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Lessons from the Insider Trading Prohibition Act After Its Likely Demise In the Senate

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For a moment there, it really looked like it was going to happen. After a long and winding road, insider trading reform had reached the floor of the House of Representatives for a vote. The Insider Trading Prohibition Act (ITPA) (http://bit.ly/2M70kg0) had support on both sides of the aisle. Learned professors had testified about the need for action. Past and present commissioners from the Securities and Exchange Commission had weighed in on the merits of the bill. Proponents from all sides of the criminal justice system called for the need for greater clarity in insider trading regulation and enforcement. On Dec. 5, 2019, the House voted to pass the ITPA with 410 yeas against only 13 nays. The hour was at hand.

Then the bill went to the Senate and vanished. It was referred to the Committee on Banking, Housing, and Urban Affairs in December and has never been seen since. By all accounts, insider trading reform is likely a dead letter for the foreseeable future.

What happened? As with many things in Congress, it's a little hard to say. The impeachment proceedings at the beginning of the year were a significant time commitment — and their partisan nature may have impacted the likelihood of bipartisan legislation.

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The investigation launched by the Department of Justice into potential insider trading by a number of senators may have dimmed enthusiasm for the bill. And the Senate has been busy on other matters, including addressing many of President Donald Trump's judicial nominations before the fall elections.

Whatever the case, if there is one thing we've learned from the history of insider trading litigation, it's that we'll all go through this again at some point in the future. An unpopular decision will occur, there will be a public outcry, and a Congressman will begin writing a bill. We should take this opportunity to learn what lessons we can from the successes and failures of the ITPA as a bill with an eye toward fashioning the best possible legislation next time — whenever that may be.

Principal Successes of The ITPA

The drafters of the ITPA set out to accomplish several goals. First and foremost was getting an insider trading law actually on the books. Insider trading is not defined by statute; instead, courts have cobbled together the elements of insider trading principally by reference to catchall antifraud provision Section 10(b) of the Exchange Act — although insider trading can be, and is, occasionally prosecuted under other statutes. A law like the ITPA would help address notice concerns raised from the regulated community by clearly stating the law in one place.

The ITPA also would have successfully broadened insider trading law to capture trading based on a wider variety of "wrongfully obtained" information. Insider trading has traditionally required a deceptive act. In the vast majority of cases, this deception comes in the form of a breach of a fiduciary duty to an employer — such as occurs when a person uses confidential business information for his or her own purposes in the stock market. But what if the information was obtained through hacking? The Second Circuit made clear in *SEC v. Dorozhko*, 574 F.2d 42 (2d Cir. 2009), that trading on hacked information only fell within Section 10(b) if the hacking involved deceptive misrepresentations — for instance, by using a false computer "identity" to gain access to information — as opposed to mere theft by breaking into a computer system. Similarly, defendants have argued before the Second Circuit in cases like *United States v. Benjamin Chow*, No. 19-325 (2d Cir. 2009), that preexisting Section 10(b) case law cannot reach simple breaches of contractual non-fiduciary duties (like those arising from a nondisclosure agreement).

The ITPA would have cleared up these issues. As drafted, the bill would have outlawed trading on all manner of wrongfully obtained information, which would have included "theft, bribery, misrepresentation, 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, a breach of any code of conduct or ethics policy, or a breach of any other personal or other relationship of trust and confidence." This would have cured, for instance, the anomalous result of insider trading liability for a person who lied to a CEO to learn about a forthcoming merger and then traded on it, but no insider trading liability for a person who broke into the CEO's office to learn the same information before trading.

The ITPA also would have eliminated the central defense raised in *United States v. Sean Stewart*, 1:15-cr-287 (S.D.N.Y. 2019). In that case, an investment banker admitted to disclosing inside information to his father, but claimed that he had not thought his father would trade on it. The ITPA would have eliminated the preexisting case law requirement that the government show a defendant passed information in "anticipation of trading" in favor of broader liability for when trading was "reasonably foreseeable" to the tipper.

The ITPA's Failure to Remedy the Personal Benefit Requirement

The ITPA would have been less successful at repairing the central fault in the law of insider trading: the question of what benefit a tipper of inside information must receive to establish liability (and the related issue of what, if anything, a downstream tippee must know about that benefit). Courts have grappled with this question since the Second Circuit's decision in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), although greater clarity has arisen since the Supreme Court's decision in *United States v. Salman*, 580 U.S. __ (2016), and the Second Circuit's own subsequent decision in *United States v. Martoma*, 894 F.3d 64 (2d Cir. 2017).

To its credit, the ITPA as drafted had a clear solution: no benefit requirement, period. And of course, there was therefore no requirement that a downstream tippee have knowledge of any benefit. It would be sufficient for the government to prove that information was "wrongfully obtained" — in the manner described above — and that downstream tippees knew it. Professor John C. Coffee of Columbia Law School, one of the bill's drafters, had testified that fixing the personal benefit issue must be one of the principal goals of the ITPA. As he noted: "If a requirement for the prosecutor to show a personal benefit were to remain, then this proposed legislation would lose much of its impact."

Problems quickly became obvious, however, when the bill arrived upon the House floor. Congresswoman Maxine Waters (D-CA), one of the chief proponents of the ITPA, championed the bill as abrogating the "new and controversial" knowledge of the benefit requirement but otherwise "codifying existing case law." It did not simply codify existing law, of course, in a variety of small ways but certainly inasmuch as it removed the personal benefit test entirely. This disconnect became clear when Congresswoman Waters referenced a forthcoming amendment to be proposed by Congressman Patrick McHenry (R-NC) — an amendment that wholly reinstated the personal benefit test as defined by the courts. Somewhat amazingly, the amendment appears to have had nearly universal support, including from the sponsor of the ITPA, Congressman Jim Himes (D-CT). The personal benefit test was swiftly revived. Shortly thereafter, the ITPA was voted out of the House.

The 11th hour rescue of the personal benefit test may also have had unintended consequences the bill's champions did not foresee. As passed by the House, the ITPA stated that the government need not prove that a tippee knew "whether any personal benefit was paid or promised" so long as the tippee knew the inside information was "wrongfully obtained." This is the language that Congresswoman Waters referenced in proclaiming the death of the "new and controversial" knowledge of the benefit element. The problem is that after the personal benefit was put back into the definition of "wrongfully obtained" information by amendment, the requirement that the government prove a tippee knew that the information was wrongly obtained meant that it must prove he or she knew the information was obtained from a breach of duty in exchange for a personal benefit. Thus, the same provision both requires and does not require the government to prove knowledge of the benefit for a remote tippee. If the ITPA had passed the Senate in this form, it is likely that the rule of lenity would have resolved this ambiguity in favor of a criminal defendant, requiring proof of the knowledge of benefit.

Conclusion

The Senate has not passed the ITPA — in this form or in any other. And it seems increasingly unlikely it will do so. That may be for the best. While the ITPA as drafted would have successfully resolved a number of smaller problems in insider trading law, the floor amendment likely undid what many — including one of the bill's drafters and a foremost proponent — would regard as the two most important parts of the reform: the abandonment of the confusing personal benefit test and the related knowledge of the benefit element. Those involved in drafting the next insider trading bill would do well to keep the lessons of the failed ITPA in mind when a new chance for reform comes around.

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