SCIENTER POTENTIA EST: THE CASE FOR THE PRESUMPTION OF USE SCIENTER STANDARD IN INSIDER TRADING

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ABSTRACT

Is it possible to accidentally insider trade? The Supreme Court has held that scienter is a necessary element of all § 10(b) and Rule 10b-5 actions,[1] but the federal appeals courts are split on how the scienter requirement applies to insider trading cases.[2] In a non-insider-trading § 10(b) case, the Supreme Court stated that § 10(b) scienter requires intentional misconduct.[3] Although the Supreme Court has not heard a case specifically about the scienter element in the context of insider trading, those who support a use requirement claim that the § 10(b) scienter element requires the plaintiff to show that the insider used the MNPI in the decision to trade.[4]

Those who support a possession standard reason that possession of MNPI creates an unfair informational advantage, which is sufficient reason to prohibit an insider from trading.[5] They also argue that it is

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1. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201-02 (1976) (holding that § 10(b) requires an element of scienter); Aaron v. SEC, 446 U.S. 680, 691 (1980) (clarifying that scienter is an element in both public and private 10b-5 cases).

2. Donald C. Langevoort, *What Were They Thinking? State of Mind Puzzles in Insider Trading* 3 (Geo. L. Fac. Pub. and Other Works, Paper No. 2496, 2023).

3. *Id.*

4. United States v. Smith, 155 F.3d 1051, 1067-68 (9th Cir. 1998); *Hochfelder*, 425 U.S. at 197.

5. United States v. Teicher, 987 F.2d 112, 120-21 (2d Cir. 1993).

impractical to require a plaintiff to prove a defendant actually used the MNPI in the decision to trade.[6]

This Note argues that possession of MNPI should create a rebuttable presumption of use for the purposes of insider trading liability under the § 10(b) and Rule 10b-5 scienter requirement. This standard best balances the Supreme Court's clarification that fraud under 10(b) includes intentional conduct[7] with the practicality of the knowing possession standard.

6. *See* Andrew Verstein, *Mixed Motives Insider Trading*, 106 IOWA L. REV. 1253, 1257 (2021).

7. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201-02 (1976) (holding that § 10(b) requires an element of scienter); Aaron v. SEC, 446 U.S. 680, 691 (1980) (clarifying that scienter is an element in both public and private 10b-5 cases).

INTRODUCTION

If material nonpublic information ("MNPI") does not factor into someone's decision to trade, is that person engaging in insider trading? For example, a company's employee owns stock in the company. She plans to sell her stock at the end of the week to make a down payment on a new home, but she does not have a written trading plan. During that week, she learns nonpublic information that the company is about to be bought by a competitor. Although she appreciates the higher selling price, the merger in no way factored into her decision to sell her shares on Friday. She sells her stock as planned. Should the employee be liable for insider trading?

Whether this employee is liable for insider trading depends on the circuit she is in. The Supreme Court has made it clear that scienter is a required element of insider trading,[8] but the circuit courts disagree on the level of scienter required. The 2nd U.S. Circuit Court of Appeals requires mere knowing possession of MNPI.[9] This standard is called the "possession" standard.[10] The 1st U.S. Circuit Court of Appeals requires knowing possession of MNPI along with knowledge that the MNPI was nonpublic and material.[11] The 9th U.S. Circuit Court of Appeals holds that scienter requires the plaintiff to show the defendant actually used the MNPI in the decision to trade (called the "use" standard).[12] The 7th and 11th U.S Circuit Courts of Appeals have middle ground standards, holding that possession of MNPI can create a presumption of use.[13]

Part I of this Note summarizes the relevant Supreme Court precedent on scienter for purposes of insider trading actions, applicable statutes, proposed legislation, and leading commentary on the state of the scienter requirement. Part II explains the circuit courts' diverging interpretations of the scienter requirement in insider trading. Part III argues that the Supreme Court should take the earliest possible opportunity to clarify that possession of MNPI creates a rebuttable

8. Dirks v. SEC, 463 U.S. 646, 663 n.23 (1983).
9. United States v. Royer, 549 F.3d 886, 899 (2d Cir. 2008).
10. *Id.*
11. SEC v. MacDonald, 699 F.2d 47, 50 (1st Cir. 1983).
12. United States v. Smith, 155 F.3d 1051, 1069 (9th Cir. 1998).
13. SEC v. Lipson, 278 F.3d 656, 661 (7th Cir. 2002); SEC v. Adler, 137 F.3d 1325, 1337-38 (11th Cir. 1998).

presumption of use. The Supreme Court should grant certiorari to a case where the defendant clearly possessed MNPI at the time of the trade and did not have a previously established trading plan. This will allow the Court to endorse the 7th and 11th Circuit's reasoning that, although insider trading liability requires use of MNPI, this use can be inferred from possession.[14]

PART I

A. SCIENTER IS AN ELEMENT OF INSIDER TRADING

The confusion around scienter in insider trading stems primarily from the awkward fit between insider trading doctrine and the Section 10(b) general fraud statute that serves as the basis of the prohibition on insider trading.[15] The victim of insider trading is generally the market as a whole, rather than a specific person who has been defrauded.[16] Insider trading laws also prohibit transactions that fall under a more intuitive notion of fraud. If a company insider directly sells a person a security for a high price when they knew undisclosed information that made the security worth much less, it takes little imagination to understand that as fraud. But insider trading law does not prohibit only such specific victims. It protects fairness in the market generally and prohibits taking advantage of "the investing public."[17]

Despite this imperfect fit, the prohibition on insider trading comes from Section 10(b) ("§ 10(b)").[18] The text of § 10(b) states that it is unlawful "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in

14. SEC v. Lipson, 278 F.3d 656, 661 (7th Cir. 2002); SEC v. Adler, 137 F.3d 1325, 1337-38 (11th Cir. 1998).

15. 15 U.S.C. § 78j; *see* Samuel W. Buell, *What Is Securities Fraud?,* 61 DUKE L.J. 511, 561 (2011); *see also* Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881, 889 (2010) (describing that "dealing with insider trading through an antifraud rule is like trying to fit a square peg into a round hole").

16. *See* Hazen, *supra* note 15, at 889 (noting that "the evils of insider trading go beyond fraud. Insider trading gives an unfair advantage to some market participants and can shake investor confidence in the securities markets").

17. SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 847-48 (2d Cir. 1968).

18. Chiarella v. United States, 445 U.S. 222, 234-35 (1980) (holding that insider trading is prohibited as fraud under § 10(b), so insider trading liability is limited to fraudulent activity).

contravention of such rules and regulations as the Commission may prescribe . . . ."[19] The plaintiff in a § 10(b) action must typically prove six elements: "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation."[20] Because of the aforementioned lack of a discrete, identifiable victim in insider trading cases, these six elements fit awkwardly with insider trading. Insider trading expands beyond face-to-face fraud, so if all six elements apply to insider trading, it is unclear who exactly must have relied on the misrepresentation and who must have experienced a loss.

Nevertheless, the Supreme Court has held that at least scienter is a necessary element of all § 10(b) and Rule 10b-5 actions.[21] The Supreme Court has not heard a case specifically about the scienter element in the context of insider trading, but it has reiterated that liability under Rule 10b-5 encompasses only fraud prohibited by § 10(b), which requires more than "mere negligence."[22] The Court has also referenced within an insider trading case the section in *Ernst & Ernst v. Hochfelder* that favored treating scienter as an element of all Rule 10b-5 actions, stating that the same logic applies to insider trading, without clearly stating that the same scienter requirement applies.[23]

Although the Supreme Court has not explained how each of the six elements of fraud applies to insider trading, the Court has held that insider trading must involve (1) manipulation or deception,[24] (2) in connection with the purchase or sale of a security,[25] and (3) in violation of a duty to disclose MNPI or abstain from trading.[26] These first two

19. 15 U.S.C. § 78j.

20. Stoneridge Inv. Partners, LLC v. Sci.-Atlanta, 552 U.S. 148, 157 (2008).

21. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201-02 (1976) (holding that § 10(b) requires an element of scienter); Aaron v. SEC, 446 U.S. 680, 691 (1980) (clarifying that scienter is an element in both public and private 10b-5 cases).

22. Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 472 (1977).

23. *See id.* at 471-72 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201-02 (1976)) (holding that the language of § 10(b) supports scienter as an element of Rule 10b-5 cases because "[t]he words 'manipulative or deceptive' [are] used in conjunction with 'device or contrivance.'").

24. *See id.* at 473-74.

25. United States v. O'Hagan, 521 U.S. 642, 655 (1997).

26. Chiarella v. United States, 445 U.S. 222, 230 (1980).

elements are lifted directly from the language of § 10(b).[27] The duty to disclose or abstain is not directly from the language of § 10(b). It is rooted in the common law interpretation that fraudulent misrepresentations can include failure to disclose information, but only when there is a duty arising from "fiduciary or other similar relation of trust and confidence."[28]

These three elements of insider trading are discussed mostly apart from the six common law elements of fraud. The Supreme Court has not listed the six common law elements in an insider trading case and has not specifically addressed scienter as an element of insider trading. Nevertheless, circuit courts and commentators alike generally agree that scienter is an element of insider trading based on *Hochfelder* and *Aaron v. SEC* both holding that scienter is a necessary element of all §10(b) and Rule 10b-5 actions.[29] But despite the agreement that scienter is relevant, the Supreme Court has not defined what constitutes sufficient scienter in insider trading, thus allowing lower courts to find various types of scienter necessary for insider trading liability.[30]

The Supreme Court has defined the scienter required for other types of securities fraud. In *Hochfelder*, the Court held that the scienter element of § 10(b) required "knowing or intentional misconduct."[31] The Court defined scienter in the context of the case at hand as "a mental

27. 15 U.S.C. § 78j.

28. *Chiarella*, 445 U.S. at 228 (1980) (quoting RESTATEMENT (SECOND) OF TORTS § 551 AM. L. INST. (1977)).

29. *See, e.g.*, Donna M. Nagy, *The "Possession vs. Use" Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never Be Golden*, 67 U. CIN. L. REV. 1129, 1176 (1999) (citing *Hochfelder* and noting that "as with any Rule 10b-5 action, there would be liability for trading while in possession of material nonpublic information only if the traditional insider acted with scienter"); Langevoort, *supra* note 2, at 3 (explaining the relevance of scienter in insider trading law and stating, "scienter always applies under Rule 10b-5"); *see also* Exchange Act Release No. 7881 (Aug. 24, 2000) (mentioning that "[s]cienter remains a necessary element for liability under Section 10(b)").

30. *See* Langevoort, *supra* note 2, at 3 (contending that the differing judicial interpretations of necessary scienter "seems based on distinctiveness of insider trading from forms of securities fraud involving false publicity or face-to-face deceit. As many have pointed out, the kind of deception we look for in conventional fraud cases simply cannot be found in insider trading").

31. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976); *see also* Aaron v. SEC, 446 U.S. 680, 691 (clarifying *Hochfelder*'s scienter requirement applies not just to private §10(b) and Rule 10b-5 cases but also to SEC enforcement cases).

state embracing intent to deceive, manipulate, or defraud," but limited the holding by stating that it was leaving open the possibility that recklessness may be an appropriate level of scienter for civil liability under § 10(b) and Rule 10b-5.[32]

Hochfelder was not an insider trading case, so its definition of scienter did not end the insider trading scienter debate, especially in light of the Court's own statement limiting its holding.[33] The plaintiffs in *Hochfelder* attempted to recover damages under § 10(b) and Rule 10b-5 on the theory that the firm was negligent in its improper audits of a company later revealed to be fraudulent.[34] In rejecting a theory of negligent nonfeasance in the context of an accounting firm's audit, the Court did not reject the possibility that knowing or even reckless conduct can meet the required level of scienter for other § 10(b) cases.[35]

The Court later referenced scienter in the context of insider trading (albeit in dicta) in *United States v. O'Hagan*, stating the following:

> Vital to our decision that criminal liability may be sustained under the misappropriation theory, we emphasize, are two sturdy safeguards Congress has provided regarding scienter. To establish a criminal violation of Rule 10b–5, the Government must prove that a person "willfully" violated the provision . . . . Furthermore, a defendant may not be imprisoned for violating Rule 10b–5 if he proves that he had no knowledge of the Rule.[36]

The court did not define "willfully," though, which left the scienter debate still unsolved.[37]

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32. *Hochfelder*, 425 U.S. at 194 n.12 ("In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.").

33. *See id.*

34. *See id.* at 190.

35. *See id.* at 194, n.12; *see also* Langevoort, *supra* note 2, at 2-3 (explaining that some courts have declined to apply the *Hochfelder* scienter standard to insider trading because "the kind of deception we look for in conventional fraud cases simply cannot be found in insider trading. If so, then it would be unwise to let the scienter case law developed as part of that body of case law play too big a role in insider trading cases").

36. United States v. O'Hagan, 521 U.S. 642, 665–66 (quoting 15 U.S.C. § 78ff(a)).

37. *Id.*

B. THE POSSESSION/USE DEBATE

This debate around the necessary scienter for insider trading liability is often framed as the "possession versus use" debate.[38] Those

38. *See* Langevoort, *supra* note 2, at 4. Not all courts or commentators root the possession/use debate in scienter. Some link it to the requirement in Rule 10b-5 that the fraud be "in connection with" the sale or purchase of a security. 17 C.F.R. § 240.10b-5 (emphasis added); *see* United States v. Teicher, 987 F.2d 112, 120 (2d Cir. 1993); *see also* Verstein, *supra* note 6, at 1269. From this view, the use standard means that mere possession of MNPI does not establish liability if the trade would have happened anyway, because the fraud was not "in connection with" a trade. *United States v. Teicher* roots its discussion of possession in the "connection" requirement. 987 F.2d at 120 (supporting the "knowing possession" standard by writing that the "connection" requirement "must be construed flexibly to include deceptive practices 'touching' the sale of securities, a relationship which has been described as 'very tenuous indeed.'") (internal quotations and ellipses omitted).

Others root the possession/use debate in the causation element. *See* Allan Horwich, *Possession Versus Use: Is There A Causation Element in the Prohibition on Insider Trading?*, 52 BUS. LAW. 1235, 1251 (1997). Though similar to the connection element, causation is a separate element of fraud. *See* Stoneridge Inv. Partners, LLC v. Sci.-Atlanta, 552 U.S. 148, 157 (2008). Causation suggests a specific type of connection, one that is less "tenuous" than the relationship that *Teicher* deciphered from the connection element. *Teicher*,987 F.2d at 120.

While the possession/use debate has implications for the causation and connection elements, the possession/use is most reliably framed as a question about scienter. The 1st, 7th, 9th, and 11th Circuits all discuss the possession/use debate in the context of scienter. SEC v. MacDonald, 699 F.2d 47, 50 (1st Cir. 1983); SEC v. Lipson, 278 F.3d 656, 661 (7th Cir. 2002); United States v. Smith, 155 F.3d 1051, 1068-69 (9th Cir. 1998); SEC v. Adler, 137 F.3d 1325, 1338 (11th Cir. 1998). Even when focusing on causation or connection, commentators and courts seem pulled toward scienter when discussing possession/use. *See, e.g.*, Allan Horwich, *Possession Versus Use: Is There A Causation Element in the Prohibition on Insider Trading?*, 52 BUS. LAW. 1235, 1248 (1997) (oscillating between framing the possession/use debate in causation and scienter); *see also Teicher*, 987 F.2d at 121 (addressing the scienter requirement, even after beginning the discussion with the connection element). Framing possession/use in connection or causation is also awkward because the possession of MNPI is itself what a court would have to find is in connection with the sale or purchase of a security. Framing possession of MNPI as part of the connection element would mean possession is both the thing that needs connecting and the connecting tool. But there is no reason why the possession/use debate cannot inform multiple elements. Questions of state of mind and motivation naturally implicate both scienter and causation. Nevertheless, this Note discusses the possession/use debate as a debate about scienter.

who support a possession standard reason that possession of MNPI creates an unfair informational advantage, which is sufficient reason to prohibit an insider from trading.[39] Supporters of a possession standard emphasize that an insider with a fiduciary duty or relationship of trust and confidence must disclose or abstain from trading when they possess MNPI.[40] They stress that this duty is not relieved by later claims about innocent reasons for trading, and that "material information can not lay idle in the human brain."[41]

Some commentators refer to the possession standard as an "awareness" standard. "Awareness" and "possession" are essentially interchangeable.[42] Both refer to liability for trading when one has MNPI, regardless of whether the MNPI was the reason they traded.[43] "Awareness" implies knowledge that the information was both material and nonpublic, and the "possession" standard is similar, often referred to as "knowing possession."[44] Thus, both "awareness" and "possession" refer to liability for trading while in knowing possession of MNPI.

Those who support a use requirement claim that the § 10(b) scienter element requires the plaintiff to show that the insider used the MNPI in the decision to trade.[45] They argue that the *Hochfelder* holding means that all § 10(b) and Rule 10b-5 actions require intent, despite the court limiting its holding.[46] Arguments for the use requirement emphasize that scienter requires a bad state of mind, which requires that the insider traded because of the MNPI, instead of a perfectly innocent reason.[47] The 9th Circuit exemplifies this line of reasoning by describing

39. *Teicher*, 987 F.2d at 120-21.

40. *Id.* at 120 (citing Chiarella v. United States, 445 U.S. 222, 227 (1980)).

41. *Teicher*, 987 F.2d at 120. Even the harshest possession standard still would only impose liability where there is a fiduciary duty or relationship of trust or confidence establishing a duty to disclose or abstain. More demanding scienter requirements (like requiring the plaintiff to prove actual use of the MNPI) would create exceptions where insiders who do have a duty to disclose or abstain can trade anyway without liability.

42. Langevoort, *supra* note 2, at 7.

43. *See id.*

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

45. *See* Langevoort, *supra* note 2, at 7.

46. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193, n.12 (1976); SEC v. MacDonald, 699 F.2d 47, 50 (1st Cir. 1983); SEC v. Lipson, 278 F.3d 656, 661 (7th Cir. 2002); United States v. Smith, 155 F.3d 1051, 1069 (9th Cir. 1998); SEC v. Adler, 137 F.3d 1325, 1338 (11th Cir. 1998).

47. *See* Verstein, *supra* note 6, at 1268–69.

its fear that the possession standard creates liability where there is no intentional fraud.[48]

C. General Background on the Securities Exchange Act of 1934

In 1984, Congress amended the Securities Exchange Act of 1934 to include penalties for purchasing or selling securities "while in possession of material, nonpublic information."[49] This could suggest that Congress meant to impose strict liability for trading while in possession of MNPI, regardless of intentionality.[50] Other interpretations assert that Congress meant possession to be "necessary, but not sufficient" for insider trading liability.[51]

PART II

A. Review of Caselaw on Scienter

Scienter is clearly an element of insider trading, but the federal appeals courts define the contours of the scienter element differently.[52] The 2nd Circuit holds that knowing possession of MNPI is sufficient to fulfill the scienter requirement.[53] The 1st Circuit has also held that knowledge is a sufficient scienter for insider trading liability, but frames scienter as knowledge that the information was nonpublic and material, rather than just knowledge of the information itself.[54]

In contrast, the 9th, 7th, and 11th Circuits hold that scienter requires intent, which requires the defendant to have used the insider information in the trade.[55] The 9th Circuit holds that the SEC always has

48. *Smith*, 155 F.3d at 1068.

49. 15 U.S.C. § 78u-1; *see also* Verstein, *supra* note 6, at 1266.

50. *See* Verstein, *supra* note 6, at 1266.

51. *See id.*

52. *See* Donald C. Langevoort, *Is motivation relevant in insider trading? – Case law background regarding scienter*, 18 INSIDER TRADING REGULATION, ENFORCEMENT AND PREVENTION § 3:13 (2024).

53. United States v. Royer, 549 F.3d 886, 899 (2d Cir. 2008).

54. SEC v. MacDonald, 699 F.2d 47, 50 (1st Cir. 1983).

55. United States v. Smith, 155 F.3d 1051, 1069 (9th Cir. 1998); SEC v. Lipson, 278 F.3d 656, 661 (7th Cir. 2002); SEC v. Adler, 137 F.3d 1325, 1338 (11th Cir. 1998).

the burden of showing use.[56] The 7th and 11th Circuits hold that possession of MNPI can create a presumption of use.[57]

1. Caselaw Supporting the Possession Standard

i. 2nd Circuit

The 2nd Circuit holds that trading while in "knowing possession" of MNPI is sufficient to establish liability.[58] *Teicher* is the first case to extensively discuss the knowing possession standard despite relegating the discussion to dicta.[59] But the 2nd Circuit clarified in subsequent rulings that the "knowing possession" standard, along with the underlying reasoning as articulated in *Teicher*, is indeed binding law.[60]

The 2nd Circuit does not hold that knowing possession is a scienter requirement, though.[61] It instead frames this standard in the § 10(b) and Rule 10b-5 requirement that the fraud be "in connection with" purchasing or selling securities.[62] It further reasoned that the possession standard is most consistent with the "oft-quoted maxim" that insiders have a duty to disclose or abstain.[63] The 2nd Circuit has explained that mere possession of MNPI creates the duty not to trade (or to disclose), so trading while in possession of MNPI should be sufficient for liability, without having to prove a causal connection.[64]

The 2nd Circuit further reasoned that a knowing possession standard has the benefit of simplicity.[65] The court explained that even small changes in trading strategies can have drastic results.[66] Requiring the plaintiff to prove use of MNPI is not as simple as showing the person simply decided to either buy or sell a security.[67] Proving a state

56. *Smith*, 155 F.3d at 1069.

57. *Lipson*, 278 F.3d at 661; *Adler*, 137 F.3d at 1339.

58. *See Royer*, 549 F.3d at 899 ("We consequently adhere to the knowing possession standard articulated in *Teicher*" which was "the product of sustained and detailed consideration as set forth in the [*Teicher*] opinion"); *see also* Steginsky v. Xcelera Inc., 741 F.3d 365, 370 (2d Cir. 2014).

59. United States v. Teicher, 987 F.2d 112, 119 (2d Cir. 1993).

60. *Steginsky*, 741 F.3d at 369; *Royer*, 549 F.3d at 899; *Teicher*, 987 F.2d at 120.

61. *Teicher*, 987 F.2d at 119.

62. *Royer*, 549 F.3d at 899; *Steginsky*, 741 F.3d at 370.

63. *Teicher*, 987 F.2d at 120.

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.*

of mind is not only difficult, but also unnecessary when there are good reasons to assume that all knowledge automatically gives a trader an advantage.[68]

Although *Teicher* does not address the possession/use debate in terms of scienter, the 2nd Circuit has separately held that plaintiffs can satisfy *Hochfelder*'s scienter requirement by showing the defendant had "a reckless disregard for the truth."[69] Although the court cites *Hochfelder*, a recklessness standard for scienter seems to be in direct contravention of *Hochfelder*, which holds that § 10(b) and Rule 10b-5's scienter element requires knowledge or intent.[70] However, in *Aaron v. SEC*, the Supreme Court left the question open in stating that it had "no occasion here to address the question, reserved in *Hochfelder*, whether, under some circumstances, scienter may also include reckless behavior."[71] Thus, though scienter is a required element in all § 10(b) and Rule 10b-5 actions, the Supreme Court left open the possibility that some such actions could require lower scienter.[72]

ii. 1st Circuit

The 1st Circuit has less clearly stated that it has adopted the knowing possession standard, but it has articulated a standard similar to the 2nd Circuit's knowing possession standard.[73] The 1st Circuit held in *SEC v. MacDonald* that scienter in insider trading requires knowledge that the MNPI was nonpublic and material.[74] The 1st Circuit draws this conclusion directly from *Hochfelder*'s holding that "§ 10(b) was intended to proscribe *knowing* or intentional conduct."[75] The court further held that the district court's finding that the inside information was a "motivating factor" for the trade is sufficient to meet this scienter

68. *Id.* ("Unlike a loaded weapon which may stand ready but unused, material information can not lay idle in the human brain.").

69. SEC v. McNulty, 137 F.3d 732, 741 (2d Cir. 1998); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

70. *Hochfelder*, 425 U.S. at 197.

71. Aaron v. SEC, 446 U.S. 680, 686 (1980).

72. *Id.*

73. SEC v. MacDonald, 699 F.2d 47, 50 (1st Cir. 1983).

74. *Id.* (holding that "the requirement is satisfied if at the time defendant purchased stock he had actual knowledge of undisclosed material information; knew it was undisclosed, and knew it was material").

75. *Id.* (quoting *Hochfelder*, 425 U.S. at 197) (emphasis added).

requirement.[76] The court reasoned that if the defendant found the information important in deciding whether to trade, he knew the information was material.[77] The court also worded the relevant standard for scienter as trading "at least in part because of the insider information."[78]

If the 1st Circuit's standard is indeed knowledge, and not intent, then its scienter requirement is not all that different from the 2nd Circuit's "knowing possession" standard.[79] Both require only showing that the defendant traded while knowing the information they had was material and nonpublic.[80]

Some commentators point out that in practice, proving possession or use often requires similar evidence.[81] Defendants often deny both possessing and using MNPI.[82] In that case, many courts hold that circumstantial evidence can be sufficient, such as the defendant trading right after a phone call with a tipper, if the timing of the trade is not part of a normal trading schedule.[83]

2. Caselaw Supporting the Use Standard

i. 9th Circuit

In *United States v. Smith*, the 9th Circuit held that the *Hochfelder* definition of scienter means that the plaintiff in an insider trading case must show actual use of MNPI to make the trade.[84] The 9th Circuit supports this standard with an interpretation of Supreme Court

76. *Id.* at 51.

77. *Id.*

78. *Id.*

79. *Id.* at 50; United States v. Teicher, 987 F.2d 112, 120 (2d Cir. 1993).

80. *Compare Teicher*, 987 F.2d at 121 ("It strains 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.") *with MacDonald*, 699 F.2d at 50 ("the requirement is satisfied if at the time defendant purchased stock he had actual knowledge of undisclosed material information; knew it was undisclosed, and knew it was material").

81. *See* Langevoort, *supra* note 52, at § 3:13.

82. *See id.*

83. *See id.*

84. United States v. Smith, 155 F.3d 1051, 1067-68 (9th Cir. 1998).

precedent, a connection between the causation requirement and scienter, and a discussion of the "disclose or abstain" maxim.[85]

The 9th Circuit views the Supreme Court's mention of "use" in *United States v. O'Hagan* as a requirement of causation between the inside information and the trade.[86] Others point out that the Supreme Court would have cited *Teicher* if it meant to reject the possession standard, as the Eighth Circuit did in the *O'Hagan* ruling on appeal.[87] The Supreme Court's ruling in *O'Hagan* also did not elaborate on the definition of "use."[88]

The 9th Circuit frames this use requirement as a causation requirement but connects the causation requirement to the scienter requirement.[89] It connects causation and scienter by stating that failing to require causation "effectively wipes out the scienter requirement."[90]

The 9th Circuit further weaves scienter into their holding by reasoning that the use requirement stems from *Hochfelder*'s language that scienter refers to "a mental state embracing intent to deceive, manipulate, or defraud."[91] The 9th Circuit holds that if a defendant possesses information but does not use it to make a trading decision, the defendant is trading on a level playing field with the rest of the market and does not meet the required intent to defraud.[92]

The 9th Circuit holds that the "disclose or abstain" maxim does not undermine the use requirement.[93] It explains that traders must only abstain from trading "on the basis of material nonpublic information."[94] The opinion emphasizes that a short maxim like "disclose or abstain" cannot contain all the complexities of insider trading law, and that the

85. *Id.* at 1067-69.

86. *Smith*, 155 F.3d at 1067 (holding that *O'Hagan* created a use requirement through the following passages, amongst others: "[t]he 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 . . . § 10(b) and Rule 10b–5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information.") (quoting United States v. O'Hagan, 521 U.S. 642, 653-56 (1997)).

87. *See* Verstein, *supra* note 6, at 1266–67 (2021).

88. *See id.*

89. *Smith*, 155 F.3d at 1070.

90. *Id.*

91. *Id.* at 1068 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976)).

92. *Id.* at 1068.

93. *Id.* at 1069.

94. *Id.*

focus on insider trading is and has always been the actual use of MNPI.[95]

The 9th Circuit declined to adopt the 11th Circuit's rebuttable presumption that possession of MNPI implies use but stated that this difference was because the case was criminal, not civil, such that it was not at liberty to create evidentiary presumptions.[96] The 9th Circuit does hold that the government can use circumstantial evidence to show use, like very unusual trading patterns.[97]

Prior to *Smith*, the 9th Circuit held that innocent explanations of trading patterns do not completely rebut the SEC's evidence of an illegitimate motive, and that multiple competing motives can simply be sufficient to create a genuine issue of material fact.[98]

3. Caselaw Supporting Standards Between Possession and Use

i. 11th Circuit

In *SEC v. Adler*, the 11th Circuit combines the possession and use rules to hold that trading while in possession of MNPI creates a rebuttable presumption of use.[99] The court reasons that a simple possession standard does not meet the requirement that any liability rooted in § 10(b) be fraudulent.[100] The *Adler* opinion quotes *Hochfelder*'s language of "intentional or willful conduct designed to deceive or defraud investors,"[101] as well as *Chiarella v United States*'s requirement that § 10(b) is "a catchall provision, but what it catches must be fraud."[102]

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95. *See id.*

96. *See id.* at 1069.

97. *See id.*

98. *See* Kaplan v. Rose, 49 F.3d 1363, 1380 (9th Cir. 1994), *overruled in part by* City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Align Tech., Inc., 856 F.3d 605 (9th Cir. 2017) (holding that a defendant showing a personal reason to "reap financial benefits" can "merely beg the question of whether they acted on the basis of undisclosed inside information in order to reap large returns. [The defendant's] implication that he wanted to retire can even be read to support a finding of his scienter.").

99. *See* 137 F.3d 1325, 1339 (11th Cir. 1998).

100. *See id.*

101. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976); *Adler*, 137 F.3d at 1338.

102. *See* Chiarella v. United States, 445 U.S. 222, 234–35 (1980); *Adler*, 137 F.3d at 1338.

In *Adler*, the 11th Circuit allowed the SEC to raise an inference of both possession and use of MNPI by showing a "suspicious chronology."[103] The SEC showed a phone call between Pegram (one of the defendants) and a tipper for 72 seconds at 7:53 AM, followed by the defendant's 7:55 AM call to his wife, followed by an 8:07 AM call from the wife to her stockbroker.[104] This resulted in selling 50,000 shares of a company's stock, along with the husband and wife's subsequent sale of 100,000 additional shares.[105] The SEC showed the other defendant, Choy, had a similar phone call followed by a trade.[106] The 11th Circuit held that this timeline sufficiently raised an inference of both possession and use of MNPI, but that this inference can be rebutted through evidence of an innocent reason to trade.[107] The 11th Circuit also held that Pegram had sufficiently alleged an alternative innocent reason to trade but Choy had not.[108]

The 11th Circuit acknowledges that the use standard imposes a difficult evidentiary burden by requiring the SEC to prove the insider used the MNPI in the decision to trade.[109] The court therefore holds that the fairest standard is the use test with the rebuttable presumption that possession implies use.[110] The court found that this standard balances the requirement that § 10(b) actions require fraudulent intent with the real evidentiary problems that the SEC would face by having to prove causation in every case.[111]

The 11th Circuit does not find that the use test conflicts with the "disclose or abstain" maxim and points out that the case that first articulated the maxim acknowledged the legal validity of preexisting trading plans as an affirmative defense.[112]

The 11th Circuit clarified that, although the timing of phone calls and trades created a presumption of use, a reasonable jury either could find that this showed the required scienter or could believe a defendant's

103. *Adler*, 137 F.3d at 1341-42.
104. *Id.* at 1341.
105. *Id.*
106. *Id.*
107. *Id.* at 1341-42.
108. *Id.*
109. *See id.* at 1339.
110. *See id.*
111. *See id.*
112. *See id.* 1338; In re Cady, Roberts & Co., 40 SEC 907, 911 (1961).

innocence defense.[113] The lower court had found for both Pegram and Choy in judgments as a matter of law, and the 11th Circuit reversed both.[114] Through this first application, the 11th Circuit showed that its "rebuttable presumption of use" standard emphasizes the fact-intensive question of causation.[115]

ii. 7th Circuit

In *SEC v. Lipson*, the 7th Circuit adopted a similar rebuttable presumption to the 11th Circuit.[116] Judge Richard Posner's majority opinion in *Lipson* noted that despite *Adler*'s and *Smith*'s consistency, *Adler* created a rebuttable presumption of proof in civil cases and *Smith* refused to apply this evidentiary presumption to a criminal case.[117] Like the 11th Circuit, the 7th Circuit held that the SEC's evidence of possession of MNPI at the time the defendant trades can create an inference of use, which shifts the burden of production to the defendant to offer rebuttal evidence.[118]

The 7th Circuit further held that "some evidence" of a preexisting plan to trade, in this case an estate plan, was sufficient to meet the defendant's burden of production and require the case to go to a jury trial.[119] The defendant had set up the estate plan two years earlier to transfer wealth to his son.[120] The plan involved his son borrowing money from a company the defendant controlled, and then using that money to buy millions of dollars of stock at a reduced price.[121] The defendant claimed he sold shares in his company to give his son cash to buy the stock.[122]

The court held that this estate plan was sufficient evidence to overcome a presumption of use from possession of MNPI. However, commentators have argued that allowing defendants to overcome the inference of use by only offering "some evidence" asserting a lawful

113. *See Adler*, 137 F.3d at 1341-42.
114. *Id.* at 1331-32, 1342-44.
115. *Id.* at 1342.
116. *See* SEC v. Lipson, 278 F.3d 656, 661 (7th Cir. 2002).
117. *See id.* (citing *Adler*, 137 F.3d at 1338 and United States v. Smith, 155 F.3d 1051, 1069 (9th Cir. 1998)).
118. *See id.* at 661.
119. *Id.*
120. *Id.*
121. *Id.* at 659.
122. *Id.* at 660.

motive lessens the practical differences between *Adler* (rebuttable presumption for civil cases) and *Smith* (requiring the SEC to prove use in criminal cases).[123]

The 7th Circuit further clarified that when a defendant has multiple motives, one innocent and one fraudulent, the innocent motive does not sanitize the fraudulent motive.[124] The innocent explanation must show that there could have been no causal connection between the illegitimate motive and the trade.[125]

B. THE 1984 INSIDER TRADING SANCTIONS ACT'S SUPPORT OF THE POSSESSION STANDARD

The 1984 Insider Trading Sanctions Act (the "1984 Act") supports the possession standard.[126] The 1984 Act prohibits trading securities "while in possession of material, nonpublic information."[127] Statutory history suggests that Congress intended to endorse the possession standard through the statutory text.[128]

Some insist that the 1984 Act did not alter the common law definition of insider trading.[129] The extensive post-1984 circuit court caselaw interpreting insider trading under the common law fraud definition supports this interpretation.[130] Others reason that even if the

123. *See* Verstein, *supra* note 6, at 1264 (citing *Lipson*, 278 F.3d at 661; *Adler*, 137 F.3d at 1337; *Smith*, 155 F.3d at 1069).

124. *Lipson*, 278 F.3d at 661 ("He might well have had two purposes, one to transfer wealth to his son and the other to avoid a loss that his inside information told him was coming. The existence of the legitimate purpose would not sanitize the illegitimate one.") (citing Sussman v. Am. Broad. Cos., Inc., 186 F.3d 1200, 1202 (9th Cir.1999)).

125. *See id.* at 661; *see also* Langevoort, *supra* note 2, at 2-3.

126. *See* Verstein, *supra* note 6, at 1266–68.

127. 15 U.S.C. § 78u-1 (emphasis added); Verstein, *supra* note 6, at 1266.

128. *See* Donald C. Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273, 1290 (1984).

129. *See* Verstein, *supra* note 6, at 1266; *see also* Stephen Bainbridge, *A Critique of the Insider Trading Sanctions Act of 1984*, 71 VA. L. REV. 455, 497 (1985) (supporting "the basic argument that the Act leaves the definition of insider trading to the common law").

130. *See, e.g.*, United States v. Smith, 155 F.3d 1051, 1067 (9th Cir. 1998); SEC v. Adler, 137 F.3d 1325, 1339 (11th Cir. 1998); SEC v. Lipson, 278 F.3d 656, 661 (7th Cir. 2002).

1984 Act was meant to alter the definition of insider trading, it only created a necessary condition, not a sufficient one.[131]

C. THE SEC'S RULEMAKING IN SUPPORT OF THE POSSESSION STANDARD

The SEC supported a possession standard in Rule 10b5-1 by clarifying that a person trades "on the basis of" MNPI "if the person making the purchase or sale was aware of the material nonpublic information."[132]

Advocates of the use standard point out that the SEC may not have the authority to change the existing law to a possession standard.[133] These critics point out that the SEC can only proscribe securities fraud that falls under § 10(b), which still requires the same six elements, including scienter.[134] The SEC denies that Rule 10b5-1 gets rid of the scienter requirement, but some commenters disagree.[135]

Advocates of the use standard also argue that 10b5-1 was not intended to change the scienter standard at all.[136] The SEC's 10b5-1 Release Notice text states "[t]he law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5, and Rule 10b5-1 does not modify the scope of insider trading law in any other respect."[137] Such interpretations square this with the "aware of" language by claiming that the rule only indicates a necessary condition, not a sufficient condition.[138]

Others interpret the Rule 10b5-1 awareness language to endorse the *Adler* standard, though this reading has not garnered significant support.[139]

Rule 10b5-1 at least seems to reject the use rule, but without a clear definition of "aware," courts will continue to diverge on whether

131. Verstein, *supra* note 6, at, 1266 (collecting sources).

132. 17 C.F.R. § 240.10b5-1 (emphasis added).

133. *See* Verstein, *supra* note 6, at 1266-67.

134. Carol B. Swanson, *Insider Trading Madness: Rule 10b5-1 and the Death of Scienter*, 52 U. KAN. L. REV. 147, 204 (2003).

135. *See* Allan Horwich, *The Origin, Application, Validity, and Potential Misuse of Rule 10b5-1*, 62 BUS. LAW. 913, 944 (2007) (collecting sources).

136. *Id.* at 922.

137. Selective Disclosure and Insider Trading, Exchange Act Release No. 7881 (Aug. 15, 2000).

138. *See* Verstein, *supra* note 6, at 1266-67.

139. *See* Langevoort, *supra* note 2, at 2-3.

awareness requires something more than mere possession (and if so, what).[140]

Regardless, Rule 10b5-1 has not ended the possession/use debate.[141] District and circuit courts still span the spectrum on what they require plaintiffs to show when establishing scienter in insider trading cases.[142]

D. DIVERGING INTERPRETATIONS OF THE 2021 INSIDER TRADING PROHIBITION ACT

In both 2019 and 2021, the U.S. House of Representatives passed legislation to clarify insider trading liability.[143] Neither bill has been passed in the Senate.[144] Both bills use the same relevant language, stating that is unlawful to purchase or sell a security "while aware of material, nonpublic information relating to such security . . . if such person knows, or recklessly disregards, that such information has been obtained wrongfully, or that such purchase or sale would constitute a wrongful use of such information.[145]

Both bills also include sections titled "Knowledge Requirement," which state in their relevant parts:

It shall not be necessary that the person trading while aware of such information (as proscribed by subsection (a)) . . . knows the specific means by which the information was obtained or communicated . . . so long as the person trading while aware of such information . . . was aware, consciously avoided being aware, or recklessly disregarded that

140. *See* Allan Horwich, *The Origin, Application, Validity, and Potential Misuse of Rule 10b5-1*, 62 BUS. LAW. 913, 918–19 (2007).

141. *See* Robert T. Miller, *Market Practices and the Awareness/use Problem in Insider Trading Law: A Response to Professor Verstein's Mixed Motives Insider Trading*, 107 IOWA L. REV. ONLINE 162, 164–65 (2022).

142. *See id.*

143. Insider Trading Prohibition Act of 2021, H.R. 2655, 117th Cong. (2021); Insider Trading Prohibition Act of 2019, H.R. 2534, 116th Cong. (2019).

144. *See* ROBERT J. WILD, INSIDER TRADING—LAWS AND REGULATIONS, CORP. COMPL. SERIES: SECURITIES § 1:137 (2024).

145. Insider Trading Prohibition Act of 2021, H.R. 2655, 117th Cong. § 16A(a) (2021); Insider Trading Prohibition Act of 2019, H.R. 2534, 116th Cong. § 16A(a) (2019).

such information was wrongfully obtained, improperly used, or wrongfully communicated.[146]

Commentary on both bills conveys a wide range of stances including pure criticism, cautious optimism, and avid support.[147] Some commentators oppose the enactment of the Insider Trading Prohibition Act ("ITPA"), saying it is unclear and will require extensive judicial interpretation.[148] They complain that the Act expands the scope of insider trading liability beyond people who have a fiduciary duty, a Rule 10b5-2 relationship of trust and confidence, or a tipper/tippee relationship.[149] Despite the awkward fit between fraud and insider trading, the current state of insider trading common law is fairly well-designed and should not be muddled by an unnecessary and unclear bill.[150]

Others remark that the legislation is a welcome effort to clarify insider trading law, and that Congress should take the opportunity to expand insider trading liability even more.[151] Some commentators take the position that legislation "is a step in the right direction" but the bill as proposed is too ambiguous.[152]

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146. H.R. 2655, 117th Cong. § 16A(c)(2) (2021); H.R. 2534, 116th Cong. § 16A(c)(2) (2019).

147. *Compare* Bainbridge, *supra* note 131, at 233, *with* Michael D. Guttentag, *Avoiding Wasteful Competition: Why Trading on Inside Information Should Be Illegal*, 86 BROOK. L. REV. 895, 900 (2021).

148. *See* Bainbridge, *supra* note 131, at 236.

149. *See id.* at 235.

150. *See id.* at 233; Peter J. Henning, *What's So Bad About Insider Trading Law?*, 70 BUS. LAW. 751, 757 (2015).

151. *See* Guttentag, *supra* note 147, at 900 (2021) ("While the ITPA of 2019 and the ITPA of 2021 are welcome efforts to place the crime of insider trading on a statutory foundation, both bills continue the practice of only prohibiting trading based on wrongfully acquired information. Instead, legislation that bans all trading when in possession of inside information should be enacted.").

152. *See* Kevin R. Douglas, *How Fatal Ambiguity Undermines Effective Insider Trading Reform*, 48 J. CORP. L. 353, 402 (2023) ("both proposals continue the tradition of using fatally ambiguous moral language to describe the law's central motivation. Describing the law as penalizing the 'wrongful' use of information is the functional equivalent of penalizing the 'unfair' use of information").

PART III

A. THE BEST STANDARD IS A REBUTTABLE PRESUMPTION OF USE WHEN IN POSSESSION OF MNPI

The Supreme Court should take the next available opportunity to clarify that possession of MNPI creates a rebuttable presumption of use for the purposes of insider trading liability under the § 10(b) and Rule 10b-5 scienter requirement. This standard correctly balances *Hochfelder*'s requirement for intentional conduct with the practicality of the knowing possession standard.

Under the rebuttable presumption of use, the employee who sold her company's stock to make a down payment on her house while in possession of MNPI will face a presumption that she used the MNPI in her decision to trade. She would be allowed to offer evidence showing the MNPI did not factor into her decision to trade. This could be in the form of a written trading plan, one of the explicit exceptions to insider trading liability under Rule 10b5-1(c).[153] If she did not have a written plan to trade, she could offer other evidence, including accounts from anyone she spoke to about her plans. The rebuttable presumption of use standard acknowledges that informational advantages exist without always leaving smoking gun evidence, while offering flexibility to defendants like this company employee who have the chance to offer any evidence to corroborate her defense that she was planning to sell on a specific date, regardless of her knowledge of the MNPI.

In addition to the standard's practicality, the presumption of use standard comports with Supreme Court precedent. *Hochfelder* states the scienter requirement in a few different ways, including "intentional or willful conduct," "willful, knowing, or purposeful conduct," and "more than negligent action or inaction."[154] Allowing the defendant to rebut the presumption of use respects the intent language of *Hochfelder*.[155] Once the plaintiff rebuts the presumption of use, use becomes a question for the jury, to whom the SEC will then have to prove use.[156] The standard is thus not lowered below *Hochfelder*'s requirement of intentional conduct.

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153. 17 C.F.R. § 240.10b5-1.

154. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 186 (1976).

155. *See id.*

156. *See* SEC v. Adler, 137 F.3d 1325, 1342 (11th Cir. 1998).

Additionally, allowing the SEC to show mere knowing possession, in the absence of evidence rebutting the presumption of use, does not contradict *Hochfelder*'s standard. While courts that find a use requirement exclusively quote the "intent to deceive" language of *Hochfelder*[157], the 1st Circuit cites the "knowing or intentional conduct" language of *Hochfelder* and holds that "[p]roof of knowing conduct is sufficient to establish the necessary scienter."[158] Even the 9th Circuit, which has since adopted a use standard, recognized that the *Hochfelder* opinion "accepted a knowledge standard."[159] Therefore, the knowing possession standard, especially when only applied to create a rebuttable presumption of use, is by no means contrary to current Supreme Court precedent.

Even if *Hochfelder* were to be interpreted as strictly requiring proof of use, *Hochfelder*'s exact scienter standard does not necessarily apply to insider trading. The *Hochfelder* opinion expressly clarifies that its scienter holding is limited to the case before it and notes that recklessness may be sufficient in some civil liability cases.[160]

A rebuttable presumption of use from knowing possession also provides the most common-sense standard for scienter in the insider trading context. While the possession/use debate has received plenty of academic analysis, trial courts already rarely require the SEC to prove anything more than possession, even at trial.[161] This standard practice of the trial courts signals the common-sense nature of the possession rule.

The presumption of use from possession is popular among the circuit courts. All three circuit courts with a use standard hold that in

157. *See Hochfelder*, 425 U.S. at 188.

158. *See* SEC v. MacDonald, 699 F.2d 47, 50 (1st Cir. 1983) (quoting *Hochfelder*, 425 U.S. at 186).

159. *See* Nelson v. Serwold, 576 F.2d 1332, 1337 (9th Cir. 1978).

160. *See Hochfelder*, 425 U.S. at 194, n.12 ("In this opinion the term 'scienter' refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5."); *see also Nelson*, 576 F.2d at 1337 (acknowledging that the Court in *Hochfelder* "expressly limited that [scienter] definition to the case before it.").

161. *See* Langevoort, supra note 52, at§ 3:13 (2024) (collecting instances of courts upholding jury verdicts based on circumstantial evidence of possession and stating: "In the typical case, once possession is proved, there is no further question that the insider traded in order to take advantage of material nondisclosed information").

some cases, use can be inferred from possession.[162] This inference comes in the form of either the presumption of use standard that this Note supports,[163] or by showing use through circumstantial evidence.[164] This circumstantial evidence can consist of showing possession at the time of the trade.[165] In circuits with the use standard, "[t]he weight of authority . . . is to allow the fact finder fairly wide latitude in inferring possession from circumstantial evidence."[166] Even when courts officially implement a use standard, courts are drawn back to the rebuttable presumption of use from possession because it is the most common-sense way to show a connection between the MNPI and a trade.

Teicher's explanation of the possession standard highlights why a rebuttable presumption of use from possession is the common-sense standard for insider trading; that the advantage is often the information itself, and that "[u]nlike a loaded weapon which may stand ready but unused, material information can not lay idle in the human brain."[167] Once the SEC shows possession of MNPI and a trade shortly thereafter, the sensible conclusion is that the person with the MNPI had an advantage. The rebuttable presumption standard is common-sense because it respects the notion that the information itself is the advantage while also allowing a truly innocent defendant to provide an alternative explanation.[168]

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162. *See* SEC v. Lipson, 278 F.3d 656, 661 (7th Cir. 2002) (adopting a presumption of use standard); *Adler*, 137 F.3d at 1338 (adopting a presumption of use standard); United States v. Smith, 155 F.3d 1051, 1069 (9th Cir. 1998) (holding that circumstantial evidence, including possession and timing, can show use).

163. *See Lipson*, 278 F.3d at 661; *Adler*, 137 F.3d at 1338.

164. *See Smith*, 155 F.3d at 1069.

165. *See id.* ("Suppose, for instance, that an individual who has never before invested comes into possession of material nonpublic information and the very next day invests a significant sum of money in substantially out-of-the-money call options. We are confident that the government would have little trouble demonstrating 'use' in such a situation . . .").

166. *See* Langevoort, *supra* note 52, at § 3:13 (citing United States v. Xie, 942 F.3d 228 (5th Cir. 2019); United States v. Heron, 323 Fed. Appx. 150, Fed. Sec. L. Rep. [CCH] ¶ 95106 (3d Cir. 2009); Drucker v. SEC, 2009 WL 3004104 (2d Cir. 2009); In re Novatel Wireless Securities Litigation, 2011 WL 5873113 (S.D. Cal. 2011)).

167. United States v. Teicher, 987 F.2d 112, 120 (2d Cir. 1993) (Stating further that "one who trades while knowingly possessing material inside information has an informational advantage over other traders. Because the advantage is in the form of information, it exists in the mind of the trader.").

168. *See id.*

Existing regulations also support the presumption of use standard. Rule 10b5-1 rejects the pure use standard by clarifying that § 10(b) prohibits trading "if the person making the purchase or sale was *aware* of the MNPI when the person made the purchase or sale."[169] While the phrasing of "aware" instead of "knowingly possessing" (as the 2nd Circuit phrases it) has created confusion regarding which standard Rule 10b5-1 was intended to support, the most obvious interpretation is that "aware" points to the knowing possession standard.[170]

Allowing a rebuttable presumption of use from knowing possession will not over-include people who can genuinely show that they would have traded anyway. First, of course, it allows innocent traders to rebut the presumption by introducing evidence of alternative motivations and plans for the trade in question. Second, the knowing possession standard has and will continue to coexist with the Rule 10b-5 trading plan exceptions.[171] Some commentators argue that even allowing certain Rule 10b-5 trading plans may be too lenient because of their potential for abuse.[172] Regardless, in addition to allowing defendants the chance to rebut the presumption of use, this standard leaves intact all of the Rule

169. 17 C.F.R. § 240.10b5-1 (emphasis added).

170. *See* Donald C. Langevoort, *What Were They Thinking? State of Mind Puzzles in Insider Trading*, 6 (Geo. L. Fac. Pub. and Other Works, Paper No. 2496, 2023), https://scholarship.law.georgetown.edu/facpub/2496 ("The first part of the rule effectively set the legal standard as one of awareness by the insider of material nonpublic information at the time of the trade—essentially the same as knowing possession"); *see also* Allan Horwich, *The Origin, Application, Validity, and Potential Misuse of Rule 10b5-1*, 62 BUS. L. 913, 921-22 (2007) ("Confronting the possession versus use issue head on, the SEC stated, without addressing contrary arguments, that Rule 10b5-1 'reflects the common sense notion that a trader who is aware of inside information when making a trading decision inevitably makes use of the information.'").

171. 17 C.F.R. § 240.10b5-1; *see also* Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1332 (1999) (citing Matter of Cady, Roberts & Co., 40 SEC 907, 916(Nov. 8, 1961)) (". . . in the first open market insider trading case under Rule 10b-5, the Commission was confronted with a claim that is still standard in insider trading enforcement proceedings: 'I would have bought [or sold] anyway--therefore I didn't misuse any information.'").

172. *See* Langevoort, *supra* note 171, at 1336 ("Indeed, there is something troubling about ever allowing a corporation to repurchase securities while knowing some highly sensitive information, even if it has a regular buy-back plan . . . such plans do represent an inevitable potential for speculative abuse given management's predictable awareness of what sorts of things lie just around the corner.").

10b-5 affirmative defenses for trades that are not made on the basis of MNPI.[173]

B. THE SUPREME COURT SHOULD TAKE THE NEXT OPPORTUNITY TO CLARIFY THE SCIENTER STANDARD

The presumption of use standard offers a clear, efficient, coherent standard that will allow traders in the fast-moving financial markets to know when they may and may not buy and sell securities. Efficiency has always been an important goal of insider trading law, motivating courts to find precise, coherent rules.[174] The current lack of clarity around scienter in insider trading is an imprecision that hinders market efficiency.

In addition to restoring precision and efficiency, the Supreme Court must clarify the scienter standard because there is no indication that the proposed legislation would resolve the debate.[175] Supporters and critics of the possession standard alike note that the bill's language is unclear about how much it is intended to expand insider trading liability.[176] In one part, the bill imposes liability on those who trade "while aware" of MNPI.[177] Later in the same section, it requires that a person "recklessly disregards . . . that such purchase or sale would constitute a wrongful use of such information."[178] The mingling of awareness, recklessness, and use points to three different competing standards of scienter.[179] Each circuit court can cherry pick the language that best supports the standard it already applies. The proposed legislation will not resolve the circuit split.

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173. 17 C.F.R. § 240.10b5-1.

174. *See* Dirks v. SEC, 463 U.S. 646, 659, n.17 (1983) ("[An imprecise rule] prevents parties from ordering their actions in accord with legal requirements. Unless the parties have some guidance as to where the line is between permissible and impermissible disclosures and uses, neither corporate insiders nor analysts can be sure when the line is crossed.").

175. *See* Bainbridge, *supra* note 131, at 242.

176. *See id.*; *see also* Guttentag, *supra* note 147, at 900.

177. H.R. 2655, 117th Cong. § 16A(a) (2021).

178. *See id.*

179. *See supra* sections A.1-3; *see also* Kevin R. Douglas, *How Fatal Ambiguity Undermines Effective Insider Trading Reform*, 48 J. CORP. L. 353, 402 (2023).

CONCLUSION

The Supreme Court should take the earliest possible opportunity to clarify that the scienter standard for insider trading liability requires use of MNPI, but allows a presumption of use when the plaintiff can show the defendant possessed MNPI, as articulated by the 11th Circuit.[180] The presumption of use standard is supported by Supreme Court precedent and is already adopted by both the 11th and 7th Circuit.[181] It is the most common-sense standard and the most widely applied standard in practice.[182] It comports with current regulations and will improve legal precision and market efficiency.[183]

180. *See* SEC v. Adler, 137 F.3d 1325, 1342 (11th Cir. 1998).
181. *See supra* section A.3; *Adler*, 137 F.3d at 1342.
182. *See supra* part III, section A.
183. *See* Dirks v. SEC, 463 U.S. 646, 659, n.17 (1983).