A CRITIQUE OF THE INSIDER TRADING PROHIBITION ACT OF 2021

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The Insider Trading Prohibition Act of 2021 has been passed by the House of Representatives and, as of this writing, is awaiting action in the Senate. The Act's proponents claim that it simply codifies and clarifies existing law. In fact, the Act does neither. It likely will expand the scope of insider trading in undesirable ways and introduce new ambiguities into the law.

The ways in which the Act likely will expand the insider trading prohibition, coupled with the new ambiguities it introduces, threatens the central policy on which the insider trading prohibition rests. The Supreme Court has recognized that the work of market analysts and other investment professionals inherently entails seeking information advantages. In turn, as the Court also recognized, that work is an essential part of maintaining efficient stock markets. By increasing the risk of liability, especially in light of the draconian penalties associated with insider trading, the Act likely will chill this vital activity to the detriment of all investors.

When a very similar bill passed the House in the 116th Congress, the legislation died in the Senate. The Insider Trading Prohibition Act of 2021 now awaits Senate action. The Senate would be well advised to let this bill die as well.

Keywords: insider trading, regulation, vagueness

The Insider Trading Prohibition Act ("Act") passed the U.S. House of Representatives by a wide bipartisan margin on May 18, 2021.[1] The Act's core adds new § 16A to the Securities Exchange Act of 1934. Its proponents claim that the bill makes only modest changes to the definition of insider trading as it has been developed in the courts,[2] while at the same time creating "a clear definition of insider trading . . . so that there is a codified, consistent standard for courts and market participants."[3] Scholars have long called for such a definition arguing that the current definition "of insider trading is so vague that practically any

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1. H.R. 2655, 117th Cong. (2021), *reprinted in* 167 CONG. REC. H2460 (daily ed. May 18, 2021).
2. *See* H.R. Rep. 116-219 at 3 (2019) ("The bill largely codifies the existing case law on insider trading.").
3. 167 CONG. REC. H2461 (daily ed. May 18, 2021) (statement of Rep. Cleaver).

investor could be found guilty of it."[4] Unfortunately, the Act neither codifies nor clarifies.[5]

The ways in which the Act likely will expand the insider trading prohibition, coupled with the new ambiguities it introduces, threatens the central policy on which the insider trading prohibition rests.[6] The Supreme Court has recognized that the work of market analysts and other investment professionals inherently entails seeking information advantages.[7] In turn, as the Court also recognized, that work is an essential part of maintaining efficient stock markets.[8] By increasing the risk of liability, especially in light of the draconian penalties associated with insider trading, the Act likely will chill this vital activity[9] to the detriment of all investors.

Part I of this article summarizes the Act. Part II argues that the Act is unnecessary. Part III argues that, contrary to claims by its drafters, the Act likely will expand the scope of insider trading liability, albeit in ways that are uncertain. Part IV argues that, contrary to claims by its drafters, the Act will not clarify the law but rather will introduce new ambiguities. Finally, Part V argues that the Act likely will impede the essential work of market analysts and other investment professionals whose efforts to obtain information advantages are essential to ensuring the efficiency of the capital markets.

I. THE ACT

If enacted, new § 16A(a) will make it illegal to trade while one is "aware of material, nonpublic information relating to such security," or to certain swaps, "or any nonpublic information, from whatever source, that has, or would reasonably be expected to have, a material effect on the market price of any 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."[10]

4. Robert W. McGee, *Information, Privilege, Opportunity and Insider Trading*, 10 N. ILL. U. L. REV. 1, 34 (1989). *See, e.g.*, Iman Anabtawi, Note, *Toward a Definition of Insider Trading*, 41 STAN. L. REV. 377, 385 (1989) (arguing that the a clearer and more consistent definition of insider trading is needed); Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1269 (1995) ("In light of the draconian penalties associated with insider trading after the 1984 and 1988 acts, [the absence of a clear definition] raises troubling vagueness concerns."); Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443 (2001) (arguing that "the legal rules concerning insider trading remain extraordinarily vague and ill-formed").

5. The foundational question of whether insider trading should be regulated at all is beyond the scope of this article. For my take on that issue, see Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589 (1999).

6. *See infra* Part V.

7. *See infra* text accompanying note 78.

8. *See infra* text accompanying note 79.

9. *See* Comment, Liza B. Fleming, *Lenity Calling: A Plea to End Chevron Deference for Criminal Insider Trading Law*, 89 TEMP. L. REV. 579, 580 (2017) (noting the "uniquely severe penalties for insider trading").

10. H.R. 2655, *supra* note 1, § 2.

Subsection (b) deals with tipping. A tipper can be held liable if she wrongfully communicates material nonpublic information to a tippee if it is reasonably foreseeable that the tippee will purchase or sell the security in question or wrongfully communicate the information to another tippee.[11] In response to concerns that this was a dramatic expansion of current law, subsection (c)(2) was added to the Act to clarify that liability requires that the tipper have received "a direct or indirect personal benefit (including pecuniary gain, reputational benefit, or a gift of confidential information to a trading relative or friend)."[12]

Subsection (c)(1), which defines what constitutes wrongful use or communication for purposes of the Act,[13] is discussed below.[14] Subsection (d) exempts control persons from liability for controlled persons who violate the prohibition unless the controlling person participated in or induced the violation.[15] Subsection (e) grants the SEC exemptive authority, preserves existing Rule 10b5-1's exemption for certain insider transactions effected pursuant to a trading plan, and instructs the SEC to conduct a review of possible abuses of such 10b5-1 plans.[16]

II. THE ACT IS UNNECESSARY

The modern insider trading prohibition began taking shape in the early 1980s with the Supreme Court's decisions in *Chiarella*[17] and *Dirks*.[18] In the subsequent decades, a plethora of judicial opinions have explored the cracks and crevices of the prohibition. As a result, the scholars' complaints are somewhat outdated. Today, we have a fairly well-developed understanding of when trading while in possession of material nonpublic information is lawful and when it is not.[19]

The Act's supporters essentially concede the point. Representative Hill, for example, opined that the Act's "intent is to codify, and neither expand nor contract, insider trading law as it is currently understood and interpreted by the Federal courts."[20] If so, one might ask, what is the point? The Act's chief sponsor, Representative Himes, offered two primary justifications for the Act. First, the

11. *Id.*

12. *Id.* For a discussion of the legislative history of subsection (c)(2), see *Guest Post: Developments in Insider Trading Enforcement: The House Passes the Insider Trading Prohibition Act*, The D&O Diary (June 7, 2021), https://www.dandodiary.com/2021/06/articles/securities-laws/guest-post-developments-in-insider-trading-enforcement-the-house-passes-the-insider-trading-prohibition-act [https://perma.cc/TMX5-3K9W].

13. H.R. 2655, *supra* note 1, § 2.

14. *See infra* text accompanying note 32.

15. H.R. 2655, *supra* note 1, § 2.

16. *Id.*

17. Chiarella v. U.S., 445 U.S. 222 (1980).

18. Dirks v. SEC, 463 U.S. 646 (1983). For a detailed discussion of *Chiarella* and *Dirks*, *see* STEPHEN M. BAINBRIDGE, INSIDER TRADING LAW AND POLICY 39–44 (2014).

19. *See* Peter J. Henning, *What's So Bad About Insider Trading Law?,* 70 BUS. LAW. 751, 757 (2015) ("Since the SEC first initiated an administrative proceeding over fifty years ago to sanction a broker for trading on confidential corporate information, the federal law of insider trading has grown into a reasonably well-defined prohibition, even with questions about its scope around the periphery.

20. 167 CONG. REC. H2461 (daily ed. May 18, 2021) (statement of Rep. Hill).

Act is necessary to reverse the Second Circuit's decision in *U.S. v. Newman*,[21] which arguably limited the extent to which tippees of inside information are liable for trading while in possession of that information.

In *Dirks*, the Supreme Court had held that a tippee can be held liable only if the tippee knew that the tipper had received a "personal benefit" from making the tip.[22] The Court elaborated that a personal benefit could be found where the insider gifts the information to the tippee, because the tippee's trading profits are the functional equivalent of "trading by the insider himself followed by a gift of the profits to the recipient."[23] In *Newman*, the Second Circuit interpreted *Dirks* as requiring "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."[24]

Representative Cleaver claims that *Newman* "has severely hampered the SEC's ability to prosecute insider trading cases."[25] But that claim is surely exaggerated. In *Salman v. U.S.*,[26] the Court held that the personal benefit test is satisfied, *inter alia,* by "the benefit one would obtain from simply making a gift of confidential information to a trading relative."[27] In doing so, the Court expressly abrogated *Newman*.[28] "The ruling was a major victory for securities regulators and prosecutors, who for two years had been grappling with" *Newman*.[29]

To be sure, *Salman* did not address the aspect of *Newman* dealing with tipping chains.[30] *Newman* held that liability could only be imposed when "the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit."[31] It is to this aspect of *Newman* that Representative Cleaver was referring and it is true that the legislation provides that it is not necessary that the tippee "the specific means by which the information was obtained or communicated, or whether any personal benefit was paid or promised by or to any person in the chain of communication, so long as the . . . was aware, consciously avoided being aware, or recklessly disregarded that such information was wrongfully obtained, improperly used, or wrongfully communicated."[32]

21. 773 F.3d 438 (2d Cir. 2014), *cert. denied*, 577 U.S. 874 (2015).

22. *Dirks*, 463 U.S. at 662 (holding that "the test is whether the insider personally will benefit, directly or indirectly, from his disclosure").

23. *Id.*

24. *Newman*, 773 F.3d at 452.

25. 167 CONG. REC. H2461 (daily ed. May 18, 2021) (statement of Rep. Cleaver).

26. 137 S. Ct. 420 (2016).

27. *Id.* at 429.

28. *See id.* at 428 ("To the extent the Second Circuit held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends, . . . we agree with the Ninth Circuit that this requirement is inconsistent with *Dirks*.").

29. Nate Raymand, *U.S. Top Court Fortifies Prosecutors in Insider Trading Cases*, 22 WESTLAW J. SECURITIES LITIG. & REGUL. 1 (2016), 2016 WL 7159473, at *1.

30. *See* Karen Patton Seymour, *Securities and Financial Regulation in the Second Circuit,* 85 FORDHAM L. REV. 225, 257 n.231 (2016) ("A tipping chain occurs when the person who receives the information further disseminates the information to others who, in turn, transmit the information to others, and so on.").

31. U.S. v. Newman, 773 F.3d 438, 450 (2d Cir, 2014).

32. H.R. 2655, *supra* note 1, § 2.

Even if it were true that *Newman* was interfering with prosecutors' ability to pursue tipping chains to their very end, for which the legislative history provides no evidence,[33] it is not clear that the Act will make their life much easier. Under the Act, information is wrongfully obtained or communicated only when:

> . . . the information has been obtained by, or its communication or use would constitute, directly or indirectly—
> (A) theft, bribery, misrepresentation, or espionage (through electronic or other means);
> B) a violation of any Federal law protecting computer data or the intellectual property or privacy of computer users;
> (C) conversion, misappropriation, or other unauthorized and deceptive taking of such information; or
> (D) a breach of any fiduciary duty, a breach of a confidentiality agreement, a breach of contract, a breach of any code of conduct or ethics policy, or a breach of 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).[34]

Therefore, the tippee at the end of the tipping chain can still only be held liable if he, at a minimum, recklessly disregarded whether the information was stolen or obtained through a breach of fiduciary duty. In *Newman*, the Second Circuit had concluded that "[n]o reasonable jury could have found beyond a reasonable doubt that the [defendants] knew, or deliberately avoided knowing, that the information originated with corporate insiders."[35] As such, the *Newman* defendants would avoid liability under the very statute purportedly intended to reverse that decision.

III. THE ACT LIKELY WILL EXPAND THE CURRENT PROHIBITION

Representative Himes argued that the Act will clarify the law while basically leaving current law intact.[36] The Act, however, does neither. First, it significantly expands the scope of insider trading liability. Presently, insider trading liability is based solely on a fiduciary relationship or some similar relationship of trust and confidence and a breach of a duty to disclose.[37] The Act, however, expands liability to include theft, hacking of computers, and so on.

33. *See* 167 CONG. REC. H2462 (daily ed. May 18, 2021) (statement of Rep. Huizenga) (arguing that "Democrats have not identified a problem within the current body of law that inhibits the prosecution of bad actors who illegally trade on material, nonpublic information").

34. *Id.*

35. *Newman*, 773 F.3d at 455.

36. 167 CONG. REC. H2461 (daily ed. May 18, 2021) (statement of Rep. Himes).

37. Deborah A. DeMott, *Relationships of Trust and Confidence in the Workplace*, 100 CORNELL L. REV. 1255, 1263 (2015) ("Breach of a duty of disclosure is crucial for insider-trading liability...").

Some of the ways in which the Act expands the prohibition might not be terribly controversial as applied to traders and immediate tippees who know how the information was obtained. After all, who thinks thieves should be able to profit from using stolen information?[38] Yet, the language that does the work of expanding the prohibition is highly problematic. Consider, for example, subsection (D) quoted above. As Columbia Law Professor John Coffee asks, "there is a question about whether the phrase 'for a direct or indirect personal benefit' modifies only 'other relationship of trust and confidence' or whether it applies to all the breaches listed in clause (D). For example, does it apply also to persons who breach a contract, a code of conduct or ethics policy, or some other source of law not involving a fiduciary duty?"[39]

But it is unclear how the Act will apply in more contentious cases. Consider, for example, the facts of *SEC v. Switzer*,[40] which involved Barry Switzer, the well-known former coach of the Oklahoma Sooners and Dallas Cowboys football teams. Phoenix Resources Company was an oil and gas company. One day in 1981, Phoenix's CEO, George Platt, and his wife attended a track meet to watch their son compete. Coach Switzer was also at the meet watching his son. Platt and Switzer had known each other for some time. Platt had Oklahoma football season tickets and his company had sponsored Switzer's television show. Sometime in the afternoon, Switzer laid down on a row of bleachers behind the Platts to sunbathe. Platt, purportedly unaware of Switzer's presence, began telling his wife about a recent business trip to New York. In that conversation, Platt mentioned his desire to dispose of or liquidate Phoenix. Platt further talked about several companies bidding on Phoenix. Platt also mentioned that an announcement of a "possible" liquidation of Phoenix might occur the following Thursday. Switzer overheard this conversation and shortly thereafter bought a substantial number of Phoenix shares and tipped off a number of his friends. Because Switzer was neither an insider nor constructive insider (do you see why?) of Phoenix, the main issue was whether Platt had illegally tipped Switzer.

Per *Dirks*, the critical issue was whether Platt had violated his fiduciary duty by obtaining an improper personal benefit: "Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider [to his stockholders], there is no derivative breach [by the tippee]."[41] The court found that Platt did not obtain any improper benefit. The court further found that the information was inadvertently (and unbeknownst to Platt)

38. In fact, I have long argued that the insider trading prohibition is best understood not as a form of securities fraud but rather as a way of protecting property rights in information. *See, e.g.*, Stephen M. Bainbridge, *Insider Trading Under the Restatement of the Law Governing Lawyers*, 19 J. CORP. L. 1, 22 (1993) (noting an "emerging consensus that the federal insider trading prohibition is justified most easily as a means of protecting property rights in information").

39. John C. Coffee, Jr., *Congress and the Insider Trading Prohibition Act: "Can't Anybody Here Play This Game?,"* THE CLS BLUE SKY BLOG (May 25, 2021), https://clsbluesky.law.columbia.edu/2021/05/25/congress-and-the-insider-trading-prohibition-act-cant-anybody-here-play-this-game [https://perma.cc/S77L-GUHG].

40. 590 F. Supp. 756 (W.D. Okla.1984).

41. Dirks v. SEC, 463 U.S. 646, 662 (1983).

overheard by Switzer. Chatting about business with one's spouse in a public place may be careless, but it is not a breach of one's duty of loyalty. Accordingly, as the court explained, "Rule 10b–5 does not bar trading on the basis of information inadvertently revealed by an insider."[42] But under the Act, prosecutors will surely be tempted to argue that persons in Platt's position have stolen or converted the information.

One can spin similar hypotheticals. Suppose someone overhears corporate insiders chatting about work and the eavesdropper infers confidential information and proceeds to trade. There is no tip here. There has been no deception. But is there a conversion or theft? Similarly, how will the Act deal with a hypothetical posed by John Coffee:

> . . . a person in the next business class seat on an international air flight reads a memo that an investment banker has left on the tray table while he or she goes to the restroom. The adjoining seat holder later trades and profits on this information. Is this a "deceptive" taking or misappropriation? Suppose the memo is instead placed back into an unlocked thick folder before the investment banker goes to the restroom, or it is placed into an unlocked briefcase (either way, the occupant of the next seat opens it and reads the memo during this interval). Arguably, this is more "unauthorized" and "deceptive" taking of information, but there is still no "personal benefit" paid by the tippee in the next seat to the unintentional tipper. While culpable, this is considerably less so than the case where money changes hands for the information.[43]

In both of these situations, unlike current law, aggressive prosecutors now will be able to argue that the information has been stolen, converted, or otherwise wrongfully obtained.

A particularly problematic expansion of current law likely will result from the Act's definition of a wrongful use or acquisition of information to include "a breach of any fiduciary duty, a breach of a confidentiality agreement, a breach of contract, or a breach of any other personal or other relationship of trust and confidence."[44] As noted below, the Act fails to define these terms, which is a key source of uncertainty created by the Act.[45] It seems probable, however, that this phrasing will result in a significant expansion of the law.

As we have seen, under current law, the predicate for insider trading liability under either the disclose or abstain rule or the misappropriation theory is the breach of a duty of disclosure arising out of a fiduciary relationship or similar relationship of trust and confidence between the insider and the person with whom he trades, in the former case, or the source of the information, in the latter

42. *Switzer*, 590 F. Supp. at 766.
43. Coffee, *supra* note 39.
44. H.R. 2655, *supra* note 1, § 2.
45. *See infra* note 65 and accompanying text.

case.[46] Obviously, the initial task, therefore, is to determine whether a fiduciary relationship exists between the inside trader and the requisite counterpart. Whether that determination is made as a matter of state or federal law, unfortunately, is unclear. Likewise, which relationships qualify as fiduciary—as opposed to arms-length—remains unclear. Dictum in all three Supreme Court insider trading precedents tells us that corporate officers and directors are fiduciaries of their shareholders. Once we get outside the traditional categories of Rule 10b–5 defendants—insiders, constructive insiders, and their tippees—things get much more complicated.[47]

In 2000, the SEC purported to address this problem by adopting Rule 10b5–2, which provides "a nonexclusive list of three situations in which a person has a duty of trust or confidence for purposes of the 'misappropriation' theory. . . ."[48] First, such a duty exists whenever someone agrees to maintain information in confidence.[49] Second, such a duty exists between two people who have a pattern or practice of sharing confidences such that the recipient of the information knows or reasonably should know that the speaker expects the recipient to maintain the information's confidentiality.[50] Third, such a duty exists when someone receives or obtains material nonpublic information from a spouse, parent, child, or sibling.[51]

The Act appears to extend the principles announced by Rule 10b5-2 to the entire insider trading prohibition, which is problematic because Rule 10b5-2 was unwise from the outset. Consider, for example, the reference in both the rule and the Act to a "relationship of trust and confidence." To be sure, in *Chiarella*, Justice Powell premised liability on "a fiduciary or other similar relation of trust and confidence between" the parties to the transaction.[52] It quickly became clear, however, that phrasing was an unfortunate choice.

If a court wished to impose liability, it simply needed to conclude that the relationship in question involved trust and confidence, even though the relationship bears no resemblance to those in which fiduciary-like duties are normally imposed. In *U.S. v. Chestman*, the Second Circuit tried to prevent such outcomes by holding that a relationship of trust and confidence must be "the functional equivalent of a fiduciary relationship" before liability can be imposed.[53] In *Chestman*, the relationship in question was a marital one between spouses. The court held that that relationship lacked the "discretionary authority and dependency" inherent in fiduciary relationships.[54] In addition, the Court emphasized

46. *See supra* note 37 and accompanying text.

47. *See* U.S. v. Chestman, 947 F.2d 551, 567 (2d Cir.1991) ("Our Rule 10b–5 precedents . . ., moreover, provide little guidance with respect to the question of fiduciary breach, because they involved egregious fiduciary breaches arising solely in the context of employer/employee associations."), *cert. denied* 503 U.S. 1004 (1992).

48. 17 CFR § 240.10b5-2.

49. 17 CFR § 240.10b5-2(b)(1).

50. 17 CFR § 240.10b5-2(b)(2).

51. 17 CFR § 240.10b5-2(b)(3).

52. Chiarella v. US, 445 U.S. 222, 228 (1980).

53. 947 F.2d 551, 568 (2d Cir.1991), *cert. denied*, 503 U.S. 1004 (1992).

54. *Id.* at 569.

that "entrusting confidential information to another does not, without more, create the necessary relationship and its correlative duty to maintain the confidence."[55] But the SEC eviscerated *Chestman* by adopting Rule 10b5–2.

Why is it important that the prohibition be subject to such a limitation? In *Chiarella*, Justice Powell noted that a broad insider trading prohibition might ban "a tender offeror's purchases of target corporation stock before public announcement of the offer," a step Congress clearly had declined to take when it adopted the Williams Act to regulate tender offers.[56] In the subsequent *Dirks* opinion, Justice Powell further explained that such a broad policy basis for regulating insider trading implied a ban that "could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market."[57] As discussed in more detail in Part 0, both this provision and others in the Act are likely to have such inhibiting influence.

IV. THE ACT LACKS CLARITY

The core prohibition created by proposed § 16A(a) contains two important ambiguities. First, it makes it illegal for someone to trade on prohibited information while she is "aware of" such information.[58] There has been a longstanding debate over whether insider trading liability arises only when one trades on the basis of such information or when one trades while in possession of such information.[59] The SEC attempted to resolve that dispute by promulgating Rule 10b5-1, which adopts a possession standard while creating certain affirmative defenses.[60] There are serious doubts, however, whether the SEC had authority to adopt that rule.[61] There is also doubt as to whether the Rule applies to criminal cases.[62] Instead of resolving these important issues, the Act adopted the new standard that one must be "aware," which presumably leans towards the possession approach but will require judicial definition.[63]

Second, Section 16(a) also imposes liability when one trades while aware of "any nonpublic information . . . that has, or would reasonably be expected to have, a material effect on the market price of any such security."[64] What

55. *Id.* at 568.

56. *Chiarella*, 445 U.S. at 233.

57. Dirks v. SEC, 463 U.S. 646, 658 (1983).

58. H.R. 2655, *supra* note 1, § 2.

59. *See generally*, Bainbridge, *supra* note 5, at 71–79 (discussing the debate).

60. *See* Bainbridge, *supra* note 5, at 74–79 (discussing Rule 10b5-1).

61. *Id.* at 75.

62. *See, e.g.*, U.S. v. Jun Ying, 2018 WL 7016349, at *6 (N.D. Ga. Sept. 17, 2018) (declining to rule on defendant's argument that "the indictment 'improperly relies on Rule 10b5-1 and its 'knowing possession' or 'awareness' standard as opposed to alleging use'"), *report and recommendation adopted as modified*, 2018 WL 6322308 (N.D. Ga. Dec. 4, 2018).

63. If "aware" is interpreted to mean knowing possession, a significant expansion of current law could result. As the Ninth Circuit has pointed out, "a knowing-possession standard would . . . go a long way toward making insider trading a strict liability crime." U.S. v. Smith, 155 F.3d 1051, 1068 n.25 (9th Cir. 1998). But, as the Ninth Circuit also noted, "the Supreme Court has consistently suggested, albeit in dictum, that Rule 10b–5 requires that the government prove causation in insider trading prosecutions." *Id.* at 1067.

64. H.R. 2655, *supra* note 1, § 2.

constitutes a "material effect" is undefined. How the information covered by this clause differs from "material nonpublic information relating to such security" also is undefined. Courts are going to have to answer these questions as well.

The phrase "indirect personal benefit" in subsection (c)(1)(D) also introduces new uncertainty since one can "describe virtually any human interaction as providing an 'indirect benefit' to the participants."[65] In addition, the phrase "a breach of a confidentiality agreement, a breach of contract, or a breach of any other personal or other relationship of trust and confidence," as used in the same section, "is silent on how courts are supposed to assess whether any of these items existed or were breached, an issue that has troubled courts for years."[66]

An additional source of uncertainty arises because of the Act's references to "any security." The regulatory acorn from which the mighty oak that is today's insider trading prohibition has grown,[67] Rule 10b-5, likewise refers to "any security." Nevertheless, there is considerable doubt as to whether insider trading applies to trading in debt securities.[68] The Act does not settle that debate.

The Act also fails to resolve the questions about the legality of brazen or authorized trading. Under current law, misappropriation theory liability arises where the trader fails to disclose his trading intentions to the source from whom he obtained the information.[69] Logically, it follows that if a misappropriator brazenly discloses his trading plans to the source, and then trades on that information, Rule 10b–5 is not violated even if the source of the information refused permission to trade and vigorously objected.[70] Alternatively, suppose the source of the information authorized the trader to go ahead with the planned transactions, which was a common practice known as warehousing in the 1980s. In the *O'Hagan* decision, the Supreme Court approvingly quoted the statement of the government's counsel that "to satisfy the common law rule the trustee may not use the property that [has] been entrusted [to] him, there would have to be consent."[71] The logical implication is that authorized trading is lawful. Yet, here is another set of questions the Act does not answer.

A final critical ambiguity is whether the Act is intended to be the exclusive basis on which insider trading will be prosecuted going forward. As dissenting Republican members of the House Committee on Financial Services explained:

65. M. Todd Henderson & Lyle Roberts, *Fixing The Insider Trading Prohibition Act*, THE HILL (June 3, 2021), https://thehill.com/opinion/finance/556627-fixing-the-insider-trading-prohibition-act?rl=1&fbclid=IwAR0B9E_zbDVG_hokqHsmi0GiNokY1IPTtkklpTO8HjB3Y61UsHOzst5jbo0 [https://perma.cc/4MGF-CXZS].

66. *Id.*

67. The analogy is drawn from Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) ("When we deal with private actions under Rule 10b–5 we deal with a judicial oak which has grown from little more than a legislative acorn.").

68. *See* Bainbridge, *supra* note 5, at 79–81.

69. *See* U.S. v. O'Hagan, 521 U.S. 642, 655 (1997) ("full disclosure forecloses liability under the misappropriation theory . . . if the fiduciary discloses to the source that he plans to trade on nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation").

70. *See* Bainbridge, *supra* note 5, at 94–96.

71. *O'Hagan*, 521 U.S. at 654.

> A predecessor bill that serves as a foundation for H.R. 2534 included an exclusivity provision stating that the bill ''shall provide the exclusive standards by which the wrongful use or wrongful communication of material, nonpublic information in connection with the purchase or sale of a security shall be ad- dressed.'' Unfortunately, H.R. 2534 does not include that exclusivity provision. Without that wording, H.R. 2534 is simply another insider trading law, rather than the insider trading law.[72]

As the dissenting Republicans observed, that omission introduces considerable uncertainty:

> Absent such an exclusivity clause, judges, prosecutors, and plaintiffs' lawyers could and likely would still cite to and bring cases under general antifraud provisions and case law, and the SEC would, theoretically, still be able to engage in exemptive rulemaking around the law that might undo the carefully constructed definition of im- proper insider trading this bill seeks to create. This would give overzealous prosecutors and plaintiffs' lawyers at least two bites at the apple using potentially varying legal requirements.[73]

"Allowing prosecutors to cherry pick their preferred law is no way to provide clear rules for the market."[74]

Put simply, a statute meant to clarify the law should not introduce new ambiguities. Yet, that is precisely what the Act does.[75]

V. WILL THE ACT IMPEDE MARKET EFFICIENCY?

Since the Supreme Court's decisions in *Chiarella* and *Dirks*, protecting the essential work of market analysts and other investment professionals has been a key goal of insider trading law. Both decisions were written by the late Justice Powell.[76] Professor Adam Pritchard conducted a detailed study not only of the opinions but also of the background materials available in Justice Powell's papers. Pritchard concludes that "Powell worried that prohibitions against insider

72. H.R. Rep. 116-219, *supra* note 2, at 27.

73. *Id. See also* Henderson & Roberts, *supra* note 65 ("ITPA does not contain an exclusivity clause stating that it will be the sole basis for bringing federal insider trading claims.").

74. Henderson & Roberts, *supra* note 65.

75. *See* 167 CONG. REC. H2462 (daily ed. May 18, 2021) (statement of Rep. Huizenga) (arguing that the Act "is flawed and could potentially create even more confusion and uncertainty within the law of insider trading"); *see also* Henderson & Roberts, *supra* note 65 ("The actual effect of ITPA would be to expand the scope of insider trading liability by turning a number of existing ambiguities, and a few new ones, into the law of the land.").

76. *See* Dirks v. SEC, 463 U.S. 646, 658–59 (1983); Chiarella v. U.S., 445 U.S. 222 (1980).

trading could chill incentives for analysts and other market professionals to uncover information about publicly traded companies."[77]

In *Dirks*, Justice Powell based his ruling in large part on a concern that overly zealous enforcement would have a highly detrimental effect on market efficiency:

> Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is commonplace for analysts to "ferret out and analyze information," and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally.[78]

In a footnote to that passage, Powell further explained that the SEC itself "expressly recognized that '[t]he value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors.'"[79]

Powell's concern was brought back to the fore in the early part of this decade by the rash of prosecutions of hedge fund managers and the so-called expert networks those managers relied for information. Expert networks were developed in the last decade to act as matchmakers between experts in various fields and financial market professionals. If a hedge fund manager wanted to consult with a physician about the likely effectiveness of a new drug or medical device before investing in the manufacturer, the expert witness would arrange for the manager to meet with the right expert. The consultant would get a handsome fee and the network would get a finder's fee. All too often, however, the expert turned out to be an insider of the company in question who passed inside information to the hedge fund manager. Former U.S. Attorney for the Southern District of New York Preet Bharara went to unprecedented lengths to criminalize such information gathering.[80]

77. A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws,* 52 DUKE L.J. 841, 931 (2003).

78. *Dirks*, 463 U.S. at 658–59 (citation omitted).

79. *Id*. at 658 n.17.

80. *See, e.g.*, Lydia DePillis, *Meet Preet Bharara, Who Just Won the Biggest Insider Trading Case Ever,* WASH. POST (Nov. 4, 2013), https://www.washingtonpost.com/news/wonk/wp/2013/11/04/meet-preet-bharara-who-just-won-the-biggest-insider-trading-case-ever/ [https://perma.cc/L2WC-FHRU].

Powell expressly endorsed allowing market analysts to "meet[ ] with and question[ ] corporate officers and others who are insiders. . . ."[81] Facilitating such meetings is precisely what expert networks do. To be sure, that doesn't give the networks a license to facilitate tipping by insiders. But it is, nevertheless, fair to wonder whether the targeting of expert networks was overdone and thereby chilled legitimate market analysis. If so, such targeting may have done more damage to market efficiency than any of the alleged insider trading activity. After all, the "incentive to acquire information in the first place goes down if the opportunity to profit by virtue of superior information is eliminated. And if there is no incentive to acquire information, markets lose their function of providing price signals to diverse participants in the economy."[82]

Yet, the legislative history is replete with praise for Bharara's inquisition. Given the Act's expansion of liability and its ambiguities, some courts may be encouraged to further crack down on what has long been regarded as legitimate market analysis, which in turn will reduce the efficiency of the capital markets. Investors will not hire analysts to "ferret out" information from insiders, and as a result, that information will never reach the market if investors fear possible persecution. Accordingly, it is hard to argue with Representative Huizenga's argument that the Act "could expand liability for good-faith traders, which would weaken investor confidence, chill vital information-gathering, and hurt the efficiency of our markets." [83] As such, the Act will chill precisely the sorts of legitimate market activity Justice Powell sought to protect.

VI. CONCLUSION

Representative Himes sententiously proclaimed that "law is to be made in this Chamber, not in the chambers of unelected judges throughout the land."[84] After all, the courts have had to develop the law in this area precisely because Congress repeatedly refused to define insider trading over a 40-year period.

Congress did so in large part because it's a hard job. In 1988, for example, Congress refused to include a definition of insider trading in the Insider Trading and Securities Fraud Enforcement Act of 1988 explaining "the Committee believed that the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and that a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law."[85] The difficulty of doing so was called to the House' attention during debate by Representative Huizenga who reminded the House that former President Obama's SEC Chairman Mary Jo White had

81. Dirks, 463 U.S. at 658–59.

82. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 253–254 (1996).

83. 167 CONG. REC. H2462 (daily ed. May 18, 2021) (statement of Rep. Huizenga)

84. 167 CONG. REC. H2461 (daily ed. May 18, 2021) (statement of Rep. Himes).

85. H.R. Rep. No. 100-910, at 11 (1988), 1988 U.S.C.C.A.N. 6043, 6048.

warned Congress "it is challenging to codify it clearly in a way that is both not too broad and retains the strength of the common law.''[86]

Representative Himes' pious invocation of Congress' duties is also risible in light of the frequency with which Congress ducks hard issues. As Abram Chayes famously remarked, "Congress is often unwilling or unable to do more than express a kind of general policy objective or orientation."[87] In the securities law area, Congress has been ducking hard issues since the very beginning. In 1934, for example, Congress tried multiple statutory approaches to regulating proxy voting. After repeatedly flubbing the job, Congress dumped the problem in the SEC's lap by adopting a nonself-executing directive in Section 14(a) of the Securities Exchange Act.[88]

Given the serious flaws in the Act, the House should have stuck with that tradition and left the problem of defining insider trading to the courts. Instead, they have passed an Act that does not codify existing law but arguably expands it. They have passed an Act that does not clarify the Act but instead introduces new ambiguities. As a result, contrary to Representative Hime's concern that law be made on Capitol Hill instead of in the courts, it will be the courts that have to sort out what the new Act does.

When a very similar bill passed the House in the 116th Congress, the legislation died in the Senate.[89] The Insider Trading Prohibition Act of 2021 now awaits Senate action. The Senate would be well advised to let this bill die as well.

86. 167 Cong. Rec. H2462 (daily ed. May 18, 2021) (statement of Rep. Huizenga).

87. Abram Chayes, *The Role of The Judge in Public Law Litigation*, 89 HARV. L. REV. 1281, 1314 (1976).

88. Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 VAND. L. REV. 1129, 1139 (1993) ("Rather than legislating specific laws to deal with proxy voting, Congress delegated the rulemaking function to the SEC.").

89. *See* 167 Cong. Rec. H2462 (daily ed. May 18, 2021) (statement of Rep. Huizenga) ("We have to ask ourselves: Why was the bill ignored by the Senate?").