Testimony of Professor M. Todd Henderson

Mr. Chairman and members of the Committee,

Thank you for having me testify on the topic of the regulation of capital raising and insider trading. These issues are at the heart of our economy. Every company has to raise money, and laws and regulations have a tremendous impact on how this is done and, most importantly, how much it costs. It is easy and maybe politically appealing to add more and more obligations on companies, but costs of compliance don't fall just on rich investors or abstract companies—they are paid for by every American. While we need some laws to prevent fraud and to ensure accurate disclosure of information, every dollar spent on complying with regulations is a dollar not spent on employing workers, investing in research and development, and in bringing products and services to everyday Americans. The goal of law should be to obligate companies to spend no more than is absolutely necessary to protect investors and ensure robust capital markets. After all, we as a society pay the costs of regulation, and we should be willing to do so only if the return exceeds that cost.

There is no real question that the costs of fundraising are too high today. The burdens of complying with securities disclosures are many times higher than they were just a few decades ago. To give just one example, consider the disclosure obligations under Regulation S-K. This regulation has 102 specific items of disclosure set forth in over 140,000 words on 385 pages of the Code of Federal Regulations—the rules have grown twenty-fold in length since 1980. This means lots of lawyers can find work, but fewer engineers, chemists, and others who actually discover things that improve our world.

Moreover, the risks of meritless securities fraud suits remains high, notwithstanding efforts by Congress to eliminate them. The result has been a sharp drop in the number of public companies and the number of companies going public. There are about half as many public companies today as there were in 2000. Companies are also resorting to new means of access public equity—such as SPACs—as a work around of the costs of going public. While the verdict is still out on SPACs, the fact that such innovation is viewed as necessary by investors and companies should give regulators pause before piling on new costs of going public through traditional means.

Instead of trying to reduce the burdens on public companies, the SEC is doubling down, issuing proposed rules that will straddle shareholders, workers, and customers with even more costs. At the same time, it is hampering the ability of all Americans to invest in private markets. Private companies are an important alternative to public ones, and returns in the private equity market and other alternative asset classes have been superior to public returns in recent decades. Private equity provides not only an important investment option for investors of all kinds, but it helps turn around struggling companies, offers all companies an alternative governance approach that can fit their needs at particular times, and, most importantly, provides discipline against public-company managers that may act in a self-serving way. Congress and the SEC should expand the opportunity of every investor to access private equity and other asset classes, consistent with fiduciary duty obligations under ERISA and other laws.

Let me turn briefly to insider trading. When talking about insider trading, it is important to put aside conventional wisdom on the topic. There is nothing unlawful about trading based on "material nonpublic information" about a company. Investment advisors and stock market analysts make their living seeking information advantages for their clients. Without these incentives, there will be less information about stock prices, which means they will be less accurate. The consequence will be that capital will not be allocated to where it is most valuable. This harms everyone, not just investors.

Insider trading based on an information advantage is only illegal when it results in a violation of the anti-fraud provisions of the federal securities laws. Under existing case law, that generally happens when a corporate insider trades on material nonpublic information for his or her own benefit, when someone deceptively takes material nonpublic information that does not belong to them and uses it to trade, or when these individuals provide — as a "tipper" — the material nonpublic information to someone else to trade on in return for a personal benefit. Justice Ginsburg made this property-based approach clear in her opinion in *United States v. O'Hagan*.

The Insider Trading Protection Act purports to merely codify our existing insider trading prohibitions. But the actual effect of ITPA would be to increase uncertainty for the analysts and traders that do the essential work of incorporating information into stock prices. When law professors can turn everyday scenarios—such as overheard conversations about deals and documents left in the back of airplane seat pockets—into challenging hypotheticals for law school exams, the result is a huge chilling effect on the work necessary to ensure accurate stock prices.

This means not only the potential for capital misallocation, but also large compliance costs for investment funds. Importantly, these costs of ensuring investment professionals do not violate the law will fall disproportionately on smaller and mid-sized investment funds. To make matters worse, these funds are more likely to be owned and operated by minorities and women, and to be the ones taking alternative positions on matters related to ESG and other matters.

There are several problems with the ITPA in its current form.

First, ITPA codifies the existing personal benefit requirement for a tipper, but includes an "indirect personal benefit." It is possible to describe virtually any human interaction as providing an "indirect benefit" to the participants. Instead, the law should reflect the common sense notion that the source of information either received something tangible and valuable in return or provided what amounts to a monetary gift to a relative or friend.

Second, ITPA uncontroversially states that trading on information wrongfully obtained or communicated as a result of theft, deception, or a breach of fiduciary duty will lead to liability. It also contains a catchall provision, however, extending the concept to "a breach of a confidentiality agreement, a breach of contract, or a breach of any other personal or other relationship of trust and confidence." This is a system ripe for abuse, with companies potentially able to prevent individual investors from trading merely by providing them with information whether they want it or not.

Third, ITPA expands the types of traders who can be held liable for insider trading. Currently, a trader has to act with some form of intent to violate the law. Under the bill, however, anyone who "was aware, consciously avoided being aware, or recklessly disregarded" that the information was wrongfully obtained or communicated can have a case brought against them. ITPA is silent on the meaning of "recklessly disregarded," which would appear to rope in innocent traders along with actual wrongdoers.

Finally, ITPA does not contain an exclusivity clause stating that it will be the sole basis for bringing federal insider trading claims. Allowing prosecutors to cherry pick their preferred law is no way to provide clear rules for the market. Indeed, there is a federal statute that allows the Department of Justice to bring criminal insider trading claims without having to demonstrate the existence of a personal benefit. So much for ITPA's personal benefit provision.

There is little dispute that the knowing use of material nonpublic information obtained in clearly illicit ways to reap securities trading gains — commonly known as “stealing” — is what the government should be trying to prevent. At the same time, we do not want to chill the valuable communications that go on between company insiders and market participants, which provide investors with important real-time information about their investments. ITPA is an opportunity for Congress to establish insider trading prohibitions with a clear set of limited rules that the government and investors alike can easily follow.

To that end, Congress needs — at a minimum — to narrowly define “personal benefit,” drop the catchall provision as to how information can be wrongfully obtained or communicated, limit liability to individuals with actual knowledge of their wrongdoing, and make ITPA the exclusive basis for federal insider trading claims.

Thank you.