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MOVING TOWARD A CLEARER DEFINITION OF INSIDER TRADING: WHY ADOPTION OF THE POSSESSION STANDARD PROTECTS INVESTORS

Lacey S. Calhoun*

In recent years, insider trading has become a publicized focus of securities law enforcement. The definition of insider trading has emerged slowly through case law, and the term has been clarified by new theories of liability. The use and possession tests are two standards of liability used to judge the treatment of inside information. The use standard offers a defense to insider trading liability while the possession standard premises liability on mere possession of inside information. This Note argues that courts should adopt the possession standard because this standard better protects investors, a primary goal of the Securities Exchange Act of 1934.

INTRODUCTION

The Securities Exchange Act of 1934 (Exchange Act)1 created the Securities and Exchange Commission (SEC) to regulate the securities markets of the United States.2 In section 4 of the Exchange Act,3 Congress delegated to the SEC “the task of grappling with the problem areas [of securities law].”4 Insider trading, “a term of art referring generally to any unlawful trading by persons possessing material nonpublic information,”5 is one such problem

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2. See James D. Cox et al., Securities Regulation 7 (2d ed. 1997).
4. Cox et al., supra note 2, at 7.
5. Id. at 775.
area and has received increasing attention since the 1980s. With the well-publicized prosecutions of such figures as Michael Miliken, Ivan Boesky, and Dennis Levine, the media has painted insider traders as greedy swindlers of the investing public who make millions off their use of inside information and are fined millions when convicted. Despite the publicity and severe penalties, insider trading continues to pervade the securities industry and the SEC has made it an "enforcement priority."8

During the past two decades, courts and litigants have begun to define more precisely the activities that give rise to insider trading liability.9 In 1997, the Supreme Court's acceptance of the misappropriation theory in United States v. O'Hagan9 resolved the question of who can be liable for insider trading,10 but lower courts continue to debate remaining issues of liability.11 In particular, courts question whether or not mere possession of inside information leads to a presumption that the inside information was the basis of a trade.12 Two tests exist to determine insider trading liability under section 10(b) and Rule 10b-5 of the Exchange Act:14 the

6. Media attention to cases involving large sums of money and Hollywood's portrayal of insider trading on Wall Street have brought the issue to the attention of the public. See, e.g., WALL STREET (Twentieth Century Fox Film Corporation 1987).


9. See generally United States v. O'Hagan, 521 U.S. 642 (1997) (accepting the misappropriation theory of liability); United States v. Smith, 155 F.3d 1051 (9th Cir. 1998) (arguing that the use standard should be used to judge insider trading liability in a criminal trading case); SEC v. Adler, 137 F.3d 1325 (11th Cir. 1998) (arguing that the use standard should be used to judge insider trading in a civil insider trading case); United States v. Teicher, 987 F.2d 112 (2d Cir. 1993) (arguing that the possession standard should be used to judge insider trading liability). For a discussion of the misappropriation theory of insider trading liability, see infra Part II.B; for a discussion of the use standard, see infra notes 17-19 and accompanying text; for a discussion of the possession standard, see infra note 16 and accompanying text.


11. See infra Part III.

12. See generally Smith, 155 F.3d at 1051; Adler, 137 F.3d at 1325; Teicher, 987 F.2d at 112.

13. See Smith, 155 F.3d at 1059; Adler, 137 F.3d at 1337; Teicher, 987 F.2d at 119.

14. See 15 U.S.C. § 78j(b) (1994); 17 C.F.R. § 240.10b-5 (1996) (stating that it is unlawful for any person to use a manipulative device, scheme, or artifice to defraud or to engage in any fraudulent or deceitful act in connection with the purchase or sale of any security).
Moving Toward a Clearer Definition

“possession” test and the “use” test. For years, the SEC has supported the stricter “possession” standard, arguing that insiders automatically violate Rule 10b-5 by possessing material nonpublic information when entering into a transaction. Defendants advocate, and courts often choose, the “use” test which requires a showing of intent to use the material nonpublic information in the transaction or proof that such inside information is the basis of a trade. Although a trade is a prerequisite to liability under both standards, an insider selling stock in his corporation is liable under the possession standard if he is shown simply to have possessed material inside information at the time of the trade. Under the use standard, he must be shown to have used the information as the basis of the trade.

Thus, the use standard allows corporations, law firms, and defendants to defend against a showing of possession. For example, an insider could rebut a showing that he possessed material nonpublic information during a transaction with evidence of his preplanned intent to sell the stock to finance his child’s college education, a plan independent of his possession of the information.

The SEC finds that the possession standard better protects investors because it removes any ambiguity as to what behavior creates liability and any possibility of false defenses. The Ninth and Eleventh Circuits have adopted the use standard while the Second Circuit has adopted the possession standard. This Note argues that the possession standard better reflects Congress’ intent in creating the Exchange Act, specifically section 10(b), and better protects the economic interests of investors and markets.

Part I of this Note identifies the statutory language and legislative history necessary to enlighten the use versus possession distinction. Part II examines recent legislative attempts to clarify the definition of insider trading. Part III provides an overview of the recently-resolved debate over the classical and the misappropriation theories, which determined the issue of who can be liable

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15. For a discussion of the questions underlying each test, see Cox et al., supra note 2, at 782.
16. See id.
17. See, e.g., Smith, 155 F.3d at 1069-70; Adler, 137 F.3d at 1332, 1337.
19. See id. at 1325.
20. See id. at 1361-65.
21. See Smith, 155 F.3d at 1070; Adler, 137 F.3d at 1337.
for insider trading. The Supreme Court's reasoning in adopting the misappropriation theory in *O'Hagan* offers a rationale for accepting the possession theory as well: investors need protection, and a stricter definition of insider trading would protect investors. Part IV identifies the current state of the use versus possession debate by examining recent circuit court decisions and the SEC's reaction to those cases. This Note concludes by recommending that the SEC or Congress promulgate a definition of insider trading that clearly sets forth the possession standard.

A concrete, uniform definition of insider trading is necessary. Congress has authorized increased penalties for insider trading, the SEC has devoted greater resources to criminal insider trading prosecutions, and the government has announced an intention to seek prison sentences more frequently. In light of this increased enforcement, the fact that the law of insider trading is open to interpretation is "unacceptable." In creating the SEC and giving it the task of dealing with "problem areas" of securities law, Congress intended the SEC to have extraordinary powers to protect investors and the public interest. Courts should accept the SEC's possession standard as consistent with Congressional intent in creating the SEC and section 10(b) of the Exchange Act.

I. STATUTORY LANGUAGE AND LEGISLATIVE HISTORY

A. Section 10(b) and Rule 10b-5

In relevant part, section 10(b) of the Exchange Act provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate com-

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24. See id. at 183.


merce or of the mails, or of any facility of any national securi-

ties exchange—

(b) To use or employ, in connection with the purchase or sale
of any security registered on a national securities exchange or
any security not so registered, any manipulative or deceptive
device or contrivance in contravention of such rules and regu-
lations as the Commission may prescribe as necessary or
appropriate in the public interest or for the protection of in-
vestors. 28

The SEC adopted Rule 10b-5 under its section 10(b) rulemaking
authority. Rule 10b-5 provides in pertinent part:

It shall be unlawful for any person, directly or indirectly, by
the use of any means or instrumentality of interstate com-
merce, or of the mails or of any facility of any national
securities exchange,

(a) To employ any device, scheme, or artifice to defraud, [or]

(c) To engage in any act, practice, or course of business which
operates or would operate as a fraud or deceit upon any per-
son, in connection with the purchase or sale of any security. 29

B. Legislative History

The Exchange Act was passed largely in response to the stock
market crash of 1929. 30 Little legislative history exists concerning
congressional intent in enacting the Exchange Act, but the protec-
tion of investors was "indisputably one of Congress's ultimate
objectives." 31 As a presidential candidate in 1932, Franklin Rooseveld

30. See Thel, supra note 27, at 408.
31. John H. Kannes, Jr., Lenders' Liability for Aiding and Abetting Rule 10b-5 Violations: The
Knowledge Standard, 41 Sw. L.J. 925, 934 n.58 (1987); see also SEC v. Texas Gulf Sulphur, 401
F.2d 833, 858 (2d Cir. 1968) (stating that the dominant congressional purposes underlying
called for federal regulation of the securities markets, and after his election efforts to draft legislation began. In February of 1934, Senator Duncan Fletcher introduced a final version of a bill called the National Securities Exchange Act of 1934. Congressman Sam Rayburn, Chairman of the House Commerce Committee, introduced the bill to the House. All the important features of the Exchange Act, except the establishment of the SEC, trace back to the Fletcher-Rayburn bill. Under section 9(c), the original version of section 10(b) of the Exchange Act, the Federal Trade Commission (the predecessor to the SEC in securities regulation) was authorized to proscribe the use of any "device or contrivance" in connection with the purchase or sale of a registered security. In fact, the language of Fletcher-Rayburn section 9(c) was quite similar to that of section 10(b) of the Exchange Act. The drafters of section 9(c) did not attempt to forbid only knowing and intentional misconduct designed to deceive investors but also "seem to have intended to authorize the FTC to regulate even innocent conduct that might injure the public at large." Although the proposed bill in its entirety elicited much comment and criticism from financial institutions, corporate managers, and the president of the New York Stock Exchange, section 9(c) itself did not draw substantial comment or harsh criticism.

the Exchange Act were to promote free and open public securities markets and to protect the investing public from suffering inequities in trading).

32. See Thel, supra note 27, at 414-15.


34. See id. at 426.

35. See id. at 430.

36. See FLETCHER-RAYBURN, supra note 33, § 9(c), quoted in Thel, supra note 27, at 429.

37. Compare text accompanying note 28 (giving language of § 10(b) of the Exchange Act) with FLETCHER-RAYBURN, supra note 33, § 9(c) ("It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails or of any facility of any national securities exchange ..., to use or employ in connection with the purchase or sale of any security registered on a national securities exchange any device or contrivance which, or any device or contrivance in a way or manner which the [FTC] may by its rules and regulations find detrimental to the public interest or to the proper protection of investors.").

38. Thel, supra note 27, at 433.

39. See id. at 440.
In March 1934, Rayburn introduced a revision of the proposed bill.\textsuperscript{40} As revised, section 9(c) applied not only to registered securities but also to those “not so registered” and added the word “manipulative” to the devices or contrivances proscribed by section 9(c).\textsuperscript{41} One change Rayburn did not add to section 9(c) may be more indicative of the intent of section 10(b)’s predecessor than the changes he did make.\textsuperscript{42} Rayburn added purpose or motive requirements to section 8 of the bill\textsuperscript{43} but significantly added no such requirement to section 9. In fact, no motive requirement was ever suggested.\textsuperscript{44} “This open-ended section was intended to authorize administrators to prohibit stock market practices, regardless of the motives of those who employed them, which were found detrimental to the public interest or the proper protection of investors.”\textsuperscript{45}

While the final version of the Senate bill\textsuperscript{46} gave the SEC the power to forbid a device that was contrary to the interests of investors, the Exchange Act authorizes the SEC to make rules necessary or appropriate to the public interest or for the protection of investors.\textsuperscript{47} There are two important purposes of the Exchange Act: to control speculation and to give the SEC extraordinary powers to achieve this control.\textsuperscript{48} “Because the Act’s narrowly defined grants of rulemaking power did not provide for complete and effective control, and because Congress realized that it lacked the expertise to enact a complete program of statutory controls, section 10(b) was designed to serve this purpose.”\textsuperscript{49}

The SEC’s promulgation of Rule 10b-5 was a turning point in the interpretation of securities law because it provided a means of prosecuting insider trading.\textsuperscript{50} As litigation under Rule 10b-5 increases, courts and private plaintiffs have assumed the

\textsuperscript{40} See id. at 442–43 (citing H.R. 8720, 73d Cong. (1934), reprinted in Stock Exchange Regulation, Hearings on H.R. 7852 and H.R. 8720 Before the House Interstate and Foreign Commerce Committee, 73d Cong., 2d Sess. 625 (1934)).
\textsuperscript{41} See id. at 443–47.
\textsuperscript{42} See id. at 447.
\textsuperscript{43} See Fletcher-Rayburn, supra note 33, § 8(a)(3) (premising liability on “the purpose of creating . . . a false or misleading appearance of active trading”); Fletcher-Rayburn, supra note 33, § 8(b) (giving a private remedy for willful violation of the statute).
\textsuperscript{44} See Thel, supra note 27, at 447.
\textsuperscript{45} Id. (emphasis added).
\textsuperscript{46} The bill went through revisions in the House and the Senate, and § 9(c) became § 10(b). See generally Thel, supra note 27, at 449–61.
\textsuperscript{47} See id. at 460.
\textsuperscript{48} See id.
\textsuperscript{49} Id.
\textsuperscript{50} See generally id. (explaining the effects of Rule 10b-5).
policy-making powers that Congress delegated to the SEC in 1934.  

In fact, commentators have gone so far as to state that "if the Supreme Court's conception of section 10(b) is fixed and if the SEC is held to the limits of that conception in the future, then it seems that the attempt to empower the SEC to regulate the stock market as it saw fit has failed." While it is impossible to avoid court interpretation of insider trading law, the SEC's promotion of standards which better protect the interests of investors matches the intent of the Exchange Act, and courts should defer to its position.

Professor Steve Thel argues that section 10(b) was meant to give the SEC the power to regulate any practice that might contribute to speculation in securities prices or that might move securities prices away from investment value. Other commentators and cases support his suggestion that the economic interests of investors and the general public are better served by regulation of the markets and insider trading.

The intent behind the creation of the Exchange Act sheds light on the use versus possession debate. Congress intended the SEC to have the power to prohibit practices regardless of motive and with an eye toward the public interest, and the possession standard is a proper exercise of that power because it disregards motive and emphasizes the public interest.

II. RECENT LEGISLATIVE INITIATIVES

Congress made numerous attempts in the 1980's to clarify and extend the reach of insider trading laws. In 1984, Congress enacted the Insider Trading Sanctions Act (ITSA), which allows the SEC to seek treble damages for insider trading violations. ITSA

51. See id. at 463.
52. Id. at 464.
53. See id. at 385–86.
54. See Cox et al., supra note 2, at 1072 (stating that there is significant public interest in the securities markets' fair, open, and competitive operation, and to that end, the markets are a crucial public factor in the functioning of the economy); Bateman, Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299 (1985) (citing SEC v. Capital Gains Research Bureau Inc., 375 U.S. 180, 196-87 (1963) (holding that the primary objective of the federal securities laws, the protection of the investing public and national economy, would be promoted through the promotion of a high standard of business ethics)).
55. See supra notes 44-45.
57. See id.
amends the Exchange Act and authorizes the SEC to seek civil penalties of up to three times the amount of profit gained or loss avoided "by purchasing or selling a security while in possession of material, nonpublic information."\textsuperscript{58} Although ITSA’s language appears to adopt the possession standard, the "legislation does not change the underlying substantive case law of insider trading as reflected in judicial and administrative holdings."\textsuperscript{59} The Eleventh Circuit considered ITSA in \textit{SEC v. Adler}\textsuperscript{60} but concluded that ITSA did not resolve the question of whether use or possession was the proper standard for insider trading liability under section 10(b) and Rule 10b-5.\textsuperscript{61}

In 1988, Congress enacted the Insider Trading and Securities Fraud Enforcement Act (ITSFEA).\textsuperscript{62} ITSFEA encourages principals to take greater responsibility for the actions of their agents; requires brokers, dealers, and investment advisors to more clearly supervise agents; increases criminal penalties; and codifies a private cause of action for people who trade contemporaneously with insiders.\textsuperscript{63} ITSFEA adds section 20A(a) to the Exchange Act.\textsuperscript{64} The new section expressly provides a private cause of action against persons who violate the Exchange Act "by purchasing or selling a security while \textit{in possession} of material, nonpublic information."\textsuperscript{65} This language also suggests that a showing of possession alone will suffice under section 20A(a).

In 1987, the SEC drafted legislation that would judge insider trading by the possession standard, prohibiting "wrongful trading in securities while in possession of material, nonpublic information."\textsuperscript{66} The SEC’s draft language made clear that no proof of use would be required and thus eliminated "‘post-hoc rationalizations’ that the trading was on the basis of something other than the

\begin{itemize}
\item \textsuperscript{58} 15 U.S.C. § 78u-1 (a) (1997).
\item \textsuperscript{59} H.R. REP. No. 98-355, at 13, \textit{reprinted in} 1984 U.S.C.C.A.N. 2274, 2286 (1984); see \textit{also} \textit{SEC v. Adler}, 137 F.3d 1325, 1336 (11th Cir. 1998) (recognizing that although ITSA uses the word "possession," legislative history seems to deny any attempt to use ITSA to modify the definition of insider trading liability).
\item \textsuperscript{60} 137 F.3d at 1325.
\item \textsuperscript{61} \textit{See id.} at 1337.
\item \textsuperscript{64} 15 U.S.C. § 78t-1 (a) (1991).
\item \textsuperscript{65} \textit{Id.} (emphasis added).
\end{itemize}
inside information. In 1988, Senators Donald Riegle of Michigan and Alfonse D'Amato of New York sponsored a different bill on insider trading. Senate Bill 1380 would have required proof that inside information was gained or used wrongfully: "trading while in possession of material, non-public information concerning a security does not, standing alone, constitute [insider trading]." Under a compromise between proposed Senate Bill 1380 and the SEC's draft, the government would have had to show wrongful trading in a security while in possession of inside information and would have had to establish scienter as well. None of these proposed definitions of insider trading were enacted.

These initiatives demonstrate the legislature's continued concern about insider trading and the SEC's early attempt to introduce legislation supporting the possession standard. Still, the use versus possession controversy has been defined more by case law than by legislative initiative. As the Circuits increasingly discuss the meaning of insider trading and whether it is judged by a use or possession standard, there is an increased need for a uniform definition.

III. THE RESOLUTION OF THE CLASSICAL AND MISAPPROPRIATION DEBATE

Two theories of who can be liable for insider trading have emerged from judicial and administrative interpretation of section 10(b) and Rule 10b-5 over the past thirty years. A corporate insider is liable under the "classical" theory of insider trading when he trades in his corporation's securities on the basis of material nonpublic information that he has obtained through his position

68. See 133 Cong. Rec. 16,387 (1987); see also SEC Submits Draft, supra note 67, at 253.
70. See SEC Submits Draft, supra note 67, at 253.
with the corporation. In contrast, section 10(b) and Rule 10b-5 liability under the "misappropriation" theory occurs when a corporate outsider trades on material confidential information in breach of a duty owed to the source of the information, not to the person with whom he trades. Circuits were divided over the appropriateness of using the misappropriation theory as an alternative to the classical theory in judging insider trading liability, until the Supreme Court ended the debate in O'Hagan by accepting the misappropriation theory.

While the classical and misappropriation theories focus on the "who" of insider trading, the use versus possession debate outlines the courts' attempts to define the "how" of insider trading. The history of the classical and misappropriation theories illustrates the Supreme Court's willingness to accept the SEC's endorsement of a more encompassing definition of insider trading. Clarification of the definition of insider trading and a broader standard of liability better protect the investing public.

A. The Classical Theory

Corporate insiders such as officers, directors, or controlling shareholders who violate their duty to the corporation's shareholders by trading on the basis of material nonpublic information are liable under the classical theory of insider trading. In 1980, in Chiarella v. United States, the Supreme Court affirmed that failure to disclose the purchase or sale of securities could be fraud under

74. The Fourth and Eighth Circuits held that insider trading liability could be premised only on the classical theory and not upon the misappropriation theory. See United States v. O'Hagan, 92 F.3d 612 (8th Cir. 1996) rev'd, 521 U.S. 642 (1997); United States v. Bryan, 58 F.3d 933 (4th Cir. 1995). The Second, Seventh, and Ninth Circuits accepted the SEC's application of the misappropriation theory, holding that insider trading liability could be based on either the classical or misappropriation theory. See SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991); SEC v. Clark, 915 F.2d 439 (9th Cir. 1990); United States v. Newman, 664 F.2d 12 (2d Cir. 1981).
75. See supra notes 71–74.
76. See O'Hagan, 521 U.S. at 651–52.
77. 445 U.S. 222 (1980). In Chiarella, a financial printer working on announcements of corporate takeover bids deduced the identities of the corporations involved, although their names were blank or false in the documents, purchased stock in the target companies, and sold the stock when the takeover attempts were made public. See id. at 224.
section 10(b), despite the lack of statutory language or legislative history connecting nondisclosure and fraud under section 10(b). The classical theory relies on the assumption that the "relationship of trust and confidence" between the insider and shareholders creates the duty to disclose. The Court relied on decisions of other courts that found section 10(b) and Rule 10b-5 violations when a relationship of trust and confidence existed between the parties.

The Second Circuit held that "[a]nyone—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose." Reversing the Second Circuit, the Supreme Court emphasized that the defendant was a "complete stranger" to the sellers and that "the element required to make silence fraudulent—a duty to disclose—is absent in this case." The Supreme Court relied heavily on the "disclose or abstain" rule, which states that "a corporate insider must abstain from trading in the shares of his corporation unless he has first disclosed all material inside information known to him."

In 1983, in *Dirks v. SEC*, the Supreme Court applied the principles of *Chiarella* to the case of a tippee who received material nonpublic information from an insider of a corporation. The Court found that the tippee could not have violated section 10(b)

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78. See id. at 230.
79. Id.
80. See, e.g., *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152–55 (1972) (holding that because officers of a bank had a responsibility to shareholders, they could not act as market makers inducing shareholders to sell without disclosing the existence of a more favorable market); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 852 (2d Cir. 1968) (finding a violation of § 10(b) where geologists and engineers of the corporation traded with nonpublic material knowledge of the discovery of a potential mine that had more than a marginal possibility of creating substantial benefits for the company); *General Time Corp. v. Talley Indus.*, 403 F.2d 159, 164 (2d Cir. 1968) (holding that no Rule 10b-5 liability existed when a purchaser of a stock was not an insider and owed no fiduciary duty to the seller); *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911–12 (1961) (finding a corporate director liable under § 10(b) and Rule 10b-5 because the antifraud obligation rests on the existence of a relationship to the company and correlative duties).
83. Id. at 227 (emphasis added) (citing *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961)). The Court found the printer, Chiarella, was not a corporate insider and thus not liable under the classical theory.
84. 463 U.S. 646 (1983). The insider, a former corporate officer, told an investment analyst, Dirks, that the corporation was overstating assets as a result of fraudulent corporate practice. Dirks investigated the allegations and discussed this information with clients but never traded on the information himself. See id. at 648–49.
85. See id.
or Rule 10b-5, because he was not an agent of the corporation, a fiduciary, or a person in whom the securities sellers had placed trust or confidence. The Court found that a tippee assumes a fiduciary duty to the shareholders of a corporation when the insider, who acts as a tipper to the tippee, has breached his fiduciary duty to the shareholders in disclosing material nonpublic information to the tippee and when the tippee knew or should have known of the breach. Here, the tipper did not breach a fiduciary duty to the corporation's shareholders. The shareholders were not harmed by his disclosure, he did not benefit from disclosing the information, and his only motivation was to expose fraud in his corporation. Because the tipper did not breach a fiduciary duty, it followed that the tippee never assumed a fiduciary duty and thus did not violate section 10(b) or Rule 10b-5.

B. The Misappropriation Theory

"In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information." Even though the person defrauded is the source of the information, not the shareholders or other party involved in the trade, the "in connection with" requirement of section 10(b) is met because, under the misappropriation theory, "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." In United States v. O'Hagan a partner of a law firm was held criminally liable under section 10(b) and Rule 10b-5 for the

86. See id. at 654 (citing Chiarella, 445 U.S. at 232). The Court recognized in Dirks that liability could apply to people typically considered outsiders—underwriters, accountants, lawyers, or consultants working for the corporation—who could be considered insiders if they became fiduciaries of the shareholders through their work with the company. See id. at 655 n.14.
87. See id. at 660.
88. See id. at 666–67.
89. See id. at 667.
90. See id.
92. Id. at 656.
misappropriation of confidential information regarding a client's planned tender offer for another company's stock. In its *amicus curiae* brief to the Eighth Circuit, the North American Securities Administrators Association (NASAA) urged the Supreme Court to find O'Hagan liable under the misappropriation theory as advanced by the SEC. NASAA noted that the Second, Seventh, and Ninth Circuits had adopted the misappropriation theory. NASAA also argued that the misappropriation theory would help protect persons who trade in the public securities markets.

The Supreme Court, overturning the Eighth Circuit, held that statutory language and caselaw allow liability under the misappropriation theory. The Court noted "that section 10(b) refers to 'the purchase or sale of any security,' not to identifiable purchasers or sellers of securities." The Court also recognized that both Chiarella and Dirks "left room for application of the misappropriation theory." Not only is the misappropriation theory consistent with the statute and precedent, it is consistent with an "animating" purpose of the Exchange Act. Prohibiting insider trading is "well tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence . . . [I]nvestors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law."

The ability to base insider trading liability on the misappropriation theory as well as the classical theory broadens the definition of insider trading by enlarging the class of potentially liable parties. By accepting the misappropriation theory and the SEC's argu-

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93. See *id.* at 647–49.
94. See *Brief of Amici Curiae North Am. Sec. Adm'rs Ass'n, Inc., and Law Professors in Support of Petitioner* at 3, United States v. O'Hagan, 92 F.3d 612 (8th Cir. 1996) (No. 96-842). NASAA is a forum where state security regulators work together and with federal and international securities regulators "to protect investors and promote fair, open and honest capital markets." *Id.* at 1.
95. See *id.* at 3.
96. See *id.* at 8–9.
97. See *O'Hagan*, 521 U.S. at 653–65 (examining the propriety of, and ultimately adopting, the misappropriation theory).
98. *Id.* at 660 (quoting 15 U.S.C. § 78j(b) (1994)).
99. *Id.* at 662–63. The cases did not hold that liability could be premised only on relationships between corporate insiders and shareholders or that a person escapes § 10(b) liability when trading on information gained through misappropriation. *See id.*
100. See *id.* at 665.
101. See *id.* at 658 (stating in part that "[t]rading on misappropriated information 'undermines the integrity of, and investor confidence in, the securities markets' ").
102. *Id.* at 658 (citation omitted).
ments in *O'Hagan*, the Supreme Court defined insider trading in a manner that allows increased liability for reprehensible activity. Further clarification of the definition of insider trading through the possession test would continue the steps taken by the Supreme Court in *O'Hagan* to allow the SEC to protect investors as Congress intended.

IV. THE USE VERSUS POSSESSION DEBATE IN THE CIRCUITS

The distinction between the use and possession standards rests on whether the government must show that the insider actually used the material nonpublic information when trading. In practice, the SEC consistently argues for the broader possession standard, while defendants in insider trading cases find the more limited use standard appealing. Neither standard is so strongly established as to provide a prescribed course of action. Although both standards arguably require use before there is an actionable claim, the focus of the standards is not on "use" in the sense that a transaction must occur to prove liability. The focus is on what intent the SEC or a private plaintiff has to show in order to prove insider trading liability.

The Second Circuit adopted the possession standard in *United States v. Teicher*. Though the Eleventh and Ninth Circuits adopted the use standard in *SEC v. Adler* and *United States v. Smith*, their discussions of *Teicher* reveal that the choice between the use and possession standards is still open to interpretation. Because there is a split in the Circuits over the use versus possession debate, the issue is ripe for a Supreme Court decision.

103. *See id.* at 653–65.
104. *See United States v. Smith*, 155 F.3d 1051, 1066 (9th Cir. 1998); United States v. Adler, 137 F.3d 1325, 1332–39 (11th Cir. 1998); United States v. Teicher, 987 F.2d 112, 120 (2d Cir. 1993).
106. 987 F.2d 112 (2d Cir. 1993).
107. 137 F.3d 1325 (11th Cir. 1998).
108. 155 F.3d 1051 (9th Cir. 1998).
In 1993, the Second Circuit in *Teicher* utilized the possession standard in its discussion of insider trading liability. During the mid-1980's, an associate at a law firm provided certain arbitrageurs with information concerning possible acquisitions by the firm’s clients, and the arbitrageurs used this information to make trades. The district court found the arbitrageurs, Teicher and Frankel, guilty of securities fraud. On appeal, Teicher and Frankel did not challenge the district court’s definition in its jury instructions that to misappropriate is “to wrongfully take and use the information in violation of a fiduciary duty to hold the information in confidence,” but they did contest the propriety of the district court’s definition of the word “use” in its definition of misappropriation. Teicher and Frankel argued that material nonpublic information is “used” only when the SEC can prove that the trading was causally connected to the misappropriated information and that the trading was not done properly without a connection to the misappropriation. The Second Circuit upheld the district court’s instruction that the government need not prove a causal relationship between the misappropriated material nonpublic information and the defendants’ trading. In this case, the court upheld jury instructions that the government did not need to prove that the defendants purchased or sold securities using the material nonpublic information that they knowingly possessed; it was sufficient for the government to prove that “the defendants purchased or sold securities while knowingly in possession of the material nonpublic information.”

The Second Circuit favorably discussed the government’s position that a person violates section 10(b) and Rule 10b-5 when he trades in possession of “material nonpublic information obtained

109. See *Teicher*, 987 F.2d at 120.
110. See id. at 114–18. Arbitrageurs are people who trade in securities in companies that are the subject of changes in corporate control in order to take advantage of fluctuations in securities prices. See id. at 114.
111. See id. at 114–18.
112. See id. at 114.
113. Id. at 119.
114. Teicher and Frankel contended that the court defined “use” as the equivalent of mere possession and challenged this as overly broad. See id.
115. See id. at 119.
116. See id. at 119–21.
117. Id. at 119 (emphasis added).
in breach of a fiduciary or similar duty.” 118 The court noted that section 10(b) and Rule 10b-5 require only that the deceptive practice be “in connection with a purchase or sale of a security” 119 and that the court had earlier found, in United States v. Newman, 120 “that the ‘in connection with’ clause must be ‘construed . . . flexibly to include deceptive practices “touching” the sale of securities, a relationship which has been described as “very tenuous indeed.” ’ 121 The Court next stated that the possession test comported with the “disclose or abstain” ideals that the Supreme Court adopted in Chiarella. 122

The Second Circuit found the possession test preferable for its simplicity because it did not require determining the motivations of those in possession of inside information. “Unlike a loaded weapon which may stand ready but unused, material information cannot lay idle in the human brain.” 123 The court noted that requiring a causal connection could frustrate attempts to distinguish between legitimate trades and improper inside trades. 124 Although the Second Circuit did not unequivocally adopt the possession standard, it nonetheless came out in strong support of the SEC’s position. 125

B. SEC v. Adler

The Eleventh Circuit adopted the use test in SEC v. Adler. 126 The case concerned use of inside information by Adler, the outside director of a corporation, and alleged tips he gave to his friend and business partner, Pegram. 127 The SEC argued that Pegram violated section 10(b) and Rule 10b-5 when he traded in the corporation’s stock while in possession of inside information, whether or not he

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118. Id. at 120 (citations omitted).
119. Id.
120. 664 F.2d 12 (2d Cir. 1981).
121. Teicher, 987 F.2d at 120 (quoting United States v. Newman, 664 F.2d 12, 18 (2d Cir. 1981)).
122. See id. For a discussion of the decision in United States v. Chiarella, see supra notes 74–80 and accompanying text.
123. Id.
124. See id. at 121 (citing 7 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3505 (3d ed. 1991) (“The very difficulty of establishing actual use of inside information points to possession as the test.”)).
125. See id. at 119–21.
126. 137 F.3d 1325, 1337 (11th Cir. 1998).
127. See id. at 1329–30.
used the information. In its brief, the SEC stated that in the insider trading context:

[T]he scienter requirement is satisfied where, as here, the defendant knew that the information in his possession was non-public and material. Once it is established that the defendant acted with scienter, there is no additional requirement that the information be used. A corporate insider like Pegram who trades in his company's stock has a duty to disclose the inside information in his possession or abstain from trading.

The SEC noted that when a corporate insider has information about his company that he knows, or is reckless in not knowing, is material nonpublic information, he acts with deception by trading without disclosing the information because he knows that the person on the other side of the trade is acting without the benefit of the information. The scienter requirement is met because a person is deemed to have intended the consequences of his actions when he knows what the consequences will be. The SEC cited the "disclose or abstain" rule of Chiarella in support of its position. Because Pegram was a corporate insider trading in the stock of his own company, the SEC reasoned that he had a duty to disclose the material nonpublic information or abstain from trading. According to the SEC, use of inside information was not a necessary element.

The Eleventh Circuit rejected the SEC's reasoning. The court stated that the combination of Supreme Court dicta and lower court precedent, suggesting no violation of section 10(b) and Rule 10b-5 in the absence of a causal connection, required the adoption of the use test. The court noted that immediately after describing

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128. See Corrected Brief of the SEC, Appellant, at 14, SEC v. Adler, 137 F.3d 1325 (11th Cir. 1998) (No. 96-6084) [hereinafter Adler Brief].
129. Id. at 14-15.
130. See id. at 18-19.
131. See id. at 18 (quoting RESTATEMENT (SECOND) OF TORTS § 8A (1965) ("If the actor knows that the consequences are certain, or substantially certain, to result from his act, and still goes ahead, he is treated by the law as if he had in fact desired to produce the result.")).
132. See id. at 20; see also supra notes 77-83 and accompanying text (discussing the analysis used by the Supreme Court in United States v. Chiarella, 445 U.S. 222 (1980)).
133. See Adler Brief, supra note 128, at 22.
134. See SEC v. Adler, 137 F.3d 1325, 1337 (11th Cir. 1998).
135. See id. at 1335-37 (stating in part that "[e]ven if the evidence was sufficient to permit an inference that one or more of the defendants had access to inside information, the defendants' actual trading would conclusively rebut an inference of scienter") (citing In
the disclose or abstain rule, the *Chiarella* court found "that an insider's duty arises from the unfairness of allowing a corporate insider to take advantage of [inside] information by trading without disclosure." Even more damaging to the SEC's reliance on *Chiarella* was the Eleventh Circuit's reference to *SEC v. Texas Gulf Sulphur Co.* "[t]he federal courts have found violations of section 10(b) where corporate insiders used undisclosed information for their own benefit." The Eleventh Circuit also interpreted the Supreme Court's decisions in *United States v. Dirks* and *United States v. O'Hagan* to provide support for its holding. The *Dirks* court stated that, "[n]ot only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain." This language in *Dirks*, and its holding that an inside tipper must gain some personal advantage in order for an outside tippee to be liable for trading on material nonpublic information, led the Eleventh Circuit to infer that possession of inside information at the time of the trade may not be enough to establish insider trading liability. The court also considered language in *O'Hagan* which emphasized use: "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, nonpublic information. Trading on such information qualifies as a 'deceptive device' under section 10(b)."

The language drawn from *Chiarella*, *Dirks*, and *O'Hagan* was dicta. In all three cases there was a trade based on the material nonpublic information. The decisions seem to indicate, at the least, confusion between the possession and use standards. The Eleventh Circuit in *Adler* rebutted the SEC's argument by

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137. 401 F.2d 833 (2d Cir. 1968).
138. *Adler*, 137 F.3d at 1333 (quoting *Chiarella*, 445 U.S. at 229–30, citing *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968)).
141. *See Adler*, 137 F.3d at 1333–34.
142. *Id.* (quoting *Dirks*, 463 U.S. at 659–60) (alterations in original).
143. *See id.* at 1334.
144. *Id.* at 1334 (quoting *O'Hagan*, 521 U.S. at 651–52) (alterations in original).
145. *See id.*
referencing the dicta in these cases, yet strangely discredited the Second Circuit's support for the possession standard in Teicher by pointing out that it was clearly dicta.\textsuperscript{146}

Despite its holding, Adler was not as definitive a statement against the SEC's position as it first appeared. The Eleventh Circuit found the decision between the use and possession tests "difficult."\textsuperscript{147} More important for the SEC's future arguments was the court's admission that it declined to "accord much deference to the SEC position for three reasons."\textsuperscript{148} First, the SEC did not contend that the Adler court should defer to its position; second, the SEC's position on use has not always been consistent; and third, the SEC had ample opportunity to adopt a rule or amend Rule 10b-5 in support of the possession standard.\textsuperscript{149} This language suggests that if the SEC makes its support of the possession standard absolute, courts will more likely defer.

The SEC did not react strongly to Adler. Commenting that the SEC approved more of Teicher than of Adler, SEC Enforcement Director Richard Walker noted that even under Adler, the burden was on the defendant to rebut the inference that use arises from possession.\textsuperscript{150} Although Walker acknowledged that the SEC must recognize the law of the Eleventh Circuit under Adler, "that is not what [the SEC] believe[s] is the law of the land at the present time."\textsuperscript{151} At the time, Walker did not expect "a stampede towards a rule proposal or rule change based solely and exclusively on Adler,"\textsuperscript{152} believing the SEC would wait to see what the outcome would be in United States v. Smith.\textsuperscript{153}

\textbf{C. United States v. Smith}

\textit{United States v. Smith} is the most recent decision in the use versus possession debate. The Ninth Circuit held that insider trading liability under section 10(b) and Rule 10b-5 requires proof of actual

\begin{itemize}
\item 146. \textit{See} id. at 1335.
\item 147. \textit{Id.} at 1337.
\item 148. \textit{Id.} at 1339.
\item 149. \textit{See} id.
\item 150. \textit{See} Internet, Munis, Microcap Fraud Head List of New Chief Richard Walker, 30 Sec. Reg.
\item 151. \textit{Id.} at 944.
\item 152. \textit{Id.} at 943.
\item 153. 155 F.3d 1051 (9th Cir. 1998).
\end{itemize}
use of the inside information. Smith, a vice-president of sales at a software design firm, learned that the firm’s earnings were going to fall short of expectations and thereafter liquidated all of his stock in the firm before the information was disclosed to the public. The district court found Smith guilty of insider trading. On appeal, Smith contended that the district court erroneously instructed the jury that he could be convicted based merely upon his possession of the material nonpublic information.

In an amicus curiae brief, the SEC argued that:

When a corporate insider like Smith has information relating to his company that he knows (or is reckless in not knowing) to be material and nonpublic and he trades in the company’s stock, he violates the antifraud provisions of the federal securities laws, whether or not the information is a factor in his decision to trade. He need not be shown to have used the information.

The SEC further argued that Smith’s fiduciary duty to shareholders “require[d] him not to disadvantage them by failing to disclose the material information he possesses.” The SEC brief cited Teicher in support of the possession standard. Although Smith contended that the proper jury instruction would have been that in order to show scienter the government had to prove that Smith sold his shares because of the material nonpublic information he possessed, the SEC disagreed. The SEC defined the scienter requirement in insider trading cases to “mean[] only that the corporate insider must know, or be reckless in not knowing, that the information in his possession is material and nonpublic, and therefore not known to the shareholders with whom he trades.”

The Ninth Circuit dismissed the Second Circuit’s reading of section 10(b) and Rule 10b-5 in Teicher in favor of its own reading that emphasized the manipulation, deception, and fraud required by

154. See id. at 1069.
155. See id. at 1053.
156. See id. at 1054.
157. See id. at 1055.
159. Id. at 6.
160. See id. at 7–8.
161. See id. at 9 (citing Appellant’s Brief at 50–51, United States v. Smith, 155 F.3d 1051 (9th Cir. 1998) (No. 98-50137)).
162. Id.
the statute. The court found the dicta in O’Hagan and Adler more persuasive than the SEC’s arguments and the dicta in Teicher. The court looked to the language of the statute, finding that the Teicher court focused too narrowly on the “in connection with” requirement while the Adler court more correctly emphasized the “manipulation,” “deception,” and “fraud” elements of section 10(b) and Rule 10b-5. The court dismissed the Second Circuit’s reading of Chiarella, stating that Teicher’s reliance on the case was misplaced because the inside trader in Chiarella had used the information to consummate the trade.

The Ninth Circuit then dismissed the Second Circuit’s policy endorsement of the possession standard. Although it found the simplicity of the possession standard compelling, the Ninth Circuit was confident that the government would have little trouble demonstrating use. The court expressed concern that “the SEC’s ‘knowing possession’ standard would not be—indeed, could not be—strictly limited to those situations actually involving intentional fraud.” The court was worried about cases where an investor with a preexisting plan to trade carried out the plan after acquiring knowledge of the material nonpublic information but with no intent to defraud or deceive. In attempting to protect these honest investors, the Ninth Circuit disagreed with the SEC’s premise that a corporate insider trading in possession of material nonpublic information disadvantages those to whom he owes a duty, noting that if the insider does not “use” the material non-public information, then both parties will make trade decisions on the basis of incomplete information.

The court asserted that the SEC’s position rested on a faulty premise that persons who trade with someone who possesses inside information are at a disadvantage to the insider whether or not the insider uses the information during the trade. The court believed, contrary to the SEC’s premise, that “[t]he persons with whom a hypothetical insider trades are not at a

163. See Smith, 155 F.3d at 1068. Because insider trading is prohibited without being defined in the statute or rule, such a reading of the language is strictly a matter of interpretation.
164. See id. at 1067–68.
165. See id. at 1066–68.
166. See id. at 1068–69.
167. See id. at 1069.
168. See id.
169. Id. at 1068.
170. See id.
171. See id.
172. See id.
'disadvantage' at all provided the insider does not 'use' the information to which he is privy." The Ninth Circuit thus came to a much stronger conclusion against the possession standard than did the Eleventh Circuit in *Adler*.

The Ninth Circuit noted that the Eleventh Circuit, while adopting a use standard, stated that "when an insider trades while in possession of material nonpublic information, a strong inference arises that such information was used by the insider in trading." Because *Smith* was a criminal case, the court could not establish an evidentiary presumption that gave rise to an inference of use, so it endorsed a second variation of the use standard.

The Ninth Circuit's rejection of the possession standard is not irrefutable and illustrates the possibility that each case on the subject will produce a unique interpretation of the definition of insider trading. In response to *Smith*, SEC Enforcement Director Richard Walker stated that the Commission was "waiting to see what the government is going to do with respect to possible rear-argument or reconsideration." While acknowledging that *Smith* was very clear, Walker emphasized that both the *Smith* and *Teicher* discussions of the use and possession standards were in the form of dicta. Despite the Ninth Circuit's adoption of the more stringent "use" standard, Smith's conviction was affirmed, and Walker predicted that the SEC "will continue to prevail because courts and juries will view [such defenses] in most instances as pretextual."

**D. Why the Teicher Decision Should Be Followed**

In sum, the Second Circuit favored the possession standard urged by the SEC while the Ninth and Eleventh Circuits adopted the use standard. In all three cases the courts believed that

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173. *Id.*
174. *Id.* at 1069 (quoting SEC v. Adler, 137 F.3d 1325, 1337 (11th Cir. 1998)).
175. *See id.*
177. *See id.*
178. *See Smith*, 155 F.3d at 1070.
179. CA 9 Adopts "Use" Test, supra note 176, at 1277.
180. See *Smith*, 155 F.3d at 1069; SEC v. Adler, 137 F.3d 1325, 1337 (11th Cir. 1998); United States v. Teicher, 987 F.2d 112 (2d Cir. 1993).
material nonpublic information was used in the transactions.181 Justice Ruth Bader Ginsburg's opinion in O'Hagan held that trading "on the basis of" inside information violates Rule 10b-5.182 While this language may indicate Supreme Court support of the use standard, William R. McLucas, former Director of the SEC's Enforcement Division, "downplayed the significance of that language . . . saying that the need to prove use was not at issue—and thus not resolved—by the court in O'Hagan."183

The SEC continues to advance the possession standard but has been slow to take strong affirmative action to promote it, perhaps because most cases have established use and punished the inside traders. While the SEC uses Teicher to argue for possession, a comparison of the language of Adler and Smith suggests that opposition to the possession standard in the courts is becoming stronger.184 Commentators have noted that a recent Second Circuit case, SEC v. Warde,185 downplayed the importance of Teicher.186 In Warde, the Second Circuit upheld a defendant's conviction because he received inside information and traded on the basis of that information.187 Although the Court recited the possession standard of liability, it did not mention Teicher or the distinction between the use and possession standards.188 The Second Circuit supported a jury finding that the defendant traded with the inside information and that the SEC presented sufficient evidence to show that the defendant relied on the inside information in trading.189 This "seems to be consistent with the use standard adopted by the Ninth and Eleventh Circuits."190

Despite Warde, the Second Circuit's clearly enunciated reasons for choosing the possession standard in Teicher remain valid.191 Just

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181. See Smith, 155 F.3d at 1070 (upholding Smith's conviction); Adler, 137 F.3d at 1341 (noting that a reasonable jury could find that Adler had engaged in illegal insider trading); Teicher, 987 F.2d at 121 (upholding the defendants' convictions).
183. Id.
184. See Adler, 137 F.3d at 1339; Smith, 155 F.3d at 1068–69.
185. Id. 151 F.3d 42 (2d Cir. 1998).
186. See Irwin H. Warren & Beth J. Jacobwitz, Courts Weigh Causation Requirement in SEC's Insider Trading Cases, N.Y. L.J., Oct. 21, 1998, at 1 (explaining that in Warde, the court purported to use a knowing possession standard; however, its analysis seemed consistent with the use standard adopted in Adler and Smith).
187. See Warde, 151 F.3d at 48.
188. See id.
189. See id.
as the Supreme Court in *O'Hagan* recognized that the misappropriation theory comported with section 10(b), Rule 10b-5, and the earlier insider trading decisions,\(^{192}\) the Second Circuit in *Teicher* noted that the possession standard comported with the language of the statute and earlier decisions defining insider trading.\(^{193}\) The Second Circuit found that section 10(b) and Rule 10b-5 require only that a deceptive practice be conducted "in connection with a purchase or sale of a security" and that the possession standard comports with *Chiarella's* "disclose or abstain" rule.\(^{194}\)

Another factor used by the Second Circuit in support of the possession standard remains strong. The Court noted that the standard was preferable for its simplicity.\(^{195}\) An insider in possession of material nonpublic information has an informational advantage over other traders.\(^{196}\) The public perceives this unfair informational advantage as harming other traders and the trading markets.\(^{197}\) The Second Circuit correctly noted that the advantage in the form of information exists in the mind of the trader. The information cannot act as a "loaded weapon" that can remain ready but unused.\(^{198}\) Whether the trader trades on the information, alters a plan to trade, continues with a previous plan to trade, or does nothing, he does so with an informational advantage over others in the market.\(^{199}\) When the person in possession of inside information does not trade, he is not prosecuted because he is not involved in any illegal activity under the "disclose or abstain" rule.\(^{200}\) While the use standard requires delving into the motivations and state of mind of the trader, the simplicity of the possession standard furthers the purpose of securities laws to protect the interests of investors and the public. The possession standard ensures that no one-sided informational advantage exists. The investing public will not be disadvantaged unknowingly by others' possession of inside information because people with such information will not trade. The integrity of the markets, and therefore the economy, will be better protected by a standard that prohibits such an informational advantage.

\(^{193}\) See *Teicher*, 987 F.2d at 120.
\(^{194}\) Id.
\(^{195}\) See id.
\(^{196}\) See id.
\(^{197}\) See *Fisch*, supra note 23, at 226.
\(^{198}\) *Teicher*, 987 F.2d at 120.
\(^{199}\) See id. at 120-21.
An endorsement of the possession standard would be preferable for its simplicity. Not only would such a standard simplify what the government or a private plaintiff has to prove by not requiring a factual inquiry into a trader’s state of mind,\textsuperscript{201} such a standard also would simplify regulation of conduct and litigation by removing any question of whether certain conduct is allowed or whether certain inferences can be established.

**CONCLUSION AND A PROPOSAL FOR REFORM**

The current state of the law, in which courts acknowledge both the use and possession standards and in which no single interpretation of insider trading exists, provides no clear standard upon which the courts, the SEC, plaintiffs, defendants, or attorneys can rely.\textsuperscript{202} Although the weight of case authority favors the use standard and is not without merit, a close reading of the cases reveals that the distinction between the use and possession standards turns on minute interpretations, and the intent behind the standards is not so dissimilar. Because the objectives are not far apart, courts should defer to the SEC's position supporting the possession standard.

The SEC's power under the Exchange Act diminishes as the courts determine insider trading policy through frequent litigation.\textsuperscript{203} Giving such weight to courts' decisions at the expense of the SEC is contrary to the intention of the drafters of section 10(b) and Rule 10b-5 of the Exchange Act.\textsuperscript{204} The drafters of the Exchange Act intended to give the SEC the power to make rules to protect investors and the public interest.\textsuperscript{205}

The possession standard simplifies what is required to prove insider trading liability and in doing so makes untenable any false

\begin{itemize}
  \item \textsuperscript{201} See Teicher, 987 F.2d at 120-21.
  \item \textsuperscript{202} See generally Fisch, supra note 23. On December 20, 1999, after this Note was written, the SEC proposed a rule addressing the use versus possession debate. See Selective Disclosure and Insider Trading, Release Nos. 33-7787, 34-42259, IC-24209, 64 Fed. Reg. 72,590 (1999) (to be codified at 17 C.F.R. pts. 230, 240, 243 and 249) (proposed Dec. 20, 1999). In that release the SEC proposed Rule 10b5-1 under which insider trading liability would arise when a person traded while "aware of" material, nonpublic information. The proposal also provides four exceptions to liability when a trade results from a pre-existing plan, a contract, or instruction that was made in good faith. See id.
  \item \textsuperscript{203} See supra notes 51-52 and accompanying text.
  \item \textsuperscript{204} See supra Part I.B.
  \item \textsuperscript{205} See Cox et al., supra note 2, at 7 (noting that the Exchange Act created the SEC to grapple with the problem areas); Thel, supra note 27, at 461.
\end{itemize}
Moving Toward a Clearer Definition

defenses of prior motive for use. In clearly setting forth what behavior courts will consider actionable, the possession standard provides a course of action for potential traders concerned about what to do with insider knowledge. This clarification protects the economic interests of the public and investors by providing a clear course of action while simplifying prosecution of obvious inside traders.

Promulgating a definition of insider trading based on either the use or possession standard would eliminate the question of what the SEC must prove in a case of insider trading liability. A definition based on the possession standard would be advantageous in that the standard does not require factual inquiry into state of mind, gives insiders a clear course of action (disclose or abstain), and can be applied in the same manner in criminal and civil cases. In light of increased enforcement of insider trading and increased section 10(b) and Rule 10b-5 litigation, a uniform definition of insider trading is necessary. The resolution of the debate over acceptance of the misappropriation theory indicates that courts should accept the SEC's theory. When coupled with the intended power of the SEC to regulate rules to protect the public interest and investors, the possession standard becomes a clear basis for a much-needed definition of insider trading.

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206. See Fisch, supra note 23, at 180.
207. See Thel, supra note 27, at 463.