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Possession Versus Use: Reconciling the Letter and the Spirit of Insider Trading Regulation Under Rule 10b-5

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POSSESSION VERSUS USE: RECONCILING THE LETTER AND THE SPIRIT OF INSIDER TRADING REGULATION UNDER RULE 10b-5

INTRODUCTION

> *I talked to Tom last night after I left you some messages and he and Lou discovered that there was about a million and a half dollar mistake in the budget, so now we're back at ground zero and we've got to scramble for the next few days. Anyway, finally I sold all my stock off on Friday and I'm going to short the stock because I know it's going to go down a couple of points in the next week as soon as Lou releases the information about next year's earnings.*[1]

The elusive smoking gun. In this excerpt from a voice mail message, a corporate insider, here a vice president of the corporation, provides clear evidence of causation between his possession of inside information and the sale of stock. However this causal link is not always so clear and can be difficult to establish.

Although the Securities and Exchange Commission (SEC) and commentators have raised concerns that demonstrating the causal link between the possession of inside information and its use may be difficult,[2] the Ninth Circuit has recently endorsed a causation standard requiring proof of actual use of inside information for a violation of Rule 10b-5.[3] The question remains, however, whether requiring a more strict standard of proof comports with the underlying statute used to combat insider trading, Section 10(b),[4] or with the theoretical underpinnings of insider trading regulation.

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1. United States v. Smith, 155 F.3d 1051, 1053 (9th Cir. 1998).
2. *See id.* at 1069 (acknowledging the SEC's concern with the difficulty of establishing actual use but holding that the government must prove, at a minimum, that the insider used the information in formulating or consumating his trade); *see also* ALAN BROMBERG AND LEWIS LOWENFELS, BROMBERG AND LOWENFELS ON SECURITIES FRAUD AND COMMODITIES FRAUD § 7.4(622), at 7:160.15 (2d ed. 1985) (identifying difficulty of proof as motivating the SEC's shift to a possession standard); LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 786 (3d ed. 1995) (finding that difficulty of establishing actual use points to possession as the test).
3. 17 C.F.R. § 240.10b-5 (1997). *See Smith*, 155 F.3d at 1068.
4. 15 U.S.C. § 78j(b) (1994).

Part I of this comment briefly outlines the prohibition of insider trading according to Section 10(b) of the Securities and Exchange Act of 1934 and the Securities and Exchange Rule 10b-5, and describes the judicial interpretation of these securities acts in insider trading enforcement. Part II outlines the competing arguments for a causation requirement in insider trading enforcement, tracing the varied judicial treatment of a causation element in three insider trading cases recently decided by the courts of appeal. Part III considers the causation dispute in light of the origins and development of Section 10(b). Part IV describes the theoretical underpinnings of insider trading regulation and considers whether the current judicial treatment of causation is in accord with these considerations.

I. THE PROHIBITION ON INSIDER TRADING: SECURITIES AND EXCHANGE ACT OF 1934 AND THE SECURITIES AND EXCHANGE RULE 10b-5

Section 10(b) of the Securities and Exchange Act of 1934[5] and Securities and Exchange Rule 10b-5[6] prohibit insiders from trading on the basis of material, non-public information. Section 10(b) serves as the SEC's principle weapon against insider trading.[7] The SEC promulgated Rule 10b-5 as an anti-fraud provision to implement Section 10(b).[8]

Rule 10b-5 has been interpreted as having five distinct elements.[9] First, there must be use of the required juridictional means in connection with the conduct.[10] Second, there must be a misrepresentation or omission.[11] Third, the misrepresentation or omission must be material.[12] Fourth, the conduct

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5. Under Section 10(b) of the Securities and Exchange Act, it is illegal to "use or employ, in connection with the purchase or sale of any security registered on a national security exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. § 78j(b) (1994).

6. The Securities and Exchange Commission created Rule 10b-5 to implement section 10(b). According to Rule 10b-5,

> it is 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 in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1997).

7. *See* WILLIAM K.S. WANG & MARC STEINBERG, INSIDER TRADING § 5.1, at 281 (1996).

8. *See id.*

9. *See* WANG & STEINBERG, *supra* note 7, § 4.1, at 122.

10. *See id.* § 4.1, at 122 n.2 (including use of national securities markets or other instrumentalities of interstate commerce).

11. *See id.* § 4.1, at 122.

12. *See id.* A statement is material if a reasonable investor would have considered the

must be in connection with the purchase or sale of securities.[13] Finally, the defendant must have acted with scienter.[14]

There are two theories of liability for insider trading under Section 10(b) and Rule 10b-5. Under the traditional theory, a violation of Section 10(b) and Rule 10b-5 occurs when a corporate insider trades in his or her corporate stock on the basis of material or confidential information obtained by reason of his or her position.[15] Under the misappropriation theory, a corporate outsider violates Section 10(b) and Rule 10b-5 when he or she misappropriates confidential information to make a securities transaction, breaching a fiduiciary duty owed to the source of the information.[16]

II. USE VERSUS POSSESSION: COMPETING ARGUMENTS FOR A CAUSATION REQUIREMENT

The two competing arguments concerning a causation requirement are requiring proof of actual use of inside information as a basis for a trade, and alternatively, trading while in knowing possession of material, non-public information.[17]

A. The Possession Standard

The possession standard is based on the idea that inside information does not just sit idle in the mind of a corporate insider.[18] Under a possession standard, causation is established when an insider is in possession of inside information and later trades.[19] Proponents of the possession standard point to the language of both Section 10(b) and Rule 10b-5, standards handed down by the United States Supreme Court, and to the difficulties of proof associated with the "actual use" test.[20] This standard allows for a broader enforcement scheme and thus is promoted by the SEC.[21] The possession standard

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information, if it had been disclosed, important in making the investment decision. *Id.* n.4.

13. *See id.* § 4.1, at 122.

14. *See id.* Scienter is the mental state embracing the intent to deceive, manipulate, or defraud. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976).

15. *See* Chiarella v. United States, 445 U.S. 222, 228-29 (1980) (holding that a financial printer did not violate § 10(b) where he was under no duty to disclose material, non-public information to selling shareholders).

16. *See* United States v. O'Hagan, 117 S. Ct. 2199, 2202 (1997) (finding an attorney liable under § 10(b) for misappropriating information gained from a client who was a takeover target, and using that information to make stock trades).

17. *See* Allan Horwich, *Possession v. Use: Is There a Causation Element in the Prohibition on Insider Trading?*, 52 BUS. LAW. 1235, 1267 (1997).

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

19. *See id.* (pointing to a number of factors that support a knowing possession standard).

20. *See id.*

21. *See* Horwich, *supra* note 17, at 1264. "It is apparent from the preceding history of legislative proposals for defining insider trading that the current SEC position is that trading while in possession of inside information is a violation of rule 10b-5." *Id.*

most notably has seen support in the decision of *United States v. Teicher*, where the Court of Appeals for the Second Circuit endorsed the "knowing" possession standard of causation in the context of a criminal prosecution for insider trading.[22]

In *United States v. Teicher*, two individuals involved in arbitrage[23] and an investment firm appealed convictions of securities fraud prosecuted under Rule 10b-5.[24] The Second Circuit affirmed the convictions of the arbitrageurs, and in doing so, endorsed the possession standard for causation in dicta.[25]

Teicher and the other defendants in this case were arbitrageurs involved in the trading of stock in corporations that were takeover targets.[26] The arbitragers were receiving lists of companies that were potential takeover targets from an analyst at an investment banking firm.[27] The arbitrageurs made numerous trades and accompanying profits on the basis of the confidential information provided by the analysts.[28]

At trial, the jury returned a guilty verdict on the insider trading counts.[29] Teicher appealed on the issue of an allegedly improper jury instruction as to the proof of a causal link between the misappropriated information and the trades.[30] Teicher alleged that the jury instruction allowed the jury to find the defendants guilty of securities fraud based upon the mere possession of fraudulently obtained material, non-public information without its actual use.[31]

In discussing the causation argument, the court focused on the factors that point to adopting a "knowing possession" standard as promulgated by the SEC.[32] According to the court, the first factor that pointed to the possession standard was the language of Section 10(b) and Rule 10b-5.[33] These rules require a deceptive practice "in connection with the purchase or sale of a security."[34] The court found this language to be consonant with the possession standard rather than requiring proof of a causal connection by use.[35]

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22. *See Teicher*, 987 F.2d at 120.

23. "Arbitrage entails trading in securities in companies that are the subject of changes in corporate control in order to take advantage of fluctuations in the price of these securities." *Id.* at 114.

24. *See id.*

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

26. *See id.* at 115.

27. *See id.*

28. *See id.* at 114-15.

29. *See id.* at 114.

30. *See id.* at 118.

31. *See id.* at 119.

32. *See id.* (finding that the SEC has consistently endorsed a standard of "knowing possession"). *But see* SEC v. Adler, 137 F.3d 1325, 1336 (11th Cir. 1998) (stating the SEC has not adopted a consistent opinion on use versus possession over the years).

33. *See Teicher*, 987 F.2d at 120.

34. *Id.* (citing 15 U.S.C. § 78j(b) (1994); 17 C.F.R. § 240.10b-5 (1997)).

35. *See id.*

Second, the court found the maxim "disclose or abstain" from trading while in possession of material, non-public information to be in accord with the possession standard.[36] Because the arbitragers held material, non-public information and were not in a position to make the information public, the court stated that they were required to completely abstain from trading.[37]

Finally, the court relied on the simplicity of the knowing possession standard in support of its adoption.[38] The court stated that information can not be held idle on the brain of a trader, and whether or not it was used in a trade is difficult to prove.[39] This seems to have been persuasive in the court's adoption of the knowing possession standard.

Acknowledging its support of the knowing possession standard as dicta, the court found the alleged fault in the jury instruction to be harmless.[40] Therefore, the holding did not actually include adopting knowing possession as the causal standard for insider trading enforcement in the Second Circuit.

B. The Actual Use Standard

The alternative theory of causation, proof of actual use of non-public information, is a more strict standard of proof for plaintiffs or prosecutors. Under the "actual use" standard, the plaintiff or prosecutor must show that the insider actually used the non-public information in question.[41] While actual use can be readily shown in most situations, significant difficulties of proof can arise in trying to examine the state of mind of the trader and the possible disingenuous excuses for making a trade.[42] There is some debate among commentators as to whether Rule 10b-5 is violated by trading while in possession of non-public information or whether actual use of the non-public information must be shown.[43] Even though the Supreme Court has not

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36. *See id.*

37. *See id.*

38. *See id.*

39. *See id.* at 121.

40. *See id.*

41. *See* Horwich, *supra* note 17, at 1250; *see also* BROMBERG & LOWENFELS, *supra* note 2, § 7.4(622), at 7:160.15. Bromberg and Lowenfels state that an inference of use from trading while in possession of material, non-public information is commonly drawn from the trading pattern, including timing, size, and type of stock transaction. *See id.* In *SEC v. Adler*, the court endorsed a rebuttable evidentiary presumption of use from possession, which may significantly ease the burden of showing actual use. *See Adler*, 137 F.3d at 1340; *see also* United States v. Smith, 155 F.3d 1051, 1069 (9th Cir. 1998) (acknowledging, but not adopting, the evidentiary presumption as a method of alleviating the difficulty of establishing actual use).

42. *See* United States v. Smith, 155 F.3d 1051, 1069 (9th Cir. 1998).

43. *See* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 786 (3d ed. 1995) (concluding that the possession standard should be used because of difficulties of proof); BROMBERG & LOWENFELS, *supra* note 2, § 7.4(610), at 7:160.1 (concluding that nonuse of material, non-public information can be used as an affirmative defense, and possession rather than use probably suffices for a prima facie case of 10-b5 insider trading).

squarely addressed this issue, support for the actual use standard can be inferred from dicta in some insider trading cases decided by the Court.[44] The issue is actually rarely addressed by the courts directly,[45] and there is often a "smoking gun" to prove causation conclusively.[46] However, two recent court of appeals decisions have endorsed an actual use standard.[47] In *SEC v. Adler*, the Court of Appeals for the Eleventh Circuit stated that the SEC must prove actual use of insider information, but permitted a rebuttable evidentiary presumption of use from possession of inside information while making a stock trade.[48]

In *Adler*, the SEC brought a civil suit against two former corporate insiders and two business associates for insider trading violations under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5.[49] The prohibited transactions were committed in various transactions in 1989 and 1992.[50] The defendants claimed that the transactions were part of a planned series of transactions, and not on the basis of any inside information.[51]

The SEC argued that the knowing possession standard should have been employed.[52] In support of this contention, the SEC cited to the familiar maxim "disclose or abstain,"[53] which according to the SEC, dictates the trader must either disclose the material, non-public information or abstain from trading while in possession.[54] The court found the disclose or abstain maxim supported the actual use standard.[55]

The court in *Adler* also looked to *Dirks v. SEC*[56] for support of the actual use standard. In the *Dirks* opinion, the Supreme Court found that the inside tipper must gain some personal advantage from the inside information for

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44. *See O'Hagan*, 117 S. Ct. at 2207. The Supreme Court has indicated that "§10(b) and rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, non-public information." Dirks v. SEC, 463 U.S. 646, 662 (1993). In dicta, the Court stated "a purpose of the securities laws was to eliminate 'use of inside information for personal advantage.'" *Id.* (quoting *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 n.15 (1961)).

45. *See* Horwich, *supra* note 17, at 1245.

46. *See id.* at 1270.

47. *See Adler*, 137 F.3d 1325 (11th Cir. 1998); *Smith*, 155 F.3d 1051, 1069 (9th Cir. 1998).

48. *See Adler*, 137 F.3d at 1340.

49. *See id.*

50. *See id.* at 1327-28, 1330-31.

51. *See id.* at 1339, 1342.

52. *See id.* at 1333.

53. *See id.* at 1338 (citing *In re* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961)).

54. *See id.* at 1338.

55. *See Adler*, 137 F.3d at 1333-34 (citing *Chiarella*, 445 U.S. at 226-28; *Dirks*, 463 U.S. at 659-60 (stating that the insider's duty is to not take advantage of the information by trading without disclosure)).

56. *See Adler*, 137 F.3d at 1332 (citing *Dirks*, 463 U.S. at 662).

the outside tippee to be liable for insider trading.[57] The *Adler* court found this language to support an actual use standard.[58] Additional support was gleaned from *United States v. O'Hagan*.[59] In *O'Hagan*, the Supreme Court defined insider trading as when "a corporate insider trades in the securities of his corporation on the basis of material, non-public information."[60] Although stated in dicta, the *Adler* court found this to be consonant with the actual use standard.[61]

Adler also addressed the SEC's position on the use versus possession issue.[62] The court determined that the SEC had not adopted a consistent stance on this issue over the years.[63] Since the SEC had changed its opinion on the appropriate standard, the court placed little emphasis on the SEC's current position on use versus possession.[64]

Next, the court examined congressional treatment of the use versus possession argument. Looking to the Insider Trading Sanctions Act of 1984,[65] the court determined that Congress deliberately chose the language "in possession" in the statute.[66] However, the court found that this choice of words was not determinative because the Insider Trading Sanctions Act was designed to address remedies for insider trading, and the legislative history explicitly stated that the act was not to supersede the case law on the subject.[67] Consequently, the court gave little weight to the legislative treatment of the Insider Trading Sanctions Act.[68]

The court ultimately found the actual use standard to be the appropriate standard,[69] concluding that a jury could have reasonably found that the insiders in question used the information in connection with the sale of stock.[70] However, establishment of a causal relationship was aided by the court's adoption of an inference of use from possession.[71] The court announced that "proof of an insider's possession of material non-public information at the time of the trade gives rise to a strong inference of use."[72] This inference allowed by the court may be rebutted with evidence of a pre-existing plan or

57. *See id.*
58. *See id.* at 1334.
59. *See id.* (citing *O'Hagan*, 521 U.S. at 642).
60. *Id.*
61. *See Adler*, 137 F.3d at 1334.
62. *See id.* at 1336.
63. *See id.*
64. *See id.*
65. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 5, 98 Stat. 1264, 1265 (1984) (codified as amended at 15 U.S.C. § 78t (d) (1994)).
66. *See Adler*, 137 F.3d at 1336.
67. *See id.* at 1337.
68. *See id.*
69. *See id.* at 1340.
70. *See id.* at 1342.
71. *See id.* at 1340.
72. *Id.*

other innocent explanations.[73] The existence of an inference of use from possession may answer the SEC's concern about the difficulties of proof and weakened enforcement authority.[74] The inference of use from possession was acknowledged but not specifically adopted in *United States v. Smith*, another recent circuit court of appeals case that endorsed the actual use test.[75]

In *Smith*, the defendant, Richard Smith, was the vice president of PDA Engineering (PDA), a publicly traded firm on the National Association of Securities Dealers Exchange (NASDAQ).[76] Smith held over 50,000 shares of stock in PDA. Between June 10 and June 18, 1993, Smith sold all of his shares in PDA.[77] In July of 1993, Smith sold short[78] 25,000 shares of PDA stock.[79]

On June 19, Smith left voicemail messages with a co-worker indicating that Smith had possession of inside information.[80] After a another co-worker obtained the voicemail and reported the suspect transactions to the U.S. Attorney, Smith was indicted for insider trading.[81] Specifically, Smith was indicted for eleven counts of insider trading in violation of Section 10(b) of the Securities Exchange Act of 1934, SEC Rule 10b-5, and obstruction of justice.[82] A jury convicted Smith on all eleven counts of insider trading.[83] Among the issues raised by Smith on appeal was the district court's jury instruction regarding Smith's state of mind.[84] The jury instruction was disputed because it left some uncertainty as to whether Smith could be found guilty of insider trading by merely trading while in possession of inside information.[85]

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73. *See id.* at 1337.

74. *See* Tower L. Snow, Jr. et al., *The Return of Insider Trading and Related Developments Under Rule 10b-5*, *in* THE ART OF COUNSELING DIRECTORS, OFFICERS, AND INSIDERS: HOW, WHEN AND WHAT TO DISCLOSE? 131, 146 (1998).

75. *See Smith*, 155 F.3d at 1068.

76. *See id.*

77. *See id.* at 1053.

78. Short selling refers to the practice of investors who speculate by selling stock they do not own, in hopes that the price will decline and the investor will then cover by buying shares at the new, lower price. *See* ARNOLD JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5, § 38.02, at 54 n.51.7 (1996) (citing Nick v. Shearson/Am. Express, 612 F. Supp. 15, 17 (D. Minn. 1984)).

79. *See Smith*, 155 F.3d at 1053.

80. The message in pertinent part said, "I talked to Tom last night after I left you some messages and he and Lou discovered that there was about a million and a half dollar mistake in the budget, so now we're back at ground zero and we've got to scramble for the next few days. Anyway, finally I sold all my stock off on Friday and I'm going to short the stock because I know its going to go down a couple of points in the next week as soon as Lou releases the information about next year's earnings. I'm more concerned about this year's earnings actually." *Id.* at 1053.

81. *See id.*

82. *See id.* at 1054.

83. *See id.*

84. *See id.*

85. The pertinent portion of the jury instruction at issue was: "However, the government need not prove that the defendant sold or sold short PDA stock solely because of the material non public information. It is enough if the government proves that such inside information

The government and the SEC contended that there should be no proof of actual use causation required in a 10b-5 insider trading prosecution. Both parties 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 non-public, 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.[86]

The court settled on the actual use requirement after examining the Supreme Court's treatment of the issue in dictum and courts of appeals' decisions that had addressed the issue of use versus possession.

First, the court examined the arguable proposition that the Supreme Court has supported an actual use causation requirement in Rule 10b-5. In dicta, the Supreme Court has stated that under the "traditional" or "classical theory" of insider trading liability, Section 10(b) and Rule 10b-5 are violated when a corporate insider trades on the basis of material, non-public information.[87] This language was interpreted by the court as pointing to the actual use standard. The *Smith* court paid further deference to the Supreme Court's statement that "the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principle, he uses the information to purchase or sell securities."[88]

The *Smith* court also found that the actual use standard comports with the language of Section 10(b) and Rule 10b-5.[89] The court found the language of the statutes that proscribe the use of manipulative and deceptive practices in connection with stock transactions to support an actual use requirement.[90] The court reasoned that the requirement of an intent to defraud dictates that only intentional conduct is prohibited, and therefore the actual use standard is the more appropriate standard.[91]

The *Smith* court put some credence in the claims of the SEC regarding the difficulty of proving actual use.[92] However, the court stated that the government could often present definitive evidence of causation through direct or circumstantial evidence.[93] Although acknowledging that proof of the state of mind of the insider may be difficult to demonstrate, the court made reference to the possibility of an inference to show use from possession.[94] However, the court felt it could not adopt any presumption that would shift the

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was a significant factor in defendant's decision to sell or sell short PDA stock." *Id.* at 1065.

86. *See id.*
87. *See O'Hagan*, 117 S. Ct. at 2207.
88. *Id.* at 2209.
89. *See Smith*, 155 F.3d at 1068.
90. *See id.*
91. *See id.* (citing *Dirks*, 463 U.S. at 663 n.23).
92. *See id.* at 1069.
93. *See id.*
94. *See id.*

burden of persuasion in a criminal prosecution for insider trading.[95]

III. CAUSATION IN LIGHT OF THE STATUTORY ORIGINS OF INSIDER TRADING REGULATION: SECTION 10(B) OF THE SECURITIES AND EXCHANGE ACT OF 1934

The preceding cases demonstrate a lack of clear consensus in the courts on the causation issue. Much of the disagreement in interpretation likely stems from the evolution of Rule 10b-5 as a "catch-all" anti-fraud provision.[96] Examining the underlying statute giving rise to Rule 10b-5 may shed some light on the appropriate standard of causation.

There is a distinct lack of legislative history on Section 10(b)'s application to insider trading, possibly owing to its broad purposes.[97] Section 10(b) of the Securities and Exchange Act of 1934 was intended to cover a broad scope of deceitful practices that Congress was concerned about in 1933 and 1934.[98] Section 10(b) expressly prohibits the use, in connection with the purchase or sale of any security, of any manipulative or deceptive device in contravention of the rules as the commission may prescribe.[99] In prohibiting deceptive or manipulative devices, Congress delegated flexible authority to the SEC to exercise rule-making powers.[100] The SEC used this authority to promulgate Rule 10b-5 to enforce the provisions of Section 10(b).[101] However, liability under Rule 10b-5 cannot be extended to conduct beyond the scope of Section 10(b).[102]

Section 10(b) has been interpreted as requiring scienter, or the intent to deceive.[103] This scienter requirement has been interpreted to include only intentional conduct calculated to defraud.[104] By prohibiting trades while in possession of inside information, the possession standard may penalize innocent trading activity done in accordance with a predetermined plan with no intent to deceive.[105] On the other hand, the actual use standard requires the prosecution to prove that the inside information was actually used, giving rise to the requisite intent to defraud.[106] Therefore, regulation of insider trading based on actual use may be more in accordance with Section 10(b).

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95. *See id.*

96. *See* Scott Davis, *Liability under Sections 10, 18, and 20 of the Securities and Exchange Act of 1934, in* UNDERSTANDING THE SECURITIES LAWS 426 (1997).

97. *See* Richard J. Morgan, *The Insider Trading Rules After* Chiarella*: Are They Consistent with Statutory Policy?*, 33 HASTINGS L.J. 1407, 1409 (1982).

98. *See* WILLIAM H. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 19 (1968).

99. *See id.* (citing 15 U.S.C. § 78p (1964)).

100. *See id.* at 18-19.

101. *See id.*

102. *See id.*; *see also O'Hagan*, 117 S. Ct. at 2199.

103. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

104. *See Smith*, 155 F.3d at 1068 (citing *Dirks*, 463 U.S. at 663 n.23).

105. *See id.*

106. *See id.*

IV. CAUSATION IN LIGHT OF THE THEORETICAL UNDERPINNINGS OF INSIDER TRADING REGULATION

Another possible approach to the causation discussion is to examine the theoretical underpinnings of the prohibition on insider trading as a guide. The policy considerations underlying the enforcement of insider trading laws may provide a clearer understanding of the difficult issues presented by insider trading, such as the causation issue.

While there has been some debate among commentators as to the policy concerns that underlie the prohibition on insider trading,[107] three considerations routinely pointed to as reasons to prohibit insider trading are: (1) Equity or Fairness, (2) Property Rights, and (3) Efficiency.[108]

A. Equity

Consideration of equity or fairness is based on the premise that trading on an informational advantage by an insider is unfair to other investors.[109] When an insider makes a illicit transaction resulting in a profit, this leaves others worse off, leading to the conclusion that the transaction is unfair.[110] There has been judicial support and recognition of this concept in insider trading cases.[111] The Supreme Court has disfavored the idea that all inequities from informational disparity should be prohibited.[112] However, the SEC has steadfastly supported the position that anyone in possession of material, non-public information must either disclose the information or abstain from trading.[113]

Further support for the concept of equity underlying the regulation of insider trading is found in the legislative record. The House Committee on Energy and Commerce identified equity and informational disparity as im-

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107. *See* Kenneth Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy, in* ECONOMICS OF CORPORATE LAW AND SECURITIES REGULATION 120, 121-30 (Richard A. Posner & Kenneth E. Scott eds., 1980) (proposing fair play as a concept to guide 10b-5 and also addressing the informed market and business property as considerations); *see also* HENRY MANNE, INSIDER TRADING AND THE STOCK MARKET (1966) (proposing management entrepreneurialism and other factors as pointing to not regulating insider trading).

108. *See* LOSS & SELIGMAN, *supra* note 2, at 760-64 (identifying equity, allocative efficiency, and property rights as considerations); Scott, *supra* note 107, at 121-30 (identifies fair play, efficiency, and property rights as considerations in regulation of insider trading).

109. *See* LOSS & SELIGMAN, *supra* note 2, at 760.

110. *See* Scott, *supra* note 107, at 124.

111. *See id.* at 121. The rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have equal access to material information. *See id.* (quoting SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968)).

112. *See Chiarella* 445 U.S. at 232-33 (stating that neither Congress nor the SEC has adopted a parity of information rule).

113. *See, e.g., Smith*, 155 F.3d 1051; *Teicher*, 987 F.2d 112; *Adler*, 137 F.3d 1325.

portant considerations in insider trading regulation, noting that "the abuse of informational advantages that other investors cannot hope to overcome through their own efforts is unfair and inconsistent with the investing public's legitimate expectation of honest and fair securities markets where all participants play by the same rules."[114]

The application of the concept of equity to the causation issue brings clarity to the dispute between mere possession or actual use as the standard for insider trading enforcement. The material, non-public information held by an insider does have the possibility of creating an unfair informational disparity between the insider and other investors.[115] Being in possession of information while making a planned series of trades does not automatically give rise to a inequitable informational disparity.[116] Unfairness is only apparent when an insider actually uses the material, non-public information as the basis for making the trade.[117] According to the court in *Smith*, "it is the insider's use, not his possession, that gives rise to an informational advantage."[118] There is further judicial recognition of the legitimacy of informational disparities in *Chiarella v. United States*.[119] Proof of actual use should be required in order to make the logical connection that demonstrates the trade was unfair to other investors by taking advantage of an inequitable informational disparity.

B. Property Rights

Information can be considered an asset.[120] Insider-held corporate information is a corporate asset, with time and corporate resources being spent developing these assets.[121] Examples of information assets include patents, trademarks, financial reports, and business plans.[122] These important segments of information, therefore, should be considered property and protected as such.[123]

Using the property theory as a basis for insider trading liability has been

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114. LOSS & SELIGMAN, *supra* note 2, at 760 (citing H.R. Rep. No. 98-355, 98th Cong., 1st Sess. 5 (1983)). The House Committee on Energy and Commerce wrote this before adopting the Insider Trading Sanctions Act of 1984, which was enacted to provide further penalties for insider trading. *See id.*

115. *See id.*

116. *See Smith*, 155 F.3d at 1068.

117. *See id.*

118. *Id.*

119. *See supra* note 112.

120. *See* Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9, 30 (1984); Richard J. Morgan, *Insider Trading and the Infringement of Property Rights*, 48 OHIO ST. L. J. 79, 94 (1987).

121. *See* Morgan, *supra* note 120, at 95.

122. *See id.*

123. *See id.*

recognized by the Supreme Court.[124] The property theory is based on the premise of a duty owed to the corporation not to misappropriate information.[125] By misappropriating material, non-public information owned by the corporation, the insider is taking the property of the corporation.[126] Insiders should be prohibited from the misuse of material, non-public corporate information by a proscription on insider trading.

The property rights underpinning points to a resolution of the causation dispute in favor of the actual use standard. It is plausible that a corporation would consent to an insider's possession of inside information.[127] Where the company has consented to the insider's access to this information as part of his or her job, there is no illicit use unless the information is used in an unconsented manner.[128] The theoretical taking of corporate property only occurs when the insider actually uses the corporate information without consent.[129] Thus, the property theory of insider trading points to requiring proof of actual use of information rather than the possession standard.

C. Economic Efficiency

Economic efficiency is another theory underlying the regulation of insider trading sometimes cited by commentators.[130] On its face, the economic efficiency argument tends to point to possession of information as the appropriate standard. The cost of capital for a corporation is minimized where investors buy corporate stock rather than the corporation relying on the debt markets.[131] The dissemination of material information about a corporation affects the prices of the corporation's securities.[132] Faster and greater disclosure of material, non-public information should cause a more efficient allocation of resources to the most productive firms.[133]

Commentators have found that limiting insider trading promotes faster and greater disclosure of material information.[134] However, on closer examination, the practical effects of the possession standard may actually have the opposite effect on the economic efficiency and the optimization of stock

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124. *See* Macey, *supra* note 120, at 35.

125. *See id.* at 47.

126. *See O'Hagan*, 117 S. Ct. at 2208.

127. *See* Morgan, *supra* note 120, at 96.

128. *See id.*

129. *See id.*

130. *See* LOSS & SELIGMAN, *supra* note 2, at 761; *see also* John F. Barry III, *The Economics of Outside Information and Rule 10b-5*, 129 U. PA. L. REV. 1307, 1317-18 (1981); Scott, *supra* note 107, at 121-30.

131. *See* Barry, *supra* note 130, at 1317-18 (finding that when security prices reflect all available information, the firm's individual costs of capital decrease because investors are eager to buy the firm's securities).

132. *See* LOSS & SELIGMAN, *supra* note 2, at 761-62.

133. *See id.*

134. *See id.* at 761 (3d ed. 1995); *see also* Barry, *supra* note 130, at 1317-18.

prices.

The possession standard is a more strict standard of enforcement. An increase in regulation on insiders may prove to be a disincentive to management ownership of the corporation.[135] Insiders may want to avoid the potential liability of trading while in possession of information.[136] Corporate managers who are also owners of the corporation are more likely to act in accord with shareholder interests, such as maximizing wealth.[137] The relationship between executive ownership interests and corporate performance has been found to be positively related.[138] The economically efficient shift of resources to firms with the greatest productivity[139] may therefore be driven by an insider trading standard that promotes management ownership. Conversely, the possible disincentive to take a larger equity stake in the ownership of the corporation, promulgated by the possession standard, may reduce a corporation's stock price, thereby not promoting economic efficiency.[140] Therefore, the actual use standard is preferable to the possession standard since it more fully comports with the goal of economic efficiency.

While there is no definite consensus as to the policy considerations underlying the regulation of insider trading,[141] or even whether insider trading should be prohibited,[142] generally accepted policy considerations provide some clarity in resolving confusing issues in insider trading. The requirement of proof of actual use finds support in the policy concerns of fairness, protecting corporate property rights, and economic efficiency.

CONCLUSION

The treatment of actual use and possession of material, non-public information in the courts is hardly of one accord.[143] The legislative record on the actual use versus possession standard is inconclusive.[144] Alternatives to these conflicting interpretations do exist. One alternative would be to legislatively define insider trading effectively and enact new laws that resolve the

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135. See Steven R. Salbu, *Tipper Credibility, Noninformational Tippee Trading, and Abstention From Trading: An Analysis of Gaps in the Insider Trading Laws*, 68 WASH. L. REV. 307, 344 (1993).

136. *See id.* at 341.

137. *See id.* at 344-45.

138. *See* Miron Stano, *Executive Ownership Interest and Corporate Performance*, *in* ECONOMICS OF CORPORATE LAW AND SECURITIES REGULATION 38, 38 (Richard A. Posner & Kenneth E. Scott eds., 1980).

139. *See* LOSS & SELIGMAN, *supra* note 2, at 762.

140. *See id.*; Salbu, *supra* note 135, at 344.

141. *See supra* notes 107, 108.

142. *See generally* HENRY MANNE, INSIDER TRADING AND THE STOCK MARKET (1966).

143. *See, e.g., Adler*, 137 F.3d 1325; *Smith* 155 F.3d at 1068 (supporting the actual use standard). *But see Teicher*, 987 F.2d 112 (supporting the knowing possession standard).

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

confusion created by a judicially-implied enforcement scheme. However, legislatures and the SEC have resisted the enactment of new legislation to better define insider trading.[145]

By examining the statutory origins of the prohibition on insider trading, and the theoretical underpinnings of the prohibition of insider trading, this comment provides a alternative analysis of the adoption of an actual use standard versus a possession standard of causation.

Section 10(b) was enacted to prohibit the use of deceptive devices in stock transactions.[146] Section 10(b) has been interpreted to apply only to intentionally fraudulent conduct.[147] The regulation of insider trading based on a possession standard may go beyond the statutory prohibition on intentional fraudulent conduct to potentially innocent transactions.[148] Therefore, regulation of insider trading based on an actual use standard would more closely parallel the statute that spawned the prohibition.[149]

Next, the policy based underpinnings of the regulation of insider trading point to actual use as the standard.[150] First, principles of equity are promoted by requiring proof of actual use of inside information. Congress and the courts have pointed to equity as an important policy consideration in insider trading enforcement.[151] Insider trading calls the notions of equity and fairness in the stock market into question.[152] Yet, principles of equity are only problematic where the insider actually takes advantage of their informational leverage and trade on the basis of inside information.[153] Thus proof of actual use should be shown to serve the policy goal of equity.[154]

Second, the policy goal of protecting property rights is more properly served by an actual use standard that reflects the nature of material, non-public information. Material, non-public information can be realistically viewed as corporate property, subject to theft and other unconsented use.[155] But where an insider is authorized to possess inside information, there is no "taking" of corporate property unless she actually uses the information in making a stock transaction.[156] Therefore, the property rights theory points to actual use as the standard for causation.[157]

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145. Congress has resisted defining insider trading more clearly, leaving the narrowing of the definiton to judicial construction. *See* WANG & STEINBERG, *supra* note 7, § 73.3, at 585-86 n.63 (citing CONG. REC. S. 8912-8913 (June 29, 1984) (remarks of Mr. D'Amato)).

146. *See supra* Part III.

147. *See supra* Part III.

148. *See supra* Part III.

149. *See supra* Part III for analysis of Section 10(b).

150. *See supra* Part IV for discussion of policy considerations.

151. *See supra* Part IV.A.

152. *See supra* Part IV.A.

153. *See supra* Part IV.A.

154. *See supra* Part IV for discussion of policy considerations.

155. *See supra* Part IV.B.

156. *See supra* Part IV.B.

157. *See id.*

Third, market efficiency may point to an actual use standard for causation in insider trading enforcement. If corporate insiders are held to a more strict regulatory standard of possession rather than use, the insiders may seek to isolate themselves from material, non-public information, or choose not to invest in their corporattion's stock.[158] This disincentive to take an active role in the corporation promulgated by the possession standard would not promote allocative efficiency.[159] Overall, it appears that the actual use standard is more consonant with the underlying statute and policy-based goals of insider trading enforcement.

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158. *See supra* Part IV.C.

159. *See id.*

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