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The Declining Need for General Deterrence in Insider Trading Sentencing

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Introduction

An important objective of both criminal and civil enforcement of the federal securities laws is to promote trust, confidence, and fairness in the financial markets. While financial fraud takes many forms, insider trading stands out, among many types of common misconduct, as creating a sense that the markets are rigged against ordinary mom-and-pop investors in favor of well-connected corporate insiders and Wall Street elites. For those reasons, regulators, prosecutors, and courts regard insider trading as a serious crime.

The serious nature of insider trading is reflected in the sentences that courts impose in criminal cases and the monetary and non-monetary penalties that courts assess in enforcement actions by the U.S. Securities and Exchange Commission ("SEC"). But there is an additional premise that underlies courts' willingness to impose substantial sanctions in insider trading matters—namely, that because insider trading is particularly difficult to detect (compared with other types of fraud), judges must impose particularly punitive sanctions in order to deter future would-be inside traders.

This concept is widely referred to as general deterrence. In the aftermath of the high-profile insider trading cases of the 1980s, courts have embraced the view—at the behest of the government—that insider trading is uniquely difficult to detect, and have incorporated that perspective into sentencing jurisprudence. As a result, many defendants are penalized more harshly than a court would be inclined to punish them based on the other more individualized sentencing considerations.

Nearly forty years later, the U.S. Department of Justice ("DOJ") and the SEC continue to routinely argue for enhanced penalties against insider trading defendants in light of the supposed difficulty in detecting illicit trading. In this article, we argue that, in light of the government's current market surveillance and data analytics capabilities, the government's legacy general deterrence arguments in insider trading cases are outmoded, and that courts should adjust their sentencing calculations in recognition of this new paradigm.

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Objectives of Federal Sentencing

Congress's passage of the Sentencing Reform Act of 1984 and the resultant creation of the United States Sentencing Commission was intended to end an era marked by sentencing inequalities and a lack of proportionality in criminal punishment.[3] Since that time, the law has evolved to require sentencing judges to consider the four statutory purposes of federal sentencing as outlined in 18 U.S.C. § 3553(a)(2): punishment, deterrence, incapacitation, and rehabilitation.

Those objectives, though reflective of a legislative attempt to achieve a principled and predictable justice system, are offender-centric.[4] Punishment is based on the notion that offenders deserve a measure of retribution. Incapacitation seeks to prevent further illegal conduct through incarceration of the individual offender. Of course, rehabilitation involves providing "correctional treatment" to the individual offender.

Which brings us to the twin goals of specific and general deterrence. Like punishment, incapacitation, and rehabilitation, specific deterrence is purely offender focused, and requires a sentencing court to determine what consequences may be necessary to deter the offender from engaging in future illegal activity.

General deterrence, on the other hand, is by definition focused on individuals besides the defendant. The goal of general deterrence is to discourage would-be defendants from committing crimes by making an example of the defendant before the court. In light of Congress's directive that courts take an individualized approach to sentencing,[5] general deterrence stands alone among the four sentencing factors as an objective concerned with the public at large. This tension has spawned a deep body of academic literature critiquing the validity and philosophical underpinnings of general deterrence as a justification for sentencing, which has developed alongside a wealth of empirical studies calling its efficacy into question.[6] Courts have struggled with this dilemma as well, and seldom embrace general deterrence as a driving consideration in sentencing unless the deterrence value is clear and compelling.[7] Crimes that are both widespread and difficult to detect are likely to carry high deterrence value (at least in theory), as are crimes most likely to be committed by rational actors.

General Deterrence and the History of Sentencing in Insider Trading Prosecutions

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[3] 28 U.S.C. § 991(a); *Mistretta v. United States*, 488 U.S. 361 (1989).

[4] *See generally* Richard S. Frase, *Punishment Purposes*, 58 STAN. L. REV. 67 (2005).

[5] 18 U.S.C. § 3553(a); *see also Gall v. United States*, 552 U.S. 38, 50 (2007) (finding that a district judge's sentence must constitute "an individualized assessment based on the facts presented.").

[6] *See generally* Professor Lucian E. Dervan, *White Collar Overcriminalization: Deterrence, Plea Bargaining, and the Loss of Innocence*, 101 KY. L.J. 723 (2013); *see also* Gary Kleck, et al., *The Missing Links in General Deterrence Research*, 43 CRIMINOLOGY 623, 653 (2005) (suggesting that increases in punishment levels do not routinely reduce crime through general deterrence mechanisms).

[7] *Compare United States v. Walker*, 252 F. Supp. 3d 1269, 1298-99 (D. Utah 2017) (sentencing defendant to non-custodial sentence where general deterrence value was found to be marginal) *with United States v. Brown*, 880 F.3d 399, 406–07 (7th Cir. 2018) ("The district court did not err, therefore, in resting its conclusion about the need for general deterrence on the basis that there was a low likelihood of getting caught for Medicare fraud.").

"White collar crime," a term coined as a reference to the comparatively high social status of this class of criminal, is considered pernicious precisely because offenders are often rational, educated, wealthy, or powerful—or a combination of all four.[8] As needles in the proverbial haystack of over 10 billion worldwide shares of stock traded per day, insider trading has long been viewed as a uniquely difficult crime to detect, and the penalties for offenders who are caught have steadily increased as a reflection of this commonly accepted notion.

The range of sanctions available to government enforcement authorities in an insider trading case runs the gamut of both civil and criminal penalties, and the options at their disposal have only increased over time.[9] Yet, penalties for inside traders have become harsher over the past fifteen years.[10] Amidst an unprecedently aggressive white collar enforcement climate in recent years,[11] United States Sentencing Commission statistics show that over 20% of insider trading offenders prosecuted during fiscal years 2021 and 2022 were sentenced to terms of imprisonment of 24 months or more.[12]

This phenomenon may be explained (at least in part) by the increasing amount of illicit monetary gains generated by insider trading in a system in which the extent of punishment depends heavily on the illegal profits generated by the offender.[13] The tendency of the Federal Sentencing Guidelines (the "Guidelines") to overstate the culpability of insider trading defendants has been not only recognized by academics, but also criticized by judges who routinely preside over insider trading prosecutions. Perhaps most famous among these critiques is Judge Rakoff's rebuke of the Guidelines' focus on monetary gains as an "overwhelming emphasis on a factor that may be central to some frauds but largely incidental to others" and thus likely to result in the very sentencing disparities that the Guidelines were created to remedy.[14]

While the precise explanation for the trend toward harsher criminal penalties for insider trading defendants may remain unclear, it is certain that both courts and commentators espouse the perception that it is difficult for the government to detect, investigate, and prosecute inside traders

8 EDWIN H. SUTHERLAND, WHITE COLLAR CRIME 9 (1950).

9 *Sec. & Exch. Comm'n v. Happ*, 392 F.3d 12, 32 (1st Cir. 2004) (discussing the ITSFEA's expansion of civil penalties available to enforcement authorities); 15 U.S.C. §§ 78o(b)(6)(A), 78o-4(c)(4), 78q-1(c)(4)(C), 80b-3(f) (Supp. IV 2011) (expanding SEC powers to suspend or bar officers and directors).

10 Todd Kowalski et al., *Securities Fraud*, 60 AM. CRIM. L. REV. 1245, 1306 (2023); Nate Raymond, *Insider Traders in U.S. Face Longer Prison Terms, Reuters Analysis Shows*, REUTERS (September 2, 2014, 1:07 PM), https://www.reuters.com/article/us-insidertrading-prison-insight/insider-traders-in-u-s-face-longer-prison-terms-reuters-analysis-shows-idUSKBN0GX0A820140902.

11 Press Release, Sec. & Exch. Comm'n, SEC Announces Enforcement Results for FY22 (Nov. 15, 2022), https://www.sec.gov/news/press-release/2022-206.

12 https://ida.ussc.gov./analytics/saw.dll?Dashboard (follow "Sentence Length" hyperlink; then use relevant offense filter and "Fiscal Year" filter for 2021 and 2022).

13 U.S. SENTENCING GUIDELINES MANUAL § 2B1.4(b)(1) (2021).

14 *United States v. Gupta,* 904 F. Supp. 2d 349, 351 (S.D.N.Y. 2012); *see generally* Danielle DeMasi Chattin, *The More You Gain, the More You Lose: Sentencing Insider Trading Under the U.S. Sentencing Guidelines*, 79 FORDHAM L. REV. 165 (2011).

offenders and other white collar criminals.[15] Thus, it is not surprising that courts routinely cite general deterrence as the paramount consideration when fashioning sentences in insider trading and other financial fraud cases.

Since the seminal *SEC v. Texas Gulf Sulphur Co*. court's recognition of punishment as a means to deter future insider trading offenses, courts in both civil *and* criminal matters have not hesitated to rely on general deterrence as the primary rationale for harsh punishment in insider trading and other white collar cases.[16] In a 2004 appeal challenging a civil penalty in an insider trading case, the First Circuit in *SEC v. Happ* held that the penalty was appropriate because it was meant "not only to punish [Happ] but to serve as a deterrent on insider trading generally."[17] In *United States v. Martin*, the Eleventh Circuit characterized white collar offenders as "prime candidate[s] for general deterrence," finding that a 7-day prison sentence "utterly fails to afford adequate deterrence to criminal conduct" in a striking admonition of the trial court's judgment.[18] More recently, in *United States v. Neff*, a 2021 case decided in the midst of the COVID-19 pandemic, an Eastern District of Pennsylvania court denied a motion for compassionate release by a 72-year old man with significant health issues in large part due to the need for "a lengthy [prison] sentence" to reinforce "a sophisticated individual's understanding of the likelihood of apprehension and length of punishment" that white collar criminals face if caught.[19]

There can be no doubt that the belief that insider trading is an especially difficult form of misconduct to deter has endured through the decades, resulting in many sentences tailored not to the individual offender, but rather to deter future violations by others. The fact that insider trading sentences continue to trend toward harsher, lengthier punishment would suggest, at a minimum, that this belief is still widely accepted by government enforcement authorities and courts, even as investigative methods have grown ever more sophisticated over the same time period.

Evolution of the Government's Ability to Detect and Prosecute Insider Trading

Over at least the last decade, government enforcement authorities have drastically improved their ability to harness big data to investigate a wide array of misconduct. Data analytics has enabled the government to identify a variety of illicit schemes across various sectors including, for example,

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[15] *See, e.g.*, *United States v. Heffernan,* 43 F.3d 1144, 1149 (7th Cir. 1994) (recognizing the importance of general deterrence in fashioning sentences for economic crimes that are "lucrative or are difficult to detect and punish"); Mirko Bagaric et. al., *Halting the Senseless Civil War Against White-Collar Offenders: "The Conduct Undermined the Integrity of the Markets" and Other Fallacies*, 2016 MICH. ST. L. REV. 1019, 1058 (2016) ("An important reason why this is so relates to the often remarked difficulty in detecting and investigating white collar crime. Insider trading is particularly hard to detect.").

[16] *Sec. & Exch. Comm'n v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 857 (2d Cir. 1968) (remanding case to trial court to determine whether penalties were necessary "to prevent or deter future violations of regulatory provisions"); *see also* J. Scott Colesanti, *Wall Street As Yossarian: The Other Effects of the Rajaratnam Insider Trading Conviction*, 40 HOFSTRA L. REV. 411, 427 (2011) ("[T]he Rajaratnam case represents a potentially dangerous view that incarceration generally deters insider trading….").

[17] *Happ*, 392 F.3d at 32.

[18] *United States v. Martin*, 455 F.3d 1227, 1240 (11th Cir. 2006).

[19] *United States v. Neff*, 523 F. Supp. 3d 726, 729 (E.D. Pa. 2021).

health care fraud,[20] violations of the Bank Secrecy Act/anti-money laundering rules, and fraud in connection with the COVID-19 Paycheck Protection Program.[21] But while sophisticated data analysis has markedly improved the government's financial misconduct enforcement capabilities generally, the impact of the government's decision to embrace big data and technology has been particularly monumental with respect to insider trading enforcement.

Prior to the current golden era of data-based enforcement, the government faced the unenviable task of penetrating insider trading networks by relying heavily on cooperating witnesses and wiretaps. In his remarks to a group of securities professionals in the aftermath of the landmark insider trading enforcement actions and prosecutions of the mid-1980s, then SEC Commissioner Charles Cox explained, "[b]y far the most common way in which an insider is caught is through a tip to the staff from an informant."[22] In those same remarks, Commissioner Cox bemoaned "that a number of violators … manage to escape the SEC's enforcement net" and noted that "[a]t least one member of the enforcement staff is on record as having said that he would like to 'create an environment where the downside is so painful, it's not worth even a million bucks to take the risk.'"[23]

Commissioner Cox's remarks occurred just days after the United States Attorney's Office for the Southern District of New York announced that former securities trader Ivan Boesky agreed to plead guilty to a securities fraud conspiracy and to accept a variety of serious civil sanctions in a parallel SEC enforcement action. Boesky's cooperation with the government led to several convictions against other notorious Wall Street fraudsters including Michael Milken, Martin Siegel, and Boyd Jeffries. It was widely understood that Boesky's cooperation was a prerequisite to the conviction of these other insiders; in turn, the government learned about Boesky's conduct when former investment banker Dennis Levine implicated Boesky as one of Levine's many tippees (the investigation of Levine originated with a tip to the SEC enforcement staff).

Eventually, the government integrated the use of wiretaps (and cooperators willing to wear wires) into its insider trading detection arsenal. FBI agents based in New York scoured thousands of hours of conversations between Wall Street insiders and other executives, which led to some of the most high-profile securities fraud convictions in recent history, including against Galleon Group's Raj Rajaratnam. These conventional investigative methods, while certainly fruitful, impose a substantial drain on law enforcement resources and rely on fraudsters' willingness to discuss openly their criminal activities.

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[20] Press Release, Department of Justice, National Health Care Fraud Takedown Results in Charges Against 601 Individuals Responsible for Over $2 Billion in Fraud Losses (June 28, 2018) https://www.justice.gov/opa/pr/national-health-care-fraud-takedown-results-charges-against-601-individuals-responsible-over.

[21] Acting Assistant Attorney General Brian C. Rabbitt, Department of Justice, Remarks at the Practicing Law Institute's White Collar Conference (Sept. 23, 2000) *available at* https://www.justice.gov/opa/speech/acting-assistant-attorney-general-brian-c-rabbitt-delivers-remarks-practicing-law.

[22] Commissioner Charles C. Cox, Sec. & Exch. Comm'n, The Law of Insider Trading – How They Get Caught, Remarks to Piedmont Economic Club (Nov. 20, 1986), *available at* https://www.sec.gov/news/speech/1986/112086cox.pdf.

[23] *Id.* at 3.

Insider trading enforcement looks very different in 2023. Over the past decade, the SEC has devoted substantial resources to enhancing its data analysis capabilities, and the crown jewel of the SEC's efforts in this regard is the Division of Enforcement's Market Abuse Unit (MAU). Formed in 2010, the MAU targets sophisticated misconduct impacting the financial markets including complex insider trading schemes. The unit is staffed by enforcement attorneys across the country and operates an Analysis and Detection Center manned by industry specialists—i.e., former traders, quantitative analysts, and experts from other law enforcement agencies.

The SEC's senior leadership has been remarkably candid in boasting about how the MAU has revolutionized insider trading enforcement. In one high-profile example, from 2015 to 2019, the SEC charged over 40 defendants in connection with a scheme to hack into the SEC's EDGAR database and trade based on illicitly obtained corporate earnings information. In announcing the first of these actions, the then-SEC Enforcement Director stated that, "[t]his cyber hacking scheme is one of the most intricate and sophisticated trading rings that we have ever seen, spanning the globe and involving dozens of individuals and entities", and added that the MAU's "use of innovative analytical tools to find suspicious trading patterns and expose misconduct demonstrates that no trading scheme is beyond our ability to unwind."[24]

The government's investment in data analytics continues to pay dividends for both criminal and civil enforcement of insider trading laws. In March 2023, DOJ brought its first ever prosecution for insider trading in connection with a Rule10b5-1 trading plan. In announcing the criminal charges in that prosecution of the CEO of a publicly traded health care company, the Assistant Attorney General for the Criminal Division touted DOJ's "use of data to proactively identify and investigate fraud as [it] continue[s] to ensure that ordinary investors are on an equal playing field with corporate insiders."[25] Both DOJ and the SEC now have the technological capability to detect and prosecute illicit trading in the digital asset markets, including by analyzing "purchases and sales using anonymous digital currency wallets and anonymous accounts on OpenSea."[26] And the government is now able to detect instances in which a corporate executive allegedly utilizes confidential information from one company to illicitly trade in the securities of a company in the same industry—so-called "shadow trading."[27]

In announcing these high-profile matters, the government's message is unmistakable: enforcement authorities are catching a growing array of illicit trading and no conduct is beyond the increasingly long arm of the government's detection capabilities. Indeed, these insider trading prosecutions

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[24] *See* Press Release, Sec. & Exch. Comm'n, SEC Charges 32 Defendants in Scheme to Trade on Hacked News Releases (August 11, 2015) https://www.sec.gov/news/press-release/2015-163.

[25] Press Release, Department of Justice, CEO of Publicly Traded Health Care Company Charged for Insider Trading Scheme (March 1, 2023) https://www.justice.gov/opa/pr/national-health-care-fraud-takedown-results-charges-against-601-individuals-responsible-over.

[26] *See* Press Release, Department 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; *see also* Press Release, Department of Justice, Three Charged In First Ever Cryptocurrency Insider Trading Tipping Scheme (July 21, 2022) https://www.justice.gov/usao-sdny/pr/three-charged-first-ever-cryptocurrency-insider-trading-tipping-scheme.

[27] *See* Litigation Release, Sec. & Exch. Comm'n, SEC Charges Biopharmaceutical Company Employee with Insider Trading (August 17, 2021) https://www.sec.gov/litigation/litreleases/2021/lr25170.htm.

and enforcement actions—along with many others filed over the last several years[28]—would have been virtually unthinkable even just a decade ago. As the government continues to refine its data analytics capabilities, we expect both DOJ and SEC to continue to prevent, detect, and pursue novel and sophisticated insider trading schemes.

Conclusion

For nearly forty years, courts have fashioned sentences against insider trading defendants based, in large part, on general deterrence considerations. Of course, general deterrence remains an important statutory objective of federal sentencing, and courts must follow Congress's directive—as memorialized in 18 U.S.C. § 3553(a)(2)—to assess the need for deterrence in imposing any sentence.

Historically, in order to investigate and prosecute insider trading rings, the government had to rely extensively on wiretaps, cooperators, and less sophisticated investigative measures. Under those circumstances, the argument that the need for general deterrence was particularly salient in insider trading cases had merit. But by its own admission, in the era of advanced analytics the government is catching a historically unprecedented amount of illicit trading. Indeed, the SEC recently boasted that "no trading scheme is beyond [its] ability to unwind."

Notwithstanding this reality, the government continues to argue that difficulties in detecting insider trading warrant harsh sentences to promote the objective of general deterrence. In light of the government's current surveillance and analytical capabilities, we submit that the government's argument is overstated. Defense counsel representing individuals at sentencing (or during the penalty phase of an SEC enforcement action) in insider trading matters should consider informing the court about how analytics have revolutionized insider trading enforcement to undermine the government's standard general deterrence arguments.

[28] *See, e.g.*, Press Release, Department of Justice, U.S. Attorney Announces Charges In Four Separate Insider Trading Cases Against Nine Individuals, Including Former U.S. Congressman, Former FBI Agent Trainee, Tech Company Executives, And Former Investment Banker (July 25, 2022) https://www.justice.gov/usao-sdny/pr/us-attorney-announces-charges-four-separate-insider-trading-cases-against-nine; Press Release, Sec. & Exch. Comm'n, SEC Files Multiple Insider Trading Actions Originating from the Market Abuse Unit's Analysis and Detection Center (July 25, 2022) https://www.sec.gov/news/press-release/2022-129 ("Each of the three actions announced today originated from the SEC Enforcement Division's Market Abuse Unit's … Analysis and Detection Center, which uses data analysis tools to detect suspicious trading patterns.").