Insider Trading Prohibition Act: First Analysis

A Lexis Practice Advisor® Article by
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Introduction

This article discusses the H.R. 2534, "Insider Trading Prohibition Act" (ITPA), passed on December 5, 2019, by a large, bipartisan majority of the House of Representatives. The bill was sponsored by Congressman Jim Himes (D-Conn.) and is one of several pieces of legislation that was initially proposed in the wake of the Second Circuit's 2014 decision, United States v. Newman, 773 F.3d 438 (2d Cir. 2014). The Second Circuit's *Newman* decision established a narrow "pecuniary benefit" view of tippee liability. The Supreme Court overturned the *Newman* court's standard for tippee liability in Salman v. United States, 580 U.S. ___ (2016), discussed *infra*. The *Salman* Court left unchallenged the *Newman* court's separate holding that conviction of an indirect tippee requires the government to prove that the tippee knew that the tipper personally benefitted from disclosing inside information.

If passed by the Senate and signed into law by the President, the ITPA would amend the Securities Exchange Act of 1934 to define "insider trading" and codify the judicial ban on insider trading. Commentators, including the authors, have warned that insider trading law is entirely judge-made and has become murky and unpredictable as a result. See, e.g., Brief for Cato Institute as Amicus Curiae, Salman v. United States, 580 U.S. ___ (2016). "Insider trading" is not presently defined in any federal statute. As it exists in case law, the ban on insider trading is rooted in Section 10(b) of the Securities Exchange Act, which prohibits "any manipulative or deceptive device or contrivance," and SEC Rule 10b-5, which prohibits "any device, scheme, or artifice to defraud." See 15 USC. § 78j(b) (2018) and 17 C.F.R. § 240.10b-5 (2019).

Initial Guidance

Section (a) of the ITPA prohibits buying or selling covered investments "while aware of material, nonpublic information relating to [a security], or any nonpublic information, from whatever source, that has, or would reasonably be expected to have, a material effect on the market price of [that security]." The bill applies to securities, security-based swaps, and security-based swap agreements.

Under the bill, insider trading is prohibited only if the trading party "knows, or recklessly disregards, that such information has been obtained wrongfully" or that the transaction "would constitute a wrongful use of such information." The bill elaborates that the use or communication of information is "wrongful" only if it constitutes:

> "(A) theft, bribery, misrepresentation or espionage (through electronic or other means);
>
> (B) a violation of any Federal law protecting computer data or the intellectual property or privacy of computer users;

(C) conversion, misappropriation, other unauthorized and deceptive taking of such information; or

(D) 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)."

A person may also be liable for insider trading under the ITPA if they were "aware, consciously avoided being aware, or recklessly disregarded that the information was wrongfully obtained, improperly used, or wrongfully communicated," even if they were not aware of the specific details. ITPA further states that, except as provided under Exchange Act § 20(a)'s control-person liability provision, a person will not be held liable "solely by reason of the fact that such person controls or employs a person who has violated this section," so long as the controlling person did not participate in, or directly or indirectly induce, the violation. This provision would allow fund managers and other controlling persons to avoid liability for the violations of a rogue employee.

Section (b) of the ITPA prohibits "wrongful communication" of material, nonpublic information to another person, commonly known as "tipping." If a person has material, nonpublic information and is prohibited from trading under Section (a) of the ITPA, that person is prohibited from acting as a "tipper," i.e., communicating that material non-public information to another person (a tippee) if it is "reasonably foreseeable" that the tippee will trade on the basis of that information. This prohibition similarly applies to a tippee who then shares material non-public information with a second tippee who trades on that basis, so long as that trading was also reasonably foreseeable.

The ITPA does not explicitly say what effect it will have on current insider trading cases or precedent based on Section 10(b) and Rule 10 b-5. The only reconciliation with current insider trading rules contained in the ITPA is that it "shall not apply to any transaction that satisfies the requirements of Rule 10b-5-1 . . . or any successor regulation." Additionally, the ITPA requires that the SEC review Rule 10b-5-1 within 180 days of its enactment and to make any modifications the SEC deems necessary to comply with the bill.

The ITPA passed the House by an overwhelming majority of 410 – 13, with 12 Republican Representatives and one Independent voting against its passage. Representatives voting against the bill cited reasons ranging from fears of prosecutorial overreach to the bill's imprecise language.

Rep. Bill Huizenga (R-Mich.) voted against the bill after his proposed amendment to replace specific language in the bill was debated and ultimately rejected. See Nicole Goodkind "Why 12 Republican Representatives Voted Against Banning Insider Trading," Fortune (Dec. 10, 2019). Huizenga's amendment attempted to change language that allows for the prosecution of those trading securities while "*aware*" of material, nonpublic information" to apply to those "*using*" insider information. See Amendments to H.R. 2534 – Insider Trading Prohibition Act. In explaining his opposition, Huizenga feared that under the current wording a trading party in possession of insider information, though not using it or acting on it, could nonetheless be found guilty of a crime if they traded while in possession of that information.

Poppy Nelson, chief of staff to Rep. Justin Amash (I-Mich.), said that the bill "expands federal criminal liability in an area not authorized by the Constitution." Nelson continued, "regulations may be appropriate, but the Constitution explicitly authorizes Congress to criminalize only a few activities that are clearly federal in nature. It increases potential liability for innocent actors."

Rep. Chip Roy (R-Md.) said that the bill "accomplishes very little, yet in what it does do, it is troublingly vague to the point of being constitutionally questionable and empowers the SEC to exempt companies from insider trading." Rep. Morgan Griffith (R-Va.) echoed those sentiments, saying that the "courts have generally found laws that are ambiguous on their face to be unconstitutional. Accordingly I voted no." Rep. Warren Davidson (R-Ohio) added that the ITPA "assumes that law enforcement . . . aren't going to do bad things with that power. I think that history shows that there are abuses and the best recipe to stop that is clear, concise language that is more specific."

Rep. Dan Bishop (R-N.C.) said that Section (b) of the ITPA broadened "tippee" liability beyond what was previously defined by the Supreme Court. In the landmark 2016 case Salman v. United States, 137 S. Ct. 420; 196 L. Ed. 2d 351, the Court rejected the Second Circuit's view of tippee liability, announced in *United States v. Newman*, which required the government to prove that a tipper received a pecuniary or similar benefit for liability to attach. The *Salman* Court instead required the government to prove that a tipper received a "personal benefit" from the disclosure, rather than a strictly pecuniary one. Bishop and other commentators say the language in the bill eliminates this personal benefit requirement, and expands the law rather than simply codifying it.

See Nicole Goodkind "Why 12 Republican Representatives Voted Against Banning Insider Trading," Fortune (Dec. 10, 2019).

Looking Ahead

The bill received overwhelming bipartisan support after Rep. Patrick McHenry, the Ranking Member of the House Financial Services Committee, inserted an amendment that added language requiring evidence of a "personal benefit" to prove certain theories of liability under the bill. Though this amendment was included, the bill does not include language that any statute passed by Congress be the "exclusive insider trading law of the land," which many Republican representatives sought to add.

The bill was submitted to the Senate on December 9, 2019, though it has yet to be considered by the Senate Banking Committee. Provisions of the ITPA remain subject to revision if and when the Senate considers it.

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Bradley J. Bondi is a nationally recognized litigation partner and board advisor in Cahill's litigation department and the Chair of the firm's White Collar and Government Investigations Practice Group. Securities Docket describes Brad as *"the first choice among Boards of Directors and Audit Committees of the Fortune 500 when their company is faced with SEC or DOJ problems."* Brad has two decades of experience representing and counseling companies, financial institutions, boards of directors, audit committees, and senior executives in a broad range of investigations and complex business litigation, with an emphasis on securities and financial regulations and corporate governance matters. He previously held senior positions in government, including at the Securities and Exchange Commission. The Legal 500 characterizes Brad as *"tenacious, knowledgeable and highly effective"* and also with *"in-depth knowledge of the SEC and how to deal with it."* Law360 named him a "Law360 2019 MVP" for White Collar.

Named by Benchmark Litigation as both a National and Local "Litigation Star," and designated since 2015 by Super Lawyers as a "Super Lawyer" for securities litigation and white-collar criminal defense, Brad leads the representation of significant legal matters including major litigation in trial and appellate courts and in arbitrations (securities litigation, derivative litigation, and complex business litigation), SEC, FINRA and PCAOB enforcement matters, criminal inquiries (including FCPA, DOJ and USAO matters), and various investigations (including independent investigations overseen by audit committees and special committees). Brad has been listed on the *Securities Docket* "Enforcement 40" since its inception, a list of the 40 best securities enforcement defense lawyers in the country. Since 2015 he has been included in the Best Lawyers publication for Financial Services Regulation Law. Brad and the Cahill team also appear on the approved counsel lists for the major insurers for litigation and government investigations.

Brad regularly serves as a senior advisor to boards of directors, audit committees, special committees, independent directors, and senior executives during corporate crises, significant transactions, and governance challenges. He has guided boards and board committees through the most extraordinary corporate events, including independent investigations, defense of derivative lawsuits against directors and officers, class actions, accounting irregularities and Restatements, auditor disputes, hostile takeover attempts and activist shareholders, mergers and acquisitions disputes, cyber intrusions and data breaches, and investigations of alleged misconduct by executives. For his experience counseling boards of directors, Brad was listed in the National Association of Corporate Directors' Directorship 100 list of "People to Watch" in the board room.

Brad advises clients in connection with regulatory enforcement actions, private lawsuits, governmental and congressional investigations arising from suspected violations of securities laws, accounting irregularities, auditor disputes, internal controls, market manipulation, revenue recognition issues, tax-related matters, insider trading, the Foreign Corrupt Practices Act (FCPA) and other commercial bribery law compliance, matters involving LIBOR and other reference rates, compliance with the Sarbanes-Oxley and Dodd-Frank Acts, potential antitrust concerns, and cybersecurity. Brad also oversees complex civil and criminal litigation, such as securities litigation, corporate control litigation, commercial litigation, contractual disputes, arbitrations, and criminal proceedings. He has litigated significant legal disputes in various state and federal courts, including serving as counsel of record for successful briefs before the Supreme Court of the United States: for an investment bank in *Credit Suisse First Boston Ltd. v. Billing* (interpreting securities laws as implicitly precluding the application of antitrust laws in the IPO process) and for an amicus curiae in *Yates v. United States* (construing Sarbanes-Oxley's criminal provision for document destruction, 18 U.S.C. § 1519). He also served as counsel of record for an amicus curiae brief before the Supreme Court of the United States in *Salman v. United States* (concerning the personal benefit element of insider trading law) and *Liu v. SEC* (concerning the SEC's authority to seek disgorgement), and he has advised on other cases before the Court.

For financial institutions, he regularly advises banking institutions, broker-dealers, investment advisers, mutual funds, and hedge funds and their respective boards on issues relating to compliance with securities laws, criminal laws, SEC and FINRA rules, and governance requirements.

Brad defends clients in enforcement actions, prosecutions, and investigations initiated by federal and state agencies and departments, including the Securities and Exchange Commission (SEC), Department of Justice (DOJ), United States Attorneys and grand juries, State Attorneys General, Federal Deposit Insurance Commission (FDIC), Office of the Controller of the Currency (OCC), Financial Industry Regulatory Authority (FINRA), Federal Reserve, Office of Foreign Assets Control (OFAC), Public Company Accounting Oversight Board (PCAOB), Consumer Financial Protection Bureau (CFPB), and Federal Trade Commission (FTC). On occasion, Brad has served as an expert witness regarding issues relating to securities law and insider trading law.

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