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The Bank Bailout: A License for Sovereign Securities Fraud

Wendy Gerwick Couture[†]

I. INTRODUCTION

As this article goes to press, the United States faces “the most severe financial crisis since the Great Depression.”¹ The stock market has plummeted, wiping out \$8.3 trillion in wealth.² On March 5, 2009, the Dow Jones Industrial Average slid to 6,594.44,³ down from its high of 14,164.53 on October 9, 2007.⁴ Banks are restricting lending,⁵ thus interfering with consumer spending and businesses’ ability to pay costs—let alone grow.⁶ As of June 2009, the unemployment rate had skyrocketed to 9.5% with 7 million more people unemployed than in December of 2007.⁷ Home prices have dropped in many areas, with prices in 20 metropolitan areas declining by 18.7% from March 2008 to March

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1. FinancialStability.gov, *The Financial Stability Plan: Deploying Our Full Arsenal to Attack the Credit Crisis on All Fronts*, <http://www.financialstability.gov/roadtostability/index.html> (last visited July 2, 2009).

2. Vikas Bajaj & Jack Healey, *Stocks Drop Sharply and Credit Markets Seize Up*, N.Y. TIMES, Nov. 18, 2008, at A1.

3. Jack Healy, *Slump Humbling Blue-Chip Stocks, Once Dow’s Pride*, N.Y. TIMES, Mar. 6, 2009, at A1.

4. Dow Jones Industrial Average, *The Dow Through History and Interactive Timeline*, <http://www.djaverages.com> (last visited July 1, 2009).

5. Michael R. Crittenden & Meena Thiruvengadam, *Treasury Finds No Rise In Bank Lending*, WALL ST. J., Feb. 18, 2009 (“The survey suggests that the market for credit remains challenging despite efforts by the Treasury, Federal Reserve and other government agencies to unclog markets.”), available at <http://online.wsj.com/article/SB123491255580303683.html>.

6. Richard A. Posner, Opinion, *Capitalism in Crisis*, WALL ST. J., May 7, 2009, at A17 (“When the banking system breaks down and credit consequently seizes up, economic activity plummets.”).

7. Economic News Release, U.S. Department of Labor, *Employment Situation Summary for June 2009*, <http://www.bls.gov/news.release/empsit.nr0.htm/pp2> (last visited July 2, 2009).

2009.⁸ The foreclosure rate reached a record high of 3.85% in the first quarter of 2009.⁹

Against this backdrop, and pursuant to authority granted by the Emergency Economic Stabilization Act of 2008, the United States Department of the Treasury has implemented multiple programs to restore liquidity and stability to the financial system. Two of those programs—the Capital Purchase Program and the Capital Assistance Program—are designed to inject capital into the domestic financial institutions. Although the Treasury disputes that these programs “bail out” the banks,¹⁰ the public commonly refers to these programs as the “bank bailout.”

A key component of these programs is the so-called “equity kicker,” which permits the Treasury, on behalf of the taxpayers, to benefit from the improved financial health of the financial institutions. Pursuant to the equity kicker, the Treasury has purchased preferred stock convertible to common stock and common stock warrants from the participating financial institutions. Congress has directed that the Treasury dispose of these securities in such a way as to maximize returns for the taxpayers.

Unaddressed by Congress or the Treasury is the potential for the Treasury to rely on material, nonpublic information when disposing of these securities. The Treasury, pursuant to contractual agreements with the financial institutions, has unfettered access to inside information about those institutions. Moreover, the Treasury has access to material, nonpublic information about future governmental and quasi-governmental conduct that could affect the price of bank securities.

Current law does not curtail the Treasury’s ability to engage in insider trading. Although § 10(b) of the Securities Exchange Act prohibits insider trading, this provision does not apply to federal departments. Moreover, even if Congress extended the current prohibition on insider trading to governmental activity, not all of the government’s trading on the basis of material, nonpublic information about the banks or about future governmental or quasi-governmental action would fall within the scope of such a prohibition. Further, any attempt to premise a common

8. David Streitfeld, *Home Prices Declined Again in March as Banks Sold More Foreclosed Properties*, N.Y. TIMES, May 26, 2009, at B3 (reporting the results of the Standard & Poor’s Case-Shiller Home Price Index 20-City Composite).

9. Press Release, Mortgage Bankers Association, *Delinquencies and Foreclosures Continue to Climb in Latest MBA National Delinquency Survey* (May 28, 2009), <http://www.mbaa.org/NewsandMedia/PressCenter/69031.htm>.

10. FinancialStability.gov, *Factsheet on Capital Purchase Program*, <http://www.financialstability.gov/roadtostability/CPFactsheet.htm> (last visited July 2, 2009) [hereinafter *CPP Factsheet*] (“CPP is not a ‘bailout.’”).

law tort claim on governmental insider trading would be outside the scope of the Federal Torts Claim Act. Finally, although there is a colorable argument that governmental insider trading constitutes a breach of contract and a taking under the Fifth Amendment, this argument, even if successful, would be limited in application.

Insider trading by the Treasury should, however, be constrained. Allowing the Treasury to trade on inside information would undercut the bailout's goals of promoting overall faith in the markets and buttressing bank stock prices. The potential for increased profits for the taxpayers does not outweigh the cost of decreased public confidence in the markets.

Multiple potential solutions are available, including nationalizing the banks, prohibiting the Treasury from using inside information when making investment decisions, and imposing a "disclose or abstain" rule on the Treasury. The best solution, however, is two-part and includes: (1) the imposition of an ethical wall between the persons making the investment decisions and the Treasury; and (2) the establishment of an investment plan that divests the Treasury of discretion over investment decisions.

Part II of this article details how the bank bailout affords the Treasury the motive and the opportunity to engage in insider trading on behalf of the taxpayers. Part III examines previous bailouts in order to place the bank bailout in historical context and to exemplify the potential for insider trading. Part IV analyzes whether the current legal and regulatory system imposes restrictions on insider trading by the Treasury, and Part V argues that, despite the lack of current checks on governmental insider trading, insider trading by the Treasury should be inhibited. Part VI examines multiple possible solutions and recommends the combination of an ethical wall and an investment plan.

II. THE BAILOUT AFFORDS THE TREASURY THE MOTIVE AND THE OPPORTUNITY TO ENGAGE IN INSIDER TRADING ON BEHALF OF THE TAXPAYERS

The central purpose of the Emergency Economic Stabilization Act of 2008 ("the EES Act") is "to immediately provide authority and facilities that the Secretary of the Treasury can use to restore liquidity and stability to the financial system of the United States."¹¹ At the same time, however, the EES Act mandates that such authority be used in a way that

11. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 2(1), 122 Stat. 3765 (codified as amended in 12 U.S.C. § 5201(1)).

protects other important goals—such as maximizing overall returns for the taxpayers and providing public accountability for the exercise of the bailout authority.¹²

A key component of the Treasury's strategy pursuant to the EES Act is the injection of capital into the domestic financial institutions. The rationale is that more capital enables financial institutions to "take losses as they write down or sell troubled assets" and "supports lending."¹³ Two of the programs implemented by the Treasury pursuant to this strategy—the Capital Purchase Program and the Capital Assistance Program—afford the government the motive and the opportunity to trade in bank stocks on behalf of the taxpayers while in possession of material, nonpublic information. First, this section discusses how these programs, by granting the Treasury authority to make investment decisions about bank securities and access to inside information, afford the Treasury the opportunity to engage in insider trading. Second, this section demonstrates that the Treasury has the motive to engage in insider trading in order to maximize returns for the taxpayers. Finally, this section proffers specific examples of how the Treasury could use this opportunity to engage in insider trading for the benefit of the taxpayers.

A. *The Treasury's Opportunity to Engage in Insider Trading*

The Treasury has the opportunity to trade in bank securities while in possession of material, nonpublic information. As explained in this section, the Treasury has the authority to make investment decisions about bank securities under the Capital Purchase Program and the Capital Assistance Program. The Treasury also has access to nonpublic information that could materially affect the price of bank securities.

1. The Treasury's Authority to Make Investment Decisions about Bank Securities under the Capital Purchase Program

The Treasury created the Capital Purchase Program ("the CPP") in October 2008.¹⁴ With the goal of encouraging "U.S. financial institutions to build capital to increase the flow of financing to U.S. businesses

12. *Id.* § 2(2) (codified as amended at 12 U.S.C. § 5201(2)). Additional important goals listed in the Act are "protect[ing] home values, college funds, retirement accounts, and life savings" and "preserv[ing] homeownership and promot[ing] jobs and economic growth." *Id.*

13. U.S. Dep't of the Treasury, Initial Section 105(a) Troubled Asset Relief Program Report to Congress for the Period of October 6, 2008 to November 30, 2008 1 (2008), *available at* <http://www.financialstability.gov/docs/105CongressionalReports/TARPFIRST-105REPORT.PDF>.

14. FinancialStability.gov, Capital Purchase Program, <http://www.financialstability.gov/roadtostability/capitalpurchaseprogram.html> (last visited July 2, 2009).

and consumers and to support the U.S. economy,” the CPP authorizes the Treasury to purchase up to \$250 billion of senior preferred stock in qualifying banks.¹⁵ As of February 28, 2009, the Treasury had purchased \$196.7 billion of preferred stock in 467 financial institutions.¹⁶

In addition, pursuant to the CPP, the Treasury receives from the participating banks “warrants to purchase common stock with an aggregate market price equal to 15 percent of the senior preferred investment.”¹⁷ The warrants’ exercise price is “the market price of the participating institution’s common stock at the time of issuance, calculated on a 20-trading day trailing average.”¹⁸ These warrants allow the taxpayers to benefit from the improved health of the banks resulting from the CPP funds.¹⁹ As of March 30, 2009, the Treasury held unexercised warrants to purchase shares of common stock in 265 banks, many of which are publicly traded.²⁰ For example, pursuant to the CPP, the Treasury received a warrant to purchase 73,075,674 shares of Bank of America Corporation common stock at an exercise price of \$30.79 per share²¹ and a warrant to purchase 210,084,034 shares of Citigroup Inc. common stock at an exercise price of \$17.85 per share.²²

If a financial institution repays the CPP preferred stock,²³ the institution has the right to repurchase the warrants issued to the Treasury for “fair market value.”²⁴ If the Treasury and the bank cannot agree on the

15. Press Release, U.S. Department of the Treasury, Treasury Announces TARP Capital Purchase Program Description (Oct. 14, 2008), <http://www.treas.gov/press/releases/hp1207.htm> [hereinafter October 14th Treasury Press Release].

16. U.S. Dep’t of the Treasury, Initial Section 105(a) Troubled Asset Relief Program Report to Congress for the Period February 1, 2009 to February 28, 2009 3 (2009), http://www.financialstability.gov/docs/105CongressionalReports/105aReport_03062009.pdf.

17. October 14th Treasury Press Release, *supra* note 15.

18. *Id.*

19. CPP Factsheet, *supra* note 10.

20. U.S. Treasury Department, Office of Financial Stability, Troubled Asset Relief Program, Transactions Report for Period Ending March 27, 2009, Capital Purchase Program (2009), http://www.financialstability.gov/docs/transaction-reports/transaction_report_03-30-2009.pdf.

21. Securities Purchase Letter Agreement, U.S. Dept. of the Treasury-Bank of America Corp., sched. A, Oct. 26, 2008, http://www.financialstability.gov/docs/agreements/BOA_10262008.pdf.

22. *Id.*

23. *See* American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, tit. VII, § 7001, 123 Stat. 115 (amending Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111(g), 122 Stat. 3765 (codified as amended at 12 U.S.C. § 5221)) (“[T]he Secretary shall permit a TARP recipient to repay any assistance previously provided under the TARP to such financial institution . . .”). As of June 19, 2009, 32 institutions had repaid approximately \$70 billion to the Treasury. *See also* U.S. Treasury Department, Office of Financial Stability, Troubled Asset Relief Program, Transactions Report for Period Ending June 19, 2009, Capital Purchase Program (2009), <http://www.financialstability.gov/docs/transaction-reports/transactions-report-062309.pdf>.

24. Securities Purchase Agreement Standard Terms ¶ 4.9, <http://www.financialstability.gov/docs/PPP/spa.pdf> (last visited July 7, 2009) [hereinafter Securities Purchase Agreement]; Financial-

fair market value of the warrants, the two parties will follow an appraisal procedure to determine the value.²⁵ In this scenario, the Treasury has little control over the timing of the warrants' sale.

If an institution repays the Treasury but fails to repurchase the warrants, however, the Treasury has the discretion to dispose of the warrants when and how it wishes.²⁶ As originally enacted, the American Recovery and Reinvestment Act of 2009 ("TARP") required the Treasury to immediately liquidate warrants of a financial institution that had fully repaid TARP funds, but not repurchased the warrants.²⁷ However, Congress recently amended the Act to remove the requirement that the Treasury liquidate warrants upon full repayment of TARP funds.²⁸ Pursuant to its discretion, the Treasury has announced that its objective is to "dispose of the government's investments in individual companies as quickly as is practicable."²⁹

With respect to financial institutions that have not repaid their preferred stock, the Treasury has complete discretion in the timing and means of disposing of the securities. The Emergency Economic Stabilization Act authorizes the Treasury to "sell, exercise, or surrender a warrant or any senior debt instrument received under this subsection," subject only to the requirement that it act for the benefit of the taxpayers.³⁰ The Treasury solicited applications from equity asset managers to man-

Stability.gov, FAQs on Capital Purchase Program Repayment, http://www.financialstability.gov/docs/PPP/FAQ_CPP_guidance.pdf (last visited July 2, 2009) ("After repaying their CPP preferred stock, institutions also have the right to repurchase the warrants issued to Treasury for their appraised market value.").

25. *Id.*

26. Press Release, U.S. Department of the Treasury, Treasury Announces Warrant Repurchase and Disposition Process for the Capital Purchase Program (June 26, 2009), http://www.financialstability.gov/latest/tg_06262009.html [hereinafter June 26th Treasury Press Release] ("If an issuer chooses not to repurchase the warrants according to its existing contractual rights, Treasury has the discretion to dispose of the warrants as it sees fit over time.").

27. See American Recovery and Reinvestment Act of 2009, § 7001 (amending Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111(g), 122 Stat. 3765 (codified as amended at 12 U.S.C. § 5221)) ("[W]hen such assistance is repaid, the Secretary shall liquidate warrants associated with such assistance at the current market price."); FinancialStability.gov, FAQs Addressing Capital Purchase Program (CPP) Changes Under the American Recovery and Reinvestment Act of 2009, (Feb. 26, 2009), <http://www.financialstability.gov/docs/PPP/FAQs.pdf> ("If your bank does not choose to exercise its option to repurchase the warrants, Treasury will attempt to liquidate registered warrants as soon as possible.").

28. Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, § 403, 123 Stat. 1632, 1658 (codified as amended at 12 USC § 5221(g)).

29. June 26th Treasury Press Release, *supra* note 26.

30. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 113(d)(2)(B) (codified as amended in 12 U.S.C. § 5223(d)(2)(B)).

age its vast portfolio³¹ and on April 22, 2009, announced that it had hired three firms to manage its investments.³² The asset managers will advise the Treasury on optimal disposition of the portfolio,³³ but the “Treasury will determine the ultimate disposition of holdings or otherwise issue disposition guidance in its Investment Policy and Guidelines.”³⁴

2. The Treasury’s Authority to Make Investment Decisions About Bank Securities under the Capital Assistance Program

On February 25, 2009, four months after the implementation of the CPP, the Treasury announced the terms of the Capital Assistance Program (“the CAP”).³⁵ Like the CPP, the CAP’s purpose is to shore up the capital of banks in order to “ensure the continued ability of U.S. financial institutions to lend to creditworthy borrowers in the face of a weaker than expected economic environment and larger than expected potential losses.”³⁶ The CAP has two components: (1) a forward-looking capital assessment of 19 major U.S. banking organizations (the so-called “stress test”); and (2) the Treasury’s purchase of additional securities from eligible, publicly traded financial institutions.³⁷

Unlike the preferred stock purchased pursuant to the CPP, the preferred stock purchased pursuant to the CAP will be convertible into common stock.³⁸ The conversion price will be set at 90% of the average closing price on the twenty trading days preceding February 10, 2009.³⁹

31. CPP Factsheet, *supra* note 10.

32. Press Release, U.S. Treasury Department Office of Public Affairs, Treasury Hires Asset Managers under the Emergency Economic Stabilization Act (Apr. 22, 2009), <http://www.financialstability.gov/latest/tg100.html>.

33. *Id.* (explaining that the asset managers’ role would include “advising on and executing transactions in accordance with the Treasury’s investment policy”).

34. U.S. Department of the Treasury, Notice to Financial Institutions Interested in Providing Asset Management Services for a Portfolio of Equity Securities, Debt Obligations, and Warrants Issued by Financial Institutions 3, (2008), <http://www.financialstability.gov/about/solicitations.html> [hereinafter Notice to Financial Institutions].

35. Press Release, U.S. Department of the Treasury, U.S. Treasury Releases Terms of Capital Assistance Program, (Feb. 25, 2009), <http://www.ustreas.gov/press/releases/tg40.htm> [hereinafter February 25th Treasury Press Release].

36. U.S. DEP’T OF THE TREASURY, TREASURY WHITE PAPER, THE CAPITAL ASSISTANCE PROGRAM AND ITS ROLE IN THE FINANCIAL STABILITY PLAN 1, *available at* http://www.treas.gov/press/releases/reports/tg40_capwhitepaper.pdf [hereinafter TREASURY WHITE PAPER].

37. *Id.* at 2.

38. *Id.*

39. TREASURY WHITE PAPER, *supra* note 36, at 4; U.S. Dep’t of the Treasury, Capital Assistance Program, Summary of Mandatorily Convertible Preferred Stock (“Convertible Preferred”) Terms 3, http://www.treas.gov/press/releases/reports/tg40_captermsheet.pdf [hereinafter Capital Assistance Program Term Sheet]. The conversion price will be reduced if stockholder consent is required and not obtained for the issuance of common shares upon conversion.

The banks have the discretion, subject to regulatory approval, to convert the shares into equity when “needed to preserve lending in [a] worse-than-expected economic environment.”⁴⁰ Moreover, at the expiration of seven years, if the convertible preferred shares have not already been redeemed or converted, the conversion into common equity is automatic.⁴¹ Therefore, unless the financial institution repurchases the convertible preferred stock before it converts into common equity, the Treasury will own common stock in the banks.

Moreover, institutions receiving capital pursuant to the CAP will issue warrants to the Treasury for the purchase of common stock.⁴² The exercise price will be equal to the conversion price for the convertible preferred stock.⁴³ The Treasury will receive enough warrants to purchase common stock having an aggregate market value, based on the conversion price, equal to 20% of the convertible preferred amount on the date of investment.⁴⁴

As noted above, under the EES Act, the Treasury has the authority, subject to the requirement that it act for the benefit of the taxpayers, to dispose of the banks’ securities as it sees fit.⁴⁵ Pursuant to this authority, the Treasury will place the securities received through the CAP in a Financial Stability Trust, which is a “separate trust set up to manage the government’s investments in US financial institutions.”⁴⁶ The trustees’ objective “will be to protect and create value for the taxpayer as a shareholder over time.”⁴⁷ In addition, the Treasury has committed to “make reasonable efforts to sell on an annual basis an amount of common stock equal to at least 20% of the total common stock” owned by the Treasury on the mandatory conversion date, with the goal of eliminating public ownership of common stock.⁴⁸

The identities of the trustees have not been publicly disclosed, so it is not clear whether they will be government officials or private citizens. In addition, the terms of the trust have not been disclosed, so it is uncertain whether the Treasury will retain ultimate decision-making authority

40. TREASURY WHITE PAPER, *supra* note 36, at 3.

41. February 25th Treasury Press Release, *supra* note 35.

42. Capital Assistance Program Term Sheet, *supra* note 39, at 7.

43. *Id.* at 3. The conversion price will be reduced if stockholder consent is required and not obtained for the issuance of common shares upon exercise of the warrants.

44. *Id.* at 3.

45. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 113(d), 122 Stat. 3765 (codified as amended in 12 U.S.C. § 5223(d)).

46. TREASURY WHITE PAPER, *supra* note 36, at 3.

47. *Id.*

48. Capital Assistance Program Term Sheet, *supra* note 39, at 6.

about the disposition of the trust assets.⁴⁹ Finally, the Treasury has not issued any guidelines restricting the flow of information from the Treasury to the trustees.

3. The Treasury's Access to Material, Nonpublic Information Affecting Bank Securities

In addition to its authority to trade in bank securities, the Treasury has access to the following nonpublic information that may affect bank securities: (1) inside information about the banks themselves, and (2) information about future governmental or quasi-governmental action.

Pursuant to the CPP and the CAP, the Treasury has access to inside information about the banks. The standard Securities Purchase Agreement between the Treasury and the bank under the CPP contains the following provision:

From the Signing Date until the date when the Investor holds an amount of Preferred Shares having an aggregate liquidation value of less than 10% of the Purchase Price,⁵⁰ the Company will permit the Investor and its agents, consultants, contractors and advisors (x) acting through the Appropriate Federal Banking Agency, to examine the corporate books and make copies thereof and to discuss the affairs, finances and accounts of the Company and the Company Subsidiaries with the principal officers of the Company, all upon reasonable notice and at such reasonable times and as often as the Investor may reasonably request and (y) to review any information material to the Investor's investment in the Company provided by the Company to its Appropriate Federal Banking Agency.⁵¹

The Treasury promises to "use reasonable best efforts" to maintain the confidentiality of this information, but there is no requirement that the Treasury not rely upon this information when making investment decisions.⁵² Similarly, financial institutions receiving capital pursuant to the CAP will undoubtedly enter into a Securities Purchase Agreement

49. For example, if the trust is revocable, the trustee will have a duty to comply with the Treasury's direction even if "the direction is contrary to the terms of the trust or the trustee's normal fiduciary duties." RESTATEMENT (THIRD) OF TRUSTS § 74 (2007). Even if the trust is not revocable, it may reserve to the Treasury "a power to direct or otherwise control certain conduct of the trustee," thus imposing a duty on the trustee to comply with the Treasury's directions, "unless the attempted exercise is contrary to the terms of the trust or power or the trustee knows or has reason to believe that the attempted exercise violates a fiduciary duty that the power holder owes to the beneficiaries." *Id.* § 75.

50. In other words, the Treasury has the right to access the bank's inside information until the Treasury has disposed of 90% of its Preferred Stock in the bank.

51. Securities Purchase Agreement, *supra* note 24, ¶ 3.5(a).

52. *Id.* ¶ 3.5(b).

with the Treasury. The terms of the standard agreement for CAP securities purchases are not yet publicly available, but it is probable that the agreement will contain a similar provision affording the Treasury access to inside information about the participating financial institutions.

Moreover, the “stress test” component of the CAP gives the Treasury access to forward-looking information that is not necessarily publicly available. The results of the stress tests themselves—namely, each financial institution’s “expected losses and the resources to absorb those losses if economic conditions were to be more adverse than generally expected”⁵³—are publicly available.⁵⁴ These estimates are based, however, on detailed data supplied by the financial institutions.⁵⁵ For instance, the financial institutions disclosed “extensive information on the characteristics of loan, trading, and securities portfolios and modeling methods.”⁵⁶ This data underlying the stress test results is not publicly available.

In addition to access to material inside information about the financial institutions themselves, the Treasury has access to nonpublic information about future governmental and quasi-governmental action. First and foremost, the Treasury has knowledge of its own future conduct, including that of its bureaus and offices,⁵⁷ in managing the United States’ financial system.⁵⁸ Therefore, the Treasury has access to advance knowledge about new Treasury programs and guidelines, changes in the regulatory requirements for financial institutions, and enforcement actions, all of which could affect the stock price of a financial institution. Moreover, as a member of the Cabinet, the Treasury Secretary has access to infor-

53. TREASURY WHITE PAPER, *supra* note 36, at 2.

54. See Board of Governors of the Federal Reserve, The Supervisory Capital Assessment Program: Overview of Results (May 7, 2009), <http://www.financialstability.gov/docs/SCAPResults.pdf>.

55. *Id.* at 1 (explaining that the stress test estimates “benefit from the input of extremely detailed information collected from each of the 19 BHCs” [bank holding companies]).

56. Board of Governors of the Federal Reserve, The Supervisory Capital Assessment Program: Design and Implementation 2 (Apr. 24, 2009), <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20090424a1.pdf>.

57. The Office of the Comptroller of the Currency, which is a bureau of the Treasury Department, “charters, regulates, and supervises all national banks.” Comptroller of the Currency, Administrator of National Banks, About the OCC, <http://www.occ.treas.gov/aboutocc.htm> (last visited July 3, 2009). The Office of Thrift Supervision, which is an office within the Treasury Department, “is the federal bank regulator and supervisor of a dynamic and diverse industry of savings associations and their subsidiaries spread across the nation.” Office of Thrift Supervision, OTS Profile, <http://www.ots.treas.gov/?p=OTSPProfile> (last visited July 3, 2009).

58. The Treasury’s mission is to “[s]erve the American people and strengthen national security by managing the U.S. Government’s finances effectively, promoting economic growth and stability, and ensuring the safety, soundness, and security of the U.S. and international financial systems.” United States Department of the Treasury, Duties & Functions of the U.S. Department of the Treasury, <http://www.ustreas.gov/education/duties/> (last visited July 3, 2009).

mation about the administration's plans in areas beyond the United States' financial system, such as international relations, which could affect the price of bank securities.⁵⁹ Finally, the EES Act created a Financial Stability Oversight Board to, among other duties, make "recommendations, as appropriate, to the Secretary regarding use of the authority under this chapter."⁶⁰ The five members of the Board are the Treasury Secretary, the Chairman of the Board of Governors of the Federal Reserve System, the Director of the Federal Housing Finance Agency, the Chairman of the Securities Exchange Commission, and the Secretary of Housing and Urban Development.⁶¹ As a result, the Treasury Secretary, when making investment decisions, could potentially have knowledge about future interest rate adjustments,⁶² future housing policies and incentives, and future SEC regulatory requirements that could be material to the market when pricing bank securities.

B. The Treasury's Motive to Engage in Insider Trading

As established above, the Treasury has the authority to make investment decisions about bank securities and has access to nonpublic information that could affect the price of bank stocks. In addition, the Treasury has the motive to rely on this inside information when making investment decisions. Unlike the usual insider-trading scenario in which

59. See The White House, The Administration: The Cabinet, <http://www.whitehouse.gov/administration/cabinet/> (last visited July 3, 2009).

60. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 104(a)(2), 122 Stat. 3765 (codified as amended in 12 U.S.C. § 5214(a)(2)).

61. *Id.* § 104(b)(1)–(5) (codified as amended in 12 U.S.C. § 5214(b)(1)–(5)).

62. It is common knowledge that interest rates and common stock prices usually move in opposite directions. Joseph H. Ellis, *Choppy Markets Ahead? Interest Rates and the Stock Market: A Concerned Look Forward from a New Book by a Renowned Forecaster*, FIN. PLAN., Oct. 1, 2005, at 2 ("Even casual observers of the stock market recognize that there is an inverse relationship between interest rates and stock valuations."). The relationship between interest rates and warrant prices is more complicated. An increase in interest rates imposes two opposite pressures on the price of the warrant: (1) it tends to depress stock prices, which imposes a downward pressure on warrant prices; and (2) it tends to make the option of purchasing a warrant, rather than a share of stock, more attractive because the upfront money saved can receive a higher rate of return. This dual impact of interest rates is reflected in the Black–Scholes method of warrant pricing. Under the Black–Scholes method, a decrease in the spot stock price (an effect of increased interest rates) decreases the call premium of a warrant, but an increase in interest rates increases the call premium. ROBERT WARD, *OPTIONS AND OPTIONS TRADING* 195–201 (2004). It is not clear which of these two pressures is stronger. Arguably, however, the effect on stock price would be stronger in stock-sensitive industries like automobile sales and financial services, resulting in an inverse correlation between warrant prices and interest rates.

the trader is motivated by self-enrichment,⁶³ the Treasury is motivated to maximize profits for the taxpayers.

Congress has repeatedly directed the Treasury Secretary to maximize returns on investments for the benefit of the taxpayers. First, one of the identified purposes of the EES Act is to ensure that the Secretary of the Treasury uses the authority and facilities provided by the Act “in a manner that . . . maximizes overall returns to the taxpayers of the United States.”⁶⁴ Second, the EES Act specifically instructs the Secretary to take into account the protection of “the interests of taxpayers by maximizing overall returns and minimizing the impact on the national debt” when exercising his or her authority under the Act.⁶⁵

The Treasury itself has incorporated this focus on maximizing returns into the CPP and the CAP. With respect to securities the Treasury receives under the CPP, the Treasury’s “primary policy goal in managing the portfolio . . . is to protect the interests of taxpayers in light of the Treasury’s stake in public and private Financial Institutions.”⁶⁶ Similarly, with respect to securities the Treasury receives under the CAP, the stated objective when disposing of them “will be to protect and create value for the taxpayer as a shareholder over time.”⁶⁷

C. Specific Scenarios of Potential Insider Trading by the Treasury

As detailed above, pursuant to the CPP and the CAP, the Treasury owns, or will own, common stock and warrants to purchase common stock of publicly-traded financial institutions. The Treasury will have several options when disposing of these securities—not all of which afford the Treasury the potential to benefit from its superior knowledge: (1) the Treasury could sell the warrants back to the financial institution; (2) the Treasury could sell the common stock back to the financial institution; (3) the Treasury could sell the warrants or the common stock to an institutional investor, or both; and (4) the Treasury could exercise the warrants and sell the common stock on the open market to the investing public. At the same time, the Treasury will potentially have access to inside information about the financial institutions themselves and about

63. See HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 171–189 (1966) (recognizing that government officials “are frequently privy to valuable information about a corporation’s shares” and discussing insider trading by government officials for their own benefit).

64. Emergency Economic Stabilization Act of 2008 § 2(2)(C) (codified as amended in 12 U.S.C. § 5201(2)(C)).

65. *Id.* § 103(1)–(2) (codified as amended in 12 U.S.C. § 5213(1)).

66. CPP Factsheet, *supra* note 10 (“The program is designed to generate a positive return over time to the taxpayer.”); Notice to Financial Institutions, *supra* note 34, at 2.

67. TREASURY WHITE PAPER, *supra* note 36, at 2.

future governmental or quasi-governmental actions that could affect the price of the financial institutions' securities.

To the extent the Treasury sells the warrants or the common stock back to the financial institution, the Treasury's access to inside information about that financial institution would not benefit the Treasury. Unlike cases in which an insider buys or sells stock from the company without disclosing secret information about the company (such as in "cooked books" scenarios), the Treasury would not have superior knowledge of inside information about the companies themselves.⁶⁸ In these scenarios, therefore, the Treasury would only be able to profit from its superior knowledge about future governmental and quasi-governmental conduct.

To the extent the Treasury sells the warrants or the common stock to an institutional investor, the Treasury could potentially profit from its superior knowledge about the financial institution itself and about future governmental and quasi-governmental conduct. Institutional investors, however, when engaging in securities transactions with the government, would presumably be sophisticated enough to factor this risk into the pricing of the securities. Thus, the Treasury's ability to profit from its superior knowledge would likely be muted.

The Treasury could profit most from its superior access to information by selling common stock on the open market. First, it would have superior knowledge about the financial institution itself and about future governmental and quasi-government conduct. Second, investors trading through the exchange would likely be unaware that the Treasury was selling its shares, thus limiting the discounting effect from the Treasury's access to this information. Finally, members of the public are less likely to be sophisticated enough to factor the Treasury's access to nonpublic information into the pricing of a financial institution's stock.

III. PREVIOUS BAILOUTS EXEMPLIFY THE GOVERNMENT'S MOTIVE AND OPPORTUNITY TO ENGAGE IN INSIDER TRADING ON BEHALF OF THE TAXPAYERS

The government has twice before exacted common stock warrants in return for federal relief: first, pursuant to the Chrysler Corporation Loan Guarantee Act and second, pursuant to the Air Transportation Safe-

68. See DONALD C. LANGEVOORT, 18 INSIDER TRADING REGULATION, ENFORCEMENT AND PREVENTION § 3:18 (2009).

ty and System Stabilization Act.⁶⁹ While there is no indication that the government misused inside information in the eventual disposition of the Chrysler or airline warrants, the circumstances surrounding their disposition exemplify the potential for abuse and place the bank bailout in historical context. The potential for insider trading is exacerbated under the CPP and CAP, which far exceed the scope of the prior programs.

A. Chrysler Corporation Loan Guarantee Act

1. Issuance and Disposition of Chrysler Warrants

In 1980, with Chrysler facing “bankruptcy and possible liquidation,”⁷⁰ Congress enacted the Chrysler Corporation Loan Guarantee Act.⁷¹ The Act established a Chrysler Corporation Loan Guarantee Board (“the Board”), whose voting members were the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System and the Comptroller General of the United States.⁷² The Act authorized the Board to guarantee up to \$1.5 billion of loans to Chrysler.⁷³

In exchange for the loan guarantees, Congress charged the Board with ensuring that the government was “compensated for the risk assumed in making guarantees.”⁷⁴ Pursuant to this charge, the Board negotiated with Chrysler to obtain warrants to buy 14.4 million shares of common stock from Chrysler at the price of \$13.00 per share until 1990.⁷⁵

In May 1983, the Board determined that it was time to reap the benefits from the bailout.⁷⁶ Chrysler had recovered its financial viability

69. Robert F. Bruner, *Chrysler's Warrants: September 1983*, Darden Case No. UVA-F-0682, available at <http://ssrn.com/abstract=909046> (“[I]n the long history of government loan guarantees, there were no examples of equity kickers [prior to the Chrysler guarantees].”).

70. H.R. REP. NO. 96-690, (1979), reprinted in 1979 U.S.C.C.A.N. 2787, 2789.

71. Chrysler Corporation Loan Guarantee Act of 1979, Pub. L. No. 96-185, 93 Stat. 825 (1980).

72. *Id.* § (codified as amended at 15 U.S.C. § 1862) (repealed 1983). The Secretary of Labor and the Secretary of Transportation were “ex officio nonvoting members of the Board.” *Id.*

73. *Id.* § 8 (codified as amended at 15 U.S.C. § 1867(a)) (repealed 1983).

74. *Id.* § 5 (codified as amended at 15 U.S.C. § 1864(d)) (repealed 1983). In order to accomplish this purpose, the Act explicitly authorized the Board to “prescribe and collect a guarantee fee,” “enter into contracts under which the Government . . . would participate in gains of the Corporation or its security holders,” or “use other instruments deemed appropriate by the Board.” *Id.*

75. James M. Bickley, *Chrysler Corporation Loan Guarantee Act of 1979: Background, Provisions, and Cost 5* (Cong. Research Serv., Report No. R40005, 2008), available at http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1575&context=key_workplace.

76. Robert D. Hershey, Jr., *Chrysler Asking the U.S. to Forgo Profit It Could Make On Loan Aid*, N.Y. TIMES, May 7, 1983, at 1.

and was on the verge of repaying in full the federally guaranteed loans.⁷⁷ Chrysler's common stock was trading around \$26 per share,⁷⁸ about \$13 more than the warrant price. The Board had two options: (1) accept bids for the warrants or (2) exercise the warrants and sell the stock on the open market.⁷⁹ The Board ultimately decided to accept bids from underwriters and from Chrysler.⁸⁰

In September 1983, after a competitive bidding process, the Board agreed to sell the warrants to Chrysler for \$311.1 million, or \$21.60 per warrant.⁸¹ If the Board had instead exercised the warrants and immediately sold the stock at the market price, the Board would have gained a profit of only about \$17 per share.⁸²

2. Circumstances Surrounding Disposition of Chrysler Warrants

The Chrysler Corporation Loan Guarantee Board had potential access to nonpublic information about Chrysler and about future governmental or quasi-governmental action affecting Chrysler's stock price. There is no indication that the Board used this information to its advantage when assessing the timing of the sale of the Chrysler stock warrants, but the circumstances demonstrate the potential for such a use.

The Board had access to myriad inside information about Chrysler. Similar to the access afforded the Treasury under the CPP, the Board was afforded unfettered access to Chrysler's "accounts, books, records, memoranda, correspondence, and other documents and transactions of the Corporation" until the loans were repaid.⁸³ In addition, in exchange for the loan guarantees, Chrysler agreed to allow the General Accounting Office to audit Chrysler whenever deemed appropriate by the Comptrol-

77. *Id.*

78. The highest closing price in May of 1983 was \$28.25 on May 9, 1983, and the lowest was \$25.125 on May 3, 1983. See Historical Stock Prices of Chrysler Corporation, CUSIP # 17119610, available at LexisNexis.com [hereinafter Historical Stock Prices of Chrysler Corp.].

79. Hershey, Jr., *supra* note 76, at 1.

80. Robert D. Hershey, Jr., *U.S. Plans to Sell Rights in Chrysler*, N.Y. TIMES, July 30, 1983, at 1.

81. Bickley, *supra* note 75, at 5; Robert D. Hershey, Jr., *Chrysler Offer By Shearson*, N.Y. TIMES, Aug. 1, 1983, at D1; Robert D. Hershey, Jr., *Chrysler Top Bids to Buy Back Stock Rights*, N.Y. TIMES, Sept. 13, 1983, at A1.

82. The highest closing price in September of 1983 was \$31.375 on September 26, 1983, and the lowest price was \$28.375 on September 1, 1983. See Historical Stock Prices of Chrysler Corp., *supra* note 78. The exercise price on the warrants was \$13 per share.

83. Chrysler Corporation Loan Guarantee Act of 1979, Pub. L. No. 96-185, § 10(a), 93 Stat. 825 (1980) (codified as amended at 15 U.S.C. § 1869(a)) (repealed 1983); H.R. REP. NO. 96-690, (1979), reprinted in 1979 U.S.C.A.N. 2787, 2803 ("Section 7 authorizes the Treasury Department to inspect all documents of the corporation at any time a guarantee is requested or outstanding.").

ler General of the United States.⁸⁴ For example, the Board may have known that Chrysler's earning reports in late 1983 and early 1984 would be unexpectedly positive.⁸⁵

The Board also had potential access to nonpublic information about future governmental or quasi-governmental actions that could affect the value of its Chrysler warrants. For example, the Board had potential access to information about future adjustments to the federal funds rate. The Chairman of the Board of Governors of the Federal Reserve System was one of three voting members of the Board, potentially providing the Board with an indication about future interest rate adjustments.⁸⁶ Indeed, the Fed raised interest rates after the Chrysler warrants were sold. After a slight decrease in the federal funds rate to around 9.25 or 9.5 in early October of 1983, the federal funds rate gradually increased to 10.5 by mid-April 1984 and to 11.5 or 11.75 in late August 1984.⁸⁷

Finally, the Board had potential access to information about future policy on trade with Japan. The Secretary of the Treasury, another voting member of the Board,⁸⁸ was also a member of the Cabinet Council on Commerce and Trade,⁸⁹ potentially providing the Board with an indication about future trade policy. In the early 1980s, the United States' automakers, and perhaps Chrysler most of all because of its production of small cars, were extremely vulnerable to competition from Japanese au-

84. *Id.* § 10(b) (codified as amended at 15 U.S.C. § 1869(b)) (repealed 1983); H.R. REP. NO. 96-690, (1979), reprinted in 1979 U.S.C.C.A.N. 2787, 2803 ("Section 7 also authorizes the Comptroller General of the United States to make any audits of the corporation and its borrowers which he considers necessary . . .").

85. *Chrysler's Iacocca Says 1st Period Net Topped Analysts' Expectations*, WALL ST. J., Apr. 16, 1984, at 1 (reporting that analysts had "forecast that Chrysler will report net income of around \$600 million, or \$4.90 a share"); Amal Nag, *Chrysler Posts 4th-Period Net Despite Charge*, WALL ST. J., Feb. 24, 1984, at 1 ("The nation's No. 3 auto maker posted record full-year net of \$700.9 million, or \$5.79 a share, after the write-down on its Peugeot investment."); Donald Woutat, *Chrysler Corp. Net Quadrupled For 1st Quarter*, WALL ST. J., Apr. 19, 1984, at 1 ("Chrysler Corp. reported that first-quarter profit more than quadrupled from a year earlier to \$705.8 million, or \$5.64 a share, setting a record for the period and exceeding the amount earned in any full year.") (characterizing Chrysler's results as "better than expected").

86. Chrysler Corporation Loan Guarantee Act of 1979, § 3 (codified as amended at 15 U.S.C. § 1862) (repealed 1983).

87. See Federal Reserve Bank of New York, Historical Changes of the Target Federal Funds and Discount Rates, 1971 to present, <http://newyorkfed.org/markets/statistics/dlyrates/fedrate.html> (last visited July 3, 2009).

88. Chrysler Corporation Loan Guarantee Act of 1979, § 3 (codified as amended at 15 U.S.C. § 1862) (repealed 1983).

89. Stuart Auerbach, *Reagan Rejects Meese's Plea to Back Bill Aiding Wineries*, WASH. POST, Feb. 17, 1984, at A2 (identifying the members of the Cabinet Council on Commerce and Trade); Dick Kirschten, *Embargo Politics*, 13 NAT'L J. 792, May 2, 1981 (same). In addition, the Treasury Secretary chaired another committee dealing with trade, the Senior Interagency Group on International Economic Policy. *Protecting America's Free Trade*, THE ECONOMIST, March 2, 1985, at 80.

tomakers.⁹⁰ In 1981, at the urging of the Reagan Administration and in response to the threat that Congress might enact strict import quotas, Japan imposed “voluntary” quotas on its auto exports to the U.S.⁹¹ These quotas were set to expire on March 31, 1985,⁹² to the anxiety of U.S. automakers, including Chrysler.⁹³ On February 19, 1985, President Reagan’s Cabinet Council on Commerce and Trade unanimously recommended that the President decline to request the extension of the voluntary quotas.⁹⁴ On March 1, 1985, accepting his cabinet’s recommendation, President Reagan announced that he would not ask Japan to extend its voluntary quotas.⁹⁵

Although the Board potentially had access to nonpublic information, there is no indication that the Board used this information in timing the sale of the warrants. With respect to inside information about Chrysler’s earnings, the Board sold the warrants to Chrysler itself, and thus the purchaser presumably had at least equal access to this information.

The effect of an increased federal funds rate on the price of Chrysler’s stock warrants is more complicated to track. On the one hand, automobile stocks are often viewed as especially sensitive to interest rates because higher rates can make auto financing less attractive, which causes downward pressure on the warrant prices.⁹⁶ On the other hand, an

90. Ford, *Chrysler Debt Upgraded by S&P; GM’s Left Unchanged*, WALL ST. J., May 22, 1984, at 1 (“S&P said [that] Chrysler remains the most vulnerable to competition from Japanese cars if the current import quotas are lifted in April 1985 . . .”); Art Pine, *Japan’s Auto Export Limit Should End, Cabinet Group Formally Recommends*, WALL ST. J., Feb. 20, 1985, at 1 (“If the quotas are lifted, Chrysler Corp. would suffer the most because of its concentration on the small car market.”).

91. Clyde H. Farnsworth, *End of Bar to Japan’s Cars Urged*, N.Y. TIMES, Jan. 25, 1985, at D1 (“The Japanese have been willing to follow Washington’s advice each year because of the implicit—and at times explicit—threat that Congress might enact even tougher curbs.”); Robert A. Rosenblatt, *Surge of Auto Imports Seen If Restraints End*, L.A. TIMES, Feb. 21, 1985, at 1 (“The ‘voluntary’ quotas were established by Japan in 1981 after intense pressure from the Reagan Administration.”).

92. Farnsworth, *supra* note 91 (identifying the expiration date).

93. *Id.* (“Chrysler’s vice chairman . . . has warned that 750,000 American jobs could be lost if the restraints were ended.”); Urban C. Lehner, *Speculation on Easing of Auto-Import Curbs Has an Impact on Stocks, Especially Subaru’s*, WALL ST. J., Feb. 11, 1985, at 1 (“Most analysts agree that an outright removal of the quotas would depress Ford and Chrysler share prices.”).

94. Pine, *supra* note 90; Stuart Auerbach & David Hoffman, *U.S. Expected to Let Japanese Car Quotas Lapse*, L.A. TIMES, Feb. 20, 1985, at F1.

95. Clyde H. Farnsworth, *U.S. Will Not Ask Japan to Extend Car Export Curbs*, N.Y. TIMES, Mar. 2, 1985, at 1.

96. Kenneth N. Gilpin, *The Markets: Stocks & Bonds; Dow Rises for a 3rd Session as Profits Exceed Forecasts*, N.Y. TIMES, July 12, 2000, at C10 (quoting the head of block trading at Morgan Stanley Dean Witter as identifying “papers, chemical, metals and autos” as “rate-sensitive areas”); Suzanne McGee, *Bond Prices Finish Lower After Early Gains As Market Prepares for Treasury Note Auctions*, WALL ST. J., May 29, 1996, at C23 (“Like housing, automobile purchases that require financing are believed to be sensitive to interest rates, falling as those financing costs rise.”);

increase in interest rates tends to make the option of purchasing a warrant—rather than a share of stock—more attractive, causing an upward pressure on the warrants prices.⁹⁷ On balance, there is no indication that the Board relied on information about future interest rate hikes when timing the sale of the warrants.

Finally, although the Board potentially had knowledge about the future direction of the Reagan Administration's policy on Japanese quotas, the sale of the Chrysler warrants occurred eighteen months before President Reagan's announcement that he would not seek further voluntary quotas from Japan. Moreover, knowledge about the likely recommendation of the Cabinet Council on Commerce and Trade was not necessarily indicative of an increase in Japanese imports. First, although unlikely, the President might have rejected the Council's recommendation. Second, Japan might have nonetheless chosen to impose a voluntary quota. And, in fact, that is exactly what Japan did, albeit imposing a far more generous quota than the one previously imposed.⁹⁸ In light of the length of time between the sale of the warrants and the inherent uncertainty about the effect of the Cabinet Council's recommendation, there is no reason to suspect that the Board timed the sale of the warrants to avoid the depressing effect of increased Japanese imports on the sale price of the Chrysler warrants.

Robert O'Brien, *GM, Ford Climb on Expectations The Fed Will Lower Rates Again*, WALL ST. J., June 22, 2001, at C2 ("Auto makers and other stocks tied to the economy rose amid hope that the Fed will cut interest rates again."); Anthony Ramirez, *Dow Swings Wildly, Ends Down by 4.05*, N.Y. TIMES, Apr. 22, 1993, at D12 ("A fourth, automobile stocks, may become part of that group [of stocks groups depressing the S & P 500] if high interest rates make auto financing unattractive."); Leonard Sloane, *Dow Drops 5.38 as Market Loses Almost 102 for Week*, N.Y. TIMES, Sept. 24, 1994 ("Among the economically sensitive stocks, auto issues were lower amid fears that consumer borrowing might slow down if interest rates are increased."); *but see* Steven E. Levingston, *Stock, Bond Markets Go Separate Way As Investors Seek Profit-Driven Shares*, WALL ST. J., Mar. 7, 1994, at C1 ("To counter the rise in interest rates, investors have dumped interest-rate sensitive stocks such as banks and utilities and snapped up earnings-driven stocks such as heavy machinery and auto makers.").

97. See WARD, *supra* note 62, at 195–201.

98. Michael White, *US Car Makers Angry at New Japanese Quota*, GUARDIAN, Mar. 29, 1985 ("The Japanese government's decision to allow car exports to the United States rise by 450,000—or 24 per cent—in the coming year appears to have got the worst of both worlds in terms of US reaction. Car makers and their allies are angry that the quota is too big and the Reagan Administration is disappointed that the Japanese have set any quotas at all.").

B. Air Transportation Safety and System Stabilization Act

1. Issuance and Disposition of Airline Warrants

On September 22, 2001, in the wake of the economic devastation of airlines caused by the terrorist attacks, Congress passed the Air Transportation Safety and System Stabilization Act.⁹⁹ The Act authorized the government to guarantee up to \$10 billion in loans to qualifying airlines.¹⁰⁰

The Act established the Air Transportation Stabilization Board to decide on applications for loans.¹⁰¹ The Act also mandated that the government be “compensated for the risk assumed in making guarantees under this title.”¹⁰² Congress left to the Board’s discretion whether to accomplish this goal with “warrants, stock options, common or preferred stock, or other appropriate equity instruments.”¹⁰³

The Board approved loan guarantees to five publicly traded airlines. The Board guaranteed \$429 million of America West Airlines debt¹⁰⁴ in exchange for warrants to purchase 18.75 million shares of the company’s Class B common stock.¹⁰⁵ American Trans Air received \$148.5 million in loan guarantees¹⁰⁶ in exchange for warrants to purchase 1.478 million shares¹⁰⁷ and Frontier Airlines received a \$63 million guarantee¹⁰⁸ in exchange for warrants to buy 3.45 million shares.¹⁰⁹ The Board guaranteed \$900 million in U.S. Airways loans¹¹⁰ and received warrants to purchase

99. See Air Transportation Safety and System Stabilization Act, Pub. L. No. 107-42, § 1, 115 Stat. 230, (2001).

100. *Id.* § 101(a)(1).

101. *Id.* § 101(b)(1).

102. *Id.* § 102(d)(1).

103. *Id.* § 102(d)(2).

104. United States Department of the Treasury, Air Transportation Stabilization Board, Recent Activity Report, <http://www.ustreas.gov/offices/domestic-finance/atstb/recent-activity.html> (last visited July 3, 2009) [hereinafter Air Transp. Activity Report].

105. *American West Meets Loan-Guarantee Conditions*, PHOENIX BUS. J., Jan 14, 2002, available at <http://phoenix.bizjournals.com/phoenix/stories/2002/01/14/daily1.html> (“To resolve the compensation condition, America West will give the ATSB warrants for the purchase of 18.75 million shares of the company’s Class B common stock at an exercise price of \$3 per share.”); Margaret M. Blair, *The Economics of Post-September 11 Financial Aid to Airlines*, 36 IND. L. REV. 367, 386 (2003) (“The warrants ultimately issued were for America West Class B common stock, which had a \$3 exercise price and an exercise period of ten years.”).

106. Air Transp. Activity Report, *supra* note 104.

107. Daniel Gross, *Bailing for Dollars: How the Feds Saved the Airlines and Made Themselves a Mint*, SLATE, May 7, 2004, <http://www.slate.com/id/2100198/> (last visited July 3, 2009).

108. Air Transp. Activity Report, *supra* note 104.

109. Gross, *supra* note 107.

110. Air Transp. Activity Report, *supra* note 104.

7.635 million shares of Class A common stock.¹¹¹ Finally, the Board guaranteed \$27 million in World Airlines debt¹¹² in exchange for warrants to purchase 2.38 million shares.¹¹³

The Board did not ultimately market any of the airlines' common shares to the public. The American Trans Air and U.S. Airways warrants were wiped out in bankruptcy.¹¹⁴ Upon emerging from bankruptcy, U.S. Airways merged with America West Airlines¹¹⁵ and repurchased the America West Airlines stock warrants from the government for \$115.8 million.¹¹⁶ The Board sold the Frontier warrants in an auction to seven institutional investors, netting the government \$6.6 million.¹¹⁷ World Airways was eventually purchased by Global Aero Logistics Inc.¹¹⁸ Prior to this purchase, the Board had exercised some of the World Airways warrants, apparently without selling the stock, and still held a sub-

111. Gross, *supra* note 107; U.S. Airways, Inc., SEC Form 10-Q, Quarterly Period Ended March 31, 2003, at 5, available at <http://www.sec.gov/Archives/edgar/data/714560/000093176303001588/d10q.htm> [hereinafter U.S. Airways Form 10-Q].

112. Air Transp. Activity Report, *supra* note 104.

113. Gross, *supra* note 107.

114. Scott McCartney, *Airline Loan-Guarantee Deal Ends With a Profit: Controversial Program Kept Some Carriers Aloft; Taxpayers Get \$300 Million*, WALL ST. J., May 30, 2006, at D4 ("Bankruptcy wiped out stock ownership in US Airways, ATA and Aloha.").

115. Air Transp. Activity Report, *supra* note 104 (reporting that the ATSB had approved the merger between America West Airlines and U.S. Airways); *US Airways to Buy Back Stock Options*, PHILA. BUS. JOUR. Oct. 3, 2005 ("US Airways and America West merged last week, creating a newly organized US Airways Group (NYSE: LCC). Last week's merger ended US Airways' Chapter 11 bankruptcy reorganization.").

116. Micheline Maynard, *US Airways to Acquire Government's Holding*, INT'L HERALD TRIB., Oct. 5, 2005 ("U.S. Airways has said that it will pay \$115.8 million to buy stock warrants that had given the U.S. government a sizable stake in America West, which merged with US Airways last week."); US Airways Inc., Form 10-K, at 111 (Dec. 31, 2007), available at <http://www.secinfo.com/dsVs6.tBe.htm#1stPage> ("In the fourth quarter of 2005, US Airways Group announced an agreement to repurchase all of the replacement warrants issued to the ATSB in connection with the merger with America West Holdings. US Airways Group repurchased approximately 7.7 million warrants to purchase shares of common stock that had an exercise price of \$7.27 per share.").

117. Press Release, U.S. Department of the Treasury, Air Transportation Stabilization Board Announces Sale of Frontier Warrants (May 31, 2006), <http://www.treas.gov/press/releases/js4297.htm> [hereinafter May 31st Treasury Press Release] ("The [ATSB] today announced the sale of the 3,450,551 warrants that it received in connection with the issuance of a loan guarantee to Frontier Airlines. The warrants were purchased in an auction by seven institutional investors at a price of \$2.03 per warrant. Total net proceeds to the government were \$6,608,604.").

118. Press Release, Global Aero Logistics, Global Aero Logistics Acquires World Air Holdings for US\$ 315 Million (Aug. 14, 2007), available at <http://studio-5.financialcontent.com/pnews?GUID=2906100&Page=MediaViewer&Ticker=WLDA> [hereinafter Global Aero Logistics Press Release] ("Global Aero Logistics Inc., the parent company of ATA Airlines, Inc., announced today the completion of its acquisition of World Air Holdings, Inc. . . . Global acquired World Air in a cash merger with a price per share of \$12.50 and a total transaction value of approximately \$315 million.").

stantial number of warrants at the time of the acquisition.¹¹⁹ The government presumably received cash for its shares of common stock and for its warrants from Global Aero Logistic pursuant to the acquisition.¹²⁰

2. Circumstances Surrounding the Disposition of the Airline Warrants

In return for the loan guarantees, the Air Transportation Safety Board (ATSB) had access to inside information about the airlines. The executive director of the ATSB described the extent of this access in Congressional testimony: “The ATSB closely monitors the financial performance of all of its borrowers. The borrowers submit monthly financial statements to the ATSB, and the ATSB meets regularly with the borrowers to discuss the state of the business.”¹²¹ Although there is no indication that the ATSB relied on inside information about Frontier when deciding when to auction its Frontier warrants to institutional investors, it is conceivable that the Board would have found this information useful.

Further, the membership of the ATSB—the Treasury Secretary, the Fed Chief, the Secretary of Transportation (or his or her designee), and the Comptroller General (or his or her designee)¹²²—afforded the ATSB access to information about future governmental and quasi-governmental conduct that could affect the airline stock prices. Again, although there is no indication that the Board relied on nonpublic information when disposing of its airline warrants, its access to superior knowledge about future interest rate adjustments, regulation of airlines, security procedures, and wider administration policies could indeed have proven useful.

119. Global Aero Logistics Inc., Form S-1/A, at F-86 (Jan. 9, 2008), *available at* <http://www.secinfo.com/dVut2.t54.htm#1stPage> (“In August 2004, the ATSB exercised warrants to purchase 111,111 shares at \$2.50 per share and, pursuant to the net exercise provisions of the warrants, received 21,994 shares of the Company’s common stock. Additionally, in February 2005, the ATSB exercised warrants to purchase an additional 111,111 shares at \$2.50 per share and, pursuant of the net exercise provisions of the warrants, received 76,345 shares of the Company’s common stock.”); May 31st Treasury Press Release, *supra* note 117.

120. Agreement and Plan of Merger between Global Aero Logistics Inc., Hugo Acquisition Corp., and World Air Holdings, Inc., Apr. 5, 2007, [Exhibit 2.1 to World Air Holdings, Inc. Form 8-K (filed April 9, 2007)] (detailing conversion of warrants to cash); Global Aero Logistics Press Release, *supra* note 118 (“Global acquired World Air in a cash merger with a price per share of \$12.50 and a total transaction value of approximately \$315 million.”).

121. Air Transportation Safety and System Stabilization Act: Testimony before the H. Subcomm. on Aviation (June 3, 2004) (statement of Michael Kestenbaum, Executive Director, Air Transportation Stabilization Board), *available at* <http://www.treas.gov/press/releases/js1710.htm>.

122. Air Transportation Safety and System Stabilization Act, Pub. L. No. 107-42, § 102(b)(2), 115 Stat. 230, (2001).

IV. INSIDER TRADING BY THE TREASURY IS LARGELY UNCHECKED BY CURRENT LAW

Governmental insider trading is effectively unchecked by current laws. First, the Treasury itself has not adopted any rules or regulations prohibiting it from engaging in insider trading. Second, insider trading is prohibited by § 10(b) of the Securities Exchange Act, but the provisions of the Securities Exchange Act do not apply to federal departments or agencies. Moreover, even if the current prohibition on insider trading were extended to governmental activity, not all of the government's trading on the basis of material, nonpublic information about the banks or about future governmental or quasi-governmental action would fall within its scope. Third, any attempt to premise a common law torts claim on governmental insider trading would be outside the scope of the Federal Torts Claim Act. Finally, although there is a colorable argument that governmental insider trading constitutes a breach of contract and a taking, this argument, even if successful, would be limited in its application.

A. Absence of Treasury Rules or Regulations Prohibiting Insider Trading

The Treasury has issued some guidance addressing conflicts of interest, but the guidance does not address the potential for the Treasury to engage in insider trading. Congress recognized the potential for conflicts of interest arising in connection with the EES Act and directed the Treasury Secretary to issue regulations or guidelines addressing conflicts of interest "as soon as practicable after the date of enactment" of the Act.¹²³ Although Congress identified certain specific scenarios as areas of potential conflicts, Congress did not identify any conflicts specifically related to the Treasury's disposition of bank securities.¹²⁴

The Treasury Secretary released interim guidelines addressing conflicts of interest on October 6, 2008, and published an interim rule implementing those guidelines on January 21, 2009.¹²⁵ The interim rule

123. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 108(b), 122 Stat. 3765 (codified as amended in 12 U.S.C. § 5218(b)).

124. *Id.* § 108(a) (codified as amended in 12 U.S.C. § 5218(a)). For example, Congress identified the following specific areas as potential sources of conflicts of interest: "(1) conflicts arising in the selection or hiring of contractors or advisors, including asset managers; (2) the purchase of troubled assets; (3) the management of the troubled assets held; [and] (4) post-employment restrictions on employees." *Id.* Congress did, however, include a residual clause, bringing within its scope "any other potential conflict of interest, as the Secretary deems necessary or appropriate in the public interest." *Id.* § 108(a)(5).

125. TARP Conflicts of Interest, 74 Fed. Reg. 3431, 3431-2, pts. II-III (Jan. 21, 2009) (to be codified at 31 C.F.R. § 31).

was effective upon publication.¹²⁶ The comment period for the interim rule expired on March 23, 2009,¹²⁷ and the Treasury has committed to “consider[ing] all comments in developing a final rule.”¹²⁸ The interim rule addresses “conflicts that may arise during the selection of individuals or entities seeking a contract or financial agency agreement with the Treasury” and “conflicts and other matters that may arise in the course of those services.”¹²⁹

The interim rule does not address the Treasury’s potential use of nonpublic information when disposing of bank securities, but the rule does recognize the potential for retained entities to engage in insider trading on the basis of nonpublic information learned from the Treasury.¹³⁰ To combat insider trading by retained entities, the rule states that any information that the Treasury provides to the entity “shall be deemed nonpublic until the Treasury determines otherwise in writing, or the information becomes part of the body of public information from a source other than the retained entity.”¹³¹ The entity is prohibited from disclosing any nonpublic information, except as required by the agreement with the Treasury or by court order or subpoena, and from using the nonpublic information to “further any private interest other than as contemplated by the arrangement.”¹³² Moreover, the entity is charged with taking security measures to prevent the disclosure or inappropriate use of nonpublic information.¹³³

B. Inapplicability of the Securities Exchange Act’s Prohibition on Insider Trading

Section 10(b) of the Securities Exchange Act prohibits the use of manipulative or deceptive devices in connection with the purchase or sale of securities, including insider trading.¹³⁴ Section 10(b) does not, however, prohibit the Treasury from relying on material, nonpublic information when disposing of bank securities. First, the Securities Exchange Act exempts the Treasury from § 10(b). Second, even if § 10(b) were amended to apply to the Treasury, the Treasury’s trading on the

126. *Id.* at 3432, pt. III.

127. *Id.* at 3431.

128. *Id.* at 3432, pt. III.

129. *Id.* at 3431, pt. I.

130. 31 C.F.R. § 31.217(a) (2009).

131. *Id.*

132. *Id.* § 31.217(b)(2).

133. *Id.* § 31.217(c).

134. 15 U.S.C. § 78j(b) (2006).

basis of material, nonpublic information might fall outside the limited scope of § 10(b).

1. Limited Reach of Current Insider-Trading Prohibitions

The Securities Exchange Act excludes federal departments and agencies, such as the Department of Treasury, from its reach, absent explicit reference in a particular provision:

No provision of this chapter shall apply to, or be deemed to include, any executive department or independent establishment of the United States, or any lending agency which is wholly owned, directly or indirectly, by the United States, or any officer, agent, or employee of any such department, establishment, or agency, acting in the course of his official duty as such, unless such provision makes specific reference to such department, establishment, or agency.¹³⁵

Section 10(b) of the Act, which prohibits manipulative or deceptive devices, including insider trading, does not explicitly reference the Department of Treasury or any United States department or agency.¹³⁶ As such, governmental insider trading is beyond the reach of the federal securities laws.

This interpretation is consistent with the few cases analyzing whether the federal securities laws reach federal actors. In *Colonial Bank & Trust Co. v. American Bankshares Corp.*, purchasers of capital of a bank in receivership alleged that the Federal Deposit Insurance Corporation had committed securities fraud by misrepresenting the bank's financial condition and the potential effect of the capital infusion and by inducing the purchasers to buy the capital.¹³⁷ The court held that the "clear language of the statute" excluded it from the scope of the federal securities laws.¹³⁸ Similarly, in *OKC Corp. v. Williams*, the plaintiff corporation alleged that individual SEC employees had violated the Securities Exchange Act by interfering with a tender offer.¹³⁹ The court dismissed the claim because SEC employees are exempt from the Act.¹⁴⁰

135. *Id.* § 78c(c).

136. *Id.* § 78j(b).

137. *Colonial Bank & Trust Co. v. Am. Bankshares Corp.*, 439 F. Supp. 797, 802 (E.D. Wis. 1977).

138. *Id.* ("[The FDIC] is not subject to the federal securities laws, nor are its officers or agents.").

139. *OKC Corp. v. Williams*, 461 F. Supp. 540, 544 (N.D. Tex. 1978).

140. *Id.* at 549.

2. Limited Scope of Current Insider-Trading Prohibitions

Even if the securities laws prohibiting insider trading were extended to the Treasury, the Treasury's trading on the basis of material, nonpublic information might fall outside the scope of current insider trading regulation. As explained below, the Securities Exchange Act's prohibition on insider trading does not bar all trading on the basis of material, nonpublic information. Rather, the prohibition extends only to trading that falls within the "classical theory" or the "misappropriation theory." Trading by the Treasury on the basis of inside information would fall within the scope of these theories only under narrow circumstances.

a. Narrow Interpretation of Insider Trading Prohibitions

The Supreme Court has narrowly interpreted the scope of current insider trading prohibitions. One of the policies underlying the securities laws, including the prohibitions on insider trading, is the promotion of "fair and honest markets."¹⁴¹ Indeed, as recognized by the SEC, "a purpose of the securities laws was to eliminate 'use of inside information for personal advantage.'"¹⁴² Taken to its extreme, this policy would prohibit all trading on the basis of material, nonpublic information.¹⁴³ Absent clear congressional intent to impose an across-the-board "disclose or abstain" rule, however, the Supreme Court has declined to interpret § 10(b) as prohibiting all trading on the basis of material, nonpublic information,¹⁴⁴ albeit while recognizing that the insider trading laws may not reach all unethical conduct.¹⁴⁵ Rather, the prohibitions on insider trading

141. 15 U.S.C. § 78b (2006) (explaining that regulation is necessary "to insure the maintenance of fair and honest markets in such transactions"); *United States v. O'Hagan*, 521 U.S. 642, 658 (1997) (recognizing that "an animating purpose of the Exchange Act" was "to insure honest securities markets and thereby promote investor confidence"); *Basic v. Levinson*, 485 U.S. 224, 230 (1988) ("Underlying the adoption of extensive disclosure requirements was a legislative philosophy: 'There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy.'" (quoting H.R. REP. NO. 1383, at 11 (1934))).

142. *Dirks v. SEC*, 463 U.S. 646, 662 (1983) (quoting *Cady, Roberts & Co.*, Exchange Act Release No. 6668, 40 SEC Docket 907, 912 n.15 (promulgated Nov. 8, 1961)).

143. *Chiarella v. United States*, 445 U.S. 222, 233 (1980) (Burger, C.J., dissenting) (arguing that the duty to abstain or disclose should arise "as a result of the 'inherent unfairness' of turning secret information to account for personal profit" (quoting *Cady, Roberts & Co.*, Exchange Act Release No. 6668, 40 SEC Docket 907, 912 (promulgated Nov. 8, 1961))).

144. *Chiarella*, 445 U.S. at 233 ("We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information. Formulation of such a broad duty . . . should not be undertaken absent some explicit evidence of congressional intent.").

145. *Dirks*, 463 U.S. at 661 n.21 ("[e]ven where permitted by law, one's trading on material nonpublic information is behavior that may fall below ethical standards of conduct. But in a statu-

extend only to (1) insiders and so-called “temporary insiders” who trade in their own company’s stock; (2) outsiders who misappropriate material, nonpublic information and trade on the basis of that information; and (3) certain tippees of the same.

The first prohibition, the “classical theory” of insider trading, is implicated “when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information.”¹⁴⁶ Classical theorists posit that the fiduciary relationship between a corporate insider and the company’s shareholders gives rise to a duty on the part of the insider to either disclose the inside information or abstain from trading on the basis thereof.¹⁴⁷ This theory is not limited to those traditionally considered corporate insiders, such as officers and directors, but extends also to temporary insiders such as “attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation.”¹⁴⁸

The second prohibition, the “misappropriation theory” of insider trading, is implicated when a person “misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.”¹⁴⁹ Here, the fiduciary relationship between the recipient and the source of the information gives rise to a duty on the part of the recipient to abstain from trading on the information rather than to “defraud[] the principal of the exclusive use of that information.”¹⁵⁰ For example, an attorney who breaches a duty to his firm and his client by trading on the basis of confidential information learned during the client relationship is liable under this theory.¹⁵¹

Finally, the third prohibition extends liability to a tippee if the tipper breaches a fiduciary duty by disclosing the information to the tippee and if the tippee knows or has reason to know that the disclosure is a breach.¹⁵² Whether the tipper’s disclosure constitutes a breach of fiduciary duty depends on whether the tipper “personally will benefit, directly or indirectly, from his disclosure.”¹⁵³ For example, if the tipper is “moti-

tory area of the law such as securities regulation, where legal principles of general application must be applied, there may be ‘significant distinctions between actual legal obligations and ethical ideals.’” (quoting an SEC report)).

146. *O’Hagan*, 521 U.S. at 651–52.

147. *Id.* at 652 (explaining the theoretical underpinnings of the classical theory).

148. *Id.*

149. *Id.*

150. *Id.*

151. *Id.* at 653.

152. *Dirks v. SEC*, 463 U.S. 646, 660 (1983).

153. *Id.* at 662.

vated by a desire to expose [a] fraud,” the tippee is not subject to insider trading liability for trading on the basis of the tipped information.¹⁵⁴

As a practical matter, the interaction of these three prohibitions prohibits most market actors from trading on the basis of material, nonpublic information in their possession.¹⁵⁵ Indeed, the Supreme Court has recognized that the misappropriation theory and the classical theory together cover most instances of trading on the basis of material, nonpublic information:

The two theories are complementary, each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities. The classical theory targets a corporate insider’s breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate “outsider” in breach of a duty owed not to a trading party, but to the source of the information.¹⁵⁶

Moreover, these theories of insider trading are supplemented with prophylactic prohibitions, including Securities Exchange Act § 16(b) and Rule 14e-3, which reach beyond the scope of the classical and misappropriation theories. Section 16(b), the so-called short-swing profit prohibition, generally provides that any profit realized by an insider within six months after the purchase or sale of an equity security of the issuer is recoverable by the issuer—regardless of the insider’s use of inside information to generate the profit.¹⁵⁷ Rule 14e-3 prohibits trading “on the basis of material nonpublic information concerning a pending tender offer that he knows or has reason to know has been acquired ‘directly or indirectly’ from an insider of the offeror or issuer, or someone working on their behalf,”¹⁵⁸ even if the trading does not involve a breach of fiduciary duty.¹⁵⁹

154. *Id.* at 667.

155. Ronald F. Kidd, *Insider Trading: The Misappropriation Theory Versus an “Access to Information” Perspective*, 18 DEL. J. CORP. L. 101, 118 (1993) (“The misappropriation theory essentially solves the problem of outsider trading.”); William K.S. Wang, *Stock Market Insider Trading: Victims, Violators and Remedies—Including an Analogy to Fraud in the Sale of a Used Car with a Generic Defect*, 45 VILL. L. REV. 27, 66 (2000) (“The ‘classical relationship’ and misappropriation theories cover, most, but not all, insider trading and tipping.”).

156. *O’Hagan*, 521 U.S. at 652–53.

157. 15 U.S.C. § 78p(b) (2006) (stating “the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer”).

158. *O’Hagan*, 521 U.S. at 669 (quoting *United States v. Chestman*, 947 F.2d 551, 557 (2d Cir. 1991) (en banc)); 17 C.F.R. § 240.14e-3 (2009).

159. *O’Hagan*, 521 U.S. at 673.

Only a few market participants slip through this broad net: (1) tippees where the tipper has not received a benefit; and (2) persons in possession of material, nonpublic information who do not violate any fiduciary duties by trading on that information. The latter category is generally limited to parties who are themselves the source of the inside information.¹⁶⁰ For example, research firms are generally not prevented by the insider trading laws from front-running the market effect of their own research,¹⁶¹ and members of Congress are not prohibited from trading on the basis of future congressional action.¹⁶²

Congress has not acted to fill these holes. First, there is little impetus to act with respect to the de minimus category of gratuitous tippees. Second, the value of analyst research is well recognized and permitting front-running is one way to encourage this research.¹⁶³ Third, absent public outcry, Congress has little incentive to impose additional restrictions on its own behavior.¹⁶⁴ Considering the narrowness of these exceptions and the rationales for Congress's failure to enact legislation covering these few gaps, Congress's inaction should not be construed as tacit approval for widespread trading on the basis of material, nonpublic information.

Even if the securities laws prohibiting insider trading were extended to the Treasury, the Treasury's trading on the basis of material,

160. Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1605 (1999) (recognizing that the "logic [of the misappropriation theory] suggests that the Wall Street Journal could lawfully trade on the same information used by Winans"); Roberta S. Karmel, *Insider Trading: Law, Policy, and Theory after O'Hagan*, 20 CARDOZO L. REV. 83, 95 (1998) (recognizing that, under the misappropriation theory, "the source could presumably trade on the information").

161. Jill E. Fisch, *Does Analyst Independence Sell Investors Short?*, 55 UCLA L. REV. 39, 53–54 (2007) ("Analysts systematically release information to their institutional investors prior to its public release." And, "[s]ecurities firms may trade ahead of an analyst's buy recommendation, effectively front-running the firm's own public statements."). The practice of front-running the overall market effect of broadly-disseminated research is distinguished from front-running a customer's purchases, which is prohibited by the Investment Advisors Act (as well as arguably by the Securities Exchange Act because it involves a violation of the fiduciary duty owed to the customer). See 15 U.S.C. § 80b-6 (1960); David M. Bovi, *Rule 10b-5 Liability for Front-Running: Adding a New Dimension to the "Money Game,"* 7 ST. THOMAS L. REV. 103, 107 (1994).

162. Matthew Barbabella, Daniel Cohen, Alex Kardon, & Peter Molk, *Insider Trading in Congress: The Need for Regulation* 24 (Dec. 20, 2008), available at <http://ssrn.com/abstract=1318682> (recognizing that there is not a "solid legal basis for liability" if a member of Congress trades on the basis of material nonpublic legislative information).

163. *Dirks v. SEC*, 463 U.S. 646, 658–59 (1983) (recognizing the crucial role that market analysts play in preserving healthy markets).

164. Barbabella et. al, *supra* note 162, at 3–4 (detailing the failure of the Stop Trading on Congressional Knowledge Act ["STOCK Act"] to gain any traction when first proposed in 2006 or when reintroduced in 2007); but see *id.* at 4 (explaining that the STOCK Act was reintroduced on January 26, 2009, as H.R. 682).

nonpublic information might fall outside the scope of current insider trading regulation. Trading by the Treasury on the basis of inside information about the financial institutions would fall within the scope of the classical theory only if the Treasury were found to be a temporary insider. Trading by the Treasury on the basis of nonpublic information about future governmental action would fall within the scope of the misappropriation theory only if the Treasury were found to have violated a relationship of trust and confidence by using the information.

b. The Treasury as Temporary Insider

The Treasury's trading on the basis of inside information about the banks implicates the classical theory of insider trading. But the classical theory would only extend to this trading if the government was classified as a "temporary insider," akin to an attorney, accountant, consultant, or underwriter working for the corporation.¹⁶⁵ An outsider becomes a temporary insider if (1) the outsider and the corporation "have entered into a special confidential relationship in the conduct of the business of the enterprise"; (2) the outsider is "given access to information solely for corporate purposes"; (3) the corporation "expect[s] the outsider to keep the disclosed nonpublic information confidential"; and (4) the relationship "at least . . . impl[ies] such a duty."¹⁶⁶

The Treasury Department might qualify as a temporary insider under this standard. On the one hand, the Treasury has been given access to the financial institutions' inside information pursuant to a special relationship. The Treasury is simultaneously an investor, a regulator, and—if not a savior—a patron.¹⁶⁷ Moreover, the Treasury has agreed to make "reasonable best efforts" to maintain the confidentiality of the information received pursuant to that relationship.¹⁶⁸ On the other hand, neither Congress nor the Treasury has been reticent about the imperative that the Treasury maximize profits for shareholders.¹⁶⁹ Yet, the financial institutions failed to negotiate for a provision explicitly banning the Treasury from relying on confidential inside information when disposing of the purchased securities.

165. *Id.* at 4.

166. *Dirks*, 463 U.S. at 655 n.14.

167. CPP Factsheet, *supra* note 10.

168. Securities Purchase Agreement, *supra* note 24, at ¶ 3.5(b).

169. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 2(2)(C), 122 Stat. 3765 (codified as amended in 12 U.S.C. § 5201(2)(C)); CPP Factsheet, *supra* note 10, at 1; Notice of Financial Institutions, *supra* note 34, at 2.

If the Treasury were classified as a temporary insider, the Treasury's disposition of a bank's securities on the basis of material inside information about the bank would fall within the scope of the classical theory of insider trading. However, to the extent the government sold the warrants directly to the bank itself rather than to an institutional investor or the public, there would presumably be no "insider trading" on the basis of inside information about the bank because both parties to the transaction would have equal access to this information. There is not a per se bar on insider trading liability for stock transactions between an insider and an issuer, but liability should attach only where the insider has knowledge of secret information about the company that he or she fails to share with the company.¹⁷⁰ In most instances, where the issuer and the insider have equal access to inside information about the issuer, there is no informational disparity, and thus, no insider trading.¹⁷¹ Indeed, when exempting certain issuer-insider trades from the short-swing profit prohibition,¹⁷² the SEC recognized that these trades "do not appear to present the same opportunities for insider profit on the basis of nonpublic information as do market transactions by officers and directors."¹⁷³

c. The Treasury as Misappropriator

The Treasury's trading on the basis of nonpublic information about future governmental action implicates the misappropriation theory. This theory would reach the Treasury's conduct only if the Treasury's use of the information violated a duty owed to the holder of the information. With respect to information about its own future conduct, this theory is inapplicable because the Treasury cannot violate a duty owed to itself. With respect to information learned from other governmental sources, the theory is again likely inapplicable because the holder and the user of the information are both arms of the United States government.

170. LANGEVOORT, *supra* note 68 ("As a general matter, the issuer is deemed to know all that its agents know, except to the extent that the agents are acting solely in a self-serving or corrupt fashion. . . . [I]n a case where the information was known only to a small group of persons who both engineered the fraud and sought to profit via purchases or sales from the company, there would be no attribution and hence there would be the requisite informational disparity."). For example, the SEC charged Enron CEO Kenneth Lay with securities fraud for repaying loans to Enron through sales of Enron stock to the company, allegedly with knowledge of undisclosed problems at Enron. See Second Amended Complaint at ¶¶ 102-106, SEC v. Kenneth L. Lay, No. H-04-0284 (S.D. Tex. 2004), available at <http://www.sec.gov/litigation/complaints/comp18776.pdf>.

171. LANGEVOORT, *supra* note 68.

172. 17 C.F.R. § 240.16b-3 (d)-(e) (2009).

173. Dreiling v. Am. Express Co., 458 F.3d 942, 948 (9th Cir. 2006) (quoting Ownership Reports and Trading by Officers, Directors and Principal Security Holders, 61 Fed. Reg. 30,376, 30,377 (June 14, 1996)).

C. Limited Reach of the Federal Torts Claims Act

Pursuant to the Federal Torts Claims Act (FTCA), the United States has consented to tort liability “in the same manner and to the same extent as a private individual under like circumstances,” but has excluded claims “arising out of . . . misrepresentation [or] deceit.”¹⁷⁴ A tort claim for insider trading would likely fall within this exclusion.

The essence of insider trading,¹⁷⁵ whether articulated as a federal statutory claim or as a tort claim, is the breach of the duty to disclose information before trading on it.¹⁷⁶ A tort claim premised on the breach of a duty to disclose information, just like an affirmative misstatement, sounds in misrepresentation or deceit, and such claims are consistently excluded from the reach of the FTCA.¹⁷⁷ Therefore, a tort claim premised on governmental insider trading is likely excluded from the waiver of immunity in the FTCA. This is consistent with the Supreme Court’s characterization of insider trading as “deception,” albeit while interpreting the “deceptive device” language of the Securities Exchange Act rather than the “deceit” language of the FTCA.¹⁷⁸

D. Arguable Breach of the Securities Purchase Agreement

The Treasury might be liable for breach of contract if it uses inside information about the financial institutions when trading in securities. The standard Securities Purchase Agreement between the Treasury and the financial institutions does not prohibit the Treasury from trading on

174. 28 U.S.C. § 2674 (1988); 28 U.S.C. § 2680(h) (2006).

175. The misrepresentation exception is premised on the essence of the claim, not on its label. *JBP Acquisitions v. United States*, 224 F.3d 1260, 1264 (11th Cir. 2000) (“[A] plaintiff cannot circumvent the misrepresentation exception simply through the artful pleading of its claims.”); *Gaudet v. United States*, 517 F.2d 1034, 1035 (5th Cir. 1975) (“Gaudet urges that his claim is grounded in negligence, not in intentional tort, but the argument is without merit. It is the substance of the claim and not the language used in stating it which controls.”).

176. *Dirks v. SEC*, 463 U.S. 646, 653 (tracing the roots of the classical theory of insider trading to the common law); *Chiarella v. United States*, 445 U.S. 222, 227–29 (1980) (interpreting the federal securities laws consistently with the “common-law rule” that trading on the basis of nonpublic information is not fraudulent absent a duty of disclosure (citing the “common law” and the RESTATEMENT (SECOND) OF TORTS)).

177. *Muniz-Rivera v. United States*, 326 F.3d 8, 13 (1st Cir. 2003) (“The case law makes manifest that the prophylaxis of the misrepresentation exception extends to failures of communication.”); *JBP Acquisitions*, 224 F.3d at 1265 n.3 (“The misrepresentation exception encompasses failure to communicate as well as miscommunication.”).

178. *United States v. O’Hagan*, 521 U.S. 642, 652 (1997) (affirming that classical insider trading is a “deception device”). The Court in *O’Hagan* explained that insider trading under the misappropriation theory “premises liability on a fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information.” *Id.* at 653. Moreover, the Court recognized that “deception through nondisclosure is central” to the misappropriation theory. *Id.* at 655.

the basis of inside information learned from the financial institutions. The agreement does, however, contain a representation by the Treasury that it will “use reasonable best efforts” to maintain the confidentiality of the inside information:

The Investor will use reasonable best efforts to hold, and will use reasonable best efforts to cause its agents, consultants, contractors and advisors to hold, in confidence all non-public records, books, contracts, instruments, computer data and other data and information (collectively, “*Information*”) concerning the Company furnished or made available to it by the Company or its representatives pursuant to this Agreement¹⁷⁹

It is conceivable that the Treasury’s trading on the basis of a financial institution’s confidential information could operate as a signal to the bank’s competitors about the content of that confidential information—thus breaching the Treasury’s promise to keep the information confidential.¹⁸⁰ In this narrow circumstance, where the Treasury’s trading operates to disclose the financial institution’s confidential information, the Treasury might be liable to the financial institution for breach of contract.

The true victims of insider trading—the investors—would not be able to seek recourse as third-party beneficiaries, however. Even if a third-party beneficiary claim against the Treasury could be articulated on these facts, the Securities Purchase Agreement explicitly disclaims any liability to third parties: “Nothing contained in this Agreement, expressed or implied, is intended to confer upon any person or entity other than the Company and the Investor any benefit, right or remedies”¹⁸¹

E. Limited Takings Clause Argument

Governmental insider trading might also, in narrow circumstances, qualify as a taking under the Fifth Amendment; however, such a taking would probably not violate the Constitution. The Fifth Amendment prohibits the taking of private property “for public use, without just compensation.”¹⁸² Under the Takings Clause, the government may take property

¹⁷⁹ Securities Purchase Agreement, *supra* note 24, at ¶ 3.5(b).

¹⁸⁰ Bainbridge, *supra* note 160, at 1607 (“Once activity in a stock reaches an unusual stage, others may guess the reason for the trading—the corporate secret.”).

¹⁸¹ Securities Purchase Agreement, *supra* note 24, at ¶ 5.10.

¹⁸² U.S. CONST. amend. V. Conceivably, a bank could also attempt to articulate a substantive due process claim based on the deprivation of its property right in its confidential information, but an analysis of the viability of such a claim is beyond the scope of this article.

for public use if it provides just compensation.¹⁸³ A taking is unconstitutional, however, if it is for a private use or if just compensation is not available.¹⁸⁴ The takings inquiry involves four issues, each of which is discussed below: (1) Is the financial institution's confidential information property for purposes of the Takings Clause? (2) Does the Treasury's trading on the basis of confidential information constitute a taking? (3) Is the taking for a public use? (4) Is just compensation available to the financial institution? An analysis of these issues demonstrates that, under narrow circumstances, insider trading by the Treasury might qualify as a taking of a financial institution's confidential information, but just compensation is likely available. Moreover, most of the insider trading anticipated by this Article would not constitute a taking.

1. Property Subject to Protection Under the Takings Clause

At least some corporate inside information is property for purposes of the Takings Clause.¹⁸⁵ For example, in *Ruckelshaus v. Monsanto Co.*, the Supreme Court held that commercial information "cognizable as a trade-secret property right under [state] law" is protected by the Takings Clause.¹⁸⁶ At the very least, therefore, to the extent a bank's inside information qualifies as a trade secret under state law,¹⁸⁷ it would be subject to the Fifth Amendment's Takings Clause.

The treatment of corporate inside information as property for purposes of the Takings Clause is consistent with the property rights rationale for insider trading regulation. Many commentators have urged that prohibitions on insider trading are justified as a means of protecting a company's property rights in its confidential information.¹⁸⁸ Indeed, al-

183. *Kelo v. City of New London*, 545 U.S. 469, 477 (2005).

184. *Id.*; *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1016 (1984).

185. See Richard J. Morgan, *Insider Trading and the Infringement of Property Rights*, 48 OHIO L.J. 79, 94–95 (1987) ("Information can be an asset. . . . So long as the information remains generally unknown, the information has potential value in the hands of the person who possesses it and who has the potential ability to benefit from the informational advantage that he or she possesses.").

186. *Ruckelshaus*, 467 U.S. at 1003–04.

187. RESTATEMENT (THIRD) UNFAIR COMPETITION § 39 ("A trade secret is any information that can be used in the operation of a business or other enterprise and that is sufficiently valuable and secret to afford an actual or potential economic advantage over others.").

188. Bainbridge, *supra* note 160, at 1606 ("There is a growing consensus that the federal insider trading prohibition is more easily justified as a means of protecting property rights in information than as a way of protecting investors."); Morgan, *supra* note 185, at 95 ("If information can be an asset whose ownership can be determined and transferred and whose uses can be allocated and restricted by agreement with the owner, it is possible to approach the regulation of insider trading as a matter of determining and protecting the ownership and use rights in the inside information on which that trading is based."); Albert D. Spalding, *Insider Tradings: Is There A Better Way?* A

beit without adopting the property rights rationale for insider trading regulation,¹⁸⁹ in *O'Hagan* the Supreme Court recognized that a "company's confidential information . . . qualifies as property to which the company has a right of exclusive use"¹⁹⁰ and compared insider trading on the basis thereof with embezzlement of tangible property.¹⁹¹

2. A "Taking" Under the Takings Clause

The Treasury's trading on the basis of a company's confidential information probably would not qualify as a "taking" unless the trading operated as a signal to the company's competitors about the content of the confidential information. When making the "ad hoc, factual" inquiry into whether a taking has occurred, courts examine the following factors: "the character of the governmental action, its economic impact, and its interference with reasonable investment-backed expectations."¹⁹² Two components of this analysis are especially relevant here: (1) whether the banks have a reasonable investment-backed expectation in the government not trading on the basis of inside information; and (2) whether governmental trading on the basis of inside information about the banks interferes with the banks' property interests in the information.¹⁹³

Banks probably do not have a broad "reasonable investment-backed expectation" that the government will not trade on the basis of inside information about the banks. In order to be reasonable, an expectation must be based on more than a "unilateral expectation of an abstract need."¹⁹⁴ For example, where a statute was silent regarding the Environmental Protection Agency's authorized use of confidential information submitted to the agency, the Supreme Court held that, "absent an

Proposed "Trade Secrets" Approach, 11 MIDWEST L. REV. 140, 149-51 (1993) (suggesting that trade secret law should inform the regulation of insider trading).

189. Bainbridge, *supra* note 160, at 1645 ("Both proponents and opponents of the property rights rationale will be able to quote passages indicating support for their position, but neither should take much comfort from *O'Hagan*.")

190. *United States v. O'Hagan*, 521 U.S. 642, 654 (1997).

191. *Id.* (citing *Carpenter v. United States*, 484 U.S. 19, 27 (1987) ("The undisclosed misappropriation of such information, in violation of a fiduciary duty, the Court said in *Carpenter*, constitutes fraud akin to embezzlement."); *see also id.* ("As counsel for the Government stated in explanation of the theory at oral argument: 'To satisfy the common law rule that a trustee may not use the property that [has] been entrusted [to] him, there would have to be consent.'" (quoting with approval the Government's statement at oral argument)); *Dirks v. SEC*, 463 U.S. 646, 653 n.10 (1983) (recognizing that confidential information is a corporate asset).

192. *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1005 (1984) (quoting *PruneYard Shopping Center v. Robins*, 447 U.S. 74, 83 (1980)).

193. *See id.* at 1005-12.

194. *Id.* at 1005-6 (quoting *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 161 (1980)).

express promise,” the submitter did not have a reasonable expectation “that its information would remain inviolate in the hands of EPA.”¹⁹⁵ Similarly, the EES Act, the CPP, and the CAP do not make express promises that the Treasury will not trade on the basis of the information provided to it. Moreover, the banks have been forewarned that the Treasury will maximize profits for the taxpayers.¹⁹⁶ Therefore, banks participating in the CPP and the CAP probably do not have a reasonable investment-backed expectation that the government will not rely on that information when selling the banks’ securities.

It is conceivable, however, that the Treasury’s trading could operate as a signal to the bank’s competitors about the bank’s confidential information.¹⁹⁷ In other words, the confidentiality of the information could be threatened by the government’s insider trading. In this specific scenario, the government’s use of the information would run afoul of the Treasury’s express promise to the financial institutions to maintain the confidentiality of the company’s inside information. The CPP standard Securities Purchase Agreement contains a representation that the Treasury “will use reasonable best efforts to hold” the inside information in confidence.¹⁹⁸ If the government’s trading on the basis of the company’s inside information destroys its confidentiality, the trading might interfere with a “reasonable, investment-backed expectation” that the Treasury maintain confidentiality.

Even if the banks did have a broad expectation that the government would not trade on the basis of confidential information about the banks, only under narrow circumstances would the government’s trading be inconsistent with the banks’ property interest in such a way as to constitute a taking. The property interest in confidential commercial information, such as a trade secret, is comprised of the right to a “competitive advantage over others” as a result of the right to exclusive access to and use of the information.¹⁹⁹ Governmental use of inside information about a bank when making trading decisions would interfere with the bank’s right to exclusive use, but such a use would not necessarily interfere with the bank’s right to a competitive advantage over others. The Supreme Court has emphasized that mere interference with the right to exclusive use of a

195. *Id.* at 1008.

196. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 2(2)(C), 122 Stat. 3765 (codified as amended in 12 U.S.C. § 5201(2)(C)); Notice to Financial Institutions, *supra* note 34, at 3.

197. Bainbridge, *supra* note 160, at 1607 (“Once activity in a stock reaches an unusual stage, others may guess the reason for the trading—the corporate secret.”).

198. Securities Purchase Agreement, *supra* note 24, at ¶ 3.5(b).

199. *Ruckelshaus*, 467 U.S. at 1011–12.

trade secret is insufficient to constitute a taking if that interference does not affect the owner's competitive advantage over others.²⁰⁰ For example, if the EPA used a trade secret when evaluating a competitor's product, thus enabling the competitor to register its product more easily, the EPA's use would constitute a taking.²⁰¹ If, however, the trade secret related to harmful side effects of the submitter's product and the EPA disclosed the trade secret to the public, the disclosure would not be a taking because the resulting "decline in profits stems from a decrease in the value of the pesticide to consumers, rather than from the destruction of an edge the submitter had over its competitors."²⁰² The crucial question, therefore, is whether governmental trading on the basis of a bank's confidential information would affect the bank's competitive advantage from that information. The direct victims of insider trading are those who engage in contemporaneous trades with the insider, but the company itself can be indirectly harmed by insider trading. If the insider trading affects the bank's stock price, it could interfere with a transaction tied to the market price of the stock²⁰³ or cause a downgrade in the bank's credit rating.²⁰⁴ But these harms do not flow from the destruction of the bank's competitive edge.

As noted above, however, it is possible that the government's insider trading could operate as a signal to the bank's competitors about the bank's confidential information,²⁰⁵ thus interfering with the bank's competitive advantage. In this specific scenario, the government's trading on the basis of the bank's confidential information would probably qualify as a use inconsistent with the bank's property interest in the information.

3. A Public Use

A taking is unconstitutional if it is accomplished for a private use.²⁰⁶ As long as the use "has a conceivable public character," however,

200. *Id.*

201. *Id.* at 1011 n.15.

202. *Id.*

203. Morgan, *supra* note 185, at 97 (noting that "insider buying might drive up the market price of the corporation's securities, thereby making more difficult the corporation's acquisition in a transaction that is tied to the market price of the corporation's securities").

204. See Standard & Poor's, Ratings Direct: How Stock Prices Can Affect An Issuer's Credit Rating 2-3 (Sept. 26, 2008), http://www2.standardandpoors.com/spf/images/media/Stock_Prices_Affect_Issuer_CreditRating.pdf (explaining that a company's stock price is important to the company's credit rating because it affects the company's access to capital and because it, especially for confidence-sensitive companies like banks, reflects the company's ability to operate).

205. Bainbridge, *supra* note 160, at 1607 ("Once activity in a stock reaches an unusual stage, others may guess the reason for the trading—the corporate secret.").

206. *Kelo v. City of New London*, 545 U.S. 469, 477 (2005).

it qualifies as a public use.²⁰⁷ For example, in *Kelo v. City of New London, Connecticut*, the Supreme Court held that a city's exercise of eminent domain to transfer private property from one private owner to another pursuant to an economic development plan satisfied the public use requirement.²⁰⁸ Here, where governmental trading on the basis of confidential information about the banks would inure to the benefit of the taxpayers, the character of the use is most likely public. As a result, even if the confidential information is property and the governmental use is a taking, governmental insider trading is not barred by the Fifth Amendment if the bank is able to recover just compensation. It is irrelevant for Fifth Amendment purposes that contemporaneous traders, those most likely to be harmed by the trading, would have no recourse.

4. Just Compensation

If a taking is for a public use, the taking is permitted if the owner is able to recover reasonable compensation.²⁰⁹ Ordinarily, a governmental taking is compensated pursuant to the Tucker Act, which affords the Court of Federal Claims jurisdiction to enter a judgment against the United States for just compensation.²¹⁰ However, even if Congress withdraws the Tucker Act remedy, other means of recovering reasonable compensation might also be available.

The EES Act, pursuant to which the CPP is administered, contains explicit limitations on remedies available to banks and thus appears to withdraw the Tucker Act remedy. First, § 119(a)(1) sets forth the following standard for reviewing the Secretary's actions:

Actions by the Secretary pursuant to the authority of this Act shall be subject to chapter 7 of title 5, United States Code, including that such final actions shall be held unlawful and set aside if found to be arbitrary, capricious, an abuse of discretion, or not in accordance with law.²¹¹

Further, § 119(a)(3) limits the claims that participating banks may pursue against the Secretary:

No action or claims may be brought against the Secretary by any person that divests its assets with respect to its participation in a

207. *Ruckelshaus*, 467 U.S. at 1014.

208. *Kelo*, 545 U.S. at 484–85.

209. *Ruckelshaus*, 467 U.S. at 1016.

210. *Id.*; 28 U.S.C. § 1491(a)(1) (2008).

211. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 119(a)(1), 122 Stat. 3765 (codified as amended in 12 U.S.C. § 5229(a)(1)).

program under this Act, except as provided in paragraph (1), other than as expressly provided in a written contract with the Secretary.²¹²

These provisions appear to bar banks from seeking just compensation from the Secretary under the Tucker Act.

Financial institutions would probably not, however, be barred from otherwise seeking just compensation from the Treasury. As discussed above in Part IV.D, if the Treasury's insider trading operates to disclose the financial institution's inside information, the Treasury would arguably be liable for breach of contract, thus affording the financial institution just compensation for this taking. Therefore, to the extent the Treasury's insider trading constituted a taking of bank property, it would only be without just compensation to the extent the trading was found not to violate the Securities Purchase Agreement. Only in this unique circumstance would the taking violate the Constitution.

V. GOVERNMENTAL INSIDER TRADING SHOULD BE CHECKED

Governmental insider trading should be prohibited. First, governmental use of inside information to trade in bank stocks implicates the policy rationales underlying the prohibition on insider trading and undercuts the purposes of the very programs that make this trading possible. Second, the potential benefits of permitting governmental insider trading to proceed unchecked fail to outweigh the aforementioned harms.

A. Undercutting the Purposes of the EES Act

In the unique context of insider trading by the government, the purposes of the bailout, the rationales for prohibiting insider trading, and even some of the arguments against the prohibition of insider trading converge to support prohibiting governmental trading on the basis of material, nonpublic information.

First, a central rationale for prohibiting insider trading—and for bailing out the banks—is to promote overall faith in the integrity of the markets²¹³ and thus encourage investors to participate in the markets.²¹⁴

212. *Id.* § 119(a)(3) (codified as amended in 12 U.S.C. § 5229(a)(3)).

213. *United States v. O'Hagan*, 521 U.S. 642, 658 (1997) (recognizing that “an animating purpose of the Exchange Act” was “to insure honest securities markets and thereby promote investor confidence”); *Selective Disclosure and Insider Trading*, Securities Act Release No. 33-7881, Securities Exchange Act Release No. 34-43154, Investment Company Act Release No. IC-24599, at 20 (August 15, 2000) (“[T]he prohibitions against insider trading in our securities laws play an essential role in maintaining the fairness, health, and integrity of our markets. We have long recognized that the fundamental unfairness of insider trading harms not only individual investors but also the very

If investors think that they are the dupes of other market participants, they will likely be deterred from participating in the market.²¹⁵ In these tough economic times when ordinary investors have lost significant amounts of money, the impression that “ordinary investors always lose” is already rampant. This impression would only be exacerbated if the government itself were perceived as using ordinary investors as pawns. The goal of promoting overall faith in the markets would be undercut if the Treasury was permitted to trade on the basis of inside information.

A second rationale for the bailout is buttressing bank stock prices.²¹⁶ As loudly proclaimed by opponents of insider trading regulation, who argue that insider trading is victimless, the presence of insider trading in the market is reflected in stock prices.²¹⁷ In other words, rational investors discount stock prices to reflect the danger of insider trading. Regardless of the merits of this argument in the overall debate about whether insider trading should be prohibited at all, the discounting of bank stock prices to account for governmental insider trading would un-

foundations of our markets, by undermining investor confidence in the integrity of the markets.”); Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1115 (1985) (“The primary policy reason for proscribing trading while in possession of material nonpublic information is to make investors confident that they can trade securities without being subject to informational disadvantages. The goal is to guarantee the integrity of the market.”); Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375, 382 (1999) (summarizing and compiling sources for the argument that insider trading prohibition “supports investor confidence in the securities markets”); *but see* Ian B. Lee, *Fairness and Insider Trading*, 2002 COLUM. BUS. L. REV. 119, 138 (2002) (characterizing concern about loss of investor faith in the markets as a result of insider trading as a “rather unsophisticated response” that “militates . . . for investor education rather than a prohibition on insider trading”).

214. Emergency Economic Stabilization Act of 2008 § 2(1) (codified as amended in 12 U.S.C. § 5201(1)) (articulating the goal of restoring “liquidity and stability to the financial system of the United States”); CPP Factsheet, *supra* note 10 (“[CPP] is designed to . . . provid[e] confidence to our nation’s financial system.”).

215. *O’Hagan*, 521 U.S. at 658 (“[I]nvestors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law.”); Ronald F. Kidd, *Insider Trading: The Misappropriation Theory Versus an “Access to Information” Perspective*, 18 DEL. J. CORP. L. 101, 120 (1993) (“[I]f the investor believes that others regularly enjoy information that is not legally available to him or to other ordinary investors, he may withdraw from the market entirely.”).

216. TREASURY WHITE PAPER, *supra* note 36, at 1 (recognizing the need to reassure investors).

217. Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 868 (1983) (“Kenneth Scott has pointed out that if the existence of insider trading is known, as it surely is, outsiders will not be disadvantaged because the price they pay will reflect the risk of insider trading.”) (citing Kenneth Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 807–09 (1980)); Lee, *supra* note 213, at 165 (summarizing and compiling sources for the argument that “[m]arket prices will adjust to reflect the sophisticated investors’ assessment of the implications of the practice [of insider trading] for the value of the firm, guaranteeing that unsophisticated investors will, despite their ignorance, be compensated for the risk they assume”).

dercut a central purpose of the financial stabilization efforts—to restore confidence in the financial system by reassuring bank investors.²¹⁸ Prohibiting governmental trading on the basis of inside information would further this goal.

Moreover, the additional key arguments for legalizing all insider trading are not implicated in the context of governmental insider trading. Prohibiting the Treasury from using its informational advantage in the marketplace would neither deprive analysts of incentive to ferret out information and analyze information,²¹⁹ nor deprive entrepreneurs of incentive to excel.²²⁰

B. Failure of Potential Profits to Outweigh the Resultant Harm

Although governmental insider trading could increase profits for the taxpayers, the cost of decreased public confidence in the markets is not worth the profits. The primary goal of the EES Act is to “restore liquidity and stability to the financial system of the United States.”²²¹ Maximizing taxpayer returns is only a secondary goal.²²² Allowing this secondary goal to override the primary goal would gut the EES Act of its purpose. Indeed, if the taxpayers’ return had been more important to Congress than stabilizing the markets, Congress would not have enacted the EES Act at all.

Moreover, permitting the Treasury to engage in insider trading for the benefit of the taxpayers forces the bank shareholders—the few—to bear the burden of the taxpayers—the many. This unfair burden shifting is contrary to the principle underlying the Takings Clause (admittedly without violating the Takings Clause because the shareholders do not have a property interest in unrealized profits) that some people should

218. FinancialStability.gov, Capital Assistance Program, at <http://www.financialstability.gov/roadtostability/capitalassistance.html> [hereinafter Capital Assistance Program].

219. Lee, *supra* note 213, at 171 (summarizing and compiling sources for the argument that banning trading on inside information might result in “less incentive to invest resources in its acquisition”).

220. MANNE, *supra* note 63, at 139 (arguing that insider trading “is merely a variant of the underlying market for entrepreneurial service”); Strudler & Orts, *supra* note 213, at 382 (summarizing and compiling sources for the argument that permitting insider trading “would provide an appropriate form of executive compensation”).

221. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 2(1), 122 Stat. 3765 (codified as amended in 12 U.S.C. § 5201(1)).

222. *Id.* § 2(2) (codified as amended in 12 U.S.C. § 5201(2)). Additional important goals listed in the Act are “protect[ing] home values, college funds, retirement accounts, and life savings” and “preserv[ing] homeownership and promot[ing] jobs and economic growth.” *Id.*

not be forced to bear alone “public burdens, which, in all fairness and justice, should be borne by the public as a whole.”²²³

VI. SPECIFIC STEPS WOULD PREVENT THE TREASURY FROM ENGAGING IN INSIDER TRADING

Several extreme solutions could prevent governmental insider trading. For example, fully nationalizing the banks would keep the Treasury from profiting from its superior knowledge when trading with the public, as there would be no public investors. Nationalization is not the only possible solution, however, and such a drastic measure is not warranted by the potential problem of governmental insider trading. Moreover, the political pressures against such a step make it unrealistic, absent other exigencies.

Rather, this article evaluates five more moderate solutions drawn from the body of precedent already developed in the context of trading by company insiders: (1) prohibiting the Treasury from using nonpublic information when making investment decisions; (2) applying of the “disclose or abstain” rule to the Treasury; (3) directing the Treasury to dispose of the warrants as soon as practicable; (4) requiring the Treasury to impose an “ethical wall” between the person making the investment decisions and those in possession of the information; and (5) requiring the Treasury to follow an investment plan akin to a Rule 10b5-1 plan.

As this article goes to press, the Treasury is poised to implement the third potential solution by committing to dispose of at least some of the warrants as quickly as practicable. This article argues that this potential solution, even if expanded to cover all warrants held by the Treasury, fails to solve the problem of insider trading, while simultaneously failing to maximize taxpayer returns. This article recommends that the Treasury instead adopt a combination of the fourth and fifth solutions.

A. Prohibiting Use of Inside Information

One possible solution would be to prohibit the Treasury from using nonpublic information when making investment decisions. Congress could impose such a prohibition on the Treasury, the Treasury could in-

223. *Armstrong v. United States*, 364 U.S. 40, 49 (1960) (explaining the policy rationale underlying the Takings Clause); *but see Dirks v. SEC*, 463 U.S. 646, 677 (1983) (Blackmun, J., dissenting) (“The court justifies *Secrist’s* and *Dirks’s* action because the general benefit derived from the violation of *Secrist’s* duty to shareholders outweighed the harm caused to those shareholders, . . . in other words, because the end justified the means. Under this view, the benefit conferred on society by *Secrist’s* and *Dirks’s* activities may be paid for with the losses caused to shareholders trading with *Dirks’s* clients.”).

clude a promise to that effect in the Securities Purchase Agreements, or the Treasury could issue the promise in a statement of Treasury policy.

Setting aside the enforceability of such a prohibition or promise, this potential solution runs contrary to the inherent inseparability of awareness and use of information. When promulgating Rule 10b5-1, the SEC recognized the “common sense notion that a trader who is aware of inside information when making a trading decision inevitably makes use of the information.”²²⁴ Therefore, Rule 10b5-1 equates trading “on the basis of” confidential information with trading while “aware” of that information.²²⁵ This same common sense notion prevents a promise by the Treasury not to use confidential information when making investment decisions, without more, from solving the potential for insider trading.

B. Imposing a “Disclose or Abstain” Rule

A second potential solution would be to impose the “disclose or abstain” rule on the Treasury identical to that imposed on private individuals in possession of material nonpublic information under the classical theory and the misappropriation theory of insider trading.²²⁶ Although this solution addresses the inherent inseparability between awareness and use, it is not viable because it would effectively bar the Treasury from ever trading in the bank securities. As outlined above in Part II.A.3, the Treasury has vast access to inside information about financial institutions and about future government conduct and policy. In other words, the Treasury is constantly aware of material, nonpublic information. Under the “disclose or abstain” rule, the Treasury could only trade if it first disclosed the confidential information that it possessed.

Disclosure is not a reasonable option for the Treasury, however. To the extent that the Treasury is aware of inside information about the financial institutions, the Treasury is contractually prohibited from disclosing the confidential information.²²⁷ Moreover, to the extent the nonpublic information related to future government conduct, the timing and means of disclosure depend on questions of diplomacy, national security, and politics, not on the whims of the Treasury. Thus, the imposition of a “disclose or abstain” rule would prevent the Treasury from trading at all.

224. Selective Disclosure and Insider Trading, Securities Act Release No. 33-7881, Securities Exchange Act Release No. 34-43154, Investment Company Act Release No. IC-24599, at 22 (August 15, 2000).

225. 17 C.F.R. § 240.10b5-1 (2000).

226. *United States v. O'Hagan*, 521 U.S. 642, 652 (1997).

227. *See supra* text accompanying notes 179–180.

C. Disposing of the Warrants as Quickly as Practicable

A third potential solution is to require the Treasury to dispose of the warrants as soon as possible. Without acknowledging that it possesses inside information, the Treasury recently recognized the impropriety of permitting it to “time” the market: “[I]t [is] not appropriate for the government to be exercising discretionary judgment on timing market sales.”²²⁸ The Treasury’s apparent solution is to commit to dispose of the securities “as quickly as practicable” (hereinafter, the “ASAP policy”).²²⁹ The Treasury has explicitly recognized the ASAP policy with respect to the warrants of banks that have fully repaid the Treasury’s CPP investment.²³⁰ The Treasury has not published a formal policy regarding the disposition of warrants of banks that have not repaid the Treasury, but it has generally stated its preference for a swift sale of the securities owned by the government.²³¹

At first glance, the Treasury’s commitment to sell the warrants of repaying banks as soon as possible appears to assuage fears that the Treasury will profit from its access to nonpublic information—at least with respect to banks that repay the Treasury’s investment—but further analysis shows that the ASAP policy is not an optimal solution. First, the “as quickly as practicable” timeline is still amorphous enough to afford the Treasury considerable discretion in the timing of warrant sales. Although the Treasury’s capacity to profit from its superior information is compressed to a shorter period of time, it is not extinguished. Second, the ASAP policy itself is an overarching timing of the market. For example, if the Treasury were currently in possession of nonpublic information that could negatively impact bank stocks in the long-term, the Treasury’s ASAP policy would itself be a misuse of that information.

Moreover, in addition to failing to solve the insider trading problem, the Treasury’s ASAP policy fails to achieve Congress’s objective of maximizing taxpayer wealth.²³² Swift disposition of the warrants, in light of the economic uncertainties currently facing the nation, fails to capture the potential upside of the Treasury’s investment. A better approach to maximizing taxpayer returns, while avoiding insider trading by the Treasury, is to dispose of the securities at an optimal time as determined through an analysis of public information. Combining an ethical

228. June 26th Treasury Press Release, *supra* note 26.

229. *Id.*

230. *Id.*

231. *Id.*; Capital Assistance Program Term Sheet, *supra* note 39, at 6.

232. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 2(2)(C), 122 Stat. 3765 (codified as amended in 12 U.S.C. § 5201(2)(C)).

wall and an investment plan, as discussed below, would allow the Treasury both to prevent the misuse of nonpublic information and to maximize taxpayer returns.

D. Imposing an Ethical Wall

A fourth option is to require the Treasury to impose an “ethical wall”²³³ between the individuals who are aware of nonpublic information and those who make the investment decisions.²³⁴ This wall would prevent any material, nonpublic information from flowing to the decision-makers.

When implementing the ethical wall, the Treasury could draw from the procedures used in other scenarios involving the segmentation of information within an entity, such as within a law firm when an attorney with a conflict of interest is screened from participation on a matter²³⁵ or within a broker-dealer when the investment banking department possesses confidential information that its retail brokers cannot use when making recommendations to their clients.²³⁶ For example, the ethical wall should restrict the decision-makers’ access to Treasury files, protect sensitive Treasury information with additional safeguards like passwords and impose strict codes of conduct enforceable with sanctions.²³⁷

233. Courts, attorneys, and securities professionals commonly refer to such a barrier as a “Chinese wall.” In light of the questionable usefulness of this term and its potentially racist undertones, this article uses the term “ethical wall.” See *Peat, Marwick, Mitchell & Co. v. Superior Court of Contra Costa County*, 200 Cal. App. 3d 272, 293–95 (1988) (Low, P.J., concurring) (questioning the usefulness of the term “Chinese wall,” recognizing that “the term has an ethnic focus which many would consider a subtle form of linguistic discrimination,” and suggesting the use of the phrase “ethics wall”).

234. This proposal is similar to the 10b5-1 affirmative defense for entities, where one or more of an entity’s agents is in possession of material nonpublic information. This affirmative defense is satisfied if (1) the individual making the investment decision on behalf of the entity is not aware of the information, and (2) the entity has “implemented reasonable policies and procedures” to ensure that the decision-maker is not violating insider trading laws. 17 C.F.R. § 240.10b5-1(c)(2) (2009).

235. See MODEL RULES OF PROF’L CONDUCT R. 1.10(a)(2) (stating that an attorney’s conflict of interest is not imputed to other attorneys within the firm if, among other steps, the disqualified attorney is “timely screened from any participation in the matter”); *id.* R. 1.0(k) (“‘Screened’ denotes the isolation of a lawyer from any participation in a matter through the timely imposition of procedures within a firm that are reasonably adequate under the circumstances to protect information that the isolated lawyer is obligated to protect under these Rules or other law.”).

236. See 15 U.S.C. §§ 78o(f), 80b-4a (2006) (requiring every registered broker, registered dealer, and investment advisor to “establish, maintain, and enforce written policies and procedures reasonably designed” to prevent the misuse of material nonpublic information); Christopher M. Gorman, Note, *Are Chinese Walls the Best Solution to the Problems of Insider Trading and Conflicts of Interest in Broker-Dealers?*, 9 FORDHAM J. CORP. & FIN. L. 475, 476 (2004) (explaining the potential flow of information from the investment banking department to the retail department).

237. Gorman, *supra* note 236, at 486–87 (identifying typical policies and procedures of a “Chinese wall”).

The imposition of an ethical wall would insulate the CPP asset managers and the Financial Stability Trust trustees from the material, nonpublic information in the possession of the Treasury.

The ethical wall alone would be insufficient, however, to prevent insider trading because, under current plans, the Treasury retains ultimate decision-making authority.²³⁸ Even if the information did not pass to the asset managers or the trustees, the securities transactions would nonetheless be tainted to the extent they were ultimately subject to the discretion of individuals in possession of that information at the Treasury. Therefore, as discussed below, the ethical wall would only be successful if combined with an investment plan.

E. Fashioning an Investment Plan

A fifth alternative is for the Treasury to fashion an investment plan, akin to a Rule 10b5-1 plan, thereby removing the day-to-day investment decisions from the Treasury's discretion. When promulgating Rule 10b5-1, the SEC recognized that, because insiders are always "aware" of inside information, the prohibition on trading while "aware" of inside information would effectively bar insiders from trading in their company's securities. In order to allow insiders to trade in their company's stock, the SEC detailed an affirmative defense whereby an insider could trade without violating Rule 10b-5.²³⁹ In particular, an insider may shield himself or herself from liability if, before becoming aware of material nonpublic information, he or she adopts a written investment plan.²⁴⁰ The plan must insulate the insider from future investment decisions, either by including a formula for future investments or by ceding all discretion over future investment decisions to a third person.²⁴¹

The Treasury, like a company insider, is always in possession of material nonpublic information, and an investment plan is a viable option for insulating the Treasury from future investment decisions.²⁴² The Treasury has already announced that it intends to designate asset managers and trustees to manage the Treasury's investments.²⁴³ As part of that designation, the Treasury should adopt an investment plan that either (1) includes a specific formula for disposing of financial institution's stock or (2) cedes all discretion to make investment decisions to the managers

238. See *supra* text accompanying notes 15, 31.

239. 17 C.F.R. § 240.10b5-1(c) (2009).

240. *Id.* § 240.10b5-1(c)(1)(i)(A).

241. *Id.* § 240.10b5-1(c)(1)(B)(2) & (3).

242. See *supra* text accompanying notes 47–56.

243. See *supra* text accompanying notes 30, 45.

and trustees. As guidance when drafting such a plan, the Treasury could rely on similar plans implemented by company insiders pursuant to Rule 10b5-1.²⁴⁴

If the investment plan is not combined with an ethical wall, however, the Treasury could nonetheless engage in insider trading. For example, the Treasury could feed material nonpublic information to the trustees and managers for their consideration when exercising their discretion. Similarly, variables in the formula could be affected by material nonpublic information leaked by the Treasury.

F. Combination of an Ethical Wall and an Investment Plan

As foreshadowed above, the best solution is to combine an ethical wall and an investment plan. The ethical wall would prevent the Treasury from leaking any inside information to the asset managers or trustees. The investment plan would prevent the Treasury from relying on material nonpublic information when deciding whether to adopt the investment recommendations of the asset managers or trustees. The combination of the two would prevent the Treasury and its agents from relying on inside information when disposing of bank securities. At the same time, this solution would allow the Treasury to maximize taxpayer returns to the extent possible without engaging in insider trading.

VII. CONCLUSION

The Treasury has the motive and the opportunity to rely on material nonpublic information when disposing of financial institutions' securities, which would undercut the purposes of the bailout. Insider trading by the Treasury would be outside the reach of the federal securities laws and the Federal Torts Claims Act. If the insider trading operated to disclose a financial institution's confidential information to a competitor, the institution might be able to assert a claim for breach of the Securities Purchase Agreement against the Treasury, but this potential remedy would not offer any recourse to injured investors. Moreover, even this limited remedy would not be available if the Treasury's insider trading were premised on nonpublic information about future governmental or

244. See, e.g., Mary J. Mullany, *SEC Rule 10b5-1 Trading Plans: Another Item to Consider During the Preparation of Annual Disclosure Documents*, 1711 PLI/CORP 919, 922 (2009) (listing common provisions of a Rule 10b5-1 plan); see also SEC Division of Corporate Finance: Manual of Publicly Available Telephone Interpretations Fourth Supplement, available as an attachment to Mary J. Mullany, *SEC Rule 10b5-1 Trading Plans: Another Item to Consider During the Preparation of Annual Disclosure Document*, 1641 PLI/CORP 1187, 1255 (2008) (answering questions about how to draft a compliant written trading plan).

quasi-governmental conduct or if the Treasury's insider trading did not operate as a signal to the bank's competitors. In light of the lack of sufficient checks on potential insider trading by the Treasury, this article recommends a two-part solution: (1) the imposition of an ethical wall between the persons making the investment decisions and the Treasury; and (2) the establishment of an investment plan that divests the Treasury of discretion over investment decisions.