What If You Could Draft an Insider Trading Law?

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What If You Could Draft an Insider Trading Law?

Recently, U.S. District Judge Jed S. Rakoff urged passage of a statute prohibiting insider trading. Currently judicial decisions define the boundaries of the law which is based on anti-fraud provisions of the Securities Exchange Act. This, the judge believes, creates "unnecessary uncertainty" as prosecutors try to "shoehorn" what should be a "cheating" concept into a "fraud" framework. In contrast, in the EU, trading on non-public information is prohibited (in order to provide for equal market access) without requiring that the source of the information "breach" a fiduciary duty.

What do litigators think of this suggestion?

Great idea. "Judge Rakoff has hit the nail squarely on its head," says David Miller of Morgan Lewis and former Assistant U.S. Attorney for the Southern District of New York (where he prosecuted insider trading cases). He goes on to explain:

"For over 30 years, courts have interpreted the anti-fraud provisions of Section 10(b) of the Exchange Act to proscribe certain trading on material non-public information (MNPI). But the statute says not one word about insider trading. Instead, judges have interpreted insider trading as a form of fraud when an individual has a duty to disclose their possession of MNPI prior to trading. Indeed, insider trading law has evolved as district and circuit courts—and occasionally the Supreme Court—have weighed in on different factual scenarios, including trading by insiders, tipping, and misappropriation of inside information by individuals who purportedly owe a duty to their source of MNPI. Consequently, while the courts may have adjudged certain conduct to be clearly unlawful, other conduct may be less certain and may depend on the district in which the case is prosecuted.

"An important example would be the Second Circuit's decision in *U.S. v. Newman et al.,* which addressed a situation involving trading by so-called "remote tippees." In that decision, the court ruled that a tippee needs to know that the insider who initially tipped the information in breach of a duty did so in exchange for a "personal benefit"—this was the core issue presented on appeal. But in the decision, the court also went beyond the core issue and created an ambiguity as to what constitutes a "personal benefit"—and thereby undermined the government's enforcement efforts in the Circuit—which was only recently clarified by the Supreme Court in *Salman v. U.S.* (an appeal from the Ninth Circuit). Given that insider trading is a criminal enforcement focus for the DOJ, and a civil enforcement focus for the SEC, Congress should make every effort to provide clarity where an individual's livelihood, and potential liberty, may be at stake. There are not many areas of law where the bounds of illegal conduct may be so uncertain."

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Not a fit with our culture. "With all respect to Judge Rakoff, I think his comments miss that the US and EU approaches reflect two different societies. What may work there probably won't work here," says Aegis J. Frumento of Stern Tannenbaum & Bell LLP. Frumento continues:

"We in the US still do not have a clear understanding of what is fundamentally wrong with insider trading, because we intuitively accept that no two sides to a trade ever have completely the same information anyway. Because of that uncertainty, trading law in the US has evolved case by case, with each case getting us closer and closer to the guts of what really bothers us. This evolutionary development of the law is in our Anglo-Saxon common law tradition, and as insider trading has so evolved, it has come to reflect the conservative American philosophy that permits parties the freedom to do whatever they can legally get away with. This evolution has taught us that what really bothers us about insider trading is not the having of inside information, but how innocently it was obtained. Hence the requirement of some breach of duty by a guilty insider trader.

"The European solution is rooted in a more authoritarian legal tradition where more precise regulations predominate over the case-by-case evolution of legal principles, and reflects the substantive view that unequal knowledge between traders is something of an evil in itself. Indeed, in Europe, an issuer's information is deemed 'owned' by its investors, and is therefore required to be disclosed more often than it is in the US. Thus, merely having inside information may reflect primarily a violation of a disclosure obligation by the issuer; using it just compounds that primary problem.

"The US and EU concepts of insider trading reflect cultural and philosophical differences in how we see the nature of corporate enterprise and the freedom of market actors. Congress is not likely to change current US law. But I doubt it is a good idea to abandon the US's long evolutionary development of insider trading law, even if it were possible."

Marc Powers of BakerHostetler concurs: "For me, in the United States, an insider trading statutory policy makes little sense. It will not likely clear up the ambiguity of what is, or is not, insider trading. How many statutes do we have on our books which are constantly subject to legal interpretation by the Courts? That is just part of our jurisprudence. Moreover, the legal landscape of judicially created law in the area of insider trading has been relatively clear. It has been the overzealous enforcement by the U.S. Attorney's Office and SEC in seeking defendants who otherwise fall outside the parameters of established Supreme Court precedent that has created the lack of clarity.

"Moreover, any suggestion that we consider an EC directive that prohibits all persons who are in possession of non-public information from trading is not consistent with our U.S. Federal Securities Laws. Our laws are built

upon the concepts of disclosure and duties, not equal access to all information. Indeed, the Supreme Court has rejected the suggestion of equal access."

Good idea, but there are issues. Tamar Frankel, Professor of Law, Boston University School of Law, sees the benefits but is uncertain what is possible. She writes, **"**Current prohibitions, as evolved by the courts, are too complicated and uncertain, leading to confusion and litigation. The statute should prohibit all transfer of insider information, except when 'a defendant had an affirmative duty to disclose confidential information and failed to do so.'" This is based on the belief that **"**Insider trading corrupts functioning securities markets. For example, investors might envy insiders and seek to follow them, feeding bribery of inside employees and other fraudulent ways of collecting insider information." However, Frankel notes the difficulty of distinguishing "between the recipients of insider information and thorough investigators that reach better investment decisions. Unfortunately, *outsiders* evaluate securities on the basis of available *uncertain* information, *insiders* act on information that is more *certain*."

Frankel discussed how a statute would help—and some concerns—as follows:

"Judge Rakoff stated that a statute should define insider information as information (i) that might affect market securities-prices, and (ii) is not publicly available (expressly excluding information that is publicly available to those who collect it for the purpose of analysis) and (iii) severely punish insider traders and feeders of insider information, whether or not they have traded. However, whether general or particular, the statute will contain gray areas. A statute that addresses every nook and cranny of insider trading will be overwhelmingly detailed, as much as the judicial decisions are.

"The main issue may not be the law but the culture that breeds insider trading. Corruption may spawn a culture of corruption. 'When *everyone* does it, why not I? This is not a wrong. This is how we do things here. This is freedom!' Thus, insider trading may be a symptom of failed leadership**.** The providers of the information may be low-level employees, but the buyers of the information may be wealthy, leaders, or trading professionals. They may find ways to induce the information, pay for it, and trade on it, easier than small investors and low-level employees.

"[L]egislation and rules are not methods of public persuasion—only, private sector leadership in the financial area can lead in this area as in any other area. First, it can condemn insider information. Second, if financial market leaders publicly distance themselves from, and avoid, those who use insider information, they can gain an enormous support of the small investors, both new retirees and others. If the leadership announces: 'We are supporting a clean securities market; we do not need laws to force us to do so.... We believe in competition but not in competition by fraud,' the leadership may have a surprisingly large following. Third, advisers and brokers have self-regulating organizations that might exclude an organization which harbored or served insider trading.

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Let these organizations substitute their rules for Judge Rakoff's statute. Fourth, financial professionals may know more about the ways and means of trading than the regulators. They can reach more traders and clients not by showing short-term profits but long-term steady and less risky income. In short, we need financial system leaders. Let the regulators and the law-makers tend to other urgent jobs on their agendas. Let the leadership of the financial system take the lead. Punishment alone may not be sufficient to simplify the issues nor to deter greed. But shame, and effective leadership might provide the simplification that is currently missing."

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