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Before the
Committee on Banking, Housing, and Urban Affairs
of the
United States Senate

Hearing on
Keeping Markets Fair: Considering Insider Trading Legislation

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Thank you, Chairman Brown, and thank you, Ranking Member Toomey, for the opportunity to testify before you today. The last time I had the honor of testifying before this Committee, it was at the hearing on my nomination to be a Commissioner of the Securities and Exchange Commission. My Mom and Dad, who grew up in big Irish Catholic families in the Bronx—my mother is one of nine kids, my father one of five—proudly sat behind me that day. The day I was born, nobody in my family had been to college. But my parents plowed their paychecks into the market—and, forty years later, sat behind their son as a Presidential nominee. So to me, markets are important not only because they encourage entrepreneurship and growth. They're important because they make it possible for two middle-class parents to change their son's life. We owe it to families pursuing their version of the American dream—just as mine did—to make sure that when they invest in our markets, they do so on a level playing field.

That's why, after I was confirmed to be Commissioner, I joined Preet Bharara, the former United States Attorney for the Southern District of New York, in calling for a national task force on the law of insider trading.[1] Because Congress has never codified insider-trading rules, both defendants and ordinary investors like my Mom and Dad are exposed to gaps in our law. The task force, which featured a bipartisan group of prosecutors, defense counsel, legal academics and judges, concluded that Congress should clarify the law of insider trading. I agree.[2]

That's why the Insider Trading Prohibition Act you are considering today is so important. The Act addresses key gaps in our outdated, judge-made insider-trading law. For example, the Act would make clear that, in order to hold an insider accountable for leaking information to a trader, prosecutors need not produce a bag of cash delivered to the source in exchange for her secrets. Instead, recognizing that information changes hands in today's markets on the basis of

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[1] Preet Bharara & Robert J. Jackson, Jr., *Insider Trading Laws Haven't Kept Up with the Crooks*, N.Y. TIMES (Oct. 9, 2018).

[2] REPORT OF THE BHARARA TASK FORCE ON INSIDER TRADING 20 (January 2020).

more than direct payments, the Act specifies that a direct or indirect personal benefit for the source, including a reputational benefit, is enough.[3] As the task force urged, the Act would focus liability on whether information was wrongfully taken, used, or communicated. And the Act would not purport to be the sole source of liability for insider traders who violate other laws.[4] Defendants whose trading violates more than one federal law should be subject to liability under more than one federal law; in my view, rather than seek solace from Congress, those defendants would be better advised to violate fewer federal laws.

For a detailed and thoughtful analysis of these questions, I commend to the Committee my colleague Professor Coffee's testimony and his writing on this subject. My testimony today will identify two additional gaps in current law that make clear the urgent need for this legislation. First, as explained below, current insider-trading law allows cyber hackers to profit from trading on their activities. Second, as I noted in a study released last week, insiders at foreign firms listed in the United States, and particularly Russian and Chinese firms, profit extensively from their trading—putting American investors at risk.

I. CYBERSECURITY AND INSIDER TRADING

As this Committee knows too well, our companies are in a constant battle to protect themselves from hackers who seek access to millions of Americans' most private information.[5]

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[3] Insider Trading Prohibition Act, 117th Cong., H.R. 2655, Section 2 (providing that a "breach of any fiduciary duty to shareholders of an issuer for a direct or indirect benefit, including" a "reputational benefit" is sufficient to sustain liability).

[4] *See* 18 U.S.C. §§ 1343, 1348; *see also Blaszczak* v. *United States*, 947 F.3d 19 (2d Cir. 2019) (holding that federal wire fraud and securities fraud statutes extend to misappropriation of a government agency's nonpublic information regarding its contemplated rules), *remanded*, *Blaszczak* v. *United States*, 141 S. Ct. 1565.

[5] SEC Commissioner Robert J. Jackson, Jr., *Corporate Governance: On the Front Lines of America's Cyber War* (March 15, 2018) (in 2017, more than 90% of American public companies suffering a cybersecurity breach did not promptly disclose that fact to investors on securities filings). Since then, the SEC has proposed important new rules requiring prompt disclosure of cybersecurity breaches. *See* U.S. Sec. & Exch. Comm'n, Proposed Rule: Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure (March 9, 2022). While those rules, if adopted, will give investors more transparency on cyber breaches, they do not address trading occurring prior to those disclosures—even trading that occurs between the time the company decides to disclose the

There is concerning evidence that these hackers not only attack our companies but also trade before the attack is revealed to the public, raising the prospect that our markets help finance the very cyberattacks that put Americans' privacy at risk.[6]

As it stands today, the law of insider trading often does not cover that activity. The reason is that establishing insider-trading liability under current law generally requires the government to show that information was obtained in breach of a duty or by way of deception.[7] Many hackers, however, attack our companies not through deception but by brute-force tactics that simply overwhelm our defenses.[8] From the perspective of the judges who have made our insider-trading law, that distinction might make a difference—but for ordinary investors like my Mom and Dad, the idea that the law of insider trading allows hackers to profit from the destruction they cause raises doubts about the fundamental fairness of our markets.

The Act would close that gap. Among the "most significant impact[s]" of the law, according to practitioners, would be to clearly outlaw trading on information obtained through cybersecurity hacks.[9] I cannot see how the current lack of clarity on that question benefits American investors, companies or markets. Indeed, even those focused on preserving the price-accuracy benefits of informed trading should support outlawing trading of this kind.

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hack and the filing of the disclosure. *See* Alma Cohen, Joshua Mitts & Robert J. Jackson, Jr., *The 8-K Trading Gap* (2015) (documenting trading between the time firms decide to make a disclosure and the disclosure's filing).

[6] *See* Joshua Mitts & Eric Talley, *Informed Trading and Cybersecurity Breaches*, 9 HARV. BUS. L. REV. 1 (2019) ("[O]ur findings appear strongly consistent with the proposition that arbitrageurs can and do obtain early notice of impending [cyber] breach disclosures, and that they are able to profit from such information.").

[7] 15 U.S.C. § 78j(b) (forbidding the use of any "manipulative or deceptive device or contrivance in contravention of such rules as the [SEC] may prescribe"); *see also* 17 C.F.R. § 240.10b-5; *United States* v. *O'Hagan*, 521 U.S. 642 (1997).

[8] *SEC* v. *Dorozhko*, 574 F.3d 42, 47 (2d Cir. 2009) ("In our view, misrepresenting one's identify in order to gain access to information that is otherwise off limits, and then stealing that information is plainly 'deceptive' within the ordinary meaning of the word. It is unclear, however, that exploiting a weakness in an electronic code to gain unauthorized access is 'deceptive,' rather than being mere theft.").

[9] *See* Insider Trading Prohibition Act, 117th Cong., H.R. 2655, Section 2 (prohibiting trading based on information "obtained by" "a violation of any Federal law protecting computer data" or "the intellectual property or privacy of computer users"); *see also* DAVIS POLK, CLIENT MEMORANDUM: HOUSE PASSES INSIDER TRADING BILL (May 25, 2021) ("Perhaps the most significant impact [of the Act] would be to cover hacking . . . without regard to whether the hacking method involved 'deceptive' conduct.").

To see why, note that the prospect of profiting from trading on an event can give the trader incentives to prefer that the event occur. In a typical informed-trading case, profits give traders incentives to invest in discovering information.[10] But in the cybersecurity context, allowing traders to profit from hacked information gives them incentives to invest in hacking. There is no reason to think that those incentives are productive for American investors or companies—yet current law leaves open the question whether such trading is illegal.[11]

Closing gaps in our insider-trading law is all the more urgent in today's fast-moving markets, where traders are constantly searching for advantages against ordinary investors. Indeed, in a study released just last week, my coauthors and I examine another such gap: insider trading by executives at foreign firms listed in the United States.

II. INSIDER TRADING AT FOREIGN FIRMS LISTED IN THE UNITED STATES

Gaps in our insider-trading law expose investors like my Mom and Dad to opportunistic behavior by market actors not only here in the United States but around the world. The reason is that foreign companies domiciled in countries like China and Russia now raise significant funds from American investors by listing on U.S. stock exchanges.[12] Unlike executives at American corporations, however, insiders at foreign firms are not subject to prompt disclosure of transactions in their company's stock.[13] I wondered whether our outdated insider-trading law

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[10] *See, e.g.*, JONATHAN R. MACEY, INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY 21-47 (1991).

[11] Matt Levine, *Is Cyber-Insider Trading Illegal?*,BLOOMBERG VIEW: MONEY STUFF (2018) (noting that even sophisticated observers do not know the answer to his title's question).

[12] As a formal matter, these firms often list on U.S. Exchanges by way of American Depository Receipts or American Depository Shares, which generally represent an interest in the shares of a company domiciled outside the United States that have been deposited with a U.S. bank or trust.

[13] Under Section 16(a) of the Securities Exchange Act of 1934, officers and directors of U.S. public companies are required to publicly disclose certain transactions in their company's stock on the SEC's Form 4. In 2002, Congress passed the Sarbanes-Oxley Act, mandating that insiders at U.S. companies report their trades under Section 16(a) within two business days and file Form 4 electronically. U.S. Sec. & Exch. Comm'n, Final Rule, Ownership Reports and Trading by Officers, Directors and Principal Security Holders (2002). But the SEC had previously exempted foreign private issuers from the disclosure requirements of Section 16(a). 17 C.F.R. § 240.3a12-3(b). Thus, insiders at foreign-domiciled firms traded on U.S. stock exchanges were not subject to the more strict insider-trading disclosure requirements imposed by Sarbanes-Oxley.

gives foreign-firm insiders unique freedom to engage in opportunistic trading.

So Daniel Taylor and Bradford Lynch of the Wharton School and I dug into the data.[14] Drawing on a unique dataset based on tens of thousands of paper filings with the SEC describing sales of stock over a five-year period, we study whether foreign-firm insiders are able to avoid losses on their U.S.-traded stocks by selling in advance of price declines.[15]

The results are striking. Our data provide systematic evidence that foreign-firm insiders avoid substantial losses by selling shares before stock-price declines. And this activity is concentrated in firms domiciled in just a few countries overseas. Figure 1 below documents the median returns, by country of domicile, at foreign firms listed in the United States during the twelve months after the insider sales we see:

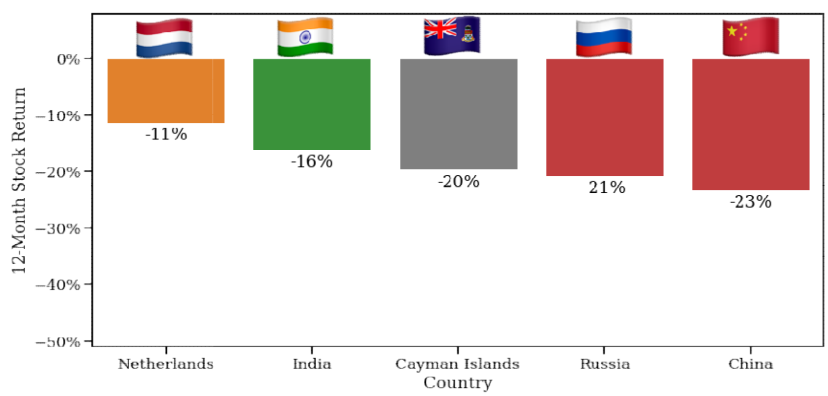

FIGURE 1. MEDIAN TWELVE-MONTH STOCK RETURNS AFTER INSIDER SALES.

When insiders of U.S.-listed Chinese companies sell shares, the median company's stock price falls by 23% in the twelve months after the sale. And when insiders at U.S.-listed Russian firms sell, the median firm's stock declines 21% in the next twelve months.These results reflect

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[14] *See* Robert J. Jackson, Jr., Bradford Lynch & Daniel J. Taylor, *Holding Foreign Insiders Accountable* (April 2022).

[15] *Id.* at 4. Although foreign-firm insiders are not required to file Form 4 under Section 16 of the Securities Exchange Act of 1934 as insiders at U.S.-domiciled public companies generally must, their stock sales may require them to file Form 144, providing a rare window into foreign-firm insider trading. Unlike Form 4, however, Form 144 is not required to be filed either speedily or electronically. Indeed, during the 2019 calendar year alone, the SEC received over 31,000 Form 144 filings, over 99% of which were filed on paper and mailed to the SEC. *See* U.S. Sec. & Exch. Comm'n, Proposed Rule: Rule 144 Holding Period and Form 144 Filings, at 122 (2020).

foreign-firms' insiders ability to avoid significant losses by selling prior to substantial stock-price declines. They are especially striking when contrasted with the returns that follow stock sales by executives at American companies, who generally do not sell before prices fall.[16]

Our study also shows that foreign-firm insiders avoid significant losses in dollar terms by selling when they do. Indeed, we estimate that insiders at Chinese-domiciled, U.S.-listed companies have avoided over $10 billion in losses as a result of well-timed stock sales:

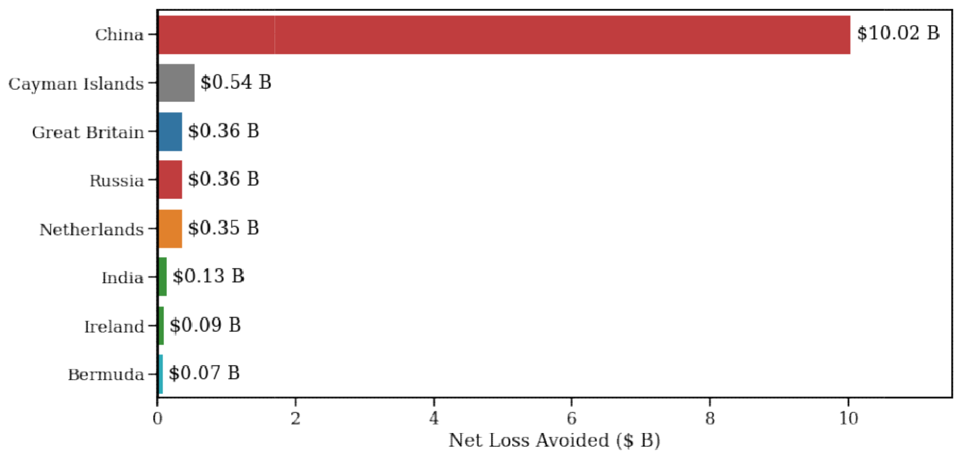

FIGURE 2. INSIDERS' NET DOLLAR LOSS AVOIDANCE BY COUNTRY OF DOMICILE.

From the perspective of ordinary investors like my parents, this evidence raises serious questions about the law of insider trading. For one thing, it is far from clear why foreign-firm insiders should be playing by a different set of rules than their American-company counterparts, who must disclose their trades promptly to investors.[17] To be sure, there are good reasons to want

[16] *See* Alan D. Jagolinzer, David F. Larcker & Daniel J. Taylor, *Corporate Governance and the Information Content of Insider Trades*, 49 J. ACCT. RSCH. 1249 (2011); Alan D. Jagolinzer, David F. Larcker, Gaizka Ormazabal & Daniel J. Taylor, *Political Connections and the Informativeness of Insider Trades*, 75 J. FIN. 1833 (2020); *see also* Jackson, Lynch & Taylor, *supra* note 14, at 2 (confirming this result in the Form 144 sample for insiders at U.S.-domiciled firms).

[17] The SEC exempted foreign private issuers from these requirements decades ago in an effort to encourage those issuers to list on U.S. exchanges. *See* Sec. & Exch. Comm'n, *supra* note 13; Steven Davidoff, *Rhetoric and Reality: A Historical Perspective on the Regulation of Foreign Private Issuers*, 79 U. CIN. L. REV. 619, 621 (2011). But several changes since that time warrant reconsideration of that decision. First, when the SEC adopted that position, American insiders were not yet subject to the more strict disclosure requirements imposed by the Sarbanes-Oxley Act, so the comparative advantage given to foreign-firm insiders was not as large as it is now. Second, far fewer foreign firms were then listed on U.S. exchanges. Third, even fewer foreign firms were domiciled in countries, like China, where many proscriptions and protections of federal securities laws cannot reach. *See* Jesse M.

to make our markets attractive places to raise capital for companies around the world. But we neither can nor should achieve that by making it easier for foreign-firm insiders to trade in the dark—and avoid losses that ordinary American investors must bear.

For another, there is longstanding evidence that increasing transparency around trading reduces insiders' opportunities to take advantage of investors.[18] Exempting foreign-firm executives from rules governing the transparency of insider trades is the kind of gap in our law that we must close to protect Americans' confidence in the fairness of our markets. That's why the SEC should reconsider foreign firms' exemption from the insider-trading disclosure rules that American companies must follow under Section 16 of the Exchange Act. And, if necessary, Congress should make clear to the SEC that requiring transparency of foreign-firm insider trading should be a priority.

For decades, the judge-made law governing insider trading has left gaps inviting insiders to take advantage of ordinary investors. Congress should make clear that all participants in American capital markets must play by the same rules. Thank you once again for the opportunity to testify before you today. I would be delighted to answer any questions you might have.

Fried & Ehud Kamar, *China and the Rise of Law-Proof Insiders* (EGCI Working Paper No. 557/2020) (referring to such insiders as "law-proof"). Today, in light of the fact that billions of dollars of American investors' money are invested in firms domiciled in countries that render those companies law-proof, the case for enhanced transparency around their insiders' trading is much stronger.

[18] Bradford Lynch Levy, *Hidden Disclosure and the Market for Information* (Wharton School doctoral thesis, January 2022) (finding that Form 144 filings "serve important valuation and monitoring roles, but only after the SEC begins electronic dissemination, suggesting that the private market for information is unable to replicate the effects of public dissemination"); *see also* Francois Brochet, *Information Content of Insider Trades Before and After the Sarbanes-Oxley Act*, 85 ACCT. REV. 419 (2010); Robert J. Jackson, Jr., *Stock Unloading and Banker Incentives*, 112 COLUM. L. REV. 951 (2012) (documenting, in a rare setting where insiders are occasionally subject to Section 16 and occasionally not, the marginal effects of applying Section 16 to insiders' trading activity).