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Securities Market Urgently Needs Federal Insider Trading Law

By **Harry Sandick and Jeff Kinkle** (February 11, 2021, 5:03 PM EST)

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Between COVID-19 relief, the looming recession and the many social problems facing our country, Congress has a lot on its plate at the moment. We write to suggest one important additional area in which legislation might receive broad bipartisan support and for which some of the groundwork has already been laid.

Congress should codify the law of insider trading. And it is important for Congress to act soon as most observers believe that new Biden administration intends to make white collar enforcement a priority for the U.S. Department of Justice and the U.S. Securities and Exchange Commission. This will include insider trading.

Until the law is clarified and codified, people will be exposed to conviction and imprisonment against a backdrop of legal uncertainty.

Insider trading has never been expressly prohibited by an act of Congress. There is no single federal statute that prosecutors and regulators use to charge those who engage in insider trading.

Rather, insider trading is enforced primarily as a violation of Section 10(b) of the Securities Exchange Act, which is a general anti-fraud statute, and SEC Rule 10b-5, which broadly prohibits employing fraud or deceit in trading securities. It has also been prosecuted through various other statutes such as wire fraud statutes and the Sarbanes-Oxley Act.

Many observers have argued that insider trading law is at once too technical and overly broad, and based on conceptions of deception and breach of fiduciary duty that do not cover many actions one might expect to be within the scope of insider trading laws. As it is judge-made law, judicial inconsistencies inevitably have developed, which creates confusion in national and international markets.

Not having a single, codified law of insider trading has also given prosecutors the opportunity to prosecute insider trading under other statutes that contain different elements, further complicating efforts to advise clients.

The patchwork of judicial decisions covering insider trading has become even more complex and inconsistent over the past decade, making the need for a statute all the more pressing.

In 2019, the U.S. House of Representatives made a valiant attempt to remedy the situation and passed a bipartisan bill titled the Insider Trading Prohibition Act, but it, like so much else in recent years, died in the U.S. Senate.

Congress should quickly take up this issue again, clarifying some of the aspects of the ITPA that were unclear in its last iteration. Even an imperfect bill could resolve some of the current ambiguity in insider trading enforcement and provide guidance to securities markets, which function best when the rules are explicit and market participants know how to conform their conduct to the law.

Brief History

Introduced by Rep. Jim Himes, D-Conn., in May 2019, the ITPA was intended to codify the law on insider trading. The bill had overwhelming bipartisan support in the House, passing in December 2019 by a 410-13 vote. The Senate did not take up the bill.

While an improvement over the status quo, the ITPA that left the House in December 2019 was not perfect. It codified the law used to prosecute insider trading, but in some respects it did this in the most literal sense by codifying even the ambiguities in the then-existing judge-made law.

Perhaps most importantly, the ITPA left unresolved one of the most inconsistent aspects of current insider trading law: What, if any, personal benefit must the individual who provides the inside information — or tipper — receive to establish liability?

Relatedly, what knowledge would those who receive the insider information — the tippees or, for those at least once removed from the tipper in the chain of tipping, downstream tippees — need to have of the tipper's personal benefit?

As originally drafted, the ITPA simply removed the personal benefit requirement, but the version of the bill that emerged following floor amendment seemed both to require and not require the government to demonstrate personal benefit. This would likely have led courts to have interpreted the ambiguity in favor of the defendant and to require proof of both personal benefit and knowledge of personal benefit.

What Should Be in a New Insider Trading Bill

A new ITPA should address a number of issues, some of which were not within the ITPA passed by the House, including the following.

Personal Benefit Requirement

A revived ITPA should state with clarity what, if any, personal benefit or knowledge of personal benefit must be proved.

The U.S. Supreme Court first grappled with the issue of personal benefit in Dirks v. SEC in 1983. The Dirks court held that not all tippers face liability for subsequent trading on material nonpublic information; instead the tipper must receive some type of personal benefit, or some sort of value, as a result of providing the inside information to the tippee.

In U.S. v. Newman in 2014, the U.S. Court of Appeals for the Second Circuit interpreted this to mean that the gift of confidential information to a trading friend or relative requires "proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." Newman also held that the remote tippee must know about the tippee's receipt of a benefit.

In Salman v. U.S. in 2016, the Supreme Court explained that this personal benefit need not have a pecuniary value. Where a tipper provides a trading relative or friend with inside information, a jury can infer the information was meant to provide the equivalent of a cash gift.

Not long after, in U.S. v. Martoma, a panel of the Second Circuit in 2018 held that it was not going to decide whether Newman's "meaningfully close personal relationship" standard survived Salman, concluding that it was unnecessary to resolve the Martoma case. U.S. Circuit Judge Rosemary Pooler, dissenting, viewed the panel's decision as an abrogation of Newman, which the majority denied.

This series of decisions left uncertainty about the line separating illegal and legal trading. The ITPA originally jettisoned personal benefit entirely and only required the government to prove that the tipper wrongfully obtained insider information, and that downstream tippees had knowledge of that fact. It may be that this went too far, as Dirks has been part of the legal landscape for decades.

Regardless of whether the new iteration of the ITPA includes the personal benefit test, omits it, or replaces it with something else, clarity on this point is essential. If experienced appellate judges are divided on the state of the law, statutory reform is necessary.

Wrongfully Obtained Information

One benefit of the previous ITPA is that it defined four forms of conduct that would qualify as ways to wrongfully obtain material nonpublic information:

1. "[T]heft, bribery, misrepresentation, or espionage (through electronic or other means)";

2. "[A] violation of any Federal law protecting computer data or the intellectual property or privacy of computer users";

3. "[C]onversion, misappropriation, or other unauthorized and deceptive taking of such information"; or

4. "[A] breach of any fiduciary duty, a breach of a confidentiality agreement, a breach of contract, a breach of any code of conduct or ethics policy, or a breach of any other personal or other relationship of trust and confidence for a direct or indirect personal benefit (including pecuniary gain, reputational benefit, or a gift of confidential information to a trading relative or friend)."

This is an improvement on the former breach of fiduciary duty standard and defines liability in a more intuitive manner. It also clarifies the scienter requirement, allowing liability to attach if the trading party "was aware, consciously avoided being aware, or recklessly disregarded that such [insider] information was wrongfully obtained, improperly used, or wrongfully communicated."

Hacking and Theft

One laudable aspect of this expanded definition of what it means to wrongfully obtain material nonpublic information is that it would allow prosecutors to pursue insider trading based on computer hacking in circumstances that might not be prosecutable under current law.

In SEC v. Dorozhko in 2009, the Second Circuit held that in order for trading on information gleaned from hacking to be prosecutable under Section 10(b) and Rule 10b-5, the hacking needs to have been based on deception, rather than, for example, exploiting a weakness in the hacked party's electronic code.

Today, this appears to be an anachronistic distinction between insider trading rooted in some form of deception and insider trading based on theft, the borders of which have been blurred in the digital age.

Regardless of whether a hacker accesses material nonpublic information by finding an unlocked door, so to speak, in the hacked party's code or by sending a phishing email to an employee, the hacker should be prosecutable for insider trading when the hacker subsequently trades on the information or informs a tippee of the information. The current law appears to be based on a distinction without difference.

Breach of Contract

The ITPA's expanded conception of wrongfully obtained information would also address the situation presented in SEC v. Cuban in the U.S. Court of Appeals for the Fifth Circuit in 2010. In that case, the SEC charged Mark Cuban with insider trading on a misappropriation theory for selling his stake in internet company Mamma.com to avoid heavy losses, despite having told the company's CEO he would keep information likely to lead to a drop in the company's share price confidential.

Cuban argued that, at most, he agreed to keep the information confidential, but never explicitly agreed to not trade on the information. The U.S. District Court for the Northern District of Texas agreed with Cuban and found that an agreement not to divulge the company's confidential information did not prevent him from trading on that information. Cuban was eventually acquitted following a jury trial.

The previous iteration of the ITPA changed the law to prohibit trading on information learned pursuant to a confidentiality agreement. This appears to be in line with what insider trading laws are meant to prevent: a party with inside knowledge profiting off that inside knowledge at the expense of others.

Exclusivity

The new ITPA should be exclusive, that is, it should make it clear that insider trading can only be prosecuted under the ITPA. In U.S. v. Blaszczak, in 2019, a split Second Circuit panel affirmed the convictions of four defendants who had been prosecuted under several criminal statutes, including the wire fraud statute and a securities fraud statute added to Title 18 of the U.S. Code by the Sarbanes-Oxley Act of 2002.

Defendants had been charged with Title 15 securities fraud charges as well, under Section 10b-5, which, as discussed above, requires the defendants — here, variously situated tippees — to know that the tipper received a personal benefit for disclosing the inside information.

They were thus acquitted under the laws typically used to prosecute insider trading, but convicted under the wire fraud and Title 18 charges, which the Second Circuit ultimately held did not require knowledge of personal benefit.

This decision expands the power of federal prosecutors, who now have a wider set of statutes under which to prosecute insider trading. A new ITPA could make clear that prosecutions for insider trading are prosecuted exclusively under Title 15. Otherwise, the improvements legislated here can be end-run by prosecutors who charge the conduct under a different, less demanding, statute.

Conclusion

No one — prosecutors, defense counsel, securities market participants or the public at large — benefits from the current regime of legal uncertainty.

In the meantime, courts — like the Second Circuit in Blaszczak — continue to render decisions that leave uncertainty about the state of the law.

The House has already shown that it is capable of making a bipartisan effort to codify insider trading law. Congress should return to this issue and pass an insider trading statute.

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