CRS Reports & Analysis

Legal Sidebar

Is There a Gap in Insider Trading Coverage for Hacking?

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On August 11, 2015, the Department of Justice (DOJ) charged nine hackers with, among other crimes, criminal securities fraud. On the same date, the Securities and Exchange Commission (SEC) charged thirty-two hackers with civil securities fraud. (In general, under federal securities laws, DOJ brings criminal prosecutions and the SEC brings civil charges.) Both the criminal and civil charges stem from a scheme in which the defendants allegedly broke into computer servers for the purpose of obtaining confidential corporate information from news releases that the corporations had not yet made public. They then allegedly traded securities based on this information and made considerable profits. This kind of securities law fraud may appear to be insider trading, but a question arises as to whether current federal laws and court case interpretations of the laws actually cover the hackers' alleged actions. (For more on insider trading in general, see CRS Report RS21127.)

Insider trading in securities occurs when a person in possession of material nonpublic information about a company trades in the company's securities and makes a profit or avoids a loss. Federal securities statutes have provisions that have been used to prosecute insider trading violations. Perhaps the most important is the Securities Exchange Act's general antifraud provision, section 10(b), and the SEC's implementing rule, Rule 10b-5. The statute does not specifically mention insider trading; instead, it forbids the use of "manipulative or deceptive" means in buying or selling securities. However, case law has made clear that insider trading is the kind of fraud that section 10(b) prohibits.

Over the years, cases have established that, in order to find a person guilty of insider trading under section 10(b), proof of a breached fiduciary relationship is important. *Securities and Exchange Commission v. Texas Gulf Sulphur*, a 1968 decision by the U.S. Court of Appeals for the Second Circuit, suggested that anyone in possession of inside information must either publicly disclose the information or not trade the particular stock until the information is made public. In 1980, the U.S Supreme Court in *Chiarella v. United States* modified the *Texas Gulf Sulphur* holding by indicating that, for there to be a fraud actionable under section 10(b) and Rule 10b-5, there must be a duty to disclose arising from a relationship of trust and confidence between parties to the transaction. A 1983 Supreme Court case, *Dirks v. Securities and Exchange Commission*, may have gone further than *Chiarella* by finding that a noncorporate person with inside information is not always liable for fraud, particularly when there does not seem to have been a breached fiduciary relationship and when the noncorporate person has himself not traded on the information but has only passed it on to others who have traded. When, however, a noncorporate person has a fiduciary status with respect to a corporate entity and willfully violates that status by trading on the information, the person may be found guilty, as in *United States v. O'Hagan*, a 1997 Supreme Court decision.

Two recent federal court decisions may have complicated the issue of liability for insider trading. *United States v. Newman*, a 2014 decision by the U.S. Court of Appeals for the Second Circuit, analyzed and applied the *Dirks* decision. The court concluded that the evidence against two stock fund analysts could not sustain a guilty verdict because the government did not adequately show that the alleged insiders received personal benefits for providing information to stock fund analysts. It also found that the government did not present evidence that the defendants knew that they were trading on inside information obtained from insiders who were violating their fiduciary duties. DOJ has asked the Supreme Court to review this decision. A 2015 decision by the U.S. Court of Appeals for the Ninth Circuit, United States v. Salman, may be at odds with the *Newman* decision by holding that a “gift” of inside information is sufficient to create liability for insider trading.

The cases discussed above, particularly the recent *Newman* decision, may call into question whether section 10(b) can be applied to hackers who profitably trade on information that they have obtained from hacking into computer databases. It is arguable that the hackers did not owe a fiduciary duty to the source of the information, which, at least according to some of the cases, is necessary for a person to have violated section 10(b). Instead, the hackers appear to have stolen the information. This type of action poses the question of whether trading on stolen inside information is securities fraud under current law.

Some of the bills introduced in the 114th Congress to make fraudulent the kind of securities trading allowed by the *Newman* decision might also treat as fraudulent the activities of hackers who trade on inside information. For example, H.R. 1625 would prohibit the trading of securities if a person has material nonpublic information about the securities or knows or recklessly disregards that the information has been wrongfully obtained or that the securities transaction would be a wrongful use of the information. S. 702 would prohibit securities transactions on the basis of material information that a person knows or has reason to know is not publicly available.