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at

Hearings before the Committee on Banking, Housing, and Urban Affairs

of the

United States Senate

Keeping Markets Fair:
Considering Insider Trading Legislation

April 5, 2022
Room 538 of the Dirksen Senate Office Building
Washington, D.C.

Chairman Brown, Ranking Member Toomey and Fellow Members of the Committee,

Thank you for inviting me today. I must begin with a very simple message: the law of insider trading has been for too long the product exclusively of judicial decision-making. Insider trading is effectively a "common law" crime that has evolved without legislative direction. Yet, it is the Congress's job to state the criminal law because it alone is the voice of the community that can reach a truly democratic decision. Letting insider trading law develop on a simply common law basis ensures that there will be inter-Circuit disparities, that the law will expand in irregular and sometimes spasmodic movements, and that the public at large will be excluded from these deliberations.

H.R. 2655 was an effort, I believe, to correct this problem and establish a clearer legislative definition of insider trading. But since its passage by the House in 2021, there have been two major developments that, I suggest, the Senate should also address:

First, although H.R. 2655 was originally intended to eliminate the "personal benefit" requirement, this provision was eliminated or downsized at the last minute.[1] Nonetheless, to the extent there is any consensus today, that consensus is probably stated best in the Report of the Bharara Task Force on Insider Trading (2020), which explicitly calls for the elimination of the "personal benefit" requirement as a major obstacle to the prosecution of insider trading.[2] That Task Force, chaired by the former U.S. Attorney for the Southern District of New York, was staffed primarily by former prosecutors, SEC enforcement officials, and judges (with a sprinkling of law professors), and it was bipartisan. It found, as I explain later, that the "personal benefit"

[1] Proposed Section 16A(c)(1)(D) does state such a requirement ("for a direct or indirect personal benefit"). Although prosecutors need not rely on clause (D) and could instead rely on (A), (B), or (C), there is an ambiguity as to whether all these sections should be read in pari materia. Given that the Supreme Court granted certiorari on this question in Blaszczak (as later explained), I would strongly recommend explicitly rejecting the "personal benefit" requirement.

[2] For the record, I was a member of this Task Force.

requirement "generated a disproportionate share of confusion and uncertainty," produced "incongruent results," and allowed clearly wrongful conduct to escape the law's reach.[3]

Second, in a recent case, United States v. Blaszczak,[4] the Second Circuit agreed that insider trading can be prosecuted under certain other federal statutes,[5] and, in such cases, there was no need to prove that a "personal benefit" was paid or promise to the tipper. However, in Blaszczak, defendants appealed this outcome on two grounds: (1) they argued that the material information that was tipped did not constitute "property" because it was developed by the Government in an effort at regulation (and not as a property holder), and (2) the various federal statutes applicable to insider trading had to be read consistently ("in pari materia" in legal parlance) and all therefore required a showing of a personal benefit. The Supreme Court granted certiorari on both questions, but later, at the request of the Solicitor General, remanded to the Second Circuit for it to reconsider its decision in Blaszczak in the light of an intervening Supreme Court decision.[6]

The net result is to leave as at a moment of great uncertainty. To illustrate, suppose the Federal Reserve were to decide to significantly raise interest rates. If one could trade in the stock market based on this material non-public information and prior to its public disclosure, one could easily reap profits in the millions of dollars. But at present, it is uncertain whether this violates the law. To be sure, the Second Circuit will eventually decide the case remanded to it, and the losing

[3] See Report of the Bharara Task Force on Insider Trading (2020) (at pp. 15-16).
[4] 947 F.3d 19 (2d. Circ. 2019).
[5] The defendants in Blaszczak were convicted under 18. U.S. C. 1343 and 18 U.S.C. 1348,but were acquitted under the Rule 10b-5 charge (probably because the jury saw no evidence of a "personal benefit").
[6] Blaszczak v. United States, 2021 U.S. LEXIS 93, 141 S. Ct. 1040 (vacating and remanding to the Second Circuit for further consideration in light of Kelly v. United States, 140 S. Ct. 1565 (2020)). Kelly involved the "BridgeGate" scandal in New Jersey in which certain officials working under the New Jersey Governor allegedly cut off access to several lanes of the George Washington Bridge to residents of Fort Lee as a political reprisal. The Supreme Court reversed their convictions on the grounds that such a political retaliation did not offend federal fraud statutes because no property was taken or sought. Kelly was a decision that in turn relied on Cleveland v. United States, 531 U.S. 12 (2000), which found that video poker licenses issued by the state were not "property" in the hands of the state, because the state was acting as a regulator, not as a property holder.

side will predictably appeal to the Supreme Court. But even if the Supreme Court takes this case, its decision may only decide the issue over a narrow factual range. Characteristically (and properly), courts rule narrowly.

More is needed. Legislation could do much better and establish general principles.

I. The Current Statutory Law on Insider Trading.

At present, the only statutory foundation for the prohibition of insider trading are a few short words in Section 10(b) of the Securities Exchange Act of 1934, which forbid the use of any "manipulative or deceptive device or contrivance in contravention of such rules as Commission may prescribe…"(emphasis added). There is no doubt that Congress wants insider trading prohibited, as it has several times passed legislation raising the penalties for insider trading.[7] But it has left the definition of insider trading to the courts.

Meanwhile, the case law has developed in different directions in different circuits. In all Circuits, there is both the "Classical Theory" of insider trading and the Misappropriation Theory, but in the Second Circuit there is also a theory recently articulated in United States v. Martoma[8] that information provided by the tipper to the tippee with the intention to benefit the tippee also violates Rule 10b-5. This expanded "gift theory," while derived from Dirks v. SEC,[9] goes further than the law in any other Circuit to reach persons who receive material confidential information (without paying or promising any person benefit). Also in Martoma, the government took the position that there was no longer any need to establish a "meaningfully close personal relationship"

[7] See, e.g., Insider Trading Sanctions Act of 1983 ("ITSA") (increasing civil penalty to three times the gain or loss avoided and raising criminal fine), Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSEA") (raising prison sentence and maximum penalty and authorizing SEC to pay whistleblowers).
[8] 894 F.3d 64 (2d Cir. 2018) (as corrected).
[9] 436 U.S. 646 (1983).

between the tipper and the tippee.[10] Without criticizing Martoma, the point here made is that the federal courts have not been able to create a reasonably uniform body of law.

Other issues also are highly uncertain that are unrelated to the "personal benefit" issue (which involves the relationship of the tipper and tippee). Let me give just two examples: First, the SEC has just succeeded in convincing a district court to accept a new and novel legal theory that prohibits what is called "shadow trading." In SEC v. Panuwat,[11] the district court refused to dismiss an SEC action brought against an employee of a company that was about to be acquired; the employee did not buy shares of either his company or the acquiring company, but instead bought stock in a company similar to his own because he guessed (correctly) that the acquisition of his company would drive up the price of similar companies. Reasonable people can disagree about the wisdom of this new theory (I was surprised that the SEC brought this case). But my point is this type of significant extension of the criminal law should be a decision for the legislature.

To give a second example, suppose that a defendant finds a way to "hack" into a company's information system to steal confidential, market-moving information. This conduct may (or may not) violate computer privacy statutes, but, even if it does, that will not help the SEC, which in fact is the principal enforcer of insider trading law (in terms of cases filed), as the SEC can only sue based on prohibitions in the federal securities laws. In truth, the SEC has been able on at least one occasion in the Second Circuit to reach such a "hacking" case,[12] but it is very uncertain whether other Circuits would follow it. H.R. 2655 would correct this problem, legislating a general prohibition that would reach virtually any form of "wrongful" hacking.

[10] See United States v. Martoma, 894 F.3d at 71 to 72.
[11] 21-CV-6322 (N.D. Cal. January 14, 2022) (denying motion to dmiss).
[12] See SEC v. Dorozhko, 574 F.3d 42, 48-50 (2d Cir. 2009).

II. The 'Personal Benefit' Requirement.

The "personal benefit" originated with Dirks as a seemingly "objective" means of distinguishing between (1) the self-serving use of corporate information that breached a duty owed to the shareholders (or the source of the information), and (2) a legitimate (or at least innocuous) use of the information. Also, the Court may have believed that it was important to protect institutional investors who might otherwise be chilled from engaging in communication with the corporations in which they invested. But experience with the "personal benefit" requirement has shown at least three problems that regularly recur:

First, it protects and immunizes defendants from liability in some cases that involve obviously wrongful behavior. Suppose, for example, an activist investor has learned material non-public information about Corporation X (possibly legitimately), and an executive at that investor tips that information to a hedge fund who trades on it. But the latter hedge fund has not paid or promised anything for this information. Thus, it has the defense that it paid no personal benefit to the tipper and so cannot be held liable. Still, there may have been an implicit, unstated understanding: the tippee who benefitted in this case would be expected to reciprocate and tip its tipper in a future case. Both sides would be wise enough to make no explicit promise (or even hint at one). Norms of reciprocity are common in most networks where repeat players interact. Only a fool would make an illegal promise to reciprocate when a silent payback (months later) will work.

Second, disparities are likely under the fact-specific character of this standard. For the law to apply, do the parties have to be very close friends or just interacting market participants who see that reciprocation can benefit both? Circuits now disagree. Moreover, the more the standard is fact-specific, the more the likelihood that circuits will disagree.

Third, prosecutors may be unwilling to investigate in detail if their only chance of winning a conviction depends on finding a fact (a quid pro quo) that can be easily hidden.

So what is the best alternative? Congress should direct federal courts to focus not on the specific case (whether a quid was paid for a quo), but on the more general issue of whether the information was "wrongfully" taken, used or communicated. That is the Bharara Task Force Report's position. This approach does not make insider trading either a strict liability crime or a crime of simple negligence, but requires culpable behavior.

III. <u>Whose Property Is It?: The Case of Governmental Information</u>.

Should the government have the right to protect its confidential information -- at least to prevent others from trading on it to overreach public investors? This is not a constitutional issue. It is simply requires the legislature to speak clearly and bar the tipping of, or trading on, such information. If statutes such as the mail and wire fraud statutes were revised to cover not just the theft or misappropriation of property, but also of information that the government had a legitimate interest in keeping confidential, such legislation would be legitimate and enforceable.

IV. <u>What Then Should Be Done To H.R. 2655</u>?

There are many ways to skin the cat! One way would be to add a new subsection (c) to proposed Section 16A, stating that:

> "(c) It shall not be necessary that any person trading while in possession of such information (as proscribed by subsection (a), or making the communication (as proscribed by subsection (b), (i) have paid or promised any benefit (monetary or otherwise) to the tipper (or on its behalf) or to any person in the chain of communication, or (ii) know the specific means by which the information was obtained or communicated, so long as the person trading while in possession of such information or making the communication, as the case may be, was aware, or recklessly disregarded, that such information was wrongfully obtained or communicated."

To ensure that there was no possible confusion, I would take "old" Section 16A(c) ("Standard and Knowledge Requirement"), renumber it as "(d)", and revise its subsection (1)(d) to read as follows:

> "(D) a breach of any fiduciary duty to shareholders of an issuer, including —
>
> (i) an existing or future pecuniary gain or reputational benefit; or
>
> (ii) a gift of confidential information to a relative or friend."

With those changes, H.R. 2655 would better arm prosecutors, while still requiring "wrongful" behavior by the criminal defendant. And it would end the "common law" nature of the crime of insider trading. But if the "personal benefit" standard is retained, I am afraid that in its practical effect, H.R. 2655 would be more a step backward than a step forward.