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at

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of the

Committee on Financial Services

of the

United States House of Representatives

**Putting Investors First: Reviewing Proposals
to Hold Executives Accountable**

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Chairman Maloney, Ranking Member Huizenga, and Fellow Members of the Committee:

I. **INTRODUCTION**

I am very happy and honored to be back before this committee. I have been asked to comment on several proposed bills, all of which I basically support, but I will focus my limited time today primarily on Congressman's Himes's Discussion Draft of an "Insider Trading Prohibition Act." I want to commend Congressman Himes for having supervised the drafting of a very careful, balanced and sophisticated bill that should serve as a model for a long overdue effort to codify the law of insider trading. To date, the law of insider trading has been solely the product of judicial law-making, and courts have been confined by the words set forth in Section 10(b) of the Securities Exchange Act. In effect, insider trading is the best example of a common law crime that survives today.

As a matter of full disclosure, I should disclose at the outset that I have been involved with the drafting of this bill over the last several years (but I am in no sense its primary draftsman). Nonetheless, I do have some suggestions for its possible modification and improvement.

I. The Insider Trading Prohibition Act

There is general agreement today that the law of insider trading has grown overly complex and technical. As a result, it is hard for the public to understand its logic or for practitioners to give advice with respect to the scope of the prohibition. Moreover, to the extent that insider trading is judge-made law, disparities and inconsistencies among the Circuit courts becomes inevitable because there is little in the way of a definitive statutory text to provide precise guidance. Currently I serve as a member of a Task Force on Insider Trading, assembled by Preet Bhahara, the former S.D.N.Y. U.S. Attorney, which is attempting to answer some of these problems. Although I cannot speak on behalf of that Task Force, I am convinced that the members of the Task Force (many of them ex-U.S. Attorneys and SEC enforcement specialists) share this view about the need for greater clarity and simplification. In this light, the key virtues of the Insider Trading Prohibition Act are that (1) it is comparatively easy to understand, and (2) it extends the criminal prohibition to reach certain clearly egregious forms of misbehavior that are largely beyond the powers of courts to reach because courts are constrained by the narrow wording of Section 10(b) of the Securities Exchange Act of 1934.

A. <u>What Does The Insider Trading Prohibition Act Do?</u>

Essentially, the Act eliminates the need to show that the tippee paid or promised some "personal benefit" to the tipper. This requirement has proven a significant barrier to insider trading enforcement, both because such payments can be artfully hidden and because a norm of reciprocity pervades Wall Street. Thus, one hedge fund may "tip" material, non-public information to another without soliciting or receiving any such payment because it is relying on this norm of reciprocity and expects that someday it will receive a reciprocal gift of information in return from the hedge fund that it is today benefitting.

This simplification that the Act effects does not threaten innocent parties who mistakenly share material nonpublic information because Section 32(a) of the Securities Exchange Act requires that any criminal violation be "willful," and courts have long read this "willfulness" requirement to require an intent to violate the law and/or engage in corrupt predatory conduct.

The Insider Trading Prohibition Act expands liability in ways that should not be controversial. Because Section 10(b) prohibits only use of "any manipulative or deceptive device or contrivance," these are words of fraud, and much egregious misconduct is not covered by Section 10(b) because the conduct does not involve fraud. For example, if a non-fiduciary breaks into an investment banker's office at 2 A.M. in the morning, steals a file on a pending secret merger, and trades on that material information, this conduct amounts to theft, not fraud, and it is therefore not reached by Rule 10b-5. But it is reached -- and properly so -- by the Insider Trading Prohibition Act. Similarly, if a computer hacker hacks into a law firm's computer system to learn material information, this could under some circumstances violate Rule 10b-5, but under other circumstances, it would not.[1] Such conduct will always, however, violate the Insider trading Prohibition Act -- and again properly so. Any deceptive taking of material, non-public information is reached by the proposed Act.

B. Some Suggestions

1. Eliminating The Personal Benefit Requirement. Section 16A(c)(2) of the proposed Act seeks to make it clear that it is not necessary for the prosecutor to show that the defendant knew "whether any personal benefit was paid or promised by or to any person in the chain of communication." This does respond to the prosecutor's problem that it is difficult to show at trial what a remote tippee actually knew. But there is at least a mild ambiguity here under the Act. Section 16A(c)(2) of the Act explicitly eliminates only the need for the defendant to have knowledge of the personal benefit, not the need

[1] See SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009) (recognizing that computer hacking to obtain an earnings report in advance of its public release could under some circumstances violate Rule 10b-5). Dorozhko, however, requires that some misrepresentation that is deceptive be made by the defendant. The Act is broader and covers all acts of theft to obtain material, nonpublic information.

for the personal benefit. Although nothing in proposed Section 16A requires the prosecution to prove a personal benefit to the tipper, it can at least be argued that this need to show such a benefit is implicit, because there would be no need to eliminate knowledge on the defendant's part of the personal benefit unless there was such a personal benefit requirement. Knowledge of the personal benefit is a secondary element, which only becomes important if there was such a personal benefit requirement.

If a requirement for the prosecutor to show a personal benefit were to remain, then this proposed legislation would lose much of its impact. The Wall Street "favor bank" would remain in full operation because investment bankers could tip material information lawfully in the hope of future reciprocal favors -- so long as there was not a provable promise of such a future benefit.

The best way to cure this ambiguity is to rewrite Section 16A(c)(2) so that its first sentence reads as follows:

> "It shall not be necessary that any person trading while in possession of such information (as proscribed by subsection (a), or making the communication (as proscribed by subsection (b), (i) have paid or promised any benefit (monetary or otherwise) to the tipper (or on its behalf) or any person in the chain of communication, or (ii) know the specific means by which the information was obtained or communicated, so long as the person trading while in possession of such information or making the communication, as the case may be, was aware, or recklessly disregarded, that such information was wrongfully obtained or communicated."

I believe this would only do what the draftsman of the Act intended, but imperfectly expressed.

2. <u>Derivative Liability</u>. Subsection 16A(d) of the Act sets a different standard for "controlling person" liability from that specified in Section 20(a) of the Securities

Exchange Act. Suppose an institutional investor employs a trader to trade for it (with discretionary authority) and compensates this trader by agreeing to pay him 20% of its trading profits obtained through his trading. This trader then engages in insider trading in violation of Section 16A. What is the institution's liability?

Under existing Section 20(a), the institution would have a defense if it "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." Under 16A(d), the defense is narrower; the institution as the employer has the defense that it "did not participate, profit from, or indirectly induce the acts constituting the violation of this section." On the above facts, the institution did "profit from" the insider trading and would be liable for damages and penalties. It no longer has a "good faith" defense. I am not certain that it should lose this defense. Language here could be easily changed to restore a "good faith" defense.

Possibly, there is concern here that some "controlling persons," such as Stephen A. Cohen, escaped liability too easily, even though several of his employees were found to have engaged in insider trading.[2] If this is a concern, the standard for the "good faith" defense could be tightened so that any awareness by a controlling person of acts by an employee or agent that could plausibly amount to insider trading (even by a different employee or agent) would deny the controlling person the "good faith" defense.

<u>SEC Rule-Making</u>. Under proposed Section 16A(e) of the Act, the Commission is given authority, by rule, to exempt certain persons or transactions. That is fine, but it is only one-way authority: authority to downsize the provision. In contrast, Section 14(e) of the Securities Exchange Act gives the Commission authority to adopt rules and regulation

[2] Mr. Cohen is the founder of S.A.C. Capital Advisors; his net worth has been estimated by Wikipedia at $13 billion. Despite settling charges with the SEC for failing to supervise employees who engaged in insider trading, he continues in business as the founder of Point 72 Asset Management.

to "prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive or manipulative." Pursuant to this authority, the SEC adopted Rule 14e-3, which is the other major rule directed at insider trading (besides Rule 10b-5).

The key point here is that the SEC's rule-making authority under Section 14(e) permits it to go beyond simply defining a practice to be "fraudulent, deceptive, or manipulative" and to prescribe rules that have a degree of overbredth, so long as they are "reasonably designed" to prevent fraud, deception or manipulation. The SEC today lacks this authority under Section 10(b), but has it under Section 14(e). Given that the world of insider trading and securities manipulation is changing at a very rapid rate, I submit that it would be wise to arm the SEC with the same authority that it already has under Section 14(e). With the Internet, new forms of securities manipulation are appearing constantly, and the SEC needs to be better armed.

II. Other Proposed Statutory Amendments

1. Whistleblowers. One bill before this Subcommittee would protect whistleblowers who report internally within the corporation and are terminated before they report to the SEC. A recent Supreme Court decision, Dig. Realty Trust v. Somers, 138 S. Ct. 767 (2018), has denied such persons the protections given by the Dodd-Frank Act to employees who report directly to the SEC. This decision was strictly a matter of statutory interpretation. Even if the Court correctly interpreted the Dodd-Frank provision, nothing precludes Congress from amending the statute to change this outcome. The proposed bill would do that by amending Section 21F(a)(6) of the Securities Exchange Act to broaden its definition of "whistleblower," and thus cover those employees who report only internally.

Although there may be some controversy within the business community, most corporations want the employee to report internally first. Today, after the Dig. Realty Trust decision, no employee represented by counsel will do that, because it exposes this employee to retaliation for which there is no federal remedy. As a result, corporations lose early notice and the opportunity to correct (or at least revise) their procedures before the Government is advised of their possible failure. This legislation costs the corporation only the chance for a quick firing (or other retaliation against) the employee before the Government is on notice. It is hard to see this dubious interest as deserving protection.

2. Mandatory Arbitration. Also before this Committee is a more sweeping provision that precludes arbitration provisions, both in agreements with brokers and investment advisers and in corporate charters. I cannot deny that this bill will be controversial, but I favor it and have two small suggestions: First, Section 4 of this bill provides that no security may be registered under the Securities Act of 1933 if an issuer's "bylaws, registration statement or other governing documents mandates arbitration for any disputes between the issuer and the shareholder of the issuer." First, I suggest that you strike the word "registration statement" and substitute "certificate of incorporation or charter." Registration statements mandate nothing; they only disclose information. Certificates of incorporation do mandate (but are probably picked up by the phrase "other governing documents").

Second, this provision may discourage some private companies from "going public." To reduce that pressure, I suggest that Section 4 of this bill provide both that issuers may not go public with such a mandatory arbitration provision and that an issuer with more than one hundred shareholders of record may not "mandate arbitration for any disputes between the issuer and the shareholders of the issuer." Although the number one hundred may seem low, this is a number of the shareholders of record, and companies can keep this number low by using "street names" or other devices to limit their shareholder of record.

Finally, simply as a drafting matter, I would strike "disputes" in line eleven on page four and substitute "dispute." This is broader language.

3. Completion of Rulemaking. Two bills before this Subcommittee would require the SEC to complete rulemaking with respect to Sections 10D and 14(i) of the Securities Exchange Act. Section 10D addresses clawbacks, and Section 14(i) address "pay versus performance." I certainly support the need for rulemaking in both areas, but I suggest that 60 days after enactment may be too short a period (perhaps 180 days would be more realistic about the pace at which the SEC can realistically proceed). The proposed sanction (forcing the SEC's Chairman to testify before you) is certainly a nuclear theat. But a lesser alternative would be to suspend the pay of the SEC's Commissioners so long as this deadline is not met. That will work!

4. The "8-K Trading Gap Act of 2018"

This bill seeks to preclude trading by officers and directors "when in possession of material nonpublic information." I suspect that its primary goal is to restrict trading during corporate stock buybacks. This is speculative inference on my part because the bill does not fully explain its purposes (and trading on material nonpublic information is already prohibited by Rule 10b-5).

Structurally, this bill applies to trading during a "covered period," which is defined in Section 2(a)(2) of this Act to mean "the period beginning on the date on which an issuer determines that the issuer possesses material nonpublic information and ending on the date on which that information is publicly disclosed or no longer material." An initial problem is that the first date may never be declared by the corporation and its determination may be very difficult. In general, corporations do declare "covered periods," but seldom do so in these terms. I respectfully suggest that some revisions in this phrasing would be useful. If the goal is to preclude trading before or during a stock buyback, this restriction should be specified in those terms, as public corporations do not concede that their announcements convey material information. Alternatively, one could define "covered period" in terms of the filing of a Form 8-K and begin the period one week before such filing and continue the period until one week after it.