

Judge Ideology and Opportunistic Insider Trading

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Abstract:

Extant evidence suggests that liberal judges prefer stricter securities enforcement to protect innocent investors. We find that firms located in circuits with more liberal judges perform fewer opportunistic insider sales, consistent with managers taking judges' political ideology into consideration. This deterrent effect is stronger when insiders are more likely to be sued. The SEC also considers judge ideology when selecting litigation venues. Finally, we validate that liberal judges are associated with heavier penalties in insider trading cases. Overall, we provide the first evidence demonstrating the importance of judicial discretion and judge political ideology in deterring opportunistic insider trading.

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1. Introduction

Insider trading based on material non-public information breaches a fiduciary duty or other relationship of trust and undermines investor confidence in the fairness and integrity of the securities markets. Not surprisingly, investors, journalists, regulators, and lawmakers pay substantial attention to insiders' trades and to allegations of illegal insider trading (Brochet 2010; Cohen, Malloy, and Pomorski 2012; Dai, Parwada, and Zhang 2015). Political ideology, in the conventional liberal to conservative continuum, can profoundly affect the legislation and implementation of regulatory policies. Compared with conservatives, liberals prefer stronger enforcement of regulations on insider trading (Fedderke and Ventoruzzo 2015). For instance, Democrats are opposed to codifying the "personal benefit" rule in the Insider Trading Prohibition Act of 2021, while Republicans generally support it (Coffee 2021).¹ Despite the importance of political ideology, little is known about whether corporate insiders consider it in their trading decisions. Our study fills this void by investigating whether the political ideologies of federal judges, who are the ultimate arbiters of insider trading enforcement (Fisch 2018), affect insiders' opportunistic trading activities. By answering the question, our paper provides valuable insights on the effectiveness of legal enforcement in deterring insider trading.

In the United States, insider trading prohibitions rely on federal legislation, Securities and Exchange Commission (SEC) regulations, and court rulings. The definition of illegal insider trading is ambiguous (Reichman 1993), leaving considerable room for regulators and corporate insiders to disagree on whether the latter have broken the law.² Such disagreements are settled in the federal courts (Newkirk and Robertson 1998). Thus, judges' attitudes can have a profound impact on insider trading enforcement.³

¹ Under the "personal benefit" rule, the tippee can be convicted of illegal insider trading only if that person paid or promised some benefit to the tipper.

² Defining illegal insider trading is not a trivial task. As then-SEC Assistant General Counsel Frank E. Kennamer Jr. commented during the Texas Gulf Sulphur trial, it is "nearly impossible ... to define a rule fitting all situations" in which corporate insiders may or may not trade in their companies' stock (Phalon 1966). Within the labyrinth of federal securities laws, no statute specifically prohibits insider trading. Rather, insider trading enforcements have evolved over decades of civil litigation, criminal prosecution, and administrative enforcement (Bainbridge 2013; LaVigne and Calandra 2016). See Section 2.4 for a detailed discussion.

³ Although several papers document the effects of legal status and precedents on insider trading (e.g., Jaffe 1974; Allen 1990; Fairfax 2018; Patel 2019; Adhikari et al. 2021), we are not aware of any study that examines the role of judges' personal preferences in insider trading decisions.

Legal studies show that judges' rulings tend to advance their personal ideological preferences, which generally fall on the conventional liberal-to-conservative continuum seen in U.S. politics (see George 1998 for a review).⁴ Regarding securities fraud, liberals are more likely than conservatives to support regulation of the free market, i.e., government intervention in the capital market (Fedderke and Ventrizzo 2015). This difference originates in divergent beliefs regarding the balance of power between capital market participants. Liberals usually believe that investors have less information than companies and financial institutions and are therefore more likely to suffer damages from securities fraud or a breach of fiduciary duties; conservatives more often view the market as efficient and believe that investors do not need protection (McCraw 2009; Lind, Rankin, and Harris 2016).⁵

These ideological differences manifest themselves in attitudes towards insider trading. Since insiders benefit from using private information and taking advantage of uninformed traders (Bhattacharya and Daouk 2002; Beny 2005), liberals prefer stronger enforcement of regulations on insider trading (Pritchard 2013; Murdock 2014; Cline and Posylnaya 2019).⁶ Thus, liberal judges are more likely to take harsh positions in such cases (i.e., to rule these activities illegal and to impose heavier penalties). For instance, Supreme Court justices appointed by Democratic presidents tend to support decisions that favor stricter enforcement in securities regulation cases that include insider trading, compared with justices appointed by Republican presidents (Fedderke and Ventrizzo 2015).⁷ The effect of judge ideology on insider trading enforcement not only affects cases that reach the court but looms over the entire enforcement process. During settlement

⁴ Both the legal studies and political science literatures have documented that judge ideology is among the most important attributes influencing judicial decisions (Johnston 1976, Tate 1981, Segal and Cover 1989, Staudt, Epstein, and Wiedenbeck 2006).

⁵ Recent anecdotal evidence shows that the number of new investigations conducted by the SEC during the Trump administration decreased every year, from 1,063 in 2016 to 827 in 2019. As an early sign that the SEC will strengthen its enforcement actions under the Biden administration, the SEC is allowing more enforcement staff to approve new probes (Michaels 2021).

⁶ Consistent with conservatives' and liberals' differing positions on insider trading, anecdotal evidence shows that Republican SEC officials are less enthusiastic about increasing penalties for insider trading than are Democratic members of Congress (Joo 2007). More recently, there was a substantial reduction in the prosecution of insider trading cases under the Trump administration (Chaffin 2021). In our empirical tests, we include year fixed effects to control for macroeconomic conditions and other factors that vary with time, such as the regulatory environment related to the president, the legislators, the SEC, and the financial markets.

⁷ In Section 5.6, we confirm that liberal judges impose heavier penalties in insider trading cases than do conservative judges, providing further support to our arguments and to evidence from legal studies. This validation test is important. Although Fedderke and Ventrizzo (2015) find that liberal ideology in the Supreme Court is associated with more pro-regulation rulings in various securities regulation cases, their results may be driven by the non-insider-trading securities regulation cases in their sample.

negotiations between the SEC and defendants, both parties likely consider how the judge's preferences might affect the case's outcome if an out-of-court settlement cannot be reached (Waldfogel 1995). In summary, the presence of liberal judges increases the expected litigation cost of opportunistic insider trading and should reduce the intensity of such trades.

The effect of judge ideology on insider trading is not without tension, for several reasons. First, profits from opportunistic insider trading may far exceed the additional litigation costs associated with liberal judges, rendering judge ideology unimportant in the insiders' decision-making process. Second, executives could believe that punishment for insider trading is unlikely and thus may not consider judge ideology in their trading decision (Soltes 2016).⁸ Third, instead of directly filing insider trading cases in the federal courts, the SEC can prosecute insider traders internally through administrative processes (see Section 5.4.2 for a detailed discussion and tests on how judge ideology affects the SEC's forum selection decision).⁹ Although decisions from administrative processes can be appealed to federal courts, the judicial branch plays an indirect role in determining the enforcement outcomes of such cases. This, in turn, may diminish the influence of federal court judge ideology on insiders.¹⁰ In summary, whether judge ideology affects insider trading decisions is an empirical question.

The U.S. federal court system comprises three hierarchical levels: district courts (the trial court), courts of appeals (also known as circuit courts), and the Supreme Court (the highest federal court). We focus on circuit courts, as they are usually the final adjudicators of securities lawsuits (Cross 2007). Because jurisdiction over an insider trading case is usually based on the insider's primary residence (15 U.S. Code § 78u-1 and 15 U.S. Code § 78aa), and because the majority of executives live near their company headquarters (Liu and Yermack 2012), we use each company's historical headquarters to identify the circuit whose judge ideology influences the executives' trading behavior.¹¹

Presidents have almost always nominated judges whose ideology is similar to their own (Goldman 1999; Pinello 1999; Dorsen 2006), so we label judges nominated by Republican

⁸ In an interview, a former partner at KPMG who had been convicted of illegal insider trading admitted that he "never once thought about the costs versus rewards" (Soltes 2016).

⁹ Between 1998 and 2018, 67% of insider trading cases associated with executives of U.S. public firms were prosecuted in federal courts, and 33% were resolved through administrative processes.

¹⁰ Though rulings by administrative law judges (ALJs) can be appealed to circuit courts, the courts usually defer to the earlier rulings unless the ALJs' conclusions were not supported by "substantial evidence."

¹¹ We do not include directors' trades in our analyses because directors, especially independent directors, are more likely to live out of state, so we cannot determine which court has jurisdiction over them.

presidents as conservative and judges nominated by Democratic presidents as liberal. Accordingly, we measure the ideology of a circuit court using the probability that a three-judge panel randomly selected from its judges is dominated by appointees of Democratic presidents. A higher probability indicates a more liberal judge ideology and a higher expected litigation cost of opportunistic insider trading. Importantly, the judge ideologies of different circuits do not change in tandem. Over the same period, some circuits became more liberal while others become more conservative. The different trends within the circuits are driven by differences in (a) the numbers of retiring judges and their dates of retirement, (b) the presidents who appointed the retiring judges, and (c) whether the current president successfully appoints a new judge. All of these differences are presumably exogenous to the firm, the executives, and information-related omitted variables that are correlated with opportunistic insider trading.¹² We take advantage of these exogenous and asynchronous variations in judge ideology across circuits and use them as the identification strategy in our empirical tests.

Our sample includes U.S. public firms covered by Thomson Reuters Insider Filing data from 1998 to 2018. Following Cohen, Malloy, and Pomorski (2012), we construct a measure of opportunistic insider trading based on trades that deviate from an insider's trading history. We find strong evidence that firms headquartered in more liberal circuits have fewer opportunistic insider sales, consistent with a deterrent effect of liberal judges. The results are economically significant: a one-standard-deviation increase in liberal judge ideology is associated with a 19.5% reduction in opportunistic sales relative to the unconditional mean.

To identify insider trades that are likely to be based on material non-public information, we focus on opportunistic insider sales before large stock price declines, defined as firm-months with returns at least two standard deviations below the average return in the previous five years. We find that such trades are more sensitive to judge ideology: a one-standard-deviation increase in liberal judge ideology is associated with a 21% decrease in these trades, relative to the unconditional mean.

We conduct a battery of sensitivity tests to ascertain the robustness of our results. First, we restrict our sample to firms that have never changed their headquarters location. Second, we exclude firms from the Second and Ninth Circuits because both of these circuits have a relatively

¹² Besides year fixed effects, 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.

high proportion of liberal judges and a high percentage of large firms. Third, we use alternative definitions of judge ideology, including one that considers the partisan composition of the Senate when judges are nominated and ones that measure judge ideology over different time horizons. Fourth, we control for state derivative securities litigation risk by including fixed effects of the interaction between a firm's state of incorporation and the year. Fifth, we control for the total compensation of the firm's top five executives. Sixth, we control for corporate political ideology by including two variables that capture the amounts of individual donations to Democrat or Republican politicians. Seventh, we estimate a specification where we exclude year dummies and separately control for the ideology of the president, the SEC chairman, and the SEC commissioners. Eighth, we use a short-window test to examine whether a change in court ideology is related to a change in opportunistic insider trading. All sensitivity tests yield results that are consistent with a negative relation between liberal judge ideology and the intensity of insiders' opportunistic sales.

Next, we conduct cross-sectional tests to examine the mechanism of this effect. If judge ideology influences insider trading through expected litigation costs, we expect its effect to be stronger when insider trading is more likely to be sued. We consider three settings where the likelihood of being sued is higher: firms in financial distress, firms that commit accounting misconduct, and firms with stronger corporate control governance.¹³ In the first two scenarios, financial distress and accounting misconduct draw scrutiny from investors and regulators who are more likely to notice opportunistic trading and to think that these trades are based on material non-public information. In the third scenario, firms are more likely to have internal mechanisms, such as whistleblower protection, that enable regulators to identify and collect evidence of opportunistic insider trading (Dyck, Morse and Zingales 2010). Consistent with our proposed mechanism, we find that the managers of firms that are financially distressed, have accounting misconduct, or have stronger corporate governance weigh judicial ideology more heavily in their trading decisions.

As the SEC is the main regulatory agency enforcing insider trading laws, we further investigate the interplay between the judiciary and the SEC. Specifically, we test whether the SEC considers judge ideology when it selects a forum in which to prosecute illegal insider trading. In an illegal insider trading case, the SEC Commissioner can either conduct an internal administrative

¹³ Note that in these cross-sectional tests, we examine how these three factors influence the effect of judge ideology on insider trading rather than the direct effects of these factors on insider trading. For example, managers of firms with stronger corporate governance may perceive higher costs and engage in less insider trading.

proceeding or bring the case to a federal district court (Zheng 2021). Since liberal federal judges improve the SEC's odds of prevailing in federal court, we predict – and find – that the SEC is more likely to file the case in a district court when the overseeing circuit court judges are more liberal. This finding suggests that the SEC indeed factors judge ideology into its insider trading enforcement.

In addition to our main analyses based on the intensity of opportunistic insider sales, we explore whether judge ideology affects the information content of insider trades. To measure this content, we use the predictability of insider trades with respect to future stock performance (Akbas, Jiang, and Koch 2020; Goldie et al., 2020). We find that liberal judge ideology is related to less informative insider sales, consistent with reduced insider trading involving material non-public information. This finding further corroborates our results based on the volume and dollar amounts of opportunistic sales.

Finally, we validate the conjecture that the judge ideology of circuit courts directly affects the outcomes of insider trading litigations. We manually collect a sample of 285 insider trading litigations from the SEC website and find that liberal circuit judge ideology does increase the severity of the penalties for insider trading.¹⁴ Specifically, cases filed in district courts under the most liberal tercile circuit courts incur a 26% higher penalty per dollar of profit compared with those filed in other circuits. This finding validates our assumption that liberal circuit court judge ideology is associated with a higher expected litigation cost of insider trading.

Our paper makes three contributions. First, it highlights the importance of political ideology in the regulation of insider trading. Anecdotal evidence suggests that political ideology plays a role in determining the resources for, and legislation underlying, insider trading enforcement. However, little is known about whether judges' political ideology affects the actual trading decisions of insiders. Building on political theory and legal research that show judge ideology as one of the most important attributes that influence judicial decisions (Pritchard 2013; Murdock 2014), we are the first to investigate its effect on insider trading and document that liberal judge ideology deters opportunistic insider trading. As such, our study provides valuable insights to regulators, investors and academics on the effectiveness of legal enforcement in deterring opportunistic insider trading.

¹⁴ We focus on monetary penalties because the literature finds that judges directly influence the magnitude of monetary penalties for corporate-related crimes (Gormley, Kaviani, and Maleki 2020).

Second, we contribute to the literature on the effect of judge ideology on the financial market. Extant research shows that judge ideology affects firm-level decisions such as voluntary disclosures (Huang et al. 2019). Despite the significant effect of insider trading on capital markets, such as liquidity and cost of equity (Cornell and Sirri 1992; Bhattacharya and Daouk 2002; Beny 2005; Christensen, Hail, and Leuz 2016; Kacperczyk and Pagnotta 2019b), whether corporate insiders consider judge ideology when they make their trading decisions remains unclear. By exploring this question, our study improves the understanding of the effect of political ideology on financial markets, which has implications for capital market participants.

Third, this paper advances our understanding of securities law enforcement. By documenting that the SEC strategically considers judge ideology when it selects forums for its cases, we show how, during the enforcement process, these two branches of the federal government interact to determine the prosecution's outcome.

2. Institutional Background and Literature Review

2.1 Enforcement of Illegal Insider Trading

Insider trading based on material non-public information breaches a fiduciary duty or other relationship of trust and undermines investor confidence in the fairness and integrity of the securities markets (SEC).^{15,16} Insider-trading laws and enforcement activities are intended to deter such trading. Enforcement against insider trading involves all three branches of the U.S. government (legislative, executive, and judicial).

The legislative branch of government passes the laws that govern the securities markets. No single statute prohibits all insider trading in the United States (Henning 2015).¹⁷ Most insider-trading cases are based on violations of broad anti-fraud provisions of securities laws, including fraud in the sale of securities (Section 15 of the Securities Act of 1933) and fraud related to securities trading (Section 10(b) of the Securities Exchange Act of 1934). A few cases are based on Section 16(b) of the Securities Exchange Act of 1934, which prohibits directors, officers, and

¹⁵ For example, see <https://www.investor.gov/introduction-investing/investing-basics/glossary/insider-trading>.

¹⁶ Prior literature such as Demsetz (1986) and Seyhun (1992) argues that insider trading can be seen as a way to compensate controlling shareholders and managers of firm-specific risks and specialized human capital. In this paper, we only examine how judges' political leanings affect insiders' opportunistic trades, and remain neutral about whether insider trading should be illegal.

¹⁷ The Insider Trading Sanction Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988 substantially increased the penalties for insider trading but did not clearly define this behavior.

blockholders with 10% or greater ownership from making short-swing profits, i.e., profits from any purchase or sale within any six-month period.

Regulatory outcomes depend not only on the legislation in play but also on how the executive branch enforces it (e.g., Bhattacharya and Daouk 2002; Djankov et al. 2003). In the United States, the SEC, an independent federal governmental agency, uses rules (primarily Rule 10b-5) and enforcement actions to prosecute illegal insider trading (Bhattacharya 2014).¹⁸ During an enforcement, the SEC's Division of Enforcement first conducts private investigations to collect evidence of wrongdoing.¹⁹ Once sufficient evidence has been collected, SEC commissioners file a case in federal court or bring an administrative action against the insiders (see Section 5.4.2 for a detailed discussion of the SEC's available forums for prosecuting insider trading cases).²⁰

While the SEC is the primary enforcer of insider trading violations, it does not have the final say on which insider trading is illegal. All of the SEC's enforcement actions and decisions are subject to review by the judicial branch. Through its rulings, the federal courts have played a major role in defining illegal insider trading (FINRA Staff 2017).²¹ For example, insider trading was first classified as a securities fraud under the Securities and Exchange Act of 1934 when the Second Circuit ruled in *SEC v. Texas Gulf Sulphur Co.* in 1968; this ruling has become the basis of almost all subsequent insider trading prosecutions (Fairfax 2018).²²

¹⁸ The SEC works closely with other agencies to uncover illegal insider trading. For instance, the Financial Industry Regulatory Authority (FINRA) oversees and examines the business conducted by more than 635,000 brokers and more than 3,900 securities firms within the U.S. public. FINRA's Office of Fraud Detection and Market Intelligence (OFDMI) conducts front-line insider trading surveillance of the U.S. markets. Stock exchanges, such as NASDAQ (<https://www.nasdaqtrader.com/Trader.aspx?id=MarketWatch>) and NYSE (<https://www.nyse.com/regulation>), also monitor insider trading activities and share information with the SEC.

¹⁹ These investigations start with informal inquiries, such as interviewing witnesses, examining brokerage records, and reviewing trading data, and may proceed to formal investigations. Once a formal order of investigation is issued, the division's staff may compel witnesses by subpoena to testify and produce books, records, and other relevant documents.

²⁰ The SEC may call upon the U.S. Department of Justice (DOJ) to conduct an independent parallel investigation. While conducting a civil action, the commission files a complaint with a U.S. District Court and asks for a sanction or remedy. The commission often asks for a court order (i.e., an injunction) that prohibits any further acts or practices that violate the law or the commission's rules. The court may also bar or suspend an individual from serving as a corporate officer or director of the firm. A person who violates the court's order may be found in contempt and be subject to additional fines or imprisonment. If the DOJ finds criminal wrongdoing, it may file criminal charges.

²¹ In addition to the enforcement of insider trading per se, other types of lawsuits may affect the risk of insider trading litigation. These include securities class action litigation (Cheng, Huang, and Li, 2016) and shareholder-initiated derivative lawsuits in state courts where the companies are incorporated (Jung, Nam, and Shu 2021, Adhikari, Agrawal and Sharma 2021).

²² In that decision, the SEC alleged that insider trading violates Section 10b of the Securities Exchange Act of 1934 and SEC rule 10b-5.

Despite the federal courts' importance in enforcement against illegal insider trading, the literature only examines how rulings in previous cases (i.e., legal precedents) influence insiders' trading decisions. For example, Jaffe (1974) and Allen (1990) find that district and circuit court rulings in the Texas Gulf Sulphur (TGS) case reduce the number and profitability of insiders' trades on negative non-public information. Similarly, using the stock-price run-ups of merger targets to capture the extent of insider trading, Patel (2019) finds that insider trading intensifies after the Second Circuit's 2014 ruling in *U.S. v. Newman*, which significantly weakened the threat of insider trading enforcement.

2.2 Ambiguity in Determining Illegal Insider Trading

Even after dozens of enforcement actions and court rulings in insider trading cases, the illegality of many insider trades remains ambiguous. One type of ambiguity involves the materiality of non-public information held by insiders (Horwich 2000; Heminway 2003, 2012; Langevoort 2010).²³ Courts have defined information as material if either (a) "there is substantial likelihood that a reasonable shareholder would consider it important" in trading decisions, or (b) there is substantial likelihood that the information "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available" (see *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) and *Basic Inc. v. Levinson* - 485 U.S. 224, 108 S. Ct. 978 (1988)). Given the diversity in investors, to stipulate how a reasonable investor views a piece of information is not a straightforward task (Heminway, 2003). Even SEC commissioners admit that regulators struggle with the meaning of materiality (Atkins 2008).²⁴ Indeed, as Langevoort (2013) observes, "Materiality is one of the hardest fact determinations in the securities laws."

Another type of ambiguity stems from whether insiders *use* material non-public information in their trading decisions or simply possess the information while trading. Courts have ruled that although defendants' possession of information creates a strong inference that the information would be used in trading, defendants can rebut the inference by showing that they do

²³ Courts have also disagreed on whether a piece of information is considered non-public when it has been leaked but not disseminated to the general public (Sinai 2000).

²⁴ In a speech to the Practicing Law Institute, former SEC commissioner Paul S. Atkins stated that "one of the most glaring examples of lack of predictability is determining what constitutes materiality," and that "issuers, investors, and regulators have struggled with applying the materiality test since the enactment of the securities laws" (Atkins 2008).

not use the information in trading (Langevoort 2013, *SEC v. Adler*, 137 F.3d 1325, 11th Cir. 1998).^{25,26}

Such ambiguities give judges leeway to exercise personal discretion. As Henderson, Jagolinzer, and Muller (2014) comment, “The result of executive agency ambiguity layered on top of congressional ambiguity is judicial power to decide what is and what is not illegal.” As such, judges’ personal preferences can influence the expected litigation costs and, in turn, insiders’ trading decisions.

3. Judge Ideology and Opportunistic Insider Trading

Legal research defines ideology along the conventional liberal-to-conservative continuum in U.S. politics. Liberals generally believe in taking government actions to achieve equality for all and to protect civil liberties and individual rights. In economic cases, they are more protective of “have-nots” than of “haves,” more likely to emphasize market failures, and more likely to assert investors’ inability to fend for themselves (Lind, Rankin, and Harris 2016). Liberals support more regulations on the free market (e.g., government intervention in the capital market), to protect “innocent” investors who might suffer damages as a result of securities fraud or a breach of fiduciary duties. In contrast, conservatives generally believe in limited government and emphasize individuals’ having the power to solve their own problems. They are more inclined to view the market as efficient and to advocate for less regulation (McCraw 2009). Given such beliefs, conservatives are less likely to accept that investors (a) hold less information than companies and financial institutions and (b) require the protection afforded by securities laws.

The ideological differences between liberals and conservatives manifest themselves in the groups’ respective attitudes towards insider trading (Pritchard 2013; Murdock 2014). As insiders benefit from private information and take advantage of uninformed traders (Fishman and Hagerty 1992; Bhattacharya and Daouk 2002; Benny 2005), liberals prefer stricter enforcement against insider trading than conservatives do. Consistent with the importance of political ideology in insider trading enforcement, Cline and Posynaya (2019) find that an SEC Committee with a Democratic majority is associated with a higher likelihood of detecting illegal insider trading. In

²⁵ In *SEC v. Adler*, the Eleventh Circuit stated, “We believe that the use test best comports with precedent and Congressional intent, and that mere knowing possession – i.e., proof that an insider traded while in possession of material nonpublic information – is not a per se violation” (*SEC v. Adler*, 137 F.3d 1325 (11th Cir. 1998)).

²⁶ The SEC also needs to show that there are “unusual” and “suspicious” levels of insider trading, criteria that are subjective and hard to define precisely (Bainbridge and Gulati 2002).

the context of the judicial branch, Fedderke and Ventoruzzo (2015) find that Supreme Court justices with a liberal ideology (i.e., those appointed by Democratic presidents) are more likely to vote for decisions that favor strict securities regulations (including insider trading prohibition) than are justices with a conservative ideology (i.e., those appointed by Republican presidents).

Federal judges' personal preferences are likely to affect insiders' trading decisions. As argued in the seminal work in Becker (1968), the decision to commit a crime is based on an assessment of the expected benefits and costs of the commission. When faced with more liberal judges, insiders who wish to trade based on nonpublic material information perceive higher expected costs due to potentially adverse outcomes of legal trials. Furthermore, because courts are the final arbiters of insider trading enforcement, liberal judges can even increase the expected costs of insider trading associated with cases that are handled *administratively*. For example, during a settlement negotiation, the accused insiders and the SEC each estimate their chances of a favorable court outcome and factor them into their willingness to settle out-of-court. The circuit court judges' political leanings are likely to play a role in these calculations (Waldfogel 1995).²⁷ We conjecture that because liberal judges increase the expected costs of opportunistic insider trading (regardless of venue), they make insiders less likely to engage in it.

4. Variable Definition and Research Design

4.1 Definition of Main Variables

4.1.1 Judge ideology

We focus on the ideology of circuit court judges for two reasons. First, although all federal cases start at the district courts, the judges on these cases tend to follow the ideologies of the local circuit courts (Randazzo 2008; Choi, Gulati, and Posner 2012). This is because district court decisions are subject to mandatory and routine reviews by circuit courts; i.e., circuit courts must review the appeals from district courts. During a review, a circuit court may disagree with and reverse a district court judge's decision and send the case back to the district court; this increases the district court judge's workload and can damage her reputation (Schanzenbach and Tiller 2007).

²⁷ In addition, the SEC Whistleblower Reward Program (WRP), implemented as part of the Dodd–Frank Act in 2011, uses monetary payments to encourage whistleblowers to provide information on insider trading activity (Raleigh 2020). The higher penalties resulting from more liberal judge ideology would lead to larger rewards for whistleblowers. This could incentivize more informants to report to the SEC, which would increase the likelihood of enforcement actions under liberal judges.

Moreover, according to the legal doctrine of *stare decisis*, circuit court rulings have binding constraints on the district courts under their jurisdiction. Therefore, district court judges must consider the positions of the overseeing circuit courts when making their decisions (Schanzenbach and Tiller 2007; Knight and Gulati 2018). Second, although the Supreme Court is the highest federal court and has the last word in federal lawsuits, it reviews appeals selectively due to its heavy case load. Less than 1% of all appeals – and very few insider trading cases – are heard by the Court (Bowie and Songer 2009). Cross (2007, page 2) notes that “the circuit courts play by far the greatest legal policy-making role in the United States judicial system.” Therefore, we expect the ideology of judges at this level to have the greatest impact on the expected outcomes of federal court cases and thus the greatest relevance for the trading behavior of corporate insiders.

To measure how liberal the circuit court judges are, we follow Huang et al. (2019) and use the probability that a three-judge panel randomly selected from that court has at least two judges who were appointed by Democratic presidents (*LiberalCourt*).²⁸ We obtain data on circuit court judge composition and the party of the appointing president from the Federal Judicial Center. We use the circuit judge composition during a calendar year to measure the predicted judicial ideology regarding lawsuits involving insider trading that year.²⁹ Specifically, for each firm-calendar year observation, we use the average monthly *LiberalCourt* value of the circuit where the firm’s headquarters are located during the calendar year (hereafter, home circuit).³⁰

We define home circuits using firms’ headquarters for two reasons. First, in insider trading cases, the district where the defendant resides has jurisdiction over the case (15 U.S. Code § 78u–1 and 15 U.S. Code § 78aa). Second, we assume that a company’s executives reside in the same circuit as its headquarters. We base this assumption on an observation by Liu and Yermack (2012) that among S&P 500 firms, the median distance between a CEO’s home and the company headquarters is 13.6 miles. This is consistent with a pattern wherein most CEOs reside in the same

²⁸ As federal judge appointments must be confirmed by the U.S. Senate, the president may consider the partisan distribution in the Senate when nominating judges. In a sensitivity test, we follow Huang et al. (2019) and define an alternative judge ideology measure that uses both the President’s party affiliation and the Senate’s partisan makeup and obtain similar results (tabulated in Internet Appendix Table IA1).

²⁹ In robustness tests, we obtain consistent results when we use the judge ideology at the beginning of the calendar year or during the next one or two calendar years (tabulated in Internet Appendix Table IA1).

³⁰ In a robustness test, we restrict our sample to firms that have never changed their headquarters location during the sample period and obtain consistent results (tabulated in Internet Appendix Table IA2).

circuit as the company headquarters.³¹ We do not include directors in our analyses because they – especially independent directors – are more likely to live out of state; thus, we cannot determine their court jurisdiction.

4.1.2 Opportunistic Insider Trades

Insiders trade for various reasons, such as to fund personal expenditures, diversify their portfolios, or profit from material non-public information. Trades that profit from material non-public information are the most likely to violate securities laws (and thus be affected by judge ideology), so they are the focus of this paper. To identify trades that are driven by private information, we look for deviations from the insiders' trading history (hereafter, opportunistic trades), following research by Cohen et al. (2012) and others.^{32,33} Specifically, we classify a trade as opportunistic if the insider has not placed a trade in the same direction in the same month during each of the three preceding calendar years. We exclude insider-year observations in which the insider has not placed at least one trade in each of the three preceding calendar years. We define the nature of insider trading at the *trade* level to allow a given trader to have both opportunistic and non-opportunistic (hereafter, routine) trades (e.g., Bricker and Markarian 2015; Billings and Cedergren 2020; Lin et al. 2020).³⁴ Next, we aggregate the opportunistic insider purchases in each firm-calendar year by both the number and the dollar value of shares traded, then do the same for opportunistic insider sales. Consistent with prior studies (e.g., Cheng et al. 2016; Billings and Cedergren 2020), we scale (a) the number of shares traded by the shares outstanding at the beginning of the calendar year, and (b) the dollar value traded by the market value of equity at the

³¹ We check a sample of insider trading cases involving employees during 2017 and 2018, and note that 19 (86%) of the 22 cases are filed in the home circuits. Of the remaining three cases, one involved an employee working outside of company headquarters, one involved an employee who moved, and one involved an employee who lived in Connecticut while working in New Jersey. We further note that if executives do not live in the home circuit, this assumption introduces noise to our empirical measure and should bias our findings towards insignificant results.

³² Note that opportunistic trades are an ex ante measure of illegal insider trading. Although prosecuted cases could be an alternative ex post measure of illegal insider trading, we avoid using them for two reasons. First and most importantly, judge ideology likely affects both insider trading commitment and detection; as a result, the use of prosecuted cases makes it difficult to disentangle the effect of judge ideology on insider trading commitment. Second, prior literature finds that the prevalence of illegal insider trading is significantly greater than the number of prosecuted cases (Patel and Putniņš 2021). Thus, focusing only on prosecuted cases would severely underestimate the effect of judge ideology.

³³ Cohen et al. (2012) show that opportunistic trades are more informative of firms' future returns than other trades and are more likely to be subject to SEC enforcement action.

³⁴ In a sensitivity test, we use a two-step procedure to identify opportunistic trades. First, we classify an insider who has not placed a trade, regardless of direction, in the same month during any of the three preceding years as an opportunistic trader. Next, we label all trades placed by opportunistic traders as opportunistic trades. Using this alternative definition of opportunistic trades, we obtain similar results as those in our main analyses (tabulated in Internet Appendix Table IA3).

beginning of the year.³⁵ Following this procedure, we obtain four measures—*#OppBuy*, *\$OppBuy*, *#OppSale*, and *\$OppSale*—that capture the number and dollar value of shares purchased and the number and dollar value of shares sold, respectively.

4.2 Research Design

To test the effect of judge ideology on insider opportunistic trading decisions, we estimate the following Tobit model at the firm–calendar year level:³⁶

$$Opp_Trade_{i,t} = \beta_0 + \beta_1 LiberalCourt_{i,t} + Controls + Industry\ FE + Year\ FE + Circuit\ FE + \varepsilon_{i,t}, \quad (1)$$

where *Opp_Trade* includes *#OppSale*, *\$OppSale*, *#OppBuy*, and *\$OppBuy*. We predict a negative coefficient for *LiberalCourt*, the variable of interest. *Controls* consists of firm- and macro-level variables that might confound the relation between judge ideology and insider trading. First, we control for firm-level characteristics. We include firm size (*Size*, the natural logarithm of market value of equity), because insiders at small firms are more likely to buy and insiders at large firms are more likely to sell (Cheng and Lo 2006; Huddart, Ke, and Shi 2007; Cheng, Huang, and Li, 2016); market-to-book ratio (*MtoB*), because insiders from growth firms tend to sell and insiders from value firms tend to buy (Cheng and Lo 2006; Huddart, Ke, and Shi, 2007; Cheng, Huang, and Li, 2016); trading volume (*Turnover*, proportion of shares traded over the year), because an increase in trading raises the likelihood that an informed trade goes unnoticed (Thevenot 2012); prior return (*PriorReturn*, buy-and-hold abnormal returns over the previous year), to control for firm performance and the tendency of insiders to be contrarians (Rozeff and Zaman 1998; Lakonishok and Lee 2001; Cheng and Lo 2006); and the natural logarithm of the total number of shares held by insiders at the end of the last year (*SharesHeld*). Second, we control for demographic variables that may be correlated with both judge ideology and insider trading: state economic growth (*GDPGrowth*), state-level unemployment rate (*Unemployment*), and the political leanings of states where firms are headquartered (*BlueState*). Detailed definitions of these variables are provided in the Appendix.

³⁵ Our results are robust if we scale the number of opportunistic trades by the total number of trades (i.e., the sum of opportunistic and routine trades) and scale the dollar value of opportunistic trades by the total dollar value of trades (i.e., the sum of opportunistic and routine trades) (tabulated in Internet Appendix Table IA3).

³⁶ We use Tobit models to estimate Equation (1) and other equations with insider trades as the dependent variables because the insider trading variables are left-censored at zero. We obtain consistent results if we use OLS regressions or estimate a logit model (tabulated in Internet Appendix Table IA4).

We include year fixed effects to control for macroeconomic conditions and other time-varying market-wide factors (such as regulatory environment related to the president, the SEC, and the financial markets). We also control for industry fixed effects (based on two-digit SIC codes), as some industries may have more material non-public information. We include circuit fixed effects to mitigate concerns about omitted correlated variables at the circuit level.³⁷ Following Huang et al. (2019), we report t -statistics based on standard errors clustered by the state where a firm’s headquarters are located.³⁸

5. Empirical Analyses and Results

5.1 Sample Selection and Descriptive Statistics

We report the sample selection procedure in Panel A of Table 1. We begin with 60,388 firm-calendar years for which executives’ insider-trading transactions are covered by Thomson Reuters Insider Filing Data files over the 1998–2018 period.³⁹ We include trades made by executives through both their own accounts and accounts they control.⁴⁰ Following the literature (e.g., Cheng and Lo 2006; Huddart et al. 2007; Skaife et al. 2013), we limit the transactions to open market purchases and sales and exclude non-open market transactions, such as option grants and exercises. We further eliminate three types of firm-year observations: ones of penny stocks (those with prices less than \$2 at the beginning of each calendar year), ones that lack sufficient historical insider trading data to enable determination of opportunistic trades (see Section 4.1 for details), and ones that are missing the data needed to construct the control variables. Our final sample includes 18,927 firm-year observations from 4,109 unique firms.

Panel B of Table 1 reports the sample distribution and mean judge ideology (*LiberalCourt*) value by circuit. A large proportion (24.93%) of firms are headquartered in the Ninth Circuit;

³⁷ We obtain consistent results when we include industry fixed effects or replace circuit fixed effects with firm fixed effects in the model (tabulated in Internet Appendix Table IA4).

³⁸ Standard errors are clustered by state rather than by circuit because a low number of clusters may bias the critical values used for rejecting the null hypothesis (Cameron, Gelbach, and Miller 2008). We find similar results (untabulated) when standard errors are clustered by circuit. Our results are also robust to clustering standard errors by both state and year, by firm, or by both firm and year. In addition, we follow Conley et al. (2018) and adopt a Fama–MacBeth-style sample-splitting approach. Specifically, we first purge the year effects from the variation in the variables used in Equation (1). We then estimate the regression for each of the 12 circuits and test whether the 12 estimated coefficients differ from zero. We obtain consistent results using this approach (untabulated).

³⁹ We start our sample period in 1998 because Thomson Reuters Insider Filing data have spotty coverage prior to 1995, and we need the three preceding years of trading history to identify opportunistic trades.

⁴⁰ The SEC requires insiders to file any indirect trades they place through accounts they control, including accounts held by family members and accounts related to retirement, foundations, and trusts.

relatively few are headquartered in the Tenth and D.C. Circuits (3.91% and 0.39% respectively).⁴¹ Firms are relatively evenly distributed among the remaining circuits. In our sample, the mean *LiberalCourt* value is 0.407, indicating a 40.7% chance that a three-judge panel randomly drawn in a firm's home circuit would be dominated by liberal judges. The mean *LiberalCourt* varies greatly across circuits, ranging from 0.144 in the Eighth Circuit to 0.636 in the Ninth Circuit. Panel C of Table 1 reports the sample distribution and associated *LiberalCourt* by year. The mean *LiberalCourt* increases from 0.384 in 1998 to 0.463 in 2001, decreases to 0.324 in 2009, then increases steadily to 0.490 in 2017.

Importantly, the judge ideologies of different circuits do not change in tandem. During the same period, some circuits become more liberal while others become more conservative. This is due to differences, between circuits, in (a) the numbers of retiring judges and their dates of retirement, (b) the presidents who appointed the retiring judges, (c) whether the current president could successfully appoint a new judge, and (d) when the new appointment(s) occurred.⁴² For instance, in 2007, during the second term of President George W. Bush, a Republican, most circuits became more conservative; the Fourth Circuit, however, became more liberal because two judges appointed by former Republican presidents left the court (due to death and retirement, respectively) and their vacancies were not filled that year.

Panel A of Table 2 reports the descriptive statistics for the variables used in our main analyses. On average, executives sell 0.195% and buy 0.021% of the outstanding shares of their firms (0.225% and 0.017% of market value of equity, respectively). The considerably larger proportion of insider sales relative to insider purchases is in line with the pattern documented in prior literature (e.g., Lakonishok and Lee 2001; Rodgers 2008; Brochet 2010; Cohen et al. 2012; Skaife et al. 2013; Cheng et al. 2016) and consistent with insiders liquidating the equity they receive as compensation. Our sample firms have an average total market capitalization of \$1,376 million and market-to-book ratio of 3.58.

Panel B of Table 2 presents the Pearson and Spearman correlations of the variables. We observe weak correlations between *LiberalCourt* and firm characteristics, suggesting that

⁴¹ In a sensitivity test, we exclude firms in the Second and Ninth Circuits – the two circuits with relatively high proportions of liberal judges and high percentages of large firms – and find similar results as in the main test (tabulated in Internet Appendix Table IA2).

⁴² The time-series average of the standard deviation in the change in ideology across circuits is 0.032, which is comparable to the average absolute time-series change in ideology in circuit-years (0.029).

variations in judge ideology are relatively exogenous to firm-level economic conditions. We similarly observe weak correlations between the control variables, indicating that multicollinearity is not a significant concern in our regressions.

5.2 The Effect of Judge Ideology on Insider Trading

Table 3 reports the results of estimation using Equation (1), which tests the effect of judge ideology on insider trading. The dependent variables in Columns (1), (2), (3), and (4) are the scaled numbers and dollar values of shares sold and the scaled numbers and dollar values of shares purchased, respectively.

We find a negative relation between *LiberalCourt* and insiders' opportunistic sales, with both estimated coefficients in Columns (1) and (2) statistically significant at the 1% level. This is consistent with our prediction that corporate insiders engage in fewer opportunistic sales when judge ideology in their home circuit is more liberal. In terms of economic significance, a one-standard-deviation increase in *LiberalCourt* (i.e., more liberal judge ideology) is associated with a 3.8% (4.8%) reduction in *#OppSale* (*\$OppSale*), or approximately 19.5% (21.3%) of the unconditional mean of *#OppSale* (*\$OppSale*).⁴³ We next illustrate this economic effect using the actual change in judge ideology in a circuit. Due to the retirements of judges and appointments of six new judges by President Obama, the Fourth Circuit became more liberal over the 2009–2017 period, as corroborated by an increase in *LiberalCourt* from 0.355 to 0.684. An average firm in the circuit experiences a reduction in opportunistic insider selling that amounts to 0.04% of outstanding shares (26.6% in relative terms) or 0.06% of market value of equity (33.6% in relative terms).

However, we do not find a significant relation between judge ideology and opportunistic insider purchasing (i.e., *#OppBuy* and *\$OppBuy*). This finding is consistent with the primary focus of regulatory enforcement being corporate executives' illegal insider sales and with insiders

⁴³ In untabulated analyses, we subclassify trading activities by executive type and find a stronger disciplinary effect of liberal judges on insider selling activities for non-CEO officers than for CEOs. One potential explanation is that CEOs who are found to trade on material non-public information have higher reputational costs; thus, the litigation costs may not have a significant additional deterrent effect. We also find that liberal judges deter not only trades in insiders' own accounts but also transactions in indirect accounts controlled by insiders (e.g., those owned by their relatives), consistent with a proposition, in prior literature (e.g., Goldie, Jiang, Koch, and Wintoki, 2020), that indirect accounts may represent a channel through which corporate insiders conduct and camouflage information-based trading.

consequently being less likely to consider judge ideology when *purchasing* shares.⁴⁴ Therefore, in our subsequent analyses, we limit our focus to the effect of judge ideology on insider sales.

Generally, the estimated coefficients on the control variables are consistent with our expectations and the literature. For example, the coefficients on *MtoB*, shown in Columns (1) and (2), are positive and significant, consistent with higher sales among insiders at growth firms than among insiders at value firms. The coefficients on *PriorReturn* are positive for insider sales and negative for insider purchases, consistent with the contrarian tendencies of insiders (Rozeff and Zaman 1998; Lakonishok and Lee 2001).

To ascertain the robustness of our results, we perform several sensitivity tests. First, we control for the risk of state derivative securities litigation – a possible deterrent of insider trading – by including fixed effects of the interaction between the firms’ state of incorporation and year (Jung et al. 2021; Adhikari et al. 2021). Second, we control for the total compensation of the top five executives (because personal wealth may influence an insider’s trading decisions), the likelihood that the top five executives will be targeted by regulators, and the intensity of pursuit of such a case. Third, we control for corporate political ideology by including two variables that capture the amounts of individual donations to Democrats or Republicans, both aggregated at the firm-year level.⁴⁵ Fourth, while the year dummies included in Equation (1) effectively control for the ideology of the president and the SEC, we estimate a specification in which we exclude year fixed effects and separately control for the partisanship of the president, the SEC chairman, and the SEC commissioners. All four of these robustness tests yield similar results as the main test (tabulated in Internet Appendix Table IA5 and IA6). As a fifth robustness check, we use a short-window test to examine how changes in judge ideology affect the intensity of opportunistic insider trading. We find that opportunistic insider sales increase as the judge ideology of the home circuit becomes more conservative (tabulated in Internet Appendix Table IA7).⁴⁶

⁴⁴ We find that, in a sample of 197 SEC enforcement actions against illegal insider trading by corporate executives from 1996 to 2018 from the SEC’s website, the majority (83.2%) of actions involve both insider sales and purchases (34.0%) or only insider sales (49.2%). Only 16.8% target only insider purchases. The SEC’s preoccupation with insider sales may exist because investors display more outrage over insider sales prior to stock price drops than over insider purchases prior to stock price increases (Eth and Dicke 1994; Cheng and Lo 2006; Dai et al. 2016).

⁴⁵ We thank Ahmed Tahoun for sharing political donation data, which have a time-series of 2002–2015.

⁴⁶ Specifically, we first identify circuit-months with changes in court ideology and define an indicator variable that equals one if the court ideology becomes more conservative and zero otherwise. We then calculate the change in either the number or the dollar amount of opportunistic sales for firms located in those circuits from three months before to three months after the change in court ideology. We regress the change on the indicator variable and find positive coefficients that are significant at least at the 10% level.

Next, we further examine the effect of judge ideology on the subset of opportunistic insider sales that occur prior to large stock price declines. We focus on these trades for two reasons. First, they likely occur when insiders hold material non-public information, which reduces the measure error of identifying opportunistic trades. Second, the SEC is more likely to pay attention to these trades, which increases the likelihood that insiders will be prosecuted for them in the federal courts. Indeed, Meulbroek (1992) and Kacperczyk and Pagnotta (2019a) show that the illegal insider sales prosecuted by the SEC usually precede events associated with stock price declines, such as negative earnings, bankruptcies, and financial fraud. Following Marin and Olivier (2008), we define a firm as experiencing a significant stock price decline in a month if the firm's excess return during the month (raw return minus the CRSP value-weighted market portfolio return) is more than two standard deviations below the average excess monthly return over the prior 60 months.

We re-estimate Equation (1) using the measures of insider sales and judge ideology calculated based on the six months prior to firm-months with significant stock price declines. The regression results are reported in Table 4. We find similar results as those in Table 3, but with greater economic magnitudes: a one-standard-deviation increase in *LiberalCourt* is associated with a 21% (26%) decrease in *#OppSale* (*\$OppSale*), relative to the average value of *#OppSale* (*\$OppSale*).

Taken together, our findings support the prediction that corporate insiders consider judge ideology when making trading decisions. Insiders are less likely to sell opportunistically, especially prior to significant stock price declines, when the judge ideology in the home circuit is more liberal.

5.3 The Effect of Judge Ideology on Insider Trading: Cross-sectional Analyses

As discussed in Section 5.2, insiders are less likely to trade opportunistically when they expect higher litigation costs due to liberal judges. To support the underlying mechanism, in this section we identify three situations where insiders are more likely to be sued for illegal insider trading and where, as a result, judge ideology should have a larger influence.

The first two situations concern firms in financial distress and firms with accounting misconduct. Cox et al. (2003) and Thevenot (2012) find that the SEC is more likely to take enforcement actions against such firms. The extra attention from investors and regulators should increase the likelihood that opportunistic insider trading is prosecuted. If corporate insiders in these firms expect that they are more likely to be sued for insider trading, they may put more weight on

judge ideology when they make their trading decisions. The third situation involves firms with stronger corporate governance. Governance mechanisms, including internal investigations and whistleblower actions, could help regulators to prosecute opportunistic insider trading by facilitating evidence collections (Meisner 2004; Dyck, Morse and Zingales 2010; Henning 2018). We expect that stronger governance increases the likelihood that insider trading cases will be litigated in court and thus increases the effect of judge ideology on trading decisions. Note that in these three cross-sectional tests, we focus on whether the effect of judge ideology on insiders' trading decisions *becomes stronger* rather than on the direct effects of these situations on insider trading.

Empirically, we use Altman's Z Score (Altman 1968) to measure financial distress. A lower Altman's Z Score indicates a higher likelihood of bankruptcy. We define an indicator variable (*Distress*) that equals one if a firm's Altman's Z score falls in the bottom decile and zero otherwise. To measure accounting misconduct, we define an indicator variable (*Fraud*) that equals one if a firm has committed accounting misconduct that affects its financial results from the prior year and is later subject to enforcement actions by the SEC, as reported in Accounting and Auditing Enforcement Releases (AAER). We capture corporate governance (*CorpGov*) using the Entrenchment Index (E-Index) of Bebchuk, Cohen, and Ferrell (2009) multiplied by negative one. The E-Index measures the degree of restrictiveness of shareholder rights by counting the number of relevant governance provisions. We then re-estimate Equation (1) by including these three variables, one at a time, and their interactions with *LiberalCourt*. We expect to obtain negative coefficients on the interactions.

Table 5 reports the findings of the tests. For each partition variable, we examine two dependent variables – the number and dollar amount of opportunistic sales. In Columns (1) and (2), the coefficients on *LiberalCourt* \times *Distress* are negative and significant at the 5% level, suggesting that corporate insiders in financially distressed firms view liberal court ideology as a greater deterrent to opportunistic trading behaviors. Economically, the effect of *LiberalCourt* on *#OppSale* is 72.19% (0.122/0.169) greater for financially distressed firms than for non-distressed firms. We obtain similar results in Columns (3) and (4) for firms with accounting misconduct. The effect of *LiberalCourt* on *#OppSale* is 2.5 times (0.585/0.235) greater for firms with accounting misconduct than for firms without such misconduct. In Columns (5) and (6), which study the interaction effect of corporate governance and judge ideology, the effect of *LiberalCourt* on

#OppSale is 13.67% (0.035/0.256) greater for firm-years involving stronger governance than for other firm-years. This indicates that, consistent with our prediction, corporate insiders at firms with a stronger corporate governance system are more concerned with liberal judge ideology when they make their trading decisions. Collectively, the results in this section suggest that insiders who are more likely to be sued for illegal insider trading are more strongly affected by judge ideology.

5.4 The Effect of Judge Ideology on SEC Forum Selection

In this section, we study the interplay between the SEC and the judiciary to further our understanding of the role of judge ideology in insider trading enforcements. Specifically, we examine whether the SEC considers judge ideology in its choice of forum when pursuing insider trading cases.

The SEC, the main regulatory agency prosecuting illegal insider trading, strives to win the cases it brings. Losing a case exposes the SEC to criticism from Congress and the media (GAO 2013), damages the reputation and career prospects of the SEC attorney (DeHaan, Kedia, Koh, and Rajgopal 2015), and emboldens other insiders to pursue opportunistic trades.⁴⁷ The SEC can choose between two trial venues when it pursues insider trading cases: administrative proceedings and the federal courts. The two trial venues differ in several aspects. In administrative proceedings, the case is adjudicated by an administrative law judge (hereafter, ALJ) who is employed by the SEC, whereas in federal district court the case is adjudicated by a federal judge. Federal judges preside over a variety of case types (both civil and criminal), but ALJs focus exclusively on SEC enforcement actions and thus have more expertise in this area. Administrative proceedings also provide a quicker resolution because SEC rules mandate an initial decision within 300 days. In contrast, federal court cases can sometimes take years. An ALJ decision can be appealed to the SEC commissioner and, if lost, to the circuit court with jurisdiction.

We expect the SEC to choose the litigation venue based on its odds of winning the case.⁴⁸ That is, the commission will be more likely to prosecute violations in a federal court as opposed to an administrative proceeding when its odds of winning in court are relatively high, i.e., when

⁴⁷ GAO, Securities Exchange Commission: Improving Personnel Management Is Critical For Agency's Effectiveness, GAO-13-621, at 36 (July 2013), (<https://www.gao.gov/assets/660/655989.pdf>), Page 15 ("senior officers and staff surveyed remarked that recent enforcement failures and related, sustained criticism ... has contributed to their unwillingness to take risk and innovate.").

⁴⁸ For example, Hume (2009) finds that federal administrators can be contemptuous of judges who might have ruled against them for ideological reasons. In his survey with federal administrators, one administrator showed disapproval of "conservatives on the D.C. Circuit who are critical of the agency with some consistency."

the circuit court that has jurisdiction is more liberal.⁴⁹ To test this prediction, we manually collect all SEC insider trading enforcement actions from the SEC website. These include 752 civil litigation releases and 386 administrative proceeding releases, which represent 546 unique civil cases (filed in federal district courts) and 331 unique administrative cases from 1998 to 2018, respectively. Following our main tests and to obtain the circuit court with jurisdiction over the defendants, we focus on executives of publicly traded companies who are trading stocks of their own companies; this reduces the sample to 97 civil cases and 28 administrative cases from the 1998–2018 period.⁵⁰ We use these cases as a sample to examine the effect of judge ideology on the SEC’s choice of forum for the case. We estimate the following Probit model:

$$FederalCourt_{i,t} = \beta_0 + \beta_1 LiberalCourt_{i,t-1} + Controls + Year FE + Circuit FE + \varepsilon_{i,t}, \quad (2)$$

where $FederalCourt_{i,t}$ is an indicator variable that equals one if an insider trading case is filed in a federal court and zero if the case is submitted for an internal SEC administrative proceeding. $LiberalCourt_{i,t-1}$ represents the judge ideology of the insiders’ home circuits in the year preceding the public announcement of the enforcement.⁵¹ As discussed in the introduction, district court judges typically follow the ideology of the circuit court (Schanzenbach and Tiller 2007; Knight and Gulati 2018). Therefore, we use circuit court ideology to measure the leaning of the district court in this test.⁵² Consistent with our main test and following the prior literature (e.g., Zheng 2021), we control for firm size, leverage, market-to-book ratio, turnover, prior market-adjusted returns, demographic variables ($GDPGrowth$, $Unemployment$, and $BlueState$), the number of defendants in the case, whether the case was filed in September (the last month of the SEC’s fiscal year), the number of SEC enforcement actions initiated during the fiscal year, the year-over-year percentage change in the SEC’s authorized budget, and circuit and calendar-year fixed effects.

The results from an estimation using Equation (2) are reported in Table 6. Note that the number of observations is smaller than in our initial sample of cases from the SEC website because the inclusion of year and circuit fixed effects removes years and circuits without variation in the

⁴⁹ When an ALJ ruling is appealed to the circuit court, the circuit court usually defers to the ALJ’s ruling unless the ALJ did not have “substantial evidence” to reach its conclusion.

⁵⁰ To narrow our focus to the selection of one forum over the other, we exclude four cases in which the SEC pursued enforcement actions simultaneously in federal courts and through administrative proceedings.

⁵¹ The median gap between the final year when insider trading occurred and the SEC’s filing of a civil lawsuit or an SEC administrative proceeding is three years and two years, respectively. Although we cannot identify the exact date when a forum for the case is determined, we believe it is reasonable to assume that the SEC makes its decision during the year before the lawsuit or proceedings.

⁵² Consistent with this argument, we find insignificant results when using district court judge ideology in this test.

dependent variable. In Column (1), we find that, consistent with our prediction, the SEC is more likely to pursue federal court actions as opposed to administrative proceedings when the federal court is more liberal. In terms of economic magnitude, an increase in *LiberalCourt* from Q1 to Q3 (from 0.328 to 0.651) more than doubles the odds of the SEC selecting a federal court as the prosecution venue (from 35.90% to 81.60%). These results suggest that judge ideology plays a significant role in the SEC’s choice of the forum in which to prosecute illegal insider trading.

We further test whether the effect of judge ideology on forum selection has become stronger since 2010. In that year, the Dodd–Frank Act expanded the SEC’s authority to pursue civil penalties through administrative proceedings against all entities, including executives in publicly traded companies, giving the agency greater flexibility to choose between administrative proceedings and federal court litigation.⁵³ Accordingly, we expect the effect of judge ideology on forum selection by the SEC to be more pronounced after 2010. To test this conjecture, we estimate Equation (3) adding the interaction of *LiberalCourt* and *Post2010*, where *Post2010* is an indicator variable that equals one if the enforcement was taken after 2010 and zero otherwise. The results in Column (2) of Table 6 show that the coefficient on *LiberalCourt* \times *Post2010* is positive and significant at the 1% level, confirming our prediction that the SEC is more likely to consider judge ideology in its forum selection processes after 2010.

5.5 Judge Ideology and the Return Predictability of Insider Trades

Our main analyses so far focus on the volume and dollar amount of trades. As an alternative measure of an insider’s trading decision, we investigate the information content of insider sales. Presumably, a more profitable trade contains more private information, indicating a more aggressive move by the insider to earn private benefits. Specifically, we examine whether judge ideology is associated with the predictability of insider trades with respect to future stock performance (e.g., Akbas et al., 2020; Goldie et al., 2020) by estimating the following equation:

$$\begin{aligned} Abnormal_Return_{j,t+1} = & \beta_0 + \beta_1 SaleSize_{i,j,t} + \beta_2 LiberalCourt_{j,t} \times SaleSize_{i,j,t} + \beta_3 LiberalCourt_{j,t} \\ & + Controls + Month\ FE + Firm\ FE + \varepsilon_{i,j,t} . \end{aligned} \quad (3)$$

Following prior studies (Akbas et al. 2020; Goldie et al. 2020), we measure future stock price performance, *Abnormal_Return*_{*j,t+1*}, as the Fama–French four-factor alpha, in percentage

⁵³ Prior to 2010, the SEC could only issue civil penalties against entities and individuals that were under its direct regulation. These included securities exchanges, brokers, dealers, investment companies, investment advisors, and auditors, according to the Securities and Enforcement Remedies and Penny Stock Reform Act of 1990 (Zheng 2021). However, most publicly traded companies (and their personnel) were not directly regulated.

terms, for firm j in month $t+1$ following the month t in which insider i trades. $SaleSize_{i,j,t}$ is the tercile rank of the number of shares sold by insider i of firm j in month t divided by total trading volume of the firm-month. $LiberalCourt_{j,t}$ is the measure of judge ideology in the circuit court with jurisdiction over firm j in month t . To facilitate interpretation, we also estimate a version in which $LiberalCourt_{j,t}$ is replaced with an indicator variable, $High_LiberalCourt_{j,t}$, that equals one if judge ideology is in the top tercile in our sample and zero otherwise. The control variables include firm size, market-to-book ratio, stock return in month t , cumulative stock return from month $t - 12$ to $t - 1$, gross profits, asset growth, volatility of daily stock returns in month t , and demographic variables as defined previously (i.e., $GDPGrowth$, $Unemployment$, and $BlueState$). We include firm and month fixed effects and cluster standard errors by month. We expect β_1 to be negative and β_2 to be positive if insider sales are predictive of future returns and if liberal judge ideology reduces information-based insider sales.

Table 7 reports the regression results. In Column (1), we include only the rank of insider sales size ($SaleSize_{i,j,t}$) along with the control variables. The coefficient on $SaleSize_{i,j,t}$ is negative and statistically significant, indicating that insider sales predict – and thus contain information about – future negative stock returns. In Columns (2) and (3), we find a positive and significant coefficient on the interaction of $LiberalCourt_{j,t}$ (or $High_LiberalCourt_{j,t}$) and $SaleSize_{i,j,t}$. Economically, the most liberal circuit court tercile is associated with a 45% ($0.310/0.685$) reduction in predictive power of insider sales, relative to the other two terciles. Taken together, our findings suggest that liberal judge ideology reduces the likelihood that insiders trade profitably, consistent with insiders changing their trading behavior to avoid higher expected litigation costs. This finding corroborates our results in Section 5.2 by using the volume and dollar amount of opportunistic sales.

5.6 Judge Ideology and Insider Trading Penalty

In motivating our hypothesis, we assume that judge ideology influences the outcomes of insider trading cases filed in federal courts. This assumption has a theoretical foundation in political science and legal research and is empirically supported – indirectly – by Supreme Court securities regulation cases that *include* insider trading (e.g., Fedderke and Ventoruzzo, 2015). However, none of the extant empirical evidence supporting our assumption is based on cases that solely deal with insider trading. In this section, we provide direct evidence to validate our

assumption. Specifically, we examine whether liberal judge ideology is associated with more adverse outcomes in insider trading lawsuits filed in federal district courts.

Following prior literature such as Gormley, Kaviani, and Maleki (2020), we use the penalties charged against defendants in insider trading cases to measure case outcomes. We manually collect the amounts of illegal profits (i.e., profit disgorgement) and penalties in civil insider trading cases during the 1998–2018 period from the SEC website. To increase sample size and thus the power of the test, we include civil insider trading cases involving not only corporate executives but also other types of insiders.⁵⁴ Our sample includes 285 cases for which the SEC provides penalty details.⁵⁵ We estimate the following OLS regression:

$$\begin{aligned} \text{Penalty}_j = & \beta_0 + \beta_1 \text{IllegalProfit}_j + \beta_2 \text{LiberalCourt}_j \times \text{IllegalProfit}_j + \beta_3 \text{LiberalCourt}_j \\ & + \text{Controls} + \text{Year FE} + \text{Circuit FE} + \varepsilon_{i,t}, \end{aligned} \quad (4)$$

where Penalty_j and IllegalProfit_j represent the natural logarithms of the dollar amounts of civil penalties and profit disgorgement paid by defendants, respectively. Similar to the previous tests, we measure LiberalCourt_j based on the judge ideology of the circuit court that oversees the district court in which case j was filed. Our variable of interest is the interaction between LiberalCourt_j and IllegalProfit_j . To facilitate interpretation, we also estimate a version using $\text{High_LiberalCourt}_j$. We expect a positive coefficient on β_2 , which would indicate that the penalty imposed for each dollar of illegal profit is higher when the judge ideology is more liberal.

We control for case characteristics that could affect the severity of penalties, including the number of defendants and whether the defendants include corporate executives. We also include demographic variables (GDPGrowth , Unemployment , and BlueState) and circuit and year fixed effects to control for the economic environment and other regional or temporal differences that could affect the severity of penalties.

Table 8 presents the results of an estimation using Equation (5). As expected, we find that liberal judge ideology increases the penalties imposed for illegal insider trading, as the interactions of IllegalProfit with both LiberalCourt and High_LiberalCourt are positive and significant at the 10% level. In terms of economic magnitude, cases in circuit courts that fall within the most liberal

⁵⁴ In the current analysis, we can retain cases associated with non-executive insiders – unlike in the SEC forum selection test (i.e., Section 5.4) – because we only focus on civil cases, for which jurisdiction information is always available.

⁵⁵ In 35 cases, the amount of disgorgement is stated as a sum with the prejudgment interests in SEC litigation releases. To preserve these cases, we include any prejudgment interests in our measurement of disgorgement. We obtain consistent results when we exclude prejudgment interests and remove these 35 cases from our sample.

tercile impose 26% (0.171/0.655) higher penalties per dollar of illegal profit than do cases in circuit courts in the other two terciles. This finding echoes those in Fedderke and Ventoruzzo (2015) and further supports our assumption that liberal ideology of circuit court judge is associated with more adverse outcomes in insider trading litigation.

6. Conclusion

Illegal insider trading has long been an issue of concern for investors and regulators. In this paper, we explore the role of political ideology in the deterrence of insider trading by examining whether federal judge ideology affects insiders' opportunistic trading decisions. Consistent with managers considering judge ideology before making their trading decisions, we find fewer opportunistic insider sales for firms that are located in circuits with more liberal judges. Our cross-sectional tests show that the effect of judge ideology is stronger when managers expect that they are more likely to be sued. Our evidence extends the literature by uncovering an important determinant of insider trading deterrence.

In addition, we find that the SEC considers judge ideology when selecting a venue in which to prosecute illegal insider trading. Our results thus demonstrate the joint efforts of the executive and judicial branches of the federal government against illegal insider trading and provide important regulatory insights. Finally, we complement prior studies and anecdotal evidence by providing the first direct evidence that liberal judge ideology is associated with heavier penalties in insider trading litigation. Taken together, our findings advance the understanding of the role of political ideology in securities law enforcement, contribute to the finance, economics, and legal studies literature, and have practical implication for regulators and investors.

Although data availability limits our analyses to the trades of corporate executives, the deterrent role of liberal judge ideology could affect other stakeholders who have access to material non-public information, such as independent directors, non-executive employees, and service providers such as consultants, lawyers, auditors, and investment bankers. Investigating their trading patterns represents a potential avenue for future research.

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Appendix: Variable Definitions

Variable	Definition
Main Variables	
<i>LiberalCourt</i>	The probability that at least two of three judges on a panel randomly selected from a circuit court were appointed by Democratic presidents; that is, $[C(x, 3) + C(x, 2) \times C(y - x, 1)] / C(y, 3)$, where y is the total number of judges in the circuit court and x is the number of judges in the circuit court who were appointed by Democratic presidents. (a, b) is the number of combinations of b objects selected from a distinct objects. For each firm-calendar year observation, we use the average monthly <i>LiberalCourt</i> measure of the circuit with jurisdiction over the firm's headquarters in the calendar year. Historical headquarters information is extracted from firms' 10-K filings. Circuit court judges' appointing presidents are from the website of the Federal Judicial Center.
<i>#OppSale</i>	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 classify a sale as opportunistic if the insider has not sold stocks in the same calendar month in all three preceding years.
<i>\$OppSale</i>	Total dollar value of opportunistic insider sales in year t divided by the market value of equity at the end of year $t-1$, multiplied by 100.
<i>#OppBuy</i>	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 classify a purchase as opportunistic if the insider has not purchased stocks in the same calendar month in all three preceding years.
<i>\$OppBuy</i>	Total dollar value of opportunistic insider purchases in year t divided by the market value of equity at the end of year $t-1$, multiplied by 100.
Control Variables used in Equation (1)	
<i>Size</i>	The natural logarithm of the market value of equity ($PRCC_F \times CSHO$) at the end of year $t-1$.
<i>MtoB</i>	Market-to-book ratio ($PRCC_F \times CSHO/CEQ$) at the end of year $t-1$.
<i>Turnover</i>	Total trading volume (VOL) scaled by the average number of monthly shares outstanding in year t .
<i>PriorReturn</i>	Buy-and-hold market-adjusted returns over year $t-1$. Market-adjusted returns are calculated as the raw monthly returns (RET) minus the value-weighted market holding period returns ($VWRETD$).
<i>SharesHeld</i>	The natural logarithm of the total number of shares held by insiders at the end of year $t-1$.
<i>GDPGrowth</i>	The percentage change in real GDP from year $t-1$ to year t of the state where the firm's headquarters is located.
<i>Unemployment</i>	The unemployment rate of the state where the firm's headquarter is located in year t .
<i>BlueState</i>	An indicator variable that equals one if the state where the firm's headquarters is located voted for a Democratic candidate in the most recent presidential election prior to year t , and zero otherwise.

Other Variables	
<i>Distress</i>	An indicator variable that equals one if the firm's Altman's Z score is in the bottom decile of all firms in year t , and zero otherwise. Altman's Z score is computed as $3.3 \times OIADP/AT + 1.2 \times (ACT - LCT)/AT + SALE/AT + 0.6 \times PRCC_F \times CSHO/(DLTT + DLC) + 1.4 \times RE/AT$.
<i>Fraud</i>	An indicator variable that equals one if the firm engaged in accounting misconduct in year t that is later under enforcement actions as listed in SEC Accounting and Auditing Enforcement Releases, and zero otherwise.
<i>CorpGov</i>	The Entrenchment Index (E-Index) of Bebchuck, Cohen, and Ferrell (2009), multiplied by (-1).
<i>FederalCourt</i>	An indicator variable that equals one if the insider trading case is filed in federal court through a civil action and zero if it is brought in an administrative proceeding.
<i>Post2010</i>	An indicator variable that equals one if the enforcement is taken after the year 2010, and zero otherwise.
<i>Leverage</i>	Total debt divided by lagged total assets, $(DLC + DLTT)/lagged AT$.
<i>NDefendants</i>	The natural logarithm of the number of defendants.
<i>SeptFiling</i>	An indicator variable that equals one if the case is filed in September (the last month of the SEC's fiscal year), and zero otherwise.
<i>TotalEnforceCases</i>	The natural logarithm of the total number of SEC enforcement actions initiated in the current SEC fiscal year.
<i>ChgSECBudget</i>	Percentage change in the authorized budget of the SEC from the previous to the current SEC fiscal year.
<i>Abnormal_Return</i>	Monthly alpha from the Fama–French four-factor model. To calculate each firm's monthly factor loadings, we follow Brennan, Chordia, and Subrahmanyam (1998) and use 60-month rolling windows, requiring at least 24 non-missing months in the 60-month period.
<i>SaleSize</i>	The tercile rank of the number of shares sold by insider i of firm j in month t divided by total trading volume of the firm-month. The rank values are adjusted to be in the range of [0,1].
<i>High_LiberalCourt</i>	An indicator variable that equals one if judge ideology corresponding to a firm-year is in the top tercile of the sample and zero otherwise.
<i>Raw_RET_{j,t}</i>	The raw stock return for firm j in month t .
<i>Raw_RET_{j,t-12,t-1}</i>	Cumulative stock return for firm j from month $t-12$ through month $t-1$.
<i>GrossProfit</i>	Gross profit, measured as $(SALES - COGS)/AT$.
<i>AssetGrowth</i>	Percentage change in total assets (AT) from year $t-1$ to year t .
<i>StockVolatility</i>	The standard deviation of the firm's daily stock returns in month t .
<i>Penalty</i>	The natural logarithm of the dollar amount of civil penalty paid by defendants.
<i>IllegalProfit</i>	The natural logarithm of the sum of the dollar amount of profit disgorgement and the prejudgment interest of the enforcement, collected from the SEC website.
<i>ExecutiveCase</i>	An indicator variable that equals one if the defendants include corporate executives, and zero otherwise.

Table 1. Sample Selection and Distribution

The table presents the selection process and distribution of the samples. Panel A presents the sample selection process. Panel B presents the sample distribution and average *LiberalCourt* value by circuit. Panel C presents the sample distribution and average *LiberalCourt* value by year. Variables are defined in the Appendix.

Panel A: Sample Selection

	# of firm-years
Open-market insider trades by officers from 1998 to 2018 from Thomson Reuters Insider Filings	60,388
(-) Firm-years without insider trades that can be defined as opportunistic or routine	(38,609)
(-) Firm-years missing data on historical headquarters location	(557)
(-) Firm-years missing data on control variables from Compustat and CRSP	(2,295)
Firm-years for the main test	18,927

Panel B: Sample Distribution by Circuit

Circuit	# of Obs.	% of Total Obs.	Average <i>LiberalCourt</i> of Obs. in the Circuit
1 st	1,211	6.40%	0.266
2 nd	1,907	10.08%	0.582
3 rd	1,628	8.60%	0.313
4 th	1,378	7.28%	0.498
5 th	1,769	9.35%	0.231
6 th	1,519	8.03%	0.283
7 th	1,482	7.83%	0.173
8 th	1,286	6.79%	0.144
9 th	4,719	24.93%	0.636
10 th	740	3.91%	0.335
11 th	1,214	6.41%	0.431
D.C.	74	0.39%	0.263
Total	18,927	100%	0.408

Table 1 Continued
Panel C: Sample Distribution by Year

Year	# of Obs.	% of Total Obs.	Average <i>LiberalCourt</i> of Obs. in the Year
1998	223	1.18%	0.384
1999	859	4.54%	0.405
2000	852	4.50%	0.448
2001	793	4.19%	0.463
2002	767	4.05%	0.442
2003	786	4.15%	0.402
2004	900	4.76%	0.367
2005	1,000	5.28%	0.354
2006	1,114	5.89%	0.346
2007	1,163	6.14%	0.324
2008	1,030	5.44%	0.318
2009	900	4.76%	0.324
2010	889	4.70%	0.358
2011	849	4.49%	0.398
2012	887	4.69%	0.422
2013	991	5.24%	0.433
2014	1,089	5.75%	0.458
2015	1,085	5.73%	0.472
2016	1,034	5.46%	0.475
2017	1,032	5.45%	0.490
2018	684	3.61%	0.478
Total	18,927	100%	0.384

Table 2. Descriptive Statistics

This table reports descriptive statistics and correlations for the variables used in our main analyses. Panel A reports the descriptive statistics for the variables. Panel B reports the correlations among the variables. The lower (upper) diagonal presents Pearson (Spearman) correlation coefficients. Correlation coefficients that appear in boldface are significant at the 5% level. All continuous variables are winsorized at the 1% and 99% levels. All variables are defined in the Appendix.

Panel A: Descriptive Statistics

	N	Mean	Std Dev	Min	1 st Qtr.	Median	3 rd Qtr.	Max
<i>LiberalCourt</i>	18,927	0.407	0.198	0.007	0.240	0.390	0.593	0.720
<i>#OppSale</i>	18,927	0.195	0.392	0.000	0.006	0.049	0.189	2.524
<i>\$OppSale</i>	18,927	0.225	0.471	0.000	0.006	0.051	0.208	3.051
<i>#OppBuy</i>	18,927	0.021	0.093	0.000	0.000	0.000	0.000	0.745
<i>\$OppBuy</i>	18,927	0.017	0.078	0.000	0.000	0.000	0.000	0.621
<i>Size</i>	18,927	7.227	1.928	2.907	5.911	7.194	8.490	11.932
<i>MtoB</i>	18,927	3.580	4.683	-10.290	1.519	2.435	4.102	32.176
<i>Turnover</i>	18,927	0.023	0.019	0.001	0.010	0.018	0.030	0.107
<i>PriorReturn</i>	18,927	0.105	0.499	-0.772	-0.175	0.026	0.267	2.567
<i>SharesHeld</i>	18,927	10.917	2.311	4.615	9.429	11.046	12.506	16.246
<i>GDPGrowth</i>	18,927	0.043	0.027	-0.087	0.029	0.043	0.060	0.247
<i>Unemployment</i>	18,927	5.938	2.015	2.300	4.600	5.400	6.800	13.700
<i>BlueState</i>	18,927	0.699	0.459	0.000	0.000	1.000	1.000	1.000
<i>Distress(before ranking)</i>	15,126	5.545	6.226	-4.697	2.287	3.858	6.462	37.935
<i>Fraud</i>	15,092	0.016	0.127	0.000	0.000	0.000	0.000	1.000
<i>CorpGov</i>	11,119	-2.966	1.175	-6.000	-4.000	-3.000	-2.000	0.000

Table 2 Continued

Panel B: Correlation Table

	<i>LiberalCourt</i>	<i>Size</i>	<i>MtoB</i>	<i>Turnover</i>	<i>PriorReturn</i>	<i>SharesHeld</i>	<i>GDPGrowth</i>	<i>Unemployment</i>	<i>BlueState</i>
<i>LiberalCourt</i>	1	0.04	0.06	0.08	0.01	0.10	0.13	0.11	0.32
<i>Size</i>	0.04	1	0.39	0.34	0.11	0.08	-0.02	-0.01	0.03
<i>MtoB</i>	0.07	0.21	1	0.28	0.23	0.13	0.11	-0.11	0.07
<i>Turnover</i>	0.10	0.19	0.16	1	0.10	0.16	-0.02	0.09	0.03
<i>PriorReturn</i>	0.02	0.03	0.18	0.18	1	0.03	0.00	0.05	-0.02
<i>SharesHeld</i>	0.09	0.07	0.08	0.12	0.04	1	0.02	0.06	0.03
<i>GDPGrowth</i>	0.12	-0.01	0.06	-0.03	0.05	0.01	1	-0.32	-0.09
<i>Unemployment</i>	0.13	-0.01	-0.07	0.08	0.02	0.06	-0.38	1	0.16
<i>BlueState</i>	0.33	0.04	0.06	0.03	-0.01	0.03	-0.08	0.17	1

Table 3. Judge Ideology and Insider Trading

This table reports the results from estimating Equation (1), which tests the effect of judge ideology on the intensity of insider trading. The sample includes 18,927 firm-year observations from 1998 to 2018. All variables are defined in the Appendix. All regressions include circuit, industry, and year fixed effects. The *t*-statistics (in parentheses) are calculated using standard errors clustered by state. *, **, and *** denote statistical significance at the 10%, 5%, and 1% level, respectively.

	<i>#OppSale</i>	<i>\$OppSale</i>	<i>#OppBuy</i>	<i>\$OppBuy</i>
	(1)	(2)	(3)	(4)
<i>LiberalCourt</i>	-0.191*** (-3.671)	-0.242*** (-3.569)	0.038 (0.972)	0.030 (0.947)
<i>Size</i>	-0.014*** (-4.398)	-0.021*** (-4.699)	-0.064*** (-19.637)	-0.054*** (-20.735)
<i>MtoB</i>	0.003*** (3.905)	0.002*** (2.715)	-0.000 (-0.348)	-0.000 (-0.413)
<i>Turnover</i>	2.493*** (11.996)	3.641*** (14.430)	0.071 (0.432)	0.004 (0.028)
<i>PriorReturn</i>	0.106*** (15.208)	0.106*** (13.020)	-0.027*** (-6.454)	-0.023*** (-6.849)
<i>SharesHeld</i>	0.042*** (21.421)	0.048*** (19.098)	0.020*** (10.940)	0.016*** (11.451)
<i>GDPGrowth</i>	0.319* (1.781)	0.498** (2.081)	-0.110 (-0.845)	-0.072 (-0.676)
<i>Unemployment</i>	0.002 (0.360)	0.005 (0.659)	-0.000 (-0.105)	0.000 (0.105)
<i>BlueState</i>	-0.008 (-0.547)	-0.015 (-0.845)	-0.008 (-0.721)	-0.005 (-0.482)
Constant	-0.191*** (-3.671)	-0.242*** (-3.569)	0.038 (0.972)	0.030 (0.947)
Circuit Fixed Effects	Yes	Yes	Yes	Yes
Industry Fixed Effects	Yes	Yes	Yes	Yes
Year Fixed Effects	Yes	Yes	Yes	Yes
SE Clustered by	State	State	State	State
Observations	18,927	18,927	18,927	18,927
Pseudo R ²	0.126	0.100	0.397	0.468

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

This table reports the results from estimating Equation (1) for insider trading before firm-months with large stock price declines. *#OppSale* and *\$OppSale* are defined based on the six months prior to the firm-month with large stock price declines; a firm-month is defined as experiencing a large stock price decline if its excess return is more than two standard deviations below the average excess monthly return in the past 60 months. All other variables are defined in the Appendix. All regressions include circuit, industry, and year fixed effects. The *t*-statistics (in parentheses) are calculated using standard errors clustered by state. *, **, and *** denote statistical significance at the 10%, 5%, and 1% level, respectively.

	<i>#OppSale</i>	<i>\$OppSale</i>
	(1)	(2)
<i>LiberalCourt</i>	-0.131** (-1.966)	-0.179** (-2.482)
<i>Size</i>	-0.013*** (-3.628)	-0.015*** (-3.490)
<i>MtoB</i>	0.002 (1.442)	0.002* (1.941)
<i>Turnover</i>	0.016*** (2.671)	0.025*** (3.380)
<i>PriorReturn</i>	0.179*** (6.535)	0.196*** (6.350)
<i>SharesHeld</i>	0.025*** (9.633)	0.027*** (9.254)
<i>GDPGrowth</i>	0.427 (1.605)	0.605* (1.954)
<i>Unemployment</i>	0.006 (0.878)	0.008 (1.061)
<i>BlueState</i>	0.018 (1.553)	0.019 (1.437)
Constant	-1.674*** (-18.900)	-1.875*** (-18.746)
Circuit Fixed Effects	Yes	Yes
Industry Fixed Effects	Yes	Yes
Year Fixed Effects	Yes	Yes
SE Clustered By	State	State
Observations	4,360	4,360
Pseudo R ²	0.237	0.188

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

This table reports the results from our cross-sectional tests, which examine whether the effect of liberal ideology on opportunistic insider sales is stronger when the firm is under greater scrutiny (i.e., when the firm is financially distressed, has accounting misstatement, or has stronger corporate governance). All variables are defined in the Appendix. All regressions include circuit, industry, and year fixed effects. The *t*-statistics (in parentheses) are calculated using standard errors clustered by state. *, **, and *** denote statistical significance at the 10%, 5%, and 1% level, respectively.

	<i>#OppSale</i>	<i>\$OppSale</i>	<i>#OppSale</i>	<i>\$OppSale</i>	<i>#OppSale</i>	<i>\$OppSale</i>
	(1)	(2)	(3)	(4)	(5)	(6)
<i>LiberalCourt</i>	-0.169*** (-2.709)	-0.222*** (-2.834)	-0.235*** (-3.271)	-0.308*** (-3.409)	-0.256*** (-2.858)	-0.320*** (-2.926)
<i>LiberalCourt</i> × <i>Distress</i>	-0.122** (-2.279)	-0.120** (-2.070)				
<i>LiberalCourt</i> × <i>Fraud</i>			-0.585** (-2.394)	-0.751** (-2.355)		
<i>LiberalCourt</i> × <i>CorpGov</i>					-0.035* (-1.836)	-0.047** (-2.093)
<i>Distress</i>	-0.168*** (-6.403)	-0.226*** (-7.379)				
<i>Fraud</i>			0.242* (1.848)	0.314* (1.852)		
<i>CorpGov</i>					0.018*** (2.661)	0.024*** (2.818)
<i>Size</i>	-0.028*** (-7.872)	-0.039*** (-7.506)	-0.013*** (-4.216)	-0.022*** (-4.796)	-0.045*** (-11.742)	-0.055*** (-10.579)
<i>MtoB</i>	0.003*** (3.945)	0.002*** (2.774)	0.003*** (3.643)	0.002** (2.121)	0.005*** (4.375)	0.005*** (4.108)
<i>Turnover</i>	2.635*** (11.847)	3.855*** (14.259)	2.757*** (11.256)	4.116*** (14.254)	0.797*** (4.097)	1.194*** (4.862)
<i>PriorReturn</i>	0.095*** (13.246)	0.092*** (11.994)	0.104*** (13.890)	0.102*** (11.558)	0.129*** (9.044)	0.122*** (7.418)
<i>SharesHeld</i>	0.046*** (21.291)	0.053*** (18.544)	0.045*** (17.551)	0.051*** (16.237)	0.042*** (23.735)	0.048*** (23.912)
<i>GDPGrowth</i>	0.249 (1.175)	0.434 (1.526)	0.419* (1.823)	0.623** (2.129)	0.473** (2.291)	0.552** (2.272)
<i>Unemployment</i>	0.005 (0.693)	0.009 (1.052)	0.004 (0.612)	0.008 (0.901)	0.003 (0.509)	0.004 (0.666)
<i>BlueState</i>	-0.010 (-0.583)	-0.019 (-0.944)	-0.011 (-0.580)	-0.020 (-0.906)	0.002 (0.175)	-0.005 (-0.327)
Constant	-0.206*** (-2.873)	-0.212** (-2.361)	-0.389*** (-5.823)	-0.419*** (-5.132)	0.042 (0.453)	0.107 (0.940)
Circuit Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Industry Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
SE Clustered by	State	State	State	State	State	State
Observations	15,126	15,126	15,092	15,092	11,119	11,119
Pseudo R ²	0.132	0.103	0.123	0.100	0.252	0.170

**Table 6. Judge Ideology and SEC Enforcement on Illegal Insider Trading:
Civil Action versus Administrative Proceeding**

This table reports the results from estimating Equation (2), which examines whether judge ideology affects the likelihood of SEC enforcement on illegal insider trading via civil actions brought in federal court as opposed to administrative proceedings. All variables are defined in the Appendix. All regressions include circuit and year fixed effects. The *t*-statistics (in parentheses) are calculated using standard errors clustered by state. *, **, and *** denote statistical significance at the 10%, 5%, and 1% level, respectively.

	<i>FederalCourt</i>	
	(1)	(2)
<i>LiberalCourt</i>	19.989*** (2.768)	17.562*** (2.612)
<i>LiberalCourt</i> × <i>Post2010</i>		6.464** (2.074)
<i>Size</i>	0.054 (0.530)	0.070 (0.763)
<i>MtoB</i>	-0.049** (-2.114)	-0.051 (-1.519)
<i>Leverage</i>	-1.513 (-0.789)	-1.246 (-0.531)
<i>Turnover</i>	4.791 (0.289)	6.910 (0.411)
<i>PriorReturn</i>	0.478*** (3.367)	0.510*** (3.293)
<i>NDefendants</i>	6.633*** (3.120)	5.882*** (3.013)
<i>SeptFiling</i>	2.025 (1.534)	1.889 (1.172)
<i>TotalEnforceCases</i>	-10.912 (-1.045)	-19.504** (-2.055)
<i>ChgSECBudget</i>	-9.506 (-1.380)	-2.179 (-0.282)
<i>GDPGrowth</i>	-7.396 (-0.394)	8.939 (0.344)
<i>Unemployment</i>	-0.336 (-0.667)	-0.161 (-0.263)
<i>BlueState</i>	-0.086 (-0.058)	-0.196 (-0.135)
Constant	59.669 (0.869)	113.290* (1.853)
Circuit Fixed Effects	Yes	Yes
Year Fixed Effects	Yes	Yes
SE Clustered by	State	State
Observations	70	70
Pseudo R ²	0.595	0.608

Table 7. Judge Ideology and the Return Predictability of Insider Trades

This table reports the results from estimating Equation (3), which examines whether judge ideology affects the return predictability of insider sales. All variables are defined in the Appendix. All regressions include firm and month fixed effects. The t -statistics (in parentheses) are calculated using standard errors clustered by month. *, **, and *** denote statistical significance at the 10%, 5%, and 1% level, respectively.

	<i>Abnormal_Return_{j,t+1}</i>		
	(1)	(2)	(3)
<i>SaleSize</i>	-0.544*** (-5.298)	-0.836*** (-4.511)	-0.685*** (-5.812)
<i>LiberalCourt</i> × <i>SaleSize</i>		0.716* (1.839)	
<i>LiberalCourt</i>		-0.732 (-1.273)	
<i>High_LiberalCourt</i> × <i>SaleSize</i>			0.310** (2.069)
<i>High_LiberalCourt</i>			-0.259 (-1.436)
<i>Size</i>	-2.483*** (-16.998)	-2.482*** (-17.007)	-2.482*** (-16.994)
<i>MtoB</i>	0.167*** (13.622)	0.167*** (13.612)	0.167*** (13.619)
<i>Raw_RET_{j,t}</i>	-1.316 (-1.387)	-1.316 (-1.387)	-1.314 (-1.385)
<i>Raw_RET_{j,t-12,t-1}</i>	-0.218 (-0.851)	-0.218 (-0.853)	-0.217 (-0.850)
<i>GrossProfit</i>	2.563*** (4.995)	2.560*** (4.990)	2.559*** (4.988)
<i>AssetGrowth</i>	2.201*** (11.786)	2.198*** (11.775)	2.198*** (11.773)
<i>StockVolatility</i>	-6.737 (-1.036)	-6.820 (-1.050)	-6.794 (-1.045)
<i>SharesHeld</i>	0.018 (1.648)	0.018 (1.610)	0.018 (1.600)
<i>GDPGrowth</i>	10.668*** (3.580)	10.653*** (3.572)	10.684*** (3.582)
<i>Unemployment</i>	0.034 (0.526)	0.040 (0.607)	0.037 (0.577)
<i>BlueState</i>	-0.417** (-2.577)	-0.395** (-2.450)	-0.396** (-2.391)
Firm Fixed Effects	Yes	Yes	Yes
Month Fixed Effects	Yes	Yes	Yes
SE Clustered by	Month	Month	Month
Observations	320,164	320,164	320,164
Adjusted R ²	0.075	0.075	0.075

Table 8. Judge Ideology and Civil Penalty for Insider Trading

This table reports the results from estimating Equation (4), which examines whether judge ideology affects the sensitivity of civil penalties to profit disgorgement for insider trading violations. All variables are defined in the Appendix. All regressions include circuit and year fixed effects. The *t*-statistics (in parentheses) are calculated using standard errors clustered by state. *, **, and *** denote statistical significance at the 10%, 5%, and 1% level, respectively.

	<i>Penalty</i>	
	(1)	(2)
<i>IllegalProfit</i>	0.462** (2.533)	0.655*** (6.693)
<i>LiberalCourt</i> × <i>IllegalProfit</i>	0.652* (2.016)	
<i>LiberalCourt</i>	-6.493* (-1.756)	
<i>High_LiberalCourt</i> × <i>IllegalProfit</i>		0.171* (1.911)
<i>High_LiberalCourt</i>		-1.438 (-1.366)
<i>NDefendants</i>	0.141 (0.896)	0.169 (1.088)
<i>ExecutiveCase</i>	0.208 (1.201)	0.204 (1.232)
<i>GDPGrowth</i>	-4.477** (-2.130)	-4.940** (-2.704)
<i>Unemployment</i>	0.044 (0.403)	0.055 (0.544)
<i>BlueState</i>	-0.100 (-0.360)	-0.130 (-0.489)
Constant	5.045*** (2.958)	3.183*** (3.782)
Circuit Fixed Effects	Yes	Yes
Year Fixed Effects	Yes	Yes
SE Clustered by	State	State
Observations	285	285
Adjusted R ²	0.640	0.639