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PERSPECTIVE

Bill aims to tidy up 'judicial mess' of insider trading law

By Thomas Zaccaro, Nicolas Morgan, Lily Lysle and Dina Ellis Rochkind

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. This so-called mess exists because Congress has never adopted an explicit prohibition on insider trading, leaving it to the courts to develop and interpret the landscape of insider trading law against a backdrop of existing anti-fraud provisions of the federal securities laws. However, with courts across the country interpreting insider trading differently, this landscape can be difficult for market participants to navigate. If passed by the Senate and signed by the President, the Insider Trading Prohibition Act will be the United States' first bill that statutorily defines insider trading.

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This aptly described "judicial mess" is due primarily to the fact that the Securities Exchange Act of 1934, the primary basis of insider trading law, does not actually mention insider trading. The resulting 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. And even when ultimately successful, the defendants in these insider trading trials often incur high costs — both monetary and reputational — in defending insider trading charges.

In its simplest terms, U.S. insider trading law prohibits the purchase or sale of securities on the basis of material, nonpublic information. To fit this definition into the Exchange Act's fraud provisions, courts have held that market participants who possess material nonpublic information may not trade on that information when they have fiduciary duties as a result of their status as a corporate insider or a duty of confidentiality to the source of that information. The breach of those duties thus becomes the cornerstone of insider trading law — but inconsistent and unpredictable court decisions illustrate the need for more certainty in this area of law.

Recent judicial dissonance over what constitutes a "personal benefit" for insider trading tipper liability also illustrates this need for more certainty. The "personal benefit" test, articulated by *Dirks v. SEC*, 103 S. Ct. 3255 (1983), requires the government to prove that an insider who tips another person with confidential information receive some personal benefit in exchange for the tip. While pecuniary gifts are obvious personal benefits, *Dirks* also allowed "gifts of confidential information" to qualify as such impermissible personal benefits. Courts over the past five years have adopted various interpretations of this holding — some expanding and some narrowing it. The uncertainty created by these inconsistent decisions was recently highlighted by a decision in the U.S. District Court for the Southern District of New York vacating an insider trading guilty plea because of the lack of clarity concerning what constituted a "personal benefit" at the time the plea was entered.

In contrast, insider trading laws in the European Union are far more clear. EU laws are statutorily defined and designed to promote information parity across all market participants. Thus, the cornerstone of EU laws is not a breach of duty, but the possession of nonpublic information itself. Under EU laws, a market participant commits insider trading when he or she uses nonpublic information in a transaction. Duty to an information source is immaterial, and the information source is only important to the extent that it informs the market participant that the information is nonpublic. Thus, nuances like the personal benefit rule are nonexistent.

The Insider Trading Prohibition Act appears to be at a halfway point between the judge-created case law and the EU model. On the whole, the bill focuses on the wrongful obtaining and use or communication of nonpublic information. Under Section 16A(c)(1) of the bill, "wrongful" actions include theft, bribery, and espionage. Thus, insider trading would no longer be limited to situations involving a breach of duty.

Further, the bill appears to abandon the personal benefit test. Under Section 16A(c)(2) of the bill, a market participant no longer needs to know the means by which nonpublic information was obtained, and explicitly no longer needs to know that a personal benefit was paid. Instead, liability hinges on the market participant's awareness that the nonpublic information used was wrongfully obtained or communicated. Despite the uncertainty regarding the personal benefit test, its elimination could ultimately provide even less notice to market participants as to what constitutes illegal insider trading because that test is designed to separate purposeful, deliberate, and criminal tipping of inside information from merely negligent and unintentional disclosures.

The proposed legislation has several other notable shortcomings. For one, the bill makes no reference to materiality. Additionally, while wrongful "use" of nonpublic information is prohibited, "use" is never clearly defined. Under Section 16A(c)(1), wrongful use could include any action that "directly or indirectly" leads to theft. Using this broad interpretation, a market participant who enters a securities transaction for a perfectly lawful reason could be liable for insider trading if that market participant also happens to possess nonpublic information. While the bill does note that transactions that are "solely" based on lawful motives are exempt, it may be difficult (or impossible) for a party successfully to satisfy that standard in the context of litigation.

Moreover, closely tracking the bill's language presents at least two problematic interpretations. First, as noted by Columbia Law Professor John Coffee Jr., although the bill explicitly removes knowledge of a personal benefit as a requirement in tipper-tippee situations, the bill is not entirely clear on whether a personal benefit still needs to be exchanged. Second, under Section 16A(b), a tipper could be liable for insider trading even if a tippee enters a transaction for a separate and lawful reason while in possession of nonpublic information.

In short, the Insider Trading Prohibition Act appears to be a step in the right direction. It removes clutter and clarifies areas of insider trading law that have long been vague. However, the bill still retains some vagueness, and also introduces new ambiguities which need to be addressed by Congress before it becomes law.

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