THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 56 No. 6 March 22, 2023

PRE-PUBLICATION ISSUE

USE AND KNOWING POSSESSION: AN OLD DEBATE GAINS NEW RELEVANCE AMIDST THE GOVERNMENT'S LATEST INSIDER TRADING ENFORCEMENT PUSH

An open question in insider trading law is whether the government must prove that an insider actually used material nonpublic information to trade, or whether the government merely must prove that the insider knowingly possessed material nonpublic information at the time of the trade. The SEC's Rule 10b5-1, which was recently amended in late 2022, still sets out a "knowing possession" standard, but this rule is in tension with previous decisions by federal courts of appeals and has received only inconsistent deference from the courts. In this article, the authors describe the "use" versus "knowing possession" debate, go over the recently amended version of Rule 10b5-1, and discuss how new enforcement initiatives may lead to renewed scrutiny of the "knowing possession" standard by the courts amidst the broader trend towards reduced deference to agency interpretations of the law.

By Brian A. Jacobs and A. Dennis Dillon *

A mid-level executive puts in an offer on her first home. She long has expected to sell stock she holds with her employer to fund the purchase. Her offer is accepted. Excited to find a place of her own in a hot market, she enters into a contract. A few weeks before closing and a week before she plans to liquidate her stock holdings, however, she learns of a major accounting error that will force the company to restate its earnings. She decides to sell her stock anyway. Has she violated Section 10(b) and Rule 10b-5 by insider trading?

The answer depends in part on whether a person can be liable for insider trading when they merely possess inside information, whether or not they actually use that information to trade. If the executive in this scenario were to trade willfully, the government's position could be that she had committed a crime. The Supreme Court has said that trading "on the basis of" inside information violates Section 10(b) of the Securities Exchange Act of 1934.[1] The SEC's Rule 10b5-1, in turn, defines trading "on the basis of" material nonpublic information as trading while "aware of" of such information. But when courts have confronted this "knowing possession" standard, they sometimes have held that the government must instead prove actual "use" of the information to

[1] *United States v. O'Hagan*, 521 U.S. 642, 652–53 (1997).

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RSCR Publications LLC Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call 609-683-4450; fax 609-683-7291; write Subscriber Services, RSCR Publications, PO Box 585, Kingston NJ 08528; e-mail cri.customer.service@comcast.net; or visit our website at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail sarah.s.himmelfarb@gmail.com. To submit a manuscript for publication contact Ms. Himmelfarb. ISSN: 0884-2426.

trade. The resulting circuit split has never been addressed by the Supreme Court.

In this article, we explore how this issue — last subject to substantive consideration by the courts decades ago, in the years before the SEC adopted Rule 10b5-1 — now appears to be ripe for renewed assessment. First, we analyze the three key decisions from the 1990s considering whether "use" or "knowing possession" is the appropriate rule. Second, we examine how the SEC responded to a trend toward the "use" standard by passing Rule 10b5-1. Third, we discuss the recent attention by the SEC and Department of Justice to potential abuses of 10b5-1 plans, which permit insiders to trade in their companies' shares if they make a binding plan to trade before they learn of material nonpublic information and outline the SEC's recent amendments to Rule 10b5-1. Finally, we evaluate some reasons — including a recent trend against judicial deference to agencies like the SEC — that courts may reach a different view on the "use" versus "knowing possession" question.

RISE OF A CIRCUIT SPLIT: *TEICHER*, *ADLER*, AND *SMITH*

In the first decades of development of insider trading law, litigants did not focus heavily on the question of "use" or "knowing possession." In the 1990s, however, a series of three appellate decisions confronted this issue.

The first in this line of cases was the Second Circuit's decision in *United States v. Teicher*.[2] In *Teicher*, the defendants had received inside information from several sources, including an associate at Paul Weiss who learned of potential transactions involving the firm's clients through his work. The defendants argued that they had traded merely on the basis of public information that had led them to become interested in the stocks at issue, rather than the tips they had received. The defendants were convicted at trial, however, of offenses including willful violation of Section 10(b) and Rule 10b-5. On appeal, among other issues, they challenged a jury instruction that stated:

> The government need not prove a causal relationship between the misappropriated material nonpublic information and the defendants' trading. That is, the government need not prove that the defendants purchased or sold securities because of the material nonpublic information that they knowingly possessed. It is sufficient if the government proves that the defendants purchased or sold securities while knowingly in possession of the material nonpublic information.[3]

The defendants argued that this instruction erroneously permitted a conviction "[b]ased upon the mere possession of fraudulently obtained material nonpublic information without regard to whether this information was the actual cause of the sale or purchase of securities."[4]

The panel rejected this argument, agreeing with the government that "knowing possession" of material nonpublic information was the only requirement. It noted at the outset that the SEC (not a party to the case) had taken the position that Rule 10b-5 required only "knowing possession," and that because Rule 10b-5 was the Commission's own rule, that interpretation — espoused in this case by the Department of Justice — was due "some consideration."[5]

The court then gave three additional justifications for a "knowing possession" standard. First, it pointed to the history of liberal interpretation of Section 10(b) and Rule 10b-5's "in connection with" standard, which it said counseled in favor of a lenient standard as to causation. Second, it concluded that "knowing possession" was a good fit with the "disclose or abstain" rule set out in *Chiarella v. United States*, 445 U.S. 222 (1980), and

[2] 987 F.2d 112 (2d Cir. 1993). The authors' law firm represented one of the defendants in *Teicher* at trial.

[3] *Id*. at 119.

[4] *Id*.

[5] *Id*. at 120 (citing *TSC Indus., Inc. v. Northway, Inc*., 426 U.S. 438, 449 n.10 (1976)).

other cases, because that rule assumes that a person in knowing possession could not trade without disclosure. Finally, the Second Circuit said, the "knowing possession" standard had a pragmatic benefit, because requiring proof of use would make enforcement too difficult. In the Circuit's view, material information was "[u]nlike a loaded weapon which may stand ready but unused," because it "[could] not lay idle in the human brain."[6]

All of this analysis, however, was dicta: the court found any error in the instruction was harmless because the defendants were permitted to argue that they had "lacked the requisite scienter to have committed securities fraud," that the trial court had adequately instructed the jury on that element, which the jury presumably had found in reaching its verdict, and that it "strain[ed] reason to argue that an arbitrageur, who traded while possessing information he knew to be fraudulently obtained, knew to be material, knew to be nonpublic, — and who did not act in good faith in so doing — did not also trade on the basis of that information."[7]

Even though the Second Circuit seemed to find this result straightforward, the next Court of Appeals to address this issue head-on reached the opposite result. In *SEC v. Adler*, an Eleventh Circuit case, the defendants included an insider who was present for a board meeting in which the company's CEO reported that the company's largest customer soon would reduce or terminate its orders.[8] That defendant had sold stock before the company disclosed this bad news but argued at trial that he had a preexisting plan to sell before the board meeting. The district court granted summary judgment to the defendant as to the related transaction, and the SEC appealed. On appeal, the SEC contended that the district court had inappropriately considered whether the defendant had used — rather than knowingly possessed — material nonpublic information at the time of the trade.

The Eleventh Circuit disagreed with the SEC, finding that the appropriate standard was "use," not "knowing possession." In addition to citing dicta in *Chiarella* and *Dirks v. SEC*, 463 U.S. 646 (1983), that it thought favored a use standard, the Circuit focused its analysis on the fact that Section 10(b) and Rule 10b-5 prohibited (respectively) "manipulative or deceptive device[s]" and "any act, practice, or course of business which operates or would operate as a fraud." In light of this statutory language and the "focus on fraud and deception" that the Circuit saw in the Supreme Court's insider trading jurisprudence, the court expressed concern that "the SEC's knowing possession test would [not] always and inevitably be limited to situations involving fraud." *Id*. at 1338. This danger, the Court found, warranted a more restrictive "use" standard.

With respect to the SEC's argument that a "knowing possession" test was more consistent with the "disclose or abstain" rule of *Chiarella*, the *Adler* court noted that in the original decision setting out the disclose or abstain rule — *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961) — the SEC had "acknowledged a preexisting plan to sell defense" that would be inconsistent with a strict "knowing possession" rule. The court also declined to defer to the SEC's interpretation of its own Rule 10b-5, noting the SEC had not consistently advocated a "knowing possession" test over time and that the agency had not "formally adopted" the test by issuing a related rule.[9] The court indicated that had the SEC issued such a rule, however, it would have considered that rule binding.[10]

On the question of practicality, the *Adler* court gave its view of how the "use" test should work in practice — in effect, as a rebuttable presumption:

> "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. The insider can attempt to rebut the inference by adducing evidence that there was no causal connection between the information and the trade — *i.e.*, that the information was not used. The factfinder would then weigh all of the evidence and make a finding of fact as to whether the inside information was used."[11]

[6] *Id*. at 120–21.

[7] *Id*. at 122.

[8] 137 F.3d 1325 (11th Cir. 1998).

[9] *Id*. at 1336 (citing *In re Investors Management Company, Inc.*, Rel. No. 34-9267 (1971), which states that one of the elements of a Section 10(b) insider trading violation was that the material nonpublic information "be a factor" in the decision to trade).

[10] *Id.* at 1337 n.33.

[11] *Id*. at 1337; *see id*. at 1339.

In the court's view, that burden-shifting framework would limit the harm a "use" standard could do to the SEC's enforcement programs.[12]

Shortly after *Adler*, in *United States v. Smith*, the Ninth Circuit took up the same question in a criminal context.[13] The defendant in *Smith* was a corporate insider who had sold stock after learning of a budget error that would negatively affect earnings. After his conviction at trial, he argued on appeal (among other things) that the jury had been improperly instructed. Even though the judge had told the jury it must find the defendant had traded "because of" his knowing possession of material nonpublic information, the court also instructed them that knowing possession need only be a "significant factor" in the defendant's decision. The defendant argued that this instruction permitted a conviction where he did not trade "because of" the material nonpublic information he possessed. This possibility, he claimed, was inconsistent with the scienter requirement of Section 10(b) and Rule 10b-5. For its part, the SEC argued that the law required only that the trade be made while in "knowing possession."

The panel rejected the SEC's theory. Agreeing with the Eleventh Circuit's reasoning in *Adler*, the *Smith* court said that *Teicher*'s focus on the "in connection with" requirement missed the forest for the trees: the real question was whether Section 10(b) and Rule 10b-5's focus on fraud, deception, and promotion of fairness required more than simple possession. The Ninth Circuit concluded that "use," rather than "knowing possession," was more consistent with that focus. Going one step beyond *Adler*, moreover, the *Smith* court declined to state that "knowing possession" would give rise to a "strong inference" of use in a criminal case, because such an inference would be inconsistent with the prohibition on presumptions of fact in criminal cases.[14]

The split at the appellate level arose in the absence of Supreme Court guidance. The Supreme Court's early major decisions regarding insider trading — *Dirks* and *Chiarella* — did not directly address the issue, and the Court denied petitions for certiorari in *Teicher* and *Smith*. In *United States v. O'Hagan*, decided shortly before *Adler* and *Smith*, the Supreme Court again did not determine whether a defendant's trade must "use" the material nonpublic information or knowingly possess it; the distinction was not necessary to deciding the case. Instead, the Court opted to describe the offense as trading "on the basis of" material nonpublic information.[15]

THE SEC'S ATTEMPT TO RESOLVE THE SPLIT BY RULEMAKING: RULE 10B5-1.

In the years after *Teicher*, the question of the appropriate standard generated considerable academic and professional discussion. The Eleventh and Ninth Circuits' disagreement with the Second Circuit only clarified the terms of that debate and intensified it. Some commentators argued in favor of a "knowing possession" standard, citing principally the practical implications for enforcement if the government were required to prove "use," its consistency with the "disclose or abstain" maxim, and Section 10(b)'s fundamental purpose of promoting fair play in the markets.[16] By contrast, others — often in the defense bar — argued that a strict "knowing possession" test

[12] Applying this inference to the facts, the court determined that there remained a genuine issue of material fact as to whether the material nonpublic information affected the defendant's decision to trade and reversed the lower court's grant of summary judgment to the defendant as to the related transaction.

[13] 155 F.3d 1051 (9th Cir. 1998).

[14] *Id*. at 1069 (citing *Sandstrom v. Montana*, 442 U.S. 510, 524 (1979)). Nevertheless, because the district court had instructed the jury it must find the defendant traded "because of" the material nonpublic information, the Ninth Circuit affirmed the conviction.

[15] 521 U.S. 642, 651–52 (1997). Even though the Court opted to describe the offense as trading "on the basis of" inside information in its principal discussion, it later stated that the "in connection with" requirement was satisfied under the misappropriation theory because "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." *Id*. at 656. The Ninth Circuit noted this statement in concluding the "use" standard was more consistent with Supreme Court precedent. *Smith*, *supra* n. 13 at 1067.

[16] *See, e.g*., Lacey S. Calhoun, *Moving Toward A Clearer Definition of Insider Trading: Why Adoption of the Possession Standard Protects Investors*, 32 U. Mich. J.L. Reform 1119, 1143–45 (1999) (arguing that simplicity, investor protection, and consistency with "disclose or abstain" rule favor knowing possession standard); Karen Schoen, *Insider Trading: The "Possession Versus Use" Debate*, 148 U. Pa. L. Rev. 239, 280 (1999) (arguing simplicity and promotion of public confidence in markets require knowing possession standard).

would penalize innocuous conduct and undermine the fundamental primacy of scienter in fraud cases.[17]

Amidst this debate, in December 1999, the SEC proposed Rule 10b5-1 to define what trading "on the basis of" insider information meant, and thereby "to address . . . whether insider trading liability depends on a trader's 'use' or 'knowing possession' of material nonpublic information."[18] The SEC's proposing release frankly acknowledged the "differing opinions expressed in [*Teicher*, *Adler*, and *Smith*]," and noted that in *Adler* the court had suggested the issue could be resolved by rulemaking. Although the Commission did not say so explicitly, the proposal of Rule 10b5-1 fairly has been seen as a response to the trend embodied in the Eleventh and Ninth Circuit's rulings.[19]

As adopted, Rule 10b5-1 purported to "define when a purchase or sale constitutes trading 'on the basis of' material nonpublic information in insider trading cases brought under Section 10(b) of the Act and Rule 10b–5 thereunder," without "modify[ing] the scope of insider trading law in any other respect." In reality, the SEC chose the most limited definition possible: "purchase or sale of a security of an issuer is 'on the basis of' material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale."

As commentators since have noted, the difference between "aware of" and "in knowing possession of" is negligible at best.[20] Thus, even though the rule ostensibly merely interprets the Supreme Court's phrasing in *O'Hagan* — indeed, it explicitly disclaims any modification of case law — the SEC in effect enacted by rulemaking the same "knowing possession" test it had sometimes failed to convince the Courts of Appeals was proper. The adopting release admits as much, stating that Rule 10b5-1 is "closer to the 'knowing possession' standard" than the alternative "use" standard.

Due to concerns over the potentially "overbroad" application of its rule, however, the SEC also included in Rule 10b5-1 an "affirmative defense" for trades made while a person is aware of material nonpublic information. The principal affirmative defense permitted a person to defeat liability under Rule 10b5-1 by showing:

1) the person made a contract, instruction, or written plan to trade before becoming aware of material nonpublic information;

2) that plan either specified the price and quantity to be purchased or sold, determined price and quantity by a specific formula or algorithm, or "did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales"; and

3) the trade actually took place pursuant to such contract, instruction, or plan.[21]

To take advantage of this affirmative defense, the new Rule 10b5-1 required that the defendant enter the trading plan in good faith. Lawyers and compliance departments subsequently used this affirmative defense to craft 10b5-1 plans, enabling trades designed to satisfy these elements.

By including the affirmative defense, the SEC responded in part to *Adler*'s and *Smith*'s concerns with the "knowing possession" rule, in particular that the rule might unfairly capture long-contemplated or otherwise innocuous trades. Nevertheless, by requiring that a trading plan predate the acquisition of any material nonpublic information, the affirmative defense did not permit trading after learning such information (absent a preexisting plan), even where that information does not affect a previous intention (as in the hypothetical that began this article). By structuring what could more naturally be construed as a safe harbor as an affirmative defense, the SEC also gave the government a procedural advantage in any charged case.

[17] *See, e.g.,* Allan Horwich, *Possession Versus Use: Is There A Causation Element in the Prohibition on Insider Trading?*, 52 Bus. Law. 1235, 1276 (1997).

[18] Rel. No. 33-7787, 64 FR 72590-01 (1999).

[19] *See, e.g.*, Carol B. Swanson, *Insider Trading Madness: Rule 10b5-1 and the Death of Scienter*, 52 U. Kan. L. Rev. 147, 190 (2003) ("[A]lthough the possession versus use issue was far from resolved, by 1999 the federal circuit courts were heading down a path that the SEC viewed as undesirable."); Donald C. Langevoort, 18 Insider Trading Regulation, Enforcement and Prevention § 3:14 (2022) ("Responding to the foregoing confusion in the case law regarding motivation and state of mind, the SEC adopted Rule 10b5-1 in the summer of 2000.").

[20] *See, e.g.*, Hui Huang, *The Insider Trading "Possession Versus Use" Debate: An International Analysis*, 34 No. 2 Securities Regulation Law Journal 3 (2006) (calling the SEC's choice of "aware of" a "tactical linguistic trick").

[21] Rule 10b5-1 contains another affirmative defense for "a person other than a natural person," *e.g.*, issuers.

Despite the SEC's attempt to resolve the debate through rulemaking, adoption of Rule 10b5-1's standard by courts has been incomplete. On the positive side of the ledger for the SEC, in *United States v. Royer*, the Second Circuit affirmed *Teicher*'s dicta, concluding a "knowing possession" standard should apply.[22] In addition to endorsing *Teicher*'s reasoning, the court also noted specifically that the SEC had adopted a "knowing possession" standard in Rule 10b5-1 after *Teicher* was decided, and that the Commission's "determination is itself entitled to deference."[23]

The other Courts of Appeals have not all followed suit. In *Fried v. Stiefel Lab'ys, Inc*., in particular, the Eleventh Circuit simply ignored Rule 10b5-1, citing *Adler* alone to conclude that the district court correctly had refused to give a jury instruction that would permit a finding of liability without proof the defendant had actually used material nonpublic information to trade.[24] Likewise, the Eighth Circuit did not cite Rule 10b5-1 in concluding in a criminal case that the government must prove the defendant "actually used the information."[25]

Lower courts similarly have differed on the deference they give to the SEC's definition. In *United States v. Jun Ying*, for example, a court in the Northern District of Georgia, refused to apply a "knowing possession" standard, ruling that the defendant could present evidence he did not use the alleged material nonpublic information to trade.[26] The foundation of the court's ruling, interestingly, was its concern that a "knowing possession" standard was inconsistent with the scienter requirement of Section 10(b). In this sense, rather than focusing on causation as a separate element, the court's analysis paralleled *Adler*'s and *Smith*'s by seeing use of the information as tied to the defendant's overall state of mind. By contrast, in *SEC v. Moshayedi*, a court in the Central District of California held that *Smith* no longer was binding precedent, given the SEC's issuance of Rule 10b5-1 had defined "on the basis of" in the interim.[27] Finding that the SEC's interpretation of that phrase was entitled to *Chevron* deference, the court held that the SEC must prove only that the defendant's "awareness or possession" of material nonpublic information.

One commonality in each of these more recent cases is their comparatively cursory analysis of the issue, regardless of outcome. As a result, the law on this issue has not developed substantially since the 1990s, though the academic and professional debate has continued.[28] As in the 1990s, the Supreme Court has not chosen to clarify the matter. In its most recent major insider trading case, *Salman v. United States*, the Court said only that Section 10(b) prohibits insiders "from secretly using [inside] information for their personal advantage" by "trading on inside information."[29] The Court's statement of the law may lend support to a "use" standard, but is hardly conclusive.[30]

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[22] 549 F.3d 886, 889 (2d Cir. 2008). The Second Circuit reiterated this holding in *United States v. Rajaratnam*, 719 F.3d 139, 159 (2d Cir. 2013), *cert. denied*, 134 S.Ct. 2820 (2014).

[23] *Id*. at 899 (citing *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843–44 (1984)).

[24] 814 F.3d 1288, 1295 (11th Cir. 2016). In this sense the *Fried* court went further than the court in *Adler*, which (as noted above) indicated that an SEC rulemaking on this issue would bind the court.

[25] *United States v. Anderson*, 533 F.3d 623, 631 (8th Cir. 2008) (citing *Smith*).

[26] No. 1:18 Cr. 74, 2018 WL 6322308, at *5 (N.D. Ga. Dec. 4, 2018) ("At trial, . . . the Government will have to establish sufficient evidence to demonstrate defendant's willful 'use' of a deceptive scheme to engage in the stock option trades at issue . . . Defendant will have the opportunity to present evidence and rebut any inference that Defendant used the information of the data breach when he traded, as provided by *Adler*.").

[27] No. 12 Civ. 1179, 2013 WL 12172131, at *13–14 (C.D. Cal. Sept. 23, 2013); *see also Sec. & Exch. Comm'n v. Panuwat*, No. 21 Civ. 6322, 2022 WL 633306, at *6 (N.D. Cal. Jan. 14, 2022) (noting disagreement among district courts in the Ninth Circuit).

[28] *See, e.g.*, Andrew Verstein, *Mixed Motives Insider Trading*, 106 Iowa L. Rev. 1253, 1314 (2021) (arguing for new "primary motive test" rather than existing use and knowing possession standards); Hui Huang, *The Insider Trading "Possession Versus Use" Debate: An International Analysis*, 34 No. 2 Securities Regulation Law Journal 3 (2006) (favoring Rule 10b-5's "modified possession" standard); Swanson, *supra* n. 19 at 209 (arguing SEC should have adopted "use" standard rather than Rule 10b5-1). Securities law treatises also typically have addressed this question in varying detail. *See, e.g.*, Donald C. Langevoort, 18 Insider Trading Regulation, Enforcement and Prevention § 3:14 (2022); Alan R. Bromberg, Lewis D. Lowenfels, and Michael J. Sullivan, 4 Bromberg & Lowenfels on Securities Fraud § 6:569 (2d ed.) (2022).

[29] 580 U.S. 39, ___, 137 S.Ct. 420, 423 (2016).

[30] Indeed, the Court has declined opportunities to review the rule, including by denying a petition for certiorari by Raj Rajaratnam. *Rajaratnam*, *supra* n. 22; *see also* Robert J. Anello and Richard F. Albert, "Revisiting Criminal Insider Trading Liability," 251 *New York Law Journal* 105 (June 3,

INCREASED ENFORCEMENT AND THE SEC'S REVISION OF RULE 10B5-1

Although Rule 10b5-1's adoption by the courts has been uneven and further development of the law has been minimal, the rule has caused a big change in market participants' behavior. Insiders hoping to trade now often use 10b5-1 plans, which set out directives intended to conform to the rule's affirmative defenses. Statistical analysis of trades under 10b5-1 plans, however, indicates that users may nevertheless take advantage of material nonpublic information through these plans to trade.[31]

Perhaps for this reason, as noted above, the SEC and DOJ appear to be ramping up investigations of potential abuses of 10b5-1 plans.[32] Indeed, the SEC already has announced an apparently connected settlement. In the *Matter of Sheng Fu & Ming Xu*, the respondents were the CEO and CTO of Cheetah Mobile, a mobile app company.[33] Aware that a key source of revenue was trending sharply downward, the two insiders implemented a 10b5-1 plan that directed the sale of stock two months before an announcement that the company would miss its revenue guidance. The SEC alleged that they had entered this plan in bad faith in order to avoid losses when the company's stock tanked after the announcement. As part of the settlement, the two executives paid combined penalties of over $750,000.

In tandem with these reported enforcement initiatives, on December 14, 2022, the SEC adopted modifications to Rule 10b5-1.[34] These amendments do not disturb the basic elements of the affirmative defense we discussed in the previous section, but they add numerous requirements that combine to make the affirmative defense more limited. The changes include:

1) A new mandatory cooling-off period before which no trading may take place under a trading plan, as follows:

   — For officers and directors, until the later of either 90 days or "two business days following the disclosure of the issuer's financial results in a Form 10-Q or Form 10-K for the fiscal quarter in which the plan was adopted."[35]

   — For other persons (*e.g.*, less senior employees), a 30-day cooling-off period.

   The stated purpose of the cooling-off periods is to "deter opportunistic trading" and reduce the chance that traders can benefit from undisclosed material nonpublic information.

2) A new requirement that directors and officers certify as part of a 10b5-1 plan that "they are not aware of material nonpublic information about the issuer or its securities" and that "they are adopting the contract, instruction, or plan in good faith."[36] The SEC's avowed intention by this amendment is to "reinforce directors' and officers' cognizance of their obligation[s]" under Rule 10b5-1.

3) New limitations on certain forms of trading plan that the Commission views as susceptible to abuse, such as overlapping plans for the sale of a single security, or plans for single trades in a particular security.

footnote continued from previous page…

2014) (discussing Rajaratnam petition and opportunity for Supreme Court to resolve circuit split).

[31] *See, e.g.*, Taylan Mavruk, H. Nejat Seyhun, *Do SEC's 10b5-1 Safe Harbor Rules Need to Be Rewritten?*, 2016 Colum. Bus. L. Rev. 133, 136 (2016) ("Our results indicate that the initial transactions from the plans show significant abnormal profitability, indicating that many plans are set up at a time when insiders possess material nonpublic information.").

[32] Tom Schoenberg and Matt Robinson, *US Probes Insider Trading in Prearranged Executive Stock Sales*, Bloomberg News (November 3, 2022), https://www.bloomberg.com/news/articles/2022-11-03/us-probes-insider-trading-in-prearranged-executive-stock-sales (describing incipient DOJ and SEC investigation of abuse of prearranged stock sale plans).

[33] Rel. No. 33-11104 (2022). For a longer discussion of this enforcement action and its implications, *see, e.g.*, Sullivan & Cromwell, *Recent SEC Insider Trading Action Provides Key Insights Into the Future of Rule 10b5-1* (September 26, 2022), https://www.sullcrom.com/files/upload/sc-publication-%20insider-trading-action-sheds-light-on-rule-10b51%E2%80%99s-future.pdf.

[34] Rel. No. 33-11138 (2022).

[35] This cooling-off period has a maximum of 120 days, however.

[36] The Commission also added to the existing requirement that a plan be "entered into in good faith" a new requirement that the trader also "act[] in good faith" with respect to a trading plan. By this addition, the Commission sought to close a perceived loophole in the previous "entered into" language that might not capture subsequent manipulation of a plan that was "entered into" in good faith.

The amendments also add a series of disclosure requirements, including a new requirement that an issuer disclose in its quarterly and annual filings whether its directors and officers recently have adopted or terminated 10b5-1 plans (or similar arrangements) and the "material terms" of those plans.

These new requirements have an obvious practical impact: they make satisfying the affirmative defense even more difficult and Rule 10b5-1 plans more cumbersome. In particular, because the SEC has chosen a much longer cooling-off period than the 30-day window many corporate compliance departments had previously adopted, directors and officers may choose to forgo the hypothetical protections of a 10b5-1 plan entirely.[37] The SEC also did not incorporate comments that suggested it clarify that the new certification requirement would not be a potential independent basis for liability under Section 10(b) or Rule 10b-5,[38] a decision that likewise may make insiders wary of putting themselves in harm's way just to gain an untested affirmative defense down the road.

Despite these modified requirements and potentially changed incentives, the SEC was careful to state that the amendments do not "alter" the existing "awareness" (i.e., "knowing possession") standard discussed above.[39] Alongside this statement — which was made only in a footnote — the SEC made two cursory claims. First, that Rule 10b5-1 is "entitled to deference," (citing the Second Circuit's decision in *Royer*), and second, a bare statement that the Eleventh Circuit's decision in *Fried*, which applied a "use" standard, was "erroneous[]." The SEC did not choose to discuss or further justify its choice two decades ago to adopt a "knowing possession" standard.

The only other indication of the SEC's current thinking on the "aware of" standard is its rejection of a comment by the Maryland Bar Association, which had suggested that the SEC clarify that insiders were permitted to file a trading plan while in possession of inside information, as long as that information became public or was no longer material by the time of the trade itself.[40] In declining to adopt that view, the SEC commented that it "concur[red] . . . that, in general, liability under Rule 10b-5 and Section 10(b) requires a showing that a covered individual was aware of material nonpublic information at the time that a trade was executed," rather than when adopting a plan for a later trade.[41] The SEC found, however, that because the affirmative defense was intended to include only clear-cut situations "where it is relatively unlikely that a trader will be able to trade on material nonpublic information," the more limited definition was the better approach. This discussion addresses a mirrored version of our hypothetical home-buyer's situation, but raises similar questions about whether 10b5-1 unduly penalizes inoffensive trades. The SEC's answer to those concerns, for now, appears to be to reject them in favor of its own restrictive view of what Supreme Court precedent requires.

WILL THE ENFORCEMENT PUSH LEAD TO NEW CHALLENGES FOR THE GOVERNMENT?

The enhanced scrutiny of trading by insiders reflected in the government's reported enforcement initiative and the SEC's revision of 10b-5, however, may well renew the debate over whether "use" or "knowing possession" of material nonpublic information is the correct interpretation of the Supreme Court's "on the basis of" standard. The issue could resurface whether the charged conduct is abuse of a 10b5-1 plan or trading in absence of such a plan. A trader such as the executive in our hypothetical — who could not use a 10b5-1 plan because she was already aware of the material nonpublic information — would have little recourse other than to assert the "use" standard should apply to her actions. Even though the law in the Second Circuit is favorable to the government, litigation of this question may prove risky, especially elsewhere, for both the DOJ and the SEC.

One area of particular vulnerability for the government could be the assumption by courts that have opted for a "knowing possession" rule — such as the Second Circuit in *Royer* — that *Chevron* deference is appropriate here.[42] (The *Chevron* doctrine holds that

[37] Letter of Rod Miller, Chair, Securities Regulation Committee, Association of the Bar of the City of New York to SEC (October 28, 2022) at 2 (noting, with respect to original SEC proposal of 120-day period, concern that "a strict 120-day cooling off period . . . would result in a dramatic decline in the use of plans," and advocating 30-day period "consistent with the practice of many public companies").

[38] Letter of Cravath Swaine & Moore LLP to SEC (Mar. 31, 2022) 6.

[39] Rel. No. 33-11138, *supra* n. 33 at 7 n. 10.

[40] Letter of Penny Somer-Greif, Chair, Committee on Securities Law of the Business Law Section of the Maryland State Bar Association to SEC (Apr. 6, 2022) 4.

[41] Rel. No. 33-11138, *supra* n. 33 at 44-45.

[42] *Royer*, *supra* n. 22.

where a "statute [administered by the agency in question] is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute."[43]). This reason for accepting the "knowing possession" rule runs contrary to the anti-deference zeitgeist of the last few years, which has had its most prominent expression in the Supreme Court's recent avoidance of the *Chevron* doctrine.[44] Where a court is inclined to apply *Chevron* deference, it is not difficult to reach the same conclusion as *Royer*: Section 10(b)'s reference to "manipulative or deceptive device[s] or contrivance[s]" does not speak explicitly about insider trading at all, let alone exactly what must be done to commit the offense, and Rule 10b5-1 offers a permissible interpretation.

A court hostile to or inclined to disregard *Chevron* (as the Supreme Court recently has done), however, likely would begin with the text of Section 10(b), seeking to reach an "independent interpretation of the law Congress wrote" without deferring to the SEC's interpretation.[45] An independent, text-focused approach could generate a wide range of potential interpretations of Section 10(b) in this context, including a reading that concludes the "use" standard is more consistent with the statute's proscription of manipulation and deception. This reading has ready support in *Adler*'s and *Smith*'s interpretations of Section 10(b), which pre-date the SEC's own formal interpretation, a fact that further increases the chances that a court unconstrained by *Chevron* would find the "use" standard more consistent with the statutory text and purpose.[46] Such an approach would be consistent, for example, with the Third Circuit's recent decision in *United States v. Banks*, in which the Third Circuit refused to defer in any way to the Sentencing Commission's longstanding commentary accompanying the United States Sentencing Guidelines and held, for the first time, that "loss" under Section 2B1.1 of the Guidelines is limited to "actual loss" (rather than the greater of actual or intended loss, per the commentary).[47] In short, without the heavy doctrinal thumb of *Chevron* on the scale, the government may well have a more difficult time than before in convincing the court that Rule 10b5-1 comports with Section 10(b).

Another obstacle for the government is the tension between doctrines of deference to agency interpretation (such as *Chevron*) and fundamental principles of criminal law. Perhaps the clearest expression of that tension has been Justice Scalia's dissent from the denial of certiorari in *Whitman v. United States*, in which

[43] *Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc*., 467 U.S. 837, 843 (1984).

[44] James Romoser, *In an opinion that shuns Chevron, the court rejects a Medicare cut for hospital drugs*, SCOTUSblog (Jun. 15, 2022, 2:24 PM), https://www.scotusblog.com/2022/06/in-an-opinion-that-shuns-chevron-the-court-rejects-a-medicare-cut-for-hospital-drugs/ (discussing *Am. Hosp. Ass'n v. Becerra*, 142 S. Ct. 1896, 1904 (2022); *see also Buffington v. McDonough*, 143 S. Ct. 14, 16, 22 (2022) (Gorsuch, J., dissenting from denial of cert.) (arguing *Chevron* deference is "judicial abdication" and that "the aggressive reading of *Chevron* has more or less fallen into desuetude").

[45] *Buffington*, *supra* n. 44; *see Am. Hosp. Ass'n v. Becerra*, 142 S. Ct. 1896, 1904 (2022) (analyzing "text and structure of the statute" to determine agency action without reference to *Chevron*); *see also* Remarks of Judge Diarmuid F. O'Scannlain, *"We Are All Textualists Now": The Legacy of Justice Antonin Scalia*, 91 St. John's L. Rev. 303, 304 (2017) (noting contemporary primacy of textualist modes of statutory interpretation).

[46] Another factor increasing the chance that a court might adopt a stricter construction is the fundamental ambiguity in what Rule 10b5-1 actually interprets — a statute (Section 10(b)), the SEC's own rule (Rule 10b-5), or merely Supreme Court precedent (the Court's meaning when it said "on the basis of"). The rule in its pre-2022 version said: "This provision defines when a purchase or sale constitutes trading 'on the basis of' material nonpublic information in insider trading cases brought under Section 10(b) of the Act and Rule 10b-5 thereunder." As revised, these claims to define statute, rule, and case law all at once have been separated into two subsections but remain substantively the same. If a court sees Rule 10b5-1 as fundamentally interpreting Supreme Court precedent, then there are even fewer constraints on the court's own interpretation. The project is further complicated, however, by the varying doctrines of deference that a court might apply in these circumstances, including the *Skidmore* doctrine (named for *Skidmore v. Swift & Co*., 323 U.S. 134 (1944)), which suggests courts should defer to agencies' interpretation of statutes they administer in proportion to that interpretation's persuasive power, or the *Auer* doctrine (named for *Auer v. Robbins*, 519 U.S. 452 (1997)), which in a manner analogous to *Chevron* counsels deference to an agency's interpretation of its own regulations in certain circumstances. In *Adler*, the Eleventh Circuit applied *Skidmore* deference and found the SEC's position wanting. *Adler*, *supra* n. 8 at 1339 n. 37.

[47] 55 F.4th 246, 257-58 (3d Cir. 2022). Because the Guidelines commentary is an "interpretive rule," the court in *Banks* considered and rejected *Auer* deference (which applies to interpretation of agency rules) rather than *Chevron* deference (which applies to interpretation of statutes). *See supra* n. 46.

Justice Scalia directly addressed the Second Circuit's decision to apply *Chevron* deference in *Royer*.[48] In *Whitman*, Justice Scalia argued that a court does not "owe deference to an executive agency's interpretation of a law that contemplates both criminal and administrative enforcement," for at least two reasons. First, deference to an agency's interpretation would allow the executive branch to decide what conduct is criminal, violating the basic requirement that crimes be specified by the legislature. Second, *Chevron* deference causes ambiguities in criminal statutes to be resolved in favor of the government, violating the rule of lenity, which requires the opposite presumption. A court inclined toward Justice Scalia's views as expressed in *Whitman* could well favor defendants' challenges to the "knowing possession" standard.[49]

CONCLUSION

The distinction between the "use" and "knowing possession" rules can have real-world consequences. Our hypothetical executive's circumstances are just one scenario in which a person could be held criminally liable without actually using inside information to trade. As we have discussed in this article, however, a criminal conviction or finding of civil liability in these circumstances may now be more vulnerable on appeal, given emerging trends in the caselaw.[50] ■

[48] 574 U.S. 1003 (2014). *See also Guedes v. Bureau of Alcohol, Tobacco, Firearms & Explosives*, 140 S. Ct. 789 (Mem.), 790 (2020) (Gorsuch, J., concurring in denial of cert.) (criticizing potential for conviction based on new interpretive rule by Bureau of Alcohol, Tobacco, Firearms and Explosives, and stating that "whatever else one thinks about *Chevron*, it has no role to play when liberty is at stake").

[49] *But see United States v. Levoff*, No. 19 Cr. 780, 2020 WL 4670913, at *3 (D.N.J. Aug. 12, 2020) (rejecting rule of lenity challenge to indictment for violation of Section 10(b) and Rule 10b-5 in which defendant cited *Whitman*, on grounds that Section 10(b) prohibits use of "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe," and noting that *Whitman* states that "[u]ndoubtedly Congress may make it a crime to violate a regulation").

[50] One question beyond the scope of this article is whether the Second Circuit's recent decision in *United States v. Blaszczak*, 56 F.4th 230 (2d Cir. 2022) (*"Blaszczak II*") will affect how the government approaches criminal insider trading prosecutions. In *United States v. Blaszczak*, 947 F.3d 19 (2d Cir. 2019) ("*Blaszczak I*"), the Second Circuit found that in insider trading prosecutions under Title 18, Section 1348, the government need not satisfy the "personal benefit" test. The upshot was creation of a distinction in insider trading law between Section 1348 and Section 10(b) that previously did not exist, but that distinction was called into doubt by the Supreme Court's decision to grant certiorari and remand the case for additional consideration in light of *Kelly v. United States*, 140 S.Ct. 1565 (2020). The *Kelly* holding did not directly affect *Blaszczak I*'s "personal benefit" holding, and in the end, the *Blaszczak II* panel elected to vacate the convictions at issue on the basis of *Kelly* alone, without addressing the personal benefit question at all. But in an unusual step, the two judges who constituted the majority of the panel wrote in concurrence to state their opposition to *Blaszczak I*'s rejection of the personal benefit test in Title 18 prosecutions. In dissent, meanwhile, Judge Sullivan — author of *Blaszczak I* — wrote to defend that distinction, in the process criticizing what he argued was an advisory opinion by the rest of the panel. In the absence of consensus on this issue in the Second Circuit, charges under either Title 18 or Title 15 pose litigation risks for the Department of Justice.