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Congress Moves a Step Closer to Codifying Prohibition on Insider Trading

The law of insider trading has long been criticized as lacking clear standards for what constitutes a violation. Unlike many aspects of federal securities law, insider trading is not defined by statute or regulation. Instead, the contours of this complex area have for decades been drawn by shifting and sometimes conflicting judicial interpretations of the anti-fraud provisions of the Securities Exchange Act of 1934 and related rules. As a result, defendants accused of insider trading face a confusing legal landscape where the boundaries of unlawful conduct are nebulous and ill-defined, and where the likelihood of being charged in a civil complaint or an indictment can depend heavily on the discretion of individual enforcement officials and prosecutors.

In May, Congress took a big step toward clarifying this area of the law, when the Financial Services Committee of the U.S. House of Representatives unanimously approved the Insider Trading Prohibition Act.[1] If the bill becomes law, it would simplify an inherently complex area. Although the proposed statute would reduce the amount of guesswork required to discern lawful from unlawful actions, it might also lead to more insider trading cases being brought by the Securities and Exchange Commission ("SEC") and the Department of Justice ("DOJ"), and open up at least one new and important area of potential liability related to information obtained from data breaches.

Key Provisions of the Bill

The Insider Trading Prohibition Act would make it unlawful for a person to trade in a security (broadly defined to include swaps) while in possession of material, non-public information about the security, if the person knows or recklessly disregards that such material, non-public information has been obtained "wrongfully," or that the trading would constitute a "wrongful use" of such information. The bill also would make it unlawful for a person in possession of material, non-public information "wrongfully to communicate" that information to another person (or "tip," in the judge-made parlance that has come to govern the field), if it is reasonably foreseeable that the person to whom the information is communicated (the "tippee") will trade or will further communicate the information to another person who trades.

The bill further states that trading or communicating information about securities is "wrongful" if the information was obtained by, or its communication or use would constitute—

- theft, bribery, misrepresentation, or espionage;
- a violation of any federal law protecting computer data or the intellectual property or privacy of computer users;
- conversion, misappropriation, or other unauthorized and deceptive taking of such information; or
- a breach of any fiduciary duty, a breach of a confidentiality agreement, a breach of contract, or a breach of any other personal or other relationship of trust or confidence.

[1] H.R. 2534, https://www.congress.gov/bill/116th-congress/house-bill/2534/text.

Importantly, under the bill, the person who trades in or communicates information about securities is not required to know the specific means by which the information was obtained or communicated, or whether any benefit was paid by or promised to anyone in the chain of communication. As long as the person knows, consciously avoids knowing, or recklessly disregards that the information was wrongfully obtained or communicated, the person can be liable.

The bill also contains a section entitled "Derivative Liability," which states that an employer of a person who violates the Insider Trading Prohibition Act is not liable for the acts of its employee, as long as the employer did not participate in, profit from, or directly or indirectly induce the acts that constituted a violation.

The bill does not discuss the circumstances under which violations can be prosecuted criminally, but another provision of existing law makes clear that a person must act willfully, or with the intent to violate the law, to be subject to criminal penalties.

Potential Implications if the Bill Becomes Law

If enacted, the Insider Trading Prohibition Act could have profound effects on insider trading enforcement.

First, it would likely result in the SEC and DOJ bringing more cases and expanding the number of defendants charged in a particular scheme. Current law requires the SEC and DOJ to prove that a defendant breached a fiduciary duty or other duty of trust or confidence to the issuer of the security and its shareholders, or to the source of the information. This focus on duty to the source can narrow the scope of persons who can be charged, particularly in the case of downstream tippees who often do not know who the source of the information was. By contrast, under the Insider Trading Prohibition Act, the focus is not on whether the defendant had a duty, but whether the defendant knew or disregarded that the information was "wrongfully obtained."

Second, and relatedly, the bill opens up a new class of potential violators: those in possession of material, non-public information obtained from a computer breach. These people might not fit within the confines of existing law, as they might not be found to have a duty of trust or confidence to the source of the information. But under the Insider Trading Prohibition Act, culpability could be triggered by communicating or trading upon wrongfully obtained electronic data. This addition would accelerate a growing trend – as evidenced by recent prosecutions in Southern and Eastern Districts of New York – toward treating computer breaches as a source of insider information.

Third, the bill eliminates the requirement that a tippee knows that the tipper received a personal benefit in disclosing material, non-public information. The Second Circuit Court of Appeals held in *United States v. Newman*, 773 F.3d 438 (2nd Cir. 2014), that the government is required to prove such a personal benefit. The personal benefit requirement has proven to be a significant hurdle to insider trading enforcement. The proposed bill would abrogate the *Newman* standard, making it easier for the SEC and DOJ to prove a violation.

Whether the bill is passed and signed into law remains to be seen. If it is, it would be a sea change, providing some clarity to the law of insider trading, but also setting the table for more enforcement actions in the future.

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