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Developments in insider trading enforcement: The House of Representatives passes insider trading bill

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On December 5, the U.S. House of Representatives passed the Insider Trading Prohibition Act (H.R. 2534). The bill amends the Securities and Exchange Act of 1934, 15 U.S. Code §§ 78a et seq., to include a new section that, for the first time, expressly defines the elements of insider trading.

If passed by the Senate and signed into law by the President, the bill would explicitly codify a securities law violation that has largely been a creature of common law. When it was first proposed last March, the bill was intended to clarify this "murky" area of the law.

Following a last minute amendment, however, the proposed legislation tracks closely the terminology the existing case law employs to define insider trading — terminology and case law that has generated significant confusion regarding the scope of the offense.

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As such, rather than bringing clarity to the law, the legislation maintains the status quo — and thus the ambiguities in how insider trading is defined.

LEGAL HAZINESS SURROUNDING INSIDER TRADING

Insider trading has never been defined by statute or regulation. Rather, the contours of the violation developed over the years through common law — common law that has created significant ambiguity in defining what conduct is prohibited, and what is permissible.

For example, following the Supreme Court's *Dirks v. S.E.C.* decision in 1983 — where the Court adopted an objective standard, assessing "whether the insider receives a direct or indirect personal benefit from the disclosure, such as pecuniary gain or a reputational benefit that will translate into future earnings" — courts have struggled to define "personal benefit."

The issue has been the subject of a well-known circuit split, with the Ninth Circuit broadly construing "personal benefit" to include an indirect benefit, such as "a gift of confidential information to a trading relative or friend," and the Second Circuit requiring "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." *Compare United States v. Salman,* 792 F.3d 1087, 1093 (9th Cir. 2015)*, with United States v. Newman,* 773 F.3d 438, 453 (2d Cir. 2014).

While the Supreme Court arguably settled the split when it heard the *Salman* case last year (holding that an insider/tipper's "gift" of inside information may suffice to confer a benefit on the tipper), the Second Circuit has continued to struggle with the definition of personal benefit, issuing not one, but two opinions in *United States v. Martoma*, 894 F.3d 64 (2d Cir. 2018) ("Martoma II").[1]

Presently, the controlling definition in the Second Circuit (for what it may be worth), is that a personal benefit "can be [found] by evidence that the tipper's disclosure of insider information was intended to benefit the tippee."

In an October 9, 2018 *New York Times* Op-Ed, former United States Attorney for the Southern District of New York Preet Bharara and SEC Commissioner Robert J. Jackson, Jr., commented on this "legal haziness," explaining that the lack of clarity in insider trading law "leaves both investors and defendants unclear about what sorts of information-sharing or other activities by investors would be considered insider trading, and what are acceptable forms of data-gathering and research that are part of any healthy, functioning financial marketplace."

'THE SAME TERMS IDENTIFIED IN THE CURRENT CASE LAW'

Against this backdrop, last March, Representative Jim Himes (D-Conn.) introduced the measure, describing it in a press release as a means for "ending decades of ambiguity for a crime that has never been clearly defined by law."

But as the bill proceeded through the amendment process last week, the Insider Trading Prohibition Act became an effort to codify the existing ambiguous case law, rather than a means to impart clarity onto this legal regime.

The limited debate in committee surrounding an amendment offered by Ranking Member Patrick McHenry (R-N.C.) is illustrative.

Whereas the initial draft of the bill did not include the personal benefit requirement, the McHenry Amendment added language requiring that material non-public information be given "for a direct or indirect personal benefit (including pecuniary gain,

reputational benefit, or a gift of confidential information to a trading relative or friend)."

In justifying the revision, Representative McHenry stated that the amendment was intended to ensure the "inclusion of an explicit personal benefit test consistent with Supreme Court precedent" and to clarify "ambiguous words to ensure judges and prosecutors know that this bill is not intended to expand or create new insider trading liability."

> While it remains to be seen whether the bill will continue to evolve in the Senate, Congress appears poised to enact legislation that neglects to provide investors and defendants with any further clarity.

Chairwoman Maxine Waters (D-Calif.) spoke in favor of the McHenry Amendment, noting that "because the bill uses the same terms identified in the current case law against insider trading, the SEC and market participants can easily understand what those terms mean."

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AN OPENING FOR FURTHER TITLE 18 INSIDER TRADING CASES?

Of note, the bill contains language that would prohibit trading on information that was "obtained wrongfully." The inclusion of the phrase "obtained wrongfully" is reminiscent of language from a recent insider trading case in the Southern District of New York, *United States v. Blaszczak*.

In *Blaszcak*, prosecutors charged the classical theory of insider trading under Title 15 of the U.S. Code, as well as a wire fraud theory under Title 18.

Under the latter theory, prosecutors argued that insider trading did not require proof of a personal benefit, but simply proof that information was obtained and traded on as part of a scheme or artifice to defraud. After a four-week trial, the defendants were acquitted of the Title 15 charges, but convicted on the Title 18 wire fraud charges.

The defendants' appeal was recently argued before the Second Circuit.

The ability to pursue more streamlined charges under Title 18 — available only to the DOJ — allows prosecutors to bring criminal charges in circumstances where the SEC is unable to bring civil charges because of insufficient evidence of personal benefit.

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Should the Senate fail to address the shortcomings of the House bill, one can expect an acceleration of this trend well beyond the Southern District of New York and the further criminalization of insider trading.

NOTES

[1] In *Martoma*, a hedge fund portfolio manager was convicted in relation to trading in the stock of two pharmaceutical companies. In an initial opinion, the Second Circuit affirmed the conviction. However, while the appeal was pending, *Newman* and the Supreme Court's decision in *Salman* came down, warranting rehearing.

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