BURR ALERT

INSIDER TRADING TRENDING

By Thomas K. Potter, III February 2020

This winter has seen insider-trading trending – and not just because President Trump pardoned Michael Milken. In sequence, several legislative proposals have been working their way through Congress, the Second Circuit dropped its *Blaszczak* bombshell, and a blue-ribbon task force issued its recommendations.

A HISTORY OF SHIFTING STANDARDS.

The Bharara Task Force on Insider Trading, convened by former S.D.N.Y. U.S. Attorney Preet Bharara has provided a good summary history of insider trading law in its recent Report. Summarizing it broadly:

When Columbia Law Prof. William Cary became SEC Chairman in March 1961, he sought to overturn *Goodwin v. Agassiz,* 283 Mass. 358, 186 N.E. 659, 1933 Mass. LEXIS 1031 (Mass. 1933), which held that insider-trading was not actionable fraud in open market trading. In *In the Matter of Cady, Roberts & Co.*¸ File 8-3925, 40 SEC 907, 911 (Nov. 8, 1961), the SEC used Rule 10b-5 as the basis for an insider-trading action and established the "disclose or abstain" rule for material nonpublic information.

Shortly after, the Second Circuit expanded the reach of insider-trading, adopting an "equal access" to market information theory. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc). But the Supreme Court rejected that "equal access" basis, instead requiring a breach of duty or trust to shareholders, in the "classical" or "traditional" theory of insider trading. *Chiarella v. United States*, 445 U.S. 222, 224 (1980). The Court later approved an additional "misappropriation theory" in circumstances where a trader knows (or should) that the information was wrongly taken. *United States v. O'Hagan*, 521 U.S. 642, 652 (1997).

In the meantime, the Court imposed a "personal benefit" test in tipper/tippee situations to distinguish dissemination of information for corporate purposes from those purely personal, said to unfairly game the system. *Dirks v. SEC*, 463 U.S. 646, 663 (1983). The "personal benefit" test became increasingly strained and its perimeter difficult to discern over time. The test was "reigned in" by *United States v. Newman*, 773 F.3d, 438, 452 (2d Cir. 2014) which purported to narrow it to those "meaningfully close personal relationships" with "at least potential gain of a pecuniary or similarly valuable nature." But *Newman* was implicitly rejected by *Salman v. United States*, 580 U.S. ___, 137 S. Ct. 420, 428 (2016). So the Second Circuit then backed away from *Newman* and reserved the issue. *United States v. Martoma*, 869 F.3d 58, 61 (2d Cir. 2017), *opinion amended and superseded*, 894 F.3d 64 (2d Cir. 2017), *cert. denied*, 139 S. Ct. 2665 (2019).

LEGISLATION: THE HIMES BILL.

Among the several bills introduced in the 116th Congress seeking to define insider trading better, HR 2534 "The Insider Trading Prohibition Act" gathered steam and was passed 410-13 by the House on December 5, 2019. The Bill would add a new Section 16A to the Securities Exchange Act of 1934 ("'34 Act," 15 U.S.C. § 78a *et seq.*) prohibiting the purchase or sale of any security "while aware of material,

nonpublic information" with knowledge or in reckless disregard that the information was "obtained wrongfully." A last-minute voice-vote amendment, however, added back a "personal benefit" test for information obtained by a non-theft-or-fraud breach of duty. HR 2534 at § 16A(c)(1)(D).

THE *BLASZCZAK* OPINION.

At the end of 2019, the Second Circuit issued its Blaszczak opinion, holding that the *Dirks* personal-benefit requirement does not apply to Title 18 criminal insider-trading offenses (wire fraud under § 1343 and securities fraud under § 1348), because it is grounded in the policy purposes of the Exchange Act and not part of the language of the criminal code. United States v. Blaszczak, 947 F.3d 19, 36 (2nd Cir. Dec. 30, 2019).

That opinion created a more lenient road-map for prosecutors, disparate standards for insider-trading as between the SEC and Department of Justice, and a clarion call for a legislative solution.

Columbia Law Professor John Coffee (a member of the Bharara Task Force) just discussed the issue (and the interrelated roles of district and appellate judges from the Second Circuit) in his article, *The Blaszczak Bombshell: Are We Returning to a "Parity of Information" Theory of Insider Trading?* at CLS Blue Sky Blog (Feb. 26, 2020). He described the series of back and forth "stealth reversals" in the jurisprudence and expressed little faith that Congress will resolve the issue effectively.

THE BHARARA TASK FORCE REPORT.

The Bharara Task Force issued its Report in January 2020. The Report sets out four key points: Reform insider trading law through (1) clear and simple legislation, (2) based upon a broader conceptual basis of "wrongfully obtained" material nonpublic information (instead of current fraud-based theories), (3) eliminating the "personal benefit" standard, with (4) clear and explicit civil and criminal knowledge requirements, both for both tippers and downstream tippees.

Bharara Task Force on Insider Trading Report can be found here.

The Bharara Task Force suggests defining "wrongfully" as meaning "obtained or communicated in a manner that involves (a) deception, fraud, or misrepresentation, (b) breaches of duties of trust or confidence or breach of an agreement to keep information confidential, express or implied, (c) theft, misappropriation, or embezzlement, or (d) unauthorized access to electronic devices, documents, or information." *Bharara Rep.* at 18.

Every decade or so, insider-trading makes headlines. These recent developments just might provide the impetus for Congress to enact a better statutory definition. Then we can start arguing over what that means.

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