

BRINGING INSIDER TRADING REGULATIONS TO THE 21ST CENTURY: THE POWER OF AI-BASED COMPLIANCE PLATFORMS

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Before the 21st century, Martha Stewart was synonymous with homemaking, cooking, and entertaining. Now, she is more commonly associated with courtroom proceedings, incarceration, and stepping down as Chief Executive Officer (?CEO?). In December 2001, Stewart sold 3,928 shares of ImClone stock just a day before the Food and Drug Administration (?FDA?) announced its decision not to review ImClone's application for a new cancer drug, Erbitux^[1], which caused ImClone's stock price to plummet.^[2]

Stewart became embroiled in controversy when she sold her ImClone shares subsequent to receiving insider information from her broker, Peter Bacanovic.^[3] Bacanovic allegedly disclosed to Stewart that ImClone's CEO, Sam Waksal, was divesting his shares due to the FDA's ruling.^[4] Upon receiving this information from Bacanovic, Stewart promptly liquidated all her shares.^[5] Authorities charged both Stewart and Bacanovic with multiple crimes, including securities fraud, obstruction of justice, and making false statements.^[6] In 2004, the Southern District Court of New York found her guilty of obstruction of justice, making false statements, and conspiracy.^[7] The court sentenced her to five months in prison, five months of home confinement, and two years of probation.^[8] Additionally, she faced personal and professional consequences, including resigning as CEO of Martha Stewart Living Omnimedia^[9] and being banned from serving as a director, CEO, or any other officer of a public company for five years.^[10] This case raised awareness about the importance of ethical behavior and transparency in financial markets, particularly with insider trading.^[11]

Although many doubt that Stewart is completely innocent, the scandal did engender critics to attack the gray areas in insider trading regulations.^[12] Rosemary Fanelli, Managing Director and Chief Regulatory Strategist at Duff & Phelps Investment Management, argued that the current regulations are confusing, ambiguous, and ?so contradictory that questions of constitutionality are legitimate.^[13] Particularly, existing law lacks clear definition regarding to whom the law applies, the type of information that must be possessed, and the kind of behavior that is prohibited.^[14] According to Fanelli, the vague wording of the law suggests that if a woman is advised by her broker to sell a particular stock after indirectly receiving a message from the company's CEO, without ever directly communicating with him, it would not constitute insider trading violations.^[15] Given that this was the situation with Stewart, there is definitely cause for concern.^[16]

Insider trading is estimated to occur at least four times more frequently than what regulators manage to detect.^[17] Specifically, estimates suggest that insider trading takes place in approximately one out of every five mergers and acquisitions and one out of every twenty quarterly earnings announcements.^[18] These statistics are disturbing because insider trading undermines the fairness and integrity of financial markets. When individuals use non-public information to gain an unfair advantage in trading, it erodes trust in the system and can lead to an uneven playing field for investors.^[19] This can ultimately discourage people from participating in the market, hindering its overall functionality.^[20] In other words, addressing insider trading is important for investor confidence.^[21] This confidence contributes to the overall stability and attractiveness of financial markets.^[22]

Even though insider trading regulation aims to prevent unfair advantages in the financial markets by prohibiting the use of material, nonpublic information for trading purposes, as mentioned previously, there are several gray areas.^[23] These gray areas include ambiguities in defining what constitutes insider trading, what information is material, and what information is nonpublic.^[24] Thus, this article proposes to address the uncertainties in insider trading regulation by introducing an innovative solution: an Artificial Intelligence (?AI?)-Based Compliance Platform. By providing clearer insights into what constitutes insider trading, this AI-powered platform promises to bring much-needed clarity and confidence to the enforcement of insider trading regulations.^[25]

Part II of this article provides a background on insider trading regulations and the challenges posed by ambiguity and lack of clarity in defining materiality and nonpublic information. Part III discusses scholars' proposed solutions to the shortcomings of insider trading regulations, such as clearer definitions and precise materiality guidance. While these proposals offer valuable insights, they will not comprehensively solve the intricate challenges of detecting and preventing insider trading in today's financial landscape.

Part IV proposes the creation of an AI-Based Compliance Platform to address the shortcomings of earlier proposals aimed at aiding companies and individuals in adhering to insider trading regulations. For example, the Platform would leverage AI algorithms trained on ethical principles and legal frameworks to provide proactive guidance and monitoring of insider trading activities, ensuring alignment with recognized standards of ethical conduct and legal compliance. Part V concludes by emphasizing how current regulations on insider trading face challenges in deterring and prosecuting offenders due to persistent gray areas. However, the AI-Based Compliance Platform offers a comprehensive solution with real-time monitoring and adaptive capabilities to detect and prevent insider trading effectively. With its dynamic approach, the Platform leads the way towards ensuring trust and accountability in global financial systems.

[1] Lynsey Eidell, *Why Did Martha Stewart Go to Prison? A Look Back at Her 2004 Fraud Case*, PEOPLE, <https://people.com/martha-stewart-fraud-case-prison-sentence-look-back-8550277> (Last updated Nov. 5, 2024, 8:40 AM).

[2] *Id.* (stating that ImClone's stock dropped by 16 percent, falling from \$60 per share to \$46 per share).

[3] *Id.*

[4] *Id.*

[5] *Id.* (explaining that when Stewart divested her ownership on December 27, 2001, the shares were liquidated for roughly \$227,000, resulting in her gaining a profit of around \$51,000 from the transaction).

[6] Eidell, *supra* note 1.

[7] Eidell, *supra* note 1

[8] Eidell, *supra* note 1

[9] *A Glance at the History of Martha Stewart Living Omnimedia*, FOX BUSINESS (last updated, Mar. 5, 2016, 5:12 AM), <https://www.foxbusiness.com/markets/a-glance-at-the-history-of-martha-stewart-living-omnimedia> (discussing how Martha Stewart established Martha Stewart Living Omnimedia in 1997, where she consolidated her books, magazine, and TV show. For the following thirty years, the company would expand to include home and kitchen products sold at Macy's Inc., Home Depot, PetSmart, Michaels, and J.C. Penney. Martha Stewart Living Omnimedia has recorded annual losses without interruption since 2003, except for the year 2007. In 2015, her company was acquired by Sequential Brands Group for \$353 million.).

[10] Eidell, *supra* note 1 (mentioning how Stewart was also required to pay \$195,000 in fines and penalties).

[11] Eidell, *supra* note 1.

[12] See Rosemary Fanelli, *50 Trades Of Grey: The Pain Of Insider Trading*, FORBES (Apr. 7, 2017, 11:16 AM), <https://www.forbes.com/sites/rosemaryfanelli/2017/04/07/50-trades-of-grey/?sh=7247a271640f>.

[13] *Id.*

[14] *Id.* (noting that due to the ambiguity of the regulations, individuals are plagued with fear and confusion, often leaving the true wrongdoers unchecked).

[15] *Id.*

[\[16\]](#) Id.

[\[17\]](#) How much insider trading really happens in US stock markets?, U. of Tech. Sydney (Mar. 23, 2021), <https://www.uts.edu.au/news/business-law/how-much-insider-trading-really-happens-us-stock-markets>.

[\[18\]](#) Id.

[\[19\]](#) James J. Park, Insider Trading and the Integrity of Mandatory Disclosure, 2018 WIS. L. REV. 1133, 1134, 1174 (2018); Reed Harasimowicz, Nothing New, Man! ? The Second Circuit's Clarification of Insider Trading Liability in *United States v. Newman* Comes at a Critical Juncture in the Evolution of Insider Trading, 57 B.C. L. REV. 765, 791-92 (2016) (explaining that this line of thinking is called the "parity of information," or fairness, rationale. The rationale asserts that federal securities laws should establish a system ensuring equal access to information in the securities market. This parity of information is deemed essential for investors to make informed and rational investment choices.).

[\[20\]](#) Park, *supra* note 19, at 1174.

[\[21\]](#) Id.

[\[22\]](#) Id.

[\[23\]](#) Cindy A. Schipani & H. Nejat Seyhun, Defining "Material, Nonpublic": What Should Constitute Illegal Defining "Material, Nonpublic": What Should Constitute Illegal Insider Information?, 21 Fordham J. Corp. & Fin. L. 327 (2016).

[\[24\]](#) See *id.*; Frank J. Cavico & Bahaudin G. Mujtaba, Insider Trading v. Trading on Inside Information: A Primer for Management, 8 Eur. J. Bus. & Mgmt. 72 (2016).

[\[25\]](#) See Schipani & Seyhun, *supra* note 23.

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