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# US Senate To Consider Historic Insider Trading Bill In 2020

## INTRODUCTION

Last month, the U.S. House of Representatives voted to pass a new insider trading bill. The House's insider trading bill was received in the U.S. Senate on December 9, 2019, and referred to the Senate's Committee on Banking, Housing, and Urban Affairs.

But everyone knows what insider trading is and that it is illegal. There is already an enormous body of case law going back decades, if not generations, dealing with insider trading cases.

So why is Congress spending time now, in 2020, debating an insider trading bill? Because, as surprising as it may sound, there is no universally-applicable federal statute actually defining and outlawing insider trading.[1]

Instead, over many years it has fallen to the courts to try to define insider trading, describe what it looks like, and determine when it amounts to a crime or violation of federal securities laws. In the absence of a single uniform standard to guide all of the different federal courts, from all across the country, over such an extended period of time, it may not be surprising that many different and sometimes conflicting descriptions, definitions, opinions, and views about insider trading have emerged.

The lack of a clear standard entered the spotlight in 2014, when the U.S. Court of Appeals for the Second Circuit issued a controversial opinion involving tippee liability for insider trading. In a different case a couple of years later, the U.S. Supreme Court ruled that the Second Circuit had gotten that case wrong, but the Supreme Court left open certain issues. As a result, there continued to be confusion and disagreement over the scope of tippee liability for insider trading.

In this uncertain environment, the House of Representatives put forth an insider trading bill to establish what it hopes will become a clear and uniform standard that can be applied nationwide.

## IF AN INSIDER TRADING BILL IS JUST NOW BEING CONSIDERED, WHAT HAS BEEN GOING ON FOR ALL THESE YEARS?

To properly understand the perceived need for the House's insider trading bill, it is useful to have some historical context.

Following the Great Depression, Congress enacted the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act"). Those two Acts, along with their amendments and other laws that have been passed over the years, form the backbone of the nation's federal securities laws. None of those Acts or laws clearly define insider trading.

Sometimes people refer to §16(b) of the 1934 Act as a prohibition on insider trading.[2] To be overly simplistic, §16(b) says that when corporate directors, officers, or shareholders who own more than 10% of a company's stock, acquire new stock in their company, they must hold on to their new stock for six months before selling it. If they sell their stock before six months have elapsed, they are required to turn over any profits they made on the sale to the company.

Section 16(b) is a very narrow prohibition that applies to only a miniscule fraction of all of the overall market participants. It is not a prohibition on insider trading broadly applicable to everyone. In part for that reason, rather than being referred to as an "insider trading" statute, it is instead commonly referred to as the "short swing profit rule".[3]

Certain provisions of the 1933 and 1934 Acts, and SEC Rules promulgated thereunder, prohibit the "employment of manipulative and deceptive devices". Those sections include §17(a) of the 1933 Act, §10b of the 1934 Act, and SEC Rule 10b-5 thereunder,[4] which are commonly referred to as the anti-fraud provisions.

Since as far back as 1961,[5] when the U.S. Securities and Exchange Commission ("SEC" or "Commission") brings an insider trading case, what it typically does is bring a cause of action alleging that the defendant "employed manipulative or deceptive devices" in violation of §17(a), §10b, and/or Rule 10b-5. It then alleges that the manipulative or deceptive "device" that the defendant employed was the insider trading.

If this sounds unnecessarily convoluted and complicated, that is because it probably is, and is another reason why the House may have believed that its new insider trading bill was necessary.

## THE SECOND CIRCUIT'S CONTROVERSIAL 2014 OPINION

Two of the most frequently cited U.S. Supreme Court insider trading rulings are *Chiarella v. U.S.*[6] and *Dirks v. SEC*.[7] These cases, along with a handful of others,[8] have provided the framework that courts and parties have applied in insider trading cases for the last forty years.

However, in 2014, the U.S. Court of Appeals for the Second Circuit released an opinion in a case called *U.S. v. Newman*.[9] Rather than being a routine opinion, the *Newman* decision had the effect of a grenade lobbed into the world of insider trading law.

In *Newman*, the Second Circuit held that in order to convict a tippee of insider trading, the federal government must prove that (1) the tippee received confidential inside information from the tipper; (2) the tippee knew that the information was confidential inside information; (3) the tippee knew that the tipper violated his or her fiduciary duties by disclosing that confidential inside information; (4) the tipper received a personal benefit from providing that inside information to the tippee;[10] and (5) the tippee actually *knew* that the tipper received a personal benefit from doing so.

Furthermore, according to *Newman*, where the government alleges that the tipper's personal benefit is not a direct material one (such as a documented kickback from the tippee), but rather is derivative and to be inferred from the nature of the tipper's relationship with the tippee, the government must prove that there was "a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[11]

In 2016, the U.S. Supreme Court abrogated the *Newman* decision, but only partially. The partial abrogation occurred in a case called *Salman v. U.S.*[12] In the *Salman* case, the Supreme Court said that the *Newman* decision had not applied *Dirks* properly. As explained by the Supreme Court, a jury is entitled to infer that, by gifting confidential inside information to a relative who then traded on that information, a tipper received a personal benefit.[13]

However, the Supreme Court did not address the *Newman* court's other ruling that the tippee must actually know that the tipper received the personal benefit.[14] Because *Salman* was decided on only certain issues, some courts have continued to rely upon *Newman* in other insider trading cases.[15]

## THE U.S. HOUSE'S INSIDER TRADING BILL: H.R. 2534

Over the years, there have been various attempts to introduce and pass an insider trading bill, with little success.[16] This is one reason why the insider trading bill introduced in the House of Representatives during 2019 is catching attention.

The House bill is called the "Insider Trading Prohibition Act" (H.R. 2534).[17] It was introduced in the U.S. House of Representatives on May 7, 2019.[18]
The House Committee on Financial Services released a 28-page report on the bill on September 27, 2019 (the "Report").[19] According to the Report, the insider trading bill:

> … formally codifies the prohibition against insider trading, creating a clear, consistent standard for both courts and market participants to follow. The bill largely codifies the existing case law on insider trading. However, the bill overturns a controversial judicially-imposed requirement that an individual who receives insider information know about the specific personal benefit received by the individual who discloses the information.[20]

The Report identifies that "controversial judicially-imposed requirement" as stemming from the Second Circuit's *Newman* opinion:[21]

> In 2014, the Second Circuit held that even though a tippee may know that the information was wrongfully disclosed, the government must also prove that they knew about the specific *personal benefit* that the insiders received…. The bill would overturn this controversial court requirement and establish a clear, legislative standard for illegal insider trading.[22]

If enacted, the House's insider trading bill would add a new Section 16A to the Securities Exchange Act of 1934 entitled "Prohibition On Insider Trading". That prohibition would make it:

> … unlawful for any person, directly or indirectly, to purchase, sell, or enter into, or cause the purchase or sale or entry into, any security, security-based swap, or security-based swap agreement, while aware of material nonpublic information … from whatever source, that has, or would reasonably be expected to have, a material effect on the market price of any such security … if such person knows, or recklessly disregards, that such information has been obtained wrongfully, or that such purchase or sale would constitute a wrongful use of such information.[23]

Among other things, the bill defines tipper liability for insider trading, and adds that the tipper must be aware that the tippee's trading on the inside information "is reasonably foreseeable."[24]

The bill also states that insider trading, whether by an insider or by a tippee, will only be illegal if the inside information is obtained by certain means, or if the conveyance of the information would constitute certain types of conduct.[25]

The list of such types of conduct is extensive and includes: theft, bribery, misrepresentation, espionage, a violation of Federal law protecting computer data or the intellectual property or privacy of computer users, conversion, misappropriation, other unauthorized and deceptive taking of such information, breach of fiduciary duty, breach of a confidentiality agreement, breach of contract, breach of a code of conduct or ethics policy, or breach of any other personal or other relationship of trust and confidence for a direct or indirect personal benefit.[26]

In a parenthetical, the insider trading bill defines direct or indirect personal benefit as "including pecuniary gain, reputational benefit, or a gift of confidential information to a trading relative or friend".[27] Moreover:

> It shall not be necessary that the person trading while aware of such information … or making the communication … knows the specific means by which the information was obtained or communicated, or whether any personal benefit was paid or promised by or to any person in the chain of communication, so long as the person trading while aware of such information or making the communication, as the case may be, was aware, consciously avoided being aware, or recklessly disregarded that such information was wrongfully obtained, improperly used, or wrongfully communicated.[28]

On December 5, 2019, the House's insider trading bill passed by a vote of 410 - 13, with 7 members not voting.[29] It was received in the U.S. Senate on December 9, 2019,[30] and referred to the Senate's Committee on Banking, Housing, and Urban Affairs.[31]

## THE ODDS OF THE INSIDER TRADING BILL BECOMING LAW IN 2020

Based on the history of federal insider trading legislation since 1934, skeptics might argue that an insider trading bill has little chance of passing the Senate and becoming law. Others might cite the current political climate and Republican control of the Senate to support dire predictions for the ultimate passage of an insider trading bill.[32]

On the other hand, in 2012 Congress did pass the STOCK Act, which affirmed that Members and employees of Congress are not exempt from liability for insider trading based on confidential information they obtain during the performance of their official responsibilities.[33] The Senate has not repealed the STOCK Act.[34]

Furthermore, House Republicans voted in favor of the Insider Trading Prohibition Act (H.R. 2534) by an overwhelming 182 - 12, with only 3 Republicans not voting.

In addition, the Senate is presently considering two bills that would grant the SEC statutory authority to seek and obtain disgorgement in court. The House's disgorgement bill, H.R. 4344, was received in the Senate on November 19, 2019. Ninety-three (93) Republican Congressmen voted in favor of H.R. 4344, with ninety-four (94) voting against it. This almost perfect split among House Republicans could imply that an automatic rejection of an insider trading bill in the Senate along strict party lines may not be a foregone conclusion.

The Senate is considering H.R. 4344 along with its own disgorgement bill called the "Securities Fraud Enforcement Act of 2019" (S. 799). The Senate bill actually goes further than the House bill in certain respects, in that in addition to disgorgement, it would also grant the SEC the statutory power to seek and obtain restitution.[35]

During 2019, both the House and the Senate also introduced bipartisan securities-related bills to enhance protections for SEC whistleblowers. One hundred eighty-one (181) Republican Congressmen voted in favor of the House bill, H.R. 2515, with only eleven (11) voting against it. This overwhelming vote by House Republicans, viewed in conjunction with the equally overwhelming House Republican vote on the insider trading bill (H.R. 2534), and the almost evenly split Republican vote on H.R. 4344, might also signal that an automatic rejection of an insider trading bill along strict party lines in the Senate is not a *fait accompli*.

Moreover, as with the SEC disgorgement and restitution bills, the Senate's own bipartisan bill to enhance SEC whistleblower protections, S. 2529, goes even further than the House bill in certain respects, in that in addition to extending Dodd-Frank whistleblower protections, it would also set a time limit on how long the Commission may take to render preliminary determinations on SEC whistleblowers' applications for awards.[36]

Additionally, 2020 is an election year, which throws a wildcard into the mix. It is possible that certain Senators might be more motivated to pass an insider trading law to appeal to their constituencies prior to the elections. But it is also possible that an insider trading bill could take a back seat should other more high profile legislation emerge.

So, what are the odds of the House's insider trading bill being approved by the Senate and enacted as law?

If that question is asking about H.R. 2534 literally, in its unaltered form, the critics may be correct and the answer may well be slim to none. Many bills get modified, amended, or reconciled with other related bills before passing. That is simply a part of the process.

But if the question is construed more broadly to refer to an insider trading bill generally, in whatever final form it may take, then the odds could go up considerably, especially if the Senate introduces its own version of an insider trading bill over the coming months. Remember that the Senate only received H.R. 2534 on December 9, 2019, and the year-end holidays intervened just two weeks later.

What will happen with the insider trading bill, not to mention the currently pending SEC disgorgement, restitution, and whistleblower protection bills, remains to be seen. All of these bills, taken separately or together, have the potential to alter the securities enforcement landscape for years to come, and bear following as 2020 progresses.

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## ABOUT THE PICKHOLZ LAW OFFICES LLC

The Pickholz Law Offices LLC is a law firm that focuses on representing clients involved with investigations conducted by the U.S. Securities and Exchange Commission, FINRA, and other securities regulators.

The Pickholz Law Offices has represented employees, officers, and others in SEC whistleblower cases involving financial institutions and public companies listed in the Fortune Top 10, Top 20, Top 50, Top 100, Top 500, and the Forbes Global 2000. We were the first law firm ever to win an SEC whistleblower award for a client on appeal to the full Commission in Washington, an achievement that Inside Counsel magazine named one of the five key events of the SEC whistleblower program. Examples of the Firm's SEC whistleblower cases are available at https://pickholzlaw.com/sample_matters.

In addition to representing SEC whistleblowers, since 1995 the Firm's founder, Jason R. Pickholz, has also represented many clients in securities enforcement investigations conducted by the SEC, FINRA, the U.S. Department of Justice and US Attorney's Offices, State authorities, and more. Examples of some of the many securities enforcement cases that Mr. Pickholz has been involved with are available at https://pickholzlaw.com/sample_matters#1578408398642-63454090-a2fe.

You can see what actual clients have had to say about The Pickholz Law Offices by going to the Client Reviews page on our website.

## HOW TO CONTACT THE PICKHOLZ LAW OFFICES LLC

If you would like to speak with a securities lawyer or SEC whistleblower attorney, please feel free to call Jason Pickholz at **347-746-1222**.



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[1] This is not unique in the federal securities laws. *See, e.g.*, Pickholz and Pickholz, "Manipulation", Journal of Financial Crime, Henry Stewart Publications (Nov. 2001), originally presented at the Eighteenth Annual International Symposium on Economic Crime, Jesus College, Cambridge University, England (2000), https://pickholzlaw.com/publications.

[2] A copy of §16(b) of the 1934 Act, 15 U.S.C. §78p(b), can be found online at https://www.law.cornell.edu/uscode/text/15/78p.

[3] Last week, on January 13, 2020, the U.S. House of Representatives passed a similarly narrow bill that would prohibit corporate executives from trading in their companies' securities between the time when certain significant corporate events

occur, and four days later when those events must be publicly reported on Form 8-K. That bill was not titled as an "insider trading" bill either. Instead it was titled the "8-K Trading Gap Act of 2019" (H.R. 4335) and was described as closing a "loophole". A copy of H.R. 4335 can be found online at https://www.congress.gov/116/bills/hr4335/BILLS-116hr4335ih.pdf. The floor debates on H.R. 4335 can be found online at https://www.congress.gov/116/crec/2020/01/13/CREC-2020-01-13-pt1-PgH188.pdf. The bill passed the House by a vote of 384 - 7 with 39 not voting. The results of the final role call vote can be found online at http://clerk.house.gov/evs/2020/roll014.xml.

[4] 17 C.F.R. § 240.10b5.

[5] *See In the Matter of Cady, Roberts & Co.*, 40 S.E.C. 907, File No. 8-3925 (1961).

[6] 445 U.S. 222 (1980). A copy of the Supreme Court's ruling in *Chiarella* can be found online at https://cdn.loc.gov/service/ll/usrep/usrep445/usrep445222/usrep445222.pdf.

[7] 463 U.S. 646 (1983). A copy of the Supreme Court's ruling in *Dirks* can be found online at https://cdn.loc.gov/service/ll/usrep/usrep463/usrep463646/usrep463646.pdf.

[8] *See, e.g.*, *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968).

[9] 773 F.3d 438 (2d Cir. 2014). A copy of the *Newman* opinion can be found online at https://h2o.law.harvard.edu/collages/40640.

[10] In a recent criminal case, the U.S. Court of Appeals for the Second Circuit held that the *Dirks* Court's "personal benefit" requirement for insider trading violations of § 10(b) of the Securities and Exchange Act and Rule 10b-5 thereunder does not apply to criminal securities fraud under 18 U.S.C. § 1348. *U.S. v. Blaszczak*, 18-2811, slip op. at 4-5, 30, 33 (2d. Cir. Dec. 30, 2019). During the few short weeks since then, some commentators have begun to cite *Blaszczak* as representing a shift in insider trading law. However, the Second Circuit specifically noted that, unlike § 10(b), the federal criminal fraud statute is derived from the law of embezzlement, and that embezzlement does not and traditionally has not required a personal benefit. *Id.*, slip op. at 29-32. This dichotomy between the federal securities laws and the federal criminal laws contributes to the confusion surrounding insider trading, and may have been another factor motivating Congress in connection with H.R. 2534.

Moreover, the criminal securities fraud statute at issue in *Blaszczak*, 18 U.S.C. § 1348, is not an "insider trading" statute. Somewhat similar to §§ 17(a) and 10(b), 18 U.S.C. § 1348 criminalizes "a scheme or artifice to defraud" and "false or fraudulent pretenses, representations, or promises" in connection with the purchase or sale of securities or commodities. Akin to SEC civil enforcement actions under §§ 17(a) and 10(b), when the government brings a criminal prosecution for "insider trading", it often charges the defendant with a "scheme or artifice to defraud" or with employing "false or fraudulent pretenses, representations, or promises", and alleges that the insider trading was the means or method used by the defendant in doing so. A copy of 18 U.S.C. § 1348 can be found online at https://www.law.cornell.edu/uscode/text/18/1348.

[11] *Newman*, 773 F. 3d at 452.

[12] 137 S. Ct. 420 (2016). A copy of the Supreme Court's ruling in *Salman* can be found online at https://www.supremecourt.gov/opinions/16pdf/15-628_m6ho.pdf.

[13] *Salman*, 137 S. Ct. at 428.

[14] *Id.*, 137 S. Ct. at 425 n.1.

[15] *See, e.g.*, *U.S. v. Lee*, 13 Cr. 539 (S.D.N.Y. June 21, 2019).

[16] *See, e.g.*, the Stop Illegal Insider Trading Act of 2015 (S. 702). A copy of S. 702 can be found online at https://www.congress.gov/114/bills/s702/BILLS-114s702is.pdf, and its legislative history can be found at https://www.congress.gov/bill/114th-congress/senate-bill/702.

[17] A copy of H.R. 2534 can be found online at https://www.congress.gov/116/bills/hr2534/BILLS-116hr2534eh.pdf.

[18] *See* https://www.congress.gov/bill/116th-congress/house-bill/2534/actions.

[19] A copy of the House Committee on Financial Services' Report on H.R. 2534 can be found online at https://www.congress.gov/116/crpt/hrpt219/CRPT-116hrpt219.pdf.

[20] *Id.*, Report at 3 (underline added).

[21] *Id.*, Report at 3 n.1, 4, 4 n.5.

[22] *Id.*, Report at 4 (citation omitted)(italics in original).

[23] Insider Trading Prohibition Act, H.R. 2534, § 16A(a).

[24] *Id.*, §§ 16A(b), 16A(b)(2).

[25] *Id.*, § 16A(c)(1).

[26] *Id.*, §§ 16A(c)(1)(A)-(D).

[27] *Id.*, § 16A(c)(1)(D).

[28] *Id.*, § 16A(c)(2).

[29] The results of the final role call vote on H.R. 2534 can be found online at http://clerk.house.gov/evs/2019/roll649.xml.

[30] For a copy of the House's insider trading bill as received in the Senate, *see* https://www.congress.gov/116/bills/hr2534/BILLS-116hr2534rfs.pdf.

[31] *See* https://www.congress.gov/bill/116th-congress/house-bill/2534/all-actions.

[32] For example, as of January 15, 2020,one organization that describes itself as a "global transparency" website (https://www.govtrack.us/about) was giving the bill a "1% chance of being enacted", relying on a purported outside analysis of factors such as the text of the bill, the home state (CT) and party affiliation (Democrat) of the bill's primary sponsor, the lack of any related bills in Congress, and that the bill's primary subject is the financial sector. *See* https://www.govtrack.us/congress/bills/116/hr2534 (claiming reliance on an undisclosed analysis or prediction by Skopos Labs, https://www.skoposlabs.com).

[33] 2012 STOCK Act, Pub. L. 112-105, 126 STAT. 291 (Apr. 4, 2012), as amended by Pub. L. 113-7, 127 STAT. 438 (Apr. 15, 2013). A copy of the STOCK Act can be found online at https://www.congress.gov/112/plaws/publ105/PLAW-112publ105.pdf as amended by https://www.congress.gov/113/plaws/publ7/PLAW-113publ7.pdf.

[34] Although in 2014, the House's Committee on Ways and Means challenged the SEC's jurisdiction to serve subpoenas on Members and employees of Congress, and the SEC's authority to enforce the STOCK Act. *See SEC v. The Committee On Ways And Means Of The U.S. House Of Representatives and Brian Suter*, 1:14-mc-00193-P1 (S.D.N.Y. 2014); *see also* Respondents' June 17, 2014 letter to the SEC (https://html2-f.scribdassets.com/82okgruyf43w4cuw/images/1-803653ec3b.jpg); and Respondents' July 4, 2014 Memorandum In Opposition to the SEC's Order to Show Cause and In Support of Respondents' Motion To Dismiss or

Transfer (https://assets.documentcloud.org/documents/2074069/congress-vs-sec.pdf). The U.S. District Court ordered the House Committee to partially comply with the SEC's subpoenas and ordered Mr. Suter to sit for a deposition. *See* Raymond, Nate, "U.S. judge rules for SEC in fight with House panel over insider trading probe", Reuters (Nov. 16, 2015) as found at https://www.reuters.com/article/usa-insidertrading-house-idUSL1N13B1IO20151116. Following oral arguments on appeal to the Second Circuit, the parties entered into a stipulated dismissal without prejudice. (Dkt. Entry #59.)

[35] For more on the pending SEC disgorgement bills, S. 799 and H.R. 4344, *see* "The Viability of Disgorgement As An SEC Remedy: 2020 Will Have Profound Ramifications", The Pickholz Law Offices LLC (Jan. 7, 2020) at https://pickholzlaw.com/securities-law-updates/sec-remedy.html.

[36] For more on the pending SEC whistleblower protection bills, S. 2529 and H.R. 2515, see "Senate, House & 68 IGs Unite Behind Strong Whistleblowing Policy: 2019 Year-In-Review", The Pickholz Law Offices LLC (Dec. 19, 2019) at https://pickholzlaw.com/whistleblowing-policy.