Judge Ideology, SEC Enforcement, and Insider Trading

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need protection with securities laws. As a result, conservative judges are less likely to draw a harsh position to punish insider trading as being illegal (Manne 1985; Kripke 1985; Meulbroek 1992). Consistent with these arguments, prior legal studies show that Supreme Court Justices appointed by Democratic presidents tend to vote for decisions that favor stricter enforcement of insider trading than Justices appointed by Republican presidents (Fedderke and Ventoruzzo 2015).

We conjecture that, as liberal judges lead to more adverse outcomes to defendants in insider-trading lawsuits, they increase the expected litigation costs of engaging in insider trading. Specifically, the threat of facing liberal judges in court looms over in the entire enforcement process regardless whether case ends up in the federal court. This alters the perceive costs and benefits trade-offs of insiders' trading decisions (Becker 1968). Thus, we hypothesize that when judge ideology is more liberal, insiders engage in less opportunistic trading.

Insider trading cases are litigated in the U.S. federal court system, which consists of three levels, the District Courts (the trial court), the Court of Appeals (also known as the Circuit Courts), and the Supreme Court (the highest federal court). Of the three, we focus on the judges in the Circuit Courts as it plays the greatest legal policymaking role in the United States judicial system (Cross 2007). First, District Court judges likely follow the ideology of the Circuit Courts (Randazzo 2008; Choi, Gulati, and Posner 2012). This is because decisions of district court judges are reviewed by the circuit courts on a mandatory and routine basis. A circuit court may find a district court judge's decision incorrect and reverse it. In the event of decision reversal, district court judges may suffer reputation damage. Circuit Court rulings also have binding constraints on the District Courts under their jurisdiction. Therefore, district court judges take the likely decision of the overseeing circuit courts into consideration when making their decisions (Schanzenbach and Tiller 2007; Knight and Gulati 2010). Second, although the Supreme Court is the highest federal court and its opinion should carry the most weights in federal lawsuits, it selectively reviews appeals due to its heavy case load. In fact, the Supreme Court reviews less than 1% of appeals and rarely hears any insider-trading case (Bowie and Songer 2009).

Empirically, we follow prior studies in political science and legal research and use the partisanship of the President who nominates a judge to reflect his or her ideological preference, because presidents have almost always nominated someone whose ideology was similar to their own (Goldman 1999; Pinello 1999; Dorsen 2006).[3] That is, we label judges nominated by Republican presidents as conservative judges and those nominated by Democratic presidents as liberal judges. Because Circuit Courts assign a panel of three judges to each case, we measure Circuit Court ideology using the probability that a three-judge panel randomly selected from judges in a Circuit is dominated by appointees of Democratic presidents, with a higher probability indicating more liberal judge ideology and higher expected litigation cost of illegal insider trading.

We use U.S. public firms with insider trading transactions covered in the Thomson Reuter Insider Filing Data files from 1998 to 2018 to conduct our empirical analyses. The jurisdiction over an insider-trading case is usually based on the insider's primary residence.[4] Assuming that executives live near their company headquarters, we use each company's historical headquarters to identify the circuit with jurisdiction over the executives. We find strong evidence that firms located in more liberal circuits have fewer opportunistic insider sales, consistent with the deterrence effect of more liberal judges on opportunistic insider trading. The results are economically significant: a one standard deviation increase in liberal judge ideology is associated

[3] Judges in federal courts are appointed by the U.S. presidents, with the nomination approved by the U.S. Senate. To secure the independence of judges, the U.S. constitution (Article III, Section 1) requires a good-behavior tenure for judges and prohibits decreasing compensation for judges. With the lifetime tenure and salary protection, federal judges have great latitude to vote in a way consistent with their political ideology.

[4] In insider-trading cases, the district in which the defendant resides has the jurisdiction over the case (15 U.S. Code § !78u–1 and 15 U.S. Code §!78aa).

with 18% decrease in opportunistic sales. We further focus on a setting where insider sales are more likely to be driven by material non-public information, that is, sales that occur before large stock price declines, and find stronger results. Specifically, Finally, we

Second, we contribute to the literature of legal and political science studies. The conventional wisdom suggests the difference between liberals and conservatives in their attitudes towards insider-trading enforcements (Pritchard 2013; Murdock 2014). P in the fairness and integrity of the securities markets (SEC 2018).[6] The enforcement against illegal insider trading involves all three branches of government, legislative, executive and judicial.

The legislative branch passes laws that govern the security markets, including those used to prosecute insider trading. In the United States, there is no one single statue that prohibits insider of

2.3 Judicial branch and insider trading

Although the SEC is the primary enforcer of insider-trading violations, all its enforcement actions and decisions, including those that arise from the administrative law judge (hereafter, ALJ), are subject to review by the judicial branch. Due to its status as the final arbiter in insider-trading cases, the federal courts, through their decisions, have played a major role in defining what is illegal insider trading (FINRA Staff 2017).[12] For example, the Second Circuit's decision in *SEC v. Texas Gulf Sulphur Co.* was the first time a federal court held that insider trading is securities fraud, which became the basis of almost all subsequent insider-trading prosecutions (Fairfax 2018).[13]

Although judicial branch is an integral part of enforcement against illegal insider trading, prior studies that examine

(Atkins 2008).[14] Similarly, courts have disagreed on whether a piece of information is non-public when it has been leaked, but not disseminated to the general public (Sinai 2000).

Another example of the ambiguities stems from whether insiders rely on the material non-public information in their trading or simply “possess” the information while trading. The SEC ne

insiders may give little weight to judge ideology when making trading decisions.[19] Nonetheless, we state our hypothesis (H1) in an alternative form:

H1: Insiders make less opportunistic trades when judge ideology is more liberal.

4. Variable definition and research design

4.1 Definition of main variables

4.1.1 Judge ideology

We measure judge ideology in the circuit court. As discussed in the introduction, judges in circuit courts are usually the final adjudicators of cases related to securities laws. Therefore, we expect judge ideology of circuit courts to have the greatest impact on the expected case outcomes and thus to be most relevant for managers' trading behavior.[20]

Empirically, we follow Huang et al. (2019) and use the probability that a three-judge panel randomly selected from a circuit court has at least two judges appointed by Democratic presidents to measure how liberal the judges are in the circuit court (*LiberalCourt*). For each firm-calendar year observation, we use the average of monthly *LiberalCourt* in the calendar year of the circuit where the firm's headquarter resides (hereafter, home circuit). We define home circuits using firms' headquarters because in insider trading cases, the district where the defendant resides has the jurisdiction over the case (15 U.S. Code §!78u–1 and 15 U.S. Code §!78aa). As a result, we focus our tests on trades of executives under the assumption that executives reside in the same

[19] Further, judges are constrained by legal precedents. However, they can ignore a precedent if they believe that it is not precisely on point. They can also choose which precedent to follow when conflicting lines of precedent exist (Wald 1987).

[20] In untabulated analysis, we find that the judge ideology in the district court with jurisdiction over the firm does not have significant effect on the magnitude of insider trading.

circuit as the company headquarters.[21] Since directors, especially independent directors, are more likely to live out-of-state, and we do not know which court has jurisdiction over them, we do not include their trades in our analyses. Also note that by using circuit judge composition during the year, we assume that insiders use contemporaneous judge ideology as the predicted judge position that would affect a potential lawsuit outcome.[22]

4.1.2 Opportunistic insider trades

Insiders can trade for a variety of reasons, for example, to pay for personal expenditure, to diversify their portfolio, or to make a profit based on non-public information. Of these trades, only the last one violates securities laws and thus might be affected by

the more trading there is, the more likely that an informed trade goes unnoticed (Thevenot 2012). In addition, we include buy-and-hold abnormal returns over the previous year (*PriorReturn*) to control for the general trend of performance as well as the fact that insiders tend to be contrarians (Rozeff and Zaman 1998; Lakonishok and Lee 2001; Cheng and Lo 2006). Second, we include an indicator variable (*HighLitiInd*) to capture whether a firm belongs to an industry with relatively high securities class action litigation risk (e.g., biotechnology, computers, electronics, and retail) following Francis, Philbrick, and Schipper (1994), because many such lawsuits use insider trading as evidence of fraud (Johnson, Kasznik and Nelson 2000; Ke, Huddart and Petroni 2003; Dai, Parwada and Zhang 2015). Third, we control for demographic variables that may be correlated with both judge ideology and insider trading, including state economic growth (*GDPGR*), state-level unemployment rate (*Unemp*), and the political leaning of firms' headquarters states (*BlueState*). Detailed variable definitions are provided in the Appendix.

We further include year fixed effects to control for macroeconomic condition as well as other factors varying with general time trends such as the regulatory environment changes related to the President, the SEC, and financial markets. We also include circuit fixed effects to mitigate the concern that any association between judge ideology and insider trading is driven by omitted correlated variables at the circuit level.[26] Standard errors are clustered by state.[27] Because insider trading variables are left-censored at zero, we use Tobit models to estimate Equation (1) and all

[26] We find consistent results (untabulated) when we additionallyn (t)0.2 (52 T.1 (52 .T Q . 0 0 Tm /TT1 7 (n) 7 ((tT Q . (52 .i)

Panel B of Table 1

sample period, state-level GDP has an average annual growth rate of 4.3% and unemployment rate averages 0.059%.

Table 2 Panel B presents the Pearson and Spearman correlations of the variables. *LiberalCourt* exhibits low correlations with firm characteristics, suggesting that the variation in other hand, t

circuits – the two circuits with relatively high proportion of liberal judges and high percentage of large firms. Third, since the appointment of federal judges must be confirmed by the U.S. Senate, we consider the partisan makeup of the Senate in our judge ideology measure following Huang et al. (2019).[33] Our results remain similar. Fourth, given existing evidence on the deterrence effect of derivative litigation risk on insider trading (Jung et al. 2018; Adhikari et al. 2019), we control for derivative litigation risk by including dummies for the combination of firms' state of incorporation and year. We find consistent results.

Next, we focus on insider trading before large stock price movements, a setting where insider trades are more likely to be driven by material non-public information, to reduce type I error in our classification of opportunistic insider trades. Marin and Olivier (2008) document that sales by insiders peak several months before a large drop in stock price and contain high information content. Illegal insider sales prosecuted by the SEC usually precede events associated with stock price declines such as negative earnings, bankruptcy, and financial frauds (Meulbroek 1992; Kacperzyk and Pagnotta 2019). Combined with our results in Table 3, we focus only on insider sales prior to stock price declines.

We follow Marin and Olivier (2008) to identify months with significant stock price declines. Specifically, we first compute the monthly excess returns for each firm-month, $ABRET_{i,t}$, as the raw return subtracts the CRSP value weighted market portfolio return

OPPSALE_D, and *LiberalCourt* based on opportunistic sales and judge ideology over prior 12 months respectively.

Table 4 reports the regression results. We find that the coefficient on *LiberalCourt* continues to be negative and significant for insider sales. The result corroborates our findings in Table 3 that liberal judge ideology constrains opportunistic information-driven insider sales. Not surprisingly, the economic significance is greater than what we find in Table 3: a one standard deviation increase in *LiberalCourt* is associated with a 23.8% (25.5%) decrease in *OppSale_N* (*OppSale_D*). Based on the average stock price decline of 22% during the sample firm-

SEC is more likely to take enforcement actions (including both civil actions and administrative these variables and their respective interactions with *LiberalCourt* in Eq. (1) and re-estimate the regressions, and expect a negative coefficient on all interactions.

Columns (1) and (2) of Table 5 display the results of financial distress. Consistent with our prediction, the coefficient on $LiberalCourt_{i,t}$ * $DISTRESS_{i,t}$ is negative and signif that the deterrent effect of liberal judge ideology is stronger when insiders are more likely to be sued for illegal insider trading.

5.4 The SEC and Judge Ideology

In this section, we explore how the interplay between the SEC.00001 653.76the dicirac

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administrative proceeding process or in a district court. If the division collects sufficient evidence, it can choose between two venues to litigate a (i.e., pro-SEC) outcomes (e.g., Fedderke and Ventoruzzo 2015), the SEC should therefore be more likely to prosecute violations in district courts as opposed to through administrative proceedings when the chance of winning in the federal court is higher. As the district court judges follow the ideology of the circuit court in making decisions (Schanzenbach and Tiller 2007; Knight and Gulati 2010), we expect that the SEC is more likely to select the district court as opposed to ALJ when the ideology of the federal circuit court judges is more liberal.[38]

To test this prediction, we manually collect all SEC insider-trading enforcements

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The results from estimating Equation (3) are reported in Table 7. In Column (1), we find that all else being equal, the SEC is more likely to pursue federal court actions as opposed to administrative proceeding process when the court is more liberal. In terms of economic magnitude, with an increase in *LiberalCourt* from Q1 to Q3 (from 0.332 to 0.651), the odds of the SEC selecting the federal courts as the venue increases by 47.36% (from 33.93% to 81.29%). Thus, our results are consistent with judge ideology playing a significant role in the SEC's significant at the 1% level, confirming our prediction that the SEC is more likely to consider judge ideology in its forum choice after 2010.

5.5 Judge Ideology and Insider Trading Penalty

Our analyses rely on an important assumption that judge ideology influences the outcomes of the insider trading cases filed in federal courts. While the political science and law literature has provided theoretical foundation as well as some empirical evidence for this assumption (e.g., Fedderke and Ventoruzzo, 2015), we validate it more directly by examining whether judge ideology is associated with the penalty charged for defendants in insider trading cases. Specifically, we estimate the following equation:

$$Penalty_j = \ {}_0 + \ {}_1 Disgorgement_j + \ {}_2$$

effects to control for economic environments and other differences over time or across geographic regions that may affect penalty.

We manually collect the amount of penalty and disgorgement of profits for civil insider trading cases from SEC website for 285 out of 577 insider trading civil cases from 1998-2018.[42] The SEC does not provide details for the remaining cases. Table 8 presents the results. We find that liberal judge ideology increases the penalty to insider trading. In terms of economic magnitude, the most liberal tercile Circuit Courts impose 25.72% (0.171/0.665) higher penalty per dollar of profit than the bottom two terciles. This analysis provides support for our assumption that liberal judge ideology is associated with more adverse outcomes in insider trading litigations.

6. Conclusion

We empirically investigate the effect of judicial position on insiders' trading decisions. Federal courts not only serve as an important component that establishes the laws against illegal insider trading, but also make the ultimate decision on insider-trading lawsuits. However, despite the ample evidence on how the laws and the SEC affect insider trading decisions, little is known about the effect of judicial position.

Our evidence fills th

thus demonstrate the joint effect of the two branches of the federal government against illegal insider trading. The understanding of the cost and benefit trade-offs in insider trading and prosecution provides important regulatory insights. Finally, while the documented effect of judge ideology on insider trading is limited to the trades of executives in public companies due to data availability, our findings may apply to other insiders who might trade on non-public information, such as independent directors, non-executive employees, consultants, and friends of corporate insiders, which represents one potential avenue for future research.

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Appendix: Variable Definitions

Variable	Definition
Main Variables	
LiberalCourt	The probability that a three-judge panel randomly selected from a circuit court has at least two judges appointed by Democratic presidents, that is, [. (/ , 3)+ . (/ , 2) # . (0 $ / , 1)] / . (0, 3), where 0 is the total number of judges in the circuit court, and / is the number of judges in the circuit court who were appointed by Democratic presidents. (&, 1) is the number of combinations of selecting 1 objects from & distinct objects. For each firm-year observation, we use the average of 231(%&4_.56%7 measure of the firm's headquarters in year t. Historical headquarters information is extracted from firms' 10-K filings. Circuit court judges' appointing presidents are from the Federal Judicial Center's website.
OppSale_N	Total number of opportunistic insider sales in year t, divided by the number of common shares outstanding at the end of year t-1, multiplied by 100. We follow Cohen et al. (2012) to identify opportunistic insider trades based on the trading history of the insider. We require the insider to place at least one trade in all three preceding years to define his/her trade as either opportunistic or routine. We classify the trade from an insider as a routine trade if he/she places a trade in the same calendar month for the three preceding years. An inside trade is classified as an opportunistic trade if there is no discernible pattern in his or her trading history.
OppBuy_N	Total number of opportunistic insider purchases in year t, divided by the number of common shares outstanding at the end of year t-1, multiplied by 100. We identify opportunistic insider trades as described in the definition of *OppSale_N*.
OppSale_D	Total dollar value of opportunistic insider sales in year t, divided by market

BlueState	An indicator variable that equals 1 if the firm's headquarters state favors a Democratic candidate in the most recent presidential election prior to year t, and 0 otherwise.
Other Variables	
Distress	An indicator variable that equals 1 if the firm's Altman's Z score is in the bottom decile of all firms in year t, and 0 otherwise. Altman's Z score is computed as 3.3*OIADP/AT + 1.2*(ACT - LCT)/AT + SALE/AT + 0.6*PRCC_F*CSHO/ (DLTT + DLC) + 1.4*RE/AT.
AAER	An indicator variable that equals 1 if the firms engaged in accounting misconduct in year t that is later under enforcement actions as listed in SEC Accounting and Auditing Enforcement Releases.
CorpGov	The Entrenchment Index (E-Index) of Bebchuck, Cohen and Ferrell (2009), multiplied by (-1).
SEC_Constraints	An indicator variable that equals 1 if the budget authority of t

Table 1 Continued

Panel C: Sample Distribution by Year

Year	Observations	Percentage	Average *LiberalCourt*
1998	222	1.17%	0.380
1999	877	4.61%	0.404
2000	869	4.57%	0.449
2001	811	4.27%	0.462
2002	774	4.07%	0.442
2003	794	4.18%	0.402
2004	906	4.77%	0.370
2005	985	5.18%	0.357
2006	1,126	5.92%	0.347
2007	1,163	6.12%	0.325
2008	1,029		

Table 2 Continued

Panel B: Correlation Table

	LiberalCourt	*Size*	*MtoB*	*Turnover*	*PriorBHAR*	*HighLitiInd*	*GDPGR*	*Unemp*

Table 3. Judge Ideology and Insider Trading

This table reports the results from estimating Equations (1), which tests the effect of judge ideology on the intensity of insider trading. The sample includes 19,005 firm-year observations from 1998 to 2018. All variables are defined in the Appendix. Year- and circuit-fixed effects are included in each regression. The ***p*-**

Table 4. Judge Ideology and Insider Trading Before Large Stock Price Declines

This table reports the results from estimating Equations (1) for insider trading in the 12 months before the firm-month with large stock price declines. We define a firm-month as one experiencing large stock price decline if the excess monthly

Table 5. Judge Ideology and Insider Trading: Cross-Sectional Tests

This table reports the results from our cross-section tests, which examines whether the deterrent effect of liberal ideology on opportunistic insider sales is stronger when the firm is under greater scrutiny, i.e., when the firm is

Table 6. Judge Ideology and Insider Trading:
SEC Resource Constraints

This table reports the results from estimating Equations (2), which examines how the SEC's resource constraints affects the deterring effect of liberal judge ideology. All variables are defined in the Appendix. Circuit-fixed effects are included in each regression. The ***p*-**values (in parentheses) are calculated using standard errors clustered by state.
*, **

Table 7. Judge Ideology and SEC Enforcement on Illegal Insider Trading: Civil Action versus Administrative Proceeding

Table 8. Judge Ideology and