

Should a Possession or Use Standard Be Employed to Prove Insider Trading?*

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* J.D. candidate May 2000, University of San Diego School of Law; B.S., *magna cum laude*, 1993, San Diego State University; Certified Public Accountant. Thanks to Professor Frank Partnoy for his helpful comments. Special thanks to my husband, Tony Ratto, and my parents, Debbie and Larry Milam, for their support.

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I. INTRODUCTION

Suppose that in early October, the Chief Executive Officer of a publicly traded company instructs his¹ stockbroker to sell ten thousand shares of his company stock immediately following the November presidential election. The trade is made pursuant to a pre-existing plan to diversify his stock holdings. After the time that he places the order, but shortly before its execution, the executive learns negative and material, non-public information about his company. If the executive does not take any action to prevent the impending stock transaction, is he guilty of unlawful insider trading? Although he possessed material, non-public information at the time the transaction was consummated, his trade was not on the basis of, or because of, the information.

The disposition of this case would likely turn on whether the court adopts a "knowing possession" or an "actual use" standard with respect to the information held by the executive. Although the common law has consistently held that a conviction for insider trading requires proof of a causal connection between the information and the trade,² a recent line of cases supports the position, espoused by the Securities and Exchange Commission (SEC), that the SEC need only prove that a defendant accused of insider trading possessed material non-public information at the time he executed the trade—not that he actually used it.³

1. This Article uses the masculine pronoun "he" for simplicity's sake; it does not indicate any sort of gender bias.

2. *See, e.g.*, *United States v. Smith*, 155 F.3d 1051, 1069 (9th Cir. 1998) (holding that Rule 10b-5, promulgated by the Securities and Exchange Commission (SEC) pursuant to section 10(b) of the Securities Exchange Act of 1934 (section 10(b)), requires that the government prove causation in insider trading prosecutions); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854 (2d Cir. 1968) (indicating that a violation of section 10(b) occurs when insiders *act on* material inside information).

3. *See, e.g.*, *United States v. Teicher*, 987 F.2d 112, 120-21 (2d Cir. 1993) (reasoning that a requirement of a causal connection between the information and the trade could frustrate prosecution attempts); *SEC v. Falbo*, 14 F. Supp. 2d 508, 524

Specifically, these cases indicate that proof of “knowing possession” by the SEC satisfies the element of scienter traditionally required by the common law.⁴ This Comment analyzes whether the SEC’s “knowing possession” standard or the common law’s “actual use” standard should be employed to prove unlawful insider trading.

This Comment endorses the legislative adoption of an initial rebuttable presumption in favor of the complainant in insider trading cases. This presumption would create a strong inference of “actual use” upon proof that the defendant was in possession of material and non-public information at the time he consummated a securities transaction. Moreover, the inference would establish a prima facie case of insider trading sufficient to withstand summary judgment. This Comment argues that such a presumption is appropriate as it is consistent with the plain language of section 10(b) of the Securities Exchange Act of 1934⁵ and SEC Rule 10b-5.⁶ Further, it has the effect of easing the near-impossible burden, traditionally assigned to the complainant, of proving the defendant’s state of mind. This Comment will show that although such a presumption has only been applied in a limited number of insider trading cases, it provides a fair alternative in both criminal and civil contexts.

II. INSIDER TRADING

The current law prohibiting insider trading has been developed largely through common law interpretation of section 10(b) of the Securities Exchange Act of 1934 (section 10(b)), and Rule 10b-5 promulgated thereunder by the SEC (Rule 10b-5). Rule 10b-5 makes it unlawful, in connection with the purchase or sale of any security, to use or employ any device, scheme, or artifice to defraud, to make any untrue statement of a material fact (or omit to state a material fact necessary in order to

(S.D.N.Y. 1998) (predicating summary judgment with respect to defendant’s 10b-5 liability on a showing that he traded while in knowing possession of material non-public information); *SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 863 (S.D.N.Y. 1997) (stating that the defendant violated Rule 10b-5 by trading “while in possession of material, non-public information”).

4. *See Teicher*, 987 F.2d at 120. The Supreme Court has held that section 10(b) of the Securities Exchange Act of 1934 applies only to practices that involve scienter and “cannot be read to impose liability for negligent conduct alone.” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976).

5. 15 U.S.C. § 78j(b) (1994).

6. 17 C.F.R. § 240.10b-5 (1998).

make a statement not misleading), or to engage in a fraudulent or deceitful act, practice, or course of business.⁷ Violation of these rules may result in criminal charges, injunctive relief, seizure of related profits, monetary penalties, and/or private civil damage actions.⁸

A. *Duty to Disclose or Abstain*

In *In re Cady, Roberts & Co.*,⁹ the SEC interpreted Rule 10b-5 to impose an affirmative duty on corporate insiders either to disclose material non-public information to persons with whom they conduct business, or to forego the transaction altogether.¹⁰ The Commission indicated that this obligation is predicated on two elements: (1) the existence of a relationship that provides access to non-public inside information “intended to be available only for a corporate purpose and not for the personal benefit of anyone,” and (2) “the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.”¹¹

Despite the SEC’s stated concern over the inherent unfairness associated with possession of non-public information, the Supreme Court has declined to extend the duty to “disclose or abstain” to all market participants. Specifically, in *Chiarella v. United States*,¹² the Court held that “a duty to disclose under [section] 10(b) does not arise from the mere possession of non[-]public market information.”¹³ Rather, a duty arises from a specific relationship of trust and confidence between the parties, similar to a fiduciary relationship (e.g., the relationship between an insider and the purchaser or seller of his company’s stock).¹⁴ The Supreme Court has expressed concern that a contrary rule would have a chilling effect on the role of market analysts, a role considered essential to the “preservation of a healthy market.”¹⁵

1. *“Constructive Fiduciary” Liability*

Recently, courts have extended the duty to “disclose or abstain” to persons who can reasonably be defined as “constructive fiduciaries.”¹⁶

7. *See id.*

8. *See* Allan Horwich, *Possession Versus Use: Is There a Causation Element in the Prohibition on Insider Trading?*, 52 BUS. LAW. 1235, 1236 (1997).

9. 40 S.E.C. 907 (1961).

10. *See id.* at 911.

11. *Id.* at 912.

12. 445 U.S. 222 (1980).

13. *Id.* at 235.

14. *See* *Dirks v. SEC*, 463 U.S. 646, 657-58 (1983).

15. *Id.* at 658.

16. *See, e.g., id.* at 655 n.14 (indicating that where corporate information is

In *SEC v. Lund*,¹⁷ for example, a California federal district court expanded the concept of “insider” to include professionals (e.g., accountants, attorneys, and consultants) who require access to inside information in order to accomplish the corporate tasks they were hired to perform.¹⁸ Thus, the court held that when an outsider is privy to information he knows or should know was conveyed in confidence for a business purpose, he assumes the role of a “temporary insider” with a concomitant duty to disclose or abstain.¹⁹

2. Tipper/Tippee Liability

Recent decisions have also held that a “tippee” (i.e., a person who receives information from a corporate insider) assumes a fiduciary duty to corporate shareholders not to trade on material and non-public information when “the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.”²⁰ In *Dirks v. SEC*,²¹ the Court indicated that the test of whether the tippee has assumed the insider’s fiduciary duty to the corporate shareholders is “whether the insider personally will benefit, directly or indirectly, from his disclosure.”²² The Court reasoned, “Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.”²³

3. Liability Based on the Misappropriation of Information

More recently, courts have imposed liability based on the misappropriation of non-public information.²⁴ Under the

revealed legitimately to an outsider working for the corporation, the outsider may become a fiduciary of the shareholders); *United States v. Chestman*, 947 F.2d 551, 565 (2d Cir. 1991) (stating that an outsider is clothed “with temporary insider status when the outsider obtains access to confidential information solely for corporate purposes”); *SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 863-64 (S.D.N.Y. 1997) (extending liability under the insider trading laws to a non-employee consultant of the corporation).

17. 570 F. Supp. 1397 (C.D. Cal. 1983).

18. *See id.* at 1402-03.

19. *Id.* at 1403.

20. *Dirks v. SEC*, 463 U.S. 646, 660 (1983).

21. 463 U.S. 646 (1983).

22. *Id.* at 662.

23. *Id.*

24. *See, e.g., United States v. O’Hagan*, 521 U.S. 642, 642 (1997) (extending

misappropriation theory, "A company's confidential information . . . qualifies as property to which the company has a right of exclusive use."²⁵ Accordingly, the unauthorized use of such information "constitutes fraud akin to embezzlement."²⁶

The misappropriation theory predicates liability on the breach of a fiduciary duty owed to the source of the information, rather than the fiduciary duty owed by an insider to a purchaser or seller of his company's stock.²⁷ Thus, primary liability under the insider trading laws can attach to a person who trades in securities for personal profit using material and non-public information without disclosing such use to the source of the information, in breach of the person's fiduciary duty to the source.²⁸

In *SEC v. Falbo*,²⁹ for example, the SEC brought a civil action alleging insider trading violations against Falbo, an electrical contractor employed by Grand Metropolitan P.L.C. (Grand Met).³⁰ Falbo's wife was employed as the secretary of Howard Chandler, an executive of Grand Met.³¹ In this position, she had access to highly sensitive and confidential information, including details related to a planned tender offer for the Pillsbury Company's (Pillsbury) common stock.³² Through eavesdropping and conversations with his wife, Falbo learned of the planned acquisition and, prior to the planned acquisition date, engaged in large purchases of both Pillsbury common stock and options to purchase such stock.³³ As a result of these trades, Falbo realized over \$165,000 in profits.³⁴ The court reasoned that at the time of his stock and option purchases, Falbo possessed material, non-public information obtained in violation of his own duty and of his wife's duty of confidentiality and loyalty to Grand Met.³⁵ This "fraud on the source" was held sufficient to sustain liability under Rule 10b-5 because it met the statutory requirement that there be deceptive conduct in connection

insider trading liability to an attorney who misappropriated confidential corporate information from the corporation's attorneys); *United States v. Cusimano*, 123 F.3d 83, 85-88 (2d Cir. 1997) (convicting the tippee friend of the corporation's District Manager); *United States v. Mylett*, 97 F.3d 663, 665-68 (2d Cir. 1996) (extending insider trading liability to a tippee friend of the corporation's Vice President of Labor Relations).

25. *O'Hagan*, 521 U.S. at 654.

26. *Id.*

27. *See id.* at 652-53.

28. *See id.* at 652.

29. 14 F. Supp. 2d 508 (S.D.N.Y. 1998).

30. *See id.* at 513, 517.

31. *See id.* at 513.

32. *See id.* at 515.

33. *See id.* at 516-17, 521-22.

34. *See id.* at 517.

35. *See id.* at 522-23.

with a securities transaction.³⁶

Based solely upon the “traditional” or “classical” theory³⁷ of insider trading, Falbo could not have been convicted. Regardless of whether the court found him to be an insider of Grand Met or a tippee, his fiduciary duty would extend only to the shareholders of Grand Met, not to the shareholders of Pillsbury with whom he transacted. Thus, the misappropriation theory represents a significant extension of insider trading liability.

B. Material Information

Pursuant to Rule 10b-5(b), it is illegal “[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading.”³⁸ The SEC and the courts have interpreted this subsection to limit insider trading violations to situations in which the defendant possessed material information at the time of the trade.³⁹ But, what constitutes material information? As the rule does not provide a definition, it is left to the trier of fact to determine on a case by case basis whether the information at issue is material.⁴⁰ Courts have adopted a variety of tests to determine materiality, application of which is largely dependent upon the specific facts of the case.⁴¹

1. The “Reasonable Shareholder”

In *TSC Industries, Inc. v. Northway, Inc.*⁴² the Supreme Court articulated the basic test of materiality to be whether a reasonable shareholder would attach importance to the information in deciding how

36. *Id.* at 524.

37. Under the “traditional” or “classical” theory of insider trading, a fiduciary relationship between the insider and the purchaser or seller of the company’s stock is necessary to sustain insider trading liability. See discussion *supra* Part II.A.

38. 17 C.F.R. § 240.10b-5(b) (1998).

39. See *SEC v. Hoover*, 903 F. Supp. 1135, 1143 (S.D. Tex. 1995) (holding that liability for insider trading can be based only on *material* information known at the time of the trade); *In re Cady, Roberts, & Co.*, 40 S.E.C. 907, 911 (1961) (stating that the duty to disclose or abstain only relates to *material* facts).

40. See Dariusz M. Budzen & Ania M. Frankowska, *Prohibitions Against Insider Trading in the United States and the European Community: Providing Guidance for Legislatures of Eastern Europe*, 12 B.U. INT’L L.J. 91, 103 (1994).

41. See *id.*

42. 426 U.S. 438 (1976).

to act.⁴³ The Court indicated that this definition would encompass any fact that would assume “actual significance in the deliberations of the reasonable shareholder,” or would be viewed by the reasonable investor as “having significantly altered the ‘total mix’ of information made available.”⁴⁴ Material information is not limited to statements concerning the value of a security, but also includes those facts that “affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company’s securities.”⁴⁵ With respect to speculative information, materiality will “depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.”⁴⁶

2. The “Wait and See” Approach

Several lower courts have endorsed a “wait and see approach”⁴⁷ to measure the materiality of confidential information. Under this approach, materiality is judged based upon the actual market impact of the information when it is eventually disclosed to the public.⁴⁸ Accordingly, in order to determine whether the information in question was material, courts have considered whether actual public disclosure of the information resulted in significant movement in the stock price.⁴⁹ However, application of this approach must be limited to situations in which it can be shown that the movement in the stock price directly resulted from dissemination of the specific information held by the defendant at the time of the trade.⁵⁰ Thus, in *SEC v. Bausch & Lomb Inc.*,⁵¹ the Second Circuit rejected the SEC’s contention that “since

43. *See id.* at 449.

44. *Id.*

45. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968).

46. *Id.*

47. *See, e.g., Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 166 (2d Cir. 1980) (indicating that a relevant question in determining materiality is whether actual disclosure of the information impacted the decisions of potential buyers and sellers); *SEC v. Lund*, 570 F. Supp. 1397, 1401 (C.D. Cal. 1983) (considering the market’s actual reaction to public disclosure of the information in determining its materiality).

48. *See SEC v. Hoover*, 903 F. Supp. 1135, 1146 (S.D. Tex. 1995).

49. *See Elkind*, 635 F.2d at 166-67 (finding information not material partly because its release did not impact stock price); *Lund*, 570 F. Supp. at 1401 (concluding that the increase in trading volume and price of the corporation’s stock following disclosure of the information confirmed the information’s materiality).

50. *See Hoover*, 903 F. Supp. at 1146-47 (reasoning that since the information that the defendant had when he traded was not the same information that was later publicly disclosed, the SEC must rely on statistical analysis to determine what the market reaction would have been if the defendant’s information had been publicly disclosed).

51. 565 F.2d 8 (2d Cir. 1977).

[Bausch & Lomb's] stock dropped 11 3/4 points on March 16th with an unprecedented volume of 348,000 shares traded, all the information conveyed by [defendant] must per se have been material."⁵² The court reasoned that "[t]he seemingly substantial decline in the value of [Bausch & Lomb's] stock . . . was not an uncommon phenomenon in the company's recent history."⁵³ The court cited several reasons, independent of the information, which may also have accounted for the decline, including reports that the Senate planned to investigate the company's "monopolistic stranglehold on the soft contact lens market"⁵⁴ and medical reports concerning the safety of soft contact lenses.⁵⁵

3. *Materiality Based on Insider Reaction*

The reactions of other insiders to the information may also provide a reliable measure of materiality.⁵⁶ Accordingly, in *SEC v. Hoover*,⁵⁷ a Texas federal district court held information that Browning Ferris Industries' (BFI) year-end earnings from continuing operations could be zero to two percent lower than originally estimated in the company's third quarter Form 10-Q⁵⁸ to be immaterial.⁵⁹ The court partly based its decision on evidence that BFI's in-house attorney, who possessed specific expertise in and responsibility for securities laws compliance, had concluded that the zero to two percent revision was not material and thus did not require immediate disclosure to the SEC.⁶⁰

C. *Non-Public Information*

In passing the Securities Exchange Act of 1934,⁶¹ Congress intended to prevent "inequitable and unfair practices and to insure fairness in securities transactions generally."⁶² Rule 10b-5 was passed in

52. *Id.* at 15 (emphasis omitted).

53. *Id.*

54. *Id.*

55. *See id.* at 16.

56. *See id.* at 18.

57. 903 F. Supp. 1135 (S.D. Tex. 1995).

58. A 10-Q is an unaudited quarterly financial report required to be filed with the SEC by corporations registered under the Securities Exchange Act of 1933. *See* BLACK'S LAW DICTIONARY 1481 (7th ed. 1999).

59. *See Hoover*, 903 F. Supp. at 1147-48.

60. *See id.* at 1148.

61. 15 U.S.C. §§ 78a-78mm (1994 & Supp. III 1997).

62. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968).

furtherance of this goal, to ensure that "all investors . . . have relatively equal access to material information."⁶³ Thus, liability under insider trading laws arises only when the defendant trades while in possession of non-public information.⁶⁴

The SEC has defined non-public information as information which has not been disseminated in a manner making it accessible to the investing public generally.⁶⁵ More specifically, in *United States v. Cusimano*,⁶⁶ the federal appeals court endorsed a district court jury instruction that "[i]nformation is non[-]public if it is not available to the public through such sources as press releases, [SEC] filings, trade publications, analysts' reports, newspapers, [and/or] magazines."⁶⁷

Even after information has been effectively disclosed to the public, insiders may be temporarily precluded from acting on it.⁶⁸ Especially in situations in which the information is not readily translatable into investment action, allowing investors to take advantage of their advance opportunity to evaluate the information would be contrary to the regulatory objective of "providing all investors with an equal opportunity to make informed investment judgments."⁶⁹ In order to provide the public with additional protection from exploitation resulting from an insider's advance notice of material information, courts can use the time that an insider actually places an order, rather than the time of its ultimate execution, as determinative for purposes of Rule 10b-5.⁷⁰

63. *Id.* More recently, this goal has been criticized as unreasonable. See *United States v. Carpenter*, 791 F.2d 1024, 1031 (2d Cir. 1986) (recognizing inherent "disparities in knowledge and the availability thereof at many levels of market functioning that the law does not presume to address"), *aff'd*, 484 U.S. 19 (1987); see also *Chiarella v. United States*, 445 U.S. 222, 232-33 (rejecting the access to information theory).

64. See *United States v. Cusimano*, 123 F.3d 83, 88-89 (2d Cir. 1997) (indicating that liability under section 10(b) and Rule 10b-5 is predicated on possession of non-public information); *United States v. Mylett*, 97 F.3d 663, 666-67 (2d Cir. 1996) (holding that Rule 10b-5 requires a showing that the information in question was non-public); *United States v. Libera*, 989 F.2d 596, 601 (2d Cir. 1993) (stating that trading on public information does not violate section 10(b)); *SEC v. Moran*, 922 F. Supp. 867, 891 (S.D.N.Y. 1996) (holding that in order to establish an insider trading violation under section 10(b) and Rule 10b-5 plaintiff must show that defendant made improper use of confidential material information).

65. See *In re Investors Management Co.*, 44 S.E.C. 633, 633 (1971).

66. 123 F.3d 83 (2d Cir. 1997).

67. *Id.* at 89 n.6 (first alteration in original).

68. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854 n.18 (2d Cir. 1968).

69. *Id.* at 854.

70. See Arthur Fleischer, Jr., *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271, 1291 (1965).

1. *Impoundment Theory*

Under the impoundment theory, information may be considered public for purposes of section 10(b) even though there has been no public disclosure and only a small number of people know of it.⁷¹ In accordance with this theory, the issue is not the number of people who possess the information, but whether their trading has caused it to be fully “impounded” into the price of the particular stock.⁷² The rationale is that once the information is fully reflected in the price of the stock, it can no longer be misused by trading because no further profit can be made.⁷³

2. *Corporate Rumor*

In order for information to be classified as non-public, it must be more specific and more private than general rumor.⁷⁴ Thus, in *United States v. Mylett*,⁷⁵ the Second Circuit held that confirmation by a corporate insider of information on which the press merely speculated was sufficient to satisfy the non-public requirement.⁷⁶ However, the court indicated that its decision was limited to situations in which the insider’s information was “qualified, supported, and credible.”⁷⁷ Based on that holding, a violation of the insider trading laws would probably not be found in a situation in which an insider had made categorical statements that were completely without foundation, but were, nonetheless, successfully used by a trader.⁷⁸

D. *Security*

1. *Statutory Definition*

The imposition of insider trading liability is expressly limited to actions pursued “in connection with the purchase or sale of any

71. See *United States v. Libera*, 989 F.2d 596, 601 (2d Cir. 1993).

72. *Id.*

73. See *id.*

74. See *United States v. Mylett*, 97 F.3d 663, 666 (2d Cir. 1996).

75. 97 F.3d 663 (2d Cir. 1996).

76. See *id.* at 666.

77. *Id.* at 667.

78. See *id.*

security.”⁷⁹ The definition of “security” provided by section 10(b) includes such instruments as notes, stocks, treasury stocks, bonds, debentures, puts, calls, straddles, options, and privileges with respect to a security or with respect to a group or index of securities.⁸⁰

2. *Stock Appreciation Rights*

Despite the broad statutory definition of security, in *Clay v. Riverwood International Corp.*,⁸¹ the Eleventh Circuit refused to extend insider trading liability to corporate insiders who exercised stock appreciation rights (SARs)⁸² on the basis of material non-public information.⁸³ The court reasoned that “[u]nlike the exercise of puts, calls, straddles or options, the ‘exercise of the SARs . . . did not affect the legal or beneficial ownership of any stock or the right to own, purchase, or sell any stock.’”⁸⁴ Further, the court rejected Clay’s argument that the SARs constituted “privileges with respect to”⁸⁵ securities, as the SARs issued by Riverwood were non-transferable and only entitled the holder to a cash payment from the company’s treasury (as opposed to company stock).⁸⁶ Finally, the court noted that since no market currently exists to trade SARs, its decision is consistent with the well-established goal of the Securities Exchange Act of 1934: “to ‘protect the integrity of the securities markets.’”⁸⁷

On petition for rehearing, the Eleventh Circuit vacated that portion of its decision in which it held that the SARs at issue were not securities subject to insider trading laws, on the grounds that Clay lacked standing to bring a claim under the Securities Exchange Act.⁸⁸ However, given the court’s extensive discussion of the issue and given that the case was one of first impression in the federal courts, the Eleventh Circuit’s well-reasoned opinion retains probative value for purposes of this Comment.

79. 17 C.F.R. § 240.10b-5(c) (1998).

80. See 15 U.S.C. § 78c(a)(10) (1994).

81. 157 F.3d 1259 (11th Cir. 1998), *vacated*, 176 F.3d 1381 (11th Cir. 1999).

82. SARs are granted by corporations as a form of executive compensation. They entitle the holder to a cash or stock payment in an amount equal to the difference between the market value of the company’s stock and the strike or grant price specified on the face of the SAR. See *id.* at 1264.

83. See *id.*

84. *Id.* at 1266 (quoting *Clay v. Riverwood Int’l Corp.*, 964 F. Supp. 1559, 1571-72 (N.D. Ga. 1997)).

85. *Id.*

86. See *id.* at 1264, 1266-67.

87. *Id.* at 1267 (quoting *United States v. O’Hagan*, 521 U.S. 642, 653 (1997)).

88. See *Clay v. Riverwood Int’l Corp.*, 176 F.3d 1381, 1381-82 (11th Cir. 1999).

E. Possession Versus Use

We now return to the question presented at the beginning of this Comment: Is an insider guilty of unlawful insider trading merely because he possesses material non-public information at the time that he executes a trade? A recent decision by the Ninth Circuit Court of Appeals in *United States v. Smith*⁸⁹ answered this question in the negative, creating a split of authority in the Circuit Courts.⁹⁰

1. Actual Use: United States v. Smith

In *Smith*, the U.S. Attorney brought a criminal action against Richard Smith, PDA Engineering, Inc.'s (PDA) Vice President for North American Sales, alleging eleven counts of insider trading in violation of section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5.⁹¹ Between June 10 and June 18, 1993, Smith sold all of the 51,445 PDA shares he owned and later sold short an additional 35,000 shares.⁹² In a voice mail to a co-worker, Smith indicated that he had engaged in insider trading, stating, "I 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 . . . next year's earnings [are released]."⁹³

On appeal from guilty verdicts on all eleven counts,⁹⁴ Smith argued that the lower court had "erroneously instructed the jury that it could convict [him] based upon his mere possession, as opposed to his use, of inside information."⁹⁵ Although the appellate court affirmed Smith's conviction, it explicitly rejected the SEC's "knowing possession"

89. 155 F.3d 1051 (9th Cir. 1998).

90. See Paul Beckett, *Ruling Delivers a Blow to Efforts by SEC to Fight Insider Trading*, WALL ST. J., Aug. 27, 1998, at B10 ("The issue may ultimately be decided by the Supreme Court because the [Smith] ruling directly conflicts with a 1993 decision by a federal appeals court in New York.").

91. See *Smith*, 155 F.3d at 1053-54.

92. See *id.* at 1053. Selling short occurs when a market participant sells stock which he does not own (at today's market price) based upon his belief that the market price of the stock will decline. If the market price does decline, he will be permitted to "cover," or tender delivery of the stock that he sold, by purchasing it at the lower price. Thus, he realizes a profit equal to the difference between the sales price and his lower purchase price. See *id.* at 1053 n.1.

93. *Id.* at 1053.

94. See *id.* at 1054.

95. *Id.* at 1055.

standard for insider trading violations, finding it contrary to “the weight of existing authority.”⁹⁶ The court held that Rule 10b-5 requires that the government (or the SEC) “demonstrate that the suspected inside trader actually used material non[-]public information in consummating his transaction.”⁹⁷

Recall the hypothetical situation presented in the introduction to this Comment.⁹⁸ The Chief Executive Officer of a publicly traded corporation instructed his stockbroker to sell a portion of his company stock. Assume that despite his subsequent receipt of material and non-public information, the executive failed to cancel the transaction. In order to secure a criminal conviction for insider trading under the Smith approach, the SEC (or the government) must prove that the executive traded on the basis of (or because of) material and non-public information. Presumably, the executive in our hypothetical would easily be able to overcome any such assertion by the SEC. He would simply need to introduce evidence that his order to trade was communicated to his stockbroker prior to his receipt of the information. In other words, evidence that he had commenced the trade prior to his receipt of material and non-public information would serve as an affirmative defense.

2. *Knowing Possession*: United States v. Teicher

The holding in *Smith* directly conflicts with the reasoning of the Second Circuit Court of Appeals in *United States v. Teicher*.⁹⁹ In *Teicher*, the U.S. Attorney filed a criminal action against defendants Victor Teicher, founder of the investment firm of Victor Teicher & Co., and Ross Frankel, research analyst for Drexel Burnham Lambert, Inc. (Drexel).¹⁰⁰ The prosecutor alleged eighteen counts, nine of which involved securities fraud in violation of section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5.¹⁰¹

Defendants Teicher and Frankel were involved in the business of “risk

96. *Id.* at 1069.

97. *Id.*

98. *See supra* Part I.

99. 987 F.2d 112 (2d Cir. 1993). Many courts and commentators have dismissed the *Teicher* court’s endorsement of a “knowing possession” standard, *id.* at 120, as dicta. In fact, the *Teicher* court itself indicated that it “need only rule with respect to the case before [it]” and thus, found it “unnecessary to determine whether proof of securities fraud requires a causal connection.” *Id.* at 121. However, the frequency with which the *Teicher* decision has been cited and relied upon by commentators and in subsequent decisions evidences its significant precedential influence. *See, e.g., In re Oxford Health Plans, Inc.*, 187 F.R.D. 133, 143 (S.D.N.Y. 1999); *SEC v. Falbo*, 14 F. Supp. 2d 508, 524 (S.D.N.Y. 1998); Beckett, *supra* note 90, at B10.

100. *See Teicher*, 987 F.2d at 114, 118.

101. *See id.* at 118.

arbitrage.”¹⁰² From December 1985 until March 1986, Michael David, an associate in the corporate department of the law firm of Paul, Weiss, Rifkind, Wharton & Garrison (Paul Weiss), repeatedly provided Teicher and Robert Salsbury, an employee of Frankel, with information concerning possible acquisitions by Paul Weiss clients and other confidential information obtained from Andrew Soloman, a trader at the brokerage firm of Marcus Schloss, Inc.¹⁰³ In addition, David provided Teicher with the names of companies contained on Drexel’s “phantom list,”¹⁰⁴ which was obtained from Salsbury.¹⁰⁵ Through the use of this information, Teicher and Frankel realized profits in excess of \$180,000.¹⁰⁶

On appeal from guilty verdicts on all eighteen counts, Teicher and Frankel argued that the lower court had “erroneously instructed the jury that the defendants could be [convicted] based upon the mere possession of . . . material non[-]public information without regard to whether this information was the actual cause of the sale or purchase of securities.”¹⁰⁷ The appellate court affirmed the convictions and endorsed the SEC’s “knowing possession” standard with respect to insider trading violations.¹⁰⁸ Specifically, the court indicated that “[u]nlike a loaded weapon which may stand ready but unused, material information can not lay idle in the human brain.”¹⁰⁹ Thus, an insider’s mere possession of material, non-public information taints a subsequent trade and renders it illegal regardless of the insider’s subjective motivation at the time the trade was executed.¹¹⁰

Based upon the court’s reasoning in *Teicher*, the executive in our hypothetical would be guilty of unlawful insider trading despite the fact that his trade was made pursuant to a pre-existing plan to diversify his holdings. Thus, under *Teicher*, evidence that the executive had

102. *Id.* at 114. Arbitrage involves trading in the corporate stock of companies that are potentially subject to changes in corporate control in an effort to profit from fluctuations in the market price of the securities. *See id.*

103. *See id.*

104. *Id.* at 115. “Drexel’s ‘phantom list’ [was] a highly confidential list of companies that were the subject of mergers or takeovers by Drexel clients and in which trading by Drexel personnel was [strictly] prohibited.” *Id.*

105. *See id.* at 114.

106. *See id.* at 115-17.

107. *Id.* at 119.

108. *See id.* at 120-21.

109. *Id.* at 120.

110. *See id.* at 120-21.

communicated the trade to his stockbroker prior to receiving the material and non-public information would not shield him from liability under the insider trading laws.

3. *Presumption of Use upon Proof of Possession: SEC v. Adler*

In *SEC v. Adler*,¹¹¹ the Eleventh Circuit Court of Appeals took a different approach. In *Adler*, the SEC brought a civil action against several executives and former executives of Comptronix Corporation (Comptronix) alleging insider trading in violation of the Securities Exchange Act of 1934 and Rule 10b-5.¹¹²

On September 14, 1989, defendant Pegram, a former executive of Comptronix, attended a meeting of the Comptronix Board of Directors. During this meeting it was reported that the company was expecting either a complete termination or a substantial reduction in the orders from one of its largest customers.¹¹³ Between September 19 and September 26, 1989, Pegram sold 20,000 shares of Comptronix stock, approximately two weeks before a press release containing the information discussed at the board meeting was issued to the public.¹¹⁴ In response to the press release, the price of Comptronix stock dropped one dollar per share, from \$3.63 to \$2.63, in two days.¹¹⁵ By trading prior to the press release, Pegram was able to avoid approximately \$17,625 in losses.¹¹⁶

Approximately three years later, Richard Adler, an outside director of Comptronix, attended a November 15, 1992 special meeting of Comptronix's board at which the directors were informed about potential fraud perpetrated by Comptronix's CEO and Vice-President.¹¹⁷ News of the fraud was reported to the public in a press release on November 25, 1992.¹¹⁸ On November 16, 1992, Pegram called Adler's home in Taiwan.¹¹⁹ Following their conversation, Pegram called his wife, who then called their stock broker and sold 50,000 shares of Comptronix stock.¹²⁰ Over the next eight days, the Pegrams sold an additional 100,000 shares of Comptronix stock, avoiding losses of

111. 137 F.3d 1325 (11th Cir. 1998).

112. *See id.* at 1327.

113. *See id.* at 1328.

114. *See id.*

115. *See id.*

116. *See id.*

117. *See id.* at 1329.

118. *See id.*

119. *See id.*

120. *See id.* at 1330.

approximately \$2.3 million.¹²¹

On appeal from summary judgment and judgment as a matter of law in favor of Pegram with respect to the 1989 and 1992 trades, respectively, the SEC argued that the lower court incorrectly adopted a causal connection standard for insider trading violations.¹²² Although the appellate court reversed the lower court's grant of summary judgment and judgment as a matter of law, the court rejected the SEC's "knowing possession" standard.¹²³ However, in an effort to alleviate the difficulties associated with proving that an alleged violator acted on the basis of material information, the court held that "when an insider trades while in possession of material non[-]public information, a strong inference arises that such information was used by the insider in trading."¹²⁴ The insider may attempt to rebut the inference by presenting evidence that there was no causal connection between the information and his decision to trade.¹²⁵

Applying the Adler approach to our hypothetical, proof that the executive possessed material and non-public information at the time the trade was executed would result in a presumption that the executive made the trade based upon such information. The executive could then rebut this presumption by presenting evidence of his pre-existing plan to diversify his stock holdings.

III. ANALYSIS

The threshold question is whether the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder, require the application of a "knowing possession" or an "actual use" standard for insider trading violations. Although the legislature has recently taken up discussion of insider trading in conjunction with its adoption of the Insider Trading Sanctions Act of 1984 (ITSA)¹²⁶ and the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA),¹²⁷ it has declined to endorse a

121. *See id.*

122. *See id.* at 1331-32.

123. *See id.* at 1337, 1343.

124. *Id.* at 1337.

125. *See id.*

126. Pub. L. No. 98-376, § 5, 98 Stat. 1264, 1265 (1984) (codified as amended at 15 U.S.C. § 78t(d) (1994)).

127. Pub. L. No. 100-704, § 5, 102 Stat. 4677, 4680 (1988) (codified as amended at 15 U.S.C. § 78t-1(a) (1994)).

formal definition of the offense.¹²⁸ Congress based its decision on the belief 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 narrowing, and in an unintended manner facilitate schemes to evade the law.”¹²⁹ Accordingly, Congress indicated that its legislation was not intended to alter the existing substantive law with respect to insider trading.¹³⁰ The significant differences in interpretation of the insider trading laws within the federal courts, however, indicate that court-drawn parameters of insider trading are anything but clear.

A. *Statutory Analysis Based on Plain Language*

The Supreme Court has held that when interpreting statutory language, courts must first look to the plain language of the statute.¹³¹ Section 10(b) of the Securities Exchange Act of 1934 provides:

It shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.¹³²

Rule 10b-5 further states:

It shall be unlawful for any person . . . [t]o employ any device, scheme, or artifice to defraud, . . . [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading, or . . . [t]o 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.¹³³

Although neither section 10(b) nor Rule 10b-5 explicitly addresses the issue of whether mere possession of material non-public information is sufficient to impose liability on a corporate insider, the language “suggests a focus on fraud, deception, and manipulation,”¹³⁴ and thus requires proof that the insider traded *on the basis of* the information by implication. Of course, contrary interpretations are possible. One such interpretation focuses exclusively on the requirement that a deceptive practice be conducted “in connection with the purchase or sale of a

128. See Horwich, *supra* note 8, at 1263.

129. *Id.* at 1262 (citing H.R. REP. NO. 100-910, at 11 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6048).

130. See *id.* at 1263.

131. See *Chicago v. Environmental Defense Fund*, 511 U.S. 328, 337 (1994).

132. 15 U.S.C. § 78j (1994).

133. 17 C.F.R. § 240.10b-5 (1998).

134. *SEC v. Adler*, 137 F.3d 1325, 1333 (11th Cir. 1998).

security.”¹³⁵ Under this interpretation, the “in connection with” clause is construed broadly to include deceptive practices merely “touching” the sale of securities.¹³⁶ Under this approach, for example, “the predicate act of fraud may be perpetrated on the source of the non-public information, even though the source may be unaffiliated with the buyer or seller of securities.”¹³⁷ Arguably, this interpretation loses sight of the law’s main thrust. 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.”¹³⁸

Another interpretation asserts that trading while in possession of material and non-public information in and of itself constitutes a “deceptive” practice, as one who trades while knowingly possessing material non-public information has an informational advantage over other market participants.¹³⁹ However, this interpretation fails to consider the “use or employ” language contained in both section 10(b) and Rule 10b-5.

In *Adler*, the court seemed to concede that the language of Rule 10b-5 does not provide courts with adequate guidance. Nevertheless, the court rejected the SEC’s “knowing possession” standard on the grounds that the SEC “has had ample opportunity to adopt a rule or amend Rule 10b-5 so as [explicitly] to provide that a trade with knowing possession of material non[-]public information triggers insider trading liability.”¹⁴⁰ In support of its position, the court cited the language of Rule 14e, which augments the insider trading prohibitions of Rule 10b-5 in the context of tender offers.¹⁴¹ Specifically, Rule 14e-3(a) states:

135. *United States v. Teicher*, 987 F.2d 112, 120 (2d Cir. 1993).

136. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12-13 (1971).

137. *United States v. Chestman*, 947 F.2d 551, 566 (2d Cir. 1991). Literally, even this interpretation seems to imply that liability only results if the insider engages in “fraudulent” or “deceitful” activity. The decision merely expands the type of activity that can be used to secure a conviction. For example, this interpretation is consistent with the interpretation used by courts in order to justify insider trading liability based on the misappropriation of confidential information. *See supra* Part II.A.3.

138. *United States v. Smith*, 155 F.3d 1051, 1068 (9th Cir. 1998) (emphasis added).

139. *See id.*

140. *SEC v. Adler*, 137 F.3d 1325, 1339 (11th Cir. 1998).

141. *See id.* at 1338. A tender offer is a “public offer to buy a minimum number of shares from a corporation’s shareholders at a fixed price, usu[ally] at a substantial premium over the market price, in an effort to take control of the corporation.” BLACK’S LAW DICTIONARY 1480 (7th ed. 1999).

If any person has taken a substantial step or steps to commence, or has commenced, a tender offer . . . , it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer . . . to purchase or sell or cause to be purchased or sold any of such securities . . . unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.¹⁴²

Thus, Rule 14e expressly provides for insider trading liability based solely upon an individual's possession of material non-public information relating to a tender offer. According to the *Adler* court, the absence of such explicit language in Rule 10b-5 weighs heavily in favor of a "use" test.¹⁴³

B. Statutory Analysis Based on Legislative History

Although the above analysis of the statutory language of section 10(b) and Rule 10b-5 seems to favor an "actual use" standard, the meaning of the language certainly cannot be described as clear. Thus, consideration of the legislative history is appropriate. In *United States v. O'Hagan*,¹⁴⁴ the Supreme Court articulated the legislature's goal in passing the Securities Exchange Act of 1934—to maintain the integrity of the securities markets.¹⁴⁵ In particular, the legislative history of the act expresses the legislature's desire to eliminate the public's perception that "the use of inside information for personal advantage was a normal emolument of corporate office."¹⁴⁶

In *Liljeberg v. Health Services Acquisition Corp.*,¹⁴⁷ the Supreme Court cited similar legislative concerns with respect to the public's faith

142. 17 C.F.R. § 240.14e-3(a) (1998).

143. See *Adler*, 137 F.3d at 1339. Note that the court's assumption about the SEC's rulemaking authority is of questionable validity. Section 14(e) provides that "[the SEC] shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent such acts and practices as are fraudulent, deceptive, or manipulative." 15 U.S.C. § 78n (1994). In contrast, section 10(b) provides that it shall be unlawful "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j (1994). "Thus, [s]ection 10(b) does not give the SEC the same authority to make rules 'reasonably designed to prevent' any acts and practices which may violate the statute as does [s]ection 14(e), but rather only the authority to proscribe the deceptive devices themselves." John H. Sturc & Catharine W. Cummer, *Possession vs. Use for Insider Trading Liability*, *INSIGHTS*, June 1998, at 3, *3.

144. 521 U.S. 642 (1997).

145. See *id.* at 653.

146. *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 n.15 (1961).

147. 486 U.S. 847 (1988).

in the legal system.¹⁴⁸ In that case, Health Services Acquisition Corporation (Health Services) brought an action against John Liljeberg, Jr., seeking a declaration of ownership of a corporation known as St. Jude Hospital of Kenner, Louisiana (St. Jude).¹⁴⁹ Judge Robert Collins tried the case and held in favor of Liljeberg.¹⁵⁰ After the judgment had been rendered, Health Services learned that Judge Collins served as a member of the Board of Trustees of Loyola University while Liljeberg was negotiating with the University to purchase a parcel of land on which to construct a hospital.¹⁵¹ Further, the benefit to Loyola of these negotiations depended on Liljeberg prevailing in the litigation before Judge Collins.¹⁵² Based upon this information, Health Services moved to vacate the judgment on the ground that Judge Collins was disqualified under 28 U.S.C. § 455(a).¹⁵³

Although the Court was satisfied that Judge Collins' decision was not influenced by the conflict of interest, it was nevertheless concerned that the integrity of the judicial system may be adversely affected by the mere appearance of impartiality.¹⁵⁴ Further, the Court expressed concern that requiring scienter as an element of section 455(a) would "contravene that section's . . . purpose of promoting public confidence in the integrity of the judicial system."¹⁵⁵ Accordingly, the Court ruled that vacatur was an appropriate remedy.¹⁵⁶

A similar argument could be made with respect to the issue presented in this Comment. If insiders are permitted to trade while in possession of material non-public information, market participants may perceive that the insiders are being afforded an informational advantage, even if they are not actually "using" the information to trade. As a result of this perception, the integrity of the market may be compromised. Based upon this argument, it appears that a "knowing possession" standard would be most consistent with the legislature's stated goal of maintaining the public's faith in the securities markets.

148. *See id.* at 859-60.

149. *See id.* at 850.

150. *See id.*

151. *See id.*

152. *See id.* Title 28, section 455(a) of the United States Code requires a judge to disqualify himself in any proceeding in which his impartiality might reasonably be questioned. *See* 28 U.S.C. § 455(a) (1994).

153. *See Liljeberg*, 486 U.S. at 850.

154. *See id.* at 848.

155. *Id.*

156. *See id.*

C. The Supreme Court's Perspective

Although the Supreme Court has not directly addressed the issue discussed herein, it has repeatedly suggested in dicta that Rule 10b-5 requires that the government prove causation in insider trading prosecutions. For example, in *O'Hagan*,¹⁵⁷ the Court implied that a prosecutor must prove that an insider *actually used* the information in order to secure a conviction, stating that "[u]nder the 'traditional' or 'classical theory' of insider trading liability, [section] 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation *on the basis of* material, non[-]public information."¹⁵⁸ Similarly, the Court has referred to the duty of an insider not to trade *based on* inside information in several other cases.¹⁵⁹ However, in each of these cases, the Supreme Court was presented with fact patterns in which "there was no question that the material [and] non[-]public information was actually used in trading."¹⁶⁰ Therefore, it is unclear whether the Court intended these statements to endorse an "actual use" standard. On the contrary, the Court's statements could be interpreted as merely communicating the Court's belief that the particular defendant's actions (i.e., trading *on the basis of* material and non-public information) were sufficient to impose liability under the insider trading laws.

D. The SEC's Perspective

1. Insider's Duty to "Disclose or Abstain"

The SEC's current position is clear: If an insider trades *while in possession* of material non-public information, he is "taking advantage of his position to the detriment of the public."¹⁶¹ Accordingly, "Rule 10b-5 does not require a showing that an insider sold his securities for the purpose of taking advantage of material non-public information."¹⁶² The Commission's earlier decision in *In re Cady, Roberts & Co.*¹⁶³ also appears to support this position.

Specifically, in *In re Cady, Roberts & Co.* the Commission introduced

157. United States v. O'Hagan, 521 U.S. 642 (1997).

158. *Id.* at 651-52 (emphasis added).

159. See, e.g., *Dirks v. SEC*, 463 U.S. 646, 653 n.10 (1983) (referring to the "duty that insiders owe . . . not to trade *on* inside information") (emphasis added); *Chiarella v. United States*, 445 U.S. 222, 227 (1980) (referring to the unfairness associated with allowing an insider to *take advantage* of confidential information).

160. *SEC v. Adler*, 137 F.3d 1325, 1334 (11th Cir. 1998).

161. *In re Sterling Drug, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 81,570, at 80,298 (Apr. 18, 1978).

162. *Id.* (citation omitted).

163. 40 S.E.C. 907 (1961).

the oft-quoted maxim that one with a fiduciary or similar duty to hold material, non-public information in confidence must either "disclose or abstain" with respect to trading.¹⁶⁴ Although the Commission did not explicitly state that possession of material non-public information was sufficient to sustain a conviction, its requirement that an insider either "disclose or abstain" seems absolute. The Commission stated that "insiders must 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."¹⁶⁵ Since material information, by definition, is information that would affect an investor's investment judgment, it follows that *all* such information held by an insider is subject to the "disclose or abstain" requirement. Further, the Commission did not limit the requirement to trades executed *on the basis* of confidential information. On the contrary, the Commission indicated that "*any* sales by the insider must await disclosure of the information."¹⁶⁶

2. *Weight of Administrative Interpretation*

The Supreme Court has consistently held that when a court interprets an administrative regulation, "the ultimate criterion" is the agency's interpretation of the regulation, which becomes of controlling weight unless that interpretation is "plainly erroneous or inconsistent with the regulation."¹⁶⁷ This position seems to favor judicial deference to the SEC's current interpretation of Rule 10b-5 in favor of a "possession" standard.

In *In re Investors Management Co.*,¹⁶⁸ however, the SEC seemed to favor an "actual use" standard. In that case, the defendant investment advisers, mutual funds, and investment partnerships had received material and non-public information concerning Douglas Aircraft Company (Douglas) from employees of Merrill Lynch (Merrill Lynch),

164. *See id.* at 911.

165. *Id.*

166. *Id.* at 914 (emphasis added). Note that application of the "disclose or abstain" rule may result in an undesired effect. Specifically, forcing an insider to cancel a transaction (i.e., to abstain) when he obtains material and non-public information may have the effect of tipping others (primarily brokers) that new information has come into existence. *See Horwich, supra* note 8, at 1274.

167. *Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410, 414 (1945).

168. 44 S.E.C. 633 (1971).

the prospective underwriter of Douglas securities.¹⁶⁹ Upon receipt of this information, defendants sold a total of 133,400 shares of Douglas stock from existing long positions, which represented virtually all of their holdings of Douglas stock. Additionally, they sold short 21,100 shares, for a total price of more than \$13,300,000.¹⁷⁰ In identifying the requisite elements for the imposition of liability under the securities laws, the Commission included a requirement that “the information *be a factor in [the individual’s] decision* to effect the transaction.”¹⁷¹ While the Commission’s change of heart is not fatal to its current position,¹⁷² it is surely relevant to this Comment’s analysis.¹⁷³

E. Use of SARs as Executive Compensation

It is certainly true that there is “an element of unfairness” associated with “taking from someone the profits he would have achieved (or imposing upon him the loss he would have avoided) when the decision to trade was made without any exploitation of material non[-]public information.”¹⁷⁴ Further, corporate management always has information available to it that could be construed as material and that is not readily available to stockholders or the investing public.¹⁷⁵ Thus, adoption of a “knowing possession” standard would, arguably, have the effect of absolutely forbidding insiders from trading stocks held in their company. Given the significant use of stock options as a means of compensation, this result is unacceptable.¹⁷⁶

The Eleventh Circuit’s recent decision concerning the use of SARs, however, may provide a reasonable alternative.¹⁷⁷ In *Clay*,¹⁷⁸ the defendant, Riverwood International Corporation (Riverwood), had

169. See *id.* at 636-37.

170. See *id.* at 636.

171. *Id.* at 641 (emphasis added).

172. See *NLRB v. Local Union No. 103*, 434 U.S. 335, 351 (1978) (“An administrative agency is not disqualified from changing its mind; and when it does, the courts . . . should not approach the . . . issue *de novo* and without regard to the administrative understanding of the statutes.”).

173. See *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944) (citing “consistency with earlier and later pronouncements” as a relevant consideration in determining the persuasiveness of an agency ruling).

174. Horwich, *supra* note 8, at 1271.

175. See Fleischer, *supra* note 70, at 1288.

176. See Kelly Smith, *America’s Best Company Benefits*, MONEY MAGAZINE, Oct. 1, 1999, at 116, 125 (reporting that seventeen percent of the 350 large, domestic companies surveyed in 1999 had granted stock options to fifty percent or more of their staffs).

177. See *supra* Part II.D.2.

178. *Clay v. Riverwood Int’l Corp.*, 157 F.3d 1259 (11th Cir. 1998), *vacated*, 176 F.3d 1381 (11th Cir. 1999).

granted a specified number of SARs as part of senior management benefits.¹⁷⁹ Under the terms of the SARs agreement, Riverwood officers would receive payment from the company treasury equal to the difference between the grant price of the SARs and the fair market value of Riverwood's stock at the time they exercised them.¹⁸⁰ "The agreement further provided that the SARs (1) did not contain any stockholder rights; (2) were not options or offers to sell stock; and (3) could not be sold, assigned, or otherwise transferred."¹⁸¹

On September 21, 1995, when the value of Riverwood's stock reached \$25.25 per share, "Riverwood officers exercised many of their SARs, collectively receiving over \$7,000,000 in cash."¹⁸² The court assumed that these trades were made on the basis of material and non-public information.¹⁸³ Rather, in rejecting the plaintiff's contention that the officers had violated the insider trading laws, the court held that the SARs, which entitled the corporate officers to cash payment rather than corporate stock, were not securities subject to the "disclose or abstain" insider trading laws.¹⁸⁴

As previously discussed in Part II.D.2, on petition for rehearing, the Eleventh Circuit vacated that portion of its opinion in which it held that the SARs at issue were not subject to federal insider trading laws on the grounds that Clay lacked standing.¹⁸⁵ However, given that this case was one of first impression in the federal courts, the Eleventh Circuit's thorough and well-reasoned opinion provides valuable guidance. Specifically, by structuring a SAR agreement materially similar to the one at issue in *Clay*, a company may be able to obtain the benefit of a traditional stock option plan (i.e., tying executive compensation to the company's market performance) without exposing corporate officers to the potential liability associated with insider trading laws. Given the possibility of this alternative, the concern that a "knowing possession" standard would entirely preclude insiders from trading in their company's stock loses some force.¹⁸⁶

179. *See id.* at 1261.

180. *See id.*

181. *Id.*

182. *Id.* at 1262.

183. *See id.* at 1264.

184. *See id.* at 1267.

185. *See Clay v. Riverwood Int'l Corp.*, 176 F.3d 1381 (11th Cir. 1999).

186. Presumably, the cost to the company of issuing a cash value SAR would approximate the cost of issuing a stock option. In the case of a stock option, the company "grants" the executive company stock held in the company treasury. The

F. Burden of Proof

The most persuasive argument cited in favor of the “knowing possession” standard concerns the difficulty associated with proving that an insider has acted on the basis of material non-public information, as “the motivations for the trader’s decision to trade are . . . peculiarly within the trader’s knowledge.”¹⁸⁷ Thus, as a matter of policy, 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.”¹⁸⁸ The difficulty associated with proving the motivations behind an individual’s actions has been a significant factor in shaping the law in several areas, including employment discrimination in violation of title VII of the Civil Rights Act of 1964 (Title VII).¹⁸⁹

1. Use of Burden Shifting in Employment Law

With respect to employment discrimination in violation of Title VII, courts have acknowledged that “[t]here will seldom be ‘eyewitness’ testimony as to the employer’s mental processes.”¹⁹⁰ In order to overcome this obstacle, the Supreme Court has adopted an initial rebuttable presumption in favor of the plaintiff.¹⁹¹ Thus, in *McDonnell Douglas Corp. v. Green*,¹⁹² the Supreme Court indicated that the complainant in a Title VII action carries the initial burden of establishing a prima facie case of racial discrimination.¹⁹³ In Title VII disparate treatment cases,¹⁹⁴ this may be accomplished by showing

- (i) that he belongs to a racial minority; (ii) that he applied and was qualified for a job for which the employer was seeking applicants; (iii) that, despite his qualifications, he was rejected; and (iv) that, after his rejection, the position remained open and the employer continued to seek applicants from persons of

executive makes a profit by selling the appreciated stock for a price in excess of the grant price. In the case of a SAR, the company pays the executive, in cash, the difference between the value of the appreciated stock and the SAR grant price. This payment can be funded by the sale of appreciated company stock held in the company treasury.

187. SEC v. Adler, 137 F.3d 1325, 1337 (11th Cir. 1998).

188. United States v. Teicher, 987 F.2d 112, 121 (2d Cir. 1993).

189. 42 U.S.C. §§ 2000e–2000e-16 (1994 & Supp. III 1997).

190. United States Postal Serv. v. Aikens, 460 U.S. 711, 716 (1983).

191. See *id.* at 714.

192. 411 U.S. 792 (1973).

193. See *id.* at 802.

194. Under Title VII jurisprudence, discrimination claims have been separated into three categories: disparate treatment, mixed motive, and disparate impact. The prima facie test varies by type of discrimination claim. See MARK A. ROTHSTEIN & LANCE LIEBMAN, EMPLOYMENT LAW: CASES AND MATERIALS 232-75 (4th ed. 1998).

complainant's qualifications.¹⁹⁵

Once these elements have been established, the burden of production shifts to the employer to "articulate some legitimate, nondiscriminatory reason for the employee's rejection."¹⁹⁶ The complainant must then be provided ample opportunity to show that the employer's stated reasons for rejection were merely pretext (i.e., that the reasons given were intended to cover up what was, in fact, a racially discriminatory decision).¹⁹⁷ Under this scheme, the court must award judgment to the plaintiff as a matter of law at the close of the defendant's case if, based upon the evidence presented, "(1) any rational person would have to find the existence of facts constituting a prima facie case [of discrimination], and (2) the defendant . . . has failed to introduce [any] evidence which, *taken as true*, would *permit* the conclusion that there was a nondiscriminatory reason for the adverse action."¹⁹⁸ The Federal Rules of Evidence provide:

In all civil actions and proceedings not otherwise provided for by Act of Congress or by these rules, a presumption imposes on the party against whom it is directed the burden of going forward with evidence to rebut or meet the presumption, but does not shift to such party the burden of proof in the sense of the risk of nonpersuasion, which remains throughout the trial upon the party on whom it was originally cast.¹⁹⁹

Accordingly, in *Texas Department of Community Affairs v. Burdine*,²⁰⁰ the Supreme Court warned that although the *McDonnell Douglas* presumption shifts the burden of production to the defendant in disparate treatment cases, "The ultimate burden of persuading the trier of fact that the defendant intentionally discriminated against the plaintiff remains at all times with the plaintiff."²⁰¹ Thus, in order to rebut the presumption of discriminatory intent, the defendant is not required to persuade the trier of fact that it was *actually* motivated by the reasons that it has offered

195. *McDonnell Douglas*, 411 U.S. at 802.

196. *Id.*

197. *See id.* at 804. The Court offered several examples of evidence that may be relevant to a showing of pretext, including facts as to the company's treatment of the plaintiff during a prior term of employment, the company's response, if any, to the plaintiff's legitimate civil rights activities, and the company's general policy and practice with respect to minority employment. *See id.* at 804-05.

198. *St. Mary's Honor Ctr. v. Hicks*, 509 U.S. 502, 509 (1993).

199. FED. R. EVID. 301.

200. 450 U.S. 248 (1981).

201. *Id.* at 253.

into evidence.²⁰² Rather, the defendant succeeds in meeting its burden of production by merely putting forth nondiscriminatory reasons for the rejection, irrespective of their persuasive effect.²⁰³ Once the defendant has met its burden, the presumption of discriminatory intent disappears.²⁰⁴

In deciding the ultimate question of whether the defendant intentionally discriminated against the plaintiff on the basis of race, the trier of fact's disbelief of the nondiscriminatory reasons for rejection offered by the defendant may be considered.²⁰⁵ Further, such disbelief, coupled with the elements of the prima facie case, may suffice to support a finding of discriminatory intent.²⁰⁶ However, the mere fact that the factfinder does not believe the reasons for rejection offered by the defendant is not sufficient to sustain a finding of discriminatory intent. Ultimately, the factfinder must be persuaded that the employer has unlawfully discriminated.²⁰⁷

2. *Use of Burden Shifting in Civil Insider Trading Cases*

In order to compensate for the difficulty inherent in requiring that a plaintiff prove a causal connection between an insider's possession of material non-public information and his decision to trade, a presumption similar to that used in employment discrimination cases could be applied in insider trading cases. This is the approach taken by the Eleventh Circuit Court in *Adler*.²⁰⁸ Specifically, the *Adler* court held that in a civil enforcement action against investors for alleged insider trading violations, the complainant carries the initial burden of establishing a prima facie case by producing evidence that the insider traded while in possession of material non-public information.²⁰⁹ Once the complainant has met this burden, "a strong inference arises that such information was used by the insider in trading."²¹⁰ The insider can attempt to rebut this inference by producing evidence that the trade was not motivated by the information (e.g., by producing evidence that the trade was made pursuant to a pre-existing plan).²¹¹ Finally, the factfinder must weigh all of the evidence and make a finding of fact as to whether the information

202. See *id.* at 254.

203. See *St. Mary's Honor Ctr.*, 509 U.S. at 510-11.

204. See *id.*

205. See *id.* at 511.

206. See *id.*

207. See *id.*

208. See *supra* Part II.E.3.

209. See *SEC v. Adler*, 137 F.3d 1325, 1337 (11th Cir. 1998).

210. *Id.*

211. See *id.*

was used in violation of the law.²¹²

Although the *Adler* court did not explicitly state whether its presumption had the effect of shifting the burden of production or the burden of persuasion to the defendant, we must assume, given the absence of an Act of Congress providing otherwise, that the court intended to comply with the Federal Rules of Evidence.²¹³ Therefore, in applying the *Adler* presumption, it is imperative that courts remember that “[t]he ultimate burden of persuading the trier of fact . . . [must] remain[] at all times with the plaintiff.”²¹⁴ Accordingly, as the Court indicated in *St. Mary’s Honor Center v. Hicks*,²¹⁵ the mere fact that the factfinder does not believe the reasons offered by the defendant is not sufficient to sustain a judgment in favor of the plaintiff.²¹⁶ The factfinder must be persuaded that the insider has unlawfully engaged in insider trading in order to render judgment against him.

3. Use of Burden Shifting in Criminal Insider Trading Cases

It is unclear whether the *Adler* presumption could be constitutionally applied in criminal insider trading actions. The Fifth Amendment carries a guarantee: “No person shall be . . . deprived of . . . liberty . . . without due process of law”²¹⁷ Accordingly, the Supreme Court has held that with respect to criminal actions, any presumption which conflicts with the “overriding presumption of innocence with which the law endows the accused” will be rejected on constitutional grounds.²¹⁸ Further, the Court has indicated that since conclusive (or mandatory) presumptions have the effect of invading the fact-finding function, they suffer from constitutional infirmities.²¹⁹ Likewise, “A presumption

212. *See id.*

213. As discussed *supra* Part III.E.1, the Federal Rules of Evidence provide:

In all civil actions and proceedings *not otherwise provided for by Act of Congress* or by these rules, a presumption imposes on the party against whom it is directed the burden of going forward with evidence to rebut or meet the presumption, but does not shift to such party the burden of proof in the sense of the risk of nonpersuasion, which remains throughout the trial upon the party on whom it was originally cast.

FED. R. EVID. 301 (emphasis added).

214. *Texas Dep’t of Community Affairs v. Burdine*, 450 U.S. 248, 253 (1981).

215. 509 U.S. 502 (1993).

216. *See id.* at 511.

217. U.S. CONST. amend. V.

218. *Morissette v. United States*, 342 U.S. 246, 275 (1952).

219. *See Sandstrom v. Montana*, 442 U.S. 510, 521-23 (1979).

which, although not conclusive, ha[s] the effect of shifting the burden of persuasion to [the] petitioner, would . . . suffer[] from similar infirmities.”²²⁰

In reliance upon such statements, the Ninth Circuit Court of Appeals in *Smith*²²¹ indicated that since it was faced with a criminal prosecution (as opposed to a civil enforcement proceeding) it was not at liberty, as was the *Adler* court, to establish an evidentiary presumption giving rise to an inference of use.²²² The court may have been a bit hasty in its conclusion. In *County Court v. Allen*,²²³ the Supreme Court reasoned that unlike a mandatory or conclusive presumption, a permissive inference or presumption “leaves the trier of fact free to credit or reject the inference and does not shift the burden of proof.”²²⁴ Thus, “it affects the application of the ‘beyond a reasonable doubt’ standard only if, under the facts of the case, there is no rational way the trier could make the connection permitted by the inference.”²²⁵ Based upon this finding, the Court upheld the constitutionality of a New York trial judge’s instructions to the jury that “[t]he presence in an automobile, other than a stolen one or a public omnibus, of any firearm . . . is presumptive evidence of its possession by all persons occupying such automobile at the time such weapon . . . is found.”²²⁶

Although the Court initially indicated that the type of presumption applied in *Adler* (i.e., a presumption that “shift[s] the burden of production to the defendant, following the satisfaction of which the ultimate burden of persuasion returns to the prosecution”) would traditionally be classified as a “mandatory” presumption,²²⁷ it later stated that “[t]o the extent that a presumption imposes an extremely low burden of production [on the defendant]—e.g., being satisfied by ‘any’ evidence—it may well be that its impact is no greater than that of a permissive inference, and it may be proper to analyze it as such.”²²⁸ Further, application of a permissible presumption to criminal insider trading actions would not fail the “rational connection” test, as there is a “rational connection [between the use and possession of confidential information] which is more likely true than not.”²²⁹

Thus, it appears that so long as courts are careful to (1) thoroughly

220. *Id.* at 524.

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

222. *See id.* at 1069.

223. 442 U.S. 140 (1979).

224. *Id.* at 157.

225. *Id.*

226. *Id.* at 142-43 n.1 (quoting N.Y. PENAL LAW § 265.13(3) (McKinney 1967)).

227. *Id.* at 157-58 n.16.

228. *Id.*

229. Horwich, *supra* note 8, at 1278.

instruct the jury that they may, *but are not required to*, infer the elemental fact (i.e., actual use of the confidential information) from proof by the prosecutor of the basic one (i.e., possession of the confidential information), and (2) limit the defendant's burden of production, the presumption applied in *Adler* would pass constitutional muster even in the criminal insider trading context.

IV. CONCLUSION

As this Comment indicates, insider trading law remains unsettled and persuasive arguments are cited on all sides. The large majority of cases clearly require a showing of a causal connection between the information and the insider's decision to trade. However, there is a conflict among these cases about whether an inference of use arises upon proof of possession.

To date, the use of a presumption to establish a causal connection between an insider's possession of material non-public information and his decision to trade has been recognized in only a small number of cases. This is unfortunate, as this approach seems to provide a fair alternative, in both civil and criminal contexts, to dealing with alleged violations of the securities laws. Application of a presumption is consistent with the plain language of section 10(b) and Rule 10b-5, which seem to favor an "actual use" standard. Further, in lieu of assigning the complainant the potentially insurmountable task of proving that the defendant traded on the basis of or because of material non-public information, it provides the complainant with the benefit of a strong inference of use upon proof of possession. Moreover, the inference created by proof of possession establishes a *prima facie* case of insider trading sufficient to withstand summary judgment. Despite this, application of the presumption is inherently fair to the defendant, as it permits him to rebut the inference by merely introducing evidence of a pre-existing plan to dispose of the stock, thus guaranteeing him the benefit of trades which were not influenced by his receipt of confidential information.

Thus, the issue presented in this Comment should be resolved by the legislative adoption of an initial rebuttable presumption in favor of the complainant.

TERI E. O'BRIEN

