appear to be a particularly cost-effective regulatory strategy. Wishnick has described the CAT as "a potentially valuable system to help the SEC carry out its statutory duties to police market integrity, but a policy albatross and a procedural quagmire."[218] In addition, Rundle & Malakian have argued that the SEC failed by not penalizing the self-regulatory organizations or contractors for delays in connection with the development of the CAT[219]—this illustrates the more general potential for regulatory bodies to waste resources by making mistakes in their choice and management of vendors.[220]

3. *Failures of Equity*

Regulatory technologies fail as a matter of equity if they do not result in "a fair distribution of the costs and benefits of regulation."[221] Equity is a particularly important concern for administrative agencies like the Social Security Administration as they consider automating the adjudication of benefit eligibility,[222] but there is no exact analogue to benefit administration in the suptech space. Still, suptech may entail technology making decisions or otherwise operating in a way that has dis-

214. *Id.*

215. John Crabb, *Primer: The Consolidated Audit Trail*, IFLR (July 1, 2020), https://www.iflr.com/article/b1lmx9hd02cr4b/primer-the-consolidated-audit-trail; Rundle & Malakian, *supra* note 211.

216. *Id.*

217. *Consolidated Audit Trail (CAT)*, SIFMA, https://www.sifma.org/explore-issues/consolidated-audit-trail/.

218. Wishnick, *supra* note 141, at 2435.

219. Rundle & Malakian, *supra* note 211.

220. "[T]asks that support agency management of resources, including employee management, procurement and maintenance of technology systems" are also important functions of the regulatory state. ENGSTROM ET AL., *supra* note 2, at 10.

221. Coglianese, *supra* note 46, at 11.

222. For discussion of how these kinds of agencies are using artificial intelligence in their adjudication tasks, *see* ENGSTROM ET AL., *supra* note 2, at 37–53.

tributional consequences. If those distributions are not fair, then the suptech could be said to have failed.

The failures of effectiveness already discussed could amount to failures of equity, if problems with efficacy impact different segments of society in different ways.[223] For example, this Article has discussed the use of automated circuit breakers as a suptech tool.[224] If decisions about whether to use a circuit breaker were delegated to a machine learning algorithm, a "black box" would be making mass adjudications about when people can and cannot transact, and this could have inequitable impacts. For example, if a circuit breaker halted people's ability to make payments in order to prevent the broader payments system from overload, that would have distributional impacts similar to those involved when deciding whether and how broadly to shut down access to power to avoid stress damaging the power grid[225] (there was significant outcry when PG&E selectively shut off power for some of its customers—but not others—during the 2019 California wildfires).[226]

Failures of equity could also occur in the enforcement context, although technology's contribution to those failures will be mitigated if there is a human in the loop. The output of artificial intelligence tools like ARTEMIS and ATLAS, for example, is reviewed by humans who then decide whether to pursue an enforcement action: most regulatory agencies anticipate keeping a human in the loop at least to some degree, in order to prevent enforcement actions that are based on specious correlations rather than actual problematic behavior.[227]

For now, the greater risk is that these tools will miss violations that *should* be investigated, which those who *are* subject to enforcement actions may consider inequitable. We generally accept that not all regulatory violations will be detected and punished—universal enforcement is currently implausible from a resource perspective (one survey of suptech innovations observed that "[s]ecurities markets supervisors . . . re-

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223. Technology can be considered to have failed if it "overreaches by using overbroad technological fixes that lack the flexibility to balance equities and adapt to changing circumstances." Mulligan & Bamberger, *supra* note 15, at 704.

224. *See supra* notes 186–92 and accompanying text.

225. Allen, *supra* note 21, at 180–81.

226. *Id.*

227. FIN. STABILITY BD., *supra* note 10, at 10.

ceive thousands of regulatory filings from supervised entities. It is impossible for supervisors to review each one closely").[228] Most administrative law precedent supports and upholds this deference to agencies' decisions not to enforce rules in some instances.[229] But if suptech is able to mitigate some of the resource constraints faced by agencies, could norms (and the law) shift so that enforcement action in the case of *all* violations is expected? In these circumstances, if the technology misses people who should be investigated, that could be considered a failure of equity. Those who are pursued in enforcement actions might even challenge the actions against them as illegitimate in light of the false-negatives that are not pursued.

Equity failures may also emerge in the compliance burdens that suptech innovation places on regulated entities. Adjusting legacy technological systems or adopting new ones in order to interact with a regulatory agency's suptech tools may pose a much larger burden for smaller financial institutions than larger ones.[230] This might ultimately limit competition, if small firms find prohibitive the costs of making their technology interoperable with suptech solutions, and it may also have knock-on distributive consequences for the customers of financial institutions. For example, when the National Bank of Rwanda shifted to a "pull" approach to regulatory reporting, financial institutions began digitizing their other processes (such as loan applications) in response.[231] Other suptech measures might also encourage increased digitization by financial institutions, which might leave behind customers without internet access or technological sophistication.

4. *Failures of Legitimacy*

Ultimately, when technology results in inequitable outcomes (directly or indirectly), that will reflect poorly upon the agency using that technology and may even jeopardize the agency's legitimacy in the eyes of both the regulated industry and the general public. At a more fundamental level, people may resist the idea that consequential decisions should *ever* be automated: people want to be treated with empathy and un-

228. BROEDERS & PRENIO, *supra* note 88, at 17.
229. Engstrom & Ho, *supra* note 14, at 829–30.
230. CRISANTO ET AL., *supra* note 73, at 2.
231. *Id.* at 11.

derstanding when the stakes are high[232] but it is hard to portray decisions that emerge from a "black box" algorithm as empathic. In a fascinating article on empathy in the digital administrative state, Ranchordas argues that the "unique human feature of forgiving . . . mistakes is disappearing with the digitization of government services and the automation of government decision-making."[233] A possible failure of suptech is that it could automatically punish financial industry participants who deserve a little grace (their own "permission to fail," as it were).

Using suptech that is inappropriately draconian could ultimately undermine the legitimacy of a financial regulatory agency not just because the technology itself lacks empathy, but also because the use of technology may reduce human regulators' empathy as well. Effective supervision requires a certain culture among the regulatory personnel who discharge supervisory tasks: ideally, financial regulatory agencies will "possess and sustain an internal culture that fosters and reinforces humility, openness, empathy, and a steadfast commitment to public service."[234] Unfortunately, as I have explored in previous research on the use of technology in the private sector, overreliance on technological tools can have psychological impacts that undermine such a culture.[235] Culture is created and maintained, in part, by offering approval for compliance with cultural norms and shaming failure to comply with them.[236] But as work is increasingly delegated to technology, it will be easier for those who work alongside that technology to convince themselves that *the technology* is responsible, allowing them to avoid any shame that they might otherwise experience for failing to comply with prevailing cultural norms.[237] In short, the human values that currently animate supervision may be abandoned as the increased use of technology allows regulators to see their work as a much more technical exercise.

232. Cary Coglianese, *Measuring Regulatory Excellence*, *in* ACHIEVING REGULATORY EXCELLENCE, *supra* note 46, at 298.

233. Sofia Ranchordas, *Empathy in the Digital Administrative State*, 71 DUKE L.J. 1341, 1341 (2022).

234. Coglianese, *supra* note 46, at 13.

235. Allen, *supra* note 21, at 187–91.

236. Richard H. McAdams, *The Origin, Development and Regulation of Norms*, 96 MICH. L. REV. 338, 355 (1997).

237. *Id.*

Because of regulatory agencies' position as public instrumentalities, the financial industry and the general public expect high standards of conduct from those agencies, including with respect to how they treat the information entrusted to them. Maintaining information privacy is therefore important to the legitimacy of financial regulatory agencies, but suptech innovation may require financial regulatory agencies to be even more vigilant regarding privacy. In a "pull" reporting system, for example, regulators would be able to reach into the data centers of regulated entities and obtain the information they need in real-time.[238] But they may be tempted to overstep and access more information than they reasonably need to discharge their regulatory tasks. Repeated "fishing expeditions" could undermine the legitimacy of a regulatory agency—at the very least, agencies must ensure that they have legal authority to access the information they collect.[239]

5. *Failures of Credibility*

Increased reliance on suptech will create new operational risks for financial regulatory agencies, and managing such risks effectively will be critical to maintaining public trust. The obvious concern is cybersecurity: the kind of non-public financial information provided to regulators is particularly attractive to hackers and to the extent regulators maintain large repositories of that kind of information, they will inevitably be targeted.[240] The SEC's EDGAR system, for example, was successfully hacked in 2016 by actors seeking information that would give them illegal trading advantages.[241] That breach generated significant negative press for the SEC and was cited as a factor contributing to delays in developing the CAT (because of increased cybersecurity concerns about the data the CAT would collect).[242] Failing to adopt strong protections for confidential reported data would undermine regulatory credibility and could even leave regulatory agencies vulnerable to civil lawsuits (some courts have found agencies liable for not

238. CRISANTO ET AL., *supra* note 73, at 9.
239. BROEDERS & PRENIO, *supra* note 88, at 18.
240. BAREFOOT, *supra* note 18, at 61.
241. SEC, *SEC Brings Charges in EDGAR Hacking Case* (Jan. 15, 2019), https://www.sec.gov/news/press-release/2019-1.
242. Rundle & Malakian, *supra* note 211.

taking adequate data security measures when private sector data was ultimately hacked).[243]

Suptech innovations that allow regulators to "pull" information from the private sector (rather than storing a goldmine of valuable information) could help alleviate this kind of operational risk. However, it's not just data that is vulnerable. Cyberattacks can also target the infrastructure on which financial regulatory agencies rely, which could paralyze an agency's ability to discharge its supervisory responsibilities. In 2021, for example, hackers targeted the computerized equipment that managed the Colonial Pipeline[244]—financial regulatory agencies also need to put in place measures to protect against these kinds of infrastructural attacks.[245] Failure to put these kinds of measures in place would certainly be a regulatory failure.

Operational problems may not always result from nefarious actions, though. Regulatory agencies also need to be increasingly attuned to the potential for technological glitches that can undermine their operations and credibility.[246] While the word "glitch" might suggest something minor, the impact is potentially significant. Research on complex systems shows that such systems are vulnerable to "normal accidents," where a seemingly minor problem kicks off a series of unanticipated, cascading failures that cause significant damage.[247] A system becomes more vulnerable to such cascade failures as it be-

243. ENGSTROM ET AL., *supra* note 2, at 72. "The conventional view is that FISMA creates liability only for the intentional agency disclosures of data, but some courts have found that even negligent failures to prevent hacks are actionable." *Id.* at 116 (citing AFGE v. Hawley, 543 F. Supp. 2d 44 (D.D.C. 2008)).

244. David E. Sanger & Nicole Perlroth, *Pipeline Attack Yields Urgent Lessons About U.S. Cybersecurity*, N.Y. TIMES (May 14, 2021), https://www.nytimes.com/2021/05/14/us/politics/pipeline-hack.html.

245. CRISANTO ET AL., *supra* note 73, at 19 (Regulators will need to "ensure that they have proper safeguards in place, such as access controls, user authentication, data encryption and strong firewalls to defend against internal and external threats.").

246. DI CASTRI ET AL., *supra* note 9, at 4 ("Crucially, the architecture must have built-in quality assurance and security features to ensure the validity and integrity of the data from the point of collection to the point of consumption by end users.").

247. *See, e.g.*, Ian Dobson et al., *Complex Systems Analysis of Series of Blackouts: Cascading Failure, Critical Points, and Self-Organization,* 17 CHAOS 026103 1 (2007); *see also* Charles Perrow, NORMAL ACCIDENTS: LIVING WITH HIGH-RISK

comes more complex[248] and as more shortcuts between the components of the system are developed.[249] This is something that regulatory agencies must be aware of as they contemplate adopting suptech solutions.

For example, aspirations for interoperable reporting systems built on APIs that can ferry information back and forth between the systems of regulators and regulated entities could serve as shortcuts that inadvertently transmit technological problems from one system to the other.[250] Regulators would therefore become vulnerable if regulated entities underinvested in the robustness of their own technology (as well as vice versa), and glitches could ricochet back and forth between regulator and industry. Regulatory agencies' successes, failures, and overall reputations have always depended to some degree on how regulated entities behave.[251] With technological integration, their fates will become even more intertwined.

In addition to investing in their own operational integrity, regulatory agencies need to thoroughly oversee any third-party vendors providing suptech solutions. Unfortunately, management of these kinds of operational risks may be impeded if third-party vendors assert intellectual property protections or fail to explain how the technology actually works (the Department of Homeland Security faced this issue, reporting that "it could not explain the failure rates of iris scanning technology due to the proprietary technology being used").[252] As we've already discussed, the use of vendors may also exacerbate opportunities for regulatory arbitrage.[253]

TECHNOLOGIES (1999) (Perrow's seminal work on complexity theory and normal accidents).

248. Samuel Arbesman, OVERCOMPLICATED: TECHNOLOGY AT THE LIMITS OF COMPREHENSION 12 (2016) ("[W]hen it comes down to the real reason for the failure, it's more accurate to say it was the system's massive complexity, rather than any single component or choice.").

249. J.B. Ruhl, *Governing Cascade Failures in Complex Social-Ecological-Technological Systems: Framing Context, Strategies and Challenges*, 22 VAND. J. ENT. & TECH. L. 407, 417–19 (2020).

250. *See supra* note 125 and accompanying text. For a more general discussion of risks arising from increased interconnectedness through technology, see FIN. STABILITY BD., *supra* note 10, at 9.

251. Coglianese, *supra* note 232, at 298–99.

252. ENGSTROM ET AL., *supra* note 2, at 89.

253. *See supra* note 67 and accompanying text.

The use of vendors for suptech solutions also risks making some of the vendors themselves "too big to fail." This concern is particularly salient in the case of vendors offering cloud computing services.[254] While most regulatory bodies (with a few exceptions) continue to store core data on their own servers rather than in the cloud,[255] early indications suggested that CAT data would be stored using Amazon Web Services ("AWS")[256] and other regulatory bodies may also be contemplating the use of external cloud providers. While external cloud providers like AWS are likely to have more robust data storage protections than data centers maintained by individual regulatory agencies, we still hear headlines like "Prolonged AWS outage takes down a big chunk of the internet" several times a year.[257] Operational failures at AWS will ultimately become a problem for any affected agency, and so it may be a form of regulatory failure if an agency that relies on a cloud provider to house core data doesn't arrange for some kind of back-up.

Regulatory credibility can thus be threatened when the technology does not perform the way it should (members of the public, who are also susceptible to automation biases, may assume that new technological tools will be foolproof in addressing problems and may be doubly disappointed when that assumption turns out to be false).[258] The public may distrust suptech even when it performs as advertised, though. Machine learning algorithms have been described as "black boxes,"[259] because the ways in which they arrive at their outputs are often inscrutable—and lack of transparency in suptech data analysis

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254. FIN. STABILITY BD., *Third Party Dependencies in Cloud Services: Considerations on Financial Stability Implications,* 7 (Dec. 9, 2019), https://www.fsb.org/wp-content/uploads/P091219-2.pdf.

255. FIN. STABILITY BD., *supra* note 10, at 22.

256. Rundle & Malakian, *supra* note 211.

257. Jay Peters, *Prolonged AWS Outage Takes Down a Big Chunk of the Internet,* THE VERGE (Nov. 25, 2020, 5:39 PM), https://www.theverge.com/2020/11/25/21719396/amazon-web-services-aws-outage-down-internet.

258. In the context of suptech reporting innovations, the BIS has noted concerns that "having access to very granular data might lead to an unrealistic public expectation that authorities would be able to prevent failure by any financial institution." CRISANTO ET AL., *supra* note 73, at 19.

259. *See, e.g.*, Frank Pasquale, The Black Box Society: The Secret Algorithms That Control Money and Information (2016).

has been identified as a real concern.[260] As several administrative scholars have explored, the inability to explain administrative decisions based on the output of black box models could be seen as a failure of accountability and, ultimately, undermine trust in the regulatory agency.[261]

III.
Permission to Fail

After reading the previous Part's parade of possible "horribles," it might be tempting to throw up one's hands and give up on suptech technology. However, such an approach would result in a different kind of failure: a failure of *in*action.[262] When an industry is innovating at a breakneck pace, regulatory agencies that do not develop their own technological innovations in tandem may cede their ability to oversee that industry and discharge their statutory mandates.[263] Failures of inaction are often less noteworthy in the moment, though, than the failures that are part and parcel of trying something new.[264] What if resources seem wasted, at least in the short-term? What if the innovation malfunctions and harms someone? What if the innovation works but has unintended consequences that undermine public policy goals? Questions like these can haunt regulators considering new forms of technological regulation, and so "permission to fail" is needed to loosen constraints on regulatory innovation.

Not all failures are created equal, however. We need more of a societal consensus about the kinds of failures that should be tolerated (and in some instances, should even be encouraged in the spirit of "fail fast")[265] as well as the types of failures that should always be discouraged. While it is impossi-

260. di Castri et al., *supra* note 9, at 2.

261. For a survey of the algorithmic accountability literature, see Engstrom & Ho, *supra* note 14, at 824–27*; see also* Fin. Stability Bd., *supra* note 10, at 10.

262. "Regulating is itself a risky business, with risks form acting as well as risks from not acting." Coglianese, *supra* note 46, at 10.

263. *See supra* notes 17–21 and accompanying text.

264. Altshuler, *supra* note 1, at 1.

265. On "failing fast," see Sunnie Giles, *How to Fail Faster—and Why You Should*, Forbes (Apr. 30, 2018, 6:47 AM), https://www.forbes.com/sites/sunniegiles/2018/04/30/how-to-fail-faster-and-why-you-should/?sh=259348d6c177.

ble to devise a bright line separating the excusable failures from the inexcusable failures (hard cases are inevitable), this Article aims to start a conversation about different types of failures, their impact on the innovation process, and their importance to democratic accountability.

Once there is more consensus around what is and is not excusable, the next step is to develop legal structures that permit the excusable failures—but while such legal structures are necessary, they will not be sufficient.[266] "Permission to fail" will also depend on public opinion, and so insights from sociology, political science, technology ethics, and other fields will also be critical to developing this concept. Ultimately, the three Sections of this Part interrelate as there is a recursive relationship among them. The kinds of failures we are willing to tolerate or excuse will depend, to some extent, on public perceptions, which will be informed by law as well as by messaging.[267] But the law adopted will also be a product of public perceptions about which failures are tolerable, and messaging can be used to urge changes in that law.

A. *Thinking About Failures*

This Article has argued for more grace for certain types of regulatory failures while urging closer scrutiny of failures of inaction, which are often less visible and tend to be minimized as a result. The consequences of financial regulators' inaction can be severe, both for individual consumers and investors who are unprotected and, in the event of a financial crisis, for the financial system and economy more broadly. The avoidance of financial crises is generally regarded as the "apex" goal of financial regulation[268] and regulatory failures of inaction were significant contributing factors to the 2008 financial crisis: the Financial Crisis Inquiry Commission stated bluntly "we

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266. *See* Peter Conti-Brown & David A. Wishnick, *Technocratic Pragmatism, Bureaucratic Expertise, and the Federal Reserve*, 130 YALE L.J. 636, 658 (2021).

267. On the expressive power of law in the financial regulation context, see Onnig H. Dombalagian, *The Expressive Synergies of the Volcker Rule*, 54 B.C. L. REV. 469, 497–98 (2013).

268. Jeffrey N. Gordon, *"Dynamic Precaution" in Maintaining Financial Stability: The Importance of FSOC, in* AFTER THE CRASH: FINANCIAL CRISES AND REGULATORY RESPONSES (Sharyn O'Halloran & Thomas Groll eds., 2019); *see also* Hilary J. Allen, *Putting the "Financial Stability" In Financial Stability Oversight Council*, 76 OHIO ST. L.J. 1087, 1088 (2015).

do not accept the view that regulators lacked the power to protect the financial system . . . . They had ample power in many arenas and they chose not to use it."[269] Consumer protection is also a critical goal of financial regulation and failure to protect consumers and investors from technologically sophisticated financial products and services has become a more pressing problem since 2008, as the financial industry's use of technology has rapidly increased.

Regulators must err on the side of precautionary intervention to prevent these harms, and failure to do so should not be readily excused.[270] The types of precautionary action needed are evolving as the technological sophistication of the financial industry increases,[271] and time is of the essence in developing suptech tools in response (failure to act now may leave regulatory agencies perpetually unable to catch up).[272]

For certain failures of inaction to become less acceptable, certain failures of regulatory action must become more acceptable. Efficiency failures (in the form of wasted resources if the innovation comes to naught or experiences vast cost overruns) are perhaps most necessary to the innovation process, and highly analogous to the failures embraced by the private sector as necessary to the innovation process.[273] If the only consequences of a failed innovation process are wasted time and resources, then any public harm is limited to seemingly wasted dollars.[274] I say "seemingly" because funds expended on innovation should not be considered "wasted" just because a partic-

269. FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT xviii (2011).

270. Hilary J. Allen, *A New Philosophy for Financial Stability Regulation*, 45 LOY. U. CHI. L. J. 173 (2013).

271. "Technology is now part and parcel of financial services and there is no question that it will continue to drive profound changes for consumers and financial institutions." JERMY PRENIO & JEFFERY YONG, FIN. STABILITY INST., FSI INSIGHTS ON POLICY IMPLEMENTATION NO. 37: HUMANS KEEPING AI IN CHECK – EMERGING REGULATORY EXPECTATIONS IN THE FINANCIAL SECTOR 1 (2021).

272. BAREFOOT, *supra* note 18, at 9–10.

273. *See supra* note 265 on "failing fast."

274. It's important to note that losses related to suptech innovation will not always come out of the public purse: many of the financial regulatory agencies in the United States are independently funded. Some regulatory agencies, like the SEC and CFTC, do rely on Congressional appropriations for their funding though. *See supra* note 54 and accompanying text.

ular innovation does not pan out. Regulators may learn important lessons from failed innovations.

Private sector venture capital funds are considered successful if only 10–20% of the companies they invest in turn out to be "winners;"[275] a similar success rate on an agency's portfolio of suptech innovation projects should be considered a success overall. Failures of efficiency should therefore be the most readily excused but, at present, these types of failures are perhaps the most frequently cited evidence of government failure (as was amply demonstrated by the Solyndra episode).[276] Efforts to reorient the law and public opinion to permit failures of efficiency are therefore some of the most important steps that can be taken towards promoting regulatory innovation.

Failures of efficacy may similarly need to be excused in order to encourage innovation, at least in the early stages of the innovation process. Not all technological experiments will achieve the desired outcome, and that is simply the nature of experimentation (in the public *or* the private sector).[277] On top of that, financial regulators are often trying to address complex problems with systemic dimensions while juggling competing mandates;[278] these problems are characterized by great uncertainty and are often far more difficult to solve than any problem the private financial industry would take on (the systemic risk that macroprudential regulation seeks to manage is a case in point).[279] Furthermore, the efficacy of a regulatory innovation will ultimately depend not just on what the regula-

275. "[M]ore than half the companies will at best return only the original investment and at worst be total losses. Given the portfolio approach and the deal structure VCs use, however, only 10% to 20% of the companies funded need to be real winners to achieve the targeted return rate of 25% to 30%. In fact, VC reputations are often built on one or two good investments." Bob Zider, *How Venture Capital Works,* HARV. BUS. REV. (1998), https://hbr.org/1998/11/how-venture-capital-works.

276. Solyndra was an innovator in clean energy technologies that received significant funding from the Obama Administration, but ultimately filed for bankruptcy. For a discussion of the rhetoric around the Solyndra bankruptcy, see MAZZUCATO *supra* note 40, at 11, 114–16.

277. TOM NICHOLS, THE DEATH OF EXPERTISE: THE CAMPAIGN AGAINST ESTABLISHED KNOWLEDGE AND WHY IT MATTERS 174–76 (2017).

278. *See* Coglianese, *supra* note 46, at 6.

279. *See generally* ENGSTROM ET AL., *supra* note 2 (reporting on use of AI by government agencies, identifying challenges, and presenting recommendations).

tors do, but also on the choices and actions of regulated private sector actors over whom regulators' control is limited.[280] Finally, the existence of potentially conflicting regulatory mandates means that different constituencies are likely to have different ideas about what "efficacy" even means (unlike corporate actors, who have the more straightforward yardstick of profitability to judge their outcomes by). A technological tool may therefore be considered effective even if it does not always succeed in preventing a particular harm if the tool was purposely designed to allow some risks to be taken in order to further competition and efficiency.[281] For all these reasons, perceived failures of the efficacy of suptech innovation should often be excused – again, though, existing perceptions around such failures must be changed.

To be clear, regulators should not be given *carte blanche* for inefficiency and inefficacy in perpetuity. Regulatory agencies should be expected to learn from their mistakes and adapt accordingly, and suptech innovations that have been deployed should be adjusted in light of new knowledge or changing circumstances.[282] While structures are needed to give regulators the kind of grace that facilitates this adaptation and learning, the legitimacy and credibility of an agency will be undermined if no learning takes place, and the same mistakes are repeated over and over again. In other words, regulators bear part of the responsibility for creating their own permission to fail: they should face public scrutiny if there is no meaningful response to failures (or no meaningful response other than blame shifting).[283] Furthermore, while we need to increase our tolerance for regulatory failures, some one-off failures of efficiency and efficacy may be so extreme that they remain incompatible with democratic accountability: the magnitude of

280. *See* Coglianese, *supra* note 46, at 7.

281. "When a disaster occurs it may not necessarily reflect the failure of regulation as much as the tragic but rare and inevitable consequence of a regulatory policy that responds to and makes tradeoffs in society's competing values." Cary Coglianese, *Preface* to REGULATORY BREAKDOWN: THE CRISIS OF CONFIDENCE IN U.S. REGULATION (Cary Coglianese ed., 2012).

282. *See* Mulligan & Bamberger, *supra* note 15, at 743.

283. For a discussion of the management literature on how to "fail better" and how it might apply to regulatory agencies, see Jodi Short, *Regulatory Managerialism as Gaslighting Government* (unpublished manuscript) (on file with author).

the failure will therefore be relevant to preserving regulators' legitimacy and credibility.

Failures of legitimacy and credibility, along with failures of equity, are highly problematic when associated with an unelected body that is publicly charged with coercing some people and protecting the rights of others.[284] Democratic accountability demands that failures of equity, legitimacy, and credibility should be less readily excused than similar failures by a private sector innovator.

One way of reconciling the need for experimentation with the need for the agency to retain legitimacy in the eyes of the public (especially when that experimentation fails) is to limit the impact of experimentation on regulated entities:[285] Conti-Brown and Wishnick argue that the least coercive activities are most able to retain legitimacy during experimentation.[286] Applying that logic to our discussion of regulatory innovation, innovation is less likely to undermine ideals of equity, legitimacy, or credibility when it is in "beta mode": technology cannot be coercive before it is launched. While that is a good strategy as far as it goes, some issues with a technology will not become apparent until it is actually operational, at which point it *will* be coercive. Heightened attention to failures of equity, legitimacy, and credibility must be applied to any technology that ultimately goes "live"—and the developers of suptech cannot wait until the launch date to start engaging with such issues.

When regulation is carried out through technological means, choices and values are embedded throughout the technological design process, "cementing regulatory compromises

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284. "The history of administrative law," Professors Sidney Shapiro, Elizabeth Fisher, and Wendy Wagner write, "constitutes a series of ongoing attempts to legitimize unelected public administration in a constitutional liberal democracy." Sidney Shapiro et al., *The Enlightenment of Administrative Law*, 47 WAKE FOREST L. REV. 463, 463 (2012). Democratic accountability requires regulators to balance the interests of the regulated industry (who are subject to the regulators' coercive powers) with the interests of the public who benefit from the regulation (who are often too dispersed to monitor the agency to ensure that their interests are being properly represented). Kathryn Harrison, *Regulatory Excellence and Democratic Accountability*, *in* ACHIEVING REGULATORY EXCELLENCE, *supra* note 46, at 56.

285. *See* Conti-Brown & Wishnick, *supra* note 266.

286. *Id.* at 664.

struck at foundational moments."[287] Because technology is often perceived as neutral, though, those choices and values may become less visible when they are carried out through technological means;[288] suptech's impact may also be more "durable" than other regulatory approaches, to the extent that it is "more automatic, more self-enforcing" than traditional regulatory strategies.[289] Suptech can therefore "bake in" failures of equity, legitimacy, or credibility,[290] and even technology that succeeds along all of these axes at the time of initial implementation may ultimately become more problematic with time, particularly if it invites unthinking deference in the form of automation bias.[291] Law and policy should therefore seek to prevent design choices from embedding and obscuring failures of equity, legitimacy, and credibility.

B. *Legal Standards*

If steps need to be taken during the suptech design process to limit failures of equity, legitimacy, and credibility, the law can and should encourage these steps, as well as lessen the consequences associated with failures of efficiency and efficacy. Many areas of law may be implicated here (for example, individual agency employees engaged in innovation may desire employment law protections that protect them should the innovation fail; uses of technology by government actors, particularly in the context of criminal law enforcement, raise Constitutional issues that are well beyond the scope of this discussion).[292] This Part, however, will focus on adapting administrative law to create permission to fail.

The starting point for this discussion is recognizing that the adoption of a new technology by a regulatory agency may,

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287. Heimer & Kuo, *supra* note 17, at 565.

288. *See* Mulligan & Bamberger, *supra* note 15, at 704.

289. Heimer & Kuo, *supra* note 17, at 564.

290. "Administrative process frequently fails even to recognize technology design choices as matters of public policy." Mulligan & Bamberger, *supra* note 15, at 701.

291. "[I]n hardened systems, regulatory complacency may further reduce capacity to respond to exogenous shocks." Heimer & Kuo, *supra* note 17, at 566.

292. *See* Andrew Guthrie Ferguson, The Rise of Big Data Policing: Surveillance, Race, and the Future of Law Enforcement (2019) for a discussion of these issues.

in some circumstances, be interpreted as the adoption of a new rule.[293] While regulatory agencies typically have significant discretion regarding how they carry out their supervision and enforcement activities, activities that rise to the level of rulemaking must follow certain procedures. The D.C. Circuit has held that the Transportation Security Agency's adoption of body scanners needed to go through the notice and comment rulemaking process,[294] and many of the suptech innovations discussed in Part III could be similarly considered as tantamount to a rulemaking as they "encode[ ] legal principles and agency priorities."[295] Where a technological innovation is itself considered a rule, it will be susceptible to both notice-and-comment rulemaking procedures and judicial review under the arbitrary and capricious standard.[296] Even where a technological innovation is not itself considered a rule, an agency may kickstart the development of that technology by adopting a rule, as was the case when the SEC adopted Rule 613 to precipitate the development of the CAT. Such rulemakings would similarly be subject to notice-and-comment and judicial review.

These rulemakings may therefore be subjected to the major questions doctrine embraced by the Supreme Court in *West Virginia v. EPA*.[297] That doctrine, which had been applied only infrequently and in "exceptional circumstances" prior to the ruling in *West Virginia v. EPA*,[298] stipulates that when the "economic and political significance" of a matter is great enough, courts should "hesitate before concluding that Congress meant to confer such authority."[299] Many have interpreted the Supreme Court's decision (which applied the major questions doctrine to invalidate certain efforts by the Environmental Protection Agency to regulate greenhouse gases) as a harbin-

293. Engstrom & Ho, *supra* note 14, at 836.
294. ENGSTROM ET AL., *supra* note 2, at 35 (citing Elec. Priv. Info. Ctr. v. Dep't of Homeland Sec., 653 F.3d 1, 8 (D.C. Cir. 2011)).
295. *Id.* at 28.
296. *Id.* at 76.
297. West Virginia v. EPA, 142 S. Ct. 2587, 2595 (2022).
298. Natasha Brunstein & Richard L. Revesz, *Mangling the Major Questions Doctrine*, 74 ADMIN. L. REV. 317, 319 (2022).
299. *West Virginia*, 142 S. Ct. at 2595.

ger of increasingly limited judicial deference to agency decision-making.[300]

Such limitations on deference unfortunately seem to be ratcheting up just as regulatory agencies need *more* grace for their technological experimentation. There is a lot of uncertainty about how the major questions doctrine will be applied going forward, but administrative law scholars have begun to explore how various other administrative law doctrines should apply to the use of technology (particularly machine learning technology) by the administrative state.[301] Many of these doctrines are designed to ensure regulatory outcomes of equity, legitimacy, and credibility, and we will return to how to navigate failures in these areas shortly. We will start, though, with administrative law requirements that are particularly inimical to regulatory innovation because they are laser-focused on efficiency and efficacy: requirements for cost-benefit analysis.

1. *Problems with Cost-Benefit Analysis*

In their strictest form, cost-benefit analysis mandates require that both the costs of an activity and its benefits be quantified, that the benefits outweigh the costs, and that this analysis be performed to the satisfaction of someone external to the agency (such as the Office of Information and Regulatory Affairs ("OIRA") or the D.C. Circuit).[302] Pursuant to Executive Orders 12,866 and 13,563, many regulatory agencies are re-

300. *See, e.g.*, New York Times Editorial Board, *The Supreme Court Sabotages Efforts to Protect Public Health and Safety*, N.Y. TIMES (July 1, 2022), https://www.nytimes.com/2022/07/01/opinion/supreme-court-epa-ruling.html ("The decision amounts to a warning shot across the bow of the administrative state. The court's current conservative majority, engaged in a counter-revolution against the norms of American society, is seeking to curtail the efforts of federal regulators to protect the public's health and safety."); Amy Howe, *Supreme Court curtails EPA's authority to fight climate change*, SCOTUSBLOG (June 30, 2022, 2:48 PM), https://www.scotusblog.com/2022/06/supreme-court-curtails-epas-authority-to-fight-climate-change/ ("Roberts' full-throated embrace of the major-questions doctrine – a judicially created approach to statutory interpretation in challenges to agency authority – likely will have ripple effects far beyond the EPA. His reasoning applies to any major policymaking effort by federal agencies.").

301. See sources cited *supra* note 14 for a more comprehensive discussion of machine learning in the administrative state.

302. John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882, 893–95 (2015).

quired to prepare quantified cost-benefit analysis in connection with every rulemaking and submit that analysis to OIRA before they publish their rules for public notice and comment.[303] Financial regulatory agencies are not covered by these executive orders and therefore do not have to submit their rules to OIRA;[304] still, as a result of a mishmash of legal requirements and external pressure, some agencies nonetheless prepare quantified cost-benefit analysis in support of their rulemakings.[305]

The D.C. Circuit has repeatedly vacated SEC rulemakings based on perceived infirmities in cost-benefit analyses, most notably in the Business Roundtable case.[306] Perhaps even more aggressively, in 2015, the D.C. Circuit struck down the Financial Stability Oversight Council's designation of MetLife, Inc. as a "systemically important financial institution" deserving of heightened prudential regulation, on the grounds that the FSOC failed to consider the costs that MetLife would bear as a result of the designation (notwithstanding the absence of any cost-benefit analysis requirement in the relevant legislation).[307] Cost-benefit analysis requirements therefore seem to be increasingly operating as constraints on financial regulatory agencies—and this could spell bad news for suptech innovation.

The adoption of a new technology that proves effective but expensive might be struck down if the D.C. Circuit determines that the technology is tantamount to a rule and its benefits do not justify the costs (which, as we saw in the case of the CAT, can be substantial).[308] In fact, unanticipated cost overruns on a technology project could conceivably result in that technology being retroactively declared "arbitrary and capri-

303. Exec. Order No. 12,866, 58 Fed. Reg. 51735 (Oct. 4, 1993); Exec. Order No. 13,563, 76 Fed. Reg. 3821 (Jan. 21, 2011).

304. The independent regulatory agencies listed in 44 U.S.C. § 3502 (which include the Federal Reserve Bank ("FRB"), the Federal Deposit Insurance Corporation ("FDIC"), the Commodity Futures Trading Commission ("CFTC"), and the Securities and Exchange Commission ("SEC")) are excluded from the ambit of Executive Order 12,866 by operation of section 3(b) of that Order.

305. Coates, *supra* note 302, at 911–12.

306. See *id.* at 912–19 for an overview of this case law.

307. Jeremy C. Kress et al., *Regulating Entities and Activities: Complementary Approaches to Nonbank Systemic Risk*, 92 S. CAL. L. REV. 1455, 1486 (2019).

308. *See supra* Section II.C.2.

cious"[309]—and therefore not able to be used—even after the development costs are incurred. Ultimately, cost-benefit analysis could exacerbate the impact of resource constraints on innovation and judicial rebukes for failure to satisfy cost-benefit analysis may reinforce public perceptions of an agency as a blundering bureaucracy, further reinforcing the constraints of rule-obsession and risk-aversion.

To be sure, requirements for strict quantified cost-benefit analysis have already been widely criticized, particularly because of their propensity to hide value judgments about the benefits of regulatory action (or inaction) beneath a veneer of seemingly impartial economics.[310] In the context of financial regulation more specifically, cost-benefit analysis has been critiqued for downplaying the benefits of financial stability[311] and for simply being an unreliable guide for policymaking because "finance is at the heart of the economy; is social and political; and is composed of non-stationary relationships that exhibit secular change . . . . These features undermine the ability of science to precisely and reliably estimate the effects of financial regulations, even retrospectively."[312] To this list of critiques we can now add another: requiring strict empirical cost-benefit analysis can impede necessary regulatory innovation.

2. *Adapting to Regulatory Innovation*

Other administrative law requirements are less focused on efficiency and efficacy, and more focused on bedrock principles of democratic accountability. Democratic accountability could be undermined by many different types of failures, but some examples already discussed in this Article include: what if the technology treats people differently when making decisions about who gets to transact, or enforcing rules? Should the public trust in decisions that come from a black box, or

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309. Administrative Procedure Act, 5 U.S.C. § 706.

310. *See, e.g.*, FRANK ACKERMAN & LISA HEINZERLING, PRICELESS: ON KNOWING THE PRICE OF EVERYTHING AND THE VALUE OF NOTHING 40 (2004) ("In practice, most cost-benefit analyses could more accurately be described as "complete cost-incomplete benefit" studies. Most or all of the costs are readily determined market prices, but many important benefits cannot be meaningfully quantified or priced, and are therefore implicitly given a value of zero.").

311. *See, e.g.*, Allen, *supra* note 270.

312. Coates, *supra* note 302, at 1003.

even from human regulators working alongside a black box? What if regulators do not invest enough in keeping their technological systems and our information safe? This Section will engage in some limited discussion of how administrative law mechanisms might afford protections to those impacted by suptech innovations—on the understanding that the broader subject of how administrative law should grapple with artificial intelligence and other technology is far too big a topic for this Article to tackle comprehensively.[313]

As we have already discussed, design choices made during the development process will have an impact on how suptech tools function once they go live. It is also important to realize that suptech innovations will not remain static in their operation but, rather, continuously evolve after launch.[314] As such, a notice-and-comment procedure that only applies to a rule outlining the initial goals for the technology (such as Rule 613, which started the CAT development process)[315] will not offer sufficient room for meaningful public engagement. As Mulligan & Bamberger have observed, the initial notice-and-comment process "misses the action when regulators delegate or hand off the design and crafting of regulatory technology to standard-setting bodies, engineers, designers, and program managers."[316]

Better engagement could be achieved by requiring transparency regarding suptech innovation during its development process and after its launch. However, achieving transparency will be challenging if the technology is provided by third-party private vendors who assert that the technology is proprietary and its details cannot be disclosed.[317] Furthermore, traditional administrative law transparency mechanisms like notice-and-comment rulemaking procedures and Freedom of Information Act ("FOIA") requests presuppose that the public can truly engage with the agency action in question. It is already challenging for people to engage with dense agency disclosures when they are dealing with words on paper:[318] public

313. For further discussion of these issues, *see* Bell, *supra* note 14, at 89–90.
314. BEERMAN ET AL., *supra* note 64, at 10.
315. *See supra* note 210 and accompanying text.
316. Mulligan & Bamberger, *supra* note 15, at 772.
317. *Id.* at 720.
318. For a discussion of the challenges everyday citizens have in participating in the notice-and-comment process for financial regulations, see

scrutiny may become near impossible when people are expected to engage with software code or some other form of complex technology.[319] For example, in order to engage meaningfully with the output of a machine learning algorithm, "[c]ommenters themselves would have to investigate the correlation [in the data] to either prove it is coincidental (essentially disproving all possible reasons for the existence of the correlation) or identify the underlying causes driving the correlation."[320]

In light of the deficiencies of existing administrative law mechanisms, Mulligan & Bamberger have suggested a useful set of norms for regulators to abide by when their regulation takes the form of a technological intervention.[321] These kinds of norms can work to limit failures of equity, legitimacy, and credibility. One such norm is that both technologists and policymakers should be "in the room where it happens," actively involved in designing the regulatory technology, so that the technology actually reflects the goals the policymakers are trying to achieve.[322] Another general guidepost is to not overreach: these types of technological regulatory solutions should be tailored as narrowly as possible to the problem at hand.[323] This will limit the coercive impact of regulatory technologies, and potentially limit the scope for unintended consequences (as compared to wider-reaching technological tools). It will also preserve more flexibility for future action. In addition, there should be a very deliberate discussion about the conflicting values at stake: the regulatory goals impacted by the technology should be clearly articulated and communicated, and assessments of technology and its impact on multiple identi-

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Kimberly D. Krawiec, *Don't "Screw Joe the Plummer": The Sausage-Making of Financial Reform*, 55 ARIZ. L. REV. 53, 80 (2013).

319. Mulligan & Bamberger, *supra* note 15, at 770 ("Diminished citizen awareness of techno-regulation, moreover, undermines the viability of traditional political checks.").

320. Bell, *supra* note 13, at 98–99.

321. Mulligan & Bamberger, *supra* note 15, at 705.

322. Mulligan & Bamberger note that, if left to their own devices, technical personnel may "maximize engineering values such as interoperability, efficiency, elegance, and innovation." *Id.* at 755.

323. *Id.* at 743.

fied goals can be made by cross-sectoral bodies[324] (the Office of Financial Research seems well suited to performing this kind of task for suptech).[325]

Administrative law norms may also have to adapt to deal with machine learning's "black box" problem. Although core administrative law doctrines are likely already expansive enough to permit the use of machine learning by administrative agencies,[326] in order to satisfy those doctrines, norms will have to evolve in terms of "explaining in general terms how the algorithm was designed to work and demonstrating that it has been validated to work as designed by comparing its results to those generated by the status quo process."[327] While strides have been made in designing machine learning algorithms that can retrospectively identify the variables they relied upon in their decision making, these types of advances are of limited utility when trying to prospectively assess how the algorithm is likely to make future decisions based on new data.[328] There are ways that the prospective workings of machine learning algorithms can be made more explainable, but these entail trade-offs (machine learning algorithms that lend themselves better to identifying the relationships between input and output variables are sometimes less predictive than more opaque machine learning algorithms).[329] And so norms will have to evolve about when to sacrifice accuracy for explainability; norms will also have to evolve about what are "acceptable" error rates for the machine learning algorithm more generally.[330]

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324. Mulligan & Bamberger, for example, have argued for a revived version of the Office of Technology Assessment that was defunded during the Gingrich era. *Id.* at 734.

325. Hilary J. Allen, *Resurrecting the OFR*, 47 J. CORP. L. 1, 44 (2021).

326. Coglianese, *Administrative Law in the Automated State, supra* note 14, at 108 ("Administrative law has never demanded anything close to absolute transparency nor required meticulous or exhaustively detailed reasoning.").

327. *Id.*

328. Allen, *supra* note 21, at 175–76.

329. *Id.* at 176*; see also* BEERMAN ET AL., *supra* note 64, at 10 ("Tightening modelling criteria may reduce noise in the results, but it could also lead to the tool not spotting supervisory issues. Loosening criteria could lead to too much noise, which could also result in the tool not being of much help in identifying real issues.").

330. Coglianese & Lehr, *supra* note 14, at 1,218.

Bearing in mind that these new types of regulatory approaches will take commitment and time to adopt and refine, it is worth considering how to minimize suptech innovations' inequities and shore up agency legitimacy and credibility in the interim. One possibility is to make experimental regulation less coercive by reducing enforcement penalties that relate to the output of suptech tools. At least at the outset, financial regulatory agencies may need to excuse errors by the regulated industry as the industry familiarizes itself with suptech regulation. Determining when private sector errors deserve forgiveness is beyond the scope of this Article, but it is worth noting that in 2018, France recognized the right for private citizens to make a one-time mistake in their interactions with government technologies.[331] This step might provide some ideas and context for how "permission to fail" should be extended to the private sector.

Another possibility is to mandate regular review of the technology involved:[332] these kinds of automatic reviews could soften the impact of technological regulatory failures and, in doing so, create more permission to fail. In general, technological tools are not "set and forget;" to retain legitimacy and credibility, they must be continually maintained and recalibrated in light of observed failures and changes in the regulated industry.[333] Finally, given the suspicion with which the public may regard automated decision-making,[334] an agency's legitimacy and credibility may depend on ensuring that technological interventions do not completely automate the regulatory function (again, at least in the early days). Instead, they

331. Ranchordas, *supra* note 233, at 44.

332. For example, the Copyright Office is charged with a unique, triennial rulemaking procedure that confers upon "the Copyright Office the responsibility to create a regularized process for reviewing the impact of technical protection measures (TPMs) on noninfringing uses. This process allows any stakeholder to petition for an exemption for a particular class of content and gives the Copyright Office the authority to establish temporary (three-year) exemptions from the law to protect such noninfringing uses." Mulligan & Bamberger, *supra* note 15, at 762.

333. In a survey of prudential regulators developing suptech tools, "[s]everal authorities mentioned assessing effectiveness through ongoing exchanges between those with data science skills and front-line supervisors/ other users." BEERMAN ET AL., *supra* note 64, at 10.

334. *See supra* notes 232-34 and accompanying text.

could serve as a complementary tool within the total mix, with human regulators kept "in the loop."

C. *Messaging & Other Methods for Building Permission to Fail*

The legal treatment of failures is not the only relevant consideration for regulators, though. Regulators understandably fear negative press—and any Congressional scrutiny that may flow from such negative press (although the more independent an agency is, the more insulated it will be from Congressional scrutiny).[335] Regulatory failures can be very noteworthy,[336] particularly in the United States where the population tends to be much less comfortable trusting government with proactive discretion.[337] Mazzucato tracks this fear of failure back to "the emergence of 'new public management' theory, which grew out of 'public choice' theory in the 1980s" and "led civil servants to believe that they should take up as little space as possible, fearing that government failures may be even worse than market failures."[338] Mazzucato emphasizes that this is, in many ways, a "discursive battle" and that "how we talk about the State [matters]."[339] Creating permission to fail, therefore, requires complementary non-legal strategies for managing the public narrative around regulatory innovation and its inevitable setbacks.[340] These strategies are critical for managing the constraints of publicness and short-termism on

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335. For further elaboration on agency independence, see *supra* notes 50–54 and accompanying text.

336. ALTSCHULER, *supra* note 1, at 1; *see also* Heimer & Kuo, *supra* note 17, at 564 ("[W]ide and vivid reporting may lead to overestimates of the frequency of regulatory failures and a belief that some exceedingly rare types of failure are pervasive problems. In contrast, regulatory successes are hard to see and remember.").

337. ALTSHULER, *supra* note 1, at 1. It's worth noting that this is not a uniform phenomenon, though. In the United States, there is often a high level of comfort with giving government significant discretion when it comes to security issues – but less so when it comes to financial regulation (as well as many other forms of government action). *See* Jonathan B. Wiener, *Whose Precaution After All? A Comment on the Comparison and Evolution of Risk Regulatory Systems*, 13 DUKE J. COMPAR. & INT'L L. 207, 209 (2003).

338. MAZZUCATO, *supra* note 40, at xxiii.

339. *Id.* at 14.

340. "[N]arrative is a key means through which people organize and make sense of reality and engage in reasoned argument." Brett Davidson, *Storytelling and Evidence-Based Policy: Lessons from the Grey Literature*, 3 PALGRAVE COMMC'NS 2 (2017).

regulatory innovation, as well as the constraints of rule-obsession and risk-aversion that flow from them (in this latter sense, it is important to shift the regulators' opinions of themselves, as well as in public opinion generally).

Cristie Ford has observed the power in framing something as innovative, because the positive connotations associated with "innovation" can provide legitimacy to the innovator.[341] So how do we build support for financial regulatory agencies as innovative bodies? Altshuler has argued that public sector innovation is more politically appealing when it addresses problems of "intense public concern."[342] Accordingly, regulators should stress that regulatory innovation is necessary to the pursuit of critically important public goods like consumer protection and financial stability—ends that are much harder to achieve than the profits that private sector innovation pursues. This needs to be messaged—in press releases, speeches, and media interviews—in snappy and accessible terms.[343]

A key messaging challenge is that regulatory successes are often invisible. When it comes to financial stability regulation, for example, successful regulation will ensure that financial crises are avoided, but it is difficult for regulators to point to the absence of crisis as evidence of their success.[344] Regulatory successes can also be overlooked to the extent that they become old news and unworthy of media attention.[345] The issue is particularly salient with respect to technological systems that may become so successful that they become a "part of the furniture" and cease to be viewed as regulation at all.[346]

It is therefore critical to message "failures of inaction" as failures, because they endanger the valuable outcomes of consumer protection and financial stability. One effective way to

341. Ford, *supra* note 28, at 220.
342. ALTSHULER, *supra* note 1, at 3.
343. For a discussion of strategies for changing a narrative, see Davidson, *supra* note 340, at 3 ("[I]nformation has to be packaged in a manner that takes into account people's inherent cognitive biases and ensures that the information is quickly and easily—and accurately—grasped."); *see also* ALTSHULER, *supra* note 1, at 3.
344. Allen, *supra* note 270, at 190.
345. Heimer & Kuo, *supra* note 17, at S64. ("Despite their importance, regulatory successes, and especially those that are old news by virtue of longevity, are rarely reported, generally lack drama, and are therefore easily overlooked and forgotten.").
346. *Id.* at S65.

build support for new regulatory responses to new regulatory problems may be to tell stories about what could go wrong in the *absence* of regulation.[347] History has demonstrated that (while sometimes minimized as "merely economic") regulatory failures to protect consumers and financial stability can cause significant harm to human beings. The public needs to be reminded of this history of human harm. A complementary, more forward-looking approach might entail regulators partnering with science fiction writers to explore what harms might lurk in an unregulated, technologized future.[348]

In addition, rather than focusing exclusively on individual innovations, the *process* of innovation should be celebrated as an indication that regulators are technologically sophisticated enough to keep up with their regulated industry. Publicizing and celebrating what would otherwise be behind-the-scenes innovation processes can act as a counterfactual to narratives of bureaucratic stodginess and inefficiency (this could also impact regulators' self-perception—hopefully in a virtuous cycle that creates a culture of innovation).[349] It can also work to improve the public profile of a regulatory agency at the time the innovation process occurs, even if the outcome of the innovation may not become apparent for some time (providing more explanation of those processes may also improve perceptions of equity, legitimacy, and transparency). For example, the private sector uses organizational management strategies like agile workflows to promote innovation; regulatory agencies should broadcast the extent to which they have adopted these kinds of strategies internally.[350] Agencies could send similar

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347. Hilary J. Allen, *Regulatory Managerialism and Failures of Inaction: A Case Study of Banking Regulation and Climate Change*, L. & CONTEMP. PROBS. (forthcoming); *see also* Davidson, *supra* note 340, at 3 ("Through the mechanism of plot, stories can help make causal relationships apparent, helping audiences process complex information even when they are engaging in fast thinking.").

348. For further exploration of science fiction stories as a vehicle for building public goodwill around financial regulation, see Allen, *supra* note 347.

349. Esty, *supra* note 55, at 141.

350. Ford, *supra* note 28, at 148 ("Attributes thought to positively influence innovativeness include how much structural flexibility and decision-making freedom employees have; whether workers have adequate resources, and reward and recognition structures that support innovation; whether the firm values open communication and participatory decision-making; how

messages by partnering (where appropriate) with industry bodies or universities for hackathons and tech sprints. Tools or projects that are abandoned or retired should be branded as learning opportunities achieved through trial and error, rather than as failures.[351]

Admittedly, successful outcomes are probably more likely to be salient to the public than successful processes. It is therefore worth identifying some outcomes from technologies developed through regulatory innovation that lend themselves well to measurement, and actually measuring those so that successes can be easily communicated to the public (this can also be a useful internal check on whether the technology itself is doing what it needs to do).[352] As we have already explored, it is critical that any benchmarks and metrics used refer to the agency's public goals, not just to efficiency.[353] Also, when it comes to selecting the outcomes to celebrate, Altshuler has argued that public sector innovations will be more politically appealing when they are "value-neutral, in the sense they can be usefully employed by partisans of divergent policy objectives."[354] It might make sense for financial regulatory agencies to build both their goodwill and their innovative "muscle" by initially engaging in win-win projects supported by the financial industry.[355] For more controversial suptech strategies, regulators can experiment with technologies now but may need to cultivate a broader coalition of public support before launch (the occurrence of a related crisis or emergency could certainly help cultivate this public support).[356]

So far, this Section has focused exclusively on messaging; the previous Section focused on administrative law measures. In between those administrative law measures and a public relations strategy lie hybrid measures that could also assist in creating permission for acceptable failures. These might include

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entrepreneurial and how cohesive it is; and how much it emphasizes learning and development.").

351. MAZZUCATO, *supra* note 40, at 10.

352. Esty, *supra* note 55, at 144.

353. ENGSTROM ET AL., *supra* note 2, at 73.

354. ALTSHULER, *supra* note 1, at 3.

355. *See supra* note 48 and accompanying text.

356. For a discussion of ways to amass public support for financial regulatory reform, see Peter Conti-Brown & Brian D. Feinstein, *The Contingent Origins of Financial Legislation*, 99 WASH. U. L. REV. 145 (2021).

the use of advisory committees (or requiring consultation with specified outside groups) that are particularly likely to value innovation in service of goals like consumer protection or financial stability (these approaches would be particularly effective if these outside groups had technological expertise). Brian Feinstein has referred to these as "identity-conscious measures," designed to "further agencies' accountability by explicitly elevating certain subgroups."[357] Such measures could be used to build goodwill for the agency's ventures that will afford some grace when its regulatory innovations inevitably fumble on the efficiency and efficacy axes—and they could be used to help prevent failures of equity, legitimacy, and credibility. These kinds of measures would not constitute a significant departure from current practice: as Feinstein observes, many financial regulatory agencies already have committees that seek to exert influence from traditionally underrepresented groups.[358] There may even be particular media interest in the view of these people by virtue of their committee membership,[359] which could serve as a potent public relations strategy.

To be clear, distrust of the regulatory state runs deep for some political persuasions.[360] Creating "permission to fail" in the minds of those who perceive regulation as generally doing more harm than good would entail resolving seemingly intractable problems of political polarization in the United States. This Article has no suggestions for how to respond to the divided media landscape and partisan online information streams that limit the efficacy of public communications strategies across party lines.[361] However, the strategies explored in this Part could incrementally build permission to fail in the minds of those who are less ideologically opposed to regulation in the first place.

357. Brian D. Feinstein, *Identity-Conscious Administrative Law: Lessons from Financial Regulators*, 90 GEO. WASH. L. REV. 1, 1 (2022).

358. *Id.* at 35 ("Of the nineteen committees that counsel agencies on financial regulatory matters, eight have charters that require their memberships to be drawn from groups that are conventionally perceived as underrepresented.").

359. *Id.* at 61–62.

360. Matthew A. Baum, *Partisan Media and Attitude Polarization: The Case of Healthcare Reform*, *in* REGULATORY BREAKDOWN: THE CRISIS OF CONFIDENCE IN U.S. REGULATION, supra note 281, at 118–19.

361. *Id.*

Conclusion

Private actors in the financial industry tend to lack both incentives and the ability to pursue public goals like consumer protection and financial stability. We therefore depend on financial regulators to pursue these goals, but regulators' ability to oversee the financial industry will increasingly depend on their ability to engage with the industry's technological innovation—which will sometimes require regulatory agencies to engage in technological innovation of their own. This Article has explored the constraints that could prevent this kind of technological innovation (and therefore lead to failures of inaction) and discussed how to lessen those constraints by expanding regulatory agencies' "permission to fail."

This idea of "permission to fail" is culturally specific, though, and the permission granted will vary between nations depending on expectations of government effectiveness, efficiency, and democratic accountability. This Article has focused on legal strategies and messaging to respond to *U.S.* attitudes on regulatory innovation (particularly about expectations of government effectiveness and efficiency), but this calculus will be different in other countries. Some foreign financial regulatory agencies may already benefit from more trust in regulation and public innovation and may therefore have much more "permission to fail" than their U.S. counterparts. The good news is that the technology driving suptech is not typically country-specific[362] and because suptech innovation is driven by a desire to create public goods (rather than competition for private profits), U.S. financial regulatory agencies will likely have significant opportunities to collaborate with their foreign counterparts.[363] If we start creating more "permission to fail" for U.S. financial regulatory agencies now, then they may soon be able to take advantage of the progress that other financial regulatory agencies have made in the area of suptech

362. *See* Yesha Yadav, *FinTech and International Financial Regulation*, 53 VAND. J. TRANSNAT'L L. 1109 (2020). (observing that some fintech may operate in culturally specific ways, and the same may be true of suptech).

363. For a discussion of the suptech collaboration that is already occurring, see FIN. STABILITY BD., *supra* note 10, at 14; *see also* DI CASTRI ET AL., *supra* note 9, at 17.

solutions,[364] preventing them from falling too far behind the financial industry's technological advancement.

364. An Informal SupTech Network was launched by the Bank for International Settlements in 2018, and members of this body can "access SupTech related materials contributed by other members through a platform hosted by the BIS." FIN. STABILITY BD., *supra* note 10, at 15.

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CORPORATE POLITICS: ESG AND THE FIRST AMENDMENT

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Citizens United *not only dramatically expanded corporate free speech protections, but also enshrined a distinctive theory of corporate politics into the United States' constitutional law and popular imagination. The Roberts Court's emphasis on companies' deliberative function, which transforms debates among stakeholders into enterprise-wide values, rejected a competing realist view, analytically rooted in individual executives' incentives and power to dominate political debate within the firm, that had defined First Amendment jurisprudence a generation prior.*

This Article explains how both sides of the contemporary debate over ESG policies accepted Citizens United*'s invitation to view corporations as political actors and internalized the Court's deliberative theory of the firm. Doing so has yielded a host of economic and legal problems for progressives and conservatives alike, from the proliferation of "greenwashing" to looming constitutional challenges to state "fair access" statutes. By reviving the realist conception of corporate politics, this Article uncovers concrete strategies to overcome these pathologies for both ends of the political spectrum.*

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INTRODUCTION

Corporations today are manifestly and self-consciously political actors.[1] To appeal to consumers and attract investors, businesses have taken public stances on a wide variety of environmental, social, and governance ("ESG") issues.[2] Corporate espousals of social and political principles are so commonplace that their underlying premise—that corporations can hold enterprise-wide values—is increasingly taken for granted.[3] But the banality of this premise today belies the bitter contestation that accompanied its ascension in American law and politics just over a decade ago.

Debates over corporations' capacity to hold values crystallized in *Citizens United v. FEC*,[4] a landmark First Amendment decision that embraced robust protections for companies' social and political stances and constitutionalized the Roberts Court's deliberative conception of corporations as "associations of citizens."[5] According to the Court, stakeholders forge corporate values by participating in the transformative debates of "corporate democracy,"[6] and governance processes like

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1. *See* James R. Bailey & Hillary Phillips, *How Do Consumers Feel When Companies Get Political?*, HARV. BUS. REV. (Feb. 17, 2020), https://hbr.org/2020/02/how-do-consumers-feel-when-companies-get-political ("As society became politically polarized, companies became more activist."); Anna Irrera, Jessica DiNapoli & Imani Moise, *Take a Stance or Tiptoe Away? Corporate America's Battle with Social Activism*, REUTERS (Oct. 27, 2020, 7:56 AM), https://www.reuters.com/article/usa-companies-activism-analysis/take-a-stance-or-tiptoe-away-corporate-americas-battle-with-social-activism-idUSKBN27C1O3 ("The unprecedented outpour of corporate support for racial justice lately follows several years of companies taking a stand on other issues that activists criticize them about, including climate change, the gender wage gap, and LGBTQ rights.").

2. *See* Pierre J. Allegaert, Note, *Codetermination and ESG: Viable Alternatives to Shareholder Primacy?*, 52 N.Y.U. J. INT'L L. & POL. 641, 666–67 (2020); David Freiberg, Jean Rogers & George Serafeim, *How ESG Issues Become Financially Material to Corporations and Their Investors* 4 (Harv. Bus. Sch., Working Paper No. 20-056, 2020), https://ssrn.com/abstract=3482546.

3. *See* Bailey & Phillips, *supra* note 1 ("[P]olitical advocacy has been absorbed to the extent that it is seen as a natural extension of a business model. . . . [I]t's seen as common practice.").

4. Citizens United v. FEC, 558 U.S. 310 (2010).

5. *Id.* at 349; *see* Jonathan Macey & Leo E. Strine, Jr., Citizens United *as Bad Corporate Law*, 2019 WIS. L. REV. 451, 461.

6. *Citizens United*, 558 U.S. at 370; *see* Leo E. Strine, Jr. & Nicholas Walter, *Conservative Collision Course: The Tension Between Conservative Corporate Law Theory and* Citizens United, 100 CORNELL L. REV. 335, 363 (2015).

shareholder voting yield ethical positions attributable to the corporation itself, rather than merely the sum of its constituent stakeholder parts.[7]

Citizens United was pathbreaking in its rejection of a competing, realist account of corporate values. In contrast to the Roberts Court's deliberative view, the realist conception understands corporations as neutral collections of stakeholders with differing views on social and political issues.[8] However, the realist conception also recognizes that because managers wield outsize influence over business operations, corporate values reflect the preferences of managers,[9] subject to the constraints imposed by a small number of large, informed shareholders.[10] Corporate democracy therefore offers cold comfort to the realist, as most stakeholders lack the power or incentive to intervene in corporations' social and political decision making.[11] Although the Supreme Court embraced this realist view in *Austin v. Michigan State Chamber of Commerce*,[12] *Citizens United* overruled *Austin* and repudiated its reasoning.[13]

In the years since *Citizens United*, the Roberts Court's deliberative conception of the corporation has captured the imagination of progressives and conservatives alike.[14] Yet contemporary debates over ESG policies demonstrate the profound flaws of the deliberative account.

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7. *See* Reuven S. Avi-Yonah, Citizens United *and the Corporate Form*, 2010 Wis. L. Rev. 999, 1043.

8. *See* David G. Yosifon, *The Public Choice Problem in Corporate Law: Corporate Social Responsibility After* Citizens United, 89 N.C. L. REV. 1197, 1199–1200 (2011). This view is realist in its emphasis on the incentives of individual stakeholders, rather than corporate abstractions. *See generally* Felix S. Cohen, *Transcendental Nonsense and the Functional Approach*, 35 COLUM. L. REV. 809, 826 (1935) (characterizing realism as rejecting "hidden causes or transcendental principles").

9. *See* Richard Hasen, Citizens United *and the Orphaned Antidistortion Rationale*, 27 GA. ST. U. L. REV. 989, 995 (2011).

10. Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91, 139–140 (2020).

11. *See id.*; FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 67 (Harv. Univ. Press, 1991).

12. *See* Austin v. Mich. State Chamber of Com., 494 U.S. 652, 660 (1990) (explaining "aggregations of wealth that are accumulated with the help of the corporate form . . . have little or no correlation to the public's support" for the values espoused by the corporation's management).

13. Citizens United v. FEC, 558 U.S. 310, 319 (2010).

14. *See infra* Part II.

Progressives mounted an unprecedented campaign over the past decade to instill liberal values in major corporations by harnessing the levers of corporate democracy.[15] While the efforts of progressive investors and customers have led major corporations to adopt policies on climate change,[16] racial justice,[17] reproductive rights,[18] and other pressing ESG issues, many on the American left have lamented the lack of substantive change accompanying these announcements. For example, progressives have accused numerous companies of "greenwashing," whereby corporations proclaim a commitment to the environment yet fail to implement meaningful climate policies in practice.[19] This gap between corporations' ESG stances and business operations is not an aberration, but rather a telling consequence of progressives' reliance on the deliberative view.[20]

Conservatives have responded to the proliferation of ESG policies by enacting state "fair access" statutes that penalize

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15. *See, e.g.*, Kai H.E. Liekefett, Holly J. Gregory & Leonard Wood, *Shareholder Activism and ESG*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 29, 2021), https://corpgov.law.harvard.edu/2021/05/29/shareholder-activism-and-esg-what-comes-next-and-how-to-prepare (describing "many signs of mounting and effective pressure from investors on public companies to enhance their performance and disclosures on environmental, social, and governance (ESG) criteria").

16. *E.g.*, Paul Coster, *Corporations Are Stepping in to Combat Climate Change*, JPMORGAN CHASE & CO., https://www.jpmorganchase.com/news-stories/corporations-are-stepping-in-to-combat-climate-change (last visited Mar. 30, 2023).

17. *See* Gillian Friedman, *Here's What Companies Are Promising to Do to Fight Racism*, N.Y. TIMES (Aug. 23, 2020), https://www.nytimes.com/article/companies-racism-george-floyd-protests.html.

18. *See* Alex Millson & Ella Ceron, *How US Companies Are Supporting Workers on Abortion*, BLOOMBERG (June 26, 2022, 5:33 PM), https://www.bloomberg.com/news/articles/2022-05-03/how-u-s-companies-are-supporting-workers-on-abortion.

19. *See* Evie Liu, *SEC's Gensler Is Targeting Greenwashing of ESG Funds*, BARRON'S (Mar. 1, 2022), https://www.barrons.com/articles/sec-gensler-greenwashing-esg-funds-51646166625; Anmar Frangoul, *Activist Investors and a "Greenwashing" Backlash: Change Is Coming to the Corporate World*, CNBC (Jan. 25, 2022), https://www.cnbc.com/2022/01/25/activist-investors-greenwashing-backlash-change-is-coming-to-business.html; Damian Carrington, *"A Great Deception": Oil Giants Ripped for Greenwashing*, MOTHER JONES (Apr. 21, 2021), https://www.motherjones.com/environment/2021/04/a-great-deception-oil-giants-ripped-for-greenwashing-campaigns.

20. *See infra* Section II.A.

firms with progressive corporate values regarding fossil fuels, firearms, and other issues.[21] Although these laws codify the deliberative conception's attribution of social and political beliefs to corporations, they seek to punish firms for expressing views disfavored by the state government on social issues like firearms and climate change, and are therefore unconstitutional under the expansive First Amendment jurisprudence of *Citizens United* and its progeny.[22] Thus, conservatives' adherence to the deliberative account has led them to a strategic dead end.

The advent of ESG policies and fair access laws reveal both the widespread acceptance and significant shortcomings of the deliberative conception articulated in *Citizens United*. This Article therefore urges progressives and conservatives alike to return to the realism of *Austin*. After exploring the clash of the deliberative and realist theories in *Citizens United* and tracing the ensuing debates over corporations' ESG positions, this Article explains how reorienting contemporary discourses on corporate values to focus on the behavior and incentives of individual stakeholders offers a fruitful path forward for progressives seeking concrete gains on ESG issues, as well as conservatives concerned with corporate overreach.

I.
CORPORATE DEMOCRACY IN THE ROBERTS COURT

In 2010 the Supreme Court delivered its decision in *Citizens United v. FEC*, striking down a federal prohibition on independent corporate political expenditures as contrary to the First Amendment.[23] The decision ignited an impassioned debate over the proper role of corporate speakers in the nation's political discourse.[24] But the case's polarizing outcome reflected a tectonic shift in perspective on corporate values. Rejecting the realist account that had dominated the Rehnquist

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21. *See, e.g.*, TEX. GOV'T CODE ANN. § 2274.002 (2022); TENN. CODE ANN. § 9-4-107 (2022).

22. *See infra* Section II.B.

23. Citizens United v. FEC, 558 U.S. 310 (2010).

24. *See, e.g.*, Justin Levitt, *Confronting the Impact of* Citizens United, 29 YALE L. & POL'Y REV. 217 (2010); Richard A. Epstein, Citizen United v. FEC: *The Constitutional Right That Big Corporations Should Have but Do Not Want*, 34 HARV. J.L. & PUB. POL'Y 639 (2011).

Court a generation prior,[25] the Roberts Court instead embraced a deliberative view that ultimately achieved currency among American progressives and conservatives alike. By enshrining the deliberative view in First Amendment doctrine, the Roberts Court redefined the debate over corporate values for the following decade.

This historic pivot arose out of a low-budget documentary entitled "Hillary: The Movie," produced by a corporation named Citizens United.[26] The film described then-Senator Clinton's involvement in a series of alleged scandals in order to provoke opposition to her campaign for the Democratic Party's 2008 presidential nomination.[27] Although Citizens United hoped to promote the film, the Bipartisan Campaign Reform Act of 2002 ("BCRA")[28] prohibited corporations from using general treasury funds for independent expenditures on electioneering communications within 30 days of a primary election.[29]

Citizens United sued for declaratory and injunctive relief, contending that the BCRA as applied to "Hillary: The Movie" violated the First Amendment.[30] A three-judge court for the U.S. District Court for the District of Columbia disagreed, observing that the Supreme Court had upheld restrictions on electioneering communications in *McConnell v. FEC*.[31] Citizens United appealed to the Supreme Court, inviting the Court to overturn the precedential foundation on which *McConnell* rested: *Austin v. Michigan Chamber of Commerce*.[32]

In an opinion by Justice Kennedy, the Supreme Court endorsed Citizen United's arguments, declaring *Austin* was "an aberration" that had to be overruled despite the principle of stare decisis.[33] Justice Kennedy explained that *Austin* upheld a Michigan law prohibiting the state's Chamber of Commerce

25. *See* Austin v. Mich. State Chamber of Com., 494 U.S. 652, 652 (1990).
26. *Citizens United*, 558 U.S. at 319.
27. *Id.* at 319–20.
28. Bipartisan Campaign Reform Act of 2002, Pub. L. No. 107-155, 116 Stat. 81.
29. *Citizens United*, 558 U.S. at 320–21.
30. *Id.* at 321.
31. Citizens United v. FEC, 530 F. Supp. 2d 274, 282 (D.D.C. 2008) (citing McConnell v. FEC, 540 U.S. 93 (2003)).
32. *See Citizens United*, 558 U.S. at 319.
33. *Id.* at 319, 355.

from spending general treasury funds on ads for specific candidates.[34] The *Austin* Court did so by recognizing a compelling governmental interest in preventing corporations from exploiting resources derived from "the economically motivated decisions of investors and customers" to support unrelated political causes.[35]

This antidistortion principle in *Austin* derived from a realist conception of corporate political activities. According to Justice Marshall's majority opinion, corporations are value-neutral enterprises that pluralistically join together a variety of different stakeholders with differing social and moral outlooks.[36] Stakeholders with conflicting worldviews can nevertheless cooperate in corporate ventures by virtue of their overlapping economic interests.[37] Thus, "limited liability, perpetual life, and favorable treatment of the accumulation and distribution of assets" are the ties that bind corporations, not a commitment to a common good.[38]

For the realist, solicitude for corporate values amounts to a category error. Although directors, officers, or employees can express values on a corporation's behalf,[39] the notion that the corporation itself holds those values is a legal fiction.[40]

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34. *Id.* at 347 (citing Austin v. Mich. State Chamber of Com., 494 U.S. 652, 695 (1990) (Kennedy, J., dissenting)).

35. Austin v. Mich. State Chamber of Com., 494 U.S. 652, 659 (1990) (Marshall, J.) (citation omitted).

36. *See id.* at 660 (stating the corporate form yields "immense aggregations of wealth" without regard to "the political ideas espoused by corporations"); *see also* Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 940 (1984) ("Pluralist decisionmaking entails compromises between competing constituent groups . . . .").

37. *Austin*, 494 U.S. at 659 (noting corporations' unique "ability to attract capital and to deploy their resources in ways that maximize the return on their shareholders' investments"). In certain respects, this account resembles the canonical "nexus of contracts" theory of law and economics. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976) (describing corporations as "legal fictions which serve as a nexus for a set of contracting relationships among individuals").

38. *Austin*, 494 U.S. at 658–59.

39. *Id.* at 657.

40. *Cf.* John Dewey, *The Historic Background of Corporate Legal Personality*, 35 YALE L.J. 655, 666 (1926) (tracing the nominalist view of corporate personhood as a "fiction" to Thomas Aquinas). Indeed, when subsequently defending this realist account, Justice Stevens claimed it rested on observable stakeholder relations and thus obviated the need for a conceptual approach

Moreover, attributing those statements to each component of the enterprise is at odds with the economic purpose that allows corporations to unite disparate interests.[41] Instead, as Justice Brennan argued in his *Austin* concurrence, expressions of corporate values often reflect the views of executives or domineering shareholders.[42] Unfettered corporate political activities thereby threaten minority shareholders and other stakeholders who do not share those social and political positions.[43] For large businesses with dispersed shareholders, many investors lack an adequate incentive to monitor and intervene in the formulation of corporate values.[44] Embracing this realist view, the *Austin* Court upheld legal checks on corporate political activities as a legitimate means of protecting the pluralistic nature of business enterprises.[45]

But two decades later, in a defining moment of the Roberts Court's First Amendment jurisprudence, the *Citizens United* majority overruled *Austin* and adopted an antithetical understanding of corporate values.[46] Justice Kennedy's majority opinion described an "open marketplace of ideas," both on a national level and within individual corporations.[47] Through the governance processes of "corporate democracy,"[48] stake-

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to corporate law. *See* Citizens United v. FEC, 558 U.S. 310, 465 n.72 (2010) (Stevens, J., dissenting).

41. Austin v. Mich. State Chamber of Com., 494 U.S. 652, 657–59 (1990) ("[T]he power of the corporation may be no reflection of the power of its ideas." (quoting FEC v. Mass. Citizens for Life, Inc., 479 U.S. 238, 258 (1986))).

42. *See id.* at 675 (Brennan, J., concurring) (citing Victor Brudney, *Business Corporations and Stockholders' Rights Under the First Amendment*, 91 YALE L.J. 235, 247 (1981)).

43. *Id.* ("[T]he State surely has a compelling interest in preventing a corporation it has chartered from exploiting those who do not wish to contribute to the [corporation's] political message.").

44. *Id.* at 674 n.5 ("[S]hareholders in a large business corporation may find it prohibitively expensive to monitor the activities of the corporation to determine whether it is making expenditures to which they object."); *accord* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 395 (1983) (citing ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 129 (rev. ed. 1967)).

45. *Austin*, 494 U.S. at 668–69.

46. Citizens United v. FEC, 558 U.S. 310, 365 (2010).

47. *Id.* at 354 (internal quotation marks omitted).

48. *Id.* at 362; *see also* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 837 (2005) ("[S]hareholders in the American public corporation have the right to vote on the election of direc-

holders forge common values as "associations of citizens."[49] Contrary to the *Austin* Court's neutral and economic vision of corporations, *Citizens United* recast business entities as social, moral, and political ventures, not just financial ones.

From the foundational premise that stakeholders join corporate enterprises both to promote values and to pursue profits, *Citizens United* constructed a theoretical justification for the legitimacy of corporations' espousal of social and political views. A company's stakeholders necessarily participate in and thereby consent to its deliberative project;[50] thus, the values that arise out of corporate democratic processes are attributable to the corporation as a whole.[51]

Citizens United's conception of corporations as sites of meaningful debates over non-economic values rejected the twin pillars of *Austin*'s realist account. First, because stakeholders tacitly consent to corporations' deliberative function, a company's free-standing values depend only indirectly on the views of individual stakeholders. Accordingly, the government lacks a compelling interest in restricting corporate political activities even if "enabled by economic transactions with persons or entities who disagree with the [corporation's] ideas."[52] Second, corporate democracy translates debates among shareholders into collective values. Because minority shareholders contribute to the marketplace of ideas from which corporate values emerge, the government likewise lacks a compelling interest in "protecting dissenting shareholders" when the com-

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tors. The U.S. corporation can be regarded as a 'representative democracy' . . . .").

49. *Citizens United*, 558 U.S. at 362. For a comparison of deliberative and nondeliberative models in democratic theory, see Robert P. George, *Law, Democracy, and Moral Disagreement*, 110 HARV. L. REV. 1388, 1393 (1997).

50. *Cf.* Guido Palazzo & Andreas Georg Scherer, *Corporate Legitimacy as Deliberation: A Communicative Framework*, 66 J. BUS. ETHICS 71, 82 (characterizing "the corporation as a political player whose legitimacy is based on civil society discourses").

51. *See Citizens United*, 558 U.S. at 361–62 (rejecting a state interest in protecting dissenting shareholders because their views are incorporated "through the procedures of corporate democracy"); *see also* Elizabeth Pollman, *Reconceiving Corporate Personhood*, 2011 UTAH L. REV. 1629, 1641–42 (discussing the "real entity" theory that "describe[s] the corporation as greater than the sum of its parts").

52. *Citizens United*, 558 U.S. at 351.

pany's ultimate convictions do not mirror the views of each participant in the corporate venture.[53]

Justice Kennedy therefore concluded that the *Austin* Court erred in "permit[ting] the Government to ban the political speech of millions of associations of citizens."[54] Having rejected the compelling governmental interests recognized in *Austin*, the *Citizens United* majority overruled *Austin*, as well as its progeny, *McConnell*.[55] The Court held that the BCRA restrictions on Citizens United's independent expenditures infringed on its right to free speech and violated the First Amendment.[56]

In radically revising the conception of corporate values underlying First Amendment doctrine, *Citizens United* transformed American law and politics. While the government was previously free to limit corporate expressions of value to protect the economic neutrality of business organizations and differing views of disempowered stakeholders, the Roberts Court's full-throated endorsement of the deliberative view instead invited the public to pursue change from within corporations.[57] Foreclosing legislative paths to define corporate values, the Court instead entrusted future debates on the social and political stances of businesses to the machinery of corporate democracy.[58]

II.
THE REIGN OF THE DELIBERATIVE VIEW

Citizens United initially sparked protest and opprobrium among American progressives, who lamented the Court's *laissez faire* approach to campaign finance.[59] But a curious and yet-

53. *Id.* at 361.

54. *Id.* at 354.

55. *Id.* at 365–66.

56. *Id.*

57. *See id.* at 372 (stating decisions concerning corporate values "are not for the Government to make").

58. *Id.* at 362.

59. *See, e.g.*, Ian Millhiser, Citizens United *Decision: A Rejection of the Common Sense of the American People*, THINKPROGRESS (Jan. 21, 2010, 8:34 PM), https://archive.thinkprogress.org/citizens-united-decision-a-rejection-of-the-common-sense-of-the-american-people-d7b83c583b1b/; Mike Ludwig, *The Movement to Overturn* Citizens United *Takes Form*, TRUTHOUT (Jan. 18, 2012), https://truthout.org/articles/the-movement-to-overturn-citizens-united-takes-form.

unremarked shift occurred in the decade following the decision: with other avenues for shaping corporate values foreclosed, progressives took up Justice Kennedy's invitation to embrace the deliberative conception and use the levers of corporate democracy to instill liberal values in companies. Thus, the nascent ESG movement blossomed into a defining feature of the current economy, prompting corporations to adopt progressive stances on a number of social, ethical, and political issues.[60]

More recently, conservatives have responded to the proliferation of progressive ESG policies by enacting a suite of state "fair access" laws that penalize firms for adopting liberal policies on climate change, firearm manufacturing, and other controversial subjects.[61] By punishing corporations for expressing particular values, these fair access statutes reflect the deliberative theory's insistence that corporations channel internal debates among stakeholders into views properly attributed to the company as a whole.

Both sides of the debate over ESG policies have thus internalized the Roberts Court's deliberative conception of corporate politics, rendering the realist theory little more than a legal relic. But emerging challenges to the current strategies of progressives and conservatives alike demonstrate the deficiencies of the deliberative view. For liberals, the fixation on propagating corporate values has led to a crisis of under-implementation and created a gap between bold ESG statements and halfhearted action, as evinced by growing concerns over greenwashing. And although conservatives' state fair access laws treat business entities as associations of citizens, these statutes defy the First Amendment doctrine developed in *Citizens*

60. *See* Tom Quaadman, *The Role of ESG in the Business Community*, U.S. CHAMBER COMM. (July 22, 2020), https://www.centerforcapitalmarkets.com/the-role-of-esg-in-the-business-community/; Kosmas Papadopoulos & Rodolfo Araujo, *Top 10 ESG Trends for the New Decade*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 2, 2020), https://corpgov.law.harvard.edu/2020/03/02/top-10-esg-trends-for-the-new-decade.

61. *See* Zack Colman & Jordan Wolman, *Climate Investing 'Boycott Bills' Flood State Capitals*, POLITICO (Feb. 15, 2022, 10:44 AM), https://www.politico.com/news/2022/02/15/climate-investing-boycott-bills-flood-state-capitals-00008641; Stephen Gandel, *The Texas Law That Has Banks Saying They Don't 'Discriminate' Against Guns*, N.Y. TIMES (May 28, 2022), https://www.nytimes.com/2022/05/28/business/dealbook/texas-banks-gun-law.html.

United and its progeny and are therefore unconstitutional under current jurisprudence. This Part explains how the deliberative conception's ascendency bred these obstacles across the political spectrum.

A. *ESG Policies*

Embracing the deliberative conception of corporate values, progressives have induced companies to adopt liberal stances on a wide range of ESG issues. But rising concerns with greenwashing reveal a profound shortcoming of the deliberative theory: its paramount focus on changing corporate values underemphasizes the role of individual personnel in implementing those commitments.

Citizens United's clarion call for corporate debates on political questions arrived at a time when interest in businesses' ESG policies remained inchoate.[62] Over the following decade, however, progressives mounted a remarkable campaign to push major companies to take stands on a broad array of ESG issues, including climate change,[63] gun violence,[64] reproduc-

62. *See History of ESG*, PREQIN (Sept. 2022), https://www.preqin.com/preqin-academy/lesson-5-esg/history-of-esg.

63. *E.g.*, *Intel Climate Change Policy Statement*, INTEL (Jan. 2020), https://www.intel.com/content/www/us/en/corporate-responsibility/environment-climate-change-policy.html; *Climate Change*, WALMART (2022), https://corporate.walmart.com/planet/climate-change; *Climate Action*, COCA-COLA CO. (2022), https://www.coca-colacompany.com/sustainability/climate.

64. *See American Businesses Are Taking a Stand on Gun Violence*, EVERYTOWN FOR GUN SAFETY (2022), https://everytownsupportfund.org/initiatives/business-leaders/businesses-taking-a-stand (describing corporate policies to reduce firearm violence). Many of these policies followed the mass shooting at Marjory Stoneman Douglas High School in Parkland, Florida. *See* Brian Berkey, Eric Orts & Robert Hughes, *Gun Control After Parkland: What Can Firms Really Do?*, KNOWLEDGE AT WHARTON (Mar. 12, 2018), https://knowledge.wharton.upenn.edu/article/ethical-debate-guns.

tive health,[65] gender-affirming care,[66] racial justice,[67] and voting rights.[68]

A primary engine of the ESG movement has been the growth of mutual and exchange-traded funds dedicated to investing in companies with particular ESG policies.[69] These funds not only created a powerful incentive for firms to adopt ESG policies to attract capital,[70] but also leveraged investors' proxy votes to advocate for ESG initiatives.[71]

Progressives also shaped companies' deliberations through other facets of corporate democracy. Customers have harnessed their purchasing power to support brands with ESG

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65. *See* Maggie McGrath & Jena McGregor, *These Are the U.S. Companies Offering Abortion-Related Benefits*, FORBES (May 7, 2022, 6:30 AM), https://www.forbes.com/sites/maggiemcgrath/2022/05/07/these-are-the-us-companies-offering-abortion-related-benefits.

66. *E.g.*, Amelia Lucas, *Starbucks to Cover Employees' Travel Expenses for Abortions, Gender-Affirming Surgeries*, CNBC (May 16, 2022, 9:00 AM), https://www.cnbc.com/2022/05/16/starbucks-to-cover-employees-travel-expenses-for-abortions-gender-affirming-surgeries.html.

67. *See* Earl Fitzhugh, JP Julien, Nick Noel & Shelley Stewart, *It's Time for a New Approach to Racial Equity*, MCKINSEY & CO. (May 25, 2021), https://www.mckinsey.com/featured-insights/diversity-and-inclusion/its-time-for-a-new-approach-to-racial-equity.

68. *See, e.g.*, David Gelles & Andrew Ross Sorkin, *Hundreds of Companies Unite to Oppose Voting Limits, but Others Abstain*, N.Y. TIMES (May 27, 2021), https://www.nytimes.com/2021/04/14/business/ceos-corporate-america-voting-rights.html.

69. *See ESG Investing: Practice, Progress and Challenges*, OECD 3 (2020), https://www.oecd.org/finance/ESG-Investing-Practices-Progress-Challenges.pdf; Int'l Monetary Fund, *Investment Funds: Fostering the Transition to a Green Economy*, *in* GLOBAL FINANCIAL STABILITY REPORT: COVID-19, CRYPTO, AND CLIMATE: NAVIGATING CHALLENGING TRANSITION 59, 60 (Oct. 2019), https://www.imf.org/-/media/Files/Publications/GFSR/2021/October/English/ch3.ashx.

70. *See ESG and Corporate Purpose in a Disrupted World*, DELOITTE 3 (July 2020), https://www2.deloitte.com/content/dam/Deloitte/us/Documents/center-for-board-effectiveness/us-deloitte-ESG-corporate-purpose-in-disrupted-world.pdf.

71. *See* Quinn Curtis, Jill Fisch & Adriana Z. Robertson, *Do ESG Mutual Funds Deliver on Their Promises?*, 120 MICH. L. REV. 393, 435–36 (2021); Matteo Tonello, *2022 Proxy Season and Shareholder Voting Trends*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 30, 2022), https://corpgov.law.harvard.edu/2022/03/30/2022-proxy-season-and-shareholder-voting-trends (explaining "institutional investors move[d] faster than ever before to implement their [ESG] views through their voting").

commitments[72] and voiced concerns when corporations remained silent on pressing issues.[73] In other cases, employees have persuaded companies to change their stances on politically controversial subjects.[74]

Progressives' multi-stakeholder approach to ESG advocacy has proven transformative. Today, approximately $38 trillion are invested in ESG funds.[75] Major companies across economic sectors have espoused liberal values on an ever-widening range of issues.[76] As BlackRock Chairman and CEO Larry Fink wrote in his 2022 Letter to CEOs: "The stakeholders your company relies upon . . . need to know where we stand on the societal issues intrinsic to our companies' long-term success."[77] The left's sustained effort to instill progressive values in American companies thus cultivated ESG policies from a marginal curiosity to a business necessity in the years since *Citizens United*.

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72. *See* Sara Savat, *Consumer Values, Brand Expectations Change in 2020*, WASH. U. ST. LOUIS (May 19, 2021) ("Today's consumers are more attuned to brands' values and willing to pay a premium to support companies that share their values, according to new research from the Bauer Leadership Center at Washington University in St. Louis . . . ."); *ESG Metrics Influence Buying Decisions*, PwC (Apr. 2021), https://www.pwc.com/us/en/industries/consumer-markets/library/esg-metrics-influence-buying.html.

73. *See, e.g.*, David Gelles, *Delta and Coca-Cola Reverse Course on Georgia Voting Law, Stating 'Crystal Clear' Opposition*, N.Y. TIMES (Apr. 5, 2021), https://www.nytimes.com/2021/03/31/business/delta-coca-cola-georgia-voting-law.html.

74. *See, e.g.*, Sara Fischer, *Disney Employees Walk out over Response to "Don't Say Gay" Bill*, AXIOS (Mar. 22, 2022), https://www.axios.com/2022/03/22/disney-employees-walkout-dont-say-gay.

75. Adeline Diab & Gina Martin Adams, *ESG Assets May Hit $53 Trillion by 2025, a Third of Global AUM*, BLOOMBERG INTELLIGENCE (Feb. 23, 2021), https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/.

76. Even companies in industries traditionally viewed as hostile to progressive causes have embraced ESG policies. *See, e.g.*, *Advancing a Lower Carbon Future*, CHEVRON (2022), https://www.chevron.com/sustainability; *ESG Portal*, LOCKHEED MARTIN (2022), https://sustainability.lockheedmartin.com/sustainability/esg-portal/index.html; *Moving Beyond Smoking: Reduce the Harm of Tobacco Products*, ALTRIA (2022), https://www.altria.com/moving-beyond-smoking/reduce-the-harm-of-tobacco-products.

77. Larry Fink, *2022 Letter to CEOs: The Power of Capitalism*, BLACKROCK (Jan. 18, 2022), https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.

The success of the ESG movement demonstrates the ascendency of the deliberative conception of corporate values, even among progressives. Consistent with the Roberts Court's characterization of business entities as sites of robust debates on social, moral, and political issues,[78] progressive proponents of ESG policies have pushed corporations to take stands on subjects beyond the narrow ambit of their immediate economic concerns. Moreover, to achieve this end, progressives followed the program proposed by Justice Kennedy—harnessing corporate democracy to generate companies' values.

But the ESG movement's deliberative and intense focus on instilling liberal values in major corporations has resulted in an implementation gap. The discrepancy between businesses' bold stances and lackluster performance on ESG issues is particularly evident in the realm of sustainability, where it is known as greenwashing.[79]

Concerns over greenwashing have grown in recent years, as the public's interest in climate-conscious companies has made sustainable branding more lucrative.[80] Indeed, empirical studies of large firms' environmental policies have identified widespread gaps between the appearance and reality of corporate sustainability pledges.[81]

Under the leadership of Chair Gary Gensler, the Securities and Exchange Commission ("SEC") has made greenwashing and other misleading ESG practices a regulatory and enforcement priority.[82] In addition to proposing rules that would

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78. *See supra* Part I.

79. *See generally* Ellen Pei-Yi Yu, Bac Van Luu & Catherine Huirong Chen, *Greenwashing in Environmental, Social and Governance Disclosures*, 52 RSCH. INT'L BUS. & FIN. 101192 (2020).

80. *See* Beau River, *The Increasing Dangers of Corporate Greenwashing in the Era of Sustainability*, FORBES (Apr. 29, 2021), https://www.forbes.com/sites/beauriver/2021/04/29/the-increasing-dangers-of-corporate-greenwashing-in-the-era-of-sustainability ("One impact of the groundswell towards global sustainability is that the consequences of corporate greenwashing are becoming more dire.").

81. THOMAS DAY ET AL., CORPORATE CLIMATE RESPONSIBILITY MONITOR 5 (2022), https://newclimate.org/sites/default/files/2022/02/CorporateClimateResponsibilityMonitor2022.pdf; Georgina Rannard, *Climate Change: Top Companies Exaggerating Their Progress*, BBC (Feb. 7, 2022), https://www.bbc.com/news/science-environment-60248830.

82. *See* Gary Gensler, *Statement by Chair Gensler on ESG Disclosures Proposal*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 26, 2022), https://

require climate risk disclosures by public companies[83] and greater ESG transparency among investment advisers,[84] the SEC established a Climate and ESG Task Force within the Division of Enforcement dedicated to ESG-related misrepresentations.[85] The Task Force has already brought an enforcement action against BNY Mellon[86] and is reportedly investigating numerous other firms for deceptive ESG commitments.[87] According to the SEC, these expressions of corporate values transgress the limits of the First Amendment and instead constitute fraud.[88]

corpgov.law.harvard.edu/2022/05/26/statement-by-chair-gensler-on-esg-disclosures-proposal/.

83. The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334 (proposed Apr. 11, 2022) (to be codified at 17 C.F.R. pts. 210, 229, 232, 239, 249); *see* Gary Shorter & Rena S. Miller, Cong. Rsch. Serv., IF12108, Overview of the SEC Climate Risk Disclosure Proposed Rule (2022), https://crsreports.congress.gov/product/pdf/IF/IF12108.

84. Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36654 (proposed June 17, 2022) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 249, 274, 279); *see* Katanga Johnson & Ross Kerber, *U.S. SEC Unveils Rules to Ensure ESG Funds Follow Through on Investments*, REUTERS, https://www.reuters.com/markets/us/us-sec-unveil-rule-crackdown-funds-greenwashing-2022-05-25/ (May 27, 2022).

85. *See SEC Announces Enforcement Task Force Focused on Climate and ESG Issues*, U.S. SEC. & EXCH. COMM'N (Mar. 4, 2021), https://www.sec.gov/news/press-release/2021-42.

86. Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations (May 23, 2022), https://www.sec.gov/news/press-release/2022-86 ("BNY Mellon Investment Adviser represented or implied in various statements that all investments in the funds had undergone an ESG quality review, even though that was not always the case.").

87. *See* Lananh Nguyen & Matthew Goldstein, *Goldman Sachs Is Being Investigated over E.S.G. Funds*, N.Y. TIMES (June 12, 2022), https://www.nytimes.com/2022/06/12/business/sec-goldman-sachs-esg-funds.html; Patricia Kowsmann, Corinne Ramey & Dave Michaels, *U.S. Authorities Probing Deutsche Bank's DWS over Sustainability Claims*, WALL ST. J. (Aug. 25, 2021), https://www.wsj.com/articles/u-s-authorities-probing-deutsche-banks-dws-over-sustainability-claims-11629923018; Chris Prentice, *SEC's Texas Office Probes Banks over Disclosures on Guns, Fossil Fuels*, REUTERS (Jan. 5, 2022), https://www.reuters.com/markets/us/exclusive-secs-texas-office-probes-banks-over-disclosures-guns-fossil-fuels-2022-01-05.

88. As a general matter, "[p]unishing fraud, whether it be common law fraud or securities fraud, simply does not violate the First Amendment." SEC v. Pirate Investor LLC, 580 F.3d 233, 255 (4th Cir. 2009).

While embracing the deliberative approach has enabled progressives to instill liberal values in major companies, the increasingly pressing problem of greenwashing and similar misconduct reveals a crack in the ESG movement's theoretical foundation. Stakeholder pressure can lead a company to endorse social and political views in press releases and policies, but to facilely attribute those beliefs to the corporation as a whole is to embrace *Citizens United*'s lulling legal falsehood.[89] Once a company proclaims its commitment to a progressive cause, the deliberative view invites advocates to declare victory and move on. Yet the prevalence of greenwashing shows that faith in the enterprise-wide sincerity of corporate values is often misplaced, since those values can only be realized through the acts of individual corporate agents. Because resistant executives, managers, or employees can thwart concrete action on ESG issues, corporate press releases are never the last word. Thus, despite successes in propagating liberal values through corporate democracy, progressives' deliberative approach to ESG has faltered due to a failure to focus on individual execution.

B. *State Fair Access Laws*

In the past two years, conservatives have responded to the ESG movement's ascendency by enacting "fair access" statutes in numerous states.[90] These laws penalize firms with progressive stances on issues like climate change and firearms by banning those companies from government contracts and requiring public pension funds to divest from their securities.[91]

State fair access regimes' entity-level punishments demonstrate a commitment to the deliberative conception of corporate politics. While a realist would stress the outsize influence of individual managers and directors on businesses' values,[92] state fair access laws—much like ESG policies—attribute social

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89. *See supra* notes 50–51 and accompanying text.

90. *See infra* notes 100–109 and accompanying text; Joshua A. Lichtenstein et al., *Navigating State Regulation of ESG Investment by Investment Managers: A Rapidly Evolving and Contradictory Landscape*, Ropes & Gray (June 30, 2021), https://www.ropesgray.com/en/newsroom/alerts/2021/June/Navigating-State-Regulation-of-ESG-Investments-by-Investment-Managers-A-Rapidly-Evolving.

91. *See, e.g.*, S. B. 205 (Ky. 2022) (enacted).

92. *See supra* note 42 and accompanying text.

and political views to entire corporate enterprises. Accordingly, fair access proponents impose firm-wide costs on businesses, without concern for the consequences for the shareholders, employees, and other stakeholders who oppose their companies' ESG commitments.

Although state fair access laws represent a logical extension of the deliberative theory, their use of state power to stifle the social and political views of corporations violates the Roberts Court's robust First Amendment protections for business entities.[93] Because these statutes cannot withstand judicial scrutiny, they offer conservatives a fleeting yet false sense of achievement in the debate over ESG policies.

Structurally, the earliest antecedents of state fair access laws were the "MacBride" statutes enacted in the 1980s and 1990s, named after a set of religious toleration principles.[94] These laws prohibit state and local agencies from contracting with businesses that operate in Northern Ireland yet fail to certify their commitment to non-discrimination against Catholics.[95] Despite their narrow ambit, MacBride laws provided a key precedent for future applications of state power to shape corporate values.

In late 2020, conservative concern with the proliferation of progressive values among financial institutions prompted the Office of the Comptroller of the Currency ("OCC") to promulgate a rule prohibiting large national banks from refusing to serve customers based on categorical ESG policies.[96] The OCC finalized this fair access rule in the final days of the

93. *See infra* notes 112–121 and accompanying text.

94. *See The Nine MacBride Principles*, IRISH TIMES (Mar. 2, 1996), https://www.irishtimes.com/news/the-nine-macbride-principles-1.32756 ("The 1984 MacBride Principles are nine equal opportunity guidelines for US firms in Northern Ireland. Companies are called on to increase job opportunities for underrepresented religious groups, ban political and religious symbols from the workplace and ensure safe travel for employees.").

95. *E.g.*, MASS. GEN. LAWS ch. 7, § 22C (2022); N.J. STAT. ANN. § 52:34-12.2 (West 2022); *see also* Douglass Cassel, *Corporate Initiatives: A Second Human Rights Revolution?*, 19 FORDHAM INT'L L.J. 1963, 1972 (1996) ("Sixteen states and more than forty cities have enacted MacBride Principles laws.").

96. Fair Access to Financial Services, 85 Fed. Reg. 75261 (Nov. 25, 2020) (to be codified at 12 C.F.R pt. 55).

Trump administration[97] but halted its application just two weeks later following the inauguration of President Biden.[98] With Democratic control of the White House and both chambers of Congress, conservatives sought a new arsenal to combat the ESG movement—state law.

Drawing heavily on MacBride statutes,[99] legislators in Texas passed a bill that revolutionized efforts to push back on ESG policies and inspired similar laws in other states.[100] Texas's fair access regime requires contracts worth at least $100,000 between governmental entities and companies with ten or more employees to include a certification that the contractor "does not have a practice, policy, guidance, or directive that discriminates against a firearm entity or firearm trade association."[101] Refusing to deal with a customer "based solely on its status as a . . . firearm trade association" constitutes discrimination under the statute.[102]

Whereas the OCC's short-lived fair access rule applied only to large national banks, Texas's statute is significantly further reaching. To serve state and local agencies, businesses in *any* sector must eschew impermissible ESG policies on firearms, if minimal employee and contract-value requirements are met. Underwriters for Texas's multibillion-dollar municipal bond market[103] therefore fall within the law's ambit, a fact

97. Press Release, Off. of the Comptroller of the Currency, OCC Finalizes Rule Requiring Large Banks to Provide Fair Access to Bank Services (Jan. 14, 2021), https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-8.html.

98. Press Release, Off. of the Comptroller of the Currency, OCC Puts Hold on Fair Access Rule (Jan. 28, 2021), https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-14.html.

99. *See* David H. Webber, *It's Time for ESG to Fight Back*, BARRON'S (Nov. 11, 2022), https://www.barrons.com/articles/esg-investing-blackrock-profits-51668185876 (stressing the similarities between Texas's anti-ESG legislation and "the MacBride Principles countering anti-Catholic discrimination in the struggle over Northern Ireland").

100. *See* Maxine Joselow & Vanessa Montalbano, *Bills in Red States Punish Climate Conscious Businesses*, WASH. POST (June 1, 2022), https://www.washingtonpost.com/politics/2022/06/01/bills-red-states-punish-climate-conscious-businesses/ ("Like many conservative causes, the trend [of anti-ESG legislation] started in Texas . . . .").

101. TEX. GOV'T CODE ANN. § 2274.002 (West 2022).

102. TEX. GOV'T CODE ANN. § 2274.001(3)(A) (West 2022).

103. *See* Richard Williamson, *Texas Expects 56% Increase in Debt Issuance in 2022*, BOND BUYER (Dec. 27, 2021, 10:11 AM), https://www.bondbuyer.com/

that forced many ESG-conscious investment firms to reevaluate their operations in the state.[104]

Texas's firearm fair access rule quickly proved influential among conservative legislators. After Texas passed a similar law disqualifying companies with certain fossil-fuel ESG stances from state and local contracts,[105] Kentucky,[106] Oklahoma,[107] Tennessee,[108] and West Virginia[109] enacted fair access statutes of their own that mirrored the Texas regime.

Much like the ESG policies these statutes seek to suppress, state fair access laws exhibit a fundamental commitment to the deliberative conception of corporate values. First, by penalizing disfavored ESG policies at the entity level, these laws attribute progressive values directly to firms, instead of focusing on the individual executives and directors who shape companies' ESG commitments.[110] State fair access regimes also disregard the interests of dissenting shareholders and employees, reflecting a conception of firms as socio-political ventures to which stakeholders lend their tacit support. Finally, state fair access laws exhibit a profound skepticism towards the notion that economic self-interest is the ultimate and unyielding aim of for-profit enterprises.[111] The asserted need for governmental checks on values-driven decisions by companies presupposes that business decisions are often ethically and politically motivated. For proponents of fair access laws, because corporations are sites of moral deliberation, state intervention is not a mis-

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news/texas-expects-56-increase-in-debt-issuance-in-2022 ("Texas agencies expect to issue about $8.05 billion in bonds, commercial paper and notes in fiscal year 2022 . . . .").

104. *See* Danielle Moran & Amanda Albright, *Texas Forces Companies to Be Neutral on Guns, or Lose Business*, BLOOMBERG (May 25, 2022, 4:28 PM), https://www.bloomberg.com/news/articles/2022-05-25/texas-forces-companies-to-be-neutral-on-guns-or-lose-business; Dan Primack, *Texas Targets Private Equity with Gun "Anti-Discrimination" Law*, AXIOS (June 2, 2022), https://www.axios.com/2022/06/02/texas-targets-private-equity-with-gun-anti-discrimination-law.

105. TEX. GOV'T CODE ANN. § 2274.002 (West 2022).

106. S.B. 205, 2022 Reg. Sess. (Ky. 2022).

107. H.B. 2034, 2022 Leg., 58th Sess. (Okla. 2022).

108. S.B. 2649, 112th Gen. Assemb., Reg. Sess. (Tenn. 2022).

109. S.B. 262, 2022 Reg. Sess. (W. Va. 2022).

110. *See supra* notes 50–51 and accompanying text.

111. For the contrary realist view, see *supra* notes 36–38 and accompanying text.

placed engrafting of politics onto business, but rather a congruent solution to the problematic rise of ESG policies.

While Texas's firearm fair access law and its imitators embody the deliberative theory of corporate values that animated *Citizens United*, these statutes nevertheless violate the letter of the Roberts Court's First Amendment jurisprudence. Three years after *Citizens United*, the Roberts Court continued its expansion of corporate free speech rights in *Agency for International Development v. Alliance for Open Society International, Inc.*[112] That case concerned a program Congress created to combat HIV/AIDS by funding nongovernmental organizations around the globe.[113] However, Congress stipulated that any organization without "a policy explicitly opposing prostitution and sex trafficking" was ineligible for funding.[114] To administer this condition, the Department of Health and Human Services and U.S. Agency for International Development required participating organizations to certify their opposition to prostitution and sex trafficking.[115]

Several domestic nonprofit corporations sued, arguing the mandatory certification violated their free speech right to hold contrary values under the First Amendment.[116] Writing for the Court's majority, Chief Justice Roberts agreed. He explained that the certification requirement constituted an "unconstitutional condition" on plaintiffs' free speech rights because it went beyond merely "defin[ing] the limits of the government spending program" and instead sought "to leverage funding to regulate speech outside the contours of the program itself."[117] The Court held that in doing so, Congress had interfered in the corporations' deliberative function and transgressed a boundary protected by the First Amendment.[118]

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112. Agency for Int'l Dev. v. Alliance for Open Soc'y Int'l, Inc., 570 U.S. 205 (2013).
113. *Id.* at 208.
114. *Id.* at 210 (quoting 22 U.S.C. § 7631(f) (2012)).
115. *Id.* (quoting 45 C.F.R. § 89.1(b) (2012)).
116. *Id.* at 212.
117. *Id.* at 214–16.
118. *See id.* at 220–21 ("If there is any fixed star in our constitutional constellation, it is that no official, high or petty, can prescribe what shall be orthodox in politics, nationalism, religion, or other matters of opinion or force citizens to confess by word or act their faith therein." (quoting Bd. of Educ. v. Barnette, 319 U.S. 624, 642 (1943)).

Texas's firearm fair access statute and the numerous state laws that share its structure have the same constitutional infirmities as the certification requirement at issue in *Agency for International Development*. The Texas legislature has disqualified firms with disfavored stances on firearm commerce from participating in state and local spending programs.[119] To administer this ban, government agencies must acquire "written verification[s]" from contracting firms that they do not have impermissible ESG policies.[120] And even more plainly than the HIV initiative in *Agency for International Development*, the firearm fair access law's certification provision seeks to leverage funding from every state and local procurement program to promote a preference for firearms, without regard to the purpose of the specific expenditure. Requiring domestic corporations to attest that they do not "discriminate against a firearm entity" in order to provide underwriting services to counties or pencils to public schools constitutes an unconstitutional condition under the First Amendment. Thus, under the Roberts Court's corporate free speech jurisprudence, these state fair access laws "cannot be sustained."[121]

By adopting the same deliberative conception of corporate politics that underlies the ESG movement yet marshaling the coercive power of state governments to override those deliberations, conservative proponents of fair access laws have erred. Corporations with progressive ESG policies have indeed reconsidered their operations in states with fair access regimes,[122] but these short-term developments belie the unconstitutionality of anti-ESG certification requirements unrelated to the state and local contracts in which they appear. Attempting to punish corporations at the entity level for their commitments to progressive values represents a logical extension of Justice Kennedy's invitation in *Citizens United* to view business entities as social and moral ventures; however, precisely because the Supreme Court has championed the political function of corporations, the legal strategy employed by propo-

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119. *See* TEX. GOV'T CODE ANN. § 2274.002(b) (West 2022).
120. *Id.*
121. *Agency for Int'l Dev.*, 570 U.S. at 221.
122. *See, e.g.*, Lydia Beyoud & Nushin Huq, *Texas Puts Banks in Tight Spot with New Law Backing Gunmakers*, BLOOMBERG L. (Sept. 1, 2021), https://news.bloomberglaw.com/banking-law/texas-puts-banks-in-tight-spot-with-new-law-backing-gunmakers.

nents of fair access laws is a constitutional dead end. The growing state fair access movement is therefore an unfruitful path for conservative opponents of ESG policies, who remain ensnared in an understanding of corporations that precludes the very means of controlling corporate values that fair access proponents believe the deliberative theory demands.

III.
Returning to Realism

The deliberative conception of corporate politics has served as a cornerstone for progressives and conservatives alike in contemporary debates over ESG commitments. Yet looming threats from greenwashing[123] and free speech doctrine[124] demonstrate the deliberative theory's fatal flaw: in treating the corporation as an ideal *tabula rasa* for social discourse, it overlooks the essential role of concentrated power in the corporate form. The separation of ownership and control necessarily empowers the directors and executives who manage corporate operations,[125] at the expense of dispersed shareholders who lack the incentives to monitor and intervene in companies' daily affairs.[126] Officers and directors therefore enjoy an outsize voice in corporate democracy, skewing deliberations towards their interests.

By reviving the realist conception of corporate values articulated in *Austin*, both ends of the political spectrum can reorient their strategies to focus on the personnel who dominate business decisions. This Part explains how doing so illuminates several concrete solutions to the aforementioned issues progressives and conservatives currently face.

A. *ESG for Individuals*

In light of the ESG movement, major corporations have issued bold espousals of progressive values, but many of these corporations have failed to deliver tangible results that match their promises.[127] This inconsistency demonstrates the deliber-

123. *See supra* Section II.A.
124. *See supra* Section II.B.
125. *See generally* Berle & Means, *supra* note 44 (offering a canonical account of the separation of ownership and control in corporations).
126. *See* Easterbrook & Fischel, *supra* note 11, at 67.
127. *See supra* Section II.A.

ative theory's overemphasis on corporate values and underemphasis on the individuals responsible for implementing them. Moreover, the preoccupation with corporations' social and moral functions has blinded progressives to the reality that officers and directors have the incentives to sacrifice ESG priorities in favor of the financial bottom line, as illustrated by the prevalence of greenwashing and similar misconduct.[128] ESG proponents should therefore revitalize their efforts by embracing the following individual-focused reforms.

First, ESG policies should consistently combine expressions of corporate values with concrete, incentive-shaping measures. For example, tying a portion of executive compensation to ESG performance would help align managerial focus with corporate commitments.[129] Likewise, to ensure reluctant employees are not undermining values-driven initiatives, internal audit and compliance functions should develop metrics to monitor progress on ESG goals across corporate departments.[130] Integrating ESG factors into routine job performance evaluations would further strengthen implementation down the corporate ladder.

In addition to adopting traditional methods for crafting incentives, a realist ESG movement should leverage behavioral insights into how individual executives, directors, and employees actualize corporate values and policies.[131] Notably, when a corporation adopts a progressive stance on an issue, confirmation bias will influence the firm's leadership to pay greater at-

128. *See supra* notes 79–81 and accompanying text.

129. *Cf.* Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSPS. 71, 82–83 (2003) (advocating for performance-based compensation to reduce agency costs among corporate executives). For a recent empirical analysis of how say-on-pay regimes for executive compensation impact ESG outcomes, see Mary Ellen Carter, Andrea Pawliczek & Rong Zhong, Say on ESG: The Adoption of Say-on-Pay Laws and Firm ESG Performance (Oct. 17, 2022) (unpublished manuscript), https://ssrn.com/abstract=4125441.

130. To date, the ESG movement has primarily developed metrics for external investors, rather than internal monitoring. *See, e.g.*, Daniel C. Esty, *Creating Investment-Grade Corporate Sustainability Metrics*, *in* VALUES AT WORK: SUSTAINABLE INVESTING AND ESG REPORTING 51 (Daniel C. Esty & Todd Cort eds., 2020).

131. For a seminal article on the salience of cognitive insights for law and economics, see Cass R. Sunstein, Christine Jolls & Richard H. Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998).

tention to data supporting the corporation's commitment to that position, instead of any information suggesting the business has fallen short on that stance.[132] Training leadership on this form of confirmation bias may reduce its distorting effects.[133] Cognitive insights also reinforce traditional strategies. Because self-serving bias leads individuals to overestimate their positive contributions and overlook failures,[134] officers, directors, and employees likely have undue confidence in their execution of ESG policies. Having internal audit and compliance functions, or even third-party auditors offer independent assessments of individuals' ESG progress would help offset self-serving bias.[135]

Finally, in keeping with the realist view, the SEC and other law enforcement agencies should prioritize individual liability over entity-level penalties when combatting greenwashing and other ESG-related misconduct. Punishing specific officers, directors, and employees who engage in wrongdoing not only provides a significant incentive to maintain honest

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132. *Cf.* Daniel F. Stone & Daniel H. Wood, *Cognitive Dissonance, Motivated Reasoning, and Confirmation Bias: Applications in Industrial Organization*, *in* HANDBOOK OF BEHAVIORAL INDUSTRIAL ORGANIZATION 114, 115 (Victor J. Tremblay et al. eds., 2018) (exploring confirmation bias in firms).

133. *See* Anne Laure Sellier, Irene Scopelliti & Carey K. Morewedge, *Debiasing Training Improves Decision Making in the Field*, 30 PSYCH. SCI. 1371, 1372 (2019) (discussing "warning about bias" as a debiasing technique).

134. *See* Bruce Blaine & Jennifer Crocker, *Self-Esteem and Self-Serving Biases in Reactions to Positive and Negative Events: An Integrative Review*, *in* SELF ESTEEM 55, 55 (Roy F. Baumeister, ed., 1993) ("The self-serving bias refers to the tendency of people to interpret and explain outcomes in ways that have favorable implications for the self.").

135. *See* Linda Babcock & George Loewenstein, *Explaining Bargaining Impasse: The Role of Self-Serving Biases*, 11 J. ECON. PERSP. 109, 115 (1997) (describing "research in psychology showing that biases are diminished when subjects question their own judgment").

and transparent ESG policies,[136] but also avoids inflicting costs on innocent stakeholders.[137]

B. *A Conservative Case for Corporate Law Reform*

Driven by the deliberative account of corporate politics, conservatives have enacted state fair access laws that impose entity-level penalties on firms with progressive stances on contentious social issues. But the deliberative view's attribution of corporate values to entire business ventures elides the intra-firm relations that actually produce ESG policies. Resurrecting the realist theory of *Austin* would enable conservatives to recognize the disproportionate influence of elite executives, directors, and asset managers on businesses' ESG commitments. Because the Roberts Court's First Amendment precedents effectively preclude the use of state power to curb the proliferation of progressive values among firms,[138] any check on left-leaning corporate leadership must come from private parties, absent a change in U.S. constitutional law. Accordingly, conservatives should consider how reforms to corporate law could empower less-elite stakeholders, who may not share executives' progressive views,[139] to exert greater influence over companies' values and ESG stances.

136. Under the Biden administration, individual liability has increasingly become a central tenet in the Department of Justice's strategy for combatting corporate misconduct. *See, e.g.*, *Deputy Attorney General Lisa O. Monaco Gives Keynote Address at ABA's 36th National Institute on White Collar Crime*, U.S. DEP'T OF JUST. (Oct. 28, 2021) ("Accountability starts with the individuals responsible for criminal conduct. Attorney General Garland has made clear it is unambiguously this department's first priority in corporate criminal matters to prosecute the individuals who commit and profit from corporate malfeasance.").

137. *See, e.g.*, John C. Coffee, Jr., *"No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 401 (1981) (explaining how "stockholders bear the penalty in the reduced value of their securities"). This concern for the welfare of dispersed shareholders, uninvolved in day-to-day corporate operations, parallels Justice Brennan's concurrence in *Austin*. *See supra* notes 42–44 and accompanying text.

138. *See supra* notes 112–21 and accompanying text.

139. *Cf., e.g.*, Nate Cohn, *Poll Shows Tight Race for Control of Congress as Class Divide Widens*, N.Y. TIMES (July 13, 2022), https://www.nytimes.com/2022/07/13/upshot/poll-2022-midterms-congress.html (finding strong Democratic support among college-educated voters and Republican support among voters without a four-year degree).

To enhance the power of investors who disagree with ESG policies that purport to speak for entire firms, conservatives should bolster shareholders' voice and exit rights.[140] Through state or federal legislation, conservatives could require shareholder votes to approve ESG policies, much like the say-on-pay requirement for executive compensation under the Dodd-Frank Act.[141] However, asset managers like BlackRock vote a large proportion of the shares at many companies,[142] so conservatives may want to strengthen shareholders' exit rights as well. For public companies, dissenting shareholders can simply sell their shares if they disagree with a companies' values.[143] But doing so is far more difficult for shareholders in private companies that lack thick equity markets.[144] While state corporate codes provide a statutory right of appraisal for dissenting shareholders in mergers and acquisitions,[145] conservatives could extend a similar right to private-company shareholders who disagree with a company's adoption of ESG policies.

Employees are another less-elite cohort that could serve as a counterweight to progressive corporate leadership. Conservatives could therefore amend state law to require employee

140. *See generally* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: REPONSES TO DECLINE IN FIRMS ORGANIZATIONS AND STATES 21–44 (1970) (describing voice and exit rights).

141. 15 U.S.C. § 78n–1(a) (2020).

142. *See* Eric Rosenbaum, *A New BlackRock Shareholder Power That May Tilt Proxy Battles of the Future*, CNBC (Mar. 1, 2022), https://www.cnbc.com/2022/03/01/a-blackrock-shareholder-vote-that-may-control-future-proxy-battles.html ("On average, over 15% of outstanding shares in corporations are held by the top four or five asset managers including BlackRock, Vanguard and State Street Global Advisors, according to data from Broadridge Financial Solutions. For some publicly traded companies, the top three fund companies can hold as much as one-third of investor shares.").

143. Accordingly, most states deny appraisal rights to dissenting investors in public companies. *See* Gil Matthews, *The "Market Exception" in Appraisal Statutes*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 30, 2020), https://corpgov.law.harvard.edu/2020/03/30/the-market-exception-in-appraisal-statues/ ("38 states now restrict the appraisal rights of shareholders of public companies through a provision in their appraisal statutes called a 'market exception' . . . . [T]hese statutes deny shareholders of publicly traded companies the right to the court-awarded assessment to which similarly-situated private company shareholders are entitled.").

144. *See id.* (noting "courts need to assess fair value for private company shareholders because no established market price for private company shares exists").

145. *E.g.*, DEL. CODE ANN., tit. 8, § 262(a) (2022).

representation in corporate governance, as is the case in numerous European jurisdictions.[146] Limiting employee participation to questions of ESG policies and corporate values would ensure that this reform is narrowly tailored to conservatives' concerns.

As a more radical measure, conservatives could reconsider the permissive approach to corporate purpose that has dominated modern business law. The dormant doctrine of *ultra vires*, by which shareholders enjoin actions outside the express purpose in a company's charter,[147] would provide a potent mechanism for limiting firms' abilities to act on social values beyond their profit-seeking function. Requiring more specific statements of purpose—in contrast to the "any permissible purpose" boilerplate that dominates such statements today[148]—would allow conservatives to draw on a well-developed body of nineteenth century precedents. While the consequences and costs associated with reversing such a foundational principle of business law would make this strategy unappealing to many,[149] a restrictive approach to corporate purpose likely represents conservatives' most formidable means of limiting ESG policies within the bounds of current First Amendment jurisprudence.

Although restructuring relationships among stakeholders within firms offers a compelling means of checking the influence of elite corporate leadership on businesses' values, reforms to governance processes cannot guarantee particular outcomes in debates over ESG issues. Thus, for conservatives committed to public oversight of the ESG movement through state coercion, overturning the Roberts Court's expansive corporate First Amendment precedents—whether through subse-

146. *See* Grant M. Hayden & Matthew T. Bodie, *Codetermination in Theory and Practice*, 73 FLA. L. REV. 321, 324 (2021) (discussing worker participation in corporate governance in several European countries).

147. *See* Kent Greenfield, *Ultra Vires Lives! A Stakeholder Analysis of Corporate Illegality (with Notes on How Corporate Law Could Reinforce International Law Norms)*, 87 VA. L. REV. 1279, 1307–08 (2001).

148. *See* David G. Yosifon, *The Law of Corporate Purpose*, 10 BERKELEY BUS. L.J. 181, 185 (2014) (describing this phenomenon).

149. *See* Greenfield, *supra* note 147, at 1310–11 (describing the history of strategic uses of the *ultra vires* doctrine to avoid contracts, creating hold-up costs); Benjamin T. Seymour, *Corporate Purpose and the Separation of Powers*, 36 B.Y.U. J. PUB. L. 113, 142–44 (2022).

quent Supreme Court decisions or a constitutional amendment—may represent the best path forward.

Conclusion

This Article traces a tension inherent in *Citizens United*'s deliberative conception of corporate politics, both as a matter of social dynamics and legal doctrine. The Roberts Court's majority opinion invited the public to understand corporations as political actors; however, the decision offered an unrealistically optimistic view of how business enterprises internalize social and ethical convictions. Moreover, the Court's corresponding solicitude for corporations' free speech rights effectively precluded exercises of state power to shape companies' values. As progressives and conservatives alike have embraced the deliberative view, these latent issues have blossomed into growing frustration with firms' stances and actions on ESG issues. Amid this rising tide of discontent, both ends of the political spectrum have only grown more entrenched, demanding further social and moral commitments from businesses.

Returning to the realist view of *Austin* could help break the chain of ever-greater politicization of corporate legal fictions by enabling progressives and conservatives to recognize that business entities are not themselves political; rather their individual stakeholders are. A less abstract approach illuminates several solutions to the deliberative conception's shortcomings, which currently beset both sides of the debate over ESG policies. Accepting the realist tenet that individuals are the ultimate units of corporate politics should spur not only a more efficacious pursuit of liberals and conservatives' current goals, but also greater reflection on what those ends are, and whether business enterprises are the best vehicles for attaining them.

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THE LAW OF INSIDER TRADING: LEGAL THEORIES, COMMON DEFENSES, AND BEST PRACTICES FOR ENSURING COMPLIANCE

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INTRODUCTION

Developments in insider trading case law and novel criminal prosecutions and SEC enforcement have prompted new questions about the extent of the government's authority to bring insider trading charges and have prompted doubts among market participants about whether their conduct is permissible. For example, the Supreme Court has resolved circuit splits regarding key elements of insider trading and the remedies available to the SEC. Additionally, an SEC enforcement action charged an individual with insider trading on a new theory of "shadow trading" and raised questions about the breadth of the breach-of-duty element of insider trading liability. Further, investment firms' new approaches to gathering data also have prompted both enforcement actions and regulatory guidance addressing permissible methods of information gathering and questions regarding whether information has entered the public domain.

Investment firms and public companies should be attuned to these developments and tailor their policies, procedures, controls, and codes of ethics to the risks relevant to their firms. As a first line of defense, firms should ensure that robust and comprehensive compliance programs are in place to reduce the risk of potential insider trading. Regardless of the quality of any firm's compliance procedures, however, institutional investors, financial services personnel, and corporate executives may be suspected of, or even face criminal and civil charges for, insider trading. To assist firms and individuals in considering and weighing possible defenses against actions brought by the Department of Justice ("DOJ") or the Securities and Exchange Commission ("SEC"), this Article proceeds as follows: Part I provides the background on insider trading; Part II summarizes the law regarding insider trading; Part III discusses some of the general legal and factual defenses that may be raised to charges of insider trading, depending on the facts and circumstances of the case; and finally, Part IV provides guidelines for establishing and maintaining an effective compliance program to minimize the risks of insider trading liability.

Any firm or individual that becomes the subject of an insider trading investigation should recognize that the law of insider trading is nuanced and highly dependent upon the facts and circumstances of a particular case. This Article analyzes the current law of insider trading and describes some of the key defenses that may be raised in consultation with counsel.

I.
Legal Overview

A. *Background on Insider Trading*

There is no federal statute that explicitly prohibits insider trading. Instead, the prohibitions against insider trading have developed through a series of Supreme Court cases applying the general anti-fraud provisions of the Securities Exchange Act of 1934 ("Exchange Act") to fact-intensive allegations of illicit trading.

In general terms, the law established through these cases prohibits trading a security on the basis of material nonpublic information, where the trader has breached a duty of trust or confidence owed to either an issuer, the issuer's shareholders, or the source of the information, and where the trader is aware of the breach.[1] Implicit in its name, the law of insider *trading* prohibits actual *trading* in a security while in possession of material nonpublic information; the law does not prohibit refraining from trading while in possession of such information.[2]

The *sine qua non* of any insider trading claim is material nonpublic information. As a general matter, information that is "public" cannot form the basis of an insider trading claim. This tenet encompasses not only publicly distributed information, but also information that an investor personally devel-

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1. *See* 17 C.F.R. §§ 240.10b5-1, 240.10b5-2 (2023). If trading relates to a planned or existing tender offer, Rule 14e-3 makes trading unlawful without regard to whether any fiduciary duty exists. *See* 17 C.F.R. § 240.14e-3 (2023).

2. *Cf.* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (holding only purchasers and sellers of securities have standing to sue for damages under 10b-5).

oped from independent observation of the public world. For example, watching trucks from a public road as they leave a warehouse (to help ascertain the level of demand for a product) cannot form the basis of an insider trading claim. Likewise, to adequately state a cause of action for insider trading, the information at issue must be "material." The Supreme Court has said that information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision.[3] This standard requires a showing that there is a substantial likelihood that the fact "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[4] One federal circuit court has added an additional gloss to this materiality standard by analyzing whether the information would have been material to reasonable investors *within the particular market* in which the trading occurred.[5]

The materiality of certain information often becomes a central question in insider trading cases involving an institutional investor. In general, an investor that assembles multiple pieces of *non-material* information to reach a material conclusion has not violated insider trading laws, regardless of whether the information obtained was nonpublic.[6] Indeed, institutional investors, such as hedge funds, often piece together bits of public and nonpublic, *non-material* information to understand the broader position of a particular company. This practice commonly is referred to as the "mosaic" theory of investing, and it can serve as the basis of a defense to insider trading charges, particularly where the SEC asserts that an investor, who may have inadvertently obtained information from

3. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (articulating materiality standard in shareholder voting context); Basic, Inc. v. Levinson, 485 U.S. 224, 231–32 (1988) (expressly adopting the standard of materiality from *TSC Indus.*, 426 U.S. 438, for the context of Rule 10b-5).

4. *TSC Indus.*, 426 U.S. at 449.

5. *See* United States v. Litvak, 889 F.3d 56, 65 (2d Cir. 2018).

6. To be sure, if all the non-material information was obtained through improper means (i.e., with knowledge of the breach of a duty to the source of the information), a court may view the information in the aggregate as a "material" whole and thus hold that the conduct constitutes insider trading, assuming all of the other elements are met. This possibility may be especially likely if all of the improperly obtained non-material nonpublic information derives from a single source.

a tipper who breached his fiduciary duty, traded on that information.[7]

B. *Liability for a Company or Fund Based on Conduct of Employees*

Although the law of insider trading is focused on the actions of individuals, a company or fund may face criminal and civil liability if management explicitly or implicitly consents to an individual's conduct such that the acts of the wrongdoer-employee are deemed to have occurred within the scope of employment.[8] For example, under Section 21A of the Exchange Act, a company or fund that employs a tipper (i.e., an employee who shares information with someone outside the firm) or tippee (i.e., an employee who receives the material nonpublic information and then trades) may itself be liable for a civil penalty of up to the greater of either three times the direct profits of the trade or $1,000,000.[9]

The company or fund also may be required to disgorge ill-gotten gains obtained through illegal insider trading, although the Supreme Court's decision in *Liu v. SEC* curtailed the SEC's historically broad disgorgement remedy. In *Liu*, the Supreme Court explained the limits of the SEC's disgorgement power. Addressing issues left unresolved by the Court's earlier deci-

7. *See, e.g.*, State Teachers Ret. Bd. v. Fluor Corp., 654 F.2d 843, 854 (2d Cir. 1981) (citing Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980)); *see also* Andrew Ross Sorkin, *Just Tidbits, or Material Facts for Insider Trading*, N.Y. TIMES (Nov. 29, 2010, 8:56 PM), https://archive.nytimes.com/dealbook.nytimes.com/2010/11/29/just-tidbits-or-material-facts-for-insider-trading/?ref=business (discussing mosaic theory as a defense employed by Raj Rajaratnam, founder of the Galleon Group).

8. *See, e.g.*, SEC v. Mgmt. Dynamics, Inc., 515 F.2d 801, 812–13 (2d Cir. 1975) (holding stock brokerage firm civilly liable for its employees' insider trading on grounds that it placed the traders in a position to engage in insider trading); *see also* RESTATEMENT (SECOND) OF AGENCY § 219(1) (AM. L. INST. 1958) ("A master is subject to liability for the torts of his servants committed while acting in the scope of their employment."). For purposes of vicarious tort liability, however, most courts have taken the view that insider trading is not within the scope of employment. *See, e.g.*, Energy Factors, Inc. v. Nuevo Energy Co., No. 91-CV-4273, 1992 U.S. Dist. LEXIS 10208, at *18 (S.D.N.Y. July 7, 1992) (holding that an employee who trades on or tips material, nonpublic information "must normally be viewed as on a frolic of his own" (quoting O'Connor & Assoc. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179, 1194 (S.D.N.Y. 1981))).

9. Securities Exchange Act of 1934 § 21A, 15 U.S.C. § 78u-1(a)(3).

sion in *Kokesh v. SEC*,[10] the Court in *Liu* held that disgorgement is lawful under §78u(d)(5) where such relief "does not exceed a wrongdoer's net profits and is awarded for victims."[11] Before *Liu*, the SEC routinely transferred to the Treasury Department any disgorgement award it obtained in an insider trading case. But *Liu*'s requirement that the disgorgement be "awarded for victims" casts doubt on this practice because courts and the SEC often find it difficult to identify the victims of insider trading. Moreover, insider trading, especially in equities, often is characterized as "victimless" because the illicit trades may have taken place regardless of whether the insider was present in the market.[12]

After *Liu*, Congress amended 15 U.S.C. § 78u—the statute authorizing disgorgement for securities law violations—as part of the National Defense Authorization Act of 2021.[13] The amendment could make it easier for the SEC to obtain disgorgement in insider trading cases, because it added a provision that does not require disgorgement to be "for the benefit of investors."[14] Since the amendment became law, the SEC has argued that the amendment gives courts "greater flexibility to determine where collected disgorgement funds may be distributed."[15] At least one district court has agreed with the SEC and held that "it may order disgorgement and direct that disgorged funds be sent to the Treasury under Section 78u(d)(7)."[16]

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10. Kokesh v. SEC, 581 U.S. 445 (2017).

11. Liu v. SEC, 140 S. Ct. 1936, 1940 (2020).

12. *See, e.g.*, Thomas C. Newkirk, Assoc. Dir., Div. Enf't, Sec. & Exch. Comm'n & Melissa A. Robertson, Senior Couns., Div. Enf't, Sec. & Exch. Comm'n, Speech by SEC Staff: Insider Trading – A U.S. Perspective (Sept. 19, 1998), https://www.sec.gov/news/speech/speecharchive/1998/spch221.htm. In this speech, senior SEC personnel acknowledged that "[w]ith respect to equities trading, it may well be true that public shareholders' transactions would have taken place whether or not an insider was unlawfully in the market." *Id.*

13. *See* The William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021, Pub. L. No. 116-283, § 6501, 134 Stat. 3388, 4625-26 (2021) (amending 15 U.S.C. § 78u).

14. *Compare* 15 U.S.C. § 78u(d)(5), *with* 15 U.S.C. § 78u(d)(7).

15. SEC v. Spartan Sec. Grp., Ltd, No. 8:19-CV-448-VMC-CPT, 2022 WL 3224008, at *9 (M.D. Fla. Aug. 10, 2022).

16. *Id.* In the alternative, the court held that the balance of the equities favored disgorgement to the Treasury: "Between the money staying with [the defendant], a key player in a [securities fraud scheme], or a fund at the

Despite the difficulties *Liu* theoretically may pose to the SEC's ability to obtain disgorgement in insider trading cases, the practical effect may be limited. Given the SEC's ability to seek penalties and courts' "wide discretion" in devising civil penalties[17] against firms and individuals for securities law violations, the SEC may elect to forego disgorgement in favor of seeking higher penalties.

An employer's liability may be established if it "knew or recklessly disregarded the fact that such [employee] was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred."[18] The employer-firm also may be liable if it "knowingly or recklessly failed to establish, maintain, or enforce any policy or procedure required under Section 15(f) [for registered broker-dealers] or Section 204 of the Investment Advisers Act of 1940 [for registered investment advisers]," and the failure is found to have substantially contributed to, or permitted the occurrence of, the act or acts constituting the violation.[19] Section 204A of the Investment Advisers Act of 1940 requires that registered investment advisers adopt a policy governing the use of material nonpublic information.[20] The SEC has brought enforcement actions against firms that failed to have reasonable policies and procedures to comply with this rule.[21] Further, the SEC's Division of Examinations (formerly known as the Office of Compliance Inspections and Examinations) also has scrutinized firms that lack appropriate

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Treasury, it is more equitable to order disgorgement." *Id.* at *10. The court cited several other district courts that had taken a similar approach post-*Liu*. *Id.*

17. SEC v. de Maison, No. 18-2564, 2021 U.S. App. LEXIS 37183, at *7 (2d Cir. Dec. 16, 2021) (summary order).

18. Securities Exchange Act of 1934 § 21A, 15 U.S.C. § 78u-1(b)(1)(A).

19. H.R. Rep. No. 100-910 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6062. The legislative history of the liability penalty provision of Section 21A(b)(1) of the Securities Exchange Act of 1934 (codified at 15 U.S.C. § 78u-1(b)(1)) implies that a firm's failure to adopt prophylactic policies and procedures may result in the firm being deemed reckless and therefore liable for the conduct of employees. *Id.* at 6062; 6073.

20. 15 U.S.C. § 80b-4a.

21. *See* MIO Partners, Inc., Investment Advisers Act Release No. 5912, at 2 (Nov. 19, 2021); Cannell Capital, LLC, Investment Advisers Act Release No. 5541, at 2 (Feb. 4. 2020).

policies, tailored to the firm's own risk profile, concerning material nonpublic information.[22]

In some instances, the SEC has charged financial firms with violating the anti-fraud provisions of Section 17(a) of the Securities Act of 1933 ("Securities Act") and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder related to employee conduct. For example, in a settled enforcement action, the SEC obtained a $10.9 million fine against Barclays Bank PLC to resolve allegations that an employee traded on the basis of material nonpublic information the employee received from serving as a representative of Barclays on credit committees.[23] The SEC alleged that Barclays' compliance department "failed to . . . enforce policies and procedures to prevent [the employee] from trading [restricted] securities on the basis of material nonpublic information."[24]

C. *Theories of Insider Trading*

The crux of criminal and civil insider trading law derives from Section 10(b) of the Exchange Act — although criminal authorities often utilize additional laws to prosecute insider trading such as those addressing conspiracy and aiding and abetting. According to case law, insider trading violates Section 10(b), which makes it unlawful to "use or employ, in connection with the purchase or sale of any security. . . any manipulative or deceptive device or contrivance in contravention of" rules promulgated by the SEC.[25] Rule 10b-5 under the Exchange Act, adopted pursuant to the SEC's authority under Section 10(b), makes it unlawful to "engage in any act, practice, or course of business which operates or would operate as

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22. *See* U.S. SEC. & EXCH. COMM'N, INVESTMENT ADVISER MNPI COMPLIANCE ISSUES, U.S. SEC. & EXCH. COMM'N (2022), https://www.sec.gov/files/code-ethics-risk-alert.pdf [hereinafter "SEC RISK ALERT"]. The Risk Alert indicated that the SEC's Division of Exams had observed investment advisers who "did not appear to adopt or implement reasonably designed written policies and procedures to address the potential risk" of certain practices.

23. *See* Litig. Release, SEC, Barclays Bank Pays $10.9 Million to Settle Charges of Insider Trading on Bankruptcy Creditor Committee Information, (May 30, 2007), https://www.sec.gov/litigation/litreleases/2007/lr20132.html.

24. *See* Complaint at 5, SEC v. Barclays Bank PLC, 07 CV 4427 (S.D.N.Y. 2007), https://www.sec.gov/litigation/complaints/2007/comp20132.pdf.

25. 15 U.S.C. § 78j(b).

a fraud or deceit upon any person, in connection with the purchase or sale of any security."[26]

Based upon these provisions, the Supreme Court has long recognized three general theories of insider trading liability, commonly referred to as: (1) the "classical" theory, (2) the "tipper-tippee" theory, and (3) the "misappropriation" theory. Importantly, to fit within any of these three categories, a person (although not necessarily the person actually trading) must have violated a duty of trust or confidence.

In addition to the aforementioned established theories of insider trading, other theories are gaining ground. The Second Circuit has recognized a potential fourth theory, "outsider trading" or the "affirmative misrepresentation" theory, based on an affirmative misrepresentation that does not require a breach of a duty. In 2021, the SEC unveiled a novel theory of "shadow trading," which is an extension of the misappropriation theory.[27] In 2022, a federal district court in California effectively endorsed this theory when it denied the defendant's motion to dismiss, which had argued against such a theory as a matter of law.[28]

1. *"Classical" Theory.*

The "classical" theory of insider trading generally applies when an insider, in violation of a fiduciary duty to his or her company (or to another company to which the insider owed a duty), trades in the securities of the company on the basis of material nonpublic information obtained by reason of the insider's position. [29] As discussed below, the SEC has defined by rule the concept "on the basis of" to mean that the person merely was aware of the nonpublic information at the time of the trade.[30] The classical theory covers situations in which a company executive, board member, or agent, such as an investment banker, trades in the company's securities or in the securities of a potential deal partner before the release of news

26. 17 C.F.R. § 240.10b-5 (2010).

27. *See* Complaint at 1–2, SEC v. Panuwat, No. 4:21-CV-06322 (N.D. Cal. Aug. 17, 2021).

28. *See* Order Denying Motion to Dismiss at 7, SEC v. Panuwat, No. 21-CV-06322 (N.D. Cal. Jan. 14, 2022), ECF No. 26.

29. *See* Chiarella v. United States, 445 U.S. 222, 228 (1980).

30. *See* 17 C.F.R. § 240.10b5-1(b) (2010). For further discussion of the term "on the basis of," see *infra* Section II.D.

about a significant event, such as a tender offer, merger, or earnings announcement.

2. *"Tipper-Tippee" Theory.*

The "tipper-tippee" theory imposes liability when (1) the tipper "has breached his fiduciary duty to the shareholders by disclosing the [material nonpublic] information to the tippee," (2) the tippee "knows or should know that there has been a breach," (3) the tippee uses the information in connection with a securities transaction, and (4) the tipper receives some personal benefit in return.[31]

In 2016, the Supreme Court resolved a circuit split regarding the nuances of the fourth "personal benefit" element. At the center of the circuit split was how to interpret the statement in the Supreme Court's opinion in *Dirks v. SEC* that the personal benefit element may be satisfied when the "insider makes a gift of confidential information to a trading relative or friend."[32] As discussed below, the disagreement between the Second Circuit and the Ninth Circuit regarding *Dirks'* test for analyzing the personal benefit element underscores the nuanced and fact-intensive nature of insider trading analysis.

Dirks was a broker-dealer who received a tip from a former officer of a publicly-traded company that the company was engaged in a massive fraud.[33] Dirks provided this information to his clients, who traded on it. Dirks did not provide any benefit to the corporate officer who tipped him about the fraud.[34] The SEC charged Dirks with insider trading, but the Supreme Court held that Dirks had not engaged in insider trading because the tipper—the former officer of the public company—did not receive a personal benefit in exchange for the information he provided to Dirks. Because the tipper did not receive a personal benefit, there was no breach of fiduciary duty and thus no insider trading liability. Although the Court stated that "a gift of confidential information to a trading friend or relative" satisfies the personal benefit requirement

31. Dirks v. SEC, 463 U.S. 646, 647 (1983).
32. *Id.* at 664.
33. *Id.* at 648–49.
34. *Id.* at 667 ("The tippers received no monetary or personal benefit for revealing [the fraud], nor was their purpose to make a gift of valuable information to Dirks.").

for tipper-tippee liability, that statement was not part of the Court's holding, and the precise meaning of the statement remained an open question.[35]

In 2014, the Second Circuit addressed that question in *United States v. Newman*.[36] *Newman* involved the criminal prosecution of a "cohort of analysts" who allegedly shared confidential information with each other and used that information to trade.[37] The Second Circuit reversed their convictions, and, focusing on the personal benefit element, held that "the mere fact of friendship, particularly of a casual or social nature" did not satisfy the personal benefit prong of *Dirks*.[38] Instead, the Second Circuit held that the personal benefit element is satisfied where there is "a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[39]

Shortly after *Newman*, the Ninth Circuit considered the same issue and disagreed with the Second Circuit.[40] In *United States v. Salman*, Bassam Salman was convicted of insider trading after receiving tips from his future brother-in-law Michael Kara, who, in turn, had received the information from his brother. Kara's brother was an investment banker who had access to material nonpublic information.[41] At trial, the government established the personal benefit element by demonstrating that the brothers had a "mutually beneficial relationship" because the investment banking brother gave Kara confidential information "to benefit him" and to "fulfill [ ] whatever needs he had."[42] Salman relied on *Newman* to rebut the existence of a personal benefit. He argued that the "evidence of a friendship or familial relationship" between Kara and his brother was insufficient to satisfy the personal benefit prong because after *Newman*, the "exchange of information must include at least a potential gain of a pecuniary or similarly valua-

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35. *Id.* at 665–67.
36. United States v. Newman, 773 F.3d 438 (2d Cir. 2014).
37. *Id.* at 442.
38. *Id.* at 452.
39. *Id.*
40. United States v. Salman, 792 F.3d 1087 (9th Cir. 2015).
41. *Id.* at 1088–90.
42. *Id.* (internal quotation marks omitted).

ble nature."[43] The Ninth Circuit rejected this argument and expressly declined to follow *Newman*.[44] Instead, the court reverted to the description of a personal benefit in *Dirks* and held that disclosing confidential information to a family member was "precisely the 'gift of confidential information to a trading relative' that *Dirks* envisioned."[45]

The Supreme Court granted certiorari to address the "tension" resulting from the *Newman* and *Salman* decisions. In affirming the Ninth Circuit's opinion in *Salman*, the Court "adhere[d] to *Dirks*," and reinforced the rule from *Dirks* that "a tipper breaches a fiduciary duty by making a gift of confidential information to a 'trading relative.'"[46] The unanimous Court held that, "[t]o the extent the Second Circuit held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends . . . we agree with the Ninth Circuit that this requirement is inconsistent with *Dirks*."[47] Although *Salman* seemingly brought clarity to the tipper-tippee theory by reinforcing the language in *Dirks*, the Court did leave some questions unanswered. For example, the Court did not address the SEC's argument that this "gift theory" applies to a gift to any person, not just to a trading friend or relative. Subsequent Second Circuit opinions suggest that *Salman* did not entirely abrogate *Newman*.[48] The personal benefit element remains fertile ground for legal debate.

3. *"Misappropriation" Theory.*

The "misappropriation" theory applies to situations in which a person, who is not an insider, lawfully comes into possession of material nonpublic information, but nevertheless

43. *Id.* at 1093.
44. *Id.*
45. *Id.* at 1092.
46. Salman v. United States, 580 U.S. 39, 48–49 (2016).
47. *Id.* at 50.
48. *See* United States v. Martoma, 894 F.3d 64, 71 (2d Cir. 2017). After initially holding that the Supreme Court's *Salman* opinion abrogated *Newman*, the Second Circuit issued an amended opinion in which it stated that it need not make that determination to resolve the *Martoma* case: "because there are many ways to establish a personal benefit, we conclude that we need not decide whether *Newman*'s gloss on the gift theory is inconsistent with *Salman*." *Id.*

breaches a duty of trust or confidence (as further discussed below) owed to the source of the information by trading on the basis of such information or by conveying the information to another person to trade.[49]

4. *"Outsider Trading" or the "Affirmative Misrepresentation" Theory.*

In 2009, the Second Circuit recognized a novel form of insider trading—referred to by some commentators as the "outsider trading" or the "affirmative misrepresentation" theory—that does not require a breach of a fiduciary duty. In *SEC v. Dorozhko*, the Second Circuit held that neither Supreme Court nor Second Circuit precedent imposed a fiduciary duty requirement on the ordinary meaning of "deceptive" where the alleged fraud is an affirmative misrepresentation rather than a non-disclosure.[50] This holding created controversy, because it marked the first time a court had recognized insider trading without finding a breach of a fiduciary duty.[51]

The case arose from an unusual set of facts. Oleksandr Dorozhko allegedly hacked into Thomson Financial's secure computer system, where he accessed the third-quarter earnings of IMS Health, Inc. ("IMS") before they were released to the public.[52] Dorozhko then purchased a substantial volume of put options expiring within two weeks.[53] When the financial results were finally publicized, Dorozhko profited by selling the put options of IMS he had purchased previously.[54]

The SEC alleged that Dorozhko committed insider trading by affirmatively misrepresenting himself (i.e., hacking into the computer system) to gain access to material nonpublic information about IMS that he used to trade.[55] The United States District Court for the Southern District of New York denied the SEC's motion for a preliminary injunction to freeze the proceeds of Dorozhko's transactions, holding that the SEC had not shown that it likely would succeed on the merits of a

49. United States v. O'Hagan, 521 U.S. 642, 652 (1997).
50. SEC v. Dorozhko, 574 F.3d 42, 49 (2d Cir. 2009).
51. *See* Michael D. Wheatley, *Apologia for the Second Circuit's Opinion in* SEC v. Dorozhko, 7 J.L. ECON. & POL'Y 25, 25 (2010).
52. SEC v. Dorozhko, 606 F. Supp. 2d 321, 325–26 (S.D.N.Y. 2008).
53. *Id.* at 326.
54. *Id.* at 326–27.
55. *Dorozhko*, 574 F.3d at 49 (2d Cir. 2009).

claimed violation of Section 10(b) of the Exchange Act.[56] Relying on insider trading law precedent, the district court determined that the "deceptive device" element of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder requires a breach of fiduciary duty.[57] Because Dorozhko, a hacker, did not owe a fiduciary duty either to the source of the information or to those persons with whom he had transacted, the court determined that he was not liable under Section 10(b).[58]

On appeal, the Second Circuit held that an affirmative misrepresentation in connection with the purchase or sale of a security is a "distinct species of fraud" that violates the securities laws, regardless of the existence of a fiduciary duty.[59] Absent a fiduciary duty to disclose or abstain from trading, the defendant still had an affirmative obligation not to mislead someone.[60] The court stated:

"[M]isrepresenting one's identity in order to gain access to information that is otherwise off limits, and then stealing that information is plainly 'deceptive' within the ordinary meaning of the word. . . . [I]t seems to us entirely possible that computer hacking could be, by definition, a 'deceptive device or contrivance' that is prohibited by Section 10(b) and Rule 10b-5."[61]

The case was remanded to the district court to resolve whether Dorozhko's hacking constituted a deceitful affirmative misrepresentation. On remand, the district court granted the SEC's unopposed motion for summary judgment.[62]

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56. *Dorozhko*, 606 F. Supp. 2d at 343 (S.D.N.Y. 2008).

57. *Dorozhko*, 574 F.3d at 47–48 (2d Cir. 2009) (citing Chiarella v. United States, 445 U.S. 222, 235 (1980) (finding that "there can be no fraud absent a duty to speak") and United States v. O'Hagan, 521 U.S. 642, 653 (1997) (finding that defendant violated duty to law firm and its clients by misappropriating and trading based on material nonpublic information)).

58. *Dorozhko*, 606 F. Supp. 2d at 324 (S.D.N.Y. 2008).

59. *Dorozhko*, 574 F.3d at 49 (2d Cir. 2009).

60. *Id.* (distinguishing insider trading in abrogation of a duty to disclose or abstain from trading from affirmative representations of those who are under no duty other than one not to mislead (citing Basic, Inc. v. Levinson, 485 U.S. 224, 240 n.18 (1988))).

61. *Id.* at 51.

62. SEC v. Dorozhko, No. 07-CV-9606 (NRB) (S.D.N.Y. Mar. 24, 2010) (order of J. Buchwald), http://law.du.edu/documents/corporate-governance/sec-and-governance/dorozhko/SEC-v-Dorozhko.pdf. In granting the motion for summary judgment, the district court directed Dorozhko to disgorge illegal gains of $286,456.59 and $6,903.94 in prejudgment interest; the

Despite the unusual facts that led to the Second Circuit's controversial *Dorozhko* opinion, the "affirmative misrepresentation" theory has been applied outside the computer hacking context. In private securities litigation, a district court applied *Dorozhko*'s "affirmative misrepresentation" test to deny an executive's motion to dismiss shareholders' securities fraud allegations. The plaintiffs were shareholders of a company that acquired the executive's company. In seeking to dismiss allegations that the executive failed to disclose or misrepresented information regarding his bonus compensation resulting from the acquisition, the executive argued that he did not owe a fiduciary duty to the shareholders of the acquiring company. The district court agreed that the absence of a fiduciary duty required it to dismiss claims based on alleged *omissions* of material facts relating the executive's bonus arrangement. Citing *Dorozhko*, the district court denied the defendant's motion to dismiss claims based on alleged "false or misleading statements" to the acquiring company's shareholders because "no fiduciary obligation is necessary to proceed with such claims."[63] The DOJ, SEC, and even private plaintiffs may continue to find new applications for the "affirmative misrepresentation" theory.

5. *"Shadow Trading" Theory*

In 2021, the SEC brought a novel enforcement action against Matthew Panuwat based on the so-called "shadow trading" theory of insider trading.[64] The SEC alleged that Panuwat, while still employed by biopharmaceutical firm

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court also barred him from future violations of federal securities laws. *Id.* Dorozhko's counsel, Charles A. Ross, had told the court that he was unable to contact his client and therefore did not oppose the motion. *See* Yin Wilczek, *Court Grants SEC Summary Judgment in Ukrainian Hacker Insider Trading Case*, BLOOMBERG L. (Mar. 26, 2010, 2:27 PM), https://news.bloomberglaw.com/securities-law/court-grants-sec-summary-judgment-in-ukrainian-hacker-insider-trading-case.

63. In re Bank of Am. Corp. Sec., Derivative, & Emp. Ret. Income Sec. Act (ERISA) Litig., 757 F. Supp. 2d 260, 288 (S.D.N.Y. 2010).

64. *See* Complaint at 1–2, SEC v. Panuwat, No. 21-CV-06322 (N.D. Cal. Aug. 17, 2021). At oral argument on the motion to dismiss, the SEC conceded that there were "no other cases where the material nonpublic information at issue involved a third party." *See* Order Denying Motion to Dismiss at 20, SEC v. Panuwat, No. 21-CV-06322 (N.D. Cal. Jan. 14, 2022), ECF No. 26.

Medivation, received material nonpublic information that Medivation would be acquired by Pfizer. The SEC alleged that, after receiving this information, Panuwat purchased out-of-the-money, short-term stock options in Incyte Corporation, another biopharmaceutical company whose shares Panuwat believed would increase once the Pfizer/Medivation acquisition was announced. According to the SEC's complaint, Panuwat knew that the acquisition of Medivation could positively affect Incyte's stock price because Panuwat had reviewed presentations authored by bankers that discussed Medivation's peer companies and the acquisition of Medivation by a large pharmaceutical company would make Medivation's peer companies more valuable acquisition targets. In addition, the SEC alleged that Panuwat knew that a previous merger involving different pharmaceutical companies positively affected the stock price of Medivation and Incyte. When the acquisition was publicly announced, both Medivation's and Incyte's stock prices rose considerably, and Panuwat earned $107,066 as a result of his option purchases. The SEC alleged that Panuwat's "undisclosed, self-serving use of Medivation's information to purchase securities, in breach of his duty of trust and confidence, defrauded Medivation and undermined the integrity of, and investor confidence in, the securities markets."[65]

In moving to dismiss the complaint, Panuwat argued that information about the Pfizer/Medivation acquisition was not material to *Incyte*, the company in whose securities Panuwat had traded.[66] The district court rejected Panuwat's argument and concluded that Section 10(b) and Rule 10b-5 "cast a wide net, prohibiting insider trading of 'any security' using 'any manipulative or deceptive device.' "[67] Panuwat also argued that he had not breached his duty to *Medivation* by trading in the securities of Incyte.[68] The court rejected this argument too. The district court pointed to Medivation's insider trading policy which prohibited trading in "securities of another publicly

65. Complaint at 8, ¶ 34, SEC v. Panuwat, No. 3:21-CV-06322 (N.D. Cal. Aug. 17, 2021).

66. *See* Motion to Dismiss at 9–10, SEC v. Panuwat, No. 21-CV-06322 (N.D. Cal. Nov. 1, 2021).

67. *See* Order Denying Motion to Dismiss at 7, SEC v. Panuwat, No. 21-CV-06322 (N.D. Cal. Jan. 14, 2022), ECF No. 26.

68. *See* Motion to Dismiss at 11–12, SEC v. Panuwat, No. 21-CV-06322 (N.D. Cal. Nov. 1, 2021).

traded company" and enumerated a non-exhaustive list of prohibited trades.[69] The district court found that the SEC adequately alleged a breach of duty because the insider trading policy could be interpreted to prohibit Panuwat from trading in Incyte's securities.[70]

After *Panuwat*, it is unclear whether, absent the court's interpretation of Medivation's insider trading policy, the court would have identified the duty necessary for the SEC's complaint to survive a motion to dismiss. Thus, this case suggests that company policies and procedures may inadvertently impose on employee's duties and obligations that go beyond the requirements of the federal securities laws. These additional duties and obligations may unintentionally expose employees to insider trading liability. Counsel for firms should give careful consideration to this risk when drafting firm policies and consider whether these policies could be read broadly to impose duties that extend beyond the requirements of the federal securities laws.

In sum, the legal framework surrounding insider trading is nuanced and comes from a multiplicity of legal sources. Different types of firms may be more likely to be charged under particular theories. For example, an issuer or investment bank more commonly may be charged under the classical theory, while an institutional investor more likely may be charged under the tipper-tippee theory. In any case, the methods to prevent insider trading and the legal issues to consider in the event of an insider trading charge require careful and detailed analysis of the particular facts.

D. *Rule 10b5-1: Definition of "on the basis of"*

In 2000, the SEC defined by rule the concept of trading "on the basis of" material nonpublic information. Under Rule 10b5-1, "a purchase or sale of a security of an issuer is 'on the basis of' material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made

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69. *See* Order Denying Motion to Dismiss at 9, SEC v. Panuwat, No. 21-CV-06322 (N.D. Cal. Jan. 14, 2022), ECF No. 26 (quoting Medivation's company policy).

70. *See id.*

the purchase or sale."[71] With a few exceptions, a trader's other motivations for making the trade are generally not a defense if he was aware of the material nonpublic information at the time of the trade.

Importantly, Rule 10b5-1 expressly provides three affirmative defenses. The trader has not traded "on the basis of" material nonpublic information if he demonstrates that, "[b]efore becoming aware of the information," he (1) entered into a binding contract to purchase or sell the security, (2) instructed another person to purchase or sell the security for the instructing person's account, or (3) adopted a written plan for trading securities (a so-called "10b5-1 plan").[72] These affirmative defenses turn on the trader's ability to show that he already had plans to execute the trade *before* learning of the material nonpublic information.[73]

With respect to 10b5-1 plans, insider trading occurs, as the name suggests, where there has been "trading." It is not an insider trading violation for a person to halt or suspend a plan and thereby *avoid* trading,[74] although repeatedly stopping and restarting a 10b5-1 plan would be viewed with skepticism by the SEC and such modifications to the plan are subject to a "cooling off" requirement adopted by the SEC in 2022 and discussed below.[75]

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71. 17 C.F.R. § 240.10b5-1(b) (2000).

72. 17 C.F.R. § 240.10b5-1(c)(1)(i)(A) (2000).

73. *See* Press Release, U.S. Sec. & Exch. Comm'n, Former Countrywide CEO Angelo Mozilo to Pay SEC's Largest-Ever Financial Penalty Against a Public Company's Senior Executive (Oct. 15, 2010), https://www.sec.gov/news/press/2010/2010-197.htm (describing SEC settlement of an insider trading suit against former Countrywide CEO Angelo Mozilo, who established four 10b5-1 plans to sell options in Countrywide's stock while aware of material nonpublic information about increasing risk due to the poor performance of loans Countrywide originated).

74. *Exchange Act Rules: Questions and Answers of General Applicability, Question 120.17*, U.S. SEC. & EXCH. COMM'N (Mar. 31, 2020), https://www.sec.gov/divisions/corpfin/guidance/exchangeactrules-interps.

75. *See, e.g.*, Linda Chatman Thomsen, Dir., Div. of Enf't, U.S. Sec. & Exch. Comm'n, Opening Remarks Before the 15th Annual NASPP Conference (Oct. 10, 2007), http://www.sec.gov/news/speech/2007/spch101007lct.htm (stating generally that the SEC is scrutinizing 10b5-1 plans to identify potential abuses where executives may be trading on inside information by using such plans for cover); Linda Chatman Thomsen, Dir., Div. of Enf't, U.S. Sec. & Exch. Comm'n, Remarks at the 2007 Corporate

In a 2022 SEC enforcement action, the SEC underscored the importance of adopting a Rule 10b5-1 plan *before* becoming aware of material nonpublic information.[76] The SEC alleged that two executives of Cheetah Mobile, Inc. learned about a trend of declining revenue.[77] According to the SEC, the executives did not disclose the trend to investors, and the executives entered into a trading plan to sell some of their Cheetah Mobile securities.[78] The SEC alleged that the executives sold 96,000 Cheetah Mobile shares pursuant to the trading plan and before the company disclosed the negative revenue trend to investors.[79] In the settlement, the executives agreed to pay hundreds of thousands of dollars in civil penalties and to comply with significant restrictions on their ability to transact in Cheetah Mobile's securities.[80]

Citing concerns about perceived "gaps" in Rule 10b5-1 "that allow corporate insiders to unfairly exploit informational asymmetries," the SEC in 2022 adopted amendments to Rule 10b5-1 that impose additional requirements that an insider must meet before qualifying for the affirmative defenses.[81] To prevent insiders from adopting plans while they are in possession of material nonpublic information, the amendments require officers and directors to certify that they are not aware of any material nonpublic information when they enter into a plan.[82] The amendments also impose a mandatory "cooling off" period prohibiting officers and directors from trading pursuant to a new plan until the later of 90 days after the adoption of the plan or two business days following the disclosure of the issuer's quarterly financial results for the quarter in which the plan was adopted.[83] Importantly, the cooling off requirement applies to the adoption of a "modified trading ar-

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Counsel Institute (Mar. 8, 2007), https://www.sec.gov/news/speech/2007/spch030807lct2.htm.

76. *See* In the Matter of Sheng Fu and Ming Xu, Securities Act Release No. 11104, Exchange Act Release No. 95847, at 7 (Sept. 21, 2022), https://www.sec.gov/litigation/admin/2022/33-11104.pdf.

77. *See id.* at 2.

78. *See id.* at 6–7.

79. *See id.* at 7–8.

80. *See id.* at 9–12.

81. *See* Insider Trading Arrangements and Related Disclosures, 87 Fed. Reg. 80362 (Dec. 29, 2022).

82. *See* 87 Fed. Reg. at 80373.

83. *See* 87 Fed. Reg. at 80369.

rangement," and the SEC considers cancelling a trade to be an adoption of a modification to a trading arrangement.[84] In other words, executives who cancel trades will have to wait at least 90 days from the cancellation before they can trade pursuant to a new plan. Perhaps to further discourage terminating a plan to *avoid* trading, the amendments also require issuers to disclose insiders' adoption *and termination* of Rule 10b5-1 trading plans in their Forms 10-Q and 10-K. Although, as discussed above, the termination of a plan cannot lead to insider trading liability because no trade has occurred, the SEC expects that the amendments requiring an issuer to disclose that an insider has terminated a plan will "affect the behavior of insiders by drawing scrutiny of investors and other market participants to trading practices of insiders."[85] The amendments also prohibit insiders from having overlapping trading plans and limit single-trade plans to one plan per twelve month period. Issuers also must disclose in their Form 10-K whether they have adopted insider trading policies and procedures that govern insiders' purchase and sale of securities.[86]

E. *Rule 10b5-2: Definition of Duty of Trust or Confidence*

In 2000, the SEC defined by rule a non-exhaustive list of the relationships that would establish a duty of trust or confidence for purposes of the misappropriation theory.[87] Under Rule 10b5-2, a duty of trust or confidence arises between a recipient of material nonpublic information and the source when: (1) the recipient "agrees to maintain the information in confidence"; (2) the source and recipient "have a history, pattern, or practice of sharing confidences," such that the recipient knew or reasonably should have known the source expected the information to be kept in confidence; or (3) where the source is the "spouse, parent, child, or sibling" of the recipient.[88] Although the validity of this rule was questioned by

84. 87 Fed. Reg. at 80366.
85. 87 Fed. Reg. at 80396.
86. *See* 87 Fed. Reg. at 80409.
87. Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, 65 Fed. Reg. 51716 (Aug. 24, 2000) (adopting, among other things, Regulation FD and Exchange Act Rule 10b5-2).
88. 17 C.F.R. § 240.10b5-2(b)(1)–(3) (2010).

the Fifth Circuit in *SEC v. Cuban*,[89] the rule remains valid in other circuits and has been reaffirmed by the Second Circuit.[90] Therefore, when designing compliance procedures, it is prudent to continue to view the duty of trust or confidence through the lens of Rule 10b5-2.

F. *Potential Criminal Charges Associated with Insider Trading*

Section 32 of the Exchange Act makes it a crime to willfully violate any provision of the Exchange Act or rule enacted thereunder, including Rule 10b-5.[91] Thus, the DOJ and the SEC can both pursue insider trading violations.

The DOJ may also bring charges that the SEC cannot. These charges include conspiracy, mail and wire fraud, false statements to investigators, and perjury. Importantly, none of the aforementioned charges requires the government to establish the elements of insider trading,[92] which could make it easier for the DOJ to obtain a criminal conviction against someone in a situation arising from an insider trading investigation than for the SEC to prevail in a traditional insider trading enforcement action.[93]

Firms also should be aware of Section 807 of the Sarbanes-Oxley Act ("SOX 807"), which makes it a crime to defraud anyone in connection with a security or to obtain, by fraud, money or property in connection with the purchase or sale of

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89. SEC v. Cuban, 620 F.3d 551, 555–58 (5th Cir. 2010) (noting, but leaving open, the question of whether Rule 10b5-2 goes beyond the scope of Section 10(b) of the Exchange Act).

90. *See* United States v. Chow, 993 F.3d 125 (2d Cir. 2021).

91. *See* Securities Exchange Act of 1934 § 32, 15 U.S.C. § 78ff.

92. The statutory bases for such charges are 18 U.S.C. § 371 (conspiracy against the United States), 18 U.S.C. § 1001(a) (false statements to investigators), 18 U.S.C. § 1341 (mail fraud), 18 U.S.C. § 1343 (wire fraud), and 18 U.S.C. § 1621 (perjury). *Compare* Indictment at 5–6, 11–12, United States v. Binette, No. 3:10-cr-30036-MAP (D. Mass. Oct. 14, 2010) (alleging defendants committed insider trading, in violation of 15 U.S.C. §§ 78j(b), 78f(a)), *with* Redacted Superseding Indictment, United States v. Stewart, 323 F. Supp. 2d 606, 624–34 (S.D.N.Y. 2004) (alleging that, in connection with a stock trade, defendants made false statements in violation of 18 U.S.C. § 1001(a), committed perjury in violation of 18 U.S.C. § 1621, and conspired to obstruct justice in violation of 18 U.S.C. § 371, but *not* alleging insider trading).

93. *See* Karen Woody, *The New Insider Trading*, 52 ARIZ. ST. L.J. 594, 639–40 (2020).

a security.[94] On its face, SOX 807 appears broader than Rule 10b-5 in important ways. The language of § 1348(1) does not include the requirement that there be a "purchase" or "sale" of a security, only that the violation be "in connection" with a security—a vague requirement that may, in itself, be subject to legal challenge. Like Rule 10b-5, SOX 807 also imposes liability for any attempt "to execute[] a scheme or artifice" to defraud.[95] Moreover, the government may argue from the face of the statute that "materiality" in the context of SOX 807 should be judged from the perspective of a reasonable employer, rather than that of a reasonable investor.[96]

In a significant case applying SOX 807, the Second Circuit highlighted the differences between Section 10(b) insider trading and SOX 807 insider trading. In *United States v. Blaszczak*, the government charged several hedge fund partners with insider trading after they received and traded on nonpublic information obtained from a former government agency official regarding upcoming agency decisions. The Second Circuit held that the personal benefit test established in *Dirks* does not apply to SOX 807. In analyzing this element, the Second Circuit observed that neither Section 10(b) nor SOX 807 contain, in their statutory text, a "personal benefit" requirement. Rather, the personal benefit test is a "judge-made doctrine premised on the Exchange Act's statutory purpose," which, according to *Dirks*, is to "[eliminate] [the] use of inside information for personal advantage."[97] The Second Circuit reasoned that SOX 807 does not have a similar statutory context, and it declined to extend *Dirks*' personal benefit test to SOX 807. The Supreme Court later vacated the Second Circuit's opinion and remanded the case for further consideration in light of a 2020 Supreme Court case that cast doubt on

94. Sarbanes-Oxley Act of 2002 § 807, 18 U.S.C. § 1348.

95. 18 U.S.C. § 1348(1).

96. *See* United States v. Mahaffy, No. 05-CR-613, 2006 U.S. Dist. LEXIS 53577, at *39–42 (E.D.N.Y. Aug. 2, 2006) (stating that materiality is satisfied where an employee's misrepresentation or omission "would naturally tend to lead or is capable of leading a reasonable employer to change its conduct" (quoting United States v. Rybicki, 354 F.3d 124, 145 (2d Cir. 2003))).

97. United States v. Blaszczak, 947 F.3d 19, 35 (2d Cir. 2019) [hereinafter *Blaszczak I*] (quoting Dirks v. SEC, 463 U.S. 646, 662 (1983)), *cert. granted, vacated*, 141 S. Ct. 1040 (2021), *and sub nom.* Olan v. United States, 141 S. Ct. 1040 (2021), *vacated in part*, No. 18-2811 2022 U.S. App. LEXIS 35638 (2d Cir. Dec. 27, 2022).

whether the information at issue in *Blaszczak* was "property" that satisfied the necessary elements of the alleged criminal fraud.[98] On remand, the Second Circuit majority opinion did not revisit the personal benefit issue, but a thoughtful concurrence highlighted the anomaly that a criminal conviction for tipper-tippee insider trading prosecuted under SOX 807 does not require proof of a personal benefit element, whereas proof of a personal benefit is required "when the government seeks criminal or civil penalties for insider trading under Section 10(b) of the [Exchange Act and Rule 10b-5 thereunder]."[99] It remains to be seen whether other circuits will adopt the Second Circuit's approach to the personal benefit element in the context of SOX 807. Although serious questions remain about the constitutionality of SOX 807 and the applicability of the personal benefit requirement, SOX 807 presents a potentially powerful tool for criminal prosecutors.[100]

G. *Insider Trading in the Debt Markets, Credit Derivatives, and Distressed Loan Markets*

Historically, regulators have focused on insider trading in equity markets rather than in debt or credit derivatives markets. The ability to transfer credit risk through credit default swaps ("CDS") and the volatility of the fixed income markets, however, have drawn attention to insider trading in debt markets.[101] As a result, the SEC has brought more insider trading cases relating to debt market activities.

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98. *See* Blaszcak v. United States, 141 S. Ct. 1040 (2021) (remanding on basis of Kelly v. United States, 140 S. Ct. 1565 (2020)).

99. United States v. Blaszczak, Nos. 18-2811, 18-2825, 18-2867, 18-2878, 2022 WL 17926047, at *13 (2d Cir. Dec. 27, 2022) (Walker, J. concurring) [hereinafter *Blaszczak II*]. In contrast, the dissent dismissed concerns about an anomaly between the requirements for securities fraud under SOX 807 and Section 10(b) and Rule 10b-5. In the dissent's view, SOX 807 was intended to give prosecutors new tools to prosecute financial crime, not to be a carbon copy of the Section 10(b) securities fraud statute. *See id.* at *25–27.

100. For additional discussion regarding the breadth of SOX 807 and the flexibility it affords prosecutors, see Sandra Moser & Justin Weitz, *18 U.S.C. § 1348—A Workhouse Statute for Prosecutors*, 66 DEP'T OF JUST. J. FED. L. & PRAC. 111 (2018).

101. This attention may have been precipitated, at least partially, by a buy-side publication that questioned whether banks were using inside information obtained as lenders to take advantage of bond investors through the purchase of credit default swaps. *See* CHRIS P. DIALYNAS, PIMCO, "RED

For example, in *SEC v. Marquardt*, the SEC brought and settled an insider trading case against the senior vice president of an investment adviser to a mutual fund, who had traded based on material nonpublic information about significant devaluations to the collateralized debt obligations, collateralized mortgage obligations, and other mortgage-related securities that the fund owned.[102] In *SEC v. Barclays Bank PLC*, the SEC brought and settled an action against Barclays Bank and one of its former proprietary traders in distressed debt for illegally trading bond securities while aware of material nonpublic information.[103] According to the settlement, the trader had misappropriated material nonpublic information he obtained while representing Barclays on several creditor committees, without disclosing the information to the bank's bond trading counterparties or disclosing the bank's trading activities to the sources of his information.[104]

Although the prohibition on insider trading applies as much to debt securities and credit derivatives as it does to equities, the application of the prohibition to the credit markets is particularly complicated for multiple reasons. Unlike the equity markets, the credit markets include similar products that may trade on the public side (debt securities) or on the private side (bank loans), as well as products that may be traded on both the public and private side of a financial institution

ALERT": THE CURRENT ACCOUNT DEFICIT AND CORPORATE BOND SPREADS 13 (2003) (citing to CHRIS P. DIALYNAS, PIMCO, BOND YIELD SPREADS REVISITED AGAIN AND PUBLIC POLICY IMPLICATIONS (2002)). After publication of the 2002 article, a number of trade associations collectively published a statement concerning the prevention of insider trading in the credit markets. *See, e.g.*, JOINT MKT. PRACTICES FORUM, STATEMENT OF PRINCIPLES AND RECOMMENDATIONS REGARDING THE HANDLING OF MATERIAL NONPUBLIC INFORMATION BY CREDIT MARKET PARTICIPANTS (2003). None of these publications has the force of law or creates any safe harbor.

102. SEC v. Marquardt, Litig. Release No. 21383, (Jan. 20, 2010), http://www.sec.gov/litigation/litreleases/2010/lr21383.htm; *see also* Complaint at ¶ 8, SEC v. Marquardt, No. 10-CV-10073 (D. Mass. Jan. 20, 2010). Given the nature of the securities held by the fund, the investment adviser valued the assets internally based on certain pre-determined methods as there was no readily-available market price.

103. SEC v. Barclays Bank PLC and Steven J. Landzberg, Litig. Release No. 20132, (May 30, 2007), http://www.sec.gov/litigation/litreleases/2007/lr20132.htm. The SEC settled the case with the defendants for nearly $11 million. *See id.*

104. *Id.*

(credit default swaps). For example, structured debt securities such as collateralized loan obligations ("CLOs") are composed of underlying loans for which material nonpublic information is often shared with loan traders. Determining whether material nonpublic information about particular loans *within* the CLO equates to material nonpublic information *about* the CLO securities is often a challenging task that could depend upon such facts as the concentration of the loans for which material nonpublic information is known and the risk of default of the CLO tranche of the investment.

The SEC has brought insider trading cases involving the credit default swap market. In *SEC v. Rorech*, the SEC brought an action against a salesman at Deutsche Bank Securities for sharing information about the restructuring of an upcoming bond issuance with a hedge fund portfolio manager, who then purchased CDS covering the particular bonds.[105] Because the price of the CDS was based on the price of the underlying bonds, the SEC argued that they were "security-based swap agreements" covered under the antifraud provisions of the securities laws.[106] Although the court held that insider trading had not occurred because the information shared was not prohibited and the SEC did not show that the parties had engaged in any deceptive acts, the court found that the CDS were "security-based swap agreements" and therefore subject to insider trading prohibitions.[107]

The question of whether a CDS constitutes a security was largely resolved by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"). In Dodd-Frank, Congress amended Section 2(a) of the Securities Act and Section 3(a)(10) of the Exchange Act to include "security-based swaps" in the definition of a security.[108]

Distressed loan trading also has received considerable attention from regulators. The primary and secondary markets

105. SEC v. Rorech, 720 F. Supp. 2d 367, 371 (S.D.N.Y. 2010); *see also* Complaint at ¶¶ 12–13, SEC v. Rorech, No. 09-CIV-4329 (S.D.N.Y. May 5, 2009) (arguing that a CDS is a type of credit derivative security, traded over the counter).

106. *Rorech*, 720 F. Supp. 2d at 405.

107. *Id.* at 405–06.

108. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 761(a)(6), 768(a)(1), 124 Stat. 1376, 1755, 1800 (2010) (codified as amended at 15 U.S.C §§ 77b, 78c).

for distressed bank debt have grown dramatically. Distressed bank debt is generally not viewed as a security, at least when traded between dealers or commercial lenders. If the bank note has a maturity of less than nine months, the note is expressly exempted from the definition of a security under Section 3(a)(3) of the Securities Act (unless the context otherwise requires).[109] For longer-term bank debt, courts have determined that the Securities Act's use of the phrase "any note" in the definition of a security generally does not apply to those notes issued in a consumer or commercial context, including consumer financing, home mortgages, or short-term notes secured by a lien on a small business or its assets, among others.[110] Nevertheless, courts recognize that greater scrutiny is often needed to assess whether a note may be characterized as a commercial loan or whether it is more appropriately viewed as a security in specific contexts.

In the seminal case *Reves v. Ernst & Young*, the Supreme Court articulated several factors that courts must consider in determining whether a note displays the economic substance of a security for purposes of applying insider trading and other securities laws. In general, instruments that are sold to raise capital, purchased for investment purposes rather than personal consumption, commonly traded, perceived by the public to be a security, or that fall outside other regulatory frameworks (such as banking regulations) may be considered securities.[111]

Effective walls are critical for participants in the distressed loan trading market. Traders at a firm that trades in distressed bank debt who receive inside information should be walled off from the traders of high-yield debt securities (subject to in-

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109. Although section 2(a)(1) of the Securities Act lists "note" among the definition of "security," 15 U.S.C. § 77b(a)(1) (2006), section 3(a)(3) exempts short-term instruments, including "[a]ny note, draft, bill of exchange, or banker's acceptance," with a maturity of nine months or less from this definition. § 77c(a)(3).

110. *See* Reves v. Ernst & Young, 494 U.S. 56, 65 (1990) (citing Exch. Nat'l Bank of Chi. v. Touche Ross & Co., 544 F.2d 1126, 1138 (2d Cir. 1976)).

111. *See id.* at 66–67 (adopting a four-part "family resemblance" test to determine the nature of specific instruments for purposes of applying the securities laws).

sider trading laws), even though the two areas are closely related from a business standpoint.[112]

H. *Insider Trading in the Commodity Futures and Derivatives Markets*

In contrast to the broad prohibition against insider trading found in the securities laws, insider trading is considered an accepted and integral practice in the commodity futures and derivatives markets. Not only does the Commodity Exchange Act (the "CEA") lack a prohibition against insider trading in commodities (except with respect to certain individuals connected with the regulation, self-regulation, or exchange governance of those markets),[113] the CEA actually accepts insider trading as a means to facilitate efficient pricing of commodities.[114]

This divergence in regulatory treatment towards insider trading in the two markets is due to fundamental differences between the equities and commodity futures markets. The purpose of the securities markets centers on capital formation, which in turn gives rise to a number of obligations, including

112. Some firms conduct bank debt trading, but do not access the inside information to which they may be entitled as a holder of the debt. This allows them to continue to trade on the public side, subject to their being able to demonstrate that they did not access the inside information. Other firms are careful to ensure that any nonpublic information they obtain on the private side is *not* material to any public securities they purchase.

113. *See* Commodity Exchange Act §9(d), (e), 7 U.S.C. §13(d), (e) (2006) (prohibiting Commissioners and Commission employees and members or employees of any governing board of trade, registered entity, or registered futures association to trade on the basis of material nonpublic information obtained through special access related to the performance of their duties); *see also* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1737–1739 (2010) (codified as amended at 7 U.S.C. § 6(c)) (prohibiting the use of nonpublic information by "any employee or agent of any department or agency of the Federal government" for personal gain by entering into or offering to enter into a futures contract, option on futures contract, or swap, or assisting another person to do the same).

114. *See* Sharon Brown-Hruska & Robert S. Zwirb, *Legal Clarity and Regulatory Discretion — Exploring the Law and Economics of Insider Trading in Derivatives Markets*, 2 Cap. Mkts. L.J. 245, 254 (2007) (observing that commodities markets, and related futures markets, "*rely upon* individuals and entities that have privileged information . . . to trade on their information in the commodities markets, whether on behalf of themselves or their firm").

those of a fiduciary nature. In contrast, the purpose of the commodity futures and derivatives markets is to provide a forum for price discovery and risk management. These latter markets, as a joint report by the SEC and Commodity Futures Trading Commission ("CFTC") acknowledged, "permit hedgers to use their nonpublic material information to protect themselves against risks to their commodity positions."[115] In other words, commodity futures and derivatives markets exist to facilitate trading based on information generated by participants' inside knowledge.[116]

As the CFTC has recognized, "it would defeat the market's basic economic function—the hedging of risk—to question whether trading on knowledge of one's own position were permissible."[117] In contrast to the often implied premise within securities law that investors should have equal access to material market information and that insiders owe a fiduciary duty, there is no similar expectation in the commodity futures and derivatives markets that market participants have, or even should have, equal access to nonpublic information, or that corporate officials and personnel have a similar fiduciary duty with respect to their counterparties.[118]

II.
Insider Trading in Digital Asset Markets

With the precipitous rise of digital assets, including cryptocurrencies, coins, fungible and non-fungible tokens ("NFTs"), and the exchanges on which such assets change hands, the DOJ and SEC actively have sought ways to curtail what they view as illicit trading on the basis of material nonpublic information. Despite the SEC's assertions to the con-

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115. U.S. Commodity Futures Trading Comm'n & U.S. Sec. & Exch. Comm'n, A Joint Report of the SEC and the CFTC on Harmonization of Regulation 7, (2009), http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf.

116. Brown-Hruska & Zwirb, *supra* note 114, at 254 (observing that such markets "*rely upon* individuals and entities that have privileged information . . . to trade on their information in the commodities markets, whether on behalf of themselves or their firm").

117. U.S. Commodity Futures Trading Comm'n, A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material, Nonpublic Information 8 (1984).

118. *Id.* at 53–54.

trary, significant questions remain regarding whether such crypto assets are securities pursuant to the Supreme Court's *Howey* test.[119] While those securities-related questions await resolution, the DOJ, which, as discussed above, can bring wire fraud charges, has more flexibility to bring cases related to crypto assets. A pair of cases illustrates the point.

In *United States v. Chastain*, the DOJ brought criminal charges against a former product manager at an online crypto marketplace. According to the indictment, the marketplace's website often highlighted certain NFTs.[120] Being featured on the website typically resulted in the NFT increasing in value, and information about which NFTs were scheduled to be featured on the website was considered confidential business information. The indictment alleged that the defendant learned which NFTs would be featured on the marketplace's website and then used that information to secretly purchase the NFTs—or NFTs by the same creator—before they were featured. According to the indictment, after the NFTs were featured on the website, the defendant sold them for a profit. The indictment further alleged that the defendant had signed a confidentiality agreement with his employer in which he acknowledged that he had an obligation to maintain the confidentiality of certain business information that he received in connection with his work.

The DOJ charged the defendant with violating wire fraud[121] and anti-money laundering[122] laws. Despite announcing that the case was the first ever prosecution of a "digital asset *insider trading* scheme,"[123] the DOJ did not allege that the defendant committed criminal securities fraud in violation of Section 10(b) of the Exchange Act. In other words, the DOJ

119. *See, e.g.*, William Hinman, Director, Sec. & Exch. Comm'n Division of Corporation Finance, Digital Asset Transactions: When Howey Met Gary (Plastic), Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018), https://www.sec.gov/news/speech/speech-hinman-061418.

120. Indictment ¶ 7, United States v. Chastain, No. 22-CR-305 (S.D.N.Y. May 31, 2022), https://www.justice.gov/usao-sdny/press-release/file/1509701/download.

121. 18 U.S.C. § 1343.

122. 18 U.S.C. § 1956(a)(1)(B)(i).

123. U.S. Dep't of Justice, *Former Employee Of NFT Marketplace Charged In First Ever Digital Asset Insider Trading Scheme* (June 1, 2022), https://www.justice.gov/usao-sdny/pr/former-employee-nft-marketplace-charged-first-ever-digital-asset-insider-trading-scheme (emphasis added).

alleged that the defendant traded on the basis of material nonpublic information in violation of a duty, but it did not allege that the trading involved a *security*, which is an essential allegation to bring a case pursuant to SOX 807 or Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

Shortly after the DOJ announced the Chastain indictment, the SEC announced that it had filed a securities fraud complaint involving analogous facts. In SEC v. Wahi, the SEC alleged that a former product manager at one of the largest crypto asset trading platforms provided material nonpublic information to his brother and his friend who then traded on it.[124] According to the SEC, the trading platform had a practice of announcing to the public via social media when a new digital asset would be listed on the platform. The prices of the digital assets typically increased after these announcements. The SEC's complaint alleged that the defendant was responsible for supporting and coordinating the platform's listing announcements and therefore had confidential information about upcoming listings. The complaint further alleged that the product manager violated a duty by breaching his agreement not to disclose confidential information—such as listing information—to family or friends. The SEC alleged that the defendant's friend and brother knew, or should have known, that the defendant was providing them with confidential information in violation of his duty to his employer. Unlike in *Chastain*, the SEC had to allege that the trading involved a security. To satisfy this element, the SEC alleged that at least nine of the crypto assets in which the brother and friend traded met the definition of a security. The SEC's complaint contains detailed allegations regarding how those assets satisfy the elements of the Supreme Court's *Howey* test.

The law in this area is far from settled. Securities law, commodities law, and criminal law will continue to evolve with the rise of decentralized finance ("DeFi") and the use of smart contracts on blockchains. Legal issues relating to the definition of a security, materiality, personal benefit, the scope of the wire fraud and money-laundering statutes, and the limita-

124. *See* Complaint ¶ 1, Sec. & Exch. Comm'n v. Wahi, No. 2:22-CV-1009 (W.D. Wa. July 21, 2022).

tions of criminal and civil venue are anticipated to flood the courts in the coming months and years.[125]

III.
Legal and Factual Defenses

Because insider trading law has developed in the courts, it is fluid and continues to evolve as markets grow, technology changes, and the DOJ and SEC press new theories of liability. Inevitably, new legal and factual defenses accompany those new and expansive prosecutorial theories.[126]

The DOJ and SEC bear the burden of proving that an insider possessed material nonpublic information on which the insider traded. Even as the law evolves, facts play a critical role in any insider trading case. The presence or absence of certain facts can make a tremendous difference in the outcome of a case.

In *SEC v. Zachariah*, the SEC lost its case against the defendant, a corporate board member, because the SEC could not prove that the CEO actually relayed certain information to the defendant before the defendant executed the trades in ques-

125. *See, e.g.*, Indictment at 1–6, 8, United States v. Bankman-Fried, No. 22-CR-673 (S.D.N.Y. filed Dec. 13, 2022) (alleging in indictment that the founder of the FTX cryptocurrency exchange committed wire fraud, commodities fraud, securities fraud, and money laundering violations); SEC v. LBRY, Inc., No. 21-CV-260-PB, 2022 WL 16744741, at *8 (D.N.H. Nov. 7, 2022) (granting the SEC's motion for summary judgment for allegedly conducting an unregistered securities offering and holding that LBRY's LBC tokens were securities under the *Howey* test); Complaint, SEC v. Ripple Labs, Inc., No. 20-10832 (S.D.N.Y. Dec. 22, 2020); SEC v. Telegram Grp. Inc., 448 F. Supp. 3d 352 (S.D.N.Y. 2020); SEC v. Kik Interactive Inc., 492 F. Supp. 3d 169 (S.D.N.Y. 2020).

126. The SEC often moves quickly to file cases and freeze assets, even before details regarding the exchange of inside information is known. *See, e.g.*, Complaint ¶¶ 1–2, SEC v. One or More Unknown Purchasers of Martek Biosciences Corp., No. 10-Civ-9527, 2010 WL 5523571, at *1 (S.D.N.Y. Dec. 22, 2010) (charging unidentified persons with insider trading violations based on purchases of a large volume of Martek call options days before a takeover announcement, resulting in unrealized profits of $1.2 million); Complaint ¶ 1, SEC v. One or More Unknown Purchasers of Options of InterMune, Inc., No. 10-Civ-9560, 2010 WL 5523583, at *1 (S.D.N.Y Dec. 23, 2010) (filing insider trading charges against unknown individuals who purchased call options days before a positive news release regarding one of InterMune's drugs, resulting in unrealized profits of over $900,000).

tion.[127] The defendant had a pattern of trading the company's stock before joining its board and actually placed trades during a specified "black-out" period.[128] The SEC, however, introduced no direct or circumstantial evidence that the defendant and the CEO spoke prior to the trades.[129] Further, the SEC could not show that the defendant received inside information from any other source.[130]

In another high-profile case, the SEC lost a long battle against Heartland Advisors when the district court granted summary judgment for the defendants because the court found that the timing and amount of the trades alone were insufficient, without more, to prove insider trading.[131]

Although highly dependent on the facts and circumstances of the particular case, legal and factual defenses generally turn on the *prima facie* elements of a cause of action for insider trading—that is, trading a security while in possession of material nonpublic information that was conveyed or obtained in breach of a duty. Therefore, it is instructive to evaluate possible defenses in the context of the elements of a cause of action.

A. *Public versus Nonpublic Information*

Under each theory of insider trading, the government must establish that the person traded with the requisite scienter while in possession of "nonpublic" information. Although the concept might seem simplistic on its face, the dividing line between public and nonpublic information is porous. Due to the prevalence of online message boards, social networking, and blogs, information and rumors about companies can spread quickly to millions of interconnected investors. In some cases, those rumors are leaked by company insiders. So-called

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127. *See* SEC v. Zachariah, No. 08-60698, 2010 WL 11505090, at *27 (S.D. Fla. Dec. 20, 2010).

128. *Id.* at *2, *5.

129. *Id.* at *27–28.

130. *Id.*

131. *See* SEC v. Heartland Advisors, Inc., No. 03-C-1427, 2006 WL 2547090, at *3-4 (E.D. Wis. Aug. 31, 2006); *see also* Memorandum Opinion and Order, SEC v. Garcia, No. 10 CV 5268 (N.D. Ill. Dec. 28, 2011) (granting summary judgment to Defendant Sanchez, explaining that the SEC could not rely on speculation without identifying the information Sanchez received and the source of that information).

watchdog groups, such as WikiLeaks or other whistleblowers, have generated a new level of uncertainty as to what information is considered "nonpublic."

The distinction between public and nonpublic information generally depends on both how the information is disseminated and the source of the information. At one end of the spectrum is the classic case of information disclosed by a company through official channels of communications, such as the filing of a Form 8-K, subsequent dissemination of a press release, or disclosure in a quarterly or annual filing.[132] At the other end of the spectrum are cases involving leaks to the media, anonymous postings on message boards, or rumors circulating in online chat rooms—each of which raises a question of whether the information, which may have been closely guarded by the company, is now public.

1. *The Test of Whether Information Is Public.*

As an initial matter, determining the point *when* information is considered to be in the public realm is critical for understanding *whether* the information is public. Courts have established two tests for determining when information is considered public. Under the first test, information has reached the public realm when it has been disclosed "in a manner sufficient to insure its availability to the investing public."[133] For example, courts routinely find that information contained in reports filed with the SEC is public information.[134]

Under the second test, information is public when trading has caused the "information to be fully impounded into the price of the particular stock."[135] In *United States v. Rajaratnam*, the United States District Court for the Southern District of New York explained this second test:

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132. For this reason, company insiders "are presumed to know when information is undisclosed." SEC v. Monarch Fund, 608 F.2d 938, 941 (2d Cir. 1979).

133. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854 (2d Cir. 1968) (en banc).

134. *See* Emerson v. Mut. Fund Series Tr., 393 F. Supp. 3d 220, 247-48 (E.D.N.Y. 2019); *see also In re* Keyspan Corp. Sec. Litig., 383 F. Supp. 2d 358, 378 (E.D.N.Y. 2003) (dismissing allegations premised on the nondisclosure of information that was actually disclosed in Forms 8-K, 10-K, and 10-Q).

135. United States v. Rajaratnam, 802 F.Supp.2d 491, 498 (S.D.N.Y. 2011) (citing United States v. Libera, 989 F.2d 596, 601 (2d Cir. 1993)).

> "[I]nformation may be considered public for Section 10(b) purposes even though there has been no public announcement and only a small number of people know of it. That is because once the information is fully impounded into the price, such information can no longer be misused by trading because no further profit can be made."[136]

Although this second approach, inspired by the efficient market theory, seems more sophisticated in taking account of new forms of online media and communications, the SEC has clung to the first test, arguing that information becomes public only by a "public release through the appropriate public media, designed to achieve a broad dissemination to the investing public generally and without favoring any special person or group."[137]

Courts have provided little guidance to explain when information is "available to the investing public," what constitutes "appropriate" media, or when information is "fully impounded into the price" of the stock. Further, the opinions construing those concepts may be outdated when applied to new media and technology. For example, in *SEC v. Texas Gulf Sulfur*, a case decided in 1968, the Second Circuit held that information contained in a press release was not public shortly after the press release was made. Instead, the court stated that insiders "should have waited until the news could reasonably have been expected to appear over the media of widest circulation, the Dow Jones broad tape."[138] Courts have found differing periods of time sufficient for information to become public, ranging from fifteen minutes to a day, or even several days after the information has been released.[139]

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136. *Id.*

137. *In re* Certain Trad. in the Common Stock of Faberge, Inc., 45 S.E.C. 249, 256 (May 25, 1973); *see also* SEC v. Davis, Litig. Release No. 18322 (Sept. 4, 2003) (charging consultant with insider trading for tipping clients of embargoed information relating to the Treasury's halt of long bond sales); *see also* Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, 65 Fed. Reg. 51716 (Aug. 24, 2000) ("Information is nonpublic if it has not been disseminated in a manner making it available to investors generally.").

138. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854 (2d Cir. 1968)

139. *See* Billard v. Rockwell Int'l Corp., 526 F. Supp. 218, 220 (S.D.N.Y. 1981) (stating that Rockwell would have fulfilled its disclosure duty by waiting fifteen minutes between announcing the favorable information and ac-

In 2000, the SEC provided some limited guidance through Regulation FD (Fair Disclosure) by allowing companies to utilize their websites to distribute information to the public. Regulation FD states that information on a company's website will be considered public information where such a disclosure is "reasonably designed to provide broad, non-exclusionary distribution of the information to the public."[140] In other words, posting information on a website that requires a subscription or membership does not constitute the public realm for purposes of Regulation FD. Now, in the age of powerful internet search engines, information posted on a corporation's website or disseminated through electronic press releases might be seen near-instantly by thousands of potential investors and hundreds of news organizations, who may be monitoring the company's website using electronic means. Additionally, information disseminated through social media, such as Twitter, can be "pushed" to the public, meaning that social media followers will receive news and other alerts on their mobile devices with the latest information rather than having to seek it out manually using a search engine.

In 2008, citing the rapid "development and proliferation of company websites since 2000" and the expectation of "continued technological advances," the SEC published updated guidance regarding the distribution of information on company websites. The guidance states that whether information distributed through a company website has become public depends on the steps that the company has taken to make investors, the market, and the media aware of the channels of distribution it expects to use.[141] Thus, a company that issues a Form 8-K to inform the public that it intends to distribute company information via social media likely has satisfied its obligations

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cepting tendered shares); *cf.* SEC v. Ingoldsby, No. 88-1001-MA, 1990 U.S. Dist. LEXIS 11383, at *5 (D. Mass. May 15, 1990) (holding that the investing public had fully digested the importance of the announcement at issue nine days after its release).

140. *See* Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, 65 Fed. Reg. 51716 (Aug. 24, 2000) (adopting, among other rules, Regulation FD and Exchange Act Rule 10b5-2), http://www.sec.gov/rules/final/33-7881.htm.

141. *See* Commission Guidance on the Use of Company Web Sites, Release No. 34-58288 (Aug. 7, 2008).

under Regulation FD and the information distributed via social media can be considered public.

The prolific rise of social media to disclose corporate information tested the boundaries of the SEC's 2008 guidance. In 2013, the SEC issued a rare Section 21(a) report of investigation after it investigated Netflix, Inc.'s practice of disclosing company information via social media.[142] The SEC's investigation focused on a post on the Netflix CEO's personal Facebook page announcing that Netflix had streamed 1 billion hours of content in June 2013. Because Netflix had not previously announced this information, the SEC investigated whether the CEO's statement constituted a selective, nonpublic disclosure in violation of Regulation FD. Ultimately, the SEC did not bring an enforcement action against Netflix. Instead, the SEC emphasized that Regulation FD applies with equal force to disclosures made through social media and that issuers must take steps to alert investors and the markets of the "channels it will use for the dissemination of material, nonpublic information," such as issuing a Form 8-K indicating that investors should look to the company's social media sites for disclosure of such information.

Since the Netflix investigation, the SEC has not brought any other enforcement actions alleging that a company disclosure via social media constituted a selective disclosure in violation of Regulation FD. Indeed, a 2022 case suggests that the SEC has returned its Regulation FD focus to disclosures by company insiders to select industry participants through more intimate interactions, such as one-on-one phone calls.[143] The lack of cases concerning social media announcements is perhaps due to the continued increase in popularity and acceptance of social media as a means of effectively disseminating information to the public. For example, some public company CEOs have tens of millions of social media followers, many of whom are members of mainstream media organizations capable of re-broadcasting a single CEO social media post with a simple thumb tap on a mobile device. This method of distrib-

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142. *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Netflix, Inc. and Reed Hastings, Exchange Act Release No. 69279 (Apr. 2, 2013).

143. *See* Press Release, U.S. Sec. & Exch. Comm'n, AT&T Settles SEC Charge of Selectively Disclosing Material Information to Wall St. Analysts (Dec. 5, 2022), https://www.sec.gov/news/press-release/2022-215.

uting information arguably is much more effective at reaching the investing public than a Form 8-K filed with the SEC and a corresponding press release issued through traditional media organizations. For this reason, cataloguing how broadly information is disseminated and how quickly information is spread and repeated by various social media followers or news outlets can be a useful tool for determining the point at which information has become "public." Counsel seeking to demonstrate that information is public should examine social media websites for posts containing the information and should take special note of the number and type of individuals and entities that "follow" the individual or entity that posted the information. Counsel also should examine the secondary and tertiary dissemination of the information through "likes," "retweets," "reposts," and "replies," for example.

2. *The Means by Which Information Becomes Public.*

Another aspect of nonpublic information is whether the information made its way into the public realm through means other than a corporate disclosure. In other words, can the spreading by rumors, postings on message boards, or leaks from insiders, convert otherwise nonpublic information into public information, even if the company guarded against the release of that information? Some courts have been reluctant to deem the circulation of rumors or "talk to the street," as constituting public disclosure, even if the rumors or talks are accurate, widespread, and reported in the media.[144]

In defending against an insider trading allegation, it is important to determine whether the alleged "inside information" made its way into the public domain prior to alleged insider trading. Information can reach the public domain through a variety of traditional means, including corporate disclosures,

144. *See, e.g.*, SEC v. Mayhew, 121 F.3d 44, 51 (2d Cir. 1997) (determining that the "nonpublic" element of an insider trading charge was satisfied because material nonpublic information was conveyed by a corporate insider, which was more reliable and specific than rumors in the press about a probable merger, despite the existence of such rumors). *But see* SEC v. Rorech, 720 F. Supp. 2d 367, 411 (S.D.N.Y. 2010) (refusing to find liability for illegal tipping and trading when a bond trader shared information about possible advice that his investment banking firm might make regarding a bond offering restructuring, which the court noted was widely discussed in the marketplace).

press releases, media interviews, analyst and investor conference calls, analyst reports, and television programs. In addition, new forms of electronic communication, such as online message boards, blogs, chatrooms, social media (e.g., Twitter, Facebook, and Reddit), professional networking websites (e.g., LinkedIn, Plaxo, and Chamber), and specialized websites focused on leaked information (e.g., WikiLeaks[145]) can place information in the public domain. If "trading has caused the information to be fully impounded into the price of the particular stock,"[146] the information arguably is no longer "nonpublic" from an economic perspective, regardless of how many people actually saw the information.[147]

3. *Fully Public vs. Partially Public.*

Difficult conceptual questions arise when additional pieces of the information remain nonpublic or when an insider provides certainty to a public rumor in a nonpublic manner. Courts have held that disclosure of partial information does not constitute public dissemination for the remaining nonpublic portion of the information.[148]

In some instances, a person may be held liable for insider trading after obtaining nonpublic information that is more specific than a general rumor already widely circulating within the public domain. For example, in *United States v. Mylett*, the Second Circuit, in a divided opinion, determined that the defendant traded on the basis of material nonpublic information after a corporate insider privately confirmed the reported rumor of an upcoming transaction and then identified the company that would be acquired.[149] In upholding the defendant's criminal conviction, the court acknowledged the existence of public rumors about the possible acquisition but explained that the information conveyed by the insider was "substantially

145. WikiLeaks describes itself as an "uncensorable system for untraceable mass document leaking." Stephen Moss, *Julian Assange: The Whistleblower*, GUARDIAN (London), July 13, 2010, § G2, at 6.
146. United States v. Libera, 989 F.2d 596, 601 (2d Cir. 1993).
147. *See id.* ("The issue is not the number of people who possess [the information] but whether their trading has caused the information to be fully impounded into the price of the particular stock.").
148. *See, e.g.*, United States v. Royer, 549 F.3d 886, 891, 898–99 (2d Cir. 2008).
149. United States v. Mylett, 97 F.3d 663, 665–66 (2d Cir. 1996).

more specific than that in the newspaper."[150] Distinguishing from mere predictions by an insider that subsequently come true, the court explained that the information conveyed by the insider was "qualified, supported, and credible" and would have had "great value to a would-be trader."[151]

In *United States v. Royer*, a criminal insider trading case, the Second Circuit further examined whether information is nonpublic when elements of that information are available in the public domain.[152] In *Royer*, a former FBI agent used confidential, nonpublic information pertaining to certain companies and executives under investigation to short the stock of those companies.[153] The defendants argued that "much of the information" was public.[154] In upholding the convictions, the Second Circuit explained that the district court correctly stated the law when it instructed the jury that "the fact that information may be found publicly if one knows where to look does not make the information 'public' for securities trading purposes unless it is readily available, broadly disseminated, or the like," although the Second Circuit observed that the instruction "might not be universally appropriate."[155] Indeed, this instruction seems outdated because an internet search engine arguably can make even a single post of information on an obscure website "readily available."

4. *Information that Was Never Nonpublic.*

On other occasions, information may not be broadly disseminated, but nevertheless can be considered public. For instance, observing a CEO walking into the official building of a rival company should not constitute nonpublic information, even though an investor may ascertain correctly that merger talks are progressing, especially where one of the companies is rumored to be for sale.[156] Similarly, for example, a company

150. *Id.* at 666.
151. *Id.* at 667; *see also* SEC v. Mayhew, 121 F.3d 44, 50–51 (2d Cir. 1997).
152. *See Royer*, 549 F.3d at 897–98.
153. *Id.* at 896–97.
154. *Id.* at 897.
155. *Id.* at 897–98.
156. The SEC, however, has taken an aggressive view of the concept of nonpublic information. *See, e.g.*, Complaint at ¶¶ 34-38, SEC v. Steffes, 805 F. Supp. 2d 601 (N.D. Ill. 2011), 2010 WL 4018839 (alleging that freight rail yard employees and four family members violated insider trading laws when

might closely guard the nonpublic sales projections of its key product, but the number of trucks leaving the key factory and entering onto a public highway is not "nonpublic."[157] Institutional investors may rely on information available to the public eye, even if that information is not yet reflected in the price of the stock.[158]

In the context of understanding whether information is nonpublic, it is important to recognize that the "information" upon which an insider trading case is based need not originate from the company that is the subject of the trading itself. Using the misappropriation theory, courts have expanded the scope of insider trading to cover material nonpublic information about a security. In the landmark case *United States v. Winans*, columnist R. Foster Winans was charged with a scheme to trade securities based on information misappropriated from his employer, The Wall Street Journal.[159] Winans authored the famous "Heard on the Street" column and relayed confidential information about the timing and content of upcoming articles to his conspirators, who traded on the information prior to the news hitting the press.[160] Winans also placed trades in his own account based on his inside knowledge.[161] The court held that Winans's actions constituted a fraud against his employer in breach of a fiduciary duty, which duty did not need to be explicit under any federal or state law, but was inherent in the employer-employee relationship.[162]

Short sellers may be vulnerable to insider trading enforcement actions based on their interactions with journalists and with the SEC. If a short seller provides negative information about public companies to media outlets and receives insight

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the employees observed unusual daytime tours by people in business attire, surmised that the company was being acquired, and informed family members, all of whom traded on the information).

157. It is difficult to identify cases describing situations where a person traded on entirely "public" information because those situations usually do not result in the SEC instituting an enforcement action.

158. In defending an insider trading case based on information asserted by prosecutors to be nonpublic, counsel should consider the extent to which information could be gathered by any member of the public or seen with the naked eye.

159. United States v. Winans, 612 F. Supp. 827, 829 (S.D.N.Y. 1985).

160. *Id.* at 829, 833–34.

161. *Id.* at 831–32.

162. *Id.* at 843–44.

into the timing and nature of ensuing news articles, that short seller may have received material nonpublic information for purposes of insider trading—i.e., the fact of an upcoming negative news story on the company may be both material to the company's stock and nonpublic and the reporter's disclosure of the fact of the upcoming publications and/or timing may be a breach of a duty to the publisher.[163] Similarly, if a short seller receives and trades on the basis of information from the staff of the SEC's Division of Enforcement about the initiation of an investigation based on information supplied by the short seller to the SEC, the short seller may have committed insider trading—i.e., the fact of a non-public SEC investigation of a company may be material, and an SEC lawyer's disclosure regarding an investigation of the company (inadvertent or intentional) may be a breach of the lawyer's duty to the SEC or a breach of the short seller's agreement with the SEC to keep information about the investigation confidential.

Counsel should be familiar with the evolving case law defining "nonpublic" information and be well versed in the various forms of electronic media. An exhaustive search of all forms of media should be conducted to determine whether the alleged nonpublic information already has reached the public realm. Economic analysis may be useful evidence to show that the public aspects of the information (whether it be anonymous reports, rumors, or leaked information) were fully absorbed into the price of the stock and that any remaining nonpublic aspects had little to no effect on the stock price (and thus, may not be material, as discussed below).

5. *Information Relayed through Expert Networks.*

Expert networks create a particular concern with regards to the conveyance of nonpublic information. The term "expert network" refers to firms that are in the business of connecting clients, principally institutional investors, with persons who may be experts in a client's area of interest. Experts can include academics, scientists, engineers, doctors, lawyers, suppliers, and even former employees of the company of interest. Networks are used to save investors the time, cost, and uncertainty associated with obtaining specialized knowledge on their own. Expert networks can be a valuable and legitimate re-

163. *See id.* at 814, 840 n.7.

search tool that facilitates efficient access by clients to persons with relevant expertise.

There is nothing inherently improper about expert networks or obtaining advice from experts through such networks.[164] But as is true in other investing contexts, a legitimate source of information can be misused. The principal concern with expert networks is that they could convey nonpublic information. Indeed, their raison d'être is to convey information that is not readily available to the public. When such nonpublic information is also material and obtained through a breach of a duty to the source, the information could trigger a violation of insider trading law.

As mentioned at the beginning of this Article, the federal government has investigated the use of expert networks by hedge funds and other institutional investors to determine whether some networks are being used as a conduit for the conveyance of material nonpublic information to investors.[165] The conduct of investors who use these networks, however legitimate, could draw the attention of government enforcement officials which attention, in turn, can have negative consequences for firms, including the possibility of putting them out of business. Responding to a government investigation can be costly and time-consuming, and if the investigation becomes public, the firm could suffer significant reputational damage, and again be put out of business regardless of whether the firm is ultimately charged with, or found guilty of, any wrongdoing.

In light of these developments, robust and comprehensive compliance programs are essential as a first line of defense against government scrutiny. If properly executed, compliance programs can demonstrate to authorities that a firm has taken

164. *See* Azam Ahmed & Peter Lattman, *Insider Inquiry Steps Up Its Focus on Hedge Funds*, N.Y. TIMES, Feb. 8, 2011, at A1 (quoting Preet Bharara, U.S. Attorney for the Southern District of New York, as confirming at a Feb. 8, 2011 press conference that there is nothing inherently wrong with hedge funds or expert networking firms, while committing to prosecute those who have "galloped over the line" to engage in illegal insider trading).

165. *See* SEC v. Mark Anthony Longoria, SEC Litig. Release No. 21836, 2011 WL 334798 (S.D.N.Y. Feb. 3, 2011) (charging two expert network employees and four consultants with insider trading for illegally tipping hedge funds and other investors who gained nearly $6 million in trading profits and losses avoided).

appropriate steps to guard against potential wrongdoing, such as the potential receipt of material nonpublic information from an expert network, thereby showing that further investigation is unlikely to reveal violations. Strong compliance programs can reduce the likelihood of employees engaging in wrongdoing and ensure that if an investigation nonetheless results, relevant information is organized in a way that allows a firm to respond quickly. Finally, the presence of a strong and effective compliance program can dissuade the DOJ and the SEC from charging the firm itself, even if particular employees have violated the law.[166] Guidelines for developing compliance policies and procedures to ensure appropriate interaction with experts and expert networks, and to address insider trading generally, are discussed in Part IV, below.

B. *Materiality*

In addition to proving that the information was nonpublic, the government must prove that the information on which an individual traded was "material." The Supreme Court has set forth two definitions for materiality in the context of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.[167]

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166. *See, e.g.*, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934, Exchange Act Release No. 44,969, 76 SEC Docket 220 (Oct. 23, 2001), http://www.sec.gov/litigation/investreport/34-44969.htm#P54_10935 (declining to press charges against a company because of its internal efforts to uncover and put a halt to internal wrongdoing).

167. Importantly, the materiality standard applicable to Section 807 is likely lower than the standard for materiality under Section 10(b). In *Neder v. United States*, 527 U.S. 1, 22 (1999), the Supreme Court interpreted the materiality standard relevant to the federal mail fraud, wire fraud, and bank fraud statutes. The Court cited with approval the Restatement (Second) of Torts § 538 (1977), which states that a matter is material if: (a) a reasonable man would attach importance to its existence or nonexistence in determining his choice of action in the transaction in question; or (b) the maker of the representation knows or has reason to know that its recipient regards or is likely to regard the matter as important in determining his choice of action, although a reasonable man would not so regard it. The language of SOX 807 mirrors the bank fraud statute, suggesting that SOX 807 includes the same materiality element as the bank fraud statute. Compared with the objective "reasonable investor" standard applicable to Section 10(b) materiality, the standard of materiality applied to SOX 807 cases arguably is lower and subjective. *See* Wendy Gerwick Couture, *Criminal Securities Fraud and the Lower Materiality Standard*, SEC. REG. L.J. 77, 79–81 (2013).

In the context of an undisclosed fact, the Supreme Court in *TSC Industries, Inc. v. Northway, Inc.* held that information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision.[168] The Court explained that, to fulfill the materiality requirement, there must be a substantial likelihood that a fact "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[169] The Court acknowledged that certain information concerning corporate developments could well be of "dubious significance,"[170] so the Court was careful not to set a standard of materiality so low that it would lead management "simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision-making."[171]

The test is not whether a fact might have some hypothetical significance. Instead, the materiality standard requires a showing that there is a substantial likelihood that, under all the circumstances, a fact "would have assumed actual significance in the deliberations of a reasonable investor."[172] Some courts have looked to the market price as a determinant of materiality, explaining that the standard set forth in *TSC Industries* requires the information to be "reasonably certain to have a substantial effect on the market price of the security."[173]

In the context of contingent or speculative events such as mergers, acquisitions, and bankruptcies, the Supreme Court set forth an additional test for materiality. In *Basic v. Levinson*, the Court held that materiality depends upon "balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."[174] Following *Basic*, an event with a rela-

168. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); *see also* Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988).

169. *TSC Indus.*, 426 U.S. at 449.

170. *Id.* at 448.

171. *Id.* at 448–49.

172. SEC v. Hoover, 903 F. Supp. 1135, 1140 (S.D. Tex. 1995) (emphasis added) (citing Justin Indus. v. Choctaw Sec., L.P., 920 F.2d 262, 267 (5th Cir. 1990)).

173. Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 166 (2d Cir. 1980) (citing SEC v. Bausch & Lomb, Inc., 565 F.2d 8, 15 (2d Cir. 1977)).

174. Basic, Inc. v. Levinson, 485 U.S. 224, 238–39 (1988) (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968)).

tively low probability, such as an upcoming merger, could have a significant impact on a small company and thus be deemed material.[175] Conversely, information regarding a similar type of event could be ruled immaterial in the context of a major, diversified company.[176]

In 1999, the staff of the SEC issued Staff Accounting Bulletin No. 99 ("SAB 99") to provide guidance on the materiality of financial misstatements.[177] SAB 99 rejected the prevailing view at the time that, to be material, the financial misstatement had to exceed five percent of the company's net income.[178] In its place, the SEC's staff interjected the more ambiguous con-

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175. SEC v. Geon Indus., Inc., 531 F.2d 39, 47–48 (2d Cir. 1976) ("Since a merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death, we think that inside information, as regards a merger of this sort, can become material at an earlier stage than would be the case as regards lesser transactions—and this even though the mortality rate of mergers in such formative stages is doubtless high."), *cited with approval* in *Basic*, 485 U.S. at 238–39; *see also* United States v. Cusimano, 123 F.3d 83 (2d Cir. 1997); *infra* note 185 and accompanying text. Indeed, a large portion of the SEC's insider trading cases concern information "tipped" or misappropriated surrounding an upcoming merger. *See infra* note 181 and accompanying text.

176. *See Hoover*, 903 F. Supp. at 1148 (concluding that the low magnitude of a revised year-end earnings estimate rendered the information immaterial as a matter of law); *see also Elkind*, 635 F.2d at 166 (finding that general information about slowing sales that was commonly known among analysts, coupled with a general comment that preliminary earnings would be released in a week, did not constitute material information). The SEC's Division of Enforcement tends to take a broad view of materiality. *See, e.g.*, SEC v. General Electric Co., Litig. Release No. 21166, 96 SEC Docket 1700 (Aug. 4, 2009) (SEC contending that General Electric overstated income because certain accounting policies it used did not comply with GAAP); In the Matter of Citigroup Inc., Respondent, Exchange Act Release No. 57970, 93 SEC Docket 1323 (June 16, 2008) (SEC contending that Citigroup materially misstated its financial results as a result of improper accounting methods used for certain bond swaps and other transactions).

177. SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150 (Aug. 12, 1999).

178. *See, e.g.*, COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMM. ON CAPITAL MKTS. REGULATION 128 (2006), http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf ("For many years, the rule of thumb was that, in determining the scope of an audit, a potential error exceeding five percent of annual pre-tax income would be considered material. In evaluating a misstatement, an error that exceeded ten percent of pre-tax income was considered material, while the materiality of an error between five percent and ten percent of pre-tax income was assessed, based on various qualitative factors.").

cept of "qualitative materiality." According to SAB 99's qualitative test, a misstatement below the five percent quantitative threshold can be material under certain circumstances, such as when it leads to financial results that meet earnings targets or criteria for awarding management bonuses, concerns a significant segment of the company's business, affects compliance with regulations, affects the company's compliance with loan covenants, or conceals an unlawful transaction.[179] Although the SEC often cites SAB 99 in its pleadings, the bulletin is not the adopted view of the SEC (i.e., the Commission has not voted on it). It is merely an official interpretation of the staff and, therefore, should not be given undue authoritative weight.

Aside from SAB 99, the SEC generally views information about major corporate events as being material.[180] In 2000, the SEC, through rulemaking in Regulation FD, set out several types of information that should be "reviewed carefully to determine whether they are material," including: "(1) earnings information; (2) mergers, acquisitions, tender offers, joint ventures, or changes in assets; (3) new products or discoveries, or developments regarding customers or suppliers (e.g., the acquisition or loss of a contract); (4) changes in control or in management; (5) change in auditors or auditor notification that the issuer may no longer rely on an auditor's audit report; (6) events regarding the issuer's securities—e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, public or private sales of additional securities; and (7) bankruptcies or receiverships."[181] Despite this guidance, a materiality determination should not be made by relying solely on this list without consideration of special

179. SEC Staff Accounting Bulletin No. 99, *supra* note 180.

180. *See* Securities and Exchange Commission, *Form 8-K*, available at https://www.sec.gov/about/forms/form8-k.pdf (last visited Mar. 1, 2023).

181. Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, 65 Fed. Reg. 51716 (Aug. 24, 2000)

circumstances.[182] Determining materiality must be done on a case by case basis.[183]

Materiality is judged from the objective standpoint of a "reasonable investor," and courts often refer to the reasonable investors as the "average investor."[184] Still, the SEC often argues that specific investor behavior is indicative of materiality, and some courts have agreed.

For example, the court in *SEC v. Thrasher* determined that the tippee's investment behavior and his payment to the tipper for the information constituted adequate circumstantial evidence that the information was material.[185] Nevertheless, when defending against an insider trading case, attention should be focused on the objective standard of materiality, not the subjective and potentially erroneous view of the person trading on the information. Indeed, if materiality hinged on the subjective view of the defendant, the element of materiality arguably would be eliminated, as a person trading following the receipt of information could be deemed to view that information as significant, even if, in fact, the information was neither objectively material nor relevant to the investor's decision.

Although information need not be certain to be material, information is not deemed material if it is highly speculative

182. *See* SEC v. Cuban, 620 F.3d 551, 554–55, 558 (5th Cir. 2010) (vacating the district court's dismissal of the suit and remanding for determination of whether trading on material nonpublic information obtained under a confidentiality agreement established liability in the context of a fiduciary relationship).

183. *See, e.g.*, Basic, Inc. v. Levinson, 485 U.S. 224, 238–40 (1988) (endorsing a fact-specific approach to determining the materiality of information regarding merger discussions); United States v. Smith, 155 F.3d 1051, 1066 (9th Cir. 1998) (stating that determining materiality requires a "nuanced, case-by-case approach").

184. *See, e.g.*, DeMaria v. Andersen, 318 F.3d 170, 181 (2d Cir. 2003) ("[W]e conclude that the erroneous information would not have misled the *average investor* in light of the accurate information contained in the prospectus. . . . A *reasonable investor* would have either noticed the discrepancy and relied upon the detailed financial data included later in the EDGAR Prospectus or believed that ILife's publishing revenue was less than it actually was.") (emphasis added); Acito v. IMCERA Grp., Inc., 47 F.3d 47, 52 (2d Cir. 1995) (reciting the "total mix" standard for materiality and concluding that certain reports "were not material to the average investor.").

185. SEC v. Thrasher, 152 F. Supp. 2d 291, 301 (S.D.N.Y. 2001).

and unreliable.[186] As the Second Circuit wrote in *SEC v. Monarch Fund*, "[c]ertainly the ability of a court to find a violation of the securities laws diminishes in proportion to the extent that the disclosed information is so general that the recipient thereof is still 'undertaking a substantial economic risk that his tempting target will prove to be a white elephant.'"[187] For this reason, the court in *SEC v. Rorech* deemed that discussions between a high-yield bond salesperson and a hedge fund portfolio manager regarding plans to modify a particular bond offering were immaterial because the information was inherently speculative in nature.[188]

In determining whether information is material, courts do not view the information in isolation. Instead, courts view the information in the context in which it was conveyed. For example, in *SEC v. Happ*, a member of the Board of Directors of Galileo Corporation was held liable for insider trading when he sold his shares after receiving information during a Board meeting that the company was facing potential financial concerns and later received a message from Galileo's CEO requesting a meeting to discuss company difficulties.[189] The court found that such information could be deemed material because Happ was a sophisticated investor, he had the benefit of the information shared during the Board meeting, and the call from the CEO was out of the ordinary.[190]

The context in which information is conveyed was central to the Second Circuit's opinion in *United States v. Litvak* evaluating the materiality requirement.[191] Although the case did not involve insider trading, the court's discussion of the "reasonable investor" standard could have implications for alleged insider trading in securities that are traded on platforms other than national stock exchanges, such as debt securities traded

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186. *See* Garcia v. Cordova, 930 F.2d 826, 830 (10th Cir. 1991) (characterizing information based on subjective analysis or extrapolation as "soft information" and, as such, too speculative and unreliable to be considered material and subject to disclosure requirements).

187. SEC v. Monarch Fund, 608 F.2d 938, 942 (2d Cir. 1979) (quoting United States v. Chiarella, 588 F.2d 1358, 1366-67 (2d Cir. 1978), *cert. granted*, 441 U.S. 942 (1979)).

188. SEC v. Rorech, 720 F. Supp. 2d 367, 410–11 (S.D.N.Y. 2010).

189. SEC v. Happ, 392 F.3d 12, 21–23 (1st Cir. 2004).

190. *Id.* at 22.

191. 889 F.3d 56 (2d Cir. 2018).

among institutional investors. The case involved alleged material misrepresentations made by a bond trader who bought and sold residential mortgage-backed securities ("RMBS"), which are marketed to large, sophisticated financial institutions. RMBS are not traded on an exchange like NASDAQ or the New York Stock Exchange. When analyzing the materiality of the alleged misstatements, the Second Circuit acknowledged that "[t]he standard of a 'reasonable investor' . . . is an objective one" but added that the "standard may vary with the nature of the traders involved in the particular market." The Second Circuit analyzed the materiality of the information at issue in the case in the context of an "objective investor in the RMBS market."[192] This interpretation could raise the standard for the government to demonstrate the materiality of information in certain markets and could provide an opportunity for defense counsel to argue that information is immaterial.

Information that is seemingly vague can be material. In *United States v. Cusimano*, a statement that "something was happening" between AT&T and a target company was determined to be material where several individuals had set up a scheme to obtain insider information from AT&T and where AT&T's interest was a significant event for the target company.[193] In another case, *SEC v. Meyhew*, a tip that a company was seeking an investment partner was deemed material, despite the fact that the potential partner was not identified and no further details about the merger were provided, because the information came from an insider who said that merger discussions were serious.[194] Courts, however, have deemed information not to be material where the information was only slightly different from prior projections and where the news, when broadly released, did not significantly affect the market.[195]

The law of materiality becomes even murkier when an investor aggregates pieces of information (often both nonpublic and public) to reach a nonpublic conclusion. As a general

192. *Id.* at 69 (emphasis added).
193. United States v. Cusimano, 123 F.3d 83, 88 (2d Cir. 1997).
194. SEC v. Mayhew, 121 F.3d 44, 51–52 (2d Cir. 1997).
195. Here, the company's Form 10-Q disclosed that it expected earnings to be 10% lower than the previous year and the individual learned that the company's earnings would actually be up to two percentage points lower than disclosed. *See* SEC v. Hoover, 903 F. Supp. 1135, 1144–46 (S.D. Tex. 1995)

matter, piecing together fragments of nonmaterial information to understand the broader position of a company (the so-called "mosaic" theory of investing, as discussed above) does not violate insider trading laws and can be used as a defense to an insider trading charge.[196] However, counsel should be cognizant of a situation where material, nonpublic information has been artificially broken into smaller pieces—similar to structuring in the money laundering context—to avoid a particular piece from being deemed material. In such circumstances, a court might treat the pieces of information in the aggregate as collectively material.[197]

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196. Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 165 (2d. Cir. 1980) ("A skilled analyst may piece seemingly inconsequential data together with public information into a mosaic which reveals material non-public information."); *see also* SEC v. Bausch & Lomb, Inc., 565 F.2d 8, 14 (2d. Cir. 1977) (explaining that "corporate management may reveal to securities analysts or other inquirers non-public information that merely fills 'interstices in analysis' or tests 'the meaning of public information'"). The SEC staff states:

> An issuer . . . would not be conveying such [i.e. material] information if it shared seemingly inconsequential data which, pieced together with public information by a skilled analyst with knowledge of the issuer and the industry, helps form a mosaic that reveals material nonpublic information. It would not violate Regulation FD to reveal this type of data even if, when added to the analyst's own fund of knowledge, it is used to construct his or her ultimate judgments about the issuer.

U.S. SEC. & EXCH. COMM'N, COMPLIANCE AND DISCLOSURE INTERPRETATION 101.03 (2009).

Similarly, the Chartered Financial Analyst Institute's Standards of Practice Handbook states:

> A financial analyst gathers and interprets large quantities of information from many sources. The analyst may use significant conclusions derived from the analysis of public and nonmaterial nonpublic information as the basis for investment recommendations and decisions even if those conclusions would have been material inside information had they been communicated directly to the analyst by a company. Under the 'mosaic theory,' financial analysts are free to act on this collection, or mosaic, of information without risking violation.

CHARTERED FIN. ANALYST INST., STANDARDS OF PRACTICE HANDBOOK 62 (2014), https://www.cfainstitute.org/-/media/documents/code/code-ethics-standards/standards-practice-handbook-11th-ed-eff-July-2014-corr-sept-2014.pdf.

197. United States v. Mylett, 97 F.3d 663, 668 (2d Cir. 1996) (upholding criminal conviction for insider trading when the defendant "was never told about the acquisition and did no more than piece together evidence ob-

In defending against a claim that information is material, counsel should look to the point, albeit uncertain, when the information ultimately reached the public domain to determine what other information was released about the company, the industry, and the overall market. Often, companies combine the release of information, particularly bad news, with other information to minimize the effect on the stock price. This combination also makes it difficult to determine whether any particular piece of information affected the stock price in a significant way. Economic analysis is key for both the government, which has the burden of proof, and also for the defendant, who often can demonstrate other reasons for a stock's movement. The SEC and DOJ often cannot prove that the piece of information at issue in a case was material because so many other pieces of information about the company reached the marketplace at the same, or nearly the same, time. In addition, defense counsel should move to exclude any expert testimony offered by the government to establish materiality that does not control for other variables at the time the information was made public.[198]

C. *Breach of a Duty*

Whether an individual has violated a duty depends on the particular theory of insider trading that the government is asserting. As discussed above, there are three traditional theories[199] of insider trading liability: the "classical" theory, the "tipper-tippee" theory, and the "misappropriation" theory, each with slight variations on the duty element. The government has the burden of proving that a person trading on a tip

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tained while working for" the acquirer); SEC v. Steffes, 805 F. Supp. 2d 601 (N.D. Ill. 2011) (denying motion to dismiss SEC's insider trading enforcement action under a "classical" theory where employees pieced together information from inside the company that led them to believe it was about to be sold); SEC v. Binette, 679 F. Supp. 2d 153, 159 (D. Mass. 2010) ("A defendant may be liable under the misappropriation theory when he pieces together incomplete fragments of confidential information provided through his employment to identify likely acquisition targets and then trades stock in those target companies.").

198. *See* Daubert v. Merrell Dow Pharm., 509 U.S. 579, 580 (1993) (stating the factors to be considered in the admissibility of expert testimony).

199. As discussed *supra* Section II.C.4, the so-called "outsider trading" or "affirmative misrepresentation" theory of insider trading articulated by the Second Circuit in *SEC v. Dorozhko* does not require a breach of a duty.

knew or should have known that there was a breach of a duty by the source of the information.[200]

1. *Duty under the Classical and Tipper-Tippee Theories.*

The duty element is essentially the same under both the classical and tipper-tippee theories. Under the classical theory, the fiduciary duty owed by the corporate insider is often evident from the individual's position in the company or as an agent of that company, and the nature of the information. The fiduciary duty to abstain from trading on material nonpublic information applies to "officers, directors, and other permanent insiders of a corporation . . . [and] to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation."[201]

Similarly, under "tipper-tippee" liability, the initial tipper breaches his or her fiduciary duty to the corporation by disclosing material nonpublic information to an outsider in violation of the tipper's fiduciary duty to the company and in return for a personal benefit.[202] Such benefit may arise through "a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings" or by making a "gift of confidential information to a trading relative or friend."[203]

200. Dirks v. SEC, 463 U.S. 646, 647, 660 (1983) ("[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material non-public information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and tippee knows or should know there has been a breach."); *see also* SEC v. Maio, 51 F.3d 623, 632 (7th Cir. 1995) (quoting *Dirks*, 463 U.S. at 660). If trading is with respect to a planned or existing tender offer, Rule 14e-3 makes trading unlawful without regard to whether any fiduciary duty exists. *Id.* at 635.

201. United States v. O'Hagan, 521 U.S. 642, 652 (1997) (citing *Dirks*, 463 U.S. at 655 n.14); *see also* SEC v. Lund, 570 F. Supp. 1397, 1403 (C.D. Cal. 1983) (holding that discussion between Lund and another businessman concerning a proposed joint venture between their respective companies created a fiduciary duty that made Lund a "temporary insider").

202. SEC v. Ingram, 694 F. Supp. 1437, 1440 n.3 (C.D. Cal. 1988) (relying on *Dirks*, 463 U.S. at 646, for the proposition that "the individual must have expressly or impliedly entered into a fiduciary relationship with the issuer.").

203. *Dirks,* 463 U.S. at 663–64. *See* discussion *supra* notes 31–48 regarding the broad view of "personal benefit" generally claimed by the SEC and upheld by courts.

Whether an insider has breached a fiduciary duty depends on the specific facts and circumstances and often turns on the person's knowledge and intent. An insider arguably may convey nonpublic information to an outsider without violating a fiduciary duty if it is done with the good-faith intent to benefit the company or if the insider honestly believes the information is already public.[204] However, if it appears that the insider also received a personal benefit, which is an element of the violation, or if the insider is reckless[205] in sharing the information, then courts are likely to find a breach of a fiduciary duty.[206]

As mentioned, liability for a tippee depends on whether the tippee was aware of the breach of a fiduciary duty, which often is established through circumstantial evidence. Courts generally look to whether the tippee was aware of the source of the information. A tippee who is aware that the material nonpublic information came from an insider is viewed by the courts as knowing that the insider breached a duty by selectively disclosing the information, as opposed to disclosing through an official corporate channel.[207]

The more difficult scenario arises when there is no direct evidence that the tippee knew the source of the information. In those circumstances, courts often look to the same facts that establish that the tippee knew the information was nonpublic, such as subsequent actions of the tippee upon learning the information. Did the tippee make what would be viewed as an

204. Company insiders "are presumed to know when information is undisclosed." SEC v. Monarch Fund, 608 F.2d 938, 941 (2d Cir. 1979).

205. *See, e.g.*, McLean v. Alexander, 599 F.2d 1190, 1197 (3d Cir. 1979); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1023 (6th Cir. 1979); Edward J. Mawod & Co. v. SEC, 591 F.2d 588, 596 (10th Cir. 1979); Hoffman v. Estabrook & Co., 587 F.2d 509, 516 (1st Cir. 1978); Nelson v. Serwold, 576 F.2d 1332, 1337 (9th Cir. 1978); Cook v. Avien, Inc., 573 F.2d 685, 692 (1st Cir. 1978); Rolf v. Blyth, Eastman Dillon & Co. 570 F.2d 38, 44-47 (2d Cir. 1978); First Va. Bankshares v. Benson, 559 F.2d 1307, 1314 (5th Cir. 1977).

206. *Id.*

207. *See, e.g.*, SEC v. Musella, 578 F. Supp. 425, 431–32, 442 (S.D.N.Y. 1984) (finding a corporate bond trader liable as a tippee for obtaining information about a pending tender offer from his friend who was employed by the law firm representing the acquiring company); *see also* SEC v. Maio, 51 F.3d 623, 632 (7th Cir. 1995) (finding the tippee liable because he knew that information he received from the CEO of an acquiring company was improper).

unusual investment (e.g., using futures or out-of-the-money options, liquidating a retirement portfolio to make the investment, or making an extraordinarily large purchase)?

In defending against an allegation of insider trading, counsel should pay particular attention to the government's proof of the tippee's knowledge of the breach of a duty. Each defendant-tippee in a chain who receives material nonpublic information must know or have reason to know of the breach of the fiduciary duty to be liable for insider trading.[208] In many cases, beyond the first few tippees in a large chain, the evidence in this regard is scarce at best.[209]

2. *Duty under the Misappropriation Theory.*

Under the misappropriation theory, liability for insider trading is broadly premised on "a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."[210] The linchpin for the government in the misappropriation theory is the establishment of a fiduciary duty or relationship of trust and confidence. Depending on the facts of the case, courts have found that such a duty or relationship exists in the following circumstances and relationships: lawyer-

208. *See, e.g.*, Complaint at 5, SEC v. Gowrish, No. 09-CV-5883 (N.D. Cal. Dec. 16, 2009) (where the SEC did not charge the brother of an insider trader, but rather named him as a relief defendant, even though he allowed the defendant to trade in his account and split the profits from the trades; he was never aware that the trades were executed on the basis of inside information); *see also* Complaint at 7, SEC v. Tang, No. 09-CV-05146-JCS (N.D. Cal. Oct. 30, 2009) (where the SEC did not charge fifteen relief defendants for insider trading even though they were family members with accounts in which the illegal trading occurred).

209. *See, e.g.*, Complaint at 2–4, SEC v. Stephanou, No. 09-CV-1043 (S.D.N.Y. Feb. 5, 2009). The SEC charged a UBS investment banker for tipping about material nonpublic information regarding the acquisition of a construction materials firm and a healthcare company. *See id.* at 1–4. His close family friend traded on the information in both cases and, in turn, "either tipped four family members with that information or traded in their accounts on the basis of that information." *See id.* at 4. Though those family members may have traded themselves, SEC did not charge these individuals. *See id.* at 1–2.

210. United States v. O'Hagan, 521 U.S. 642, 652 (1997).

client,[211] director-corporation,[212] employee-employer,[213] busi-

211. *Id.* In *O'Hagan*, a law firm partner obtained material nonpublic information from his firm when it represented Grand Met in its contemplated tender offer for Pillsbury. *Id.* at 647–48. Mr. Hagan did not participate in the representation of Grand Met, but instead he obtained the information despite the efforts of Grand Met and his law firm to keep the information confidential. *Id.* Nevertheless, the Supreme Court found that O'Hagan violated the duty that he owed to his law firm when he misappropriated the information and used it to purchase a large number of Pillsbury call options and shares, making a profit of more than $4.3 million. *Id.*

212. SEC v. Talbot, 530 F.3d 1085, 1087–88 (9th Cir. 2008) (holding that a director of a public company misappropriated nonpublic information about a proposed acquisition of which he learned during a board of directors meeting of his company). The Ninth Circuit remanded the case to the district court for a determination of whether the information was material. *Id.* at 1097–98.

213. *See, e.g.*, United States v. Carpenter, 791 F.2d 1024, 1028 (2d Cir. 1986) (affirming United States v. Winans, 612 F. Supp. 827 (S.D.N.Y. 1985)); SEC v. Materia, 745 F.2d 197 (2d Cir. 1984) (affirming lower court decision that found defendant breached a fiduciary duty to his employer and its clients when he traded on the basis of confidential information obtained during the course of his employment); United States v. Newman, 664 F.2d 12 (2d Cir. 1981) (reversing dismissal of an indictment against the defendant by finding that the defendant employee violated his duty to his employer brokerage firm and the firm's clients by misappropriating confidential information and concealing it when he was under a duty to disclose); *Winans*, 612 F. Supp. at 844–45 (holding that the defendant owed a fiduciary duty to his employer not to disclose contents of material nonpublic information he obtained in the course of his employment).

ness partners,[214] accountant/tax planner-client,[215] doctor-patient,[216] and familial.[217]

The SEC set forth in Rule 10b5-2 a non-exhaustive list of the relationships that would establish a duty of trust or confidence under a theory of misappropriation.[218] According to Rule 10b5-2, a duty of trust or confidence arises between a recipient of material nonpublic information and the source when: (1) the recipient of the information "agrees to maintain

214. SEC v. Peters, 735 F. Supp. 1505, 1520 (D. Kan. 1990) (applying the misappropriation theory in the context of a business partnership), *rev'd on other grounds*, 978 F.2d 1162 (10th Cir. 1992); SEC v. Lund, 570 F. Supp. 1397, 1403 (C.D. Cal. 1983) (holding that discussion between Lund and another businessmen concerning a proposed joint venture between their respective companies created a fiduciary duty because the two men were "long time friends and business associates").

215. SEC v. Kornman, 391 F. Supp. 2d 477, 489 (N.D. Tex. 2005) (noting that defendant's knowledge regarding estate and tax planning may indicate that a duty of trust had developed between defendant and the two corporate executives from whom he obtained information about upcoming acquisitions and buy-outs).

216. United States v. Willis, 737 F. Supp. 269, 271, 277 (S.D.N.Y. 1990) (holding that a psychiatrist could be convicted for trading on the basis of material nonpublic information that he learned in the course of treating his patient, the wife of a corporate executive; explaining that the doctor had adequate notice that it would "be unlawful for him to disclose his patient's information and use it to trade in securities for his personal benefit").

217. *See* SEC v. Yun, 327 F.3d 1263, 1272–74 (11th Cir. 2003) (holding that the defendant spouse owed her husband, an executive at the issuer, a duty of loyalty and confidentiality not to disclose material nonpublic information related to revised earnings information he relayed to her); SEC v. Lenfest, 949 F. Supp. 341, 345 (E.D. Pa. 1996) (denying defendant's motion for summary judgment due to her potential liability for trading based on material nonpublic information that she obtained in confidence from her husband, the board member of a merger target); United States v. Reed, 601 F. Supp. 685, 718 (S.D.N.Y. 1985) (denying defendant's motion to dismiss, holding that sufficient facts existed for a jury to decide that defendant, the son of a corporate director, misappropriated information concerning a potential acquisition involving his father's company in violation of a confidential relationship with his father), *rev'd on other grounds,* 773 F.2d 477 (2d Cir. 1985). *But see* United States v. Chestman, 947 F.2d 551, 567 (2d Cir. 1991) (holding that prosecutors failed to establish a "functional equivalent of a fiduciary relationship" between the wife who shared information about a family business transaction and her husband, who relayed the information to his stockbroker who traded on the information).

218. *See* Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, 65 Fed. Reg. 51716 (Aug. 24, 2000), http://www.sec.gov/rules/final/33-7881.htm.

information in confidence"; (2) two individuals have a "history, pattern, or practice of sharing confidences such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality"; and (3) an individual receives "material nonpublic information from certain enumerated close family members," including "spouses, parents, children, and siblings."[219]

In attempting to clarify what relationships would indicate a duty of trust and confidence, the SEC may have exceeded the constitutional bounds of its authority with Rule 10b5-2. The district court in *SEC v. Cuban* held that Rule 10b5-2 was an unconstitutional exercise of the SEC's power, stating that the SEC "cannot by rule predicate liability on an agreement that lacks the necessary component of an obligation not to trade on or otherwise use confidential information for personal benefit."[220] The court held that finding liability on a mere agreement to maintain information in confidence exceeds the SEC's authority under Section 10(b) to proscribe deceptive conduct.[221] Additionally, the district court held that Rule 10b5-2(b)(3), which creates a presumption of a duty of trust or confidence for the enumerated family members, is an unconstitutional shift in the government's burden in a criminal case because the government always must carry the burden to prove each element of an insider trading offense.[222]

Certain business interactions may seem ripe for insider trading opportunities, yet they do not give rise to a duty to not trade under the elements established by the Supreme Court in *O'Hagan*. Consider the following scenario: an investment banker may contact a hedge fund regarding a deal and relay

219. 17 C.F.R. § 240.10b5-2(b)(1), § 240.10b5-2(b)(3) (2010). The enumerated family members in the rule are presumed to create a duty of trust and confidence, but the SEC recognizes that it is a rebuttable presumption. *Id.*

220. SEC v. Cuban, 634 F. Supp. 2d 713, 729 (N.D. Tex. 2009). On appeal, the Fifth Circuit questioned but did not address the validity of Rule 10b5-2(b)(1). *See* SEC v. Cuban, 620 F.3d 551, 555, 558 (5th Cir. 2010). The *Cuban* case also illustrates a situation where a fiduciary duty or a relationship of trust or confidence is not apparent.

221. *Cuban*, 634 F. Supp. 2d at 730–31.

222. *Id.*; s*ee also Chestman*, 947 F.2d at 567 (holding that prosecutors failed to establish their case because they did not prove that a "functional equivalent of a fiduciary relationship" existed between husband and wife).

material nonpublic information about an issuer in the course of the discussion. The hedge fund later trades in the issuer's stock on the basis of the information. Is the hedge fund liable for misappropriating the information to trade for its benefit? The answer depends on whether the hedge fund owes a duty to the investment bank or to its clients. Courts have held that arm's-length negotiations do not constitute a relationship of trust or confidence.[223] Even an agreement to keep the deal confidential may not give rise to a duty to not trade.[224] Unless it can be shown that the investment bank and hedge fund had an established relationship of trust or confidence before their discussions, it might be difficult to establish the legal elements of insider trading.

In this situation, the investment bank nevertheless clearly has a duty to the issuer to ensure that the information is maintained in confidence by any potential investors. Thus, the investment bank should not disclose the information to an investor unless the bank obtains the investor's agreement to keep the information confidential and not to trade on it. When the

223. *See, e.g.*, United States v. Cassese, 273 F. Supp. 2d 481, 485–86 (S.D.N.Y. 2003) (finding that negotiations between defendant and a competitor constituted potential arm's length business dealings rather than a fiduciary relationship). *But see* SEC v. Lund, 570 F. Supp. 1397, 1403 (C.D. Cal. 1983) (holding that discussion between Lund and another businessman concerning a proposed joint venture between their respective companies created a fiduciary duty that made Lund a "temporary insider"; observing that the two men were "long time friends and business associates").

224. *See, e.g.*, Walton v. Morgan Stanley & Co., 623 F.2d 796, 799 (2d Cir. 1980) (upholding dismissal of claims brought against defendant Morgan Stanley for trading in stock of its client's potential takeover target based on confidential information received in the course of merger discussions). In *Walton*, the court determined that the defendant did not have a relationship with the issuer other than through discussions about the possible deal, explaining that "although, according to the complaint, Olinkraft's management placed its confidence in Morgan Stanley not to disclose the information, Morgan Stanley owed no duty to observe that confidence." *Id.* Where a confidentiality agreement exists, the relevant factor is whether the parties had a relationship of trust and confidence outside of the particular discussions at issue. *See also Cuban*, 620 F.3d at 557–58 (reversing the district court's dismissal of the case for further proceedings to evaluate whether the understanding between the CEO and Cuban went beyond a "simple confidentiality agreement"). Note, however, that the SEC maintained in *Cuban* that a confidentiality agreement itself created a duty to disclose or refrain from trading based on information received under the agreement. *Id.* at 552–53.

bank discloses the information without having obtained a confidentiality agreement or having gone through proper procedures the hedge fund, which may be the recipient of information it did not seek, is put in a difficult situation. On the one hand, if the fund trades in the securities of the company that are the subject of the unwanted disclosure, the SEC or a prosecutor might argue that the fund has committed insider trading under a misappropriation theory, pointing to some expectation of confidentiality based on a pattern of interactions between the investment bank and the hedge fund.[225] On the other hand, if the fund is forced to refrain from trading in the relevant securities—particularly where it would have traded the relevant securities absent a call from the bank—the hedge fund's refraining from trading may be in breach of the adviser's fiduciary obligation to trade for the benefit of its investors, and the fund could not justify its failure to trade because the hedge fund has no obligation to the bank or the underlying company.

In short, a hedge fund seeking to stay out of the government's crosshairs does not want to receive unwanted information concerning securities of companies that it trades. To avoid receiving such information, funds may put banks or other agents on notice that they should not supply such information without first requesting appropriate consent to supply the information.

The Panuwat case discussed above demonstrates that the SEC may seek to establish the existence of a duty in misappropriation cases by referring to insiders' agreements to comply with company policies regarding insider trading, even if those policies are stricter than the federal securities laws. In Panuwat, the SEC alleged that the defendant engaged in insider trading when he learned that his employer was about to be acquired and then traded in the securities of an industry peer, believing that the peer company's stock price would rise on news of the acquisition. In response, the defendant argued

225. *See, e.g.*, *Cuban*, 634 F. Supp. 2d at 727–29; *see also supra* text accompanying note 127. Failing to prove an agreement to maintain the information in confidence and not trade, an aggressive SEC lawyer or prosecutor might try to argue that the hedge fund somehow tricked the investment bank into divulging the information by making an affirmative misrepresentation. *See* SEC v. Dorozhko, 574 F.3d 42, 49 (2d Cir. 2009); *see also supra* text accompanying notes 50–51.

that he did not owe a duty to the peer company and therefore his trading in that company's securities did not satisfy the breach-of-duty element. The SEC argued that the defendant's duty arose from his own employer's insider trading policy, which broadly prohibited trading on the basis of material nonpublic information, even if the trades related to another publicly-traded company. The district court agreed with the SEC and ruled that the defendant had breached a duty by violating his employer's policy not to trade in the securities of another company on the basis of material nonpublic information.[226]

Although the misappropriation theory is used to establish liability, it also can be raised as a defense by insiders who provide inside information to someone who ultimately trades. For example, in a situation where a corporate executive provides material nonpublic information to a family member, friend, or business associate who trades, the corporate executive may cite Rule 10b5-2 to argue that he and the recipient of the information have a "history, pattern, or practice of sharing confidences such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality."[227] In this example, the corporate executive might not be liable for tipping the recipient, yet the recipient could be liable for insider trading based on the misappropriation theory.

There are several cases where the facts could support a tipper-tippee theory of liability, but the government proceeded instead under the misappropriation theory. For example, in *United States v. Corbin*, a district court found that the misappropriation theory applied where a tippee received information from a friend who had breached his duty of confidentiality to his wife.[228] The friend and his wife had an express agreement to keep information that the wife learned from her company confidential, and they had a duty based on a history, pattern, or practice of sharing confidences.[229] In SEC v. Stum-

226. *See* Order Denying Motion to Dismiss, SEC v. Panuwat, Case No. 4:21-CV-06322-WHO (N.D. Cal. Jan. 14, 2022), ECF No. 26.

227. Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, 65 Fed. Reg. 51716, 51730 (Aug. 24, 2000), https://www.sec.gov/rules/final/33-7881.htm.

228. United States v. Corbin, 729 F. Supp. 2d 607, 615–16 (S.D.N.Y. 2010).

229. *Id.*

mer, the defendant settled with the SEC on insider trading charges after he misappropriated material nonpublic information by guessing the password to his brother-in-law's computer.[230] Stummer's brother-in-law was a director of the private equity firm that was rumored to be involved in a potential acquisition, and Stummer logged into the private equity firm's network to research and obtain confidential information on which he traded.[231]

IV.
Compliance Practices to Address Insider Trading[232]

Companies and financial services firms must establish policies and procedures to address insider trading and interactions with potential tippers, including experts and expert networks. For funds, such compliance procedures should also address their interaction with investment dealers or others that might have agency duties to a public company. Effective policies and procedures should address: (1) the implementation of information barriers between the firm's public and private sides; (2) the selection of expert networks and experts, including the firm's due diligence, screening, and approval process before a network or expert is engaged; (3) the interaction with investment dealers and experts, including identification of personnel designated to interact with them, the manner in which the interaction is to occur, and the documentation of that interaction; and (4) the monitoring, surveillance, and supervision of the interaction between the firm and investment dealers or experts, and of trading with issuers that are subjects of such interactions. All employees at the firm should be

230. SEC v. Stummer, Litig. Release No. 20,529, 93 SEC Docket 115 (Apr. 17, 2008) (announcing the settlement of the action); Complaint at 2, 5, SEC v. Stummer, No. 08-CIV-3671 (S.D.N.Y. Apr. 17, 2008).

231. Complaint at 4–5, SEC v. Stummer, No. 08-CIV-3671 (S.D.N.Y. Apr. 17, 2008).

232. This article focuses on issues involving the DOJ and the SEC. There are steps that can be taken to protect against a private action by a counterparty. For example, private parties to a transaction sometimes enter into so-called "big boy" letters whereby they agree, in essence, not to sue each other for violating insider trading laws. These agreements might protect a party against a private lawsuit from a counterparty, but they provide little protection against a government enforcement action or criminal prosecution.

trained thoroughly on the laws governing insider trading and the firm's policies and procedures. The firm should create a culture wherein employees are encouraged to report to compliance or legal personnel any unusual or problematic activity, as well as any information that arguably constitutes material nonpublic information. Firms should document both the processes implemented and the steps personnel take in compliance with these processes, thereby creating a detailed record of the firm's efforts to meet its legal and regulatory obligations.

A. *Insider Trading – Information Barriers*

Firms should implement adequate information barriers between their public and private lines of business. Employees who have acquired or who, in the course of their normal business dealings, are likely to acquire material nonpublic information (i.e., private-side employees) should be screened from communications with employees involved in trading (i.e., public-side employees). Furthermore, persons in a position to make trading decisions should be trained in distinguishing "nonpublic" information from "public" information.

Public-facing employees must understand the need to inform compliance or legal personnel promptly when they are exposed, for any reason, to material nonpublic information and to refrain from sharing such information or otherwise using or relying upon it. Moreover, the line between legitimate, public information and material nonpublic information is frequently unclear. Therefore, it is critical for public-facing employees to understand that, where there is any doubt as to whether information may be material nonpublic information, or where red flags may be present, the employee must consult with appropriate compliance or legal personnel promptly. The employee should not share, use, or rely on such information unless and until such information is approved following a review by compliance and legal personnel.

B. *Expert Network Procedures*

1. *Expert Network Compliance Program.*

Firms that use expert networks should consider instituting a review and approval process to document that the expert network being used employs reasonable practices and compliance efforts. In particular, firms should ensure that the expert network employs a strong screening process. Firms should ask who at the network approves experts, what background check processes are employed with regard to experts, and whether the process is documented adequately. Furthermore, firms should consider inquiring about the contractual arrangements between the expert network and their experts, including compensation structure and any representations and warranties provided. A firm's compliance or legal personnel should review and approve use of the network.

2. *Expert-Specific Procedures.*

In addition to the expert network's compliance program, firms should screen experts independently. Firms should perform at least basic background checks (e.g., use public search engines) on all experts utilized. Any potential "red flags" that appear in the background check, such as disciplinary and regulatory actions, could be reviewed by a member of the firm's compliance or legal team before any discussions with the expert occur. Consideration should be given to criteria that might cause firms to prohibit the use of an expert, or at the very least, subject such approval to stricter scrutiny or involve more senior reviewers within the firm. One important consideration is whether the firm should prohibit the use of experts who were employed within a certain time frame at a company in which the firm is considering investing. Experts who were recently employed by, or affiliated with, the company at issue may have been exposed to material nonpublic information. Even if the former employees do not possess material nonpublic information, government investigators may view such experts with suspicion.

3. *Pre-Approvals.*

Employees should not hold any discussions with experts unless and until they have first received approval from their supervisor and the firm. The approval should be documented appropriately and reflect the expected scope of the discussions as well as the general purpose behind the use of such experts.

4. *Documentation of Meetings.*

Firms should document all discussions or meetings with experts. These records should include, at a minimum, who participated, the expert's current place of employment, the expert's basis of knowledge, and the topics covered. Firms also should consider whether to require a member of the compliance or legal team to participate in certain discussions with experts, particularly with experts who may have had direct involvement with a relevant issue.

Furthermore, dealings with particular experts should be conditioned on the expert providing certain commitments prior to or at the opening of the meetings. Firms also may consider requiring that all discussions with an expert begin with a script in which the expert assents to the following points:

- that the expert understands that the client does not wish to receive material nonpublic information;
- that the expert has not breached, and will not breach, any confidential agreement, policy obligation, or legal duty that the expert has to any party;
- that no one else has breached a legal duty in providing information to the expert;
- that the expert is not an employee, affiliate, or supplier of the company that will be discussed on the call;[233]
- that the expert did not pay an employee, affiliate, or supplier of the company at issue to obtain the information;
- to the extent possible, an acknowledgement that the information the expert plans to provide was not obtained directly or indirectly by anyone who would not be able to assent to each of the foregoing representations.

At the end of the meeting, firms should obtain confirmation that nothing discussed during the meeting changed the assent obtained at the beginning of the meeting.

Supervisors should review and approve all documentation from meetings with expert networks. Firms also may wish to

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233. If the expert is an employee, affiliate, or supplier of the company, the firm should obtain confirmation from the company as to the company's knowledge and approval of the expert's activities and any limitations thereon.

consider routine review of such information by a member of the firm's compliance or legal teams. Moreover, all employees who may engage in discussions with experts and those employees' supervisors should be trained to identify problematic answers to scripts or other issues noted during these meetings and should understand the importance of promptly directing issues to the attention of compliance or legal personnel for review. Information should not be shared or otherwise used or relied upon pending completion of the review process and, if applicable, the approval process. This protocol is especially important with respect to any information that is flagged as problematic and in need of further review.

Securities of relevant issuers should be added to the firm's watch list to ensure appropriate monitoring of future trading therein. In light of *Panuwat*, the watch list may need to include securities of issuers in similar industries as those discussed during calls with consultants.[234]

5. *Follow-Up Communications.*

Communications with experts should be made only through approved means of communication that are tracked by the firm. Firms should prohibit employees from using informal means of communication when interacting with experts. Communications through text messaging, instant messaging, and social networking are difficult for firms to monitor, lend themselves to informality, and can easily be taken out of context. Their informality makes them easy targets for enforcement authorities seeking evidence of inappropriate behavior. Accordingly, employees should be instructed to communicate by phone or in person with experts using the compliance procedures outlined in this Section B.

If there are any electronic communications with experts, those communications should be conducted over firm-approved messaging channels and reviewed by compliance personnel or the employee's supervisor. If a message is ambiguous, firms should consider follow-up written communications to clarify the intent of the message. At the very least, firms should document the meaning of an ambiguous phrase to avoid confusion later after memories have dimmed.

234. *See* SEC RISK ALERT, *supra* note 22, at 3.

C. *Alternative Data Procedures*

The SEC increasingly has become interested in financial firms' use of so-called alternative data or "alt data." This data is derived from non-traditional sources outside of a company's public filings, such as "information gleaned from satellite and drone imagery [ ] . . . , analyses of aggregate credit card transactions, social media and internet search data, geolocation data from consumers' mobile phones, and email data obtained from apps and tools that consumers may utilize."[235]

In 2021, the SEC settled an enforcement action brought against a data aggregator, App Annie Inc., and its founder alleging securities fraud related to the sale and use of alternative data. Although the SEC did not allege insider trading, the matter has implications for investment firms who purchase and rely on alternative data.[236] App Annie gathered mobile app data from the apps of publicly-traded companies. App Annie then sold that data to investment firms and encouraged the firms to make investment decisions using the data. The SEC alleged that App Annie and its founder violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by making material misrepresentations about how App Annie derived the data it made available to subscribers and misrepresented that it had internal controls and processes to prevent the misuse of confidential information and to comply with the federal securities laws. According to the SEC, App Annie's misrepresentations induced securities trading firms to subscribe to App Annie's services and to use App Annie's data to purchase and sell securities. In particular, the SEC alleged that App Annie did not have a documented policy to exclude confidential information from the data it provided to subscribers, and, once it adopted such a policy, did not take sufficient measures to ensure that the policy was implemented company-wide.[237]

The App Annie case highlights the risk that investment firms might receive material nonpublic information from alt data sources. Firms that purchase alt data should take precautions to avoid receiving material nonpublic information. These precautions include: (1) adopting policies and procedures tai-

235. *See id.*
236. *See* App Annie Inc., Exchange Act Release No. 92975 (Sept. 14, 2021), https://www.sec.gov/litigation/admin/2021/34-92975.pdf.
237. *Id.*

lored the use of alt data; (2) consistently conducting and memorializing diligence processes; (3) implementing policies and procedures to assess the terms, conditions, or legal obligations related to the collection or provision of the data, including processes for employees to follow when they learn about potential red flags involving the source of alt data; and (4) maintaining documentation to demonstrate that the firms' policies have been consistently applied to alt data providers.[238]

D. *Other Procedures*

1. *Supervision.*

Investment firms' supervisory programs should be ongoing and tailored to the particularities of a firm's respective business. Supervisors should meet regularly with supervised persons and be informed fully of the person's conduct and the business being conducted. Firms' supervisory procedures should include appropriate documentation of applicable processes, including: (1) monitoring of employees' compliance with procedures; (2) supervisory approval; and (3) trade monitoring and review. As noted, the purpose of supervisory documentation is to document compliance with internal firm processes. Such documentation should not, however, include conclusions regarding factual findings or other evidence obtained during a supervisory review. Instead, such matters should be discussed with legal or compliance personnel, who should take responsibility for documenting any reviews, findings, or conclusions with respect thereto.

2. *Surveillance.*

Internal surveillance programs should closely monitor the firm's trading positions and strategies. Surveillance should not be limited to firm proprietary accounts but also should include trading that occurs in customer accounts and employees' personal trading accounts.[239] These surveillance systems should monitor for, among other things: (1) significant gains and avoidance of large losses; (2) patterns of trades in advance of

238. SEC RISK ALERT, *supra* note 22, at 2–3.

239. *See* Investment Advisers Act of 1940 Rule 204A-1, 17 C.F.R. § 275.204A-1 (2016) (requiring investment advisers' codes of conduct to contain "provisions that require all your access persons to report, and you to review, their personal securities transactions and holdings periodically").

market moving news; (3) unusual trading methods, products, and the like; and (4) trades outside the firm's strategy. The firm should investigate any triggering events and document the resulting investigation, including any reasonable explanations for the conduct. Although supervisory personnel and traders should be consulted during any such investigation, the investigation should be led by the firm's compliance or legal personnel or outside counsel. All trading in securities related to any expert discussions should be subject to ongoing surveillance.

3. *Culture of Compliance or so-called "Speak-up" Culture.*

Compliance programs should encourage employees to voice concerns and question conduct where doubt exists as to the propriety of trading on certain information. Even firms with the most well-designed and well-operated compliance programs will find it difficult to safeguard themselves completely from all regulatory problems. Creating an atmosphere in which employees feel comfortable raising legal and compliance questions helps firms ensure that they are taking a broad view on regulatory concerns.

4. *Training.*

Training programs should be robust, regular, and well-documented, including topics covered and attendance. Such programs should focus on: (1) the substance of the law; (2) the substance of the firm's procedures; and (3) the need to self-report or flag problematic issues for further discussion and review.

To the extent possible, training programs should avoid abstract analysis and instead reflect and address real life activities and behaviors faced by firm personnel. Firms should consider more focused training programs for individuals who will communicate directly with experts and those individuals' supervisors. Training should emphasize the need to reach out immediately to compliance and legal personnel with any doubts as to whether certain information can be used.

5. *Documentation.*

It is important to be able to demonstrate to government investigators the extent to which a firm strives to comply with the law. For this reason, a firm should maintain consistent and thorough documentation of its compliance program. Firms should be able to show examiners and investigators that they have taken steps to inform employees of appropriate policies and procedures, actively followed through in implementing and enforcing the policies and procedures, and consistently investigated red flags and other unusual matters.

Conclusion

The law of insider trading is nuanced and highly dependent on the facts and circumstances of a particular case. Different theories of insider trading may be more relevant to different groups of companies and financial services firms. Because the law has developed in the courts, however, insider trading law is fluid and continues to evolve as markets grow, technology changes, and the DOJ and SEC press new theories of insider trading. Inevitably accompanying those new and expansive prosecution theories are new legal and factual defenses that should be considered.

The first line of defense to insider trading is a strong compliance program. Companies and financial services firms must establish policies and procedures to address insider trading and interactions with potential tippers, including, where applicable, experts and expert networks. For funds, such compliance procedures also should address their interaction with investment dealers or others that may have agency duties to a public company.

The consequences for noncompliance with the laws pertaining to insider trading can be devastating. The DOJ may bring a criminal prosecution, resulting in a significant prison sentence and fine if an individual defendant is found guilty. The SEC may bring an enforcement action seeking disgorgement of ill-gotten gains (or losses avoided), a civil monetary penalty, and certain professional bars. A strong compliance program is not only essential for preventing insider trading but also provides defenses to charges and serves as a mitigating factor in the event of any prosecution or enforcement action.

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INSTITUTIONAL CAPTURE: WHY WE'RE OVERDUE FOR A NEW BANKRUPTCY ACT

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"*We have always known that heedless self-interest was bad morals; we know now that it is bad economics.*"
– Franklin Delano Roosevelt[1]

The paper, in short, explores how the structure of the bankruptcy system in the United States serves large corporations. This underlying purpose is shielded in the 'debtor-friendly' model, as the system is theoretically designed to help debtor businesses get back on their feet and serve their creditors and consumers. However, rather than actually being a debtor-friendly system, the Bankruptcy Code is 'large corporation friendly', helping corporate debtors and creditors alike before providing any protections for 'the little guy.' The paper then proposes a "New Bankruptcy Act," with several reforms designed to return to the original debtor-friendly model of the Code, while providing additional protections against abuse and capture.

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1. *Forbes Quotes: Thoughts on the Business of Life*, FORBES, https://www.forbes.com/quotes/3116/.

INTRODUCTION

As Professor Jon Hanson recently proclaimed in the Last Lecture series at Harvard Law School, we currently exist in *the* moment.[2] They do not come often. "They happen every 50 years: a moment when the granite of the system—petrified hierarchy and injustice—is actually in flux, and it is changing rapidly."[3] Injustice does not exist only in matters of civil rights, human dignity, and economic development. Rather, the grains of inequity can be found in all of our institutions, and each must be critically examined to determine the cause of

2. Brett Milano, '*Recommit to your childhood dreams of justice*', HARVARD LAW TODAY (Apr. 27, 2022), https://hls.harvard.edu/today/recommit-to-your-childhood-dreams-of-justice/.
3. *Id.*

systemic injustice and how it may be rectified for the betterment of the whole. The same is true for the U.S. bankruptcy system and Bankruptcy Code ("the Code"). Looking from the outside, the bankruptcy system appears designed to protect crucial stakeholders in the economy, particularly because the Code is the most "debtor-friendly" in the world.[4] However, upon closer view, the deep institutional capture of the system becomes clear. Through a series of exemptions, promises of regulation, and broad drafting, the bankruptcy system has been reduced to nearly a puppet show, orchestrated by powerful corporations and financial institutions. The inequity has become vast, leaving unprotected stakeholder-creditors with little refuge.

The Code, as it stands now, was drafted in 1978 (though there have been amendments since). It comes as no surprise, given the academic discourse during the 1970s, that the Code is corporate-friendly as opposed to debtor-friendly. The previous version of the Code was drafted forty years prior, demonstrating that, if the pattern holds, we may have reached a point on the timeline for a new analysis. The American Bankruptcy Institute shares this view, creating a commission in 2012 to study Chapter 11 reform.[5] The commission then presented a 400-page report to Congress in 2014, outlining changes thought to "better balance the goals of rehabilitating companies, preserve jobs, and provide value to creditors."[6] Even so, we have yet to see significant change in the Code. Though not an easy undertaking, a new Bankruptcy Act would serve to better protect stakeholders and vulnerable debtors than does the current Code.

As evidenced by several features of the Code, including the automatic stay, third-party releases, and safe harbors, it is clear that the purported goal of the bankruptcy system has been warped to protect its strongest players rather than its weakest. Each of these topics could constitute a paper of their own, but each also serves a crucial role in the systemic analysis of the fallacies of the bankruptcy system. The paper then turns

4. *See generally* Rafael La Porta et al., Law and Finance Working Paper (on file with author).

5. AMERICAN BANKRUPTCY INSTITUTE, AMERICAN BANKRUPTCY INSTITUTE COMMISSION TO STUDY THE REFORM OF CHAPTER 11 (2014).

6. *Id.*

to the increased role (and success) of government intervention in bankruptcy, primarily analyzing the politics of the Chrysler reorganization in the 2000s. Lastly, the paper suggests three major changes to the Code intended to protect the equity and promise of the bankruptcy system.

I.
AMERICA'S UNIQUELY DEBTOR-FRIENDLY MODEL

The Code is well-known as a "debtor-friendly" model for bankruptcy and reorganization.[7] Simply, this means that the Code is drafted in a manner thought to protect debtors (those entering bankruptcy) more so than creditors (those seeking to collect value from the debtor in bankruptcy). Under a microscope, though, comes an important distinction. While the Code purports to protect weakened debtors, it in fact contains a number of loopholes, safe harbors, and other avenues which stronger creditors or tactical debtors may leverage for greater profits.[8] Thus, the Code can more accurately be described as "corporate-friendly" or "institution-friendly" rather than "debtor-friendly."

A. *A Brief History of Chapter 11*

The Code, as we know it, was not actually created until 1978. Prior to that, the system looked much different. The bankruptcy system is only briefly mentioned in the Constitution[9] and has been altered several times throughout the course of American governance. Perhaps unsurprisingly, during the first century of American history, the changes in bankruptcy structure were tied primarily to economic downturns.[10] The Bankruptcy Act of 1898 represented the first attempt to stabilize the bankruptcy system, which was further expanded throughout the 1930s in response to the Great Depression, including expansions in 1933, 1934, and 1938.[11]

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7. *See generally* La Porta et al., *supra* note 4, at 22.
8. *See infra* Parts II–III.
9. U.S. CONST. art. I, § 8.
10. ELIZABETH WARREN, ESSENTIALS, CHAPTER 11: REORGANIZING AMERICAN BUSINESSES 6 (Wolters Kluwer, 3d ed. 2008).
11. *Id.* at 6–7.

In the Chandler Act of 1938,[12] businesses were split into two separate classifications, each with their own procedures for bankruptcy. The Act distinguished between publicly traded companies and small, "local" businesses.[13] Chapter X was for publicly traded companies and involved a much more rigorous process, including a full Securities and Exchange Commission ("SEC") investigation concerning the reasons for the corporation's failure.[14] Alternatively, Chapter XI was available to small businesses and the process was much simpler.[15] The former distinction rested on the complexity of larger corporations and raises policy considerations for evaluating the current Chapter 11 system today.[16] Even so, Chapter X was not without its critics, with many arguing that the SEC requirement delayed proceedings and gave the agency too much power. For instance, Senator Elizabeth Warren wrote that: "[Chapter X] . . . created leverage for the SEC, giving it the power to insist that management be replaced with a trustee to run the business or that public stockholders receive higher payments than they were otherwise due."[17] Chapter X also required replacing management, whereas Chapter XI allowed management to remain.[18] Proponents of Chapter X commended this requirement, arguing that it allowed "bums" to be removed and that one should be wary of a company trying too hard to avoid the scrutiny of a trustee.[19] This is especially critical. Empirical evidence suggests that the requirement to replace management was often nominal: the first act of many trustees was simply to rehire management to consult on the specifics of the business.[20] The positive effect of this structure, though, remains: management could provide institutional knowledge but

12. Bankruptcy Act of 1938, Pub. L. No. 75-696, 52 Stat. 840.

13. WARREN, *supra* note 10, at 7.

14. *Id.*

15. *Id.*

16. The current Code can be distinguished from references to the old Code, as it uses numerical chapters, rather than Roman numerals.

17. WARREN, *supra* note 10, at 7.

18. *Id.* at 7–8. There is evidence, though, that this requirement was often ineffective, as the first act of many trustees was simply to rehire management to consult on the specifics of the business. This, though, seems to be a positive—as management would be there for institutional knowledge, but the trustee in place to ensure equity and honesty.

19. *Id.* at 8.

20. *See id.*

the trustee would ensure equity and honesty in the company's continued operations.

Nonetheless, companies avoided Chapter X at all costs.[21] The SEC permitted companies to stay in Chapter XI so long as public stockholders and bondholders were treated "satisfactorily," with the effect of diverting value from higher-ranking creditors.[22] These maneuvers proved fatal to the former bankruptcy system, leading to the Bankruptcy Reform Act of 1978 and the current Code. By merging the old Chapters X and XI into a single Chapter 11,[23] companies were no longer hesitant or disincentivized to file for bankruptcy. Because Chapter 11 lacks a good faith filing requirement[24] and management no longer faces removal from the SEC, companies may file for Chapter 11 strategically, reaping the benefits with little cost or risk.[25]

Policy is not written in a vacuum; it is crucial to understand the greater context and conversation surrounding any legislative draft. Given that the Code was enacted in 1978, it is unsurprising that it lifted many restrictions on large corporate debtors. The 1970s were a crucial time for American corporate law, with a reinvigorated argument against regulation. 1968 is often deemed "The Year That Changed America"[26] due to the major gains in social movements and resulting backlash among legal theorists. As Professor Hanson stated in reference to that period, the resulting narratives "[a]ll say the same thing: [w]e're going to throw out conceptions of social responsibility and we're going to accept a notion of freedom behind ideas of markets and aversion for regulation. . . . That collection of ideas becomes dominant, and each one of those stories empowers corporations."[27] These narratives all circled the same concept: the role of a corporation is profit and any regu-

21. *See id.* at 8–9.
22. *Id.*
23. *See id.* at 9.
24. *See infra* Section VI.A.
25. Arguably, the biggest cost to companies is reputational—that the stock market will know they filed for bankruptcy and their stock price will decline. However, this is likely a repercussion the company would already face if they were, for example, facing a mass tort, eliminating this argument for the focus of this paper.
26. CNN, *1968: The Year That Changed America*, https://www.cnn.com/shows/1968 (last visited Feb. 13, 2023).
27. Milano, *supra* note 2.

lation or attempt to promote other social benefits is misplaced.

Perhaps most notably, Lewis Powell wrote the infamous "Powell Memo" in 1971, asserting that American values of business and enterprise were "under attack."[28] The Powell Memo is a topic of its own exploration, but the language Powell used is crucial to understanding the influences at the time the Code was drafted. The Powell Memo articulated the view that the American economy was in grave danger of falling apart: "[t]he overriding . . . need is for businessmen to recognize that the ultimate issue may be survival—survival of what we call the free enterprise system, and all that this means for the strength and prosperity of America and the freedom of our people."[29] By framing the prosperity of large corporations as equivalent to the freedom of Americans, Powell's view became the dominant narrative of corporate law.

Thus, the focus became ensuring profitability of corporations at all costs. That focus left no room for regulation or diversion of shareholder funds to other social purposes. As Milton Friedman believed, "[a]ny investment of [corporate] assets toward ends other than profit—like 'spending someone else's money for a general social interest'—is tantamount to 'taxation without representation.'"[30] This argument became ubiquitous, as Professor Mark J. Roe has pontificated, "[a]lthough aggressive when it appeared, Friedman's perspective is now mainstream in American business circles."[31] However, with the rise in Environmental, Social, and Governance

28. *See* Memorandum from Lewis F. Powell, Jr. to Eugene B. Sydnor, Jr., Educ. Comm. Chairman, U.S. Chamber Com., 1–7 (Aug. 23, 1971), https://law2.wlu.edu/deptimages/Powell%20Archives/PowellMemorandumTypescript.pdf (describing the source, nature, and tone of the attack on the system of American enterprise).

29. *Id.* at 10.

30. Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimating Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1, 44 (2004) (citing Milton Friedman, *A Friedman Doctrine – The Social Responsibility of Business is to Increase Its Profits*, N.Y. TIMES (Sep. 13, 1970), https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html).

31. Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2080 n.2 (2001).

("ESG") practices,[32] as well as broader conversations about corporate responsibilities and expectations,[33] a gateway may exist to reevaluate their role in bankruptcy proceedings.

B. *American 'Exceptionalism:' Debtor Protections*

The current U.S. bankruptcy system "protects" debtors more than any other current bankruptcy system. As it stands, "the U.S. Bankruptcy Code is oriented towards rescuing insolvent businesses and is considered to be 'soft' or 'debtor-friendly,' favoring incumbent management."[34] In a study of forty-nine countries (not including any socialist or transitional economies), the United States was found to have the least protections in place for creditors based on an index of several different creditor "rights".[35] For example, where Chapter 11 in the United States gives management the ability to file for bankruptcy without consulting creditors, other countries require creditor consent in order to file.[36] By creating an aggregate index of four variables, the authors found that:

> The United States is actually one of the most anti-creditor common law countries: it permits automatic stay on assets, allows unimpeded petition for reorganization, and lets managers keep their jobs in reorganization. The average aggregate creditor rights score for common law countries is 3.11—by far the highest among the four families,—but this score is only 1 for the United States.[37]

Thus, the United States (at least nominally) offers some of the lowest protections for creditors in the world.

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32. *See, e.g.*, Lucian A. Bebchuk & Roberto Tallarita, *Will Corporations Deliver Value to All Stakeholders?*, 75 VAND. L. REV. 1031, 1042 (May 2022).
33. *See generally id.* (discussing changes in corporate responsibilities and the increase in consideration of stakeholders).
34. TIMOTHY FISHER & JOCELYN MARTEL, THE IMPACT OF DEBTOR-FRIENDLY REFORMS ON THE PERFORMANCE OF A REORGANIZATION PROCEDURE 1 (2012), https://hal.archives-ouvertes.fr/hal-00707359/document.
35. La Porta et al., *supra* note 4, at 23.
36. *See id.* at 22.
37. *Id.* at 23.

C. *But Shouldn't Debtors Be Protected?*

Even with the Code's nominal debtor protections, the actual protection of businesses and institutions rests on numerous factors. For instance, the Code requires that repayment to creditors be "fair and equitable," representing the "absolute priority" requirement in repayment.[38] Priority can be determined through a myriad of ways (e.g., security interests, contract, statutory priority, etc.) but ultimately represents the order in which creditors are paid out.[39] In a simple reorganization, this means that creditors with priority (usually from a security interest or other institutional modes) will be paid first, followed by unsecured creditors (such as trade creditors, pension holders, tort claimants, etc.), and lastly shareholders (in the unlikely event that any payout remains). Upon first impression, this seems reasonable: creditors who have contracted for higher priority take it and other stakeholders are still paid out before CEOs and company insiders. However, this priority scheme does not always follow in practice.

For institutional powerhouses, there are avenues through which a company insider may contract into receiving payment before stakeholders. For example, shareholders aware of the reorganization process may purchase stock in the new "reorganized" company and, in-turn, receive a payout for creation of "new value."[40] This practice has faced criticism. The Code specifies that shareholders may not receive value "on account of" their position within the company[41] and many argue (rightfully) that such shareholders would not have received a "new value" deal absent their internal positions during the reorganization.[42] For example, in 1999, the U.S. Supreme Court

38. 11 U.S.C. § 1129; *see also* Gary L. Kaplan, *Understanding the Rules of Bankruptcy Cramdown*, LAW360 (Sept. 4, 2013, 3:31 PM), https://www.friedfrank.com/siteFiles/Publications/Understanding%20The%20Rules%20Of%20Bankruptcy%20Cramdown.pdf.

39. *See* Kaplan, *supra* note 38.

40. Kevin Hellon, *The Absolute Priority Rule and the 'New Value' Exception*, ANAND LAW (Nov. 3, 2022), https://www.anandlaw.com/the-absolute-priority-rule-and-the-new-value-exception/.

41. 11 U.S.C. § 1129(b)(2)(B)(ii). Specifically, the Code states: "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan *on account of* such junior claim or interest any property . . . . " *Id.* (emphasis added).

42. *See, e.g.*, *id.*

held that shareholders who received property after creating "new value" could not adequately show that they were not receiving such "on account of" their junior interest unless there was a market value test in place.[43] The Court articulated that insider shareholders had a structural advantage in the process, which allowed them unfettered access to the reorganized company.[44] Nonetheless, this standard has been criticized and even ignored by some circuit courts.[45]

Some bankruptcy scholars have internalized the underlying protection of creditors, arguing that this is, in fact, the true purpose of bankruptcy proceedings. Under the nominal debtor-friendly model, as they see it, institutional creditors should have the ultimate power in determining reorganization and repayment. For example:

> Professors Thomas Jackson and Douglas Baird advance the "creditor's bargain heuristic" to test whether a certain provision should or should not be part of the bankruptcy scheme. As they see it, bankruptcy rights should be no more—and no less—than the rights the creditors would have bargained for as a group pre-bankruptcy, if they had taken the time to do so.[46]

In promulgating this theory, scholars seem to advocate for what already exists, but wish to make creditors' protections more explicit. By advancing stronger protections for creditors (but only those with bargaining power), Professors Jackson and Baird would produce a more "free-market" system, where actors with bargaining power control the restructuring. This, though, is already the case in practice; the difference is that this free-market system masquerades under the guise of being "debtor-friendly." It is the stakeholders without bargaining power (e.g., securities fraud claimants, tort claimants, public

43. Bank of Am. Nat'l Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434 (1999).

44. *Id.* at 454–55.

45. Paul T. Musser, *Castleton: 7th Circuit's Answer to 203 N. LaSalle's Market Test*, AM. BANKR. INST. J. (Dec. 2015), https://katten.com/Files/133949_Castleton_7th_Circuits_Answer_to_203_N_LaSalles_Market_Test.pdf.

46. WARREN, *supra* note 10, at 13 (first citing Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law*, 100 HARV. L. REV. 2074 (1987); and then citing Douglas G. Baird, *The Uneasy Case for Corporate Reorganization*, 15 J. LEGAL STUD. 127 (1986)).

stockholders, trade creditors, etc.) who are already left unprotected. Those groups often already suffer at the bottom of the reorganization totem pole, even though it is supposedly debtor insiders at the bottom.

II.
The Automatic Stay

Prioritizing the debtor, or, rather, de-prioritizing unsecured creditors, centers around the automatic stay on litigation. Once a corporation files under Chapter 11, the stay kicks in. To be sure, the automatic stay has a valid legislative purpose: protecting debtors and small creditors from a "race to the courthouse," in which all creditors would sue to collect and be repaid. In theory, the automatic stay prevents such a race from occurring, as creditors are stayed from litigation and myriad other collection activities, and thus encouraged to cooperate with each other and the debtor to create a plan that benefits the most amount of people. In practice, though, the stay provides a malicious incentive for solvent corporations to file and potentially skirt liability that they would otherwise face.

A. *Intended Purpose of the Stay*

The automatic stay, captured in 11 U.S.C. § 362, is drafted in extremely broad terms—so much so that including the entirety of the section here would require pages. However, subsection (a), which outlines the actions prevented by the stay, is as follows:

> (a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970, operates as a stay, applicable to all entities, of—
>
> (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor

that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning a tax liability of a debtor that is a corporation for a taxable period the bankruptcy court may determine or concerning the tax liability of a debtor who is an individual for a taxable period ending before the date of the order for relief under this title.[47]

The stay language is intentionally drafted to prevent "all entities" from collecting against the debtor and, in turn, hindering the restructuring process.[48] Some influential bankruptcy scholars believe that the automatic stay is the bedrock of Chapter 11. Senator Warren, for example, described the

47. 11 U.S.C. § 362(a).

48. *See id.*

stay as "[c]ritical to the operation of the bankruptcy system."[49] This is generally uncontroversial: the automatic stay is thought to be the main mechanism in the Code which protects against the "race to the courthouse." In essence, absent the stay on collection and recovery efforts, all creditors would *race* to collect what they are owed. This would produce a poor system of creditor incentives and serve the same on a first-come basis.

The automatic stay carries with it significant force. Any creditor who violates the stay, either by attempting to collect, pursuing litigation, or any other action against the debtor, is subject to punishment by the bankruptcy court.[50] This may include fines and even civil imprisonment until full compliance with the court and its order.[51] Additionally, one who violates the stay is not absolved by a lack of knowledge, as "a violation is a violation; knowledge of the filing is relevant only to the question of willfulness and the scope of an appropriate remedy."[52] Thus, the protection for the debtor is immense. If a debtor is injured while in bankruptcy, it has a clear pathway for reparation.

The same is not necessarily true for creditors or other entities in business with the debtor. While the automatic stay prevents creditors of any kind from attempting to collect against the debtor, the debtor may continue its normal course of business.[53] This includes spending money, pursuing business opportunities, and even initiating lawsuits.[54] This allows the debtor to game the system, for example, by making its business riskier to alter the valuation in a way beneficial to its shareholders. The Hunts, for example, placed their lucrative oil company into Chapter 11 in 1986, but continued spending their financial reserves lavishly, seeking new, risky oil explorations.[55] In doing so, the Hunts used money unavailable to their creditors with the hope of striking rich and saving their company, or altering the valuation of the company in the

49. WARREN, *supra* note 10, at 27.
50. *Id.* at 28.
51. *Id.*
52. *Id.*
53. *See id.* at 29.
54. *Id.*
55. MARK J. ROE & FREDERICK TUNG, BANKRUPTCY AND CORPORATE REORGANIZATION: LEGAL AND FINANCIAL MATERIALS 85–86 (4th ed. 2016).

meantime.[56] Thus, a debtor in Chapter 11 is allowed significant leeway that is not available to others actors in the system.

B. *A Look at Actual Practice*

It is crucial to emphasize that the creditor in a given case is not always a large, diversified institutional lender, such as J.P. Morgan or Apollo Management. Rather, creditors are often parties one would not think of as a creditor. For example, in the Chrysler reorganization, pension fund holders and employee unions constituted creditors.[57] In asbestos cases, creditors are usually everyday citizens with massive medical bills.[58] Thus, the automatic stay prevents more than just the "Big Bad Bank" from blowing down the business.

In fact, those more intuitive creditors—big banks, hedge funds, private equity firms, etc.—are given an additional leg up in this section of the Code by way of their usually having "secured" status. While unsecured creditors (including tort claimants, tradesmen, employees, etc.) are left without any course of action, secured creditors hold a special power to lift the automatic stay. If a secured creditor wants to lift the stay, they can petition the court to lift or modify.[59] This opportunity for relief "centers around permission for a secured creditor to repossess the collateral that is the subject of its security interest notwithstanding the stay imposed in bankruptcy. . . . Unsecured creditors have no corresponding right."[60] Thus, "[s]ecured creditors have somewhat protected status."[61]

Remember, though, that the purported purpose of bankruptcy is protecting the debtor and ensuring equity in the proceeding. Thus, there must be some balancing to determine whether the stay should be lifted for a secured creditor's benefit. Balancing tests, though, are notoriously fact-dependent, allowing a creditor seeking to lift the stay to make arguments based on general equity principles, which may be difficult to

56. *See id.* at 85–87.

57. *See* Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727, 760 (2010).

58. *See generally* Joe Lahav, *Mesothelioma and Asbestos Trust Funds*, ASBESTOS.COM (Jan. 9, 2023), https://www.asbestos.com/mesothelioma-lawyer/compensation/trust-fund.

59. WARREN, *supra* note 10, at 33.

60. *Id.*

61. *Id.* at 34.

weigh or predict. It is thus difficult to create a test composed of bright-line rules, but, in sum: "[t]he secured party loses some rights (the right of immediate repossession and concomitant cash-out) to enhance the value of the estate, but it retains some rights (e.g., the right to repossess if the debtor cannot ensure adequate protection) that put it ahead of the general unsecured creditors."[62] Though "balance" appears to indicate equity, it remains crucial to consider the systemic influences at play in the proceedings. With an unclear standard, there is an increased likelihood that a better-represented party will fare better in court proceedings than others. Namely, resources are crucial, and those with more are better equipped for a battle of the facts.

There are, of course, some exceptions to the stay's broad protection. Criminal enforcement, for example, can still proceed with an automatic stay in place,[63] as can government enforcement action.[64] Even these exceptions, though, become murky under a microscope. Courts "have struggled to separate debt collection attempts that should be stayed by a bankruptcy petition from criminal penalties that should proceed regardless of the bankruptcy."[65] The same is true for collection under civil enforcement. For example, after the collapse of WorldCom, the SEC sought to fine WorldCom for defrauding creditors and chose an amount significant enough to ensure compensation to fraud claimants (since they would otherwise be unsecured creditors and likely receive nothing).[66] The court approved the fine, stating that it "fairly and reasonably reflects the realities of this complex situation," but noted that the SEC cannot determine the size of a fine primarily based on compensating claimants, which would undermine 11 U.S.C. § 510(b).[67]

Thus, the execution of the automatic stay reflects the deeply rooted bias within the Code as written. Though the goal is to protect going-concern—a valid legislative purpose—the system has fallen victim to puppetry from big business (institutional creditors and large corporate debtors), who are af-

62. *Id.* at 35.
63. *Id.* at 31.
64. *Id.*
65. *Id.*
66. *See* SEC v. WorldCom, Inc., 273 F. Supp. 2d 431 (S.D.N.Y. 2003).
67. *Id.* at 436.

forded a higher status in both general distribution and relief from the automatic stay. Even the government has only a limited ability to act without being encumbered by the stay—that is, where it is acting within its police power and not in pursuit of a "money judgment."[68] Secured creditors, while not immune from the stay, enjoy a multitude of workarounds.[69] Additionally, some debtors may use the stay to their advantage as well, specifically aiming to prevent unsecured creditors from collecting the full value of what they are owed.

A company may, for a variety of strategic reasons, file for Chapter 11 without a reorganizational purpose. Perhaps the most common are single asset cases, in which a debtor files with only one asset (usually real estate), few employees, and little unsecured debt.[70] Usually, the debtor files in response to a two-party dispute with an under-secured lender in an attempt to delay foreclosure.[71] A related phenomenon is the new debtor syndrome, which follows a similar fact pattern. Here, the entity itself is usually created on the eve of bankruptcy to shield the single asset from creditors.[72] These scenarios usually involve small debtors, rather than large corporations, seeking to use the bankruptcy system for a relatively clear purpose: shielding assets from creditors in what are otherwise two-party disputes.[73]

In a more complex example of abuse, debtors may file for a litigation advantage. For example, in *SGL Carbon*, the debtor filed for bankruptcy in response to antitrust litigation.[74] The petition was filed in the Third Circuit—a circuit which had already established a good faith filing requirement—but the bankruptcy court refused to dismiss the case on bad faith grounds.[75] Specifically, the lower court found that the litigation was "distracting management," and, if successful, would likely send the company into a tailspin.[76] The Third Circuit

68. *See* 11 U.S.C. § 362(b)(4); *see also* ROE & TUNG, *supra* note 55, at 349.
69. *See* discussion *supra* Section II.B.
70. Judith Greenstone Miller, *Amendment to Provide Good Faith Filing Requirement for Chapter 11 Debtors*, 102 COM. L.J. 181, 183 (1997).
71. *Id.*
72. *Id.*
73. *See id.*
74. *In re* SGL Carbon Corp., 200 F.3d 154, 167 (3d Cir. 1999).
75. *Id.* at 158.
76. *Id.*

reversed, finding that the debtor's filing was premature and done for reasons inconsistent with the principles of bankruptcy.[77] More recently, in the same circuit, a bankruptcy court held that a subsidiary of Johnson & Johnson, established solely to acquire company liability related to talc use, had filed for bankruptcy in good faith.[78] To be sure, the case is highly complex, involving Johnson & Johnson's strategic liability shifting and forum shopping. Nonetheless, the bankruptcy court in New Jersey articulated that:

> The Court cannot help but ponder how a bankruptcy filing, which took place in North Carolina and most likely satisfied the good faith standards under the applicable law in that jurisdiction, suddenly morphs post-petition into a bad faith filing simply because the case travels 400 miles up I-95 to Trenton, New Jersey.[79]

Unintentionally, in denying this motion, the District of New Jersey has highlighted why an amendment to the Code is critical to protecting the integrity of the bankruptcy system.[80]

III.
Third-Party Releases

Perhaps the strongest example of corporations warping the Code beyond its original purpose can be found in third-party releases. Third-party releases have split the circuits, receiving various degrees of support, disapproval, and something in the middle.[81] Unlike other examples of distortion, though, there is no explicit foundation for third-party releases within the Code. Rather, courts have found authority for such releases in 11 U.S.C. § 105(a), which states that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."[82] Courts have interpreted this provision broadly, with many believing that it permits a third-party release. The theoretical argument is simple: third-party releases extend to parties against which

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77. *Id.* at 163.
78. *See In re* LTL Mgmt., LLC, 637 B.R. 396, 400 (Bankr. D.N.J. 2022).
79. *Id.* at 406.
80. *See infra* Section VI.A.
81. *See infra* Section III.A.
82. 11 U.S.C. § 105(a).

collection of assets would be detrimental to the debtor.[83] Namely, if a third party holds an asset that the debtor could draw upon during reorganization, then that asset should be protected. This view is controversial, as it allows a "bankruptcy benefit without the burden of all the bankruptcy rules."[84] The Code, though, takes the controversy further, as it states that "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."[85] Section 524(e) seems in tension with the administration of third-party releases, as extending the release to additional parties directly affects their liability. Thus, when presented with differing sections of the Code, courts reach different conclusions on the permissibility of third-party releases.[86] The issue was recently explored in the Purdue Pharma restructuring and the Sackler family's request and possible receiving of a third-party release.[87]

A. *Not in the Code and Unconstitutional*

Third-party releases may be either consensual or non-consensual.[88] The distinction is based on whether consent was obtained by the creditors, as the release would be proposed by the debtor to protect a third party. Consent, though, should not necessarily be taken at face value, as:

> Debtors often utilize third-party releases to incentivize parties to support a plan or to influence others to contribute to and fund the plan. Nondebtor third parties under Chapter 11 are often insiders of the debtor—such as directors and officers—as well as the debtor's insurers or major plan contributors.[89]

Though these incentives are provided to compliant parties who would logically provide their consent, the threat or promise of one may also sway other voting creditors. Thus, institutional creditors and big businesses find themselves with

83. *See* WARREN, *supra* note 10, at 30.
84. *Id.*
85. 11 U.S.C. § 524(e).
86. Dorothy Coco, *Third-Party Bankruptcy Releases: An Analysis of Consent Through the Lenses of Due Process and Contract Law*, 88 FORDHAM L. REV. 231, 236 (2019).
87. *See infra* Section III.B.
88. Coco, *supra* note 86.
89. *Id.* at 235.

yet another leg up on other parties in a system promising equity.

Even more troubling than the skew of consent, though, is the permissibility of non-consensual third-party releases. To be fair to bankruptcy courts, there is a strong statutory argument that courts have the authority to approve a plan generally, and thus approve all aspects of the plan as binding. The plan is viewed as a contractual agreement with strict voting requirements[90] and the threat of a contractual claim if breached. Without consent from the parties, though, the bankruptcy court has no real contract to approve.[91] Courts are split on this matter. Upon conducting a survey of the circuits, W. Glenn Jensen found that:

> The Sixth and Seventh Circuits are the ones recognizing that Sections 105(a) and 1123(b)(6) give bankruptcy judges some "residual authority" to impose releases. The Fourth and Eleventh Circuits have concluded that Section 105(a) authorizes such releases. While the Fifth, Ninth and Tenth Circuits have rejected the notion that a bankruptcy court can authorize non-debtor releases outside of the asbestos context under Section 524(g).[92]

Though the Circuits remain split, there is a strong argument that third-party releases run counter to the U.S. judicial system and its processes. This argument is three-fold: (1) bankruptcy courts may lack jurisdiction; (2) releases impede on

90. "A class of claims has accepted a plan if such plan has been accepted by creditors, other than any entity designated under subsection (e) of this section, that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors, other than any entity designated under subsection (e) of this section, that have accepted or rejected such plan." 11 U.S.C. § 1126(c).

91. *See* Coco, *supra* note 86, at 239.

92. W. Glenn Jensen, *Third-Party Releases Are Not Consistent with Bankruptcy Code: Creditors Can Still Maintain Direct Claims*, NAT'L L. REV. (Dec. 22, 2021), https://www.natlawreview.com/article/third-party-releases-are-not-consistent-bankruptcy-code-creditors-can-still-maintain. 11 U.S.C. § 1123(b)(6) simply articulates that: "Subject to subsection (a) of this section, a plan may . . . include any other appropriate provision not inconsistent with the applicable provisions of this title." 11 U.S.C. § 524(g) is specific to asbestos claims and is not the same provision explored above (§ 524(e)). Rather, § 524(g) provides specific instruction to the court for discharging asbestos claim liability.

due process rights without compensation; and (3) releases violate the inherent right to contract. Each will be analyzed in turn.

1. *Bankruptcy courts may lack adequate jurisdiction*

Though bankruptcy courts have express power to approve a reorganization plan and all that goes with it, bankruptcy judges are not Article III judges. Thus, bankruptcy judges do not have the same breadth of jurisdiction as U.S. district court judges or circuit judges. As Martin Bienenstock[93] explains to his class, one need only ask seven questions to determine if a bankruptcy judge is exercising proper jurisdiction:

(1) Does the bankruptcy power in the U.S. Constitution authorize this relief?
(2) Does 28 U.S.C. § 1334 grant the subject matter jurisdiction necessary to grant relief?
(3) Is the relief constitutional?
(4) Can the bankruptcy judge constitutionally exercise the subject matter jurisdiction?
(5) Can the non-Article III bankruptcy judge constitutionally issue the relief?
(6) Is there reference withdrawal?
(7) Is there personal jurisdiction?[94]

In the case of third-party releases, the inquiry may not go further than question one. As explored in Section III.A., third-party releases lack a clear foundation in the Code,[95] likely because the Constitution's bankruptcy power does not permit such releases. Specifically, the Constitution permits the discharge of debt, but this is limited to the debtor and does not reach third parties.[96] To be sure, discharging debt of third par-

93. "Martin J. Bienenstock is Chair of Proskauer's Business Solutions, Governance, Restructuring & Bankruptcy Department. He also teaches Corporate Reorganization as Lecturer in law at Harvard Law School and as an adjunct professor at University of Michigan Law School." Faculty page of Martin J. Bienenstock, HARV. L. SCH., https://hls.harvard.edu/faculty/martin-j-bienenstock (last visited Jan. 9, 2023).

94. Martin Bienenstock, Corporate Reorganization Class Lecture (2022) (notes on file with author).

95. *See* discussion *supra* Section III.A.

96. Bienenstock, *supra* note 94; *see also* Local Loan Co. v. Hunt, 292 U.S. 234 (1934) (discussing the permissibility and scope of discharge of individual debt through bankruptcy).

ties directly contradicts the explicit purpose of bankruptcy, which is an "equitable remedy" aimed at ensuring the fair distribution of value to creditors.

Beyond question one, third-party releases likely survive question two. Namely, because third-party releases are supposedly given to entities whose success directly relates to the success of the reorganized debtor, jurisdiction is likely granted. Bankruptcy judges possess power over all matters related to the Title 11 case,[97] which likely includes parties so related to the debtor that the release "must be granted" to ensure the success of the reorganized debtor. Still, third-party releases surely fail at question three.

2. *Revocation of due process rights*

By permitting a third-party release, the approving court is granting immunity to a party not subject to bankruptcy, and thus preventing claimants from seeking their day in court against that party. Though debtors enjoy the automatic stay and all claims against the debtors are released, claimants still retain mechanisms to be heard. Though arguably a weak protection, tort claimants, for example, are provided with an agent for their claims during bankruptcy proceedings.[98] The theory is that all claims are handled jointly but all claims are still being heard.[99] The same cannot be said for third parties under a release.

In determining whether due process rights are violated, the examining court would determine whether the claimant has been deprived of life, liberty, or property without an ability or opportunity to be heard.[100] This right is guaranteed by the Fifth Amendment[101] and represents a deeply rooted value in the United States. To be sure, "the Court has stated that the right to be heard before suffering a loss is a basic societal principle."[102] However, a third-party release tramples this guarantee. Given the structure of a third-party release, "the creditors whose claims are under consideration for release are poten-

97. 28 U.S.C. § 1334(a)–(b).
98. *See generally* Frederick Tung, *The Future Claims Representative in Mass Tort Bankruptcy: A Preliminary Inquiry*, 3 CHAP. L. REV. 43 (2000).
99. *See id.*
100. U.S. CONST. amend. V.
101. *Id.*
102. Coco, *supra* note 86, at 249.

tially losing a legitimate claim of entitlement defined by state law and the Constitution—the right to petition."[103]

Even in scenarios where the third-party release is deemed "consensual," and thus more likely to be approved by the bankruptcy judge, a significant possibility remains that not every creditor has, in fact, granted consent. For consent to be granted, each class would have to accept the plan. A class is deemed to have accepted the plan of reorganization if at least two-thirds in dollar amount and more than one-half in number have accepted that plan.[104] Consent is then achieved when each class accepts the plan, but that does not mean every creditor has actually accepted the plan. Rather, up to one-third of creditors could have explicitly not provided their consent but would be deemed to have consented. These non-consenters, then, are bound by a release that they explicitly did not consent to, even if the release itself is deemed "consensual."[105] Even for circuits that have articulated a consent requirement, third-party releases are likely not fully consensual. These non-consenters are undoubtedly being forced to relinquish their due process rights.

3. *The right to contract*

Along with jurisdictional concerns and the infringement on due process, third-party releases also raise concerns about the right to contract. Keep in mind the voting requirements discussed *supra* Section III.A.2—two-thirds in amount, and more than one-half in number. The strongest argument for third-party releases is that a bankruptcy judge approves a plan of reorganization, which is essentially a large contract involving multiple parties.[106] If the parties contracted to include the release, it is not the judge's place to remove their contractual terms. With a closer look, though, the issue becomes nuanced.

A debtor will likely present the plan of reorganization as a unilateral contract, and the court would then determine what constitutes acceptance or consent, likely using the plan confir-

103. *Id.* at 248.
104. 11 U.S.C. § 1126(c).
105. Coco, *supra* note 86, at 248–49.
106. *Id.* at 245 ("Some bankruptcy courts analogize bankruptcy plans containing third-party releases to a contract that binds those who vote in favor of it.").

mation standards.[107] Consent, under contract law principles (not specific to bankruptcy) may be given either expressly or through conduct, but contractual rights may only be waived "knowingly, voluntarily, and intentionally."[108] The nuance is that a waiver may also be express or inferred from conduct,[109] which presents a difficulty in ascertaining whether a non-consenting creditor has approved a third-party release. To be sure, the answer remains the same: no. Consider a plan that was confirmed by a judge and is therefore treated as a unilateral contract. If a creditor rejects a plan, but is outvoted, he is then treated as having consented to the plan. By analogy, consider a family that puts their dinner choice to a vote. One child said no, was outvoted, and then complained about the dinner choice making her ill. She would not be told it was her fault for choosing that dinner option, as she clearly had not. Though seemingly a flippant analogy, give this some thought. How, then, can a creditor, who outright voted against providing protection to a party not at all involved in the bankruptcy, be told he contracted away his right to sue that party?

Thus, when analyzing the power of the bankruptcy court, or any court, to approve a third-party release, the release should not be treated as a unilateral contract in which consent is given clearly. Rather, third-party releases squander several constitutional rights of those involved, with the biggest weight falling on under-protected stakeholders seeking their day in court.

B. *Third-Party Releases in Practice: A Look at Purdue Pharma*

"[A]ddiction 'is not caused by drugs.'"[110] At least, that is what Purdue Pharma advertised in promoting its drug, Oxycontin. Purdue Pharma has since been identified as a strong contributor to what became the opioid crisis, with swaths of people from all regions and socioeconomic statuses becoming addicted to the drug.[111] In 2007, Purdue Pharma signed its first plea agreement with the U.S., agreeing to pay $600 mil-

107. *Id.* at 245–46.
108. *Id.* at 246.
109. *Id.*
110. *In re* Purdue Pharma, LP, 635 B.R. 26, 43 (S.D.N.Y. 2021).
111. *See generally* Howard Koh, *What Led to the Opioid Crisis—and How to Fix It*, HARV. T.H. CHAN SCH. PUB. HEALTH (Feb. 9, 2022), https://www.hsph.harvard.edu/news/features/what-led-to-the-opioid-crisis-and-how-to-fix-it.

lion for false marketing.[112] Nonetheless, the company continued marketing the product and increasing profits.[113] By 2019, Purdue Pharma was facing seemingly endless lawsuits from users of its drug.[114] It was not until 2020 that Purdue Pharma admitted to "substantial deliberate wrongful conduct," signing a plea agreement with the Department of Justice.[115] That plea catalyzed the controversy surrounding Purdue Pharma's bankruptcy.

Since, in the 2007 plea, executives of Purdue Pharma accepted personal liability and agreed to pay $34.5 million in personal fines,[116] the 2020 plea agreement raised alarm for the Sackler family, who own Purdue Pharma. Luckily, they had prepared; "[c]oncerned about how their personal financial situation might be affected, the family began what one member described as an 'aggressive[ ]' program of withdrawing money from Purdue almost as soon as the ink was dry on the 2007 papers."[117] The Sackler family was incredibly effective in shoveling funds—pulling $10.4 billion out of the company and substantially affecting its solvency.[118] This money was then invested in accounts, trusts, and ventures that made it nearly impossible to reach.[119] Pulling money from the company was a crucial part of the plan to insulate the family's finances from the company's liabilities. So much so that "Purdue went from distributing less than 15% of its revenue to distributing as much as 70% of revenue."[120] The Sackler family then stepped away from the company to keep their personal finances secure. And it worked. The family knew they had the company, and its creditors, in a stronghold. Once the company reached bankruptcy "the Sacklers offered to contribute toward a settlement, but if—and only if—every member of the family could 'achieve global peace' from all civil (not criminal) litigation,

112. *See* Barry Meier, *In Guilty Plea, OxyContin Maker to Pay $600 Million*, N.Y. TIMES (May 10, 2007), https://www.nytimes.com/2007/05/10/business/11drug-web.html.
113. *Id.*
114. *See In re Purdue Pharma*, 635 B.R. at 34.
115. *Id.* at 35.
116. Meier, *supra* note 112.
117. *In re Purdue Pharma*, 635 B.R. at 36.
118. *Id.*
119. *See id.*
120. *Id.* at 57.

including litigation by Purdue to claw back the money that had been taken out of the corporation."[121] The injustice need not be spelled out. The Sackler family arguably knew what they were doing, putting victims of their company in a position where they are unable to recover the full amount of money they are owed.

Stuck between a rock and a hard place, the plan was confirmed by a supermajority of each class of creditors and approved by the bankruptcy judge. Remember, though, this does not mean every person provided their consent to what is being treated as a binding contract. Rather, there were several notable objections:

> [N]ot everyone voted yes. Eight states and the District of Columbia [ ], as well as certain Canadian municipalities and Canadian indigenous tribes, the City of Seattle (alone among all voting municipalities in the United States), as well as some 2,683 individual personal injury claimants, voted against the adoption of the Plan. . . . The United States Trustee [ ] in Bankruptcy and the U.S. Attorney's Office for this District on behalf of the United States of America join in their objections.[122]

Thus, the plan reached the District Court, where it was struck down by Judge McMahon.[123]

In so holding, Judge McMahon focused on whether bankruptcy courts had statutory authority to grant third-party releases.[124] Finding none, she noted that she need not address the constitutional and due process claims, rather inviting a higher court to do so; "[t]his opinion will not be the last word on the subject, nor should it be."[125] Noting that the justification for third-party releases is that they are integral to the reorganization, Judge McMahon articulates that:

> The third-party claims at issue neither stem from Purdue's bankruptcy nor can they be resolved in the claims allowance process. Yet those claims are being finally disposed of pursuant to the Plan; they are be-

121. *Id.* at 36.
122. *Id.* at 35–36.
123. *See id.* at 37–38.
124. *Id.*
125. *Id.* at 38.

> ing released and extinguished, without the claimants' consent and without any payment, and the claimants are being enjoined from prosecuting them.[126]

This analysis shifts the focus of the conversation from whether the release is integral to the plan to whether they are allowable at all. To be sure, Judge McMahon pointedly notes that some of the protections the Sackler family is seeking—e.g., personal liability releases—are "claims [that] could not be released if the Sacklers were themselves debtors in bankruptcy."[127] Judge McMahon also hones in on a key issue: the trouble of treating a plan of reorganization as a unilateral contract. By emphasizing all the parties who objected and articulating that such parties would be prevented from seeking justice on their claims, Judge McMahon is carving the way for a successful argument that third-party releases are unconstitutional, not just lacking a statutory foundation. The appeal that will likely result from this holding will be crucial to the future of third-party release doctrine.

IV.
THE SAFE HARBORS

Another method employed by institutional influences to alter the risk and rewards of bankruptcy are the safe harbors placed throughout the Code. These safe harbors remove various liabilities from institutional actors—mainly financial institutions—who game the markets for profit. Importantly, fraudulent conveyance liability allows the trustee of a bankrupt estate to void a transfer of money.[128] A basic example of fraudulent conveyance might look something like the following: Imagine that you knew that you had lost all your money in Vegas and owed some money to your bookie. You have no money to your name, but you do have the signed football from what was thought to be Tom Brady's last touchdown (which sold for $518,628 in 2022).[129] To ensure nobody takes your

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126. *Id.* at 81.
127. *Id.* at 36.
128. 11 U.S.C. § 548.
129. Ian Oxborrow, *Tom Brady's last touchdown ball sells for $518,628, then he 'unretired'*, THE NATIONAL NEWS (Mar. 16, 2022), https://www.thenationalnews.com/business/money/2022/03/16/tom-bradys-last-touchdown-ball-sells-for-518628-then-he-unretired.

ball (even though it is not the last touchdown ball anymore), you give it to your cousin. That transfer is a fraudulent conveyance: moving assets away from the debtor to another party to prevent, hinder, or delay creditors' collection. Doing so shifts the value out of a debtor, and thus hinders the creditors at the bottom of the priority list the most, as they are the last to be paid.[130] In many ways and as discussed in the following Sections, financial institutions find themselves exempt from this liability.

A. *The Repo Safe Harbor*

The first of these exemptions, which also provides strong evidence of institutional capture in the Code, is the repurchase agreement (or "repo") safe harbor. A repo is an agreement made by financial institutions in the securities industry, in which Company A will sell a security (usually either a Treasury bond or a mortgage-backed security) to Company B, with an explicit agreement to repurchase that security back at a specified price.[131] In the most typical example, repurchase would occur the next day, and the transaction itself is done for quick cash and loans.[132] Repos are most commonly used by major financial institutions, as well as the Federal Reserve, and account for a significant portion of their financial prosperity.[133] As repo use increased, they became a larger problem for bankruptcy courts. Initially, bankruptcy courts treated repos as a simple secured loan.[134] In *Lombard-Wall*, for example, the bankruptcy court articulated that a repo was a secured loan and deserved no special treatment.[135] Panicked, the banking

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130. If this is setting off alarm bells for the *supra* discussion of the Sackler family finances, it should be. In the proceedings, the bankruptcy judge considered this evidence, and "[w]hile he made no finding that these distributions qualified as fraudulent conveyances, or that they could be recouped by Purdue, Judge Drain also acknowledged that the estate had potential claims of 'over $11 billon of assertedly avoidable transfers.'" *In re Purdue Pharma*, 635 B.R. at 40.

131. Jeffrey Cheng & David Wessell, *What is the repo market, and why does it matter?*, BROOKINGS (Jan. 28, 2020), https://www.brookings.edu/blog/up-front/2020/01/28/what-is-the-repo-market-and-why-does-it-matter.

132. *Id.*

133. *See generally id.*

134. ROE & TUNG, *supra* note 55, at 398.

135. *In re* Lombard-Wall, Inc., 23 B.R. 165, 166 (Bankr. S.D.N.Y. 1982), *aff'd* 39 B.R. 958 (Bankr. S.D.N.Y. 1984).

industry turned to Congress, seeking exemption from many debtor protections.[136] Now, the repo market falls under a vast umbrella of protections, including exemption from the automatic stay, exemption from voidable transfer and fraudulent conveyance laws, as well as several other limitations put in place to discourage creditors from self-interested bankruptcy practices.[137]

The special treatment of the repo market has received significant attention in academia. Professor Roe, for example, argues that granting repos priority in bankruptcy "perniciously weakens market discipline . . . because the stronger counterparties know that they often enough will be paid even if their . . . repo counterparty fails."[138] By removing the burden of greater risk from those stronger parties (namely large financial institutions), there is little incentive for those institutions to contain the risk internally.[139] Professor Roe then pinpoints a crucial policy consideration, namely that the federal government is a creditor missing from the repo risk analysis; "[t]he national government is typically distant from the scene until a crisis arises, has diffuse incentives, can face difficulties in hiring those with the relevant expertise, and is often politically constrained from being aggressive. Often the market players themselves influence government policy in their immediate favor."[140] In so highlighting, Professor Roe has identified the motif: policy written by those who are subject to it are likely writing in their own self-interest. By neglecting to anticipate or regulate the fallacies of the repo market, the federal government made itself a central actor in the failures of the financial system.

Professor Roe is not alone in this analysis. Professor Kenneth C. Kettering published a scathing 200-page exposé of the financial market's failures, as well as the government's failure

136. ROE & TUNG, *supra* note 55, at 398.

137. All told, the repo market is awarded special treatment in 11 U.S.C. §§ 362(b), 559, 549, 546, executory contract rejections, and setoff restrictions.

138. Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 542 (2011).

139. *Id.* at 555.

140. *Id.* at 559.

to regulate them.[141] In explaining the evolution of repo protections, Professor Kettering states "[t]he repo experience also suggests that if a financial product with shaky legal underpinnings becomes sufficiently well established, those who are invested in the success of the product may find powerful allies in the financial regulators. . . ."[142] Though rationales for repo market protections in bankruptcy do exist, they are not convincing. The strongest "micro" theory is the importance of *timing* in the repo market. Repos are designed to be quick turnaround loans and cannot survive the delay of bankruptcy.[143] On the "macro" side, allowing repo protections allegedly works against systemic risk, namely the risk that if one financial institution were to fail, the rest would fall like dominos.[144] More likely, as Professors Roe and Kettering identified, the regulations themselves are drafted by players in the market and therefore benefit those players.

B. *The Settlement Safe Harbor*

An additional safe harbor drafted by and for the securities industry is the settlement safe harbor. The Code articulates that settlement payments are exempt from other regulations in the Code,[145] such as fraudulent conveyance liability, like the repo exemptions outlined *supra* Section IV.A. However, determining what constitutes a "settlement payment" is akin to Justice Stewart's "I know it when I see it" standard.[146] The Code provides the following guidance: "[A] 'settlement payment' means a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade. . . ."[147] Essentially, as Professor Roe states, "a settlement payment is a settlement payment is a settlement payment."[148] Keeping in

141. Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1,553 (2008).
142. *Id.* at 1,645; *see also* ROE & TUNG, *supra* note 55, at 399.
143. *See* ROE & TUNG, *supra* note 55, at 399.
144. *See id.* at 398.
145. 11 U.S.C. § 546(e).
146. *See* Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring).
147. 11 U.S.C. §741(8).
148. ROE & TUNG, *supra* note 55, at 587.

mind that the Code is often drafted by the securities industry,[149] a vague definition is logical. Like the automatic stay's broad and vague definition,[150] the settlement safe harbor rests on a similar type of definition, and thus is susceptible to broad application for the benefit of the industry.

The exemptions have since been applied to shareholders, namely large management-owners of corporations, who received payment in a financial transaction called a "leveraged buyout" ("LBO"). An LBO is a commonly used transaction in which the stock of the "target company" is bought by a purchasing company (usually a shell created for this purpose) in order to switch the ownership of the company.[151] Often, manager-owners of the target stay on in the new company, but still receive the payout that other shareholders receive.[152] The transaction, though, often renders the target insolvent, preventing creditors from collecting the money placed in owner-managers' pockets.[153] Thus, LBOs have increasingly come under fraudulent conveyance liability, with creditors suing to recover the money from owner-managers.

To avoid liability, parties involved in LBOs have asserted that the settlement safe harbor applies and have largely been successful. Of the six circuits who have heard this argument, five have agreed that the LBO transaction falls under the settlement safe harbor (including the manager-owners' profits).[154] The winning streak ended in 2018, when the Supreme Court heard *Merit Management Group v. FTI Consulting, Inc.*[155] The Court reasoned that these exemptions did not protect all parties in the transaction, as the language states that it is only for financial institutions.[156] Specifically, the Code articulates that "the trustee may not avoid a transfer that . . . [a] settlement payment, as defined in section 101 or 741 of this title, *made by or to (or for the benefit of)* a commodity broker, forward contract merchant, stockbroker, *financial institution*, financial

149. *See supra* Introduction.
150. *See supra* Section II.A.
151. *See* ROE & TUNG, *supra* note 55, at 563.
152. *See id.* at 563.
153. *See id.* at 564.
154. *See id.* at 600.
155. Merit Mgmt. Grp., LP v. FTI Consulting, Inc., 138 S. Ct. 883 (2018).
156. *Id.* at 887.

participant, or securities clearing agency. . . ."[157] Again, the language is incredibly broad and, as a result, unclear. However, the key phrasing for the Court was that the payment be made "by or to" a "financial institution." In its holding, the Court stated "[b]ecause the parties do not contend that either [party] is a [financial institution or other] covered entity, the transfer falls outside of the § 546(e) safe harbor."[158] The language, though, leaves room for a new argument, namely, that those parties are "financial institutions."

Professor Roe has explored this idea, highlighting that the Code defines a "financial institution" as including the "customer" of a financial institution.[159] In doing so, the Code allows for all parties who merely employ a financial institution for such a transaction to seek refuge in its settlement harbor. To be sure, the U.S. District Court for the Southern District of New York—the financial capital—has already reached this conclusion.[160] The implications of this are vast—indicating that owner-managers may safely orchestrate LBOs to line their pockets and reduce payments to creditors. Seeing as financial institutions are necessary to complete these transactions, non-financial institution creditors will likely be those lower on the priority totem pole, namely unsecured creditors who would already be paid last.

V.
A Signal for Change: The Appetite for Intervention

Government activism in bankruptcy proceedings is a rather new phenomenon. However, the principles that it represents are crucial to understanding how (and why) a new Bankruptcy Act must be drafted. Over a decade has passed since the federal government first dared to step into a bankruptcy proceeding with the goal of assisting the industry and, more importantly, its stakeholders.[161] Since then, some state

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157. 11 U.S.C. § 546(e) (emphasis added).

158. *FTI*, 138 S. Ct. at 887.

159. Mark J. Roe & Frederick Tung, Bankruptcy and Corporate Reorganization: Legal and Financial Materials, Spring 2022 Supplement 107 (Dec. 2021).

160. *In re* Trib. Co. Fraudulent Conv. Litig., 2019 WL 1771786, at *8 (S.D.N.Y. 2019), *aff'd*, 10 F.4th 147 (2d Cir. 2021).

161. *See generally* Roe & Skeel, *supra* note 57.

government actors have followed suit[162] and academics have taken notice.[163] With an increasing conversation surrounding government activism and regulation through bankruptcy proceedings, we are able to make note of what drives actors, as well as what concerns them. These factors, then, can be addressed and accounted for in the amended Bankruptcy Act.

The first notable example of government using bankruptcy to protect public stakeholders occurred during the automotive industry crisis of the 2000s—namely, the cases of Chrysler and General Motors ("GM"). Chrysler received significantly more attention than GM, as the federal government was much bolder in its involvement of that reorganization. In the Chrysler reorganization, the federal government ultimately orchestrated a sale to Fiat, which would allow Chrysler to be reorganized both financially and managerially for long-term success.[164] In doing so, the Chrysler plan (not just the assets, but liabilities such as the pension fund) was offered to the highest bidder.[165] Though a business-savvy decision intended to avoid a federal buyout that would cost taxpayers millions,[166] the sale was controversial on Wall Street.[167] The issue was simple: the government's structured plan subverted some absolute priority rules by paying back unsecured creditors before secured creditors were paid in full.[168] It is worth noting, though, that many of these creditors agreed to the plan as written.[169]

Chrysler became a highly politicized restructuring endeavor. In his announcement of the reorganization plan, President Obama utilized some phrases used by economists in the

162. *See* Jared A. Ellias & George Triantis, *Government Activism in Bankruptcy*, 37 EMORY BANKR. DEV. J. 509, 509 (2021).

163. *See generally id.*

164. *See* Roe & Skeel, *supra* note 57, at 733.

165. *Id.*

166. *Id.* at 760.

167. *See, e.g.*, Mark Roe, *The Chrysler Bankruptcy Sale: An Assessment*, FORBES (June 15, 2009, 12:00 AM), https://www.forbes.com/2009/06/14/chrysler-uaw-bankruptcy-fiat-opinions-contributors-general-motors.html?sh=4c5e75a35c75.

168. Austan D. Goolsbee & Alan B. Krueger, *A Retrospective Look at Rescuing and Restructuring General Motors and Chrysler* 30 (Nat'l Bureau of Econ. Rsch., Working Paper No. 21000, 2015).

169. *Id.* at 30–31.

1970s[170] (arguing for lesser regulations, corporate power, etc.) to showcase the importance of Chrysler to its stakeholders. In introducing the company, President Obama remarked, "it's been responsible for helping build our middle class, giving countless Americans the chance to provide for their families, sending their kids to college, saving for a secure retirement."[171] President Obama thus drew upon an ideal that had previously been used by the opposing political side, but for stakeholders. By taking control of the narrative, President Obama was able to gain traction, and even went so far as to note specifically that the plan protected "Chrysler's largest stakeholders, including auto workers and its largest lenders."[172] Positioning auto workers first after the word "stakeholders" was a subtle, yet powerful, political statement about who should be prioritized in restructurings. President Obama then made a powerful statement, listing all of the actors and their concessions throughout the process,[173] and then juxtaposed that by saying, "while many stakeholders made sacrifices and worked constructively, I have to tell you some did not."[174] He went on to elaborate that "a group of investment bankers and hedge funds decided to hold out," hoping that the government would conduct a bailout resemblant of the financial crisis, noting that "they were hoping everyone else would make sacrifices and they would have to make none."[175] He stated, clearly, "I don't stand with them."[176]

In a similar speech to the United Auto Workers, the union involved in and protected through the Chrysler restructuring, President Obama again showed the power of his hand:

> The heartbeat of American manufacturing was flatlining and we had to make a choice. With the economy in complete free fall there were no private inves-

170. *See supra* Section I.A.
171. *Presidential Remarks on the Auto Industry*, C-SPAN (Apr. 30, 2009), https://www.c-span.org/video/?285605-4/presidential-remarks-auto-industry.
172. *Id.* at 4:05.
173. Notably, this includes a specific mention of a group of banks, led by J.P. Morgan, who President Obama thanked for their cooperation and concessions. *Id.* at 6:30.
174. *Id.* at 7:08.
175. *Id.* at 7:24.
176. *Id.* at 7:29.

> tors or companies out there willing to take a chance on the auto industry. . . . And all of you, the men and women who built these companies with your own hands, would have been hung out to dry.[177]

In so stating, President Obama again highlighted the failures of the private market during times of financial crisis: the weight falls on those who are least equipped to handle it. This general motif need not be applied only to economy-wide crisis. Rather, it is the unprotected stakeholders that receive the least protections in bankruptcy. Each bankruptcy is its own miniature financial crisis, regardless of whether the company is solvent or not, and needs to be considered as such when determining who is most deserving of protections.

VI.
THE NEW BANKRUPTCY ACT

The signaling through Chrysler is clear: both governmental and non-governmental actors (including some banks and financial institutions) are willing to protect stakeholders in bankruptcy in ways they have not been previously. While not universal, this sentiment suggests a growing concern about the imbalance of power within bankruptcy proceedings. Through a handful of case studies, one theme has become clear: though the debtor is promised prioritization, the true power resides in big business, whether it be a large corporate debtor, institutional creditors such as hedge funds and big banks, or even a powerful family with a third-party release. In order to make good on that promise, as well as protect stakeholders who do not have the institutional power of other creditors, it is time for an amended code. Taking lessons from prior versions of the bankruptcy system,[178] as well as other governmental and business entities, we can structure a bankruptcy system that both protects going-concern and prevents abuse.

Briefly, the structure is as follows:

(1) Reflecting an understanding of incentives and Federal Circuit trends, the amended code will include a

177. Barack Obama, U.S. President, Remarks by the President to UAW Conference, Office of the Press Sec'y (Feb. 28, 2012, 11:30 AM), https://obamawhitehouse.archives.gov/the-press-office/2012/02/28/remarks-president-uaw-conference.

178. *See supra* Section I.A.

good faith filing requirement, rather than only requiring good faith at the plan proposal stage.

(2) Taking note from the Chandler Act, the amended code will split businesses based on market capitalization. This is crucial, as mom-and-pop businesses will not have the same concerns as large corporate entities.

(3) The control of the large corporation who enters bankruptcy will be passed over to the federal government. The government, then, will handle the bankruptcy proceedings while the corporation remains in bankruptcy.

These three key steps—requiring good faith, separating businesses by market capitalization, and then passing the reigns to an unbiased government actor—will ameliorate the abuses we have seen previously.

A. *A Good Faith Filing Requirement*

As the Code is currently written, the eligibility for a company to file for bankruptcy is near limitless. Eligibility is governed by § 109,[179] which articulates the types of entities who may file,[180] but includes neither a requirement of insolvency nor a requirement the petition be filed in good faith.[181] In fact, "[t]he minutes of the Commission on the Bankruptcy Law of the United States, the original draftsmen of the Bankruptcy Code, suggest that this omission was intentional," as drafters feared abuse of such a requirement.[182] Thus, the only explicit good faith requirement is that the plan of reorganization be proposed in good faith,[183] which often occurs long after the company has entered and reaped the benefits of Chapter 11. Additionally, though the Code requires a plan be proposed in good faith, it does not provide a definition of "good

179. 11 U.S.C. § 109.

180. Patrick A. Jackson & Robert S. Brady, *Dismissal for Bad-Faith Filing Under § 1112(b)(1): Whose Burden Is It, Anyway?*, 28 AM. BANKR. INST. J. 63, 64 (Dec./Jan. 2010).

181. *Id.*

182. *Id.*

183. William Thomas Thurman & Brett P. Johnson, *Bankruptcy and the Bad Faith Filing*, 10 UTAH BAR J. 12, 13 (Dec. 1997).

faith" or "bad faith."[184] Thus, the current requirements are few and vague.

That is not to say, though, that the bankruptcy system has not implemented mechanisms to protect the integrity of the Chapter 11 system, despite the (perhaps intentional) omission of a good faith requirement. Rather, though there is "no explicit statutory good faith filing requirement [ ], bankruptcy relief is considered an equitable remedy and *courts have imposed by judicial interpretation* the requirement that debtors file petitions in good faith."[185] To be sure, every federal circuit court that has directly addressed the issue of a good faith filing requirement has held that it is a necessity for ensuring equity in the system.[186] This includes ten of the thirteen federal circuits: the First,[187] the Second,[188] the Third,[189] the Fourth,[190] the Fifth,[191] the Sixth,[192] the Seventh,[193] the Eighth,[194] the Ninth,[195] and the Eleventh.[196] Notably, the Third Circuit, often thought of as home to corporate law norms, was the most recent to implement a good faith filing expectation in 2004.[197] Additionally, a district in the Third Circuit, the Dis-

184. *Id.*

185. *Id.* (emphasis added).

186. Greenstone Miller, *supra* note 70, at 181.

187. *See* Connell v. Coastal Cable T.V., Inc. (*In re* Coastal Cable T.V., Inc.), 709 F.2d 762, 764 (1st Cir. 1983).

188. *See* Sonnax Indus., Inc. v. Tri Component Products Corp. (*In re* Sonnax Indus., Inc.), 907 F.2d 1280, 1286 (2d Cir. 1990).

189. *See* Integrated Technology Express Inc. v. Integrated Telecom Express, Inc. (*In re* Integrated Telecom Express, Inc.), 384 F.3d 108, 112 (3d Cir. 2004); *see also* Mem'l Corp. v. Bepco, L.P. (*In re* 15375 Memorial Corp.), 589 F.3d 605, 608 (3d Cir. 2009).

190. *See* Carolin Corp. v. Miller, 886 F.2d 693, 694 (4th Cir. 1989).

191. *See* Little Creek Dev. Co. v. Commonwealth Mortg. Corp. (*In re* Little Creek Dev. Co.), 779 F.2d 1068, 1072 (5th Cir. 1986).

192. *See* Laguna Assocs. Ltd. P'ship v. Aetna Casualty & Surety Co. (*In re* Laguna Assocs. Ltd. P'ship), 30 F.3d 734, 737 (6th Cir. 1994), *as amended on denial of reh'g and reh'g en banc* (Sept. 9, 1994); *see also* Trident Assocs. Ltd. P'ship v. Metro. Life Ins. Co. (*In re* Trident Assocs. Ltd. P'ship), 52 F.3d 127, 131 (6th Cir. 1995), *cert. denied*, 116 S. Ct. 188 (1995).

193. *See In re* Madison Hotel Assocs., 749 F.2d 410, 425 (7th Cir. 1984).

194. *See* Prod. Credit Assoc. v. Wieseler (*In re* Wieseler), 934 F.2d 965 (8th Cir. 1991).

195. *See* Idaho Dep't of Lands v. Arnold (*In re* Arnold), 806 F.2d 937, 939 (9th Cir. 1986).

196. *In re* Phoenix Piccadilly, Ltd., 849 F.2d 1393 (11th Cir. 1988).

197. *In re* Integrated Telecom, 384 F.3d 108, 118 (3d Cir. 2004).

trict of New Jersey, recently held that a Johnson & Johnson subsidiary responsible for talc claimants filed in good faith,[198] making it clear that the good faith filing requirement is still an amorphous standard.

Though the Commission appears to have intentionally left a good faith filing requirement out of the Code, that does not prevent bankruptcy practitioners and academics from amending the Code to include one. As ten of the thirteen circuits are in agreement, there is no valid argument as to why the amended code should not include an express definition and requirement of good faith in filing for Chapter 11.

1. *The Purpose of the Requirement*

Even though the federal circuits are relatively clear[199]—a good faith filing purpose is necessary to preserve equitable treatment in bankruptcy—this does not eliminate the need to amend the Code. Though the conclusion of the circuits is the same, the means are drastically different. For example, the Ninth Circuit articulated that the "test is whether a debtor is attempting to unreasonably deter and harass creditors or attempting to effect a speedy, efficient reorganization on a feasible basis," or is "seek[ing] to achieve objectives outside the legitimate scope of bankruptcy laws."[200] In contrast, the Third Circuit explained the standard as requiring a "valid reorganizational purpose," that "falls along the spectrum ranging from the clearly acceptable to the patently abusive."[201] The Fourth Circuit addressed the amorphous nature of the standard directly, stating "[d]espite widespread judicial acceptance and application of the good faith filing requirement, no gen-

198. *In re* LTL Mgmt., LLC, 637 B.R. at 429–30. When presented to the Third Circuit, the appellate court yet again emphasized the importance of good faith filing, dismissing the bankruptcy of the subsidiary. *See In re* LTL Mgmt., LLC, 58 F.4th 738 (3d Cir. 2023).

199. As explored *supra*, ten of the thirteen federal circuits have come to the conclusion that filings need to be made in good faith. As this represents all of the circuits that have directly addressed the issue, they will be referred to generally as the 'federal circuits.'

200. Robert J. Keach, *Solvent Debtors and Myths of Good Faith and Fiduciary Duty*, 23 AM. BANKR. INST. J. 36 nn.13–14 (Dec./Jan. 2004) (citing In re Marsch, 36 F.3d 825, 828 (9th Cir. 1994)).

201. *Id.* nn.15–16 (citing *In re* SGL Carbon Corp., 200 F. 3d 154, 162, 165 (3d Cir. 1999)).

erally accepted proof requirements have emerged."[202] The Eleventh Circuit attempted to overcome this hurdle by outlining clear factors: "(1) a one-asset debtor; (2) improper pre-petition conduct of the debtor; (3) relatively few unsecured creditors; (4) posting of the debtor's property for foreclosure . . .; (5) two-party dispute; (6) evasion of a state court order; (7) no ongoing business or employees of the debtor; and (8) insufficient cash flow and no available income to fund a plan of reorganization."[203] Thus, the circuits have not reached a consensus on application of the good faith standard, and as a result, possible bad faith debtors can forum shop for an interpretation favorable to their specific facts.

Additionally, though there appears to be agreement among the federal circuits that good faith is required, courts do not uniformly apply a specific standard. Because of the fact-intensive nature of the circuit court tests, it is difficult to draw a bright line indicating when a lower court should dismiss a filing for bad faith. As a result, not all courts do. In the District of Massachusetts, for example, Bankruptcy Judge Queenan notoriously denied a motion to dismiss on good faith filing grounds, stating that "[g]ood faith, like apple pie, is difficult to oppose. The good faith of this doctrine, however, has nothing to do with honesty. When its true content is revealed, the doctrine is exposed as being in conflict with the Bankruptcy Code, its legislative history, Supreme Court precedent, and logic."[204] Though the case is decades old, the principle is not outdated.[205] Many bankruptcy judges and practitioners recognize that a good faith filing requirement is a judge-made law and one that, arguably, contradicts the plain language of the Code as written. Thus, some judges may choose not to apply a good faith requirement, as they "ha[ve] no express authority under the Code to make decisions affecting eligibility to seek Chapter 11 relief. Article 1, Section 8 of the United States Constitution reserves this role specifically for the United States

202. Carolin Corp. v. Miller, 886 F.2d 693, 701 (4th Cir. 1989).

203. Greenstone Miller, *supra* note 70, at 184 (citing In re Phoenix Piccadilly, Ltd., 849 F.2d 1393 (11th Cir. 1988)).

204. *In re* Victoria Ltd. P'ship, 187 B.R. 54, 54 (Bankr. D. Mass. 1995).

205. This case has been cited as recently as 2021 by the First Circuit. *See, e.g.*, La Trinidad Elderly LP SE, 627 B.R. 779 (B.A.P. 1st Cir. 2021) (citing *In re* Victoria Ltd. P'ship as an example of a court not permitting a bad faith objection).

Congress and not Article III judges, let alone Article I bankruptcy judges."[206] Current circuit unanimity aside, there remains a need to amend the Code to include an express good faith filing requirement. Bankruptcy judges cannot be expected to act beyond their authority, even if applying a principle established by a higher court. In arguing for an amended Code, Judith Greenstone Miller articulates three reasons that circuit standards must be codified: (1) clarifying the precedent and current "rule" would encourage consistency across circuits; (2) codifying the rule will provide bankruptcy judges the express authority they need to uphold this standard; and (3) preventing abuse of Chapter 11 filings will strengthen the overall integrity of the bankruptcy system.[207] In considering these arguments, the objective of the bankruptcy system remains crucial.

The bankruptcy system is designed around the successful and equitable reorganization of a company's debt. Specifically, the "Chapter 11 system is designed to preserve the 'going concern' value—that is, to maximize the value of the business so that more value is available for the repayment of the creditors."[208] In order to achieve this goal, the system is designed to encourage cooperation between creditors and the debtor through various mechanisms that remove self-interested incentives (e.g., the automatic stay, the period of exclusivity, etc.). Thus, "[i]n effect, bankruptcy is a constant struggle involving both allocative efficiency (eliminating waste and raising total collective value) and distributive justice (distributing the value of a reorganized business among all the stakeholders according to normative principles."[209] Given the balance between the transactional and litigious aspects of the bankruptcy system, there is a high standard for meeting expectations and cooperating with other parties in each matter. This goal provides a crucial factor for consideration: clear norms for parties to observe. If uncertainty around acceptable norms for filing remain, "the expectations of the parties will forever be dashed . . . . Commercial parties cannot adjust to such a fluid doctrine

206. Miller, *supra* note 70, at 182.
207. *Id.* at 181–82.
208. Warren, *supra* note 10, at 12.
209. *Id.* at 17.

that is constantly evolving."[210] Rather than only considering the judges' need for clear standards, proponents must anticipate the needs of commercial parties as well.

In drafting the requirement for the Code, proponents have weighed an objective-subjective model.[211] Specifically:

> [t]he principal inquiry under the objective-subjective test is whether the goals of the reorganization case are consistent with the policies underlying the Code. The objective part of the test is intended to ensure that the debtor has the ability to reorganize. The subjective part of the test is designed to prevent the debtor from abusing Chapter 11 and the creditors.[212]

This model for a good faith requirement guarantees that the integrity and objective of the bankruptcy system is left intact, while allowing for a combination of fact-based and normative assessments by the bankruptcy judge. To reflect a "totality of the circumstances"[213] standard, Greenstone Miller highlights the faults of using only an objective or subjective standard.[214] With just an objective test, the debtor's intents become irrelevant to the calculus. However, Greenstone Miller notes that, "[b]ecause the debtor's motives are often difficult to ascertain absent a lie detector test, using the subjective test is too reliant on the whims of judicial fiat."[215] Anticipating and responding to criticisms, Greenstone Miller elaborates that, "[u]sing only the subjective test also undermines the principles of rule of law, uniformity and certainty, and public confidence in the predictability of the system."[216] Thus, an ideal good faith requirement would account for both the need for uniformity and equity through an objective test, as well as the debtor's motivations through a subjective test. This would promulgate the expectations and goals of the bankruptcy system for all actors.

210. Miller, *supra* note 70, at 188.
211. *Id.* at 196.
212. *Id.* at 194.
213. *See, e.g.*, *In re* Integrated Telecom, 384 F.3d 108, 108 (3d Cir. 2004).
214. Miller, *supra* note 70, at 188.
215. *Id.*
216. *Id.*

2. *Criticisms and Counterarguments*

As Judge Queenan stated, "good faith, like apple pie, is difficult to oppose."[217] That does not, though, mean that the standard of good faith is without critics—himself included. Judge Queenan has also written that, "[a] rule of law should be susceptible to clear statement, so that the result of its application to particular facts can be predicted with reasonable certainty," arguing the good faith filing requirement "fails this test miserably."[218] Though cherry-picking a few common criticisms, Judge Queenan serves as an example of the multifaceted nature of opposition to a good faith filing requirement. However, these counterarguments can be addressed as easily as they have been raised. Predictability, as raised by Judge Queenan, is solved through the implementation of a clear standard for good faith filing in the amended code. As explored in Section VI.A., the various circuits have attempted to articulate specific standards for what constitutes "good faith" or "bad faith."[219] This necessarily creates discrepancies across circuits, allowing for forum shopping, different standards, and inconsistent application of those standards. However, if the Code were amended to include specific factors to be applied by all circuits, this disparity would drastically decrease. Though there can be no guarantee for complete uniformity, as very few legal principles are applied in a truly uniform fashion, clear expectations in an amended code would alleviate these concerns.

Perhaps the most pervasive, and most convincing, counterargument is that a good faith filing requirement would initiate unnecessary litigation in an early stage of the proceeding. This argument, in fact, may have defeated a good faith filing requirement in the existing Code. Greenstone Miller articulates that:

> During the formulation of its report leading to the adoption of the Code, the Commission on the Bankruptcy Laws of the United States believed a good faith requirement would lead to needless litigation with secured creditors early in the case and was a harsh obstacle for a debtor undergoing operational

217. *In re* Victoria Ltd. P'ship, 187 B.R. 54, 54 (Bankr. D. Mass. 1995).
218. Keach, *supra* note 200, at 3.
219. *See supra* Section VI.A.

> changes. The Commission did not recommend that good faith be eliminated altogether, but left it as a plan confirmation issue.[220]

The argument, however, was and is misplaced. Though, admittedly, the concern is valid—imprecise standards surely will lead to litigants seeking a clear articulation of the standard—the lack of a good faith requirement has not fended off unnecessary litigation. Rather, it has simply shifted the placement of that litigation.

Take, for example, any number of cases attempting to decipher a clear standard for the good faith filing expectation. By not articulating the standard in the Code, the Commission has merely shifted the burden of litigation to the federal circuits to determine a standard. By clearly setting a test in an amended code, this litigation would cease. Additionally, beyond litigation around the precise standard, the lack of a good faith expectations allows for additional unnecessary litigation. Without clear eligibility requirements or thresholds, creditors seek relief from the automatic stay or more general dismissals for debtors believed to not belong in Chapter 11.[221] Thus, while the Commission was concerned about excess litigation with a good faith requirement, that repercussion exists even without the requirement. By including a clear standard, much of this litigation can be easily dismissed or will not be brought with frequency in the first place.

Lastly, there is an argument that a good faith filing requirement may be translated into an insolvency or lack of liquidity requirement.[222] This is a distinct issue, one that cannot be conflated with a good faith requirement. An insolvency requirement has clear downfalls; particularly, it would require companies to file too late in the process, almost guaranteeing their failure to restructure successfully. Given that the objective of Chapter 11 is to provide for an equitable restructuring which promotes sustainable success of the company, the requirement that a company be insolvent or illiquid upon entering would set this objective on fire. Rather, a good faith requirement would not be equated to insolvency. In fact, "courts applying the 'good faith filing' doctrine are also uniform in

220. Miller, *supra* note 70, at 185–86.
221. Miller, *supra* note 70, at 186.
222. Keach, *supra* note 200, at 36–37.

stating that insolvency is not a prerequisite to seeking [C]hapter 11 relief and that solvency alone will not result in dismissal for an absence of good faith."[223] Nonetheless, because the criticism remains, the need for express requirements is further apparent. With a clear standard in an amended code, no room would exist for misrepresentations or misstatements of what "good faith" means.

As articulated by Judge Edith H. Jones of the Fifth Circuit, "[t]he debtor must be in bankruptcy because there is an entity to reorganize and because such a reorganization is reasonably possible within a reasonable period of time. Absent such proof, the reorganization goal of Chapter 11 is meaningless."[224] The federal circuits have reached the same conclusion: a good faith filing requirement is necessary to ensure the integrity and equity of the bankruptcy system. There is no convincing counterargument to the contrary. By articulating a clear standard and granting bankruptcy judges clear authority to dismiss cases filed in bad faith, the amended code would better protect the bankruptcy system for the foreseeable future.

B. *Separation by Market Capitalization*

A separation of companies filing for bankruptcy would resemble that in the Chandler Act of 1938.[225] When Chapter X and Chapter XI were both in effect, companies spent significant time and resources attempting to switch to Chapter XI (the less restrictive bankruptcy system designed for small, mom-and-pop-type businesses).[226] It was this effort that made Chapter X less efficient. In self-interest (which can be expected of businesses in a capitalist structure), these companies wasted their own resources along with those of the courts and SEC, simply in an effort to skirt requirements. In drafting the amended code, the distinction between the two bankruptcy pathways should be simple: a clean market capitalization cutoff. By using market capitalization to determine the appropriate pathway, the burden of bankruptcy filings rest appropri-

223. *Id.* at 36.
224. Edith H. Jones, *The "Good Faith" Requirement in Bankruptcy*, 1988 ANN. SURV. OF BANKR. L. 45, 48 (1988).
225. *See generally* Chandler Act, Pub. L. No. 75-696.
226. *See supra* Section I.A.

ately on companies. Small town restaurants would progress through bankruptcy more quickly due to less-stringent requirements than those explored *infra*,[227] justified by their lesser resources and (likely) stronger need for leeway. On the other hand, large corporations, the failure of which would have monumental effects, would undergo a more stringent process, designed to ensure that failure is not replicated and that the bankruptcy proceedings are conducted in good faith.

A bias towards small businesses is both common and rooted in logical policy. For example, the Small Business Reorganization Act sets out different requirements for bankruptcy proceedings of "small" businesses, which are those with less than $2.7 million in debt.[228] Confirmation requirements differ and shareholders are left with more power than is the case in larger restructurings.[229] This follows logically, as small businesses likely have fewer assets and creditors, and the shareholders are usually just the full-time owners of the business itself. Despite this general trend, the 2005 amendment to the Code[230] was unique in that it made bankruptcy filings more difficult specifically for small businesses owners and individual debtors.[231]

A split by company size was also more effective. Discounting the loss in efficiency, which is largely a result of the actions of companies trying to get out of Chapter X, the confirmation rates tell a story different than the dominant narrative. Under the current Chapter 11, the plan confirmation rate rests quite

227. *See infra* Section VI.C.
228. Small Business Reorganization Act, Pub. L. No. 116-54.
229. *Id.*
230. 11 U.S.C. § 105(51D)(A).
231. The amendment was drafted with the specific goal of making bankruptcy proceedings less accessible to the individual, harming small business owners and low-income citizens disproportionately. *See* Matthew Notowidigdo, *Assessing the Bankruptcy Law of 2005*, NORTHWESTERN INST. FOR POL'Y RSCH. (Dec. 16, 2019) https://www.ipr.northwestern.edu/news/2019/assessing-the-bankruptcy-law-of-2005.html#:~:text=IN%202005%2C%20Congress%20passed%20the,well%20as%20less%20financially%20advantageous ("The new law was designed to deter people from pursuing bankruptcy by making filing for it more difficult and expensive, as well as less financially advantageous.").

low at 17%.[232] Comparatively, plans filed under the predecessor Chapter XI[233] had a confirmation rate of 33%.[234] It could be argued that the confirmation rate does not reflect the Chandler Act's success, largely due to the fact that this is only the Chapter XI rate (not Chapter X) and does not account for time progressed. However, that argument fails to capture the bigger picture: a split by company size is *effective*. In fact, a split can be expected to be even more effective when the parameters are made clearer, because that anticipates and attempts to prevent excessive litigation from companies trying to be declared small businesses. With a clear market capitalization cutoff, this litigation will be moot, and the system will be more efficient and likely retain its efficacy.

C. *Government control of the proceedings*

The most radical step in the proposal is also the most crucial—passing control of the debtor (only those in the large market capitalization track) over to a truly neutral government entity. Whether it takes the form of a subdivision of an existing governmental entity or an entirely new entity, the policy justification remains. Instilling a good faith filing requirement is commonsense policy, but will not solve the overarching incentive structure for businesses considering bankruptcy. Rather, by requiring a company to install a truly neutral party—a government employee—the equity promised by the bankruptcy system can be achieved more wholly. The evidence of success is apparent from the Chrysler reorganization,[235] where the federal government effectively protected middle class jobs while also gaining the support of major banks, such as J.P. Morgan.[236] Rather than being the anomaly, this type of restructuring should be the standard.

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232. Warren, supra note 10, at 17 (citing Ed Flynn, Administrative Office of the U.S. Courts, Statistical Analysis of Chapter 11, at 10–11 (1989)).

233. Even though Chapter XI was initially designed for small businesses, most companies switched over. *See supra* Section I.A.

234. Warren, *supra* note 10, at 17 (citing David Stanley and Marjorie Girth, *Bankruptcy: Problem, Process, Reform*, Brookings, 109, 115, 143, tbl. 7–8 (1971)).

235. *See supra* Part III.

236. *See* Roe, *supra* note 167.

1. *Lessons from the Reconstruction Finance Corporation*

In envisioning government or quasi-government control of the bankruptcy process, one would be remiss not to look first to the Reconstruction Finance Corporation ("RFC") of the 1930s. In short, "[t]he RFC was a quasi-public corporation, staffed by professionals recruited outside of the civil service system but owned by the federal government, which appointed the corporation's executive officers and board of directors."[237] The RFC was originally submitted by the Hoover Administration to Congress in 1931, and received broad, bipartisan support, with Congress expediting the relevant legislation.[238] The initial funding for the RFC came from bond offerings sold by the Treasury, which allowed the RFC to get off the ground.[239] The goal of the RFC was to aid corporations during reconstruction, providing loans to promote a company's successful reorganization.[240] The RFC was specifically looking for "solvent but illiquid institutions whose assets appeared to have sufficient long-term value to pay all creditors but in the short run could not be sold at a price high enough to repay current obligations,"[241] as loans would provide the temporary assistance these companies needed to exit bankruptcy.

The RFC was focused specifically on providing immediate assistance to companies most in need. In President Hoover's words, "[i]t [was] not created for the aid of big banks or big industries. . . amply able to take care of themselves. . . . It [was] created for the smaller banks and financial institutions. . . to give renewed support to business, industry, and agriculture."[242] President Hoover's description reflects his awareness of a need for government intervention in reconstruction and, thus, restructuring of industries. President Franklin D. Roosevelt later expanded the program, encouraging the RFC to make direct business loans to stimulate industrial expan-

237. Michael Gou, et al., *Reconstruction Finance Corporation Act*, FEDERAL RESERVE HISTORY (Nov. 22, 2013), https://www.federalreservehistory.org/essays/reconstruction-finance-corporation.

238. *Id.*

239. *Id.*

240. Lisa Thompson, *Reconstruction Finance Corporation*, THE LIVING NEW DEAL (May 31, 2019), https://livingnewdeal.org/glossary/reconstruction-finance-corporation-1932-1957.

241. Gou, et al., *supra* note 237.

242. Thompson, *supra* note 240.

sion.[243] In sum, the RFC provided funds to struggling small businesses to ensure their successful growth in the future.

The RFC was largely viewed as a success.[244] The responsibilities of the RFC slowly diverged, dissolving the organization into several distinct agencies, notably including the Small Business Administration.[245] However, the success of the organization provides a framework for envisioning how a potential bankruptcy agency or sub-division would operate. First, it highlights that government intervention in financial transactions is beneficial so long as such intervention is done properly. It also suggests possibilities for funding, hiring, and other administrative concerns.

The goal of the RFC was similar, but not the same, as would be the goal for the new agency or subdivision on bankruptcy, but the processes would be similar. With the RFC focusing on providing financial support to small businesses, the new agency or subdivision would be providing financial and governance support to only large corporations, those in the higher market capitalization channel. The structure of the RFC, though, provides a crucial datapoint; namely, that specialists were hired from outside civil service, and funding was initially secured through bonds offered by the Treasury.

2. *The Creation of an Agency or Subdivision*

Specialization is undoubtedly necessary to the success of any agency or subdivision devoted to moving companies through bankruptcy. Thus, reminiscent of the RFC, specialized attorneys and investment bankers would be hired from outside civil service. Whether it be a new agency or a subdivision of an existing one, the creation of an organization devoted to the execution of bankruptcy proceedings will allow for greater efficiency and equity in the process. Though certain agencies and organizations (such as the SEC or the U.S. Trustee) are currently dedicated to specific aspects of bankruptcy, this new organization would specialize in operating companies while they are in bankruptcy. Accordingly, it would not face the limitations of current agencies nor be focused solely on civil or criminal enforcement. Rather, its focus would

243. *Id.*
244. Gou, et al., *supra* note 237.
245. Thompson, *supra* note 240.

be operating the business and orchestrating a restructuring plan that it deems equitable under the circumstances. Initial funding for the agency, like in the case of the RFC, can come from bond issuances. For continued funding, a progressive corporate tax may be instituted. Thus, almost like buying insurance, a corporation is paying into a fund that it may use in the event of insolvency or a valid restructuring. The organization would remain well-funded and well-equipped to execute its mission.

Beyond the structure of the agency or subdivision, its purpose remains critical. By replacing the current debtor-in-possession model with an agency-in-possession model, the amended code instills a very clear (and likely strong) disincentive to file for bankruptcy. As discussed *supra* Section II.B., a company may file for Chapter 11 for myriad reasons unrelated to reorganization. Creating an explicit good faith filing requirement will deter some of these filers, but such requirement is still just a legal architecture response and unlikely to *significantly* deter debtors from filing. More likely, debtors who have determined they need to file will do so and ensure that they meet the test included in the good faith requirement. These debtors have significant resources and surely excellent attorneys, and thus likely require a stronger disincentive touching upon business motivation.

This incentive analysis necessitates the government control aspect of the amended code. By forcing major debtors to pass over the reins after filing for bankruptcy, there is a strong deterrent effect in filing. No company looking to utilize bankruptcy for, say, a litigation tactic, would be able to do so if their CEO is no longer in control of the operations. This, then, would alter the calculus of companies considering filing for bankruptcy. Rather than being able to enter, absorb protections, and then leave with restructured debt, the company would have to consider the effect of passing over control, even if briefly. This should not, though, be considered a be-all-end-all, as there is some value in retaining management for the success of the company. Accordingly, like the Chandler Act,[246] the government actor in control should have the discretion to retain management if deemed suitable. This provides the best middle ground: a truly neutral party retains control, but man-

246. *See* Pub. L. No. 75-696.

agement remains available for the nuanced aspects of their business.

D. *Criticisms and Counterarguments*

Of course, replacing management as the default with a government organization is a drastic remedy. To be sure, some may argue that this remedy is *too* drastic and does not carry water when analyzed closely. In support, many have deemed the SEC's role in the Chandler Act a failure, as it was inefficient and often resulted in incorrect valuations. Take, for example, Atlas Pipeline.[247] Atlas Pipeline filed for bankruptcy in 1939, and initially the judge had conducted a market test with a valuation of $1.2 million to no avail.[248] Thereafter, the judge sought valuation opinions from the trustee and the SEC.[249] The trustee determined that Atlas Pipeline could continue as a perpetuity, averaging $170,000 per year with a 10% discount rate, thus valuing the company at $1.7 million.[250] The SEC, presented with the same information as the trustee, produced a significantly lower valuation, ultimately reaching the conclusion that a reorganization was not feasible nor wise.[251] The SEC reasoned that Atlas Pipeline would last no longer than five years, gave it a higher discount rate, determined its margins to be razor-thin, and included an account of freight rate deductions.[252] The SEC arguably double counted some of these deductions, for example only counting earnings up to year five while also increasing the capitalization rate for the first five years because of this prediction.[253]

In any event, the bankruptcy judge determined that the SEC was wrong, adopting the trustee's valuation and ultimately producing a very successful company.[254] It is likely that the SEC did not make any unintentional errors. Rather, the SEC could have chosen a low valuation due to a sense that insiders

247. *See* Roe & Tung, *supra* note 55, at 91.
248. *Id.* at 91–95.
249. *Id.*
250. *Id.* at 104–05.
251. *Id.* at 102–04.
252. *Id.*
253. *Id.*
254. *Id.* at 104–05.

were receiving more profit than was just.[255] With a close look at the plan of reorganization for Atlas Pipeline, this becomes readily apparent:[256]

Security Holder	**Amount**	**Annual Income**	**Rate of return**
Bonds	$1M (4.5%)	$45K	4.5%
Preferred	$435K (4%)	$17K	4%
Common Stock	$100K	$108K (170-45-17)	108%
Enterprise total	$1.7M	$170K	10%

With other creditors all receiving rates of returns below 5% in the trustee's plan, the shareholders of Atlas Pipeline received a 108% return. Thus, the dominant narrative is challenged: was the SEC wrong, or were the other parties just corrupt?

This challenges the narrative that the SEC failed, or at least the extent of such failure. First, the SEC was pursuing objectives that simply digressed from the objectives of private financiers. Whether the focus is discouraging corruption,[257] protecting securities fraud claimants,[258] or promoting beneficial public policy overall,[259] the motivations of a government actor are simply different than private parties. Additionally, while there is some merit to the argument that the SEC was slow or inefficient, this cannot be heard in a vacuum. It was private companies that pursued endless litigation in an effort to switch into Chapter XI, which necessarily drew out the process.[260] Additionally, a significant portion of the SEC's role was to investigate *why* the company failed, an objective which takes time and is often not accounted for in the explanation of delay.[261] Regardless, many of these efficiency concerns would be

255. The SEC hints at this possibility in their advisory opinion, stating "they are to place the fate of their investment in the hands of the Producers Group despite the latter's conflicting interests. . . leading in our opinion to the conclusion that the plan cannot be considered fair." *Id.* at 103.

256. *Id.* at 96.

257. *See In re* Atlas Pipeline Corp., 39 F. Supp. 846 (W.D. La. 1941).

258. *See* SEC v. WorldCom, Inc., 273 F. Supp. 2d 431 (S.D.N.Y. 2003).

259. *Id.*

260. *See supra* Section I.A.

261. *Id.*

ameliorated by creating a specific agency or subdivision devoted to executing bankruptcy proceedings. Rather than it being the responsibility of an entire agency, particularly one with a broad mandate in securities regulation, the amended code would provide for an organization that specializes in bankruptcy and *only* handles bankruptcy.

Certain middle ground approaches could also be successful, but would likely not achieve the same deterrent effect. For one, the power of the U.S. Trustee Program ("USTP") could be expanded. As stated on their website, the mission of the USTP is "to address fraud and abuse by debtors, creditors, and others in the bankruptcy system by taking both formal and informal civil enforcement actions and making criminal referrals to U.S. Attorneys as appropriate."[262] However, in doing so, the USTP is limited by the previous discussion on the difficulty of government enforcement measures balanced against the automatic stay.[263] It is possible, however, that the proposed subdivision would sit within the USTP. This arrangement would provide several benefits, including the established relationship between the USTP and the U.S. Attorney's Offices. It would also, however, centralize the bankruptcy functions in a manner that may make the new division more vulnerable to corporate capture.

Alternatively, with the current prevalence § 363 sales, stakeholders may have some faith in a market valuation or bankruptcy judge valuation. Thus, rather than bringing on an agency or subdivision, the power to value the debtor (or to hire an expert to value) could be granted to the bankruptcy judge. A bankruptcy judge, though, also does not exist in a vacuum. Several scholars note a "race to the bottom" phenomenon whereby certain bankruptcy judges are thought to be lenient to debtors in order to attract more high-profile debtors to their district.[264] This incentive structure can be beneficial,

262. U.S. DEP'T. OF JUST., UNITED STATES TRUSTEE PROGRAM (USTP), https://www.justice.gov/legal-careers/job/law-student-volunteer-academic-year-65. This analysis is not to minimalize the work of the US trustee, rather the proposal of a new division could be seen as an expansion of the powers of the trustee.

263. *See supra* Section II.B.

264. *See, e.g.*, Kenneth M. Ayotte & David A. Skeel Jr., *Why Do Distressed Companies Choose Delaware? An Empirical Analysis of Venue Choice in Bankruptcy*, FACULTY SCHOLARSHIP AT PENN L. (2003); David A. Skeel Jr., Bankruptcy

as was the case for Delaware courts, whose noted efficiency attracted many debtors seeking speedy resolution.[265] Alternatively, such incentives could distort the judges valuation and impact his decision regarding whether to install a trustee in place of current management. Because removing management is already thought to be a drastic remedy, it is unlikely that a judge would promote that as the new norm. Thus, the deterrent effect of removing management would likely fail, and it is possible that valuations would be affected given a judge's stake in his district's popularity.

Another potential counterargument to government control is its potential to chill investment by financiers, as they may hesitate to invest in a company whose management may be removed in bankruptcy. A similar argument was raised by Wall Street after the Chrysler organization, discussed *supra* Part V, in which financiers believed that secured creditors would no longer invest in companies because there was no guarantee that their security would be honored.[266] Warren Buffet, for example, warned ominously that the federal government's actions in the proceeding would have "a whole lot of consequences" for Wall Street deal-making.[267] This criticism has proven meritless.[268] In fact, one may argue that Chrysler's restructuring had a beneficial financial impact for those who needed it most. In analyzing senior debt securities traded over a two-year period following the Chrysler reorganization, Deniz Anginer and A. Joseph Warburton found no evidence of a negative financial reaction to unionized firms.[269] Instead, they observed a positive impact on returns, indicating that "bondholders interpreted the Chrysler bailout not as a threat to bankruptcy priorities, but rather as a signal that the government will stand behind the obligations of unionized firms."[270] Thus,

Judges and Bankruptcy Venue: Some Thoughts on Delaware, FACULTY SCHOLARSHIP AT PENN L. (1998).

265. *Id.*

266. Deniz Anginer & A. Joseph Warburton, The Chrysler Effect: The Impact of the Chrysler Bailout on Borrowing Costs, (World Bank Pol'y Rsch., Working Paper No. 5462, 2011), https://law.stanford.edu/wp-content/uploads/sites/dfault/files/event/265497/media/slspublic/The_Chrysler_Effect_The_Impact_of_the_Chrysler_Bailout_on_Borrowing_Costs.pdf.

267. *Id.* at 2.

268. *Id.*

269. *Id.* at 5.

270. *Id.*

a similar increased confidence in debtor firms may be seen with the proposal of neutral government action.

Conclusion

All told, it is clear that the same feeling of inequity that plagues other legal disciplines can be found within the bankruptcy system and traced back to similar stakeholders. That is not to say that all parties are consciously gaming the system. Rather, the underlying systemic forces and distribution of resources has led to a warped interpretation of provisions within the Code, which threaten to undermine bankruptcy's standing as an equitable remedy. Though aiming to protect the weakened company, the implementation of the Code now leaves its weakened stakeholders with little protection and even fewer remedies. By making three key adjustments—a good faith filing requirement, a split of filing companies based on market capitalization, and increased government involvement—an amended code would be better equipped to return to (and remain) an equitable remedy.