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Insider Trading Law in Flux — What Advisers Need to Know

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“For too long,” a task force on insider trading headed by former U.S. Attorney Preet Bharara concluded in a report issued this week, “insider trading law has lacked clarity, generated confusion, and failed to keep up with the times.”[1] The unusual “uncertainty and ambiguity” of insider trading law, the report explains, is attributable to the fact that it has been fashioned by courts without the benefit of any statutory definition of insider trading.[2] As a result, the U.S. Securities and Exchange Commission (“SEC”) and the U.S. Department of Justice (“DOJ”) have spent decades exercising their discretion over what cases to bring, how to charge them and which judicial construct of the law best suits their objectives.

Two recent developments, one legislative and one judicial, seek to bring clarity to the law of insider trading. However, it remains to be seen whether these efforts will in fact clarify the law or will instead create new confusion.

Insider Trading Prohibition Act

In December 2019, with overwhelming bipartisan support (410-13), the U.S. House of Representatives passed the Insider Trading Prohibition Act (“ITPA”) in an effort to simplify the law of insider trading and address certain of its inconsistencies. The ITPA would amend the Securities and Exchange Act of 1934,[3] creating civil and criminal liability for:

(A) Any person who buys or sells securities[4] while aware of material non-public information relating to such security, or any nonpublic information,

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from whatever source, that has or would reasonably be expected to have, a material effect on the market price of any such security, if the person knows or recklessly disregards that the information has been obtained wrongfully or that such trading would constitute a wrongful use of the information; and

(B) Any person, if that person's own purchase or sale of a security would violate section (A), to provide such material non-public information to another if it is reasonably foreseeable that the recipient will buy or sell securities or communicate the information to another person who will buy or sell securities.

Wrongfully obtained information, per the ITPA, includes information obtained by virtue of:

- Theft, bribery, misrepresentation or espionage;
- A violation of any federal law protecting computer data or the intellectual property or privacy of computer users;
- Conversion, misappropriation or other unauthorized and deceptive taking of information; or
- Breach of any fiduciary duty, confidentiality agreement, contract, code of conduct or ethics policy or any other personal or other relationship of trust and confidence for a direct or indirect personal benefit (including pecuniary gain, reputational benefit or a gift of confidential information to a trading relative or friend).

If enacted into law, the ITPA would make it easier in certain respects for the government to bring insider trading cases. For example, the legislation prohibits trading while "aware" of material non-public information, irrespective of whether the trader "used" the information in his or her trading decision (in fact, the House rejected a proposed amendment to incorporate a "use" standard). An existing SEC regulation, Rule 10b5-1, provides that the government need only show the defendant's "awareness" of the information, but in the absence of clear statutory language some courts have required a showing of "use" as well, particularly in criminal cases. In addition, the ITPA explicitly allows for mere recklessness to satisfy the government's burden of proof, specifying that liability may be found if a trader either "was aware, consciously avoided being aware *or* recklessly disregarded" that material non-public

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information was wrongfully obtained, improperly used or wrongfully communicated.

For advisers, what might appear to be subtle changes in pleading requirements will have real implications. Advisers will need to conduct due diligence with respect to any information received that may have been wrongfully obtained. If the source of information is a former company executive, expert, consultant or any other person who may have received information from someone in one of these groups, advisers should inquire, at a minimum, about (1) the confidentiality of the information; (2) the source of the information; and (3) whether the source was authorized to share the information. Failure to inquire may be considered tantamount to conscious avoidance or reckless disregard, so advisers should ask questions and document the responses to be able to show robust processes.

United States v. Blaszczak

One of the ways criminal prosecutors have sought to avoid the complexity of insider trading law in recent years has been to charge insider trading under the general securities fraud statute enacted as part of the 2002 Sarbanes-Oxley Act, 18 U.S.C. § 1348. Like § 10(b) of the Securities and Exchange Act of 1934, § 1348 does not mention insider trading, but courts have increasingly allowed the DOJ to use it in insider trading cases. In cases brought under § 10(b), courts have long required the government to prove that a tipper received a “personal benefit” in exchange for providing material non-public information.[5] But in *United States v. Blaszczak*,[6] the Second Circuit Court of Appeals recently held that the government does *not* have to prove a personal benefit in cases brought under § 1348.

In *Blaszczak*, a paid consultant to hedge funds received nonpublic information from a friend who worked for the Centers for Medicare and Medicaid Services (“CMS”) regarding pending changes in reimbursement rates. The consultant passed that information to employees of hedge funds who traded profitably. Evidence of a personal benefit was scant — sports tickets and free meals — and, perhaps for that reason, the jury acquitted the defendants of the § 10(b) charges. The jury convicted the defendants, though, on the charges brought under § 1348, which the trial court held did not require proof that the tipper received a personal benefit.

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On appeal, the defendants argued that the government should have to prove a personal benefit under § 1348, just as it has to under § 10(b). The Second Circuit disagreed. The court wrote that the personal benefit test was a "judge-made doctrine premised on the Exchange Act's statutory purpose . . . [that is,] eliminating the use of inside information for personal advantage." By contrast, "Section 1348 was added to the criminal code . . . in large part to overcome the 'technical legal requirements' of the Title 15 fraud provisions." Said more simply, the Second Circuit approved the use of § 1348 as an easier way to prosecute insider trading. Although some federal district courts have also held the personal-benefit requirement inapplicable in a § 1348 prosecution,[7] *Blaszczak* is the only federal court of appeals decision to have addressed this issue.

In a key additional holding, the Second Circuit found that a government agency's "nonpublic predecisional information" constitutes "property" under § 1348. After emphasizing that Supreme Court precedent "did not . . . establish any rigid criteria for defining property," the court found that "CMS has a property right in keeping confidential and making exclusive use of its nonpublic predecisional information," and, thus, held that such information may constitute government property for purposes of the SOX statute. One of the three judges on the panel dissented on this issue, arguing that CMS's confidential predecisional information should not be considered the agency's "property" because the premature disclosure of such information "has no economic impact on the government" and need not affect the substance or timing of the planned regulation.

The *Blaszczak* defendants have indicated that they intend to file a petition for rehearing *en banc*, seeking review of the decision by the full Second Circuit, and have obtained an extension of time until Feb. 3, 2020, within which to do so.

Takeaways

The *Blaszczak* ruling does not relieve the government of proving a personal benefit in all insider trading cases going forward. § 1348 applies only to trading in registered securities (as well as commodities), whereas § 10(b) applies to trading in any security, registered or unregistered. In addition, § 1348 imposes only criminal liability — civil insider trading charges brought by the SEC still must be pursued under § 10(b) and, therefore, must satisfy the personal benefit test. Moreover, § 1348

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imposes certain requirements on the government not found in § 10(b), such as in the requirement to show a deprivation of "property."

The ITPA does include a personal benefit requirement, added by an amendment passed on the day of the House vote.[8] But unless and until the ITPA is passed by the Senate and signed into law, and potentially thereafter, the law will remain unclear and prosecutors may continue their use of § 1348 as an end-run around § 10(b). Indeed, even if the ITPA does become law, its personal benefit requirement may be viewed as inapplicable in an insider trading prosecution under § 1348 because, as currently drafted, the bill does not provide that it would be the exclusive means of bringing insider trading charges.[9]

Advisers should be mindful that despite the shifting legal landscape, ultimately prosecutors continue to focus on information traders come by "wrongfully" that confers an unfair advantage. The SEC and DOJ will continue to exercise their notion of rough justice rather than be constrained by rigid legal standards. Accordingly, managers must do more than have robust policies regarding insider trading. However a manager comes into possession of nonpublic information, trading decisions should be carefully evaluated with an eye toward how they will be viewed by a regulator down the road. Being able to show due diligence with respect to vetting information, particularly information obtained from management, experts and consultants, will go a long way with regulators and may protect the firm against charges.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] Report of the Bharara Task Force on Insider Trading, January 2020.

[2] For more than 50 years, § 10(b) of the Securities Exchange Act has formed the principal basis for liability for insider trading, prohibiting it as a form of securities fraud, even though the text of the statute does not mention insider trading.

[3] The ITPA, while leaving § 10(b) intact, would create a new § 16A under the Exchange Act, where the ITPA would be codified.

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[4] The ITPA reaches trading in security-based swap agreements as well as securities.

[5] *See Dirks v. SEC*, 463 U.S. 646 (1983).

[6] *United States v. Blaszczak*, 2019 WL 7289753 (2d Cir. Dec. 30, 2019).

[7] *See,* e.g., *United States v. Slawson*, 2014 WL 5804191 (N.D. Ga. Nov. 7, 2014).

[8] While its own recommendations generally accord with the provisions of the ITPA, the Bharara report disagrees with the bill's inclusion of a personal benefit requirement, saying it "undermines much of the improvement and simplification that [the ITPA] otherwise achieves."

[9] Congressional Record, H9275-76 (Dec. 5, 2019).

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