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UNITED STATES v. SMITH: THE USE-POSSESSION DEBATE IN SEC ENFORCEMENT ACTIONS UNDER § 10(b)

Oriana N. Li

Abstract: The U.S. Supreme Court has yet to address an underlying issue in the evolution of insider trading law: whether Rule 10b-5 liability should attach when someone trades while "in the possession of" material, nonpublic information, or whether a more stringent standard of having actually used or traded "on the basis of" such information must be met. In United States v. Smith, the Court of Appeals for the Ninth Circuit held that a violation of Rule 10b-5 requires an actual causal connection between the possession of inside information and the decision to trade in securities. This Note argues that the court erred in dismissing the knowing possession standard in favor of adopting an actual use standard. Although a causal connection between inside information and trading is an element of the Rule 10b-5 offense, this Note argues that knowing possession alone sufficiently satisfies the scienter and "to use and employ" elements of § 10(b) to establish the causal connection. The knowing possession standard finds support in the statutory interpretation of § 10(b), analogous anti-fraud provisions, judicial and administrative precedent, and the policy objective of achieving an honest securities market through full disclosure of material nonpublic information.

The use-possession debate centers on whether an insider trading conviction under § 10(b) of the 1934 Securities Exchange Act (Exchange Act)1 and Rule 10b-5,2 promulgated thereunder, requires the Securities and Exchange Commission (SEC) to prove both that the defendant was in knowing possession of material nonpublic information4 and actually

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1. 15 U.S.C. § 78j(b) (1994). Section 10(b), the central anti-fraud provision of the Securities Exchange Act of 1934, provides:
   It shall be unlawful for any person... [to] 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.


2. 17 C.F.R. § 240.10b-5 (1998). Rule 10b-5 provides that:
   It shall be unlawful for any person, directly or indirectly... (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... 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.

17 C.F.R. § 240.10b-5.

3. This Note assumes the uniform standard of materiality under § 10(b) as adopted by the U.S. Supreme Court in Basic, Inc. v. Levinson, which held that a fact is material if there is a substantial likelihood that a reasonable investor would consider it as altering the total mix of information in deciding whether to buy or sell. 485 U.S. 224, 240 (1988).

4. This Note uses "material nonpublic information" and "inside information" interchangeably.
used that information in trading, or whether possession alone suffices. A trilogy of recent appellate decisions indicates that the circuits are split on this issue in the context of the SEC’s civil and criminal enforcement actions against individuals. The majority of commentators favor an actual use standard in determining § 10(b) liability. A clear resolution of the issue is necessary to enable the SEC to carry out its enforcement mandate and to guide attorneys in advising clients on how to refrain from illegal trading.

This Note argues that the debate hinges on the definitions of scienter and use because the key inquiries in choosing a standard are the level of scienter required to establish deception under § 10(b) and what type of use or misuse of inside information sufficiently satisfies scienter. It further argues that the knowing possession standard satisfies the § 10(b) deception element under any of the three culpability requirements that encompass scienter because to establish that the defendant intended, knew of, or was reckless in misusing inside information, the SEC need only prove that the defendant withheld disclosure in one of these ways in breach of a fiduciary duty. This Note concludes that gaining profits or avoiding losses through deceptive nondisclosure and illegal acquisition of inside information satisfies the scienter requirement and constitutes affirmative uses that give rise to § 10(b) liability.

Part I of this Note provides an overview of the use-possession debate by examining recent circuit court decisions on the subject, including the Ninth Circuit’s decision in United States v. Smith. Part II argues that the Ninth Circuit erred in applying an actual use standard and that the knowing possession standard better comports with the language of § 10(b) and judicial and administrative interpretation of that language. The application of the requirements of the common law action of deceit in the federal securities context and the classic and misappropriation theories of insider trading all support the knowing possession standard. Such a standard establishes the requisite causal connection between inside information and trading because knowing possession, as one form

5. All are issues of first impression for the respective circuits. See infra Part I.
7. 155 F.3d 1051 (9th Cir. 1998).
of misuse of such information in breach of a fiduciary duty, is sufficient to satisfy the scienter requirement. Part III further argues that because the knowing possession standard honors legislative intent to achieve a fair and honest securities market by eliminating unnecessary evidentiary hurdles to SEC enforcement efforts, courts must defer to the SEC's preference for the standard.

I. CIRCUITS ARE SPLIT ON THE USE-POSSESSION DEBATE

In United States v. Smith, the Ninth Circuit echoed the Eleventh Circuit's holding in SEC v. Adler\(^8\) that proof of knowing possession of insider information while trading is insufficient to impose liability under § 10(b).\(^9\) The Smith and Adler courts both rejected the Second Circuit's widely commented\(^10\) dicta in United States v. Teicher,\(^11\) which suggested that knowing possession is the better standard. This trilogy shows the split of authority among the circuits and creates uncertainty in the effective enforcement of insider trading regulations under § 10(b).

A. United States v. Teicher: The Knowing Possession Standard

The use-possession debate first surfaced in Teicher.\(^12\) The defendants were arbitrageurs who had profited by trading while in possession of material nonpublic information misappropriated by their tippers—insiders from a law firm and a brokerage firm who had access to confidential client information.\(^13\) They contended on appeal that the district court had erroneously instructed the jury that the SEC need not

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8. 137 F.3d 1325.
9. United States v. Smith, 155 F.3d 1051 (9th Cir. 1998).
10. See, e.g., Horwich, supra note 6, at 1250 (recognizing that Teicher "devoted considerable attention" to possession-use debate in its "admittedly dictum" ruling in favor of possession standard); Martin Flumenbaum & Brad S. Karp, Insider Trading, Nat'l L.J., Mar. 24, 1993, at 3, 27 (concluding that by eliminating causation requirement, Teicher "may greatly increase the scope of both criminal and civil liability for insider trading" and predicting that more criminal prosecutions and civil litigations will "test the contours of the court's Teicher ruling"); Harvey L. Pitt & Karl A. Grosskaufmanis, Actual Use of Inside Information at Issue, Nat'l L.J., June 21, 1993, at 20, 20 (observing that impact of Teicher's "broad articulation of a possession standard," albeit in dicta, will be "felt most profoundly not in litigation but in the day-to-day efforts by market participants . . . to avoid trades that, in hindsight, cross the murky line into illegality").
11. 987 F.2d 112, 121 (2d Cir. 1993) (finding it "unnecessary to determine whether proof of securities fraud requires a causal connection" because there was ample evidence that defendants used inside information).
12. Id.
13. Id. at 114–15.
prove a causal relationship between their trading and the misappropriated information. They further contended that to establish causal connection through actual use, the government must prove that the trade was not conducted "on an independent and proper basis." The SEC countered that liability arises under § 10(b) and Rule 10b-5 when trading is conducted in "knowing possession" of inside information "obtained in breach of a fiduciary or similar duty." In affirming the criminal convictions, the Second Circuit concluded that a person who traded while possessing information known to be material, nonpublic, and fraudulently obtained must have traded on the basis of that information.

Teicher enunciated three reasons why proof of knowing possession is sufficient to sustain an insider trading prosecution. First, 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." This clause must be construed flexibly. Second, the knowing possession standard better comports with the principle that one with a fiduciary or similar duty to hold material nonpublic information in confidence must either disclose the information before trading, or abstain from trading. Third, as a matter of policy and pragmatism, a knowing possession standard avoids the evidentiary difficulty of establishing a causal connection.

B. SEC v. Adler: The Actual Use Standard

SEC v. Adler addressed the causal connection issue head-on. The principal defendant was a corporate director who avoided losses by selling his corporate stock upon learning of unreleased, adverse earnings projections and accounting fraud. The Eleventh Circuit provided four

14. Id. at 119.
15. Id.
16. Id. at 120 (citing Sterling Drug Inc. Investigation, Exchange Act Release No. 14,675, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,570, at 80,298 (Apr. 18, 1978) ("The Commission also believes that [under] Rule 10b-5 . . . . [i]f 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.").
17. Id. at 121.
18. Id. at 120.
19. Id.
20. Id. (citing United States v. Newman, 664 F.2d 12, 18 (2d Cir. 1981)).
21. Id. (citing Chiarella v. United States, 445 U.S. 222, 227 (1980)).
22. Id. at 120–21.
23. 137 F.3d 1325 (11th Cir. 1998).
24. Id. at 1327–29.
reasons in support of its holding that knowing possession of material nonpublic information while trading is not a per se violation of insider trading laws and that the defendant may present evidence to rebut any reasonable inference of scienter. First, the inference of use from possession overcomes evidentiary difficulties. Second, the actual use standard comports better with the language of § 10(b), Rule 10b-5, and Supreme Court authority that has emphasized that the focus in determining § 10(b) liability is on deception and fraud. Third, trading with material nonpublic information does not “always and inevitably” constitute a breach of the duty to disclose or abstain. Lastly, Adler declined to defer to the SEC’s preference for the knowing possession standard because the SEC had not been consistent on the issue.

C. Smith Follows Adler in Favor of an Actual Use Standard

In United States v. Smith, the Ninth Circuit invoked the actual use standard to affirm a criminal insider trading conviction. The defendant, Smith, was an insider who sold his corporate stock holdings upon learning of unreleased, adverse earnings projections from conversations with corporate officers. Smith contended on appeal that the district court had erroneously instructed the jury that he could be convicted based upon his possession, as opposed to his use, of inside information. The SEC countered that the jury instruction had generously exceeded the requirements of existing law for two reasons. First, there is no causation element to an insider trading prosecution. Second, § 10(b) liability

25. Id. at 1337.
26. Id. at 1337–38. Under the inference of use rule, the insider can produce rebuttal evidence to show that there was no causal connection between the information and the trade. The fact-finder then weighs all evidence to determine whether inside information was actually used. See infra Part III.B.
27. Adler, 137 F.3d at 1338.
29. Id. (citing Cady, Roberts & Co., 40 S.E.C. 907, 916 (1961)); id. at 1333 (citing Chiarella, 445 U.S. at 226–28) (stating that duty to disclose or abstain derives from fiduciary duty that corporate insiders owe to corporate shareholders not to take advantage of inside information by trading without disclosure).
30. Id. at 1339.
31. 155 F.3d 1051 (9th Cir. 1998).
32. Id. at 1053.
33. Id. at 1055.
34. Id. at 1066.
35. Id.
arises when an insider like Smith trades in his company stock while possessing corporate information "that he knows (or is reckless in not knowing) to be material and nonpublic," whether or not the inside information is a factor in the decision to trade.\textsuperscript{36}

In holding that Rule 10b-5 requires the SEC to prove actual use of inside information in consummating a trade, the Smith court concluded that authority better supported the Adler court's arguments in favor of the actual use standard.\textsuperscript{37} In particular, the Smith court emphasized that Supreme Court dicta and lower court precedent suggest that Rule 10b-5 requires the SEC to prove causation in insider trading prosecutions.\textsuperscript{38} The court concluded that a violation of Rule 10b-5 arises only when there is "intentional or willful conduct designed to deceive,"\textsuperscript{39} and that it is the use rather than the possession of inside information that gives rise to the requisite intent to defraud.\textsuperscript{40}

D. Summary

Smith's criticism of Teicher's possession standard and adoption of Adler's actual use standard further polarized the debate without weighing the key question of whether possession of inside information is alone sufficient proof of the scienter element of § 10(b)'s deception requirement. Inherent in the holdings of Adler and Smith is the courts' conclusion that proof of scienter requires both possession and actual use of inside information when consummating a trade. By contrast, Teicher suggested that trading while in knowing possession of fraudulently obtained inside information

\textsuperscript{36} Id.

\textsuperscript{37} Id. at 1067–68 (agreeing with Adler's analysis that SEC's position on causation has "fluctuated over time") (citing SEC v. Adler, 137 F.3d 1325, 1336 (11th Cir. 1998)). The Smith court agreed with Adler that a "use" requirement is more consistent with the language of § 10(b) and Rule 10b-5, which emphasizes manipulation, deception, and fraud. Id. at 1068. Specifically, the Smith court criticized the Second Circuit's focus on the phrase "in connection with" in Teicher as misplaced because the "main thrust" of Rule 10b-5 is not just to prohibit certain acts "in connection with" transactions in securities, but rather to prohibit the employment of "manipulative" and "deceptive" trading practices in connection with those transactions. Id. Moreover, the Smith court reasoned that, because Cady, Roberts's "disclose or abstain" maxim aimed to effectuate congressional intent in enacting the Securities Exchange Act by eliminating the use of inside information for personal advantage, the latter half of the maxim does not enjoin all trading but only trading that is conducted on the basis of insider information. Id. at 1069 (citing Cady, Roberts & Co., 40 S.E.C. 907, 912 n.15 (1961)).

\textsuperscript{38} Id. at 1067–69.

\textsuperscript{39} Id. at 1068 (quoting Dirks v. SEC, 463 U.S. 646, 663 n.23 (1983)).

\textsuperscript{40} Id.
information is sufficient to satisfy scienter and refute good faith by concluding that any alleged defects in the jury instruction defining “use” as the “equivalent of mere possession” were “harmless beyond doubt.”

II. STATUTORY INTERPRETATION SUPPORTS THE KNOWING POSSESSION STANDARD

Answering the key question of whether reckless, knowing, or intentional conduct in failing to disclose inside information in one’s possession satisfies scienter requires an analysis of the § 10(b) statutory interpretation of “any,” “in connection with,” “fraud,” and “to use and employ.” Four major sources of authority on statutory interpretation support the knowing possession standard. First, judicial and administrative interpretation, which are almost entirely responsible for the development of the federal law of insider trading, help illuminate the broad scope of prohibitions. The common law action of deceit also supports a flexible interpretation of § 10(b). Second, deceptive nondisclosure of material nonpublic information in one’s possession gives rise to fraud or manipulation under both the classic and misappropriation theories of insider trading. Third, inherent in the process of illegally acquiring, misappropriating, or withholding inside information lies the requisite scienter to defraud, defined by the federal courts and at common law to include all three mental states. A synthesis of these first three sources of authority refutes Smith’s interpretation of Supreme Court dicta as requiring an exclusive use of inside information to establish the causal connection element. Lastly, the “in possession of” language and the legislative history of an analogous anti-fraud provision explicitly supports the knowing possession standard.

42. Id. at 119.
43. Id. at 121.
44. 15 U.S.C. § 78j(b) (1994); see also supra note 1.
46. See Chiarella v. United States, 445 U.S. 222, 230 (1980) (noting that silence in connection with purchase or sale of securities may operate as fraud under § 10(b) despite absence of statutory language addressing issue).
A. The Supreme Court Has Held that § 10(b) Should Be Interpreted Flexibly

The Supreme Court has held that the anti-fraud provisions of federal securities laws should be construed "not technically and restrictively, but flexibly to effectuate [their] remedial purposes." 47 A very recent example of the Court's liberal construction of § 10(b) is United States v. O'Hagan, where in response to the split among the circuits regarding the validity of the misappropriation theory, 48 the Court endorsed the misappropriation theory of liability. 49 The Court reasoned that the misappropriation theory comports with the statutory language that requires deception "in connection with the purchase or sale of any security," rather than deception of identifiable purchasers or sellers. 50 O'Hagan is important to the use-possession debate because it supports the knowing standard, which recognizes that because the multiple uses of information include its misappropriation and nondisclosure, knowing possession is both a necessary and a sufficient condition in giving rise to § 10(b) liability.

1. Judicial and Administrative Interpretation

The starting point of statutory construction is the statutory language itself. 51 Section 10(b) bans the use of any deceptive device in the purchase or sale of any security by any person. 52 This sweeping proscription of fraudulent and deceptive practices must be read broadly because of the "any person" language preceding the "in connection with" phrase. 53 This open language indicates that congressional concern was not limited to corporate insiders, 54 a view that finds support in the seminal administrative

48. See infra note 71 and accompanying text.
50. Id. at 2210; cf. id. at 2225–26 (Thomas, J., concurring in part and dissenting in part) (refusing to adopt dissent's narrow statutory construction of "in connection with," which would have required SEC to prove that sole use for undisclosed misappropriated information was for directly consummating securities transaction).
52. 15 U.S.C. § 78j(b) (1994); see also supra note 1.
53. See, e.g., United States v. Newman, 664 F.2d 12, 18 (2d Cir. 1981) (adopting broad "touch" test enunciated by Supreme Court where phrase "in connection with" was flexibly construed to include deceptive practices "touching" the sale of securities).
54. See, e.g., O'Hagan, 117 S. Ct. at 2207 (extending § 10(b) liability to corporate "outsiders" through misappropriation theory).
Use-Possession Debate Under § 10(b)

case of Cady, Roberts, which held "any person" to mean that the class of persons who has the duty to disclose or abstain includes "anyone" who misuses corporate information for personal benefit. Because the repeated use and plain meaning of the word "any" evidences legislative intent to draft an inclusive and broad rule, it supports a broader knowing possession standard.

2. Federal Courts Have Modified the Application of the Requirements of the Common Law Action of Deceit in the § 10(b) Context

Because the legislative history of § 10(b) sheds little light on the individual substantive elements of an insider trading action, the common law backdrop is particularly relevant in determining the proper interpretive scope of the statute. Many jurisdictions agree that the elements of Rule 10b-5 actions involving misrepresentations or omissions generally mirror the elements of the common law tort action of deceit, upon which the Rule 10b-5 action is based. The Supreme Court has explicitly analogized the elements of an offense under § 10(b) and Rule 10b-5 to those of the common law of deceit, which consist of (1) false representation, (2) fraudulently made, (3) with the intention of inducing another to justifiably rely thereon, and that (4) causes damage. However, because Congress intended to remedy deficiencies in the common law by enacting federal securities regulation and because the modern securities

55. Cady, Roberts & Co., 40 S.E.C. 907 (1961). In this first government prosecution of insider trading, the SEC established that the duty to disclose or abstain stems from both a fiduciary relationship “giving access . . . to information intended to be available only for a corporate purpose and not for the personal benefit of anyone,” as well as a result of the “inherent unfairness” of using confidential information for personal advantage, and that tippees assume a tipper’s fiduciary obligation to shareholders to disclose or abstain from trading in the corporation’s securities. Id. at 912.


58. See, e.g., Lucas v. Florida Power & Light Co., 765 F.2d 1039, 1040 (11th Cir. 1985) (stating that elements of rule 10b-5 action are “(1) a misstatement or an omission; (2) of material fact; (3) made with scienter; (4) on which the class reasonably relied; (5) which proximately caused the class’ injury”); Bloor v. Carro, Spanbock, Lendin, Rodman & Fass, 754 F.2d 57, 61 (2d Cir. 1985) (holding that 10b-5 claims require that plaintiff allege that, “in connection with the purchase or sale of securities, the defendant, acting with scienter, made a false material representation or omitted to disclose material information and that plaintiff’s reliance on defendant’s actions caused him injury”).


60. 2 Fowler V. Harper et al., The Law of Torts § 7.1, at 381 (2d ed. 1986) (citing Restatement (Second) of Torts § 525 (1977)).
markets do not resemble the face-to-face transactions typical of the common law deceit action, courts have modified their application of the common law to Rule 10b-5.⁶¹

For example, the federal courts have relaxed the common law requirements of reliance and causation, two concepts that have been used interchangeably in the context of Rule 10b-5.⁶² The Supreme Court has ruled that, where circumstances primarily involve an omission of material information, positive proof of reliance on the part of the plaintiff is not necessary to establish the causal connection.⁶³ This has removed a "stumbling block for extending the common law duty of fiduciary disclosure to open-market trading cases."⁶⁴ However, it is important to distinguish the concept of causation defined at common law from that defined in SEC enforcement actions. At common law, proof of causation is necessary for plaintiffs to recover losses suffered in reliance on an insider’s nondisclosure in private § 10(b) actions. In SEC enforcement actions, proof of causation is necessary to show that the defendant profited from reliance on the undisclosed information. The use-possession debate focuses on the latter.

B. Deceptive Nondisclosure in Breach of Fiduciary Duty Constitutes Fraud Under the Classic and the Misappropriation Theories

Deception and manipulation are key elements of a § 10(b) offense.⁶⁵ Even though the courts have repeatedly stated that the anti-fraud provisions of the Exchange Act are not limited to circumstances that would give rise to a common law action for deceit, they have traditionally declined to define fraud with specificity.⁶⁶ Fraudulent uses of confidential information fall within the purview of § 10(b)’s prohibition if the fraud is

⁶¹ See, e.g., SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 192 (1963) (rejecting technical interpretation of “fraud or deceit” as requiring common law proof of intent to injure and actual injury); Freeman v. Decio, 584 F.2d 186, 191 (7th Cir. 1978) (observing that “[j]udicial development of a private right of action under [Rule 10b-5] has led to significant relaxation of many of the elements of common law fraud, including privity, reliance, and the distinction between misrepresentation and non-disclosure”); 2 Harper et al., supra note 60, § 7.13, at 464–65; infra notes 62–64, 66, 114, 115 and accompanying text.

⁶² Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 239 (2d Cir. 1974).


⁶⁴ Langevoort, supra note 45, at 18.


⁶⁶ Loss & Seligman, supra note 6, at 3429–30.
in connection with” any securities transaction.\textsuperscript{67} The Supreme Court has held that without a predicate breach of fiduciary duty, there can be no underlying fraud within the meaning of § 10(b).\textsuperscript{68} A breach of fiduciary duty without any deception, misrepresentation, or nondisclosure, however, does not violate § 10(b) or Rule 10b-5\textsuperscript{69} because Congress did not intend to “prohibit any conduct not involving manipulation or deception.”\textsuperscript{70} Therefore, the Supreme Court has held that a breach of fiduciary duty involving nondisclosure constitutes deception under § 10(b). While the classic insider trading theory is predicated on the breach of fiduciary duty by the insider in failing to disclose inside information to the shareholders of a corporation, the misappropriation theory predicates liability “on a fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information.”\textsuperscript{71}

1. The Knowing Possession Standard Comports with the Disclose or Abstain Premise of the Classic Insider Trading Theory

The classic theory of insider trading found its conceptual underpinnings in \textit{Chiarella v. United States}.\textsuperscript{72} In that case, the Supreme Court held that, as a matter of statutory construction, the duty to disclose under § 10(b) does not arise from the “mere possession” of nonpublic information because the “catchall provision” of § 10(b) must catch fraud\textsuperscript{73} and not every instance of financial unfairness constitutes such fraud.\textsuperscript{74} The Court relied on administrative\textsuperscript{75} and judicial interpretations\textsuperscript{76} to conclude

\begin{itemize}
\item \textsuperscript{67} United States v. O’Hagan, 117 S. Ct. 2199, 2209 (1997).
\item \textsuperscript{68} See, e.g., id. at 2207; Chiarella v. United States, 445 U.S. 222, 231 (1980).
\item \textsuperscript{69} \textit{Santa Fe Indus.}, 430 U.S. at 476 (holding that unfairly low valuation price that was fully disclosed could not amount to fraud unless disclosure was misleading). Because 10b-5 does not cover allegations of corporate mismanagement unless the shareholder can point to inadequate disclosure or manipulation of stock prices through deception, the court in \textit{Santa Fe Industries} was reluctant to extend 10b-5 into the province of state law regarding corporate mismanagement. \textit{Id.} at 479.
\item \textsuperscript{70} \textit{Id.} at 473.
\item \textsuperscript{71} \textit{O’Hagan}, 117 S. Ct. at 2207.
\item \textsuperscript{72} 445 U.S. 222.
\item \textsuperscript{73} \textit{Id.} at 235.
\item \textsuperscript{74} \textit{Id.} at 232–33 (citing \textit{Santa Fe Indus.}, 430 U.S. at 474–77). The \textit{Chiarella} court thus rejected the parity of information theory because that theory assumes that all unequal access to material nonpublic information constitutes fraud. \textit{Id.} at 233.
\item \textsuperscript{75} \textit{Id.} at 226–27 (citing Cady, Roberts & Co., 40 S.E.C. 907 (1961)); see also supra note 55.
\item \textsuperscript{76} \textit{Id.} at 229 (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc) (finding violations of § 10(b) where corporate insiders used undisclosed information for their own benefit); Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972) (holding officers of

405
that the duty to disclose or abstain arises from fiduciary or other relationships of "trust and confidence." Further, the Court noted that at common law a tippee's duty to disclose or abstain arises from his "role as a participant after the fact in the insider's breach of a fiduciary duty." 

In *Dirks v. SEC*, the Court held that a tippee assumes a fiduciary duty to the corporate shareholders not to trade on inside information only when: (1) the insider-tipper has breached his fiduciary duty to the shareholders not to disclose the information, and (2) the tippee knows or has reason to know that the insider tipper had improperly disclosed the information. Although the decision turned in part on whether the insider's purpose in making disclosure was fraudulent, the Court stressed that in first determining whether there has been a breach of duty by the insider, the SEC and the courts are not required to read the parties' minds, but rather to focus on "objective criteria" such as whether the insider received a direct or indirect personal benefit from the disclosure "that will translate into future earnings." *Dirks* found the tippee not liable because he did not "misappropriate or illegally obtain" the inside information. Neither he nor the tippers personally benefited from the disclosure and thus had not breached their fiduciary duty because they were "motivated by a desire to expose the fraud" and not monetary profit.

In the wake of *Chiarella*, the primary justification for the public disclosure rule became the prevention of unjust enrichment. *Chiarella* and *Dirks* established that mere possession of inside information is no longer sufficient to give rise to insider trading liability under §10(b) because the method of obtaining or using the information must include a breach of a fiduciary duty. The focus on breach of fiduciary duty in defining fraud supports the knowing possession standard, which emphasizes that it is the failure to disclose this information or abstain

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78. *Id.* at 230 n.12.
79. 463 U.S. 646, 660 (1983); *id.* at 661 n.19 (citing Investor Management Co., 444 S.E.C. 633, 641 (1971), where SEC stated that one element of tippee liability is that tippee knew or had reason to know that information "was nonpublic and had been obtained *improperly* by selective revelation or otherwise").
80. *Id.* at 663.
81. *Id.* at 665.
82. *Id.* at 667.
84. *See supra* notes 73–82 and accompanying text.
from trading in violation of a fiduciary duty that makes insider trading fraudulent. Liability arises where the defendant is unjustly enriched after taking advantage of inside information to trade through personal misuse of confidential corporate information. The misuse may well arise from either failing to disclose the inside information in the classic context or improperly acquiring such information in the tippee context.

2. **Focus on Deceptive Nondisclosure Under the Misappropriation Theory Supports the Knowing Possession Standard**

The misappropriation theory, deemed complementary to the classic theory, offers strong support to the less restrictive knowing possession standard by broadening the scope of Rule 10b-5 liability to allow third-party employers who are not defrauded purchasers or sellers to sue for injunctive relief. Legislative history supports O'Hagan's endorsement of the misappropriation theory, which bars trading of information that the "wrongdoer converted to his own use" in violation of some fiduciary duty to the rightful owner of the information. Like Chiarella, O'Hagan did not seek to catch "all conceivable forms of fraud involving confidential information," but rather "fraudulent means of capitalizing on such information through securities transactions." O'Hagan also found support for the misappropriation theory from Dirks by emphasizing that liability arises only if there was an expectation on the part of the information source that the tippee would keep the inside information in confidence and not illegally obtain or misappropriate it in the first place.

Deceptive nondisclosure is essential to § 10(b) liability under the misappropriation theory. For example, in O'Hagan the Court held that

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87. *See*, e.g., *United States v. Newman*, 664 F.2d 12, 17 (2d Cir. 1981) (holding employee-tippers liable for violation of their duty to employer-investment banks and also violation of banks' duty to clients).
88. *See* H.R. Rep. No. 100-910, at 10 (1988) (stating that Committee believes that securities fraud under misappropriation theory should be encompassed within § 10(b) and Rule 10b-5).
90. *See supra* notes 73-74 and accompanying text.
92. *Id.* at 2213 (citing Dirks v. SEC, 463 U.S. 646, 665 (1983)).
93. *Id.* at 2208.
the defendant’s failure to disclose his personal trading to his employer—a law firm representing the tender offeror—and to the tender target was “deceptive” because the misappropriator is guilty of deceiving the principal who reposed confidence and trust in him. Of importance is the Court’s emphasis that full disclosure to the information source of the fiduciary’s intent to trade would necessarily foreclose liability under the misappropriation theory. This suggests that deception is essential to the misappropriation theory.

3. Summary

In the use-possession context, fraud and deception stem from a breach of fiduciary duty in merely failing to disclose inside information in one’s possession while trading. Smith’s rejection of the “possession only” standard was misguided because the standard is one of knowing possession, which retains Chiarella’s and Dirks’s requirement of a predicate breach of fiduciary duty as a sine qua non of disclose or abstain liability. It is clear from Chiarella, Dirks, and O’Hagan that Rule 10b-5 only regulates deception and fraud in breach of a fiduciary duty.

The focus on nondisclosure as a deceptive breach of fiduciary duty supports the knowing possession standard under both the classic and misappropriation theories of insider trading. The application of the knowing possession standard in the misappropriation context is not unduly broad for two reasons. First, as a logical extension of the classic theory, the misappropriation theory retains and extends the duty to disclose or abstain. Second, the misappropriation theory is firmly grounded in the prevention of unjust enrichment by those who gain informational advantage through the unlawful acquisition or use of confidential information. Therefore, both the classic and misappropriation theories support the knowing possession standard by requiring a preexisting fiduciary relationship between the insider and corporate shareholders in the classic context and between the “outsider” tipper and the information source in the misappropriation context.

94. Id.
95. Id.
96. Langevoort, supra note 85, § 3.04, at 3-23.
97. United States v. Smith, 155 F.3d 1051, 1066–67 (9th Cir. 1998).
98. See supra notes 86–87 and accompanying text.
C. Scintar Is Critical to the Use-Possession Debate

Scintar is critical to the use-possession debate because it is an element in proving § 10(b) deception and Rule 10b-5 fraud. The key inquiries are what level of scintar the SEC must prove and whether knowing possession is a type of use that satisfies scintar. The crucial difference between the knowing possession standard and the actual use standard is that the former finds liability under all three levels of culpability whereas under the latter, liability presumably only arises upon a specific finding of intent to defraud, a standard that lacks authoritative support. Analysis of the federal and common law precedent conclusively supports the knowing possession standard because scintar embraces all three mental states showing a lack of good faith. Reckless, knowing, or intentional conduct in withholding, acquiring, or misappropriating inside information each constitutes a different form of affirmative use of that information. Because these uses satisfy the scintar requirement, knowing possession is sufficient to give rise to insider trading liability under § 10(b).

I. Scintar Under the Knowing Possession Standard Embraces the Three Mental States of Reckless, Knowing, and Intentional Conduct

In the federal securities context, it is well-established that liability under § 10(b) and Rule 10b-5 in private actions and enforcement actions requires a showing of scintar on the part of the defendant. While the courts have not offered a clear definition of scintar, it requires some sort of showing of "a mental state embracing intent to deceive, manipulate, or defraud." In Ernst & Ernst v. Hochfelder, the Supreme Court explicitly rejected negligence as sufficient for scintar. Hochfelder's invocation of scintar as an element of a § 10(b) offense that excludes negligence left open the question of whether § 10(b) liability should include a less

100. See infra Part II.C.1.
101. See, e.g., SEC v. MacDonald, 699 F.2d 47, 50 (1st Cir. 1983) (holding that in Rule 10b-5 actions, proof of knowing conduct is sufficient to establish necessary scintar).
102. See, e.g., Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976); see also SEC v. Fehn, 97 F.3d 1276, 1289 (9th Cir. 1996) (holding that scintar is necessary element of insider trading violation).
103. 425 U.S. at 200–01.
104. See id. at 193–94 (recognizing that in certain areas of law recklessness is form of intentional conduct, but concluding that whether reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5 need not be addressed).
demanding culpability standard, such as knowledge or recklessness, than a specific intent to deceive. Following Hochfelder, commentators soon concluded that recklessness satisfied the scienter requirement, and ten of the twelve courts of appeals to decide the question have unanimously reached the same conclusion. Supreme Court and courts of appeals decisions have also concluded that proof of knowing conduct is sufficient to establish scienter.

To the extent that the federal anti-fraud provisions are based on the common law of fraud, the latter authority is “at least as persuasive an advocate of a recklessness as of a strict intent standard.” At common law, the necessity for scienter was difficult to ascertain. The term was defined to mean everything from knowing falsity with an implication of mens rea, through various gradations of recklessness, to negligence or even liability without fault. Importantly, a “watered down scienter”

107. Johnson, supra note 106, at 674 n.22 (listing cases from circuits in numerical order: Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 46–47 (2d Cir. 1978); Sharp v. Coopers & Lybrand, 649 F.2d 175, 193 (3d Cir. 1981); Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961–62 (5th Cir. 1981) (en banc); Maasbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1024 (6th Cir. 1979); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1044–45 (7th Cir. 1977); Van Dyke v. Coburn Enter., 873 F.2d 1094, 1100 (8th Cir. 1989); Nelson v. Serwold, 576 F.2d 1332, 1337 (9th Cir. 1978) (per curiam); Hackbart v. Holmes, 675 F.2d 1114, 1117 (10th Cir. 1982); Woods v. Barnett Bank, 765 F.2d 1004, 1010 (11th Cir. 1985); Dirks v. SEC, 681 F.2d 824, 844–45 (D.C. Cir. 1982), rev'd on other grounds, 463 U.S. 646 (1983)). For another comprehensive list of many other lower courts that have found that Rule 10b-5 liability can be premised on recklessness, see 3 Arnold S. Jacobs, Litigation and Practice Under Rule 10b-5 § 63, at 3-321 to 3-322 (Mar. 1992).
108. See, e.g., Aaron v. SEC, 446 U.S. 680, 686 n.5 (1980) (stating that “scienter” is used throughout this opinion, “as it was” in Hochfelder); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976) (concluding that § 10(b) was intended to proscribe “knowing or intentional conduct”); Nelson v. Serwold, 576 F.2d 1332, 1337 (9th Cir. 1978) (per curiam) (finding that Hochfelder only went so far as to eliminate negligence as basis for liability and agreeing with other courts that have found that Congress intended “ambit of § 10(b) to reach a broad category of behavior, including knowing or reckless conduct”); SEC v. Blatt, 583 F.2d 1325, 1334 (5th Cir. 1978) (“We are confident that ‘knowing’ conduct satisfies the scienter requirement.”).
109. Bucklo, supra note 105, at 230; see also Page Keeton, Fraud: The Necessity for an Intent to Deceive, 5 U.C.L.A. L. Rev. 583, 590 (1958) (citing Derry v. Peek, 14 App. Cas. 337 (1889), which stated that fraud is proved when it is shown that misrepresentation has been made knowingly or “recklessly”).
110. See, e.g., Leon Green, Deceit, 16 Va. L. Rev. 749, 750–52 (1930) (concluding that between two extremes of actual fraud for which scienter was sine qua non, and innocent misrepresentation for which scienter was dispensed altogether, lay wide array of different scienter formulae); Keeton, supra note 109, at 598.
111. Loss & Seligman, supra note 6, at 3424.
Use-Possession Debate Under § 10(b)

element implies inclusion of recklessness.\textsuperscript{112} Like the common law, scienter in the § 10(b) context encompasses states of mind that include "intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud."\textsuperscript{113} In holding that reckless nondisclosure suffices for scienter, the Seventh Circuit considered it "highly inappropriate to construe the Rule 10b-5 remedy to be more restrictive in substantive scope than its common law analogs."\textsuperscript{114} The Supreme Court has read into a federal securities provision a more liberal alternative scienter doctrine than that used at common law by stating that in an injunctive action, less scienter need be shown than that required in a private action for damages.\textsuperscript{115} Because an actual use standard requires the strictest possible interpretation of the scienter requirement and goes beyond the modern interpretations of the common law requirements, it is incompatible with the Court's construction of modern federal anti-fraud provisions in the securities field.

The knowing possession standard is able to withstand scrutiny under any of these standards of culpability because reckless, knowing, or intentional conduct in withholding material nonpublic information in one's possession is sufficient to satisfy scienter or refute good faith. The Hochfelder court's statement that because no one should be held liable unless "he acted other than in good faith [and] § 10(b) should be interpreted no more broadly,"\textsuperscript{116} failed to recognize that in the common law of fraud, recklessness constitutes intent,\textsuperscript{117} that good faith is a defense to recklessness,\textsuperscript{118} and that the "quest for recklessness in a fraud action is the search for tell-tale signs of bad faith."\textsuperscript{119} In Teicher, the jury instruction with respect to scienter also turned on whether the defendants acted in good faith\textsuperscript{120} and the Second Circuit rejected such a defense.

\begin{itemize}
\item \textsuperscript{112} Bucklo, supra note 105, at 233 (internal quotations omitted) (quoting Professor L. Loss's comment on scienter as "knowledge or 'not giving a damn' ").
\item \textsuperscript{113} Lanza v. Drexel & Co., 479 F.2d 1277, 1301 (2d Cir. 1973) (en banc) (quoting Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971)).
\item \textsuperscript{114} Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1044 (7th Cir. 1977).
\item \textsuperscript{116} Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206 (1976); see also Langevoort, supra note 85, § 3.04, at 3-22 (stating that liability arises only in absence of good faith).
\item \textsuperscript{117} Kuehnle, supra note 106, at 180 n.284 (citing Restatement (Second) of Torts, § 526 cmt. e (1977) (stating that recklessness is sufficient for liability for fraud)).
\item \textsuperscript{118} \textit{Id.} at 181 (reasoning that recklessness "affirmatively is bad faith").
\item \textsuperscript{119} \textit{Id.} at 192.
\end{itemize}
“centered on the strategy” of the lack of scienter because it failed to find any signs of good faith. At the same time, the Hochfelder statement indicates that the Court clearly equated scienter with a lack of good faith. This is crucial in concluding that all three levels of culpability satisfy scienter because they may all be inconsistent with good faith.

2. Smith Incorrectly Raised the Threshold Proof of Scienter by Limiting It to a Finding of Specific Intent to Defraud

Despite ample evidence that Hochfelder did not establish a standard of specific intent to defraud and precedent in its own circuit, the Ninth Circuit in Smith incorrectly raised the threshold for proof of scienter from recklessness or knowing conduct to a finding of specific intent to defraud. Smith concurred with the Adler court in expressing the concern that the knowing possession standard would not be strictly limited to scenarios involving intentional fraud and selectively quoted Hochfelder by omitting the “knowing or intentional misconduct” phrase from the Court’s statutory interpretation of scienter. The Smith court cited to its decision in Hollinger v. Titan Capital Corp., where it defined scienter as “a mental state embracing intent to deceive, manipulate, or defraud.” However, the court failed to point out that after Hollinger acknowledged this description of scienter, it went on to affirm the conclusion of ten other circuits that “recklessness may satisfy the element of scienter in a civil action for damages under § 10(b) and Rule

120. United States v. Teicher, 987 F.2d 112, 121 (2d Cir. 1993). The jury instruction read:

It is not a willful deceptive device in contravention of Rule 10b-5 for a person to use his superior financial or expert analysis or his educated guesses or predictions or his past practices or experience to determine what stocks to purchase or sell. Nor is it a deceptive device in contravention of Rule 10b-5 for a person to buy or sell stocks based on rumors, gossip, stories, or any other source consisting of unverified, unsubstantiated information . . . .

. . . If you decide that the defendant you are considering at all relevant times acted in good faith, it is your duty to acquit him . . . .

Id.

121. Id.

122. See SEC v. Texas Gulf Sulphur, 401 F.2d 833, 868 n.4 (2d Cir. 1968) (Friendly, J., concurring) (observing that defendant’s erroneous view of law is pardonable but it is not “good faith” in legal sense) (internal quotations omitted).

123. See supra note 107 and accompanying text.

124. United States v. Smith, 155 F.3d 1051, 1068 (9th Cir. 1998).

125. Id. at 1068 & n.25.


127. Smith, 155 F.3d at 1068 (internal quotations omitted).

128. Id. (quoting Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568 (9th Cir. 1990)).
Significantly, the *Hollinger* court expressly held that for purposes of satisfying the scienter requirement of a securities fraud case, the standard of recklessness requires highly unreasonable conduct that amounts to an "extreme departure from standards of reasonable care." This definition of recklessness is "the kind of recklessness that is equivalent to willful fraud." Therefore, as long as the SEC were able to prove this type of recklessness, it would have met *Smith*'s insistence that the SEC prove "intent to defraud." That *Hollinger* was a civil case and *Smith* a criminal prosecution does not change the conclusion that *Smith*, in reliance on the civil case of *Adler*, unreasonably, and in manifest disregard of precedent, limited scienter to its strictest possible interpretation by requiring a specific intent to defraud.

3. **Knowing Possession Is a Type of "Use" that Satisfies the Scienter Requirement**

The definition of "use of inside information for personal advantage" is not restricted to any one type of use in reliance on that information. One reason supporting the knowing possession test is that liability under Rule 10b-5 may arise if insiders disseminate false information without trading at all. Since the enactment of § 10(b), the SEC has used its provisions to remedy unlawful trading and tipping by persons occupying various positions of trust and confidence who have "illegally acquired or illegally used" inside information. The provisions reach those who "unlawfully possess or use" such information and profit from it as well as those who convert lawfully obtained information entrusted to them solely for business purposes in breach of relationships of trust and confidence. The use of disjunctives in the legislative history not only indicates that both possession and acquisition of inside information constitute use but also strengthens the argument that § 10(b)'s "use" is not an exclusive use.
in directly consummating a trade. Therefore, more than one “actual use” can establish the causal connection requirement.

Dirks’s focus on motivation in determining scienter\(^{136}\) may be read to support the knowing possession standard because the motivation of one who trades while in possession of inside information that is known to be material and possibly fraudulently obtained without disclosure must be questioned. Specifically, the decision not to abstain from a trade while in possession of such information constitutes an affirmative use of the information. Thus construed, the “[t]o use or employ”\(^{137}\) phrase covers a wide range of possible deceptive behavior, including intentional nondisclosure in the classic context and unauthorized disclosures to others in the misappropriation context, which may ultimately contravene the spirit and letter of the statute protecting market participants.

Smith rejected the SEC’s position that inherent in the act of trading while in possession of material nonpublic information lies the requisite intent to defraud.\(^{138}\) It reasoned that if an insider “merely” possesses and does not use the information, the two parties are trading on a level playing field because both are making decisions based on incomplete information.\(^{139}\) However, Smith’s rejection of the SEC’s argument was flawed because it did not point out that Teicher’s dictum in support of a broad possession standard was in the context of the misappropriation theory of liability, premised on the trader’s having wrongfully received material nonpublic information from a tipper who had breached a fiduciary duty to the information source. Chiarella’s holding, that the duty to disclose does not arise from “mere” possession of inside information,\(^ {140}\) does not preclude equating knowing possession with use when a fiduciary relationship exists. In the classic context, reckless, knowing, or intentional failure to disclose while in knowing possession of inside information satisfies scienter for which possession is not only a necessary but also a sufficient condition. The standard is not mere possession but knowing possession, which requires a breach of fiduciary duty, to the information source in misappropriation cases, and to corporate shareholders in the classic context. Thus, knowing possession of material and undisclosed or fraudulently obtained information

138. United States v. Smith, 155 F.3d 1051, 1068 (9th Cir. 1998).
139. Id.
140. See supra notes 73–74 and accompanying text.
Use-Possession Debate Under § 10(b)

necessarily creates an asymmetry in the playing field because such
deceptive misuse of information is in breach of trust and confidence. It is
this asymmetrical use that satisfies the scienter requirement of § 10(b).

4. Summary

Different manifestations of fraudulent use of inside information may
establish scienter to defraud and therefore the causal connection between
the trading and inside information. This supports the knowing possession
standard, and militates against the actual use standard, which relies on
the exclusivity of use in the direct consummation of trading.

D. Smith Misread Supreme Court Dicta as Supporting the Actual
Use Standard

The Supreme Court dicta on which Smith principally relied for its
adoption of the actual use standard supports the knowing possession
standard because the crux of the breach of fiduciary duty lies in trading
without disclosure of inside information. In addressing the “in connection
with” element of § 10(b), O’Hagan stated that “the fiduciary’s fraud is
consummated, not when the fiduciary gains the confidential information,
but when, without disclosure to his principal, he uses the information to
purchase or sell securities.” Smith cited this as strong support for the
actual use standard. However, the O’Hagan passage suggests that the
real focus of the Court’s inquiry is on nondisclosure as fraud or
deception. That is, if a fiduciary discloses the confidential information to
his principal, there would not be a Rule 10b-5 violation even if he used
the information in trading. The passage should be construed to support
the knowing possession standard which premises liability on deceptive
nondisclosure. Because it is the deceptive nondisclosure that gives rise to
advantage-taking in the form of a deceptive use, the passage better
supports the knowing possession standard that encompasses such uses.

While both Smith and Adler were correct in concluding that the
statutory interpretive focus is on fraud, they misread Supreme Court

141. Smith, 155 F.3d at 1067 (citing O’Hagan, Dirks, and Chiarella as supporting “on the basis
of” standard that requires disclosure so as to prevent defendant’s actual advantage-taking of material
nonpublic information for personal benefit).
143. Smith, 155 F.3d at 1067.
144. See supra notes 28, 37 and accompanying text.
dicta from cases where there was no question that inside information was actually used. They quoted similar passages from *Chiarella, Dirks,* and *O'Hagan* in ruling that knowing possession may be insufficient to establish liability for insider trading, and that the Supreme Court "has consistently suggested" that Rule 10b-5 requires the SEC to "prove causation in insider trading prosecutions." However, the import of the quoted passages offers no substantive support for an actual use standard for two reasons. First, repeated use of the words "use" and "on the basis of" stems from the fact that their determination was not at issue in those three cases. The injection of "in possession of" as a necessary condition would have been without substance in such cases where the use-possession debate was not implicated. Second, the passages' emphasis on advantage-taking of inside information for personal gain merely highlights the judicial interpretation, the legislative intent, and the administrative enforcement goals of § 10(b). It does not undermine a knowing possession standard that seeks to reach the same goals of preventing unjust enrichment by insiders, tippees, and misappropriators whose trading without disclosure violates a fiduciary or similar duty to maintain confidentiality.

E. Smith Failed to Discuss Adler's Incorrect Interpretation of the Insider Trading Sanctions Act

*Smith*‘s analysis of *Adler* was deficient because it failed to discuss *Adler*‘s erroneous interpretation of the “in possession” language of the Insider Trading Sanctions Act of 1984 (ITSA). The legislative history of the ITSA is relevant to § 10(b) interpretation because both statutes aim to insure the fairness and integrity of the securities markets, and because the legislative history indicates that Congress recognized the need to bolster the SEC’s enforcement arsenal.

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145. See *Smith*, 155 F.3d at 1067; SEC v. *Adler*, 137 F.3d 1325, 1334 (11th Cir. 1998).
146. *Smith*, 155 F.3d at 1067; *Adler*, 137 F.3d at 1333–34.
147. *Smith*, 155 F.3d at 1067; see also *Adler*, 137 F.3d at 1335.
150. Id. at 2279 (observing that in recent years SEC enforcement resources have declined as securities markets have grown “dramatically in size and complexity”).
In rejecting Teicher’s knowing possession standard, Adler found that the ITSA does not resolve whether possession or use is the proper standard.151 However, the exchange during the House hearings shows that Congress was fully aware of the difference between the two standards. The drafting committee specifically declined suggestions that liability under the legislation be limited to those who “knowingly cause” the transaction because the legislation “is not intended to change current law with respect to the level of awareness required of a violator” or to “require a higher standard of proof than the ‘preponderance of the evidence’ test now applicable to Commission injunctive actions.”152 In response to congressional inquiry, the SEC Chairman unequivocally stated that the existing law prohibits “trading while in possession of material nonpublic information,”153 and the director of the SEC Division of Enforcement stated that scienter must be proven but the burden of proof is “while in possession of” material nonpublic information as opposed to trading “based on” such information.154 These exchanges reflect congressional awareness of the proof of violation standard as “while in possession of” rather than “on the basis of” material nonpublic information. Therefore, because the underlying offense of the proposed legislation arises directly from § 10(b), Adler’s attempt to completely bifurcate the analysis is flawed in that it failed to recognize that the congressional choice of the “in possession of” language reflects its conception of the prevailing interpretation of the underlying violation.

The legislative history of the ITSA points to the “in possession of” language as an endorsement of a broader test for insider trading liability.155 It rejects the alternative interpretation that the phrase “while in possession of” could be “either an endorsement of the broader standard or a refusal to choose between the two standards.”156 In spite of

151. Adler, 137 F.3d at 1337.
153. Id. at 2304 (statement of Hon. John S.R. Shad, SEC Chairman).
155. Adler, 137 F.3d at 1336–37.
156. 15 U.S.C. § 78u-1(a) (1994); see also supra note 148.
157. Langevoort, supra note 85, § 3.04, at 3-25.
158. See Horwich, supra note 6, at 1257 (quoting William K.S. Wang & Marc I. Steinberg, Insider Trading § 4.4.5, at 183–84 (1996)).
advocacy for the “based on” standard,\textsuperscript{159} the passage of the ITSA on the heels of all the testimony shows that Congress chose not to read a stringent causal connection element into the underlying § 10(b) offense of insider trading. Because Congress was fully aware of the sharp debate over which of the two standards to adopt, its retention of the “in possession of” language supports an endorsement of the broader knowing possession standard.

\textbf{III. POLICY AND EVIDENTIARY REASONS SUPPORT THE SEC PREFERENCE FOR THE KNOWING POSSESSION STANDARD}

The SEC preference for the knowing possession standard should be accorded deference because it is consonant with legislative intent and is rooted in evidentiary difficulties that significantly impede enforcement. \textit{Smith} focused its analysis on use not as a necessary fact to show a breach of duty, but as a necessary element to establish scienter by reasoning that the investor who carries through a preexisting plan to trade after coming into possession of material nonpublic information lacks the intent to defraud or deceive.\textsuperscript{160} This extraordinarily high level of culpability ignores the SEC’s concern that the “use” requirement will “entail significant factual inquiries into the state of mind and the motivations” of inside traders.\textsuperscript{161} The inference of use rule, adopted in \textit{Adler}\textsuperscript{162} and endorsed in \textit{Smith},\textsuperscript{163} is insufficient to overcome the evidentiary difficulties. Further, the rule is of little practical utility under \textit{Smith}’s significant factor causation test which comports with the knowing possession standard.

\textbf{A. The Knowing Possession Standard Is Consistent with the Policy Goals of the Federal Securities Laws}

Policy and pragmatic considerations underlying § 10(b) further lend support to the knowing possession standard. Two of the primary goals of the federal securities laws are to maintain fair and honest securities

\begin{thebibliography}{9}
\item 159. See, e.g., \textit{House ITSA Hearing}, supra note 154, at 196–97 (statement of Arnold S. Jacobs, Chairman of New York City Bar Ass’n Comm. on Sec. Reg.).
\item 160. \textit{United States v. Smith}, 155 F.3d 1051, 1068 (9th Cir. 1998).
\item 161. See supra Parts II.C.1–2.
\item 162. \textit{Smith}, 155 F.3d at 1069.
\item 163. See supra note 26 and infra notes 181–82 and accompanying text.
\item 164. See infra note 181.
\end{thebibliography}
markets and to prevent unfair practices in these markets. The Supreme Court has repeatedly described the fundamental purpose of the Exchange Act as implementing "a philosophy of full disclosure." This philosophy accords with the common law, under which the courts have consistently imposed on a fiduciary an affirmative duty of "utmost good faith" and "full disclosure of all material facts." Therefore, not only is trading while in possession of inside information unfair at common law, it undermines legislative intent to prevent unfair practices in the securities markets. The difficulties of enforcing the anti-fraud provisions of the Exchange Act under a strict actual use standard that requires a finding of specific intent to defraud thwart the legislative intent of a broad remedial measure premised on full disclosure. Conversely, the less restrictive knowing possession standard is consonant with legislative intent to provide the broad scope of the antifraud provisions necessary to cover the "infinite variety of deceptive conduct."

B. Smith's Endorsement of the Inference of Use Rule Fails to Alleviate the Onerous Evidentiary Difficulties

Smith's analysis of Teicher ignored one of the most compelling reasons to adopt the knowing possession standard: simplicity of evidentiary proof. In its administrative rulings the SEC has consistently endorsed the knowing possession standard in part because the "on the basis of" standard subjects evidentiary proof to "metaphysical impossibility." Inherent difficulties associated with evidentiary proof corroborate the SEC's fear that the actual use standard will both complicate and handicap SEC enforcement efforts. Because of the subjectivity of intent, circumstantial evidence rather than direct evidence suffices as proof of scienter. However, such evidence, which may rebut the inference of use from the possession of material nonpublic information, will rarely be able to relieve the defendant of liability

165. See, e.g., 15 U.S.C. § 78j(b) (1994); see also supra note 149.
because it is nearly impossible to rebut an inference of use once knowing possession at the time of the trade is established. For example, the Teicher court observed that it is impossible to determine whether a particular piece of information was a factor in choosing from myriad alternative courses of action, such as to trade based on the information, to change a previously decided transaction, to continue with an original plan in spite of the information, or to refrain from trading.\(^{172}\) In keeping with the legislative goals, the SEC’s enforcement efforts should not be impeded by unnecessary evidentiary hurdles. Allowing a defendant to avoid liability by simply presenting an independent reason\(^ {173}\) for trading will severely hamper the SEC enforcement efforts.

Ninth Circuit decisions addressing scienter have invoked the inference of use rule in the § 10(b) context of disclosing misleading statements where there were no implications of the use-possession debate. In *In re Apple Computer Securities Litigation (Apple)*,\(^ {174}\) the Ninth Circuit held that “credible and wholly innocent explanations” for stock sales were sufficient to defeat any inference of bad faith or scienter, which the court interpreted to include recklessness.\(^ {175}\) In short, insider trading in suspicious amounts or at suspicious times is “probative of bad faith and scienter.”\(^ {176}\) However, countervailing evidence requires persuasive explanations for the transactions other than reliance on inside information, and this requirement has not been met in many cases.\(^ {177}\) *Kaplan v. Rose* illustrates the difficulty of rebutting such an inference of use from possession.\(^ {178}\) In reversing summary judgment in favor of the defendants, the Ninth Circuit held that the defendants’ rebuttal evidence of innocent explanations for the suspicious timing of their stock sales was inconclusive because the sales were not consistent with earlier patterns,
Use-Possession Debate Under § 10(b)

in large amounts and at sensitive times. Further, the contention that the stock sale was to fund retirement plans showed motivation to inflate the stock price.

Because Smith acknowledged Adler's version of the inference of use test, it is necessary to analyze Adler's conclusion that this test suffices to alleviate the SEC's difficulties in proving use. To bolster the rebuttable inference of scienter rule, Adler cited In re Worlds of Wonder Securities Litigation (WOW) as concluding that:

[W]here an inference of possession of material nonpublic information and scienter arises from sales of stock prior to financial collapse, credible and wholly innocent explanations for the sale—e.g., sales pursuant to a predetermined plan, because of a pressing need to service a huge debt or sale of only a small fraction of holdings—can rebut the inference of possession.

Adler's reading of WOW is flawed on two levels. First, the court in WOW was not even able to establish an inference that the defendants had possession of inside information when they traded and called the plaintiff's speculation "fantastic." Second, the Adler court agreed with the SEC that cases such as Apple are inapplicable to the use-possession debate because the issues did not involve whether the allegedly adverse inside information was the basis or cause of the insider trading. However, WOW relied on Apple's reasoning to hold the defendants not liable for insider trading. Therefore, support for Adler's inference of use rule is weak at best.

179. Id.
180. Id.
181. United States v. Smith, 155 F.3d 1051, 1069 (9th Cir. 1998); SEC v. Adler, 137 F.3d 1325, 1341 (11th Cir. 1998) (holding that where inference of possession of inside information arises from suspicious timing of sale, credible and wholly innocent explanation for said sale and timing can rebut inference).
182. Adler, 137 F.3d at 1339.
183. Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1427–28 (9th Cir. 1994).
184. Adler, 137 F.3d at 1341 (quoting Worlds of Wonder Sec. Litig., 35 F.3d at 1427–28).
185. Worlds of Wonder Sec. Litig., 35 F.3d at 1427.
186. Adler, 137 F.3d at 1335 n.26 (conceding that SEC was correct in pointing out that cases such as Apple are inapplicable to use-possession debate because they did not involve insider trading violations, but rather actions in which insiders' trading was introduced as evidence of insiders' failure to make timely public disclosure of adverse corporate information or as evidence that insiders' disclosure of positive information was misrepresentation).
187. Worlds of Wonder Sec. Litig., 35 F.3d at 1428 (concluding that defendants provided sufficient "credible and wholly innocent explanations" as evidence to rebut "any inference of bad faith").
In addition, Adler cited Dura-Bilt Corp. v. Chase Manhattan Corp., for its proposition that "defendants' reliance on inside information . . . may be inferred from [their] possession of the information."\textsuperscript{188} This recitation does no more than define the rebuttable inference of use or scienter rule. It does not show, as Smith concludes,\textsuperscript{189} how the rule is able to alleviate the SEC's difficulties in proving use. In sum, Smith's endorsement of Adler's inference of use rule as sufficient to overcome evidentiary difficulties begs the question because the key inquiry is not the rebuttal of scienter through proof of non-use of inside information, but rather, whether knowing possession is a type of use that satisfies scienter so as to render rebuttal superfluous.

C. Smith's Significant Factor Test of Causation Comports with the Knowing Possession Standard

The defendant in Smith could just as well have been convicted under a knowing possession standard because Smith's significant factor causation test supports the standard. Smith used this test to uphold the jury instruction, which provided that the government need only prove that the inside information was a "significant factor" in the defendant's decision to trade and not "the reason."\textsuperscript{190} The logical conclusion is that a causal connection can be established when evidence points to inside information as being one significant factor in a defendant's decision to trade. Adler's inference of use rule basically requires an insider who allegedly traded with nonpublic information to show the absence of a causal relationship between the information and a particular trade. However, under Smith's "significant factor"\textsuperscript{191} formulation, it is almost impossible for a defendant to successfully make a showing that there was absolutely no causal relationship between the material nonpublic information and a particular trade because the inside information need not be the sole or dispositive reason for trading. Therefore, this causation test undermines the actual use standard because its saving grace, the inference of use rule, has little practical utility under the test. Furthermore, the significant factor test shows that the Smith court acknowledges that there is usually more than one reason for a decision to trade. This also undercuts the actual use

\textsuperscript{188. Adler, 137 F.3d at 1335 (citing Dura-Bilt Corp. v. Chase Manhattan Corp., 89 F.R.D. 87 (S.D.N.Y. 1981)).}

\textsuperscript{189. United States v. Smith, 155 F.3d 1051, 1069 (9th Cir. 1998).}

\textsuperscript{190. Id. at 1066.}

\textsuperscript{191. Id.}
standard which implicitly requires that the inside information be the exclusive reason for the decision to trade.

D. Summary

The proper standard must balance legislative intent and the enforcement goals of the SEC against the need to avoid casting an unnecessarily wide net in SEC enforcement efforts. The knowing possession standard, under which § 10(b) liability arises only when a person trades while in possession of undisclosed information obtained or used fraudulently in breach of a fiduciary duty, achieves that balance with clarity and efficiency. The knowing possession standard also amply protects the legitimate use of information acquired through "superior experience, foresight or industry." Additional support comes from the Supreme Court's pronouncement that in determining whether the analogous Rule 14e-3(a)'s disclose or abstain requirement is reasonably designed to prevent fraudulent acts, the Court must accord the SEC's assessment "controlling weight unless [it is] arbitrary, capricious, or manifestly contrary to the statute." This strongly indicates that judicial interpretation of the antifraud provisions, including § 10(b) of the Securities and Exchange Act, should accord great weight to SEC interpretation.

IV. CONCLUSION

Statutory interpretation and policy considerations conclusively favor a knowing possession standard under which reckless, knowing or intentional breaches of fiduciary duty in failing to disclose, illegally acquiring or misappropriating inside information establishes the causal connection between such information and trading on its basis. The knowing possession standard comports better with the language and purposes of § 10(b) and Rule 10b-5 as flexibly interpreted by the


193. 17 C.F.R. § 240.14e-3(a) (1998). Rule 14e-3 prohibits trading in securities of a tender offer target by any person (other than the bidder) "who is in possession of material information relating to such tender offer which information he knows or has reasons to know has been acquired directly or indirectly" from the bidder, the target, or persons acting on behalf of either.

Supreme Court and the SEC. In addition, the standard is consistent with the disclose or abstain rule and the significant factor test of causation, and finds support under both the classic and misappropriation theories of insider trading and in the analogous anti-fraud provisions of the Exchange Act. Accordingly, the Ninth Circuit should have adopted the knowing possession standard in upholding the criminal conviction in *United States v. Smith*.

Because violations are frequent and enforcement difficult, the higher evidentiary hurdle of establishing causal connection through the exclusive use of inside information in directly consummating a trade flies in the face of the statutory language, legislative intent, common law, and federal precedent. The knowing possession standard would enhance SEC enforcement efforts by significantly expanding the number of successful prosecutions under § 10(b)'s intended broad reach. The standard will also provide the kind of bright-line test necessary for lower courts and counselors to render consistent decisions and advice. Therefore, the standard should be uniformly applied to all SEC enforcement actions.