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Insider Trading: Does “Aware” Really Resolve the “Possession” Versus “Use” Debate?

Jennifer L. Neumann*

Congress passed Rule 10b5-1¹ in August 2000² to resolve a circuit split among federal courts as to whether the “possession” or “use” of material³ nonpublic⁴ information is the proper standard for courts to use in cases of insider trading.⁵ Rule 10b5-1 imposes liability when a person is “aware” of the material nonpublic information when they participate in a securities trade.⁶ This Note addresses whether the inclusion of the term “aware” resolves a circuit split centering on a debate between the terms “possession” and “use.”⁷

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1. 17 C.F.R. § 240.10b5-1 (2000); *see infra* note 6.

2. *Id.*

3. Under the uniform standard, information is considered “material” if the reasonable investor would place significance on the withheld or misrepresented information. *Basic, Inc. v. Levinson*, 485 U.S. 224, 240 (1988).

4. Two cases from the same circuit established two different views as to when information is considered public. In *S.E.C. v. Texas Gulf Sulphur Co.*, information is public if it has been, “[e]ffectively disclosed in a manner sufficient to insure its availability to the investing public.” *S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854 (2d Cir. 1968). In *United States v. Libera*, the court determined that information is public even if it was not publicly announced when those that knew the information caused the information to be “[f]ully impounded in the price of a particular stock.” *United States v. Libera*, 989 F.2d 596, 601 (2d Cir. 1993). Information is nonpublic according to the SEC when “[i]t has not been disseminated in a manner making it available to investors generally.” *In re Investors Management Co., Inc.*, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,163, at 80,519 (July 29, 1971).

5. *Selective Disclosure Rule Gains Approval by Divided SEC*, 32 Sec. Reg. & L. Rep. (BNA) 1089, 1090 (2000); *SEC Ends Selective Disclosure and Clarifies Insider Trading Rules*, 6 SEC. LITIG. & REG. REP. 10, 10 (2000); *SEC Proposes Rules to Clarify Insider Trading Laws*, 15 CORP. OFFICERS & DIRECTORS LIABILITY LITIG. REP. 13, 13 (2000).

6. 17 C.F.R. § 240.10b5-1(b). “[A] purchase or sale of a security of an issuer is ‘on the basis of’ material nonpublic information about that security or issuer if the person making the purchase or sale was *aware* of the material nonpublic information when the person made the purchase or sale.” *Id.* (emphasis added).

7. Passage of a regulation using either the term “possession” or “use” as the proper standard to use in cases of insider trading would leave no room for debate. Instead of using either term, Congress adopted the term “aware.” *Id.* § 240.10b5-1 (2000).

Under § 10(b) of the Securities Exchange Act of 1934⁸ and Rule 10b-5,⁹ insiders¹⁰ are prohibited from trading securities on the basis of material nonpublic information.¹¹ A violation of federal securities law occurs when an insider trades on the basis of information obtained as a result of her position, which violates a duty owed to another.¹² Federal circuit courts are divided regarding whether “on the basis of” involves the “possession” or “use” of material nonpublic information.¹³

This Note argues that Rule 10b-5-1 does resolve the current circuit split.¹⁴ The Rule adopts the Securities and Exchange Commission’s (SEC) long-held belief that knowing possession is the proper standard to apply in cases of insider trading.¹⁵ Rule 10b5-1 also addresses and resolves the main concerns expressed by those that advocated the use standard as the proper standard.¹⁶

Part I of this Note examines the current circuit split regarding the “possession” versus “use” debate as to the proper interpretation of

8. 15 U.S.C. § 78j(b) (1994). Specifically, it is illegal “[t]o use or employ, in connection with the purchase or sale of any security registered on a national security exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe.” *Id.*

9. 17 C.F.R. § 240.10b-5 (1998).

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

10. An insider is “a person who has knowledge of facts not available to the general public.” BLACK’S LAW DICTIONARY 798 (7th ed. 1999).

11. 15 U.S.C. § 78j(b) (1994); 17 C.F.R. § 240.10b-5 (1998); *see also supra* notes 8-9.

12. *Chiarella v. United States*, 445 U.S. 222, 228-30 (1980). Under an alternative theory, the misappropriation theory, the Rules are violated when a corporate outsider misuses information received from a source to whom a fiduciary duty is owed. *United States v. O’Hagan*, 521 U.S. 642, 652 (1997). This theory will not be discussed in this Note.

13. *See, e.g., United States v. Teicher*, 987 F.2d 112 (2d Cir. 1993); *United States v. Smith*, 155 F.3d 1051 (9th Cir. 1998), *rev’d on other grounds*, 236 F.3d 1035, 1044 (9th Cir. 2001); *SEC v. Adler*, 137 F.3d 1325, 1337 (11th Cir. 1998); *see also supra* note 5.

14. *See infra* notes 293-96 and accompanying text.

15. *See infra* notes 200-50 and accompanying text.

16. *See infra* notes 251-94 and accompanying text.

what constitutes a trade made “on the basis of” material nonpublic information.¹⁷ Part II of this Note addresses the passage of Rule 10b5-1.¹⁸ Part III analyzes the success of Rule 10b5-1 in resolving the circuit split.¹⁹ Finally, Part IV contains the conclusion.²⁰

I. THE “POSSESSION” VERSUS “USE” DEBATE

The SEC first stated the classic “disclose or abstain” theory²¹ of insider trading in *In re Cady, Roberts & Co.*,²² which was subsequently adopted by the U.S. Supreme Court in *Chiarella v. United States*.²³ This theory imposes a duty on corporate insiders to reveal to shareholders material facts known as a result of the insider’s position that would affect the shareholders’ investment decisions.²⁴ If it is too difficult to disclose the information as required by this first part of the theory, the second part of the theory provides that the insider must refrain from partaking in any transaction involving the inside information.²⁵ These two rules arise from the desire to prevent the unfairness that occurs when insiders use the material nonpublic information for their personal benefit.²⁶

Commentators label the debate that instigated the passage of Rule

17. See *infra* notes 21-226 and accompanying text.

18. See *infra* notes 227-50 and accompanying text.

19. See *infra* notes 251-92 and accompanying text.

20. See *infra* notes 293-96 and accompanying text.

21. See *United States v. O’Hagan*, 521 U.S. 642, 651-52 (1997) (citing *Chiarella v. United States*, 445 U.S. 222, 228 (1980), as the source for the classic theory of insider trading liability).

22. *In re Cady, Roberts & Co.*, [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,803, at 81,013 (Nov. 8, 1961). The duty to disclose or abstain originates from a fiduciary relationship “[g]iving access . . . to information intended to be available only for a corporate purpose and not for the personal benefit of anyone” and the “inherent unfairness” that results when confidential information is used for personal advantage. *Id.* at 81,017.

23. *Chiarella*, 445 U.S. at 227-28.

24. *Id.* at 227. Specifically, the Court noted, “[t]he obligation to disclose or abstain derives from ‘[a]n affirmative duty to disclose . . . material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment.’” *Id.* (citing *In re Cady, Roberts & Co.*, [1961-1964 Transfer Binder] (CCH) ¶ 76,803, at 81,016) (alteration in original).

25. See *In re Cady, Roberts & Co.*, [1961-1964 Transfer Binder] (CCH) ¶ 76,803, at 81,016. Specifically, the Commission noted, “[i]f . . . disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances . . . the alternative is to forgo the transaction.” *Id.*

26. *Id.* at ¶ 76,803; *Chiarella*, 445 U.S. at 222; *S.E.C. v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968).

10b5-1 as the “possession” versus “use” debate.²⁷ The dispute centers on whether insiders must “disclose or abstain” when they possess material nonpublic information or, in the alternative, only when they actually use that information as the basis for a trade.²⁸ The SEC often adopts the position that mere knowing possession is enough to warrant a violation of Rule 10b-5, while defense attorneys argue that actual use of the material nonpublic information is required.²⁹

The federal judicial decisions in three recent cases frame the debate.³⁰ The Second Circuit in *United States v. Teicher*³¹ stated in dicta that possession of material nonpublic information was the correct standard for courts to use in cases of insider trading.³² In *SEC v. Adler*³³ and *United States v. Smith*,³⁴ the Eleventh and Ninth Circuits, respectively, found that actual use of nonpublic information was necessary to find that an insider trading violation occurred.³⁵

27. See *United States v. Smith*, 155 F.3d 1051, 1066 (9th Cir. 1998) (discussing the “the use-possession debate”); see also Allan Horwich, *Possession Versus Use: Is There a Causation Element in the Prohibition on Insider Trading?*, 52 BUS. LAW. 1235 (1997); Bryan C. Smith, Note, *Possession Versus Use: Reconciling the Letter and the Spirit of Insider Trading Regulation Under Rule 10b-5*, 35 CAL. W. L. REV. 371 (1999); John H. Sturc & Catharine W. Cummer, *Possession vs. Use for Insider Trading Liability*, 12 No. 6 INSIGHTS 3 (1998); Oriana N. Li, Note, *United States v. Smith: The Use-Possession Debate in SEC Enforcement Actions Under § 10(B)*, 74 WASH. L. REV. 395 (1999); Donna M. Nagy, *The “Possession vs. Use” Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never be Golden*, 67 U. CIN. L. REV. 1129 (1999).

28. See Nagy, *supra* note 27, at 1130. According to Nagy:

[T]here remains a sharp divergence of views as to whether persons subject to this rule must disclose or abstain from trading securities on all occasions when they are *in possession* of material nonpublic information or only on those occasions when they are affirmatively using that information in the course of their securities trading.

Id. (emphasis in original); see also, e.g., *supra* note 26.

29. Nagy, *supra* note 27, at 1130-31.

30. See *United States v. Teicher*, 987 F.2d 112 (2d Cir. 1993); *S.E.C. v. Adler*, 137 F.3d 1325 (11th Cir. 1998); *United States v. Smith*, 155 F.3d 1051 (9th Cir. 1998), *rev'd on other grounds*, 236 F.3d 1035, 1044 (9th Cir. 2001).

31. *Teicher*, 987 F.2d at 112.

32. Specifically, the court noted, “[a] number of factors weigh in favor of a ‘knowing possession’ standard.” *Id.* at 120.

33. *Adler*, 137 F.3d at 1337.

34. *Smith*, 155 F.3d at 1067.

35. In *S.E.C. v. Adler* the court chose to follow the use test. “[W]e believe that Supreme Court dicta and the lower court precedent suggest that the use test is the appropriate test.” *Adler*, 137 F.3d at 1337. In *United States v. Smith*, the court similarly determined that the use test was the appropriate test. “[W]e believe the weight of authority supports a ‘use’ requirement.” *Smith*, 155 F.3d at 1067.

A. United States v. Teicher³⁶

The “possession” versus “use” debate first surfaced in *United States v. Teicher*.³⁷ The Second Circuit affirmed the district court’s convictions of Victor Teicher and Ross Frankel for securities violations.³⁸

Teicher and Frankel were arbitrageurs.³⁹ Michael David, who was interested in arbitrage,⁴⁰ worked in the corporate department of the law firm of Paul, Weiss, Rifkind, Wharton, and Garrison (Paul Weiss).⁴¹ David provided Teicher and Robert Salsbury,⁴² who worked under Frankel, with information regarding potential acquisitions by Paul Weiss clients from December 1985 through March 1986.⁴³ David, Teicher, and Andrew Solomon, a trader at the brokerage firm of Marcus Schloss, Inc., also traded confidential information between themselves.⁴⁴ Salsbury provided Teicher with a confidential list of companies that Drexel clients were contemplating either merging with or taking over.⁴⁵

On appeal, Teicher and Frankel argued the jury was improperly instructed regarding the required elements of a securities violation.⁴⁶

36. 987 F.2d 112 (2d Cir. 1993).

37. *Id.*; see also Li, *supra* note 27, at 397 (“The use-possession debate first surfaced in *Teicher*.”).

38. *Teicher*, 987 F.2d at 114, 121. Teicher was found guilty on fourteen counts, nine of which were for violations of § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. *Id.* at 114. Frankel was found guilty on six counts, one of which was for violation of § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. *Id.*

39. *Id.* at 114. Webster’s dictionary defines arbitrage as “simultaneous purchase and sale of the same or equivalent security, commodity contract, insurance, or foreign exchange on the same or different markets in order to profit from price discrepancies.” WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY 110 (1986). The *Teicher* court states that “[a]rbitrage entails trading in securities in companies that are the subject of changes in corporate control in order to take advantage of fluctuations in the price of these securities.” *Teicher*, 987 F.2d at 114.

40. *Teicher*, 987 F.2d at 114.

41. *Id.*

42. *Id.* Salsbury was a “close personal friend” of David’s and both were key governmental witnesses. *Id.*

43. *Id.*

44. *Id.*

45. *Id.* at 115.

46. *Id.* at 119. They contended “that the district court’s jury charge erroneously instructed the jury that the defendants could be found guilty of securities fraud based upon the mere possession of fraudulently obtained material nonpublic information without regard to whether this information was the actual cause of the sale or purchase of securities.” The jury charge at

Defendants claimed the instruction created the possibility that a trader could be convicted if they continued with a previously planned transaction after illegitimately receiving material nonpublic information.⁴⁷ The court did not agree that the jury was incorrectly instructed.⁴⁸

Defendants argued that the *use* of material nonpublic information was a prerequisite to a finding that a securities violation occurred.⁴⁹ To support their position, defendants relied on several cases that used language such as “trading on the basis of” to describe the actions of those charged with securities fraud.⁵⁰ Defendants asserted that their interpretation would eliminate the situation where one who previously arranged to buy or sell a stock would be guilty of a securities violation if they happened to learn material nonpublic information prior to the completion of the planned transaction.⁵¹

The government argued that a violation occurs when a “trade is conducted in ‘knowing possession’ of material nonpublic information obtained in breach of a fiduciary or similar duty.”⁵² The court gave

issue stated:

The government need not prove a causal relationship between the misappropriated material nonpublic information and the defendant’s trading. That is, the government need not prove that the defendants purchased or sold the securities because of the material nonpublic information that they knowingly possessed. It is sufficient if the government proves that the defendants purchased or sold securities while knowingly in possession of the material nonpublic information.

Id. The defendants also appealed because they felt “the district court improperly excluded evidence of bias by a government witness.” *Id.*

47. *Id.* Specifically, defendant’s argued that “[a] causal connection standard would find no violation where a trader executes a previously and legitimately planned transaction after the trader wrongfully receives material nonpublic information which confirmed the transaction.” *Id.*

48. *Id.* Specifically, the court noted, “Teicher and Frankel argue that the charge permitted the jury to find them guilty of securities fraud even if they had traded upon only publicly available information. We [the court of appeals] find this argument unpersuasive.” *Id.*

49. *Id.* at 120.

50. *Id.*; *see, e.g.*, *Dirks v. SEC*, 463 U.S. 646, 648 (1983); *SEC v. Materia*, 745 F.2d 197, 199-200 (2d Cir. 1984).

51. *Teicher*, 987 F.2d at 119; *see supra* note 47.

52. *Teicher*, 987 F.2d at 120. The knowing possession standard is “consistently endorsed by the SEC.” *Id.*; *see, e.g.*, *In re Sterling Drug, Inc.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,570, at 80,295 (Apr. 18, 1978). The Commission stated:

The Commission also believes that Rule 10b-5 does not require a showing that an insider sold his securities for the purpose of taking advantage of material nonpublic information . . . [i]f an insider sells his securities while in possession of material

due weight to the government's contention because the promulgators of Rule 10b-5, the SEC, also supported the knowing possession standard.⁵³

The court listed several factors it considered important in determining that knowing possession was the proper standard.⁵⁴ First, the court noted, "both § 10(b) and Rule 10b-5 require only that a deceptive practice be conducted 'in connection with the purchase or sale of a security.'"⁵⁵ The fact that the court applied the "in connection with" requirement broadly indicates that the looser knowing possession⁵⁶ standard was the correct standard.⁵⁷

Second, the court reasoned that the knowing possession standard complies with the "disclose or abstain" theory.⁵⁸ That theory requires a fiduciary who possesses knowledge to either reveal that knowledge or refrain from acting on that knowledge.⁵⁹ Since responsibility is placed on the possessor of information, the court noted that consistency dictated mere possession be the standard.⁶⁰

adverse nonpublic information, such an insider is taking advantage of his position to the detriment of the public.

Id.

53. *Teicher*, 987 F.2d at 120. Specifically, the court noted, "[a]s the promulgator of Rule 10b-5, the SEC's interpretation that this rule only requires 'knowing possession' is entitled to some consideration." *Id.*; see, e.g., *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 n.10 (1976); see also *supra* note 52.

54. *Teicher*, 987 F.2d at 120-21. It is worth noting that the "possession" versus "use" discussion was purely dicta. Specifically, the court stated, "[v]iewing the jury charge in its entirety and based upon the record, we find that it is unnecessary to determine whether proof of securities fraud requires a causal connection, because any alleged defect in the instruction was harmless beyond a doubt." *Id.* at 120.

55. *Teicher*, 987 F.2d at 120.

56. The actual use standard is harder to prove because it must be shown that the material nonpublic information the insider had was at least a factor in the decision to make or not to make a certain trade. It is often difficult to prove one's mental state. Whereas with possession, it only need be shown that the insider had the information.

57. *Teicher*, 987 F.2d at 120. Specifically, the court noted, "[w]e have previously stated that the 'in connection with' clause must be 'construed . . . flexibly to include deceptive practices 'touching' the sale of securities, a relationship which has been described as 'very tenuous indeed.'" *Id.* (citing *United States v. Newman*, 664 F.2d 12,18 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983) (citing *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971)).

58. *Teicher*, 987 F.2d at 120; see also *supra* notes 21-26 and accompanying text.

59. *Teicher*, 987 F.2d at 120; see also *supra* notes 24-25 and accompanying text.

60. *Teicher*, 987 F.2d at 120.

Finally, the court discussed concerns of proof.⁶¹ The court concluded that the knowing possession standard is less burdensome to prove.⁶² Further, the knowing possession standard “recognizes that one who trades while knowingly possessing material inside information has an informational advantage over other traders.”⁶³ The court reasoned that the minor changes that could occur in the decision making process once information is obtained would be significantly reflected in “our increasingly sophisticated securities markets.”⁶⁴

B. SEC v. Adler⁶⁵

The Eleventh Circuit dealt directly with the “possession” versus “use” debate in *SEC v. Adler*.⁶⁶ The *Adler* court adopted the use test.⁶⁷

The SEC brought suit against Harvey L. Pegram,⁶⁸ Richard F.

61. *Id.*

62. *Id.* at 121. Specifically, the court noted, “[a] requirement of a causal connection between the information and the trade could frustrate attempts to distinguish between legitimate trades and those conducted in connection with inside information.” *Id.*; see also 7 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3505 (3d ed. 1991) (“The very difficulty of establishing actual use of inside information points to possession as the test.”).

63. *Teicher*, 987 F.2d at 120.

64. *Id.* Specifically, the court noted:

Unlike a loaded weapon which may stand ready but unused, material information can not lay idle in the human brain. The individual with such information may decide to trade upon that information, to alter a previously decided-upon transaction, to continue with a previously planned transaction even though publicly available information would now suggest otherwise, or simply to do nothing. In our increasingly sophisticated securities markets, where subtle shifts in strategy can produce dramatic results, it would be a mistake to think of such decisions as merely binary choices—to buy or to sell.

Id.

65. 137 F.3d 1325 (11th Cir. 1998).

66. *Id.*; see *supra* note 54 (noting that the discussion in *Teicher* regarding the “possession” versus “use” debate was purely dicta).

67. *Id.* at 1337. Specifically, the court stated, “we believe that Supreme Court dicta and the lower court precedent suggest that the use test is the appropriate test.” *Id.*

68. *Id.* at 1327. Pegram founded Comptronix Corporation, “which provides contract manufacturing services to original equipment manufacturers in the electronics industry,” along with two others in 1984. *Id.* At that time he was a member of the board of directors and Vice President of Purchasing and Material Management for Comptronix. *Id.* The relationship between the partners “disintegrated” and Pegram was let go in 1989. *Id.* at 1327-28.

Adler,⁶⁹ Philip L. Choy,⁷⁰ Magatronic Trading Limited,⁷¹ and Domer L. Ishler⁷² for insider trading in 1989 and 1992.⁷³ The district court granted the defendant's motion for summary judgment on each count.⁷⁴ The Court of Appeals for the Eleventh Circuit reversed and remanded to the district court⁷⁵ because there were genuine issues of material fact present that must be determined by a jury.⁷⁶

1. The 1989 Transactions of Pegram

Comptronix⁷⁷ began to receive fewer orders from a large customer in the beginning of 1989.⁷⁸ In August of 1989, Comptronix issued a press release explaining the decrease in orders.⁷⁹ On September 14, 1989, Pegram attended a meeting that involved more detailed discussion of Comptronix's status.⁸⁰ Although the content of the information revealed is disputed among the parties,⁸¹ the record is

69. *Id.* at 1327. Adler was an outside director of Comptronix and also a close personal friend of Pegram's. *Id.* at 1329.

70. *Id.* at 1327. Choy was a business associate and social friend of Pegram, Adler, and Ishler. *Id.* at 1330 n.14.

71. *Id.* at 1327. Specifically, the court described Magatronic as follows: "Magatronic Trading, Limited is a company owned by Philip Choy and on behalf of which Choy traded his Comptronix stock. A default judgment was entered against Magatronic on November 30, 1995, in the amount of \$75,000. This default judgment had not been appealed." *Id.*

72. *Id.* Ishler was a business associate and friend of the other three individuals. *Id.* at 1330 n.14.

73. *Id.* at 1327. Suit was brought for violations of § 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5. The parties were also charged with violations of § 17(a) of the Securities Act of 1933. The SEC sought treble damages for all violations under the Insider Trading Sanctions Act of 1984. *Id.*

74. *Id.* at 1331. Summary judgment was granted for the 1989 trades. After a deadlocked jury, the district court granted the defendants' motion for judgment as a matter of law for the 1992 trades as well. *Id.*

75. *Id.* at 1344.

76. *Id.* at 1342-43.

77. *See supra* note 68.

78. *Id.* at 1328.

79. *Id.* Comptronix's press release stated it "received less than anticipated orders from another major customer for disk drive products. As a result, management expects that sales and earnings for the second half of 1989 will be lower than previously anticipated, but still significantly higher than the levels of the previous year." *Id.*

80. *Id.* at 1328.

81. *Id.* Pegram asserted that "nothing new of a material nature" was relayed other than "Connors shaky possibly all business offshore." *Id.* The SEC contended that the chief executive officer (CEO) of Comptronix reported:

clear that the board mentioned the instability of future orders from at least one major company.⁸²

Pegram sold 20,000 shares of Comptronix stock⁸³ between September 19 and September 26, 1989.⁸⁴ Comptronix issued another press release on October 6, 1989 similar to the August press release informing the public that it received less orders than expected from a major customer.⁸⁵ The price of Comptronix stock dropped over the next two trading days in response to the press release.⁸⁶ Pegram saved a significant amount of money by selling his Comptronix stock before the October 6 press release.⁸⁷

Pegram alleged that he did not sell the stock because of any material nonpublic information received at the September 14 meeting,⁸⁸ but instead, because of a pre-existing plan to do so.⁸⁹ He

The Company was expecting either a complete termination or a substantial reduction in the orders from Connors, which is the largest customer of the Company due to Connors moving much of its manufacturing off-shore. [The CEO] stated that because Connors was the Company's largest customer, when the information was disseminated the stock of the Company would likely drop substantially.

Id. This information was reflected in the revised minutes of the September 14 meeting. *Id.* Pegram contended that "the revised minutes were 'doctored' by [the CEO] in order to make it appear that Pegram obtained material nonpublic information at the . . . meeting." *Id.* at 1328 n.3.

82. *Id.* at 1328.

83. *Id.* Pegram was issued 869,897 shares of Comptronix stock in 1984. *Id.* at 1327.

84. *Id.* at 1328.

85. *Id.* The release stated that the company "had received less than anticipated orders from a major customer for disk drive products." *Id.*; see also *supra* note 79. This release also contained language that informed the public that the earnings for the fourth quarter would be lower than the earnings for the same quarter in 1988. *Adler*, 137 F.3d at 1328. The company "expect[ed] orders from this customer to decline even further in the fourth quarter . . . as a result, Comptronix anticipates that sales and earnings in the fourth quarter will be below the levels in the same period of 1988." *Id.* (alteration in original). Pegram alleged that a press release was issued later that same day which retracted the statement that the earnings would be lower in the fourth quarter of 1989 than in the fourth quarter of 1988. *Id.* at 1328 n.5. No evidence of such an amended release was ever presented. *Id.*

86. *Adler*, 137 F.3d at 1328. Specifically, "the price of Comptronix stock dropped from \$3.63 to \$2.63 over the next two trading days [following the October 6th press release]." *Id.*

87. *Id.* Specifically, the court noted, "[t]he SEC maintains that by selling 20,000 shares of Comptronix stock before the October 6 press release, Pegram avoided \$17,625 in losses." *Id.* Regardless of the validity of the arguments presented by either side, simple math dictates that if Pegram had sold after the October 6 press release, he would have received less money for each share he sold.

88. *Id.* at 1328.

89. *Id.* Specifically, the court noted, "Pegram contends that his September 1989 sales of

claimed he was forced to wait until after September 14, 1989⁹⁰ to sell the stock because of a lock-up agreement.⁹¹ He also offered evidence that he gained the required permission⁹² to sell from Comptronix's counsel.⁹³

The district court expressed doubt that the information Pegram obtained at the September 14 meeting was material⁹⁴ and concluded that Pegram did not act with scienter⁹⁵ as required.⁹⁶ Thus, the district court granted Pegram's motion for summary judgment.⁹⁷

On appeal,⁹⁸ the SEC contended that the district court "incorrectly adopted a causal connection standard⁹⁹ for insider trading violations that allows a trader to avoid liability if the trader proves that he did not purchase or sell securities because of the material nonpublic information that the trader knowingly possessed."¹⁰⁰ The SEC argued

Comptronix stock were not made as a result of any alleged material nonpublic information, but were part of a preexisting plan to sell Comptronix stock in order to buy an eighteen wheel truck for his son's business." *Id.*

90. *Id.* at 1329. Pegram met with his stockbroker on September 1, 1989 and was informed that the lock-up agreement expired on September 14, 1989. *Id.*

91. *Id.* at 1328. Specifically, the court noted, "[t]his lock-up agreement prevented Comptronix officers and directors from selling any shares of Comptronix stock until 120 days after the initial public offering of Comptronix stock on May 19, 1992." *Id.* at 1328 n.6.

92. *Id.* at 1329. Pegram was required by Comptronix's company policy to obtain approval from Comptronix's general counsel before selling shares. *Id.* Pegram actually received permission for a sale on both August 4 and September 16, 1989. *Id.*

93. *Id.* "When asked why he interposed no objection when told of Pegram's proposed sale, and whether he believed Pegram possessed material nonpublic information at the time, [general counsel] stated that he 'really did not think of it in those terms.'" *Id.* at 1329 n.7.

94. *Id.* at 1329.

95. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (stating that "scienter refers to a mental state embracing intent to deceive, manipulate, or defraud"); BLACK'S LAW DICTIONARY 1347 (7th ed. 1999) (defining scienter as "1) A degree of knowledge that makes a person legally responsible for the consequences of his act or omission . . . 2) A mental state consisting of an intent to deceive, manipulate, or defraud. In this sense, the term is used most often in the context of securities fraud. The Supreme Court has held that to establish a claim for damages under 10b-5, a plaintiff must prove that the defendant acted with scienter").

96. *Adler*, 137 F.3d at 1329. Acting with scienter is required under § 10(b) and Rule 10b-5. *Id.*; see also Horwich, *supra* note 27 (stating that "[s]cienter is a necessary element of an SEC or private civil action under Rule 10b-5, as well as a criminal action"); *Hochfelder*, 425 U.S. at 193; *Aaron v. SEC*, 446 U.S. 680, 695 (1980); *supra* note 95.

97. *Adler*, 137 F.3d at 1329.

98. *Id.* at 1327.

99. The terms "use" and "causal connection" can be used interchangeably.

100. *Adler*, 137 F.3d at 1332. The SEC contended that if the "use" standard was not applied, the district court would not have considered summary judgment proper. *Id.*

that Pegram, as a corporate executive,¹⁰¹ violated § 10(b) and Rule 10b-5 because he “traded in his company’s stock while in possession of material nonpublic information.”¹⁰²

The court of appeals first focused on the language of § 10(b) and Rule 10b-5.¹⁰³ The court determined that although it was not explicit, “the language suggests a focus on fraud, deception, and manipulation.”¹⁰⁴ The court then mentioned several applicable Supreme Court cases wherein the Court acknowledged in dicta that use of material nonpublic information was an element of insider trading.¹⁰⁵

The court noted that the SEC’s view on the possession versus use debate was inconsistent over time.¹⁰⁶ In 1971, the SEC determined that one of the elements required for violations of insider trading was that “the material nonpublic information ‘be a factor in [the insider’s] decision to effect the transaction.’”¹⁰⁷ This element reflects an adoption of the use standard. The SEC ignored the 1971 decision

101. See *supra* note 68.

102. *Adler*, 137 F.3d at 1332. Specifically, the court noted, “[t]he SEC argues that it presented evidence that Pegram knowingly possessed material nonpublic information.” *Id.*

103. *Id.* at 1332-33.

104. *Id.* at 1333.

105. *Id.* at 1333-34. According to the court in *Adler*, in *Chiarella v. United States*, 445 U.S. 222 (1980), the Court stated “an insider’s duty arises from the ‘unfairness of allowing a corporate insider to take advantage of [inside] information by trading without disclosure.’” *Adler*, 137 F.3d at 1333 (alteration in original) (citing *In re Cady, Roberts & Co.*, [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,803, at 81,017 n.15 (Nov. 8, 1961)). The *Chiarella* Court also stated that “[t]he federal courts have found violations of [section] 10(b) where corporate insiders used undisclosed information for their own benefit.” *Adler*, 137 F.3d at 1333 (alteration in original) (citing *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968)). The *Adler* court also looked to *Dirks v. SEC*, 463 U.S. 646 (1983). The *Adler* court stated:

“[N]ot only are insiders forbidden by their fiduciary relationship from personally using disclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain.” This language and the *Dirks* Court’s holding that an inside tipper must gain some personal advantage in order for an outside tippee to be liable for trading on material nonpublic information, suggests that knowing possession of material nonpublic information at the time of trading may not be enough to establish liability for insider trading.

Adler, 127 F.3d at 1333-34 (citing *Dirks*, 463 U.S. at 659-60).

106. *Adler*, 137 F.3d at 1336.

107. *Id.* (citing *In re Investors Management Company, Inc.*, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH), ¶ 78,163, at 80,519 (July 29, 1971)).

when it found that mere possession of material nonpublic information was sufficient to find that a violation of § 10(b) and Rule 10b-5 occurred in 1978.¹⁰⁸ Since then, the SEC consistently adopted this position.¹⁰⁹

The court recognized that the choice between possession and use was difficult, but chose to adopt the use standard.¹¹⁰ The court indicated that the SEC's concern over matters of proof was countered by the "inference of use that arises from the fact that an insider traded while in possession of inside information."¹¹¹ The elimination of the proof concern by this inference was one of several reasons given for the adoption of the use test.¹¹² It was also important to the court that the use test "best comports" with the applicable statutes.¹¹³ The court was fearful that convictions based on mere possession of material nonpublic information would "prohibit actions that are not themselves fraudulent."¹¹⁴

The court, however, did not uphold the district court's grant of

108. *Adler*, 137 F.3d at 1336. Specifically, the court noted "that 'Rule 10b-5 does not require a showing that an insider sold his securities for the purpose of taking advantage of material nonpublic information.'" *Id.* (citing *In re Sterling Drug, Inc.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,570 at 80,298 (Apr. 18, 1978)).

109. *Adler*, 137 F.3d at 1336 n.28; see also *Insider Trading Sanctions and S.E.C. Enforcement Legislation: Hearing on HR 559 Before Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce*, 98th Cong. 48-49 (1983) (stating that the SEC's "consistent position has been that possession of material inside information is the test"). The *Adler* court also noted, "[i]n a 1983 address, the S.E.C. General Counsel stated that the S.E.C. 'will continue to consider trading while in possession of insider information as the test of liability, not the more stringent [use] test,' but acknowledged that where the trader has a 'plausible argument that complicates proof,' the S.E.C. will be 'cautious' about bringing the case." *Adler*, 137 F.3d at 1336 n.28 (citing *Dirks Enhanced SEC Enforcement of Insider Trading*, *Goelzer says*, 15 Sec. Reg. & L. Rep. (BNA) 1820, 1821 (1983)).

110. *Adler*, 137 F.3d at 1337. The court noted that the Supreme Court provided no definite guidance, "[h]owever, we believe that Supreme Court dicta and the lower court precedent suggest that the use test is the appropriate test." *Id.*

111. *Id.* Specifically, the court noted, "when an insider trades while in possession of material nonpublic information, a strong inference arises that such information was used by the insider in trading. The insider can attempt to rebut the inference by adducing evidence . . . that the information was not used." *Id.*

112. *Id.*

113. *Id.* at 1338. The court of appeals noted that the statutes and the Supreme Court focused on the elements of fraud and deception. *Id.*; see also *United States v. O'Hagan*, 521 U.S. 642, 655 (1997) (stating that "§ 10(b) is not an all-purpose breach of fiduciary duty ban; rather it trains on conduct involving manipulation or deception").

114. *Adler*, 137 F.3d at 1338.

summary judgment for Pegram.¹¹⁵ The court of appeals instead concluded that possession of material nonpublic information created a real possibility that this information was used in the trade.¹¹⁶ The court concluded that because genuine issues of material fact remained regarding whether or not the information was used in the decision to make the trades, summary judgment was inappropriate.¹¹⁷

2. The 1992 Transactions of Pegram, Choy, and Ishler

Adler attended a Comptronix board meeting on November 15, 1992¹¹⁸ during which the board informed him of potential fraud within the company.¹¹⁹ Adler was part of the Special Committee created at this meeting to oversee the inquiry into the fraud.¹²⁰ After investigating,¹²¹ the board issued a public statement on November 25, 1992 that described the fraud and indicated that there would be “material adjustments to the Company’s historically audited financial statements.”¹²² On the day of the announcement, trading was suspended for a period of time.¹²³ Comptronix’s common stock dropped significantly in value when trading resumed.¹²⁴

Adler and Pegram had been friends for a number of years.¹²⁵ The day following Adler’s disclosure of the potential fraud, Pegram called Adler at 7:53 in the morning.¹²⁶ Pegram called his wife, Margie, at

115. *Id.* at 1339.

116. *Id.*; *see also supra* note 111.

117. *Adler*, 137 F.3d at 1339.

118. *Id.* at 1329.

119. *Id.* Specifically, the board alleged that Comptronix executives “made \$4 million in false accounting entries in order to support certain capitalized costs of the company.” *Id.*

120. *Id.* The members of the Special Committee “were expressly advised that they must keep the information they learned at the Board meeting secret and confidential.” *Id.* at 1329 n.8.

121. The Special Committee determined that “\$16 million in false accounting entries had actually been made, that there were not legitimate capitalizable costs to offset these false entries, and that Comptronix’s sales records and earnings had been misstated.” *Id.* at 1329.

122. *Id.*

123. *Id.*

124. *Id.* Specifically, “[w]hen trading resumed by the end of the day, Comptronix common stock had lost 72 percent of its value, dropping from a closing price of \$22 per share on November 24th to a closing price of \$6 1/8 per share on November 25.” *Id.*

125. *Id.*; *see also supra* note 69.

126. *Adler*, 137 F.3d at 1329. At this time, Pegram was no longer an officer or director of Comptronix. *Id.* The phone call lasted seventy-two seconds. *Id.* Another call, lasting 114 seconds was placed to Adler at 4:26 p.m. *Id.* at 1330 n.9.

home two minutes later.¹²⁷ At 8:07 a.m., Margie called their stockbroker to sell 50,000 shares of Comptronix stock.¹²⁸ A total of 150,000 shares of their Comptronix stock were sold between November 16 and November 24, 1992.¹²⁹

The SEC alleged that the stock was sold because of information given to Pegram by Adler,¹³⁰ and, as a result, Pegram saved \$2,315,375 in losses.¹³¹ Pegram alleged that the sale of the stock was part of a “pre-existing plan to sell 150,000 shares of Comptronix after the November 3 presidential election.”¹³²

Pegram argued that the phone call to his wife was a wake-up call during which no mention of Adler or the stock was made.¹³³ According to Pegram, the calls to Adler were similar to those made for about a year regarding normal business operations.¹³⁴ He contended, therefore, that he was not in the possession of material nonpublic information when the trades were made.¹³⁵

The SEC alleged that Pegram provided Choy¹³⁶ and Ishler¹³⁷ with the material nonpublic information the SEC maintains he received from Adler.¹³⁸ Pegram made a call to Choy the same day he called Adler.¹³⁹ After the call, Choy sold Comptronix stock.¹⁴⁰ The SEC

127. *Id.* at 1330.

128. *Id.* Pegram’s wife told the stockbroker to sell the shares at a limit price of \$21 per share or better. *Id.*

129. *Id.*

130. *Id.*

131. *Id.*

132. *Id.* Pegram contended that he was told to diversify his stock holdings and was told to do so during the fourth quarter. *Id.* Pegram also contended that he and his wife had to wait until November 16, 1992 to sell due to Margie’s father’s illness. *Id.* As well, Pegram pointed out that the sale of the stock was “consistent with their sale of 60,000 Comptronix shares in 1990 and 380,000 Comptronix shares in 1991.” *Id.*

133. *Id.*

134. *Id.* The court noted, “Pegram testified that between December 1991 and December 1992, he frequently contacted Adler concerning requests for price quotes on electronic parts and materials that Pegram needed for his business, BST manufacturing.” *Id.*

135. *Id.*

136. *See supra* note 70.

137. *See supra* note 72.

138. *Adler*, 137 F.3d at 1330.

139. *Id.* Pegram called Choy at 8:02 p.m. on November 16. *Id.* The call lasted four minutes forty-two seconds. *Id.* at 1331 n.15.

140. *Id.* at 1330. The court noted, “[a]t 9:39 p.m. [on November 18] Choy telefaxed the brokerage firm for his company and directed its stockbroker to sell 5,000 shares of Comptronix stock at a price of US \$21/22. The order was executed on November 17th and 19th.” *Id.* at

alleged that Choy was able to avoid substantial losses because he traded while in the possession of material nonpublic information.¹⁴¹ Both Pegram and Choy testified that they did not discuss Comptronix stock during their phone call.¹⁴²

Ishler called Adler on November 15, 1992 while Adler was joining, via telephone, the meeting at Comptronix about the potential fraud.¹⁴³ They were unable to speak at that moment and Ishler was not able to speak to Adler again until November 23, 1992.¹⁴⁴ Adler and Ishler alleged that the conversation only centered on trying to arrange a meeting.¹⁴⁵

On November 24, 1992, Ishler purchased 300 “put options”¹⁴⁶ in Comptronix stock. The SEC maintained that Ishler purchased these put options because of the material nonpublic information he received.¹⁴⁷ Ishler gained a substantial amount of money¹⁴⁸ when he exercised his put options after Comptronix’s November 25 public announcement.¹⁴⁹

The district court denied the motion for summary judgment pertaining to the 1992 transactions “because the timing of the telephone calls between the appellees raised a ‘reasonable inference

1330-31.

141. *Id.* at 1331. Specifically, the S.E.C. contended that Choy and Magatronic avoided losses of approximately \$75,000. *Id.*

142. *Id.* Pegram and Choy claimed the phone conversation “was related to price quotes for Pegram’s business and that Comptronix was not discussed by the parties.” *Id.* Pegram contended that phone calls pertaining to business commonly occurred between the two from December 1991 through January 1993. *Id.*

143. *Id.*

144. *Id.* During the original phone call, “Adler put the Board meeting on hold and told Ishler that he could not talk with him and than Adler would call Ishler later.” *Id.* They finally spoke when Adler was in the United States for a Comptronix board meeting. *Id.*

145. *Id.* “Adler told Ishler that he was in a meeting and that as soon as he knew his schedule, Adler would call Ishler so they could get together.” *Id.*

146. *Id.* The put options, purchased for \$21,000, “gave Ishler the right to sell 30,000 shares of Comptronix stock at \$20 a share and the options expired in three weeks.” *Id.* at 1331 n.17. Comptronix was selling at \$22 ½ per share and Ishler would lose his investment if the price did not fall below \$20 per share. Ishler maintains that he went to his stockbroker to sell some Comptronix shares short, but that either he or his stockbroker made the decision that buying the put options would be more profitable. *Id.*; see also *infra* note 167 for meaning of a short sale.

147. *Adler*, 137 F.3d at 1331. The SEC contended that he received the material nonpublic information from either the phone calls with Adler or a phone conversation with Pegram. *Id.*

148. *Id.* Specifically, Ishler made approximating \$368,750 when he exercised the options. *Id.*

149. *Id.*; see also *supra* text accompanying note 122.

of materiality and scienter on the part of [Pegram].”¹⁵⁰ The jury was not able to reach a verdict after trial,¹⁵¹ and the district court granted the renewed motions for summary judgment as a matter of law.¹⁵²

The court of appeals held that the “SEC raised a reasonable inference that Pegram possessed nonpublic information.”¹⁵³ The court followed the same rationale as when discussing Pegram’s 1989 transaction¹⁵⁴ when the court required that use of the material nonpublic information must be proven in order to find a violation of § 10(b) or Rule 10b-5.¹⁵⁵ Nevertheless, since a jury could reasonably conclude that the parties possessed the material nonpublic information,¹⁵⁶ the district court’s granting of summary judgment was inappropriate.¹⁵⁷

C. United States v. Smith¹⁵⁸

Shortly after the Eleventh Circuit decided *SEC v. Adler*,¹⁵⁹ the Ninth Circuit also chose to apply the use standard¹⁶⁰ in *United States v. Smith*.¹⁶¹

Richard Smith worked for PDA Engineering, Inc. (PDA),¹⁶² a publicly traded software design firm.¹⁶³ In 1993, after working for PDA for about three years,¹⁶⁴ Smith owned 51,445 shares of PDA stock.¹⁶⁵ He sold all of these shares between June 10 and June 18,

150. *Adler*, 137 F.3d at 1331.

151. *Id.*; see also *supra* note 74.

152. *Adler*, 137 F.3d at 1331-32; see also *supra* note 74.

153. *Adler*, 137 F.3d at 1340.

154. See *supra* notes 98-117 and accompanying text.

155. *Adler*, 137 F.3d at 1340.

156. *Id.* at 1341.

157. *Id.* at 1342-44.

158. *United States v. Smith*, 155 F.3d 1051 (9th Cir. 1998).

159. *Adler*, 137 F.3d at 1325; see also *supra* notes 65-157.

160. *Smith*, 155 F.3d at 1067. Specifically, the court stated, “we believe that the weight of authority supports a ‘use’ requirement.” *Id.*

161. *Smith*, 155 F.3d at 1051.

162. *Id.* at 1053. Smith was the Vice President of North American Sales and worked in the Nashville office. *Id.*

163. *Id.* PDA’s headquarters were in Orange County. *Id.*

164. *Id.*

165. *Id.*

1993¹⁶⁶ as well as “selling short”¹⁶⁷ an additional 35,000 shares.¹⁶⁸ Smith’s parents also sold a substantial number of shares during the same time period.¹⁶⁹

Smith left a message on a co-worker’s answering machine on June 19, 1993¹⁷⁰ indicating that he sold the shares of stock because he was worried about a decline in value.¹⁷¹ As a result, the SEC decided to investigate Smith regarding his sale of stock.¹⁷² The SEC held an investigation¹⁷³ and after nine months, turned the matter over to the U.S. Attorney in Los Angeles for potential criminal prosecution.¹⁷⁴

The government indicted Smith on eleven counts of insider trading in violation of § 10(b) of the Securities Exchange Act of

166. *Id.*

167. *Id.* A short sale is:

A sale of a security that the seller does not own or has not contracted for at the time of sale and that the seller must borrow to make delivery. Such a sale is usu[ally] made when the seller expects the security’s price to drop. If the price does drop, the seller can make a profit on the difference between the price of the shares sold and the lower price of the shares bought to pay back the borrowed shares.

BLACK’S LAW DICTIONARY 1339 (7th ed. 1999); *see also* LOUIS LOSS AND JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 699 (3d ed. 1988) (citing S. REP. NO. 73-1455, at 50-51 (1934)).

168. *Smith*, 155 F.3d at 1053. 25,000 shares were sold on July 8, 1993 and the other 10,000 were sold on July 20, 1993. *Id.*

169. *Id.*

170. *Id.* Smith left the message on the machine of Angela Bravo de Rueda who worked in the Los Angeles office. *Id.* A co-worker of Bravo de Rueda’s who broke into her voicemail system heard the message. A chain of people informed the SEC that an “anonymous informant had a tape of a conversation involving an individual purporting to be Smith discussing insider trading.” *Id.* at 1054.

171. *Id.* at 1053.

Hi Angie, Rich . . . I talked to Tom last night after I left you some messages and he and Lou discovered that there was about a million and half dollar mistake in the budget, so now we’re back at ground zero and we’ve got to scramble for the next few days. Anyway, finally sold all my stock off on Friday and I’m going to short the stock because I know its going to go down a couple of points here in the next week as soon as Lou releases the information about next year’s earnings actually.

Id.

172. *Id.* at 1053. Interestingly, Smith’s sales did save him a significant amount of money. *Id.* After PDA released its fourth-quarter sales figures on August 19, 1993, the stock dropped from \$8 per share to \$5 per share. The sale allowed Smith to avoid \$150,000 in losses and the short selling allowed him to gain a profit of \$50,000. *Id.* at 1053 n.2.

173. *Id.* at 1054. During the investigation, the SEC obtained documents, deposed witnesses, and gained a copy of the answering machine recording. *Id.*

174. *Id.* The U.S. Attorney’s Office and the FBI investigated further. *Id.*

1934¹⁷⁵ and Rule 10b-5.¹⁷⁶ A jury found Smith guilty of insider trading and Smith appealed.¹⁷⁷ Smith alleged on appeal that the information leading to his prosecution was illegally gained,¹⁷⁸ that the information he possessed was not material,¹⁷⁹ and that the jury instructions were incorrect as they allowed a conviction based on mere possession.¹⁸⁰

The court rejected Smith's contention that the information he possessed was not material.¹⁸¹ Smith contended that because the information he dealt with was forward-looking¹⁸² it could not be material as defined by Rule 10b-5.¹⁸³ The court rejected the idea that forward-looking information could not be material.¹⁸⁴

The court dealt more directly with the "possession" versus "use" debate during the discussion of the appropriateness of the jury

175. *Id.*; see also 15 U.S.C. § 78j(b) (1994); *supra* text accompanying note 8.

176. *Smith*, 155 F.3d at 1054; see also 17 C.F.R. § 240.10b-5 (1998); *supra* text accompanying note 9.

177. *Smith*, 155 F.3d at 1054. During the district court proceedings, Smith successfully moved to have the voicemail message suppressed. *Id.* After the jury's guilty finding, Smith filed a motion for acquittal or a new trial. This motion was denied. *Id.*

178. *Id.* Smith felt that the government derived their evidence from an illegal wiretap and it should have been excluded. *Id.* Smith was unsuccessful in this appeal. Because the nexus between the intercepted voicemail message and the lion's share of the evidence independently gleaned from the SEC's investigation (which the U.S. Attorney and the FBI subsequently inherited) is sufficiently attenuated, the court affirmed the district court's decision insofar as it concludes that the government's evidence was not 'derived from' the unlawful wiretap within the meaning of 18 U.S.C. § 2515. *Id.*

179. *Id.* at 1055. Specifically, Smith alleged, "that the information he possessed was forward-looking, or 'soft' information, and hence was not 'material' within the meaning of Rule 10b-5." *Id.*

180. *Id.*, at 1066. Smith argued that his conviction should have been based on the use of inside information. *Id.*

181. *Id.* at 1066. Specifically, the court stated, "[w]e reject Smith's contentions that the district court erred in denying his motion for a judgment of acquittal and in instructing the jury based upon the *Basic* definition of materiality." *Id.*

182. *Id.* at 1064. The information consisted of "forecasts of future sales and revenue." *Id.*

183. *Id.*

184. *Id.* at 1066. Specifically, the court stated:

There is, quite simply, no case law to support Smith's blanket assertion that forward-looking statements cannot, as a matter of law, constitute "material" information within the meaning of Rule 10b-5. Indeed, both the Supreme Court and this court have held to the contrary and have observed that determining materiality requires a nuanced, case-by-case approach.

Id.

instructions.¹⁸⁵ The government argued that it was proper for the district court to instruct the jury¹⁸⁶ that Smith could be convicted of insider trading if he possessed material inside information.¹⁸⁷ Smith contended that the jury instructions inaccurately defined the burden the government must meet.¹⁸⁸

The court confirmed that no court in the Ninth Circuit had dealt with the “possession” versus “use” debate before it began its analysis.¹⁸⁹ The court then indicated that the case¹⁹⁰ relied upon by the government and the SEC for their contention that the possession standard was the proper standard only dealt with that determination in dictum.¹⁹¹

After discussion of the analysis in *Teicher*,¹⁹² the court determined that the use standard was the proper standard to apply.¹⁹³ The court highlighted the Supreme Court’s past requirement that causation be proved,¹⁹⁴ as well as the *Adler*¹⁹⁵ decision, to reach that conclusion.¹⁹⁶

185. *Id.*

186. *Id.* The jury instructions concluded with, “[i]t is enough [to find Smith guilty] if the government proves that such inside information was a significant factor in defendant’s decision to sell or sell short PDA stock.” *Id.*

187. *Id.* Specifically, “the government contends, it needed only to prove that Smith knowingly *possessed* material nonpublic information . . . in deciding to buy or sell.” *Id.* The government further contended that “there is no causation element to an insider trading prosecution.” *Id.*

188. *Id.* Specifically, “they ‘confused the jury’ by providing that the government need only demonstrate that the inside information was a ‘significant factor’ in his decision to trade, and not ‘the reason.’” *Id.*

189. *Id.* at 1066. “Although the use-possession debate has attracted a good deal of attention from academic commentators, very few courts (and none in this circuit) have addressed the issue head on.” *Id.*

190. *United States v. Teicher*, 987 F.2d 112 (2d Cir. 1993); *see also supra* notes 36-64 and accompanying text.

191. *Smith*, 155 F.3d at 1066. Specifically, the court noted, “in support of their proposed ‘possession-only’ standard, the government and the SEC rely principally upon dictum from a Second Circuit case, *United States v. Teicher*.” *Id.*

192. *Teicher*, 987 F.2d at 112.

193. *Smith*, 155 F.3d at 1067. Specifically, the court stated, “[d]espite the Second Circuit’s thoughtful analysis, we believe that the weight of authority supports a ‘use’ requirement.” *Id.*

194. *Id.* Specifically, the court noted, “[t]he Supreme Court has consistently suggested, albeit in dictum, that Rule 10b-5 requires that the government prove causation in insider trading prosecutions.” *Id.* The court of appeals then cited such cases as *United States v. O’Hagan*, 521 U.S. 642 (1997) and *Dirks v. SEC*, 463 U.S. 646 (1983) to support this contention. *Id.*

195. 137 F.3d 1325 (11th Cir. 1998).

196. *Smith*, 155 F.3d at 1067. “The only court of appeals squarely to consider the causation issue concluded that Rule 10b-5 does, entail a ‘use’ requirement.” *Id.*; *see also supra* notes 65-

The court thought it significant that the language of the rules supported the necessity of finding a knowing misuse of inside information.¹⁹⁷ The court expressed concern that those who did not actually commit fraud would be punished if the court adopted the strict knowing possession standard.¹⁹⁸ The court dismissed concerns that the burden of proof in criminal cases would be too severe if the court adopted the use standard.¹⁹⁹

D. The SEC's Viewpoint on the Debate

Although the SEC was leery of defining exactly what constituted an insider trading violation,²⁰⁰ attempts by Congress to legislate²⁰¹ a definition encouraged the SEC to verbalize its own.²⁰² The SEC

157.

197. *Id.* at 1068. Specifically, the court stated:

After all, section 10(b) and Rule 10b-5 do not just prohibit certain unspecified acts “in connection with” the purchase or sale of securities; rather, they prohibit the employment of “manipulative” and “deceptive” trading practices in connection with those transactions. This court has expressly held that “scienter” is a necessary element of an insider trading violation and has defined scienter as “a mental state embracing intent to deceive, manipulate or defraud.”

Id. (internal citations omitted).

198. *Id.* Specifically, the court noted, “[w]e are concerned that the SEC’s ‘knowing possession’ standard would not be—indeed, could not be—strictly limited to those situations actually involving intentional fraud.” *Id.* “Any construction of Rule 10b-5 that de facto eliminates the mens rea requirement should be disfavored.” *Id.* at 1068 n.25.

199. *Id.* at 1069. Specifically, the court stated, “[w]e appreciate that a ‘use’ requirement renders criminal prosecutions marginally more difficult for the government to prove. The difficulties, however, are by no means insuperable. It is certainly not necessary that the government present a smoking gun in every insider trading prosecution.” *Id.*

200. *See, e.g.*, H.R. REP. NO 98-355, at 27 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2299 (letter from John S. Shad, June 29, 1983).

201. Hearing on S.1380 Before Senate Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs. S 1380, 100th Cong. § 2 (1987). The original proposed Insider Trading Proscriptions Act of 1987 found illegal “use [of] material, nonpublic information to purchase or sell any security . . . if [the user] knows or is reckless in not knowing that such information has been obtained wrongfully, or if the purchase or sale of such security would constitute a wrongful use of such information.” *Id.*; *see also* John F. Olson et. al., *Recent Insider Trading Sanctions Developments: The Search for Clarity*, 85 NW. U. L. REV. 715, 728-29 (1991).

202. Specifically, the SEC proposed:

It shall be unlawful for any person, directly or indirectly, to purchase, sell or cause the purchase or sale of, any security while in possession of material nonpublic information concerning the issuer or its securities, if such person knows or recklessly disregards

adopted the possession standard in its definition.²⁰³ The SEC reasoned that the possession standard was proper because it would preclude the oft-argued claim that a trade was made on some other basis than the illegal information.²⁰⁴ Unfortunately,²⁰⁵ Congress never enacted legislation containing this concise definition.²⁰⁶

that such information has been obtained wrongfully or that such purchase or sale would constitute a wrongful use of such information.

Text of Draft "Insider Trading Act of 1987" submitted by SEC, 19 Sec. Reg. & L. Rep. (BNA) 1284, 1284 (Aug. 14, 1987).

203. After a compromise between the legislators and the SEC, the following appeared in the proposal:

It shall be unlawful for any person, directly or indirectly, to purchase, sell, or cause the purchase or sale of, any security, while in possession of material, nonpublic information relating thereto, if such person knows or recklessly disregards that such information has been obtained wrongfully, or that such purchase or sale would constitute a wrongful use of such information. For the purposes of this subsection, such trading while in possession of material, nonpublic information is wrongful only if such information has been obtained by, or its use would constitute, directly or indirectly, (A) theft, bribery, misrepresentation, espionage (through electric or other means) or (B) conversion, misappropriation, or any other breach of a fiduciary duty, breach of any personal or other relationship of trust and confidence, or breach of any contractual or employment relationship.

SEC Compromise Proposal on Insider Trading Legislation, 19 Sec. Reg. & L. Rep. (BNA) 1819 (Nov. 27, 1987); see supra note 202 to compare this version with the SEC's original verbiage.

204. *Proposed Language for Inclusion in Committee Report on Insider Trading Definition, 20 Sec. Reg. & L. Rep. (BNA) 279, 280 (Feb. 19, 1988).* Specifically:

Individuals who have actually traded on the basis of inside information frequently attempt to invent arguments that they have traded for other reasons. Under a 'possession' standard, such post hoc rationalizations would be irrelevant, and could not be used to impede enforcement of the law. Concerns that the 'possession' standard would lead to inappropriate liability are unwarranted, in view of the fact that the prohibition would require knowing or reckless conduct as a predicate to any violation.

Id.

205. Unfortunately, because if it was enacted, the current split among circuits might not exist.

206. The rationale for failing to adopt a definition of insider trading was explained in a House Report:

While cognizant of the importance of providing clear guidelines for behavior which may be subject to stiff criminal and civil penalties, the Committee [on Energy and Commerce] nevertheless declined to include a statutory definition in this bill for several reasons. First, the Committee believed that the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and that a statutory definition could potentially be more narrowing, and in an unintended manner facilitate schemes to evade the law. Second,

This definition was not the only time the SEC adopted a knowing possession standard.²⁰⁷ The briefs in both *Adler*²⁰⁸ and *Smith*²⁰⁹ evidenced a preference for the knowing possession standard.²¹⁰ The full SEC has only confronted the debate in two opinions:²¹¹ *In re Investors Management Co., Inc.*²¹² and *In re Sterling Drug, Inc.*²¹³

The SEC determined that the use standard was the appropriate standard in *In re Investors Management, Co., Inc.*²¹⁴ Critics debate the significance of the SEC's adoption of the use standard, but nonetheless, it remains the test adopted in *In re Investors Management, Co., Inc.*²¹⁵

the Committee did not believe that the lack of consensus over the proper delineation of an insider trading definition should impede progress on the needed enforcement reforms encompassed within this legislation. Accordingly, the Committee does not intend to alter the substantive law with respect to insider trading with this legislation. The legal principals governing insider trading cases are well-established and widely-known.

H.R. REP. NO. 100-910, at 11 (1988), *reprinted in* 1988 U.S.C.A.N. 6043, 6048.

207. *See* United States v. Smith, 155 F.3d 1051 (9th Cir. 1998); SEC v. Adler, 137 F.3d 1325 (11th Cir. 1998); *see also* Sturc & Cummer, *supra* note 27.

208. SEC v. Adler, 137 F.3d 1325 (11th Cir. 1998); *see also supra* notes 65-157.

209. United States v. Smith, 155 F.3d 1051 (9th Cir. 1998); *see also supra* notes 158-99.

210. Corrected Brief of the SEC at 18, SEC v. Adler, 137 F.3d 1325 (11th Cir. 1998) (No. 96-6084); Brief of the SEC at 5-6, United States v. Smith, 155 F.3d 1051 (9th Cir. 1998) (No. 97-50137) (“[W]hen a corporate insider like Smith has information relating to his company that he knows (or is reckless in not knowing) to be material and nonpublic and he trades in the company’s stock, he violates the antifraud provisions of the federal securities laws, whether or not the information is a factor in his decision to trade.”).

211. *See* Nagy *supra* note 27, at 1148 (“The full Commission, however, has only rarely addressed the possession vs. use debate. Indeed, there are only two opinions by the full Commission that contain anything more than a passing reference to the issue.”).

212. *In re Investors Management Co., Inc.*, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,163, at 80,514 (July 29, 1971).

213. *In re Sterling Drug, Inc.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,570, at 80,295 (Apr. 18, 1978).

214. *See in re Investors Management Co., Inc.*, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 80,519.

215. Nagy, *supra* note 27, at 1149. Specifically, Nagy noted, “because the opinion adopts a use test, some authorities, including the courts in both *Adler* and *Smith*, have concluded that *In re Investors Management* undercuts the validity of the SEC’s current interpretation of Rule 10b-5. But careful analysis of *In re Investors Management* reveals that this conclusion may have been reached in haste.” *Id.* After some analysis, Nagy concludes:

Whether the SEC’s statements in *In re Investors Management* are inconsistent with the SEC’s later conclusion in *In re Sterling Drug* depends on how broadly one reads the two opinions. Particularly because the SEC emphasized at the outset of *In re Investors Management* that it was addressing Rule 10b-5 liability in the context of trading by

In *In re Investors Management, Co., Inc.*, owners of Douglas stock sold almost all of their holdings when they learned of unfavorable Douglas earnings information that was not yet released to the public.²¹⁶ After review, the SEC affirmed the hearing examiner's conclusion penalizing all parties for use of material non-public information.²¹⁷ In deciding to do so, the SEC traced past cases where they found violations as a result of the use of inside information.²¹⁸ The SEC determined that all the necessary elements,²¹⁹ including use,²²⁰ were present in *In re Investors*

tippees, its causality requirement may be read somewhat narrowly, as an element essential to establishing tippee liability. The SEC's statements in *In re Sterling Drug* may also be read more narrowly, to apply only in those contexts in which traditional insiders are trading in the shares of their own corporation. In contrast, *Adler and Smith* read both cases more broadly, and implicitly concluded that *In re Investors Management's* causality requirement was directed at not only securities transactions by tippees but also transactions by traditional insiders. It is only through this broader reading that one can claim that the SEC's position in the possession vs. use debate has 'undergone some fluctuation over time.'

Id. at 1150-51.

216. *In re Investors Management, Co., Inc.*, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,163, at 80,515-16. Specifically, the Commission noted, "[u]pon receiving the unfavorable Douglas earnings information between June 21 and June 23, respondents on those days sold a total of 133,400 shares of Douglas stock from existing long positions, which constituted virtually all of their holding of Douglas stock, and sold short 21,100 shares, for an aggregate price of more than \$13,300,000." *Id.*

217. *Id.* at 80,514, 80,533. Specifically, the Commission noted, "[w]e find no reason for disturbing the hearing examiner's conclusion that each of the respondents be censured." *Id.*

218. *Id.* at 80,514, 80,515-16. Specifically, "in a number of . . . cases . . . we . . . found violations of antifraud provisions where persons effected transactions after having obtained non-public information." *Id.*; see also *In re Cady Roberts & Co.*, [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,803 (Nov. 8, 1961); Herbert E. Honahan, 13 S.E.C. 754 (1943) (violation when broker obtained confidential information relating to tenders by other bondholders, and with the benefit of such information he purchased bonds and successfully tendered them to the fund at higher prices); Mates Financial Services, Exchange Act Release Nos. 8626 (June 12, 1969) and 8836 (Mar. 9, 1970) (violation when investment adviser purchased securities after receiving information of a rise in sales and earnings); Van Alstyne, Noel & Co., Exchange Act Release No. 8511 (Jan. 31, 1969) (violation when broker-dealer, partners and employees purchased securities for themselves after broker learned of sharp rise in sales and earnings); Blyth & Company, Inc., Exchange Act Release No. 8499 (Jan. 17, 1969) (violation when broker-dealer effected transactions in securities after receiving advance information).

219. *In re Investors Management, Co., Inc.*, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,163, at 80,518-19. Specifically:

It is clear that in light of the foregoing principles, the conduct of respondents in this case came within the ambit and were violative of the antifraud prohibitions of the

Management, Co., Inc. to find that the actions were in violation of securities laws.²²¹

Seven years later, the SEC adopted a knowing possession standard in *In re Sterling Drug, Inc.*²²² The report was issued, but was not the result of any judicial proceeding.²²³

In *In re Sterling Drug, Inc.*, several directors sold stocks after being informed of decreasing sales before such information was released to the public.²²⁴ The directors maintained that the inside information and the sale of the shares were unconnected.²²⁵ The SEC

securities laws. All the requisite elements for the imposition of responsibility were present on the facts found by the examiner. We consider those elements to be that the information in question be material and non-public; that the tippee, whether he receives the information directly or indirectly, know or have reason to know that it was non-public and had been obtained improperly by selective revelation or otherwise, and that the information be a factor in his decision to effect the transaction.

Id.

220. *Id.* at 80,531. Specifically:

Turning next to the requirement that the information received be a factor in the investment decision, we are of the opinion that where a transaction of the kind indicated by the information (e.g., a sale or short sale upon adverse information) is effected by the recipient prior to its public dissemination, an inference arises that the information was such a factor. The recipient of course may seek to overcome such inference by countervailing evidence. Respondents did not meet that burden in this case.

Id.

221. *See supra* notes 219-20.

222. *In re Sterling Drug, Inc.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,570, at 80, 295 (Apr. 18, 1978).

223. *Id.* at 80,295. Specifically, the Commission noted, “[t]he investigation on which this Report is based was in no sense an adjudicatory proceeding and no hearing has been conducted by the Commission with respect to any of the issues of fact or law contained herein. Nor is the report a determination of the rights or liabilities of any person.” *Id.*

224. *Id.* at 80,297. Specifically:

At the Board of Directors meeting on November 1, 1974, the directors were given the detailed breakdown of the operating performance for the first nine months of 1974. The breakdown showed that although Sterling’s overall sales were up by 13.3% and overall net income was up 10.5%, the source of Sterling’s earnings had shifted during this accounting period from recent patterns as a result of below-average performance by two major domestic divisions and above-average performance by other divisions.

Id. Two directors sold shares of stock after the meeting. Specifically, “[o]n November 5, 1974, the first director sold 8,034 shares of Sterling stock. Between November 6 and [November] 14, the second director sold 10,000 shares of Sterling stock.” *Id.*

225. *Id.* at 80,298. “The three directors also maintain that their reasons for selling their Sterling stock were based on considerations completely independent of the performance of [the

determined that it was irrelevant whether the two were connected; possession of material inside information at the time of trading was enough to find a violation of securities laws.²²⁶

II. THE PASSAGE OF RULE 10b5-1

The SEC proposed Rule 10b5-1²²⁷ in December 1999 to resolve the circuit split between the possession or use standards in cases of insider trading.²²⁸ Although debate existed over whether or not the SEC should offer a formal definition,²²⁹ the SEC determined that the time had come to provide a definition.²³⁰ The proposed rule stated that insider trading liability arises when a person is “aware” of material nonpublic information.²³¹ Proposed Rule 10b5-1 provided four affirmative defenses under which a person could avoid

company].” *Id.*

226. *Id.* at 80,298.

The Commission also believes that Rule 10b-5 (17 C.F.R. § 240.10b-5) does not require a showing that an insider sold his securities for the purpose of taking advantage of material non-public information. Purchasers of securities in the public market should be able to rely upon information available to the public at the time of the transaction. If an insider sells his securities while in possession of material adverse non-public information, such an insider is taking advantage of his position to the detriment of the public.

Id.

227. 17 C.F.R. § 240.10b5-1 (2000); *see supra* note 6.

228. Selective Disclosure and Insider Trading, Sec. Act Rel. 33-7787, 71 SEC Docket 7 (CCH) ¶ 7, at 732 (Dec. 20, 1999) [hereinafter Selective Disclosure]; *see also supra* notes 21-199 and accompanying text.

229. H.R. REP. NO. 98-355, at 13 (1983). “[J]udicial interpretations have not provided clear boundaries of acceptable conduct and that the case-by-case approach, while appropriate for a remedial sanction such as an injunction, would not be appropriate for the civil penalty provided under the legislation.” *Id.* Compare this view to that of Arnold S. Jacobs: “As with any broad anti-fraud remedy, the fringes of what constitutes the prohibited act are occasionally fuzzy. This, however, does not justify placing a definition in the bill; unscrupulous traders would skirt around any definition constructed.” *Id.*; *see also* SEC v. Adler, 137 F.3d 1325 (11th Cir. 1998) (suggesting that the SEC adopt a definition if they are not pleased with the various judicial interpretations of Rule 10b-5). *Id.* at 1337 n.33.

230. Selective Disclosure, *supra* note 228, at 746. Specifically, the Commission noted, “in view of the differing opinions expressed in the three cases discussed above [United States v. Teicher, 987 F.2d 112 (2d Cir. 1993); United States v. Smith, 155 F.3d 1051 (9th Cir. 1998); and S.E.C. v. Adler, 137 F.3d 1325], . . . it would be useful to define the scope of Rule 10b-5, as it applies to the use/possession debate.” *Id.*

231. 17 C.F.R. § 240.10b5-1 (2000); *see supra* note 6.

liability.²³²

After outlining the circuit split within the proposal introducing the Rule,²³³ the SEC affirmed its long-held view that knowing possession was the correct standard.²³⁴ The SEC contended that knowing possession best satisfied the goals of insider trading laws to protect investors and the market.²³⁵ The proposed rule includes several affirmative defenses because it recognized that knowing possession may not always provide the most equitable result.²³⁶

The SEC expressed the view that the strict liability offered by the knowing possession standard would incorrectly prosecute individuals who make plans to trade prior to obtaining material nonpublic information and then trade under the same plan after being made aware of the material nonpublic information.²³⁷ The SEC rejected the use test suggested by the courts under which possession would create a strong inference of use.²³⁸ According to the SEC, an awareness rule with affirmative defenses best allowed for compliance and refuted ambiguity.²³⁹

232. See Selective Disclosure, *supra* note 228, at 733. Specifically, the Commission noted, “in these four situations, where a trade resulted from a pre-existing plan, contract, or instruction that was made in good faith, it will be clear that the trader did not use the information he or she was aware of.” *Id.*

233. *Id.* at 745-46.

234. See *supra* notes 200-26 and accompanying text.

235. Selective Disclosure, *supra* note 228, at 746. Specifically, the Commission stated, “[i]n our view, the goals of insider trading prohibitions-protecting investors and the integrity of securities markets-are best accomplished by a standard closer to the ‘knowing possession standard.’” *Id.*

236. *Id.* Specifically, the Commission reasoned, “[w]e recognize that an absolute standard based on knowing possession, or awareness, could be overbroad in some respects.” *Id.*

237. Selective Disclosure, *supra* note 228, at 746. Specifically:

We recognize that an absolute standard based on knowing possession, or awareness, could be overbroad in some respects. Sometimes a person may reach a decision to make a particular trade without any awareness of material nonpublic information, but then come into possession of such information before the trade actually takes place. A rigid ‘knowing possession’ standard would lead to liability in that case. We believe, however, that for many cases of this type, a reasonable standard would not make such trading automatically illegal.

Id.

238. *Id.* at 746. The Commission noted, “[t]he *Adler* case attempted to balance these considerations by means of a ‘use’ test with a strong inference of use from ‘possession.’” *Id.*

239. *Id.* The affirmative defenses are only available “if a contract, plan, or instruction to trade relied on for a defense was entered into in good faith, and not as part of a plan or scheme

During discussion of the cost-benefit analysis, the SEC highlighted two benefits and labeled no costs.²⁴⁰ The SEC thought it significant that the proposed rule would increase confidence in the market.²⁴¹ As well, insiders would be able to plan trades without fear of prosecution if they complied with the elements outlined in the affirmative defenses.²⁴²

The SEC requested comments on the proposed rule.²⁴³ There were few.²⁴⁴ Of those that did respond, most supported the clarifying aspect of Proposed Rule 10b5-1, but expressed concern that the affirmative defenses were too narrow.²⁴⁵ The SEC rejected a broadening of the affirmative defenses in the final rule because doing so would contravene the clarity Rule 10b5-1 was meant to instill.²⁴⁶

The SEC, however, modified the affirmative defenses in response to some of the comments.²⁴⁷ The new and final affirmative defenses²⁴⁸ allowed for trades to be arranged when one was unaware

to evade the prohibitions of this Rule.” *Id.* at 748.

240. *Id.* at 755.

241. *Id.*

242. *Id.*

243. *Id.* at 748.

244. Proposed Rule 10b5-1 was issued in the same proposal as Regulation FD. Regulation FD received countless email comments to the SEC whereas Rule 10b5-1 only received a few. Comments on Proposed Rule: Selective Disclosure and Insider Trading, 17 C.F.R. § 240.1065-1 (codified as of April 2001), available at <http://www.sec.gov/rules/proposed/s73199.shtml> (last visited Aug. 30, 2001).

245. Selective Disclosure and Insider Trading, Securities Act of 1933 No. 7881 [August 11, 2000-August 17, 2000 Releases] 73 SEC Docket (CCH) ¶ 1, at 19 (Sept. 18, 2000) [hereinafter Selective Disclosure: Final Rule]; see also E-mail from LeBeouf, Lamb, Greene & MacRae, L.L.P., to Jonathan G. Katz, Secretary, SEC (Mar. 29, 2000), at <http://www.sec.gov/rules/proposed/S73199/lgm1.htm>; E-mail from David M. Furbush, Brobeck, Phleger, and Harrison LLP, to Jonathan G. Katz, Secretary, SEC (Mar. 29, 2000), at <http://www.edgar-online.com/fdexpress/comments/furbrush1.asp>.

246. Selective Disclosure: Final Rule, *supra* note 245, at 19.

247. *Id.* at 20.

248. The affirmative defenses provided for by Rule 10b5-1 are as follows:

1(i) Subject to paragraph (c)(1)(ii) of this section, a person's purchase or sale is not 'on the basis of' material non public information if the person making the purchase or sale demonstrates that: (A) Before becoming aware of the information, the person had: (1) Entered into a binding contract to purchase or sell the security, (2) Instructed another person to purchase or sell the security for the instructing person's account, or (3) Adopted a written plan for trading securities; (B) The contract, instruction, or plan described in paragraph (c)(1)(i)(A) of this Section: (1) Specified the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; (2) Included a written formula or algorithm, or

of material nonpublic information in a manner considered satisfyingly flexible to the SEC.²⁴⁹ The language declaring that a violation occurs when a person trades when she is aware of material nonpublic information remained the same as proposed and is the standard set under Rule 10b5-1.²⁵⁰

computer program, for determining the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or (3) Did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales; provided, in addition, that any other person who, pursuant to the contract, instruction, or plan, did exercise such influence must not have been aware of the material nonpublic information when doing so; and (C) The purchase or sale that occurred was pursuant to the contract, instruction, or plan. A purchase or sale is not 'pursuant to a contract, instruction, or plan' if, among other things, the person who entered into the contract, instruction, or plan altered or deviated from the contract, instruction, or plan to purchase or sell securities (whether by changing the amount, price, or timing of the purchase or sale), or entered into or altered a corresponding or hedging transaction or position with respect to those securities. (ii) Paragraph (c)(1)(i) of this section is applicable only when the contract, instruction, or plan to purchase or sell securities was given or entered into in good faith and not as part of a plan or scheme to evade the prohibitions of this section. (iii) This paragraph (c)(1)(iii) defines certain terms as used in paragraph (c) of this Section. (A) *Amount*. 'Amount' means either a specified number of shares or other securities or a specified dollar value of securities. (B) *Price*. 'Price' means the market price on a particular date or a limit price, or a particular dollar price. (C) *Date*. 'Date' means, in the case of a market order, the specific day of the year on which the order is to be executed (or as soon thereafter as is practicable under ordinary principles of best execution). 'Date' means, in the case of a limit order, a day of the year on which the limit order is in force. (2) A person other than a natural person also may demonstrate that a purchase or sale of securities is not 'on the basis of' material nonpublic information if the person demonstrates that: (i) The individual making the investment decision on behalf of the person to purchase or sell the securities was not aware of the information; and (ii) The person had implemented reasonable policies and procedures, taking into consideration the nature of the person's business, to ensure that individuals making investment decisions would not violate the laws prohibiting trading on the basis of material nonpublic information. These policies and procedures may include those that restrict any purchase, sale, and causing any purchase or sale of any security as to which the person has material nonpublic information, or those that prevent such individuals from becoming aware of such information.

17 C.F.R. § 240.10b5-1 (2001).

249. Selective Disclosure: Final Rule, *supra* note 245, at 20. One hypothetical the SEC offered involved a situation where an issuer "adopt[s] a written plan, when it is not aware of material nonpublic information, that uses a written formula to derive amounts, prices, and dates." *Id.*

250. 17 C.F.R. § 240.10b5-1 (2001); *see also supra* note 6.

III. ANALYSIS OF THE SUCCESS OF 10b5-1 TO RESOLVE THE CIRCUIT SPLIT

Application of Rule 10b5-1 to the facts of *Teicher*,²⁵¹ *Adler*,²⁵² and *Smith*²⁵³ is helpful in determining whether 10b5-1 actually resolves the circuit split regarding “possession” versus “use.”

A. *United States v. Teicher*²⁵⁴

In *United States v. Teicher*,²⁵⁵ the Court of Appeals for the Second Circuit found that the knowing possession standard was the proper standard to apply in cases of insider trading.²⁵⁶ This standard complies with the government’s arguments in that case²⁵⁷ and, upon analysis, is consistent with Rule 10b5-1.²⁵⁸

It is clear from the facts of *Teicher*²⁵⁹ that Teicher received material nonpublic information.²⁶⁰ After the passage of Rule 10b5-1, one violates § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 if they trade while aware of material nonpublic information.²⁶¹ Teicher was aware of material nonpublic information²⁶² and was therefore in violation.

Interestingly, Rule 10b5-1 appears to resolve one of Teicher’s main concerns on appeal. Teicher felt the jury instructions would allow a conviction for trading under an established plan, when the individual learned of material nonpublic information after making the plan, but prior to trading.²⁶³ The affirmative defenses offered by Rule 10b5-1 ensure that in exactly such a situation a defendant will avoid liability by showing that the trade in question was made pursuant to a

251. 987 F.2d 112 (2d Cir. 1993).

252. 137 F.3d 1325 (11th Cir. 1998).

253. 155 F.3d 1051 (9th Cir. 1998).

254. 987 F.2d 112 (2d Cir. 1993).

255. *Id.*

256. *See supra* notes 54-64 and accompanying text.

257. *See supra* notes 52-53 and accompanying text.

258. *See infra* notes 260-65 and accompanying text.

259. 987 F.2d 112 (2d Cir. 1993).

260. *See supra* notes 42-45 and accompanying text.

261. 17 C.F.R. § 240.10b5-1 (2001).

262. *See supra* notes 42-45 and accompanying text.

263. *See supra* notes 46-51 and accompanying text.

prior plan.²⁶⁴ Based on the facts presented, Teicher did not offer evidence of a prior plan and therefore would not have a successful affirmative defense.²⁶⁵ This case would have the same outcome if Rule 10b5-1 was applied.

B. SEC v. Adler²⁶⁶

In *SEC v. Adler*,²⁶⁷ the Court of Appeals for the Eleventh Circuit upheld the use standard.²⁶⁸ The court rejected the SEC's desire for application of a knowing possession standard.²⁶⁹ This rejection of the knowing possession standard is not as contrary to Rule 10b5-1 as it might seem at first glance.²⁷⁰

The case facts show that the parties were aware of material nonpublic information at the time of the trades.²⁷¹ Pegram's main argument was that he should not be found guilty because he traded on the basis of a plan and not the material nonpublic information he possessed.²⁷² The SEC argued that regardless of whether or not the material nonpublic information was used in the trade, a person violates insider trading laws if she trades while in possession of the material nonpublic information.²⁷³ The SEC recognized the severity of such a statement and rejected such absolute liability when it decided to offer affirmative defenses in Rule 10b5-1.²⁷⁴

The court of appeals did not uphold the district court's granting of summary judgment²⁷⁵ because the court felt that while use was necessary, possession made the probability of use very high.²⁷⁶ The court's ultimate ruling, although the court did advocate the use

264. 17 C.F.R. § 240.10b5-1 (2001).

265. *See supra* notes 42-51 and accompanying text.

266. 137 F.3d 1325 (11th Cir. 1998).

267. *Id.*

268. *See supra* note 67 and accompanying text.

269. *See supra* notes 98-102, 130 and accompanying text.

270. *See infra* notes 275-78 and accompanying text.

271. *See supra* notes 80-82, 118-29, 139-40, 143-49 and accompanying text.

272. *See supra* notes 88-93, 132 and accompanying text.

273. *See supra* notes 98-102, 130 and accompanying text.

274. 17 C.F.R. § 240.10b5-1 (2001).

275. *See supra* notes 94-97, 153-57 and accompanying text.

276. *See supra* notes 115-17 and accompanying text.

standard within its discussion,²⁷⁷ correlates with Rule 10b5-1. The affirmative defenses, by their very meaning, indicate that the defendant can offer proof to rebut the presumption of use created once an insider is aware of material nonpublic information.²⁷⁸ The *Adler* court's concerns are met and resolved by Rule 10b5-1.

C. United States v. Smith²⁷⁹

The Court of Appeals for the Eleventh Circuit also upheld the use standard.²⁸⁰ Again, this adoption of a use standard does not mean the court would reject Rule 10b5-1.

The defendant, Smith, was aware of material nonpublic information when he executed trades.²⁸¹ Smith feared that the jury instructions would allow a conviction based on mere possession.²⁸² The court chose the use standard because it was concerned about the strict liability that was likely to result if the stringent knowing possession standard was adopted.²⁸³ The affirmative defenses offered by Rule 10b5-1 alleviate these concerns.²⁸⁴

D. Application of Principles

Analyses of these three cases show that the courts' and even the defendants' concerns about the strict liability of a knowing possession standard are met within Rule 10b5-1.²⁸⁵ Defendants who can prove that they created a plan to trade before becoming aware of material nonpublic information will avoid liability.²⁸⁶ Apparently, even the SEC realized the dangers associated with a strict knowing possession standard.²⁸⁷

The SEC consistently adopted an unequivocal knowing possession

277. See *supra* notes 67, 103-14 and accompanying text.

278. 17 C.F.R. § 240.10b5-1 (2001).

279. 155 F.3d 1051(9th Cir. 1998).

280. See *supra* note 160 and accompanying text.

281. See *supra* notes 162-74 and accompanying text.

282. See *supra* note 180 and accompanying text.

283. See *supra* notes 197-99 and accompanying text.

284. 17 C.F.R § 240.10b5-1 (2001).

285. See *supra* notes 254-84 and accompanying text.

286. 17 C.F.R. § 240.10b5-1 (2001).

287. See *supra* notes 243-50 and accompanying text.

standard.²⁸⁸ Interestingly, the SEC did not choose to use the term “knowing possession” within Rule 10b5-1 and instead chose “aware,”²⁸⁹ the two terms are used interchangeably by the SEC and mean the same thing.²⁹⁰ When faced with defining “on the basis of,” the SEC wisely listened to the concerns presented by advocates of the use standard. The SEC showed its acknowledgment of the pitfalls of a strict knowing possession standard when it adopted Rule 10b5-1 with affirmative defenses.²⁹¹

Parties now have a clear understanding of what constitutes a trade on the basis of material nonpublic information and in turn, will be better able to avoid doing so. This ability will instill confidence in the integrity of the market²⁹² and prevent unwarranted prosecutions. The SEC responded successfully to the circuit split and offered a pleasing resolution in Rule 10b5-1.

IV. CONCLUSION

Rule 10b5-1 resolves the circuit split regarding the “possession” versus “use” debate.²⁹³ It alleviates the concerns of the courts adopting the use test.²⁹⁴ Defendants who can prove that they did not become aware of material nonpublic information until after making a plan to trade can avoid liability.²⁹⁵ Just as the affirmative defenses placate the courts and defendants, the “awareness” element of Rule 10b5-1 allows the SEC to maintain the knowing possession standard it advocated for so long.²⁹⁶

288. See *supra* notes 200-26 and accompanying text.

289. See *supra* note 7.

290. See *supra* note 237.

291. See *supra* notes 227-50 and accompanying text.

292. See *supra* note 235 and accompanying text.

293. See *supra* notes 254-92 and accompanying text.

294. See *supra* notes 254-92 and accompanying text.

295. 17 C.F.R. § 240.10b5-1 (2001).

296. See *supra* notes 233-36 and accompanying text.