Regulatory and Enforcement Alert

Developments in Insider Trading Enforcement: The House Passes the Insider Trading Prohibition Act

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On May 18, the U.S. House of Representatives passed the Insider Trading Prohibition Act (H.R. 2655). The bill would amend the Securities and Exchange Act of 1934, §§ 15 U.S. Code § 78a *et seq.*, to include a new section that, for the first time, expressly prohibits insider trading and defines the legal elements of insider trading. Commentators think there is a reasonable likelihood that the bill will pass in the Senate, although the timing of any vote is unclear. If signed into law by the President, the bill would explicitly codify a securities law violation that has largely been a creature of common law.

The Insider Trading Prohibition Act

Insider trading has never been defined by statute or regulation. Rather, the contours of an insider trading violation have developed over the years through the application and judicial interpretation of general fraud statutes. Along with market participants, courts have confronted significant ambiguity in defining what conduct is prohibited, and what is permissible. A version of the Insider Trading Prohibition Act, sponsored by Congressman Jim Himes (D-Connecticut), was passed by the House in 2019, but was not acted on by the then-Republican controlled Senate.

In explicitly defining an insider trading violation, Section (a) of the Insider Trading Prohibition Act makes it unlawful for a person to trade a security while "aware of material, nonpublic information related to 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."

Section (a) defines "material, nonpublic information" essentially as nonpublic information "that has, or would reasonably be expected to have, a material effect on the market price of any security." This definition could limit the government's ability to show materiality solely by reference to quantitative materiality and leaves ambiguity as to what constitutes a "material effect on the market price." This definition also differs from the Supreme Court's broader interpretation, which defines information as material if "there is a substantial likelihood that a reasonable [investor] would consider it important in deciding how to [invest]." *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1998).

In addressing what has been known as tipping, Section (b) makes it unlawful "wrongfully to communicate material, nonpublic information." Under Section (b), it is unlawful for a "tipper" to communicate the material,

nonpublic information to another person (a "tippee") if it is "reasonably foreseeable" that the tippee will make "a purchase, sale, or entry while aware of this information." When the House passed the bill in 2019, it was amended at the eleventh hour by Rep. Patrick McHenry (R-North Carolina) to require a "personal benefit" provided by the tippee to a tipper. The McHenry Amendment remains in the version of the bill that was passed on May 18. Specifically, the McHenry Amendment added language under Section (c) requiring that material, nonpublic information be given "for a direct or indirect personal benefit (including pecuniary gain, reputational benefit, or a gift of confidential information to a trading relative or friend)." In justifying the revision in 2019, Rep. McHenry stated that the amendment was intended to ensure the "inclusion of an explicit personal benefit test consistent with Supreme Court precedent" and to clarify "ambiguous words to ensure judges and prosecutors know that this bill is not intended to expand or create new insider trading liability." Chairwoman Maxine Waters (D-California) spoke in favor of the McHenry Amendment in 2019, noting that "because the bill uses the same terms identified in the current case law against insider trading, the SEC and market participants can easily understand what those terms mean."

Under Section (c) of the bill, one of the ways that trading while aware of material, nonpublic information is wrongful is if the information has been obtained by or its communication would constitute a breach of a fiduciary duty, a confidentiality agreement, a contract, a code of conduct or ethics policy, or "any other personal or other relationship of trust and confidence." While courts have previously rejected limiting liability to only breaches of fiduciary or fiduciary-like relationships between the trader and the source of the information (*see, e.g.*, *S.E.C. v. Cuban*, 620 F.3d 551 (5th Cir. 2010)), by broadly expanding liability to breaches of "any other" relationship of trust and confidence, the bill begs the question of how informal a fiduciary-like relationship may be to give rise to potential liability.

Finally, Section (d) of the bill shields employers from liability based solely on an employee's violation where the "employer did not participate in, or directly or indirectly induce the acts constituting a violation." Section (e) provides an affirmative defense to liability where a person acts at the direction of, and solely for the account of, another person whose own trading would be lawful. Section (e) also provides for an affirmative defense where the transaction satisfies the requirements of Rule 10b5-1. Rule 10b5-1 contains a safe harbor provision, which provides for an affirmative defense to insider trading when a written plan for trading securities is established in good faith at a time when the person was unaware of material, nonpublic information. Section (e) further provides the SEC with the power to issue rulemaking to "exempt any person, security, or transaction, or any class of persons, securities, or transactions, from any or all of the provisions of this section, upon such terms and conditions as it considers necessary or appropriate in furtherance of the purposes of this title."

Of note, the bill contains language that would prohibit trading on information that was "obtained wrongfully." The inclusion of the phrase "obtained wrongfully" is reminiscent of language from an insider trading case in the Southern District of New York, *United States v. Blaszczak*. In *Blaszczak*, prosecutors alleged that the defendants engaged in an insider trading scheme by misappropriating confidential nonpublic information. Prosecutors charged violations of federal wire fraud, securities fraud, and conversion statutes, codified at 18 U.S.C. §§ 1343,

1348, and 641, and securities fraud in violation of Section 10(b) of the Securities and Exchange Act, 15 U.S.C. § 78j(b), and SEC Rule 10b-5 (Title 15 securities fraud). Prosecutors argued that insider trading did not require proof of a personal benefit, but simply proof that the defendants obtained information and then traded while in possession of it as part of a scheme or artifice to defraud. A jury found defendants guilty of wire fraud, conversion, and, with the exception of one defendant, Title 18 securities fraud and conspiracy. The jury acquitted defendants on all counts alleging Title 15 securities fraud.

The Second Circuit upheld the convictions, expanding insider trading liability to cases where there was no personal benefit to the tipper. *United States v. Blaszczak*, 947 F.3d 19 (2d Cir. 2019), *cert. granted, judgment vacated sub nom. Olan v. United States*, 141 S. Ct. 1040, 208 L. Ed. 2d 513 (2021), and *cert. granted, judgment vacated*, 141 S. Ct. 1040 (2021). However, at the Government's request, the Supreme Court vacated the Second Circuit's 2019 decision and remanded the case to the Second Circuit in light of the Court's recent decision in *Kelly v. United States*, 140 S. Ct. 1565 (2020). *Blaszczak v. United States*, 141 S. Ct. 1040 (2021). The Second Circuit will hold oral argument in *Blaszczak* on June 9. The continuing proceedings in *Blaszczak* and the ambiguity surrounding the contours of the prohibition on insider trading may have provided further impetus for Congressional action.

The Senate will likely be amenable to passing this legislation, although it may seek to modify portions. If the bill is enacted, the SEC will have the opportunity to review. The bill directs the SEC to study Rule 10b5-1 in light of this legislation and, as discussed above, ties an affirmative defense in this bill to an affirmative defense in Rule 10b5-1. The SEC will have 180 days after the enactment of the bill to make any modifications to 10b5-1 that it deems necessary. Should this bill be enacted into law, it is possible that the SEC will narrow 10b5-1's safe harbor provision in the 180 days following the bill's enactment.

Although this bill would finally provide clarity as to the core elements of insider trading, which to date have largely been a creature of common law, should this bill become law, there will almost certainly be judicial skirmishing and uncertainty over many aspects of the bill.

For further information about this Alert, please contact one of the following members of the Firm's Litigation Department.

NEW YORK CITY

Brooke E. Cucinella
+1-212-455-3070
brooke.cucinella@stblaw.com

Stephen M. Cutler
+1-212-455-2773
stephen.cutler@stblaw.com

Sarah L. Eichenberger
+1-212-455-3712
sarah.eichenberger@stblaw.com

Nicholas S. Goldin
+1-212-455-3685
ngoldin@stblaw.com

Joshua A. Levine
+1-212-455-7694
jlevine@stblaw.com

Michael J. Osnato, Jr.
+1-212-455-3252
michael.osnato@stblaw.com

Jonathan T. Menitove
+1-212-455-2693
jonathan.menitove@stblaw.com

Anar Rathod Patel
+1-212-455-2206
apatel@stblaw.com

Rebecca A. Sussman
+1-212-455-2823
rebecca.sussman@stblaw.com

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