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Outside Counsel

'Blaszczak' and the ITPA: Toward a Statutory Definition for Insider Trading?

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This second of three articles discussing insider trading law considers the options for national legislation defining insider trading. This topic has taken on new life in light of the Democratic Party's control of the Senate, the Second Circuit's decision permitting prosecutors to use a Title 18 statute to prosecute insider trading, and continuing uncertainty in other judicial opinions about the metes and bounds of insider trading. In light of the significant impact a federal law defining insider trading could have on civil and criminal investigations, it is worth examining the history and potential future of reform proposals.

Legislative Reluctance To Define Insider Trading

The legislation underlying modern insider trading prosecutions—§10(b) of the Securities and Exchange Act—was passed in 1934. Franklin D. Roosevelt was President, only a tiny fraction of the population owned any stock, and corporate news and information was widely available through only a few outlets. Neither §10(b), nor the resulting regulations, provided any definition of insider trading. The courts instead developed the law of insider trading on a case-by-case basis.

Despite repeated proposals to define insider trading, Congress has shied away from codifying a definition which could prove over- or under-inclusive. When the draft 1983 Insider Trading Sanctions Act declined to define "insider trading," the SEC concurred, expressing concern that a stagnant statutory definition could "freez[e] into law either a definition which is too broad, or too narrow to deal with newly emerging issues." H.R. Rep. No. 355, 98th Cong., 1st Sess. (1983). Despite last-minute attempts in the Senate, the bill passed without any definition of insider trading. See Donald C. Langevoort, The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law, 37 Vanderbilt Law Review 1273 (1984). The next (and last) major legislation to address the issue—the 1988 Insider Trading and

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Securities Fraud Enforcement Act—also declined to create a statutory definition. The House Report explained that "the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and…a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law." H.R. Rep. No. 100-910, at 14 (1988).

Confusion and Proposals For Clarification

Within the last decade, major cases have led to confusion regarding the boundaries of permissible trading. In *United States v. Newman*, for example, the Second Circuit held that prosecutors must provide "proof of 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" to show a "personal benefit" to the tipper. 773 F.3d 438, 452 (2d Cir. 2014). The Supreme Court in *Salman v. United States* rejected the requirement to show a tangible benefit to the tipper, but did not address Newman's "meaningfully close personal relationship" language. 137 S. Ct. 420, 428 (2016).

The Bharara Report

Amid some frustration with recent insider trading jurisprudence, in January 2020 the Bharara Task Force on Insider Trading—which included former prosecutors—proposed three changes to existing law. First, it proposed focusing on material nonpublic information that is "wrongfully" obtained or communicated, rather than obtained as a result of "deception or fraud." Report at 2. It noted "deception" and "fraud" are vague concepts that courts have interpreted inconsistently, and that "insider trading is just as unfair and harmful when information is obtained through wrongful means not involving manipulation or deception." Id. at 15, 18. This change, according to the Task Force, would also address perplexing decisions like *S.E.C. v. Dorozhko*, where the Second Circuit suggested that trading on hacked information would be prohibited where it involved "deceptive" hacking, rather than "exploiting a weakness in an electronic code to gain unauthorized access." 574 F.3d 42, 51 (2d Cir. 2009).

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Second, the Task Force suggested eliminating the "personal benefit" requirement set out in *Dirks* and clarified in *Salman*. It cited wasteful litigation and inconsistent results, including the Second Circuit's decision to require a "meaningfully close personal relationship" in *Newman* and its failure to conclusively resolve that issue in *Martoma*. Id. at 7-8.

Finally, the Task Force proposed definitions for the required intent: willfulness for criminal violations, and recklessness for civil violations. Id. at 17. For criminal tippee liability, it would require the tippee to know that the tipper obtained or communicated the information wrongfully. Id. For civil tippee liability, the tippee would have to at least have recklessly disregarded that fact. Id.

The ITPA

In December 2019, the House passed the most recent proposed legislation on insider trading: the Insider Trading Prohibition Act, H.R. 2534 (the ITPA, or Himes Act). The ITPA would have created a new §16A of the Exchange Act expressly prohibiting insider trading. Anticipating the Bharara Report's recommendation, it would have applied to "wrongfully obtained" information rather than information obtained through fraud or deception, but would not have distinguished between criminal and civil intent. Early drafts of the bill eliminated the personal benefit requirement, but a bipartisan group revived it. See Telemachus P. Kasulis, Lessons From the Insider Trading Prohibition Act After Its Likely Demise in the Senate, Law Journal Newsletters (August 2020). The bill passed the House by a vote of 410 to 13 on Dec. 5, 2019, but vanished in the Senate Committee on Banking, Housing, and Urban Affairs.

'Blaszczak'

Continuing proceedings in *Blaszczak v. United States* may provide further

impetus for legislative reform. In *Blaszczak*, the Second Circuit (1) held that confidential government information can be "property" underlying wire and securities fraud convictions; and (2) allowed prosecutors to bypass the personal benefit requirement by charging insider trading as securities fraud under §1348 of Title 18, a criminal securities fraud provision adopted in 2002 as part of the Sarbanes-Oxley Act. *Blaszczak* effectively created a two-track system: criminal prosecutors could charge insider trading under §1348 when unable to prove the personal benefit requirement, but the SEC would remain subject to prior Exchange Act jurisprudence.

In January 2021, the Supreme Court vacated the Second Circuit's opinion and remanded for reconsideration in light of *Kelly v. United States*, 590 U.S. __ (2020), which held that disrupting the government's regulatory interests does not amount to obtaining property. Though *Kelly* did not concern insider trading, the Supreme Court's vacatur of the *Blaszczak* judgment "deprived that … opinion of precedential effect," *Los Angeles Cty. v. Davis*, 440 U.S. 625, 634 n.6 (1979), thereby abrogating the Second Circuit's ruling that securities fraud under 18 U.S.C. § 1348 does not require a showing of personal benefit. On remand, the government has conceded that the confidential agency information was not "property," and urged reversal of the wire-fraud and securities-fraud convictions, telling the Second Circuit it need not reach the personal benefit issue.

Blaszczak's short-lived personal benefit holding, and its possible continued effect as nonbinding "shadow precedent," may give further fuel to calls for legislative reform. Many industry participants prefer to preserve the personal benefit requirement, citing the Supreme Court's recognition that it protects market analysts' incentive to "ferret out and analyze information," which is "necessary to the preservation of a healthy market." *Dirks v. S.E.C.*, 463 U.S. 646, 658 (1983); see also Benjamin Bruenstein and Miriam Rosenbaum, What's Left of the 'Personal Benefit' Requirement After '*U.S. v. Martoma*'? New York Law Journal (July 24, 2019). An investment management group has filed an amicus brief in the *Blaszczak* remand urging the Second Circuit to clarify that the personal benefit requirement does apply to Title 18 securities fraud, or at least that the now-vacated *Blaszczak* opinion to the contrary is no longer good law.

This topic has taken on new life in light of the Democratic Party's control of the Senate, the Second Circuit's decision permitting prosecutors to use a Title 18 statute to prosecute insider trading.

Recent Events

Legislation with apparent bipartisan support, like the ITPA, remains a possibility. There are some headwinds: The ITPA had few co-sponsors, and none in the Senate. Ranking Democratic Senate Committee Member Sherrod Brown has not made any public statement on the bill. And the new Congress is occupied with issues like immigration reform.

That said, Senator Brown is widely considered a foe of Wall Street, and co-sponsored the unsuccessful Ban Conflicted Trading Act legislation in 2019, which aimed at prohibiting members of Congress from purchasing or selling investments related to their Congressional work. As a bipartisan bill, legislation like the ITPA may be well-positioned to pass quickly. In addition, many predict that the volatility in the market and the abundance of market-moving insider information are an invitation to Congress, regulators, and prosecutors to focus on insider trading.