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The Insider Trading 'Mess' Congress Is Trying To Fix

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The House Committee on Financial Services recently approved a bill, the Insider Trading Prohibition Act, which creates a statutory definition of insider trading in response to what Rep. Jim Himes, D-Conn., called a "judicial mess" of court decisions on the subject. This "judicial mess" exists, of course, because Congress has never adopted an explicit prohibition on insider trading, leaving it to the courts to interpret and develop the contours of an insider trading prohibition within the context of the existing anti-fraud provisions of the federal securities laws.

Whether or not the proposed legislation will improve matters remains to be seen, but the history of insider trading cases prosecuted civilly by the U.S. Securities and Exchange Commission and criminally by the U.S. Department of Justice supports the need for clarification.

A recent ruling in a criminal trial by Judge Jed S. Rakoff in the U.S. District Court for the Southern District of New York makes the point.

In ruling against the government on a pretrial motion, Judge Rakoff had to remind the U.S. attorney's office not to tell the jury that the stock market is meant to be a "level playing field."[1] Attorneys representing the defendant argued that the government's argument misrepresents the reality of the stock market and is not consistent with the U.S. Supreme Court's rulings, including Dirks v. SEC, which recognize that traders routinely seek out advantages over their counterparties in perfectly legal ways. Rakoff agreed, noting that "[a]nyone who thinks that the stock market is a level playing field obviously has no contact with reality." That the government could be so mistaken about a fundamental aspect of insider trading law may not be surprising given the state of the law.

Indeed, Judge Rakoff has been a longtime critic of insider trading jurisprudence. In 2012, he observed in United States v. Whitman, "the prohibition of insider trading in the United States has developed in a somewhat ad hoc manner, leaving many unanswered questions."[2] Rakoff noted that Congress never passed a statute outlawing insider trading in part because "the SEC has generally opposed such proposals on the ground that that any statutory definition of illegal insider trading would inevitably create 'loopholes.'" But, as Judge Rakoff noted, "the judge-made law of insider trading, however flexible, can create potential gaps in coverage that are the functional equivalent of legislative loopholes."[3]

The ill-defined, constantly evolving legal concepts are inherently difficult to explain — much less prove — to a jury, which has led to some high-profile jury trial losses for the government. Even though ultimately victorious, the defendants in insider trading trials often incur huge costs — monetary and reputational — in achieving those victories.

For example, earlier this year in the U.S. District Court for the District of Vermont a jury returned a verdict in favor of a former software administrator for a Vermont-based coffee company accused of misusing sensitive company financial data to make $2 million in "nefarious" profits. Following a lengthy trial, the jury found the defendant not liable. While the defendant was no doubt gratified by the result, his attorney pointed out that he had "endured five years of unsupported allegations" and had been fired by his employer for purportedly violating the company's insider trading policy.

One of the most widely publicized insider trading losses came in the SEC's 2013 case against billionaire Mark Cuban. The Texas jury in that case deliberated for less than five hours before deciding in Cuban's favor. Cuban, who reportedly spent more money defending the case than he would have paid in penalties had he lost, allegedly received information about a private transaction relating to a publicly traded company in which he owned shares. Some of the poorly defined legal issues at stake in the trial included whether Cuban owed a duty to refrain from trading on the information, whether the information was material, and whether the information was even nonpublic.

Recent judicial dissonance over what constitutes a "personal benefit" for tipper liability illustrates the need for more certainty for what constitutes illegal insider trading. The "personal benefit" test, articulated by Dirks, requires the government to prove that an insider who tips another person with confidential information must receive some personal benefit from the tip.

The most obvious and provable personal benefits are pecuniary or reputational ones, but Dirks also allowed "gifts of confidential information" to friends or relatives to qualify as impermissible personal benefits. In a series of circuit court cases and one Supreme Court decision, courts over the past five years have adopted various interpretations of this language — sometimes expanding it and other times limiting it. Recent briefs filed in connection with a certiorari petition filed in Martoma v. United States, an appeal from an insider trading conviction that was affirmed by the U.S. Court of Appeals for the Second Circuit, reflect the confusion this judicial disagreement has caused. In particular, both Martoma and amici have persuasively argued that the lack of a clear legislative or judicial definition of what constitutes an improper "personal benefit" violates due process.

The recently proposed insider trading legislation attempts to resolve some of the judicially created uncertainty by, for example, eliminating the need to prove that a personal benefit was paid to a tipper. However, the proposed legislation also contains its own ambiguities and would do nothing to eliminate overzealous charging decisions or alleviate due process concerns. Whatever the fate of the bill, securities market participants would do well to steer clear of transactions that might ultimately be determined by a jury or judge to be perfectly legal.

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