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CHAIRWOMAN

United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

PATRICK MCHENRY, NC
RANKING MEMBER

March 29, 2019

Memorandum

To: Members, Committee on Financial Services

From: FSC Majority Staff

Subject: April 3, 2019 Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets Hearing entitled: "Putting Investors First: Reviewing Proposals to Hold Executives Accountable"

On Wednesday, April 3, 2019 at 2:00 p.m., the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will hold a hearing entitled, "Putting Investors First: Reviewing Proposals to Hold Executives Accountable." Witnesses for the hearing are:

- **John Coffee**, Adolf A. Berle Professor of Law, Director of the Center on Corporate Governance at Columbia Law School
- **Melanie Lubin**, Maryland Securities Commissioner, on behalf of the North American Securities Administrators Association, Inc (NASAA)
- **Remington A. Gregg**, Counsel for Civil Justice and Consumer Rights, Public Citizen
- **Tom Quaadman,** Executive Vice President, U.S. Chamber Center for Capital Markets Competitiveness, Chamber of Commerce of the United States of America

This hearing will examine six legislative proposals that are designed to hold public company[1] executives accountable to both investors and the general public.

1. H.R. ____: Insider Trading Prohibition Act (Himes)

There is no Federal statute defining "insider trading" — the law of insider trading has been developed on a case-by-case basis by the courts over several decades, and insider trading is prosecuted under the general securities fraud section of the Securities Exchange Act of 1934.[2]

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[1] Public companies are companies that are subject to the reporting requirements of section 13 or section 15(d) of the Securities Exchange Act of 1934 [15 U.S.C. 78a *et seq*.]. When this memo uses the term "companies," it is referring to public companies.
[2] Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)]; 17 C.F.R. § 240.10b-5. *See also United States v. Newman*, 773 F.3d 438, 445 (2d Cir. 2014) ("Although Section 10(b) was designed as a catch-all clause to prevent fraudulent practices, … neither the statute nor the regulations issued pursuant to it, including Rule 10b-5, expressly prohibit insider trading. Rather, the unlawfulness of insider trading is predicated on the notion that insider trading is a type of securities fraud proscribed by Section 10(b) and Rule 10b-5.") (internal citations omitted).

In general, insider trading refers to undisclosed trading on material, nonpublic corporate information by individuals who are under a duty of trust and confidence that prohibits them from using such information for their own personal gain.[3] Individuals who are subject to this duty of trust and confidence also may not disclose (or "tip") the material, nonpublic information to outsiders (known as "tippees"), who then trade on the information themselves even though they know the information was wrongfully obtained.[4] Under this theory, known as "tipper/tippee liability," the corporate insider's duty not to secretly trade on the information transfers to the tippee if the tip itself constituted a breach of the insider's fiduciary duty.[5] In the seminal case of *Dirks v. SEC*, the Supreme Court held that an insider's tip of confidential information to an outsider constitutes a breach of the insider's fiduciary duty if the insider "personally will benefit, directly or indirectly, from his disclosure."[6]

In the controversial decision *United States v. Newman*, the Second Circuit in 2014 reversed the convictions of two portfolio managers who were tipped material, nonpublic information by insiders because: (1) the personal benefit that the insiders received from tipping was not "consequential" enough; and (2) even though the tippees knew that the information was wrongfully disclosed, the government could not prove that the tippees knew about the specific *personal benefit* that the insiders received.[7] The Supreme Court partially narrowed one aspect of the *Newman* decision in 2016,[8] but the parts of *Newman* that remain have made it significantly more difficult for the government to successfully prosecute insider trading cases. Due to the confusion that the *Newman* decision created around insider trading law, U.S. District Judge Jed Rakoff wrote in 2015 that "if unlawful insider trading is to be properly deterred, it must be adequately defined. The appropriate body to do so, one would think, is Congress."[9]

The Insider Trading Prohibition Act, sponsored by Rep. Jim Himes (CT-04), formally codifies the prohibition on insider trading, creating a clear, consistent standard for both courts and market participants to follow. The bill largely codifies the existing case law on insider trading; however, the bill overturns the controversial requirement in *Newman* that a tippee know about the specific personal benefit that the tipper received.

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[3] *See generally Chiarella v. United States*, 445 U.S. 222, 226–230 (1980); *Dirks v. SEC*, 463 U.S. 646, 653–654 (1983); *Salman v. United States*, No. 15-628, slip op. at 1 (2016); *see also In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).
[4] *See Salman*, slip op. at 2 ("The tippee acquires the tipper's duty to disclose or abstain from trading if the tippee knows the information was disclosed in breach of the tipper's duty, and the tippee may commit securities fraud by trading in disregard of that knowledge.").
[5] *See Newman*, 773 F.3d at 446–451 (discussing tipper/tippee liability).
[6] *Dirks*, 463 U.S. at 662. The Court further held that a personal benefit to the tipper can be inferred from the relationship between the tipper and the tippee — for example, if the relationship "suggests a *quid pro quo* from the [tippee], or an intention to benefit the particular recipient," then courts can assume that the tipper personally benefited from the tip. *Id.* at 664.
[7] *See Newman*, 773 F.3d at 452.
[8] *See Salman*, slip op. at 10 (holding that the government need not prove that a tipper received "something of a 'pecuniary or similarly valuable nature' in exchange for" the tip when the relationship between the tipper and tippee is one of "family or friends.").
[9] *SEC v. Payton*, No. 14-4644, slip op. at 1 (S.D.N.Y. April 6, 2015).

2. H.R. ____: Investor Choice Act of 2019 (Foster)

When an investor opens an account at a broker-dealer, the account agreement almost always includes a clause requiring the parties to settle any future dispute through arbitration, rather than through the courts.[10] The Financial Industry Regulatory Authority (FINRA) is responsible for overseeing and administering arbitration between broker-dealers and their customers.[11] The Supreme Court has upheld the validity of mandatory arbitration clauses in broker-customer agreements — but *only* because the arbitration process is administered and overseen by the SEC, acting through FINRA.[12] In 2014, FINRA ruled that a mandatory arbitration clause that prevented customers of a broker-dealer from participating in a judicial class action violated FINRA rules.[13] The Dodd-Frank Act gave the SEC the authority to prohibit or condition the use of mandatory arbitration clauses in broker-customer agreements, as well as in agreements between investors and investment advisers.[14] However, the SEC has never used this authority.

The Investor Choice Act of 2019, sponsored by Rep. Bill Foster (IL-11), would prohibit both broker-dealers and investment advisers from including mandatory arbitration clauses in their agreements with customers. In addition, the bill would prohibit public companies from including mandatory arbitration clauses in their bylaws or other corporate governance documents.[15]

3. 8-K Trading Gap Act of 2019 (Maloney)

Public companies are required under the Exchange Act to disclose significant corporate events to investors and the public on Form 8-K.[16] SEC rules require companies to file a Form 8-K within 4 business days after the corporate event occurs.[17] This means that company executives will know about material, nonpublic information for up to 4 days before it is disclosed to investors and the public. However, there is no SEC rule prohibiting these executives from buying (or selling) the company's securities during this 4-day gap between the occurrence of the

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[10] *See* SEC, INVESTOR BULLETIN: BROKER-DEALER/CUSTOMER ARBITRATION (December 20, 2016), *available at* https://www.sec.gov/oiea/investor-alerts-bulletins/ib_arbitration.html.
[11] *See* FINRA Rule 2268, *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=9955.
[12] *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 234 (1987) (holding narrowly that "where, as in this case, *the prescribed procedures are subject to the Commission's § 19 authority*, an arbitration agreement does not effect a waiver of the protections of the Act.") (emphasis added).
[13] Decision, *Department of Enforcement v. Charles Schwab & Co.*, Complaint 2011029760201 (FINRA Board of Governors, Apr. 24, 2014).
[14] 12 U.S.C. § 5518.
[15] The SEC staff's longstanding position has been that the inclusion of mandatory arbitration clauses in corporate governance documents of public companies violates the anti-waiver provisions of the Federal securities laws. *See e.g.*, Thomas L. Riesenberg, *Arbitration and Corporate Governance: A Reply to Carl Schneider*, 4 Insights 8 (1990); Gannett Co., Inc., SEC No-Action Letter (February 22, 2012).
[16] *See* Section 13(*l*) of the Exchange Act [15 U.S.C. § 78m(*l*)].
[17] SEC, FORM 8-K, GENERAL INSTRUCTIONS, at 2, *available at* https://www.sec.gov/about/forms/form8-k.pdf.

material event and the filing of the Form 8-K. In fact, a 2015 study found that over a 6-year period, insiders who traded during this 4-day gap successfully earned $105 million in above-market returns on these trades.[18]

The 8-K Trading Gap Act of 2019, sponsored by Rep. Carolyn B. Maloney (NY-12), would direct the SEC to issue a rule requiring public companies to put in place policies and procedures that are reasonably designed to prohibit officers and directors from trading company stock after the company has determined that a significant corporate event has occurred, and before the company has filed a Form 8-K disclosing such event.

4. A bill to require the SEC to complete rulemaking required by section 10D of the Securities Exchange Act of 1934

Section 954 of the Dodd-Frank Act directs the SEC to issue a rule requiring exchange-traded companies to have policies in place that will allow them to recover money that they previously paid to executives as incentive compensation, if the incentive compensation was paid due to material noncompliance with the financial reporting or accounting rules.[19] The purpose of this rule is to prevent executives from keeping incentive compensation that they would not have been entitled to if the financial reporting and accounting had been done properly. However, in the over 8 years since Dodd-Frank was signed into law, the SEC has never issued this mandatory rulemaking. This discussion draft would require the SEC to finalize the section 954 rulemaking within 60 days. If the SEC has not finalized the rulemaking within 60 days, the SEC Chair is required to testify in the House Financial Services Committee and the Senate Banking Committee once a month until the rule is finalized.

5. A bill to require the SEC to complete rulemaking required by section 14(i) of the Securities Exchange Act of 1934

Section 953(a) of the Dodd-Frank Act[20] directs the SEC to issue a rule requiring public companies to disclose in their annual proxy statements a clear description of any executive compensation required to be disclosed under SEC rules.[21] Further, this disclosure must include information on "the relationship between executive compensation actually paid and the financial performance" of the company (taking into account share price movements and dividends) — in other words, pay vs. performance information.[22] The purpose of this rule is to increase the accountability of corporate executives by strengthening the link between executive

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[18] Robert J. Jackson, Joshua Mitts, and Alma Cohen, *The 8-K Trading Gap*, COLUM. LAW & ECON. WORKING PAPER NO. 524 (2015), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2657877.
[19] 15 U.S.C. § 78j-4.
[20] 15 U.S.C. § 78n(i).
[21] *See* 17 C.F.R. § 229.402 (listing the information about executive compensation that public companies are required to disclose in their proxy statements).
[22] 15 U.S.C. § 78n(i).

compensation and company financial performance — and by highlighting for shareholders when increasing executive compensation is not matched by improved financial performance.

However, despite this being a mandatory rulemaking, the SEC has never issued the rule required by section 953(a). This discussion draft would require the SEC to finalize the section 953(a) rulemaking within 60 days. If the SEC has not finalized the rulemaking within 60 days, the SEC Chair is required to testify in the House Financial Services Committee and the Senate Banking Committee once a month until the rule is finalized.

6. A bill to amend the Securities and Exchange Act of 1934 to amend the definition of whistleblower (Green)

Section 922 of the Dodd-Frank Act created a whistleblower program at the SEC that provides monetary awards to whistleblowers who contribute "original information" that results in monetary sanctions of over $1 million.[23] In addition, section 922 explicitly protects whistleblowers from retaliation by their employers simply for reporting suspected misconduct.[24] In 2018, the Supreme Court held in *Digital Reality Trust v. Somers* that whistleblowers who report alleged misconduct internally, but not to the SEC, are not protected by the anti-retaliation provisions of Dodd-Frank.[25]

This discussion draft, sponsored by Rep. Al Green (TX-09), would amend section 922 of Dodd-Frank to clarify that whistleblowers who only report alleged misconduct to their employers, and not to the SEC, are also protected by the anti-retaliation provisions in section 922. Thus, the bill would encourage employees to communicate potential securities law violations to their employers without fear of being fired before they are able to report to the SEC.

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[23] *Id.* at § 78u-6.
[24] *Id.* at § 78u-6(h).
[25] *Digital Reality Trust, Inc. v. Somers*, No. 16-1276, slip op. at 2 (2018).