Congress and Insider Trading: Breaking the Law and Making the Law

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This descriptive case study concerns the insider trading prosecution against former U.S. Representative Chris Collins, which resulted in his guilty plea in 2018, incarceration, and then release in December 2020, after receiving a pardon by outgoing president Donald Trump. It uses that case's unique facts as a launching point and thematic device for summarizing illegal insider trading law, while emphasizing the difficulty in recognizing that insider trading law requires first that the wrongful trader have—and violate—a fiduciary duty. This is done by noting the influence federal case law has had on determining what insider trading is. The case study then continues the congressional line of analysis by focusing on the 2012 STOCK Act, which prohibits Congress from profiting off their access to inside information, as well as the Insider Trading Prohibition Act, current legislation that might become America's first, criminal insider trading statute.

Keywords: insider trading, Tipper-Tippee, misappropriation, fiduciary duty, Insider Trading Prohibition Act, STOCK Act

LEARNING OUTCOMES

In completing this case study, students should be able to:

1. Classify the required elements of illegal insider trading.
2. Assess the way a fiduciary, or legal, duty arises for insider trading.
3. Distinguish tipper-tippee insider trading from misappropriation insider trading.
4. Assess the implications of members of Congress and their staff having access to material, nonpublic information that can affect stock values.
5. Compare and contrast current insider trading elements with the Insider Trading Prohibition Act.

APPLICATION

This case is most appropriate for undergraduate and graduate versions of the following courses: Business Law; Commercial Law; Elements of Law; Securities Law

INTRODUCTION

It is a rare thing to see insider trading being committed. We expect to see all kinds of violent and property crimes being recorded in a world where there's always a camera or phone somewhere filming. But

insider trading, like many other white-collar crimes, happens alone or in secret. That is unless you're on your phone while attending the 2017 White House Congressional Picnic, urgently telling your son to sell his shares as soon as possible because you just got some really bad news. Then the odds are good a news camera is filming, especially when Jared Kushner is walking across the grass near where you're standing. And so, when then-U.S. Congressman Chris Collins, a Republican from Buffalo, New York, was indicted on insider trading charges, there actually was CBS news footage of the infamous phone call that can easily be found today. That Mr. Kushner's father-in-law pardoned the former Congressman in late December 2020 didn't erase Mr. Collins's 2019 guilty plea, but it did allow him to leave prison 15 months early. Even though the power to pardon is clear, what has never been clear for decades is what insider trading actually is and if there's a way to clarify the confusion. Congress might now have a solution.

THE BASICS OF INSIDER TRADING

It may come as a surprise, but one can't look up the criminal statute for insider trading because there is none. Illegal Insider trading has a commonly stated definition, which includes, "buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, on the basis of material, nonpublic information about the security." (seclaw.com) That's not *the law*, as one might say, but it is an effective description. Just because there is no statute on insider trading doesn't mean there is no legal authority for it. Quite the opposite.

Congress created the Securities and Exchange Commission (SEC) in 1934 when it passed the Securities Exchange Commission Act, which is a collection of statutes related to the securities markets. In one of the statutes, Section 10b of the Act, Congress gave the SEC the power to prohibit using "any manipulative or deceptive device," later in the statute called "fraud," with respect to the "purchase or sale of any security." In response, the SEC created in 1948 a very famous rule, 10b-5, which makes it unlawful to, among other things, "defraud," "make an untrue statement of a material fact," or to commit "fraud or deceit upon any person," when engaged in a transaction on a national securities exchange (SEC). And many federal courts, most importantly the U.S. Supreme Court, have made numerous precedents in insider trading cases, which ultimately create an ever-evolving doctrine on insider trading and its various types (Eisenberg, 2017).

Broad as those prohibitions are, they need a starting point. Using the commonly stated definition above, one must first determine who is an "insider." According to Sec. 16 of the Securities Exchange Act (1934), an insider is a director, or officer, or owner of at least 10% of the underlying company's stock. Then there is another type of insider, the temporary insider, someone whose special working relationship to the company gives them access to inside information (*Dirks v. SEC*, 1983). Those persons would include outside lawyers or accountants who are hired by the company and who, for example, have access to the kinds of information the traditional insiders have. "Inside information" is that which has not yet been made publicly available (*Elkind v. Liggett & Myers, Inc.*, 1980). And "material" information is that which, if known, would have a substantial likelihood to affect a reasonable investor's decision to buy or sell the company's stock (SEC, 1951), or would have an impact on the security's price (*SEC v. Texas Gulf Sulphur*, 1968). Examples of material information would include the company's earnings, an impending merger, an impending bankruptcy, or a new product or discovery.

Going back to the case of that unfortunate phone call filmed at the White House picnic, Chris Collins was on the board of directors of an Australian pharmaceutical company, Innate Immunotherapeutics, which clearly makes him an insider. Beyond being on the board, Collins was also the largest shareholder and someone for whom it was reported bragged about getting his congressional colleagues to invest in Innate Immunotherapeutics (Wong, 2017). The reason for his urgent phone call was that he had just gotten an email, which began with "I have bad news to report," from Innate's CEO (Department of Justice, 2018). The email announced the company's multiple sclerosis drug, which was its only major product in development, had failed a drug trial.

That information is also clearly "inside," since it hadn't yet been made public. And there are two ways to know it was material: a) bad news about a drug trial for a company who sells drugs would naturally affect whether someone would want to sell their shares; and b) it immediately affected Collins's behavior. He

couldn't sell his shares, since he was a board member and would have easily been caught, so he lost $16.7 million after the stock dropped over 90% when the bad news hit (Cao, 2017). But Collins's son, Cameron, did sell in time, as did others who were also tipped, including Cameron's fiancé and future father-in-law. They avoided a $768,000 loss, but not the long arm of the law (Zremski, 2021). [In September 2018, Innate Therapeutics changed its name to Amplia Therapeutics.]

THE DUTY NOT TO TRADE: THE KEY TO INSIDER TRADING AND NOT SO EASY TO UNDERSTAND

If you ever bought or sold any stock or mutual fund or even bitcoin, did you know who was on the other end of the transaction? Of course not. It's not like buying or selling vegetables at a farmer's market or even selling a car on eBay. So how can someone commit "fraud" against a person who doesn't with whom they are transacting and who didn't make the decision to buy or sell based on anything the other person told them? Chris Collins's son sold his shares ASAP after his father's phone call, but whoever bought them didn't know who was selling or why, so how is that fraudulent? The answer is in the last part of the working definition of insider trading and is the most difficult part of insider trading to comprehend. There must be a duty not to trade. But not just any duty, a fiduciary duty, which means something beyond a moral duty. A legal duty.

The SEC's regulation of the securities markets and of brokers is meant to ensure transparency, and fraud—whether by saying something false in order to get someone to do something or not saying something true when one has a duty to speak—is an act of concealment. A member of the board of directors of a company, has a legal duty—alternately called a fiduciary duty—to act in the best interests of the shareholders (Cal. Corp. Code, 1987), and so does an officer of a corporation (*Gantler v. Stephens*, 2009). Owners of at least 10% of the company's stock, and temporary insiders, are also placed in this class of those who are in effect committing fraud on the current shareholders when they sell shares because they know something the shareholders don't. Likewise, as this theory goes, when insiders buy shares based on material inside information, they are committing a fraud on the stock market as a medium of honest exchange. In fact, a line of insider trading cases discusses the requirement that an insider has a "duty to disclose" or abstain from buying or selling stock based on material inside information (*SEC v. Texas Gulf Sulphur Co.*,1968; *Chiarella v. U.S.*, 1981; *Dirks v SEC*, 1983).

Because illegal insider trading requires a violation of a duty not to trade, it is inaccurate to think insider trading is always committed when someone buys or sells a stock just because they knew a secret about the company. This duty requirement was confirmed in a U.S. Supreme Court case involving a stock analyst who passed on inside information about a company's financial fraud in order to help his institutional investor clients who owned that company's shares. Because that analyst (who was a temporary insider) didn't personally benefit from passing on the inside information and because he was trying to prevent his clients from owning stock in a company whose financial documents were fraudulent, the Court held he hadn't violated any fiduciary duty (*Dirks,* 1983). As an extreme example, suppose you were sitting in a Manhattan bar and overheard a drunk CEO loudly tell their drinking buddy something confidential about the company that is absolutely great news. If you immediately bought shares in that company, have you committed insider trading? No, because you have no fiduciary duty to anyone involved, including the shareholders of that company.

THE THREE TYPES OF INSIDER TRADING

The original sin of illegal insider trading is traditional, or classic, insider trading, where an insider buys or sells stock in a publicly traded company because of material inside information and in violation of the insider's fiduciary duty to the company. Suppose the corporate attorney and board member of a publicly traded tech company learns first that the company will lose an appeal in a trademark case that will cost the company billions of dollars and then immediately sells all her shares. That is classic insider trading and when a corporate lawyer at Apple was indicted for insider trading in 2019, he attempted to have the

indictment thrown, claiming "there is no statute that expressly criminalized insider trading." (Bennet, 2020). That long-shot argument failed (Pierson, 2020).

Tipper-tippee insider trading takes traditional insider trading one step further. It occurs when an insider (the tipper) violates their duty by passing on the inside information to another person (the tippee), in exchange for a personal benefit (*Dirks*, 1983). For the tippee to commit insider trading, they need to trade in the underlying stock because of the inside information given to them and with the awareness that the tipper shouldn't have provided the tip (*Chiarella*, 1980, *Dirks,* 1983). Notice that in the Chris Collins case, Mr. Collins didn't sell his shares of Innate Immunotherapeutics and lost close to $17 million once the stock dropped precipitously after the bad news was released. But in telling his son, Mr. Collins became the tipper and Cameron Collins became the tippee. Then Cameron became a tipper when he told his future father-in-law, fiancé and a few others.

But if you're wondering what the "exchange" would be between a father and son, the Supreme Court also said a tipper can violate the law when "making a gift of confidential information to a trading relative or friend." (*Dirks*, 1983) Not only can the benefit be a gift it can be intangible. And in 2016 in *Salman v. U.S.*, the Supreme Court explicitly confirmed that policy in a case where a tippee unsuccessfully argued he couldn't be convicted of insider trading from information he got from a relative, which originated from another relative, because that original tipper got nothing in return for his tip. So, the benefit to the tipper can be the gift of inside information and, according to the *Salman* court, is no different than if the tipper had instead wrongfully profited from insider trading and gave the proceeds to the relative.

The third type of insider trading is misappropriation, and it is only committed by outsiders. Odd as it might seem, someone who has no insider status and didn't get a tip from an insider can still commit insider trading. Misappropriation theory is formalized in a 1997 Supreme Court case, *U.S. v. O'Hagan*, where the court held that a person commits the fraud of insider trading when he or she "misappropriates confidential information for securities trading purposes in breach of a duty owed to the source of the information." In the case, a lawyer at a Minneapolis law firm learned that a corporate client at the firm was going to attempt a takeover of The Pillsbury Co. and thereafter began investing in Pillsbury before the news broke, resulting in a gain of over $4 million. A temporary gain, since he was charged with insider trading. The lawyer argued that he violated no legal duty since he didn't represent the company trying to acquire Pillsbury. But the court ruled otherwise in affirming his conviction, concluding he had violated a legal duty. Essentially, a lawyer's duty of confidentiality applies to all the clients at a law firm and not just the lawyer's own clients (Kauffman, 2013), and so by acting on the secret information he learned because he worked at that law firm, Mr. O'Hagan violated the lawyer's duty of client confidentiality.

In an oddly similar case, a psychiatrist was charged with misappropriation because he traded stocks based on what his patient, the wife of a CEO at a publicly traded company, was telling him during her appointments with him. The doctor argued that he hadn't committed misappropriation, but the court concluded a doctor's duty of confidentially and the trust a patient has in her doctor are violated when doctors trade based on what they learn from their patients (U.S. v. Willis, 1990). The doctor eventually pled guilty. Of course, the patient wasn't a tipper because she didn't even realize she was giving her doctor stock tips.

Beyond lawyers and doctors, it can be difficult to find where nonprofessionals have a duty to someone else that is strong enough for misappropriation, since misappropriation is about violating a duty of trust or confidence to the source of the inside information (O'Hagan, 1997). In 2000, the SEC adopted a new rule, 10b5-2, which identifies three nonexclusive circumstances where one has a "duty of trust or confidence" for misappropriation insider trading. First is "Whenever a person agrees to maintain information in confidence." (SEC). So, according to the SEC, a simple promise to keep a secret is tantamount to a fiduciary duty for misappropriation purposes. Second, is when a person "with a history of sharing confidences," is given material inside information and the receiving person realizes or should realize that the provider of the information expected it to remain confidential. And the last category in 10b5-2 is when the receiver of the information is related to the sender as spouse, child, parent, or sibling – with limited exceptions.

A wrinkle that needs to be straightened is that one can commit misappropriation without telling anyone what the big secret is. The violation of duty or trust to the source of the information is acting on the information by trading in the stock, not necessarily disclosing it. Billionaire sports owner and "Shark Tank"

judge Mark Cuban was once accused of noncriminal misappropriation insider trading years after he sold his shares in a tech company because of something significant the company's CEO told him on the phone earlier that day (Kauffman, 2012). The CEO called Mr. Cuban without solicitation and Cuban claimed he never promised to keep the information a secret. The jury believed Cuban and he won the case (Pruet, 2013).

One of the odder misappropriation cases involving whether a relationship is close enough to create a duty of trust or confidence comes from Alcoholics Anonymous. Two guys had become AA buddies for nearly a decade and when friend A told B that he (A) was considering drinking again due to stress at work because his employer was going to be taken over by another company, friend B started buying shares in A's company. Then B told his friends and family to do the same. B was eventually charged with misappropriation and also for being a tipper (*U.S. v. McGee*, 2012). After conviction, the Third Circuit Court of Appeals confirmed the SEC's power to make such a broad rule with criminal law consequences (*U.S. v. McGee*, 2014). And it also agreed with the government that a relationship created through the mentoring of Alcoholics Anonymous could be close enough that it would have a "history of sharing confidences" as stated in Rule 10b5-2 (2000).

CONGRESS AND ITS (FORMER) CAPABILITY TO COMMIT INSIDER TRADING

If you knew that a pandemic was coming before the rest of America did and then bought or sold shares in companies who would be as affected by the pandemic as the rest of us, would that be smart, unethical, or illegal? Well, if you were a member of Congress, it would be illegal, thanks to a law Congress passed on itself in 2012. Known as the STOCK Act, the Stop Trading on Congressional Knowledge Act prohibits Congress from profiting off what it knows (15 U.S.C. § 78u-1, 2012). It does so by directly stating that members or employees of Congress owe a duty of trust or confidence to "…the citizens of United States with respect to material, nonpublic information" gained by virtue of their governmental positions or activities (§ 78u-1 (g)(1)).

One might incredulously ask: "What took so long to get Congress to stop itself from such unscrupulous investing?" You can thank the 1st Amendment, because a cultural flashfire was lit when a 2011 CBS News "60 Minutes" piece showed how members of Congress—because they know where the money is going to be spent or they know first what the bad news will be—profited off material nonpublic information during the 2008 financial crisis and the passage of the Affordable Care Act in 2010. In fact, a study conducted of the U.S. Senate from 1993-1998 showed that an investment portfolio that mimicked the investment activities of the Senate, both buying and selling, beat the market averages by 1 percentage point per month, which is a remarkable improvement. (Ziobrowski, Cheng, Boyd, and Ziobrowski, 2004).

Perhaps it wasn't a total shock when, in March 2020, four Senators were investigated for insider trading related to their private and first-hand knowledge about the scope and severity of COVID-19. While other members of Congress had made well-timed sales of stocks just prior to public dissemination of the impending pandemic, four senators were investigated by the U.S. Justice Department for trades made after a private briefing on the Pandemic was provided to them: Diane Feinstein (D) of California; James Inhofe (R) of Oklahoma; Richard Burr (R) of North Carolina; and Kelly Loeffler (R) of Georgia. Sen. Loeffler, who lost a run-off election in January 2021, is married to the chair of the New York Stock Exchange. And Sen. Burr not only sold millions of dollars in companies who would be negatively by COVID in February 2020, he did so after publicly expressing a positive outlook while also at the same time privately telling certain constituents quite a different story (Annello, 2020). And Burr was one of only three senators who voted against the 2012 STOCK Act, calling the legislation "insane." (Kelly, 2020) While the Justice Department cleared the senators of wrongdoing, it left some wondering if the STOCK Act went far enough, and if members of Congress should be allowed to trade stocks at all, in light of the unique access they have to material information that will affect stock prices (Gellasch, 2020).

THE INSIDER TRADING PROHIBITION ACT: THE FIRST INSIDER TRADING STATUTE MIGHT BE ON ITS WAY

Insider trading law is a patchwork of federal case law and SEC regulations – and more case law interpreting those regulations. Some have advocated for a criminal law statute on insider trading (Bharara Task Force, 2020; Fisher, 2017), so there is legal clarity, at least as a starting point. At one time in America's history, crimes were defined by the common law and then eventually they were "codified," meaning succinctly and strategically put into a statutory code. Burglary is likely the most famous example of a common law crime. Up to seven elements constituted common law burglary, but it was made more streamlined years ago when burglary was added to every jurisdiction's criminal code. For those who think the same thing should be done with insider trading, they might get their wish.

In May 2021, the U.S. House of Representatives passed by a wide margin of 350-75 the "Insider Trading Prohibition Act." The bill's sponsor, Rep. Jim Himes (D) of Connecticut said the legislation, officially known as H.R. 2655, is intended to simplify existing case law on insider trading (Godoy, 2021). Although not the first time an insider trading law was attempted, this bill might get passed in a Senate that has a tight Democrat majority, considering the bill's bipartisan support in the House. If so, it would put America in a similar way with the European Union, which has a more singular definition and prohibition of insider trading (Baker, 2008).

H.R. 2655 codifies much of the language that is often used in insider trading case law, with its emphasis on material nonpublic information (Sec. 16A(a)). It still requires a breach of a duty as a prerequisite for wrongful trading. That's an important qualification because at one time, it was illegal to simply trade while in possession or because of the awareness of material inside information. Sometimes called the parity-of-information theory, that doctrine didn't concern itself if the trader had any fiduciary duty they were violating. However, the U.S. Supreme Court changed that doctrine in *U.S. v. Chiarella* (1980), reversing the conviction of a very enterprising printing press employee who was making investment decisions as a result of the corporate takeover documents he was seeing (first, of course) at his job. Holding that a fiduciary duty has to be violated for insider trading, the Court determined that Mr. Chiarella didn't owe such a duty to any of the companies whose documents he was reading and the fact he was reading them before anyone else didn't create a legal duty (*Chiarella*, at 235).

But H.R. 2655 does make some key departures from current insider trading law. The focus it places on one having knowledge that inside information was wrongfully obtained includes "recklessly" disregarding whether the information was wrongfully obtained or wrongfully used (Sec. 16A(a)). Recklessness is a state of mind that is less than what one thinks of as criminal intent, so it is unclear how one could be a criminally reckless insider trader, as opposed to one who knows what they are doing is wrong.

For tipper-tippee activities, the bill makes a tipper liable even where the personal benefit to the tipper is "indirect," (Sec. 16(A)(c)), which has caused some legal scholars to wonder what limit there is on anything being an indirect personal benefit (Henderson, Roberts, 2021). For misappropriation, the proposed legislation establishes when one has wrongfully obtained inside information, which includes: a) theft, bribery, misrepresentation, or espionage; b) a violation of federal statutes protecting computer data; or c) a breach of fiduciary duty, contract, 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). But the statute doesn't define those confidential arrangements, evidently leaving the SEC's rules and case law to fill in the blanks.

And the bill makes it unnecessary that a person trading on the basis of wrongfully obtained inside information know "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 person trading while aware of such information or making the communication, as the case may be, was aware, consciously avoided being aware, or recklessly disregarded that such information was wrongfully obtained, improperly used, or wrongfully communicated." (Sec. 16A(c)(2)) Summarily, that word salad might be distilled to mean that if material inside information lands in your lap and you have reason to

believe it started that journey unlawfully, even if you had nothing to do with it getting to you, do not buy or sell that stock.

SUMMARY

Suppose you are attending that fateful White House Picnic in 2017 and while trying to eat a hot dog you're holding in one hand and balancing with your other hand your paper plate and that potato salad on it you're never going to eat, you happen to overhear former Rep. Collins frantically telling his son the bad news he just got himself. Also imagine you own those share yourself. If you (literally) dropped everything to reach for your phone to "sell, sell, sell!" by way of your online brokerage app, would you have committed insider trading under current law? Probably not. You overheard something at a public place and violated no fiduciary duty to Mr. Collins or the company on which he was a board member. And there is no general duty for shareholders to refrain from trading because they inadvertently happen to learn valuable, company information.

Now suppose the same scenario, including that potato salad, and apply it to the Insider Trading Prohibition Act. Here are some questions to consider: Are you aware of or in possession of wrongfully obtained material nonpublic information? Do know something about a company that, if publicly known, would reasonably be expected to have a material affect the price of that company? What if instead of selling your Innate Immunotherapeutics shares, you call your best friend who also owns some of those shares and tell them to sell theirs as fast as possible. If it would be illegal for you, then you would be a tipper. But can one be a tipper without first violating a fiduciary duty in giving the tip? And did you get even an indirect benefit by telling your best friend to sell short Innate Immunotherapeutics stock without telling them why? If your friend does what you say and makes a killing, have they committed insider trading? As unoriginal as it might seem, the only way to know the answers to those thorny questions is to…ask some judges. Appellate court judges. It is called precedent, or common law.

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TEACHING NOTE
CONGRESS AND INSIDER TRADING: BREAKING THE LAW AND MAKING THE LAW

CASE SYNOPSIS

This descriptive case concerns the insider trading prosecution case brought against former U.S. Representative Chris Collins. Mr. Collins was inadvertently filmed at the 2017 White House Picnic, while making a cell phone call to his son, telling the younger Collins to sell his shares in Innate Immunotherapeutics. The reason for the urgent phone call was that Rep. Collins was on the board of directors at Innate Immunotherapeutics and had just gotten word from the CEO that the company's multiples sclerosis drug had failed a critical test, which would cause the stock to drop precipitously once the news became public.

The Collins incident is used as a thematic device throughout the case study to help the reader understand the difficulty of grasping the common law doctrines of insider trading and to distinguish traditional insider trading from tipper-tippee insider trading and misappropriation insider trading. Because there is no insider trading statute, the law on insider trading is an amalgam of federal case law that interpret the Securities Exchange Act of 1934 and related rules created by the SEC. Those cases place emphasis on insider trading as a form of fraud, as well as a requirement that someone who commits insider trading first have a fiduciary, or legal, duty not to trade. The case law on tipper-tippee insider trading focus on what kind of personal benefit to the tipper qualifies as a predicate to the illegal tip given to the tippee, while the case law on misappropriation often contemplates what relationships are close enough to have the kind of duty and trust that is essential.

Due to this patchwork of interweaving legal doctrines, it has been suggested that Congress finally create a statute on illegal insider trading. Congress did pass a precursor law in 2012, known as the STOCK Act, which prohibited itself from profiting off its own access to material nonpublic information. And in May 2021, the U.S. House of Representative passed the Insider Trading Prohibition Act. Although the Senate has yet to take up the House's bill, this legislation attempts to clarify insider trading law by codifying the varying legal doctrines. But it has also added a few wrinkles and, according to some legal scholars, provides new questions that will, inevitably, need courts to answer.

COURSES

This case would be appropriate for use in undergraduate and graduate versions of the following courses: Business Law; Commercial Law, Elements of Law; and Securities Law.

TEACHING PLAN

This case is best used in a structured classroom discussion format, but it is also effective for an online learning environment. Parts of this case have been tested in undergraduate and graduate settings.

RESEARCH METHODS

All of the information for this case study was found in secondary and legal sources.

LEARNING OUTCOMES

In completing this case study, students should be able to:

1. Classify the required elements of illegal insider trading.
2. Assess the way a fiduciary, or legal, duty arises for insider trading.
3. Distinguish tipper-tippee insider trading from misappropriation insider trading.
4. Assess the implications of members of Congress and their staff having access to material, nonpublic information that can affect stock values.
5. Compare and contrast current insider trading elements with the Insider Trading Prohibition Act.

DISSCUSION QUESTIONS

1. What are the elements of illegal insider trading? (LO 1, 2)
2. What are the three types of insider trading? (LO 3)
3. How is insider trading a type of fraud? (LO 2)
4. Apply tipper-tippee insider trading theory to former Representative Chris Collins and his son? (LO 3)
5. Do you think members of Congress and their staffs should be prohibited from owning stocks during their times of service? (LO 4)
6. What are the key differences between the current insider trading doctrines and the proposed Insider Trading Prohibition Act? (LO 5)

ANSWERS TO DISCUSSION QUESTIONS

1. What are the elements of illegal insider trading? (LO 1, 2)

Insider trading has a commonly used definition which is, "buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, on the basis of material, nonpublic information about the security." (seclaw.com) More formally, the genesis of insider trading begins with the Securities Exchange Act of 1934 (Sec. 10b), which prohibits the use of "any manipulative or deceptive device," later in the statute called "fraud," with respect to the "purchase or sale of any security." In 1948, the Securities and Exchange Commission created a famous rule, 10b-5, which makes it unlawful to, among other things, "defraud," "make an untrue statement of a material fact," or to commit "fraud or deceit upon any person," when engaged in a transaction on a national securities exchange (SEC).

Insider trading requires an insider, with limited exception, and Sec. 16 of the Securities Exchange Act (1934), states an insider is a director, or officer, or owner of at least 10% of the underlying company's stock. Then there is another type of insider, the temporary insider, someone whose special working relationship to the company gives them access to inside information (*Dirks v. SEC*, 1983). Examples of temporary insiders include lawyers or accountants who have access to a company's inside information.

"Inside information" is that which has not yet been made publicly available (Elkind v. Liggett & Myers, Inc., 1980). And "material" information is that which, if known, would have a substantial likelihood to affect a reasonable investor's decision to buy or sell the company's stock (SEC, 1951), or would have an impact on the security's price (*SEC v. Texas Gulf Sulphur*, 1968). Examples of material information would include the company's earnings, an impending merger, an impending bankruptcy, or a new product or discovery.

All illegal insider trading requires that the wrongful trader first have a fiduciary, sometimes also known as a legal, duty not to trade (*Chiarella v. U.S.*, 1981). For traditional insiders, the duty is owed to the shareholders of the company, and for situations when outsiders commit inside appropriation, the duty is owed to the source of the material, nonpublic information (U.S. v. O'Hagan, 1987; SEC 10b5-2 (2000)). For example, if A and B are best friends and A tells B something confidential about the company A works for and which would affect the price of the company's stock if known, B would violate a duty of trust to A if B traded in that stock because of what B now knows.

2. What are the three types of insider trading? (LO 3)

Traditional insider trading is committed when a previously defined insider trades based on (or in possession of) material, nonpublic information, in violation of a fiduciary or legal duty (SEClaw.com).

Taking traditional insider trading one step further is tipper-tippee insider trading, wherein an insider (the tipper) violates their duty by passing on the inside information to another person (the tippee), in exchange for a personal benefit (*Dirks*, 1983). For the tippee to commit insider trading, they need to trade in the underlying stock because of the inside information given to them and with the awareness that the tipper shouldn't have provided the tip (*Chiarella*, 1980, *Dirks,* 1983). The Supreme Court has ruled that the personal benefit received by a tipper doesn't have to be tangible and can even be a gift of information to a trading relative or friend (*Salman v. U.S*., 2016).

The third type of insider trading is misappropriation, and it is only committed by outsiders who violate a duty of trust or confidence to the source of the inside information on which they traded. Misappropriation theory is formalized in a 1997 Supreme Court case, *U.S. v. O'Hagan*, where the court held that a person commits the fraud of insider trading when he or she "misappropriates confidential information for securities trading purposes in breach of a duty owed to the source of the information." In 2000, the SEC adopted a new rule, 10b5-2, which identifies three nonexclusive circumstances where one has a "duty of trust or confidence" for misappropriation insider trading. First is "Whenever a person agrees to maintain information in confidence." (SEC). So, according to the SEC, a simple promise to keep a secret is tantamount to a fiduciary duty for misappropriation purposes. Second, is when a person "with a history of sharing confidences," is given material inside information and the receiving person realizes or should realize that the provider of the information expected it to remain confidential. And the last category in 10b5-2 is when the receiver of the information is related to the sender as spouse, child, parent, or sibling – with limited exceptions.

3. How is insider trading a type of fraud? (LO 2)

The problem with the fraud analysis is that usually one commits fraud by saying something to the victim in order to induce the victim to do something they wouldn't otherwise do. However, it is possible to commit fraud through silene, but only when there is a legal duty to speak.

The SEC's regulation of the securities markets and of brokers is meant to ensure transparency, and fraud—whether by saying something false in order to get someone to do something or not saying something true when one has a duty to speak—is an act of concealment.

For traditional and temporary insiders, contemplating their insider trading as a form of fraud is relatively straightforward. The law imposes on them a legal duty for the benefit of the shareholders of the companies whose inside information the insiders have. So, when an insider trades on that information (and without disclosure about why they are trading), that is treated as a fraud against those shareholders. That line of reasoning applies to tippers and also to tippees who trade with the realization that a legal duty was breached in the transmission of the tip.

For those who are not insiders and yet are accused of misappropriation insider trading, things get tricky. There, the legal duty imposed is based on the type of relationship or an existing duty between the misappropriator and the person who innocently shared inside information (*U.S. v. O'Hagan*, 1997; SEC 10b5-2, 2000). For example, a lawyer has a legal duty of client confidentiality that would be breached if the lawyer trades based on information that came by way of the lawyer-client relationship. Although there is a line of cases discussing the requirement that an insider has a "duty to disclose" or abstain from buying or selling stock based on material inside information (*SEC v. Texas Gulf Sulphur Co.*; 1968, *Chiarella v. U.S*., 1981; *Dirks v SEC*, 1983), it would be hard to imagine a lawyer telling the client about the lawyer's plan to buy or sell shares in the client's company, in light of what the lawyer has come to know because of the client relationship.

4. Apply tipper-tippee insider trading theory to former Representative Chris Collins and his son? (LO 3)

Former U.S. Representative Chris Collins was on the board of directors of an Australian pharmaceutical company, Innate Immunotherapeutics (now called Amplia Therapeutics), which clearly makes him an insider. The reason for his urgent phone call was that he had just gotten an email, which began with "I have bad news to report," from Innate's CEO (Department of Justice, 2018). The email announced the company's multiple sclerosis drug, which was its only major product in development, had failed a drug trial. That information is also clearly "inside," since it hadn't yet been made public. And there are two ways to know it was material: a) bad news about a drug trial for a company who sells drugs would naturally affect whether someone would want to sell their shares; and b) it immediately affected Collins's behavior. He couldn't sell his shares, since he was a board member, so he lost $16.7 million after the stock dropped over 90% when the bad news hit (Cao, 2017). But by tipping his son Cameron, Chris Collins made a way for Cameron to sell in time, which he did, as did others who were also tipped, including Cameron's fiancé and future father-in-law. They collectively avoided a $768,000 loss (Zremski, 2021), which they eventually gave back as part of conclusion of their legal cases. Notice that while Cameron Collins first was a tippee, he became a tipper when he told his future father-in-law, fiancé, and a few others.

5. Do you think members of Congress and their staffs should be prohibited from owning stocks during their times of service? (LO 4)

[This is an opinion question, wherein students should be able to assess the implications of government officials having access to material nonpublic information that has an effect on the markets.]

Passed in 2012, the STOCK Act, officially titled the Stop Trading on Congressional Knowledge Act, prohibits Congress from profiting off what it knows (15 U.S.C. § 78u-1, 2012). It does so by directly stating that members or employees of Congress owe a duty of trust or confidence to "…the citizens of United States with respect to material, nonpublic information" gained by virtue of their governmental positions or activities (§ 78u-1 (g)(1)). Prior to the STOCK Act, it would have been nearly impossible to accuse members of Congress (or their employees) of insider trading unless they happened to be insiders of certain companies, independent of their congressional status. That was the situation for Chris Collins, who was on the board of Innate Immunotherapeutic, which is an Australian company.

It might be impossible to prevent members of Congress and their staffs from owning stocks or other investments during their times in office. It might be more possible to prohibit them from making sales of stocks they own prior to joining Congress, or from making new purchases. There is an argument to be made that members of Congress and their staffs should have their investments put in a blind trust during their times of government service. This arrangement, which would go beyond the STOCK Act, would prevent public servants and their employees from even knowing what investments are being made on their behalf. Another alternative is to prohibit congressional actors from being involved in legislation that could have an effect on their investments, but if that would include abstaining from voting, one might ask if such a policy would prevent member of Congress from doing the most direct aspect of their jobs.

In Chris Collins's case, it was known in the halls of Congress that he encouraged his Washington friends to invest in Innate Immunotherapeutics, even bragging about how many others he made rich, and inviting key members of the government to buy shares at a discount (Wong, 2017). In fact, prior to being accused of tipper-tippee insider trading at that fateful picnic, Collins was already under investigation by the House of Representatives' ethics investigators related to his behavior, in light of the Stock Act (Wong, 2017). But as demonstrated by the 2020 insider trading investigations of Senators Burr, Feinstein, Inhofe, and Loeffler, it can be difficult to clearly determine the intent or motivations behind the stock purchases or sales of members of Congress, even those taking place during curiously noteworthy time periods.

6. What are the key differences between the current insider trading doctrines and the proposed Insider Trading Prohibition Act? (LO 5)

The Insider Trading Prohibition Act, officially known as H.R. 2655, is intended to simplify existing case law on insider trading (Godoy, 2021). If passed by the Senate and signed by the President, it would

put America on a similar path with the European Union, which has a more singular definition and prohibition of insider trading (Baker, 2008). The bill codifies much of the language that is often used in insider trading case law, with its emphasis on material nonpublic information (Sec. 16A(a)). And it still requires a breach of a duty as a prerequisite for wrongful trading.

H.R. 2655 does make some key departures from current insider trading law. The focus it places on one having knowledge that inside information was wrongfully obtained includes "recklessly" disregarding whether the information was wrongfully obtained or wrongfully used (Sec. 16A(a)). Recklessness is a state of mind that is less than what one thinks of as traditional criminal intent, so it is unclear how one could be a criminally reckless insider trader, as opposed to one who knows what they are doing is wrong.

For tipper-tippee activities, the bill makes a tipper liable even where the personal benefit to the tipper is "indirect," (Sec. 16(A)(c)), which has caused some legal scholars to wonder what limit there is on anything being an indirect personal benefit (Henderson, Roberts, 2021). For misappropriation, the proposed legislation establishes when one has wrongfully obtained inside information, which includes: a) theft, bribery, misrepresentation, or espionage; b) a violation of federal statutes protecting computer data; or c) a breach of fiduciary duty, contract, 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). But the statute doesn't define those confidential arrangements, evidently leaving the SEC's rules and case law to fill in the blanks.

And the bill makes it unnecessary that a person trading on the basis of wrongfully obtained inside information know "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 person trading while aware of such information or making the communication, as the case may be, was aware, consciously avoided being aware, or recklessly disregarded that such information was wrongfully obtained, improperly used, or wrongfully communicated." (Sec. 16A(c)(2)) Summarily, that lengthy passage means that if material inside information lands in your lap and you have reason to believe it started that journey unlawfully, even if you had nothing to do with it getting to you, do not buy or sell that stock.

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