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Rule 10b5-1 and Criminal Insider Trading Cases

Rule 10b5-1, which became effective on Oct. 23, 2000,[1] purported to resolve the unsettled question of whether actual use of material, nonpublic information was required for insider trading liability under §10(b) of the Securities Exchange Act and Rule 10b-5, or whether a lesser standard of trading while in knowing possession of inside information was sufficient.

The rule adopts a standard of mere "awareness" — that is, mere awareness of material, nonpublic information at the time of the trade suffices for insider trading liability.[2]

It also creates three affirmative defenses to an allegation of insider trading. A defendant has an absolute defense to insider trading under Rule 10b5-1 if the defendant can demonstrate that before becoming aware of material, nonpublic information, he had: (1) entered into a binding contract to purchase or sell the security; or (2) instructed another person to purchase or sell the security for his or her account; or (3) adopted a written plan for trading securities.

The rule sparked controversy and was the subject of many articles at the time of its promulgation.[3] Many commentators criticized the Securities and Exchange Commission's adoption of the awareness standard as an unprincipled expansion of §10(b) that would penalize conduct that was perfectly lawful under the statute. Possessing inside information, but not actually using it while trading, the argument goes, is simply not a fraud, and therefore, cannot be not unlawful.

Role of the Rule

Much has happened since the adoption of Rule 10b5-1. Corporate scandals have filled the news. Important insider trading cases have also been brought, most notably the case against ImClone System's Samuel Waksal and the related obstruction of justice case against Martha Stewart. What role has Rule 10b5-1 played in these scandals?

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Surprisingly, a review of the reported case law reveals very little in the way of judicial decisions on the subject. There has not been one criminal insider trading case in the Southern District of New York where a federal judge has charged a jury with the "awareness" standard in Rule 10b5-1.

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As a result, the legitimacy of Rule 10b5-1 remains an open issue.

In 1993, the U.S. Court of Appeals for the Second Circuit affirmed the criminal insider-trading convictions of an arbitrager and his co-defendant, an analyst at Drexel Burnham, in *United States v. Teicher*, 987 F.2d 112.

The defendants received material, nonpublic information from an associate at a Manhattan law firm, who breached his fiduciary duties to the law firm and its clients. On appeal, the defendants challenged the district court's instruction that the jury could find them guilty of insider trading based on their knowing possession of material nonpublic information at the time of their trades. The prosecution argued that the instruction was a correct statement of the law.

The Second Circuit rejected the defendants' argument and held that "any alleged defect in the instruction was harmless error." The court concluded that the jury charge did not adversely affect the defense at trial because the defendants had argued that they did not know the information was nonpublic and wrongfully obtained — not that they did not actually use the information.

While reserving decision on the use versus possession issue for another day, the Second Circuit suggested, in dicta, that it would approve the "knowing possession" standard citing three policy justifications.

First, the "knowing possession" standard was consistent with the accepted practice of interpreting §10(b) and Rule 10b-5 broadly to further the objectives of stopping fraudulent practices.

Second, the "knowing possession" standard comported with the maxim that a fiduciary with "material nonpublic information in confidence must either 'disclose or abstain' with regard to trading."

Third, the "'knowing possession' standard [had] the attribute of simplicity." And, finally, the court questioned whether information could really ever be possessed in the mind of the defendant, but not actually used.

'O'Hagan'

About four years after *Teicher*, the U.S. Supreme Court decided *United States v. O'Hagan*, 521 U.S. 642 (1997), in which it accepted the misappropriation theory of insider trading liability. Significantly, the Court defined insider trading as trading "on the basis of

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material non-public information."

On its face, this language strongly suggests that the Court, in contrast to the Second Circuit's *Teicher* dictum, would require actual use of material, nonpublic information to establish insider trading liability.

In the wake of *O'Hagan*, a dispute developed in the federal circuit courts about what trading "on the basis of material non-public information" meant. Did it mean actual use of the information, mere possession of the information, or something in between?

The Split

In *SEC v. Adler*, 137 F.3d 1325 (1998), a civil SEC enforcement action, the Eleventh Circuit rejected the *Teicher* dictum and adopted the actual use standard.

The circuit court held that trading by an insider with material, nonpublic information created a rebuttable presumption that the information was used by the insider. The burden was on the defendant to produce evidence that "the information was not used."

The court reasoned that a "knowing possession" standard would be inconsistent with the statutory purpose of §10(b), preventing fraud and deception, because the knowing possession standard could ensnare conduct that was neither fraudulent nor deceptive.

Notably, the Eleventh Circuit declined "to accord much deference to the SEC's position" that knowing possession was the appropriate standard. The court observed that the SEC had been inconsistent in its advocacy of a possession test and that the SEC's position had evolved from one of actual use in 1971 to mere possession by 1978.

The court found it significant that the SEC had never promulgated a rule "formally adopt[ing] the knowing possession test."

The Ninth Circuit was next to consider and reject the knowing possession standard in the case of *United States v. Smith*, 155 F.3d 1051 (1998).

Smith, a vice president of a publicly traded company, was convicted of insider trading after trial. He had liquidated his entire position in the company's stock and then shorted the stock after having learned of material, nonpublic information — namely, an undisclosed $1.5 million shortfall in the company's fourth-quarter sales.

After the company restated its sales figures, its stock plummeted by roughly 38 percent. By liquidating his position in advance of the company's restatement, Smith avoided losses of approximately $150,000 and by virtue of his short sales, gained an additional $50,000.

On appeal, Smith argued that the district court should have charged the jury that they must find that the material, nonpublic information was "the reason" for his trades in order to convict. The government argued for the knowing possession standard.

The Ninth Circuit carefully considered the *Teicher* dictum and rejected the knowing possession standard in favor of the actual use test. (Unfortunately for Smith, his conviction was affirmed.)

The Ninth Circuit also discussed *Adler's* rebuttable-presumption approach and rejected it in criminal cases because it constituted impermissible burden shifting, but "express[ed] no view as to whether or not an *Adler*-type presumption may be employed in civil enforcement proceedings under Rule 10b-5."

The Aftermath

Roughly a year after the Ninth Circuit's decision in *Smith*, the SEC promulgated Rule 10b5-1.[4] The SEC Release announced that Rule 10b5-1 was "designed to address only the use/possession issue in insider trading cases under Rule 10b-5 ... [and] does not modify or address any other aspect of insider trading law."

The rule, as explained above, did not contain an *Adler*-type presumption, but rather, created a series of affirmative defenses.[5]

Since the SEC adopted Rule 10b5-1, there have been only a handful of judicial decisions discussing it and none, by our account, in the criminal context.[6]

Furthermore, we are unaware of a single criminal case in the Southern District of New York where the court has instructed the jury to apply the "awareness" standard of Rule 10b5-1 or the knowing possession dictum of *Teicher*.

However, two judges in the Southern District — Judges Richard M. Berman and Lewis A. Kaplan — declined prosecution requests to instruct the jury on the knowing possession standard in criminal insider trading cases involving conduct pre-dating the adoption of Rule 10b5-1.[7]

Those decisions arose in the context of charge conferences during trial and there is no written opinion in either case. In refusing to give the charge, Judge Kaplan explained that there was plainly a "circuit conflict" on this issue and, in the event of a conviction and affirmance by the Second Circuit, "You're off to the Supreme Court."[8]

What accounts for the lack of criminal insider trading cases applying Rule 10b5-1? Although it is possible that criminal cases charging Rule 10b5-1 have yet to percolate through the judicial system, this explanation seems unlikely given that the rule was adopted more than three years ago. It is also possible that some defendants charged under the rule have undoubtedly pled out, thus obviating the need for a trial and judicial consideration of the issues raised here.

Another explanation is that prosecutors have charged Rule 10b5-1 sparingly because they probably do not want and do not need to use it.

Prudent concerns of jury nullification and the fear of confronting the issues raised in this article on appeal counsel against charging criminal insider trading on the "awareness" standard.

Furthermore, in a typical insider trading case, prosecutors have abundant circumstantial evidence — including telephone records, bank records, the defendant's historical trading patterns, the trading records relating to the allegedly unlawful trades, and profits made or losses avoided as a result of the trades — to demonstrate that the defendant actually used the material, nonpublic information.

1. Selective Disclosure and Insider Trading Act, Exchange Act Release Nos. 33-7881, 34-43154, IC-24599, 65 F.R. 51,716 (2000).

2. 17 C.F.R. §240.10b5-1(b) (2000).

3. See Carol B. Swanson, Insider Trading Madness: Rule 10b5-1 and the Death of Scienter, 52 U.Kan. L. Rev. 147, 193-96 (2003). See also Otto G. Obermaier and Robert S. Berezin, SEC Now Defining Crimes?, NYLJ, July 10, 2000, at col. 4.

4. S.E.C. Release No. 7787, No. 42259, 33-7787, 34-42259, IC - 24209, 1999 WL 1217849 (Dec. 20, 1999).

5. By creating a series of affirmative defenses in Rule 10b5-1, the SEC arguably avoided the infirmity of impermissible burden-shifting that the Ninth Circuit found objectionable in *Smith*. See *Martin v. Ohio*, 480 U.S. 228, 234 (1987).

6. There have, however, been developments in civil insider trading cases. See, e.g., *SEC v. Lipson*, 278 F.3d 656, 660-61 (7th Cir. 2002) (upholding a jury charge similar to the *Adler* presumption); *SEC v. Thrasher*, 152 F. Supp. 2d 291, 303 (S.D.N.Y. 2001) (following *Teicher* dicta); *In re Enron Corp. Sec., Derivative & ERISA Lit.*, 258 F. Supp. 2d 576, 593 (S.D. Tex. 2003) (adopting Rule 10b5-1's awareness standard).

7. See *U.S. v. Robles*, S1 00 Cr. 1169 (RMB) (S.D.N.Y. Sept. 30, 2002), and *U.S. v. Ballesteros*, 01 Cr. 258 (LAK) (S.D.N.Y. Feb. 25, 2002).

8. *U.S. v. Ballesteros*, 01 Cr. 258, Transcript at 691 (S.D.N.Y. Feb. 25, 2002). In *Robles*, Judge Berman did not state his reasons for refusing the charge on the record.