The Myriad Ways SEC Rule 10b5-1 Is Invalid

*By Allan Horwich**

The Securities and Exchange Commission (SEC) adopted Rule 10b5-1 to define an element of insider trading in violation of Rule 10b-5. Rule 10b5-1 provides that Rule 10b-5 is violated by purchasing or selling a security of any issuer "on the basis of" material nonpublic information about that security or issuer, which means "the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale." The rule also adopted exclusive defenses a purchaser or seller can use to demonstrate that he did not use material nonpublic information in trading and thus did not violate Rule 10b-5.

Critical aspects of Rule 10b5-1 are invalid.

1) *Rule 10b5-1 exceeds the SEC's rulemaking powers under section 10(b) because a 10(b)-based rule cannot impose liability unless the rule prohibits the use or employment of material nonpublic information.*

2) *The definition of "on the basis of" in Rule 10b5-1(b) disregards controlling caselaw in at least one significant respect, departing from the SEC's own understanding of the phrase. In particular, the courts have determined that in a misappropriation case, "use" of material nonpublic information, not mere awareness of that information, is an essential element of the claim. For this and other reasons, the SEC's adoption of the definition was arbitrary and capricious.*

3) *The SEC exceeded its authority in adopting exclusive affirmative defenses to a charge of violating Rule 10b-5 that preclude an alleged violator from asserting other grounds to demonstrate that he did not use the material nonpublic information in trading.*

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4) Rule 10b5-1 fails to make any distinction between claims based on the classical theory or based on the misappropriation theory and between civil enforcement and criminal claims.

Contents

The otherwise laudable efforts of the Securities and Exchange Commission (SEC or Commission) to rein in trading on the basis of material nonpublic information (MNPI) have been accompanied by an administrative overreach when the SEC adopted a rule that seeks to define an essential element of unlawful insider trading. This Article does not argue that the rule should have been drafted differently as a matter of judgment among permissible alternatives, as many who commented on the proposed rule argued. Rather, this Article addresses the heart of the rule, demonstrating fundamental legal shortcomings.[1] The flawed aspects of the rule should not be countenanced—they are not enforceable.

I. Introduction

A. The Law of Insider Trading in Summary

A substantial body of federal common law delineates when it is unlawful to trade securities based on MNPI.[2] This law springs primarily from SEC Rule 10b-5,[3] adopted pursuant to authority granted by section 10(b) of the Exchange Act.[4]

1. This Article significantly refines, expands upon, and updates arguments advanced seventeen years ago by the present author. Allan Horwich, *The Origin, Validity, and Potential Misuse of Rule 10b5-1*, 62 Bus. Law. 913, 943–49 (2007) [hereinafter *Horwich Validity*]. This Article takes into account important developments in administrative law and subsequent securities law scholarship, as well as cases decided in the quarter-century since the earlier publication of the present author's survey of the law. Allan Horwich, *Possession Versus Use: Is There a Causation Element in the Prohibition on Insider Trading?*, 52 Bus. Law. 1235 (1997) [hereinafter *Horwich Possession*].

2. *See* Donald C. Langevoort, Insider Trading: Regulation, Enforcement & Prevention § 1:10 (2023) [hereinafter Langevoort Insider Trading] (the two principal theories of insider trading under Rule 10b-5 "are largely federal common law concepts accepted judicially as a way of interpreting the very general language of Rule 10b-5").

In this Article "insider trading" means "insider trading in violation of Rule 10b-5." The meaning of the phrase "based on" is addressed in depth in *infra* Part VI.

3. 17 C.F.R. § 240.10b-5 states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Insider trading in violation of Rule 10b-5 generally involves deception in the nature of silence when there is a duty to speak, violating clause (a) or (c), as described in *infra* Part I.B.1.

4. 15 U.S.C. § 78j(b) (2018). This provides 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 contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." Rule 10b-5 is such a rule.

Under the classical, or traditional, theory of insider trading, Rule 10b-5 is "violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information" about the company or its securities.[5] This is because "a relationship of trust and confidence" exists "between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation."[6] In open market transactions, Rule 10b-5 imposes a duty upon the insider to make public disclosure of the MNPI before trading or to abstain from trading.[7] Under the classical theory, the duty to abstain or disclose is imposed not only upon a member of the board of directors and a senior officer of the company but upon *any* employee of the company that issued the securities in which the "insider" traded.[8] This theory also reaches a "temporary insider."[9]

Under the misappropriation theory of insider trading, a person—whether or not she is an insider of the company in whose securities she trades—violates Rule 10b-5 when she takes confidential information, for securities trading purposes, in breach of a duty owed to the source of the information. There the trader violates Rule 10b-5 by the undisclosed, self-serving use of a another's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality to the source of the information. There is no requirement that the trader first obtain permission from the source to trade nor, unlike the classical theory, is there a requirement to make *public* disclosure of the MNPI before trading.[10]

A fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. An omitted fact is material if there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly

Criminal prosecutors have also relied on section 1348 of Title 18 to pursue insider trading. That section provides that it is unlawful to "knowingly execute[], or attempt[] to execute, a scheme or artifice—to defraud any person in connection with . . . any security of [a public company]." *See, e.g.*, United States v. Blaszczak, 56 F.4th 230 (2d Cir. 2022) (addressing the scope of an insider tipping claim under section 1348).

5. As shown in *infra* Part VI, "on the basis of"—properly understood—means to use the information in trading.

6. United States v. O'Hagan, 521 U.S. 642, 651–52 (1997) (summarizing the import of *Chiarella v. United States*, 445 U.S. 222, 228 (1980)).

7. *O'Hagan*, 521 U.S. at 652.

8. *See* Langevoort Insider Trading, *supra* note 2, § 3:5 ("Employees of the issuer are agents/servants of the corporation, and are held to duties of loyalty that include the obligation not to profit from confidential information given to them in the course of their employment.").

9. Dirks v. United States, 463 U.S. 646, 655 n.14 (1983) ("Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders."); *see* Langevoort Insider Trading, *supra* note 2, § 3.8 (describing the temporary insider). A third subcategory, "traditional insiders," is addressed at *infra* text accompanying notes 77–81.

10. *O'Hagan*, 521 U.S. at 652. *See also* United States v. Falcone, 257 F.3d 226, 232 n.3 (2d Cir. 2001) (Sotomayor, J.) ("notwithstanding the damaging effects of unequal information, if the fiduciary discloses to the information source his or her intent to trade based on the information, there is no fraud constituting a violation of section 10(b)").

altered the "total mix" of information made available.[11] "[W]ith respect to contingent or speculative information or events . . . materiality 'will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.'"[12] Whether information is nonpublic is usually addressed by determining whether the information is public.[13]

A person who cannot lawfully trade under either theory who conveys MNPI to another may be liable for unlawful tipping. A recipient of the information who trades may be liable as a tippee. The elements of wrongful tipping and tippee trading need not be understood for purposes of this Article.[14]

In any claim brought under section 10(b) and Rule 10b-5 the plaintiff, including the SEC in an enforcement action, must plead and prove that the defendant acted with scienter, "a mental state embracing intent to deceive, manipulate, or defraud."[15] The SEC has the power to bring a civil action against someone alleged to have engaged in insider trading; the Department of Justice (DOJ) may pursue criminal charges.[16]

B. The Issues Addressed in This Article

This Article critiques the SEC's rulemaking regarding a fundamental element of insider trading: whether there must be a causal connection between MNPI and the decision to trade, sometimes described as the "possession versus use debate."[17] The question was—and in the view of the present author to a significant extent remains—whether Rule 10b-5 is violated only when the person who traded consciously *used* MNPI in deciding to make the trade or whether it is sufficient that he was merely aware of (or possessed) the MNPI when the trade occurred. The Exchange Act does not answer this question. The SEC sought to

11. Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988).

12. *Id.* at 238 (quoting SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc), where the source of the information was the corporation Texas Gulf Sulphur). *Texas Gulf Sulphur* was the first major federal appellate case involving insider trading.

13. *See generally* Langevoort Insider Trading, *supra* note 2, § 5.4 ("Information is 'nonpublic' if it is not generally available to the investing public.").

14. *See id.* ch. 4 (explaining the elements of tipper and tippee liability).

15. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 & n.12 (1976) (holding that scienter is an essential element of any violation of section 10(b) of the Exchange Act and thus of Rule 10b-5); Aaron v. SEC, 446 U.S. 680, 691 (1980) (holding that the SEC must prove scienter). The concept of "scienter" in this context has uniformly been interpreted to encompass reckless conduct; the Supreme Court has yet to address the issue. *See* Donna M. Nagy et al., Securities Litigation, Enforcement, and Compliance Cases and Materials 116 (5th ed. 2023) [hereinafter Nagy Litigation].

16. Exchange Act § 21(d), 15 U.S.C. § 78u(d) (2018) (authorizing the SEC to file a civil action in federal court for violations of the Exchange Act and rules thereunder); *id.* § 32, 15 U.S.C. § 78ff (providing for criminal prosecution for violations of the Exchange Act and rules thereunder). The Commission may also bring an administrative proceeding before the Commission itself pursuant to section 21C of the Exchange Act. 15 U.S.C. § 78u-3 (2018). The Supreme Court has granted certiorari to address questions raised about these administrative proceedings. Jarkesy v. SEC, 34 F.4th 446 (5th Cir. 2022), *cert. granted*, 143 S. Ct. 2688 (2023). Petition for Certiorari at (I), Jarkesy v. SEC, 143 S. Ct. 2688 (2023) (No. 22-859), 2023 WL 2478988, at *I. The questions presented include whether administrative proceedings unconstitutionally deprive the respondent of a jury trial.

17. *See Nagy Litigation*, *supra* note 15, at 359.

"clarify" the issue by adopting Rule 10b5-1.[18] That rule provides that to engage in insider trading means to trade "on the basis of MNPI," which in turn means to be "aware" of MNPI when trading.[19] This Article demonstrates that Rule 10b5-1 is facially invalid in critical respects.

1. In adopting Rule 10b5-1, the SEC likely exceeded its rulemaking powers under section 10(b). Any violation of a rule adopted under that section *must* prohibit *using or employing* deception—deceptive silence in the case of insider trading because the gravamen is a breach of duty to make disclosure. A prohibition of conduct that does not involve "use" exceeds the Commission's power. This itself answers the possession versus use question for all cases—unlawful "use" is required by the statute.

2. Pre-Rule 10b5-1 caselaw was clear—as the SEC had acknowledged—that proof of use of MNPI is required in all misappropriation cases. Rule 10b5-1 is invalid because it cannot, in effect, reverse that settled law.

3. The SEC lacks authority to (re)define in Rule 10b5-1 a term used in caselaw—"on the basis of"—to mean to be "aware" of MNPI when trading. Because the phrase "on the basis of" is not a statutory term the SEC cannot, for example, argue it has implicit delegated authority to interpret the phrase.

4. The SEC exceeded its authority in adopting affirmative defenses that are designed to be the *only* defenses available to a charge of insider trading in any civil or criminal case. Moreover, the rule improperly shifts the burden on this issue to a defendant in a criminal case.

II. The Possession Versus Use Debate

The possession versus use debate is more than a matter of scholarly interest; it can have meaningful consequences when the SEC or the DOJ seeks to prove a civil or criminal case. Consider the person who was aware of MNPI but can demonstrate that the reason he traded had nothing to do with that information. For example, he had decided to trade at the market price tomorrow and later learned MNPI. The debate centers on whether that person violated Rule 10b-5 when he traded as planned. The substantive rule affects the government's path to proving

18. Rule 10b5-1, 17 C.F.R. § 240.10b5-1 (2023). The rule was adopted in Selective Disclosure and Insider Trading, Securities Act Release No. 7,881, 65 Fed. Reg. 51716, 51716 (Aug. 24, 2000) [hereinafter *2000 Adopting Release*]. The rule had been proposed in Selective Disclosure and Insider Trading, Securities Act Release No. 7,787, 64 Fed. Reg. 72590 (Dec. 28, 1999) [hereinafter *1999 Proposing Release*]. Amendments were proposed in 2022. Rule 10b5-1 and Insider Trading, Securities Act Release, No. 11,013, 87 Fed. Reg. 8686 (Feb. 15, 2022) [hereinafter *2022 Proposing Release*]. Amendments were adopted in 2022. Insider Trading Arrangements and Related Disclosures, Securities Act Release, No. 11,138 87 Fed. Reg. 80632 (Dec. 29, 2022) [hereinafter *2022 Adopting Release*]. The 2022 changes did not affect the issues addressed in this Article. *See infra* Part III.B.

19. Rule 10b5-1(a)–(b), 17 C.F.R. § 240.10b-5(a)–(b) (2023).

its case. Proving possession or awareness of MNPI is inherently easier than proving that someone made use of MNPI in deciding whether to trade.[20]

This Part II demonstrates that, before Rule 10b5-1 was adopted, courts held that in misappropriation cases there is liability—civil or criminal—*only* if the trader used MNPI. The Commission itself had recognized that a use test—not the lighter awareness or possession test—applies in all misappropriation cases.[21] In adopting Rule 10b5-1, the agency thus ignored controlling caselaw and its own prior position.[22] If, as shown here, Rule 10b5-1 is invalid insofar as the definition of "on the basis of" is concerned, the law would revert to the prior split among the Circuits.[23]

A. The Common Law on Possession Versus Use

In a 1997 article, the present author examined the common law of insider trading, concluding that in those jurisdictions that recognized a private damage claim on behalf of a corporation against an insider to recover profits for what is now called insider trading, proof of *use* of MNPI was required to establish liability.[24] The common law in this respect has not changed.[25]

B. The Federal Law of Possession Versus Use

Apart from "traditional insiders," such as officers and directors trading in the securities of their own company, the SEC and the courts often predicated insider trading liability under Rule 10b-5 on proof of use of MNPI, though in some cases trading while in possession of MNPI without proof of use of MNPI was explicitly or implicitly found to be sufficient. The lack of a consensus in some respects might provide an opportunity for clarification by the SEC by rule. As shown later, however, the SEC squandered the chance. The most significant federal decisions are discussed in the following subparts.

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20. This Article demonstrates that in any misappropriation case the government, *i.e.*, the DOJ or the SEC, must prove use of MNPI. *See, e.g.*, *infra* Part III.B. Whether (A) the burden of proof and of persuasion on that issue is on the government or (B) the defendant has a non-use defense, the substantive issue to be decided by the trier of fact is the same. In criminal cases, however, the DOJ has the burden in both respects. *See, e.g.*, *infra* text accompanying notes 66–70. *See also* Stephen M. Bainbridge, Insider Trading Law and Policy 73 (2014) [hereinafter Bainbridge] ("a use standard significantly complicates the government's burden in insider trading cases, since motivation is harder to establish than possession, although the inference of use permitted by *Adler* (discussed at *infra* text accompanying notes 62–63) substantially alleviates this concern").

21. *See, e.g.*, *infra* text accompanying note 71.

22. *See infra* Part VI.B.

23. *See infra* Part II.B.3 (discussing differing law in the Second Circuit on the one hand and the Ninth and Eleventh Circuits on the other).

24. *See Horwich Possession*, *supra* note 1, at 1242–45. Many jurisdictions do not recognize this claim. *See, e.g.*, Freeman v. Decio, 584 F.2d 186 (7th Cir. 1978) (ruling there is no such cause of action under Indiana law).

25. *See, e.g.*, Novavax Inc. Stockholder Derivative Litig., Nos. DC-21-2996 et al., 2023 WL 5353171, at *13–16 (D. Md. Aug. 21, 2023) (denying motion to dismiss portion of complaint that relied on the seminal Delaware decision, Brophy v. Cities Service Co., 70 A.2d 5 (Del. Ch. 1949), to recover trading profits of an insider).

1. Rulings and Statements by the Commission and Its Staff

Consideration of the position of the Commission is important in deciding whether to credit the Commission's explanation for adopting an awareness test in Rule 10b5-1, because the validity of the rule may depend on whether its adoption was arbitrary and capricious in the context of the Commission's stated views.[26]

In the seminal SEC case, the Commission ruled that a broker-dealer firm and one of its brokers engaged in unlawful insider trading in violation of Rule 10b-5.[27] In finding that the trading was unlawful, the opinion referred to "use" of MNPI,[28] although certain passages of the opinion may also be read as suggesting a possession test.[29] When one respondent argued that the sales made were "merely a continuance of his prior schedule of liquidation," the Commission could have, but did not, reject the non-use argument as a matter of law. Rather, it ruled that the facts did not support the argument.[30] In a later case the Commission described *Cady, Roberts* as ruling that certain persons are "subject to the fiduciary responsibilities of a traditional corporate 'insider' . . . with respect to the investing public and could not make advance *use* of the information."[31]

In another case, the Commission ruled that investment advisers, mutual funds, and investment partnerships that received MNPI from a broker-dealer violated Rule 10b-5 when they traded in the stock that was the subject of the MNPI.[32] This time the Commission majority described *Cady, Roberts* in possession terms.[33] The majority opinion, however, also cited several Commission matters where the focus of the analysis was wrongful "use" of MNPI.[34] Notably, the majority opinion stated that the MNPI *must be a "factor" in making the trade*.[35] That is manifestly a use element.

Concurring Commissioner Smith stated he would have predicated liability on a finding that respondents had used the MNPI.[36] He explained:

26. *See infra* Parts V.B. & VI.C (evaluating the validity of Rule 10b5-1 under prevailing administrative law principles).

27. Cady, Roberts & Co., 40 S.E.C. 907, 1961 WL 60638 (1961).

28. *Id.* at 907, 912 n.15, 917.

29. *See, e.g.*, *id.* at 911 ("[I]nsiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment.").

30. *Id.* at 916.

31. Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 936, 1968 WL 86072 (1968) (describing *Cady, Roberts* as ruling that "a partner was subject to the fiduciary responsibilities of a traditional corporate 'insider,' such as an officer, director or controlling person, with respect to the investing public and could not make advance use of the information"). The proceeding charged tipping in violation of sections of the Exchange Act and Investment Advisers Act of 1940.

32. Investors Management Co., Inc., 44 S.E.C. 633, 1971 WL 120502 (1971).

33. *Id.* at 460.

34. *Id.* at 640 nn.12–15 (citing cases).

35. *Id.* at 646 (stating "the requirement that the information received be a factor in the investment decision," and where the trade "is effected by the recipient prior to its public dissemination, an inference arises that the information was such a factor. The recipient of course may seek to overcome such inference by countervailing evidence.").

36. *Id.* at 650–51.

> It is important in this type of case to focus on policing insiders and what they do, which I think appropriate, rather than on policing information *per se* and its possession, which I think impracticable. I believe the emphasis in the law should continue to be upon the conduct of corporate insiders and their privies, as it has been since [1909] and as it was in *Cady Roberts* [and two court cases] rather than upon a concept—too vague for me to apply with any consistency—of relative informational advantages in the marketplace.[37]

He concluded, stating "that the information must be shown . . . to have substantially contributed to the trading which occurred."[38] The majority's requirement that MNPI be a "factor" and Commissioner Smith's clear preference for a use requirement speak strongly for a use test. Since then, inexplicably, the SEC has largely ignored *Investors Management* on the possession versus use issue, not even distinguishing it from some other test.[39]

Two years later, the Commission solicited public comments on "the circumstances under which material information of a previously undisclosed nature may be utilized in connection with the purchase or sale of securities."[40] Among other things, the notice requested comment on "[w]hether guidelines can be established to designate categories of individuals and entities which may be considered to have a sufficient nexus to preclude their *use* of material, undisclosed information concerning the issuer, in the absence of any general public disclosure of that information."[41] Nothing public appears to have come of this. Five years later the SEC issued a Section 21(a) report[42] in an insider trading matter which rejected a use test.[43]

37. *Id.* at 648.

38. *Id.* at 651.

39. *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, 1148–52 (1999) [hereinafter *Nagy Golden*] (concluding that the SEC has "simply ignored *Investors Management*'s causality requirement"); Dennis J. Block & Jonathan M. Hoff, *Insider Trading Liability: "Use v. Possession*," N.Y.L.J. 5, 5 (Oct. 29, 1998) (noting that the SEC did not cite either *Cady, Roberts* or *Investors Management* in "abruptly alter[ing] its position" in using a possession test in the report cited at *infra* note 42). One exception was Certain Trading in the Common Stock of Faberge, Inc., 45 S.E.C. 249, 254, 1973 WL 149283 (May 25, 1973) (citing *Investors Management* in a settled matter where the Commission stated that the settling respondents "effected securities transactions while in possession of such information without disclosing the information to the other side of the transactions"). However, the order also referred to "misuse" and "use" of MNPI. *Id.* at 249 (twice), 250 (twice) ("We now set forth how the parties on October 6, 1970, obtained, transmitted, and used the adverse inside information before its public release."), 254 (twice), 255, 257 (twice), and 258.

40. Guidelines on the Utilization and Dissemination of Undisclosed Material Information, Exchange Act Release No. 10,316, 38 Fed. Reg. 21541 (Aug. 9, 1973). The notice referred to "an inquiry already underway by its staff." *Id.* at 21541. The present author has not been able to determine what that inquiry was.

41. *Id.* (emphasis added).

42. A Section 21(a) Report is a report issued by the Commission pursuant to that section of the Exchange Act, 15 U.S.C. § 78u(a) (2018) ("The Commission is authorized in its discretion, to publish information concerning any such violations"), to "articulate novel legal theories or standards of conduct" without the need to hold a hearing, which avoids judicial review of its statement of the law. *See Nagy Litigation*, *supra* note 15, at 543 (describing Section 21(a) Reports).

43. Report of Investigation in the Matter of Sterling Drug, Inc., Exchange Act Rel. No. 14,675, 1978 WL 198166, at *5 (Apr. 18, 1978) ("The Commission also believes that Rule

In these matters, the Commission's expression of the elements of the wrong were not consistent, especially viewed in hindsight after possession versus use became an issue. In later years, however, the Commission made unambiguous statements, as a party to litigation or as an amicus curiae, that recognized that a use test applies in misappropriation cases.[44]

During the legislative process leading to the 1984 and 1988 insider trading amendments to the Exchange Act the Commission favored a possession test in the context of express consideration of adopting a statutory definition of insider trading.[45] No definition was enacted.

In 2006, six years *after* Rule 10b5-1 was adopted, then director of the SEC's Division of Enforcement effectively acknowledged that a use test is required to prove insider trading—without distinguishing between cases under the two theories:

> The challenge [in proving insider trading] is not to establish facts that show suspicious trading—the surveillance records alone are often sufficient to establish that much. The real challenge is to establish that a particular individual was in *possession* of material non-public information *and in fact traded on it* in breach of a duty, and to establish those facts based on admissible evidence that can withstand challenge at trial.
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> . . . *It is quite common for insider traders to come up with alternative rationales for their trading*—rationales that the staff *must refute* with inferences drawn from the timing of trades, the movement of funds and other facts and circumstances.[46]

"Alternative rationales"—undoubtedly referring to proof of non-use—would be entirely irrelevant if all that mattered were possession or awareness. The Commission should move to strike any evidence proving non-use, before being put to the task of rebutting it.

The Commission's position on possession can charitably be characterized as shifting, or at least lacking in rigor.

2. Insider Trading Opinions of the Supreme Court

In the Supreme Court's four Rule 10b-5 insider trading cases, coming after *Cady, Roberts* and *Investment Management*, the possession versus use question was not potentially outcome-determinative. The cases expressed the core legal principles, however, in a manner that suggests a disposition in favor of a use test, until the critical misappropriation case that spoke definitively of a use test.

10b-5 (17 C.F.R. § 240.10b-5) does not require a showing that an insider sold his securities for the purpose of taking advantage of material non-public information.").

44. *See infra* notes 71–72 and 185.

45. *See infra* text accompanying notes 81–113.

46. *Testimony Concerning Insider Trading Before the U.S. S. Comm. on the Judiciary*, 109th Cong., 2d Sess. 5 (Oct. 5, 2006) (emphasis added) (statement of Linda Chatman Thomsen, Director, Division of Enforcement, Securities and Exchange Commission), http://www.sec.gov/news/testimony/2006/ts092606lct.htm.

In *Chiarella*, the Court's first case, the Court stated its understanding that *Cady, Roberts* ruled "that a broker-dealer and his firm violated [section 10(b)] by selling securities *on the basis of* undisclosed information."[47] Next, in *Dirks*, the Court used "on the basis of" in describing the elements of insider trading.[48]

United States v. O' Hagan is the most important Supreme Court decision for present purposes. There the Court, using the phrase "on the basis of," first recognized the misappropriation theory under Rule 10b-5.[49] The Court held that the necessary component of deception under Rule 10b-5 "is satisfied [in a misappropriation case] because the fiduciary's fraud is consummated . . . when, without disclosure to his principal, he *uses the information* to purchase or sell securities."[50] In a later case, the Court described *O'Hagan* as holding "that the defendant had committed fraud 'in connection with' a securities transaction when he *used* misappropriated confidential information for trading purposes."[51] At this point the Court had made clear that "on the basis of" means "to use" and proof of use is necessary to establish a misappropriation violation.

The *O'Hagan* references to "use" have been described as dicta, because there was no occasion for the Court to distinguish between possession and use and if a more demanding use test had been applied the Court would have found it to have been satisfied.[52] Nevertheless, subsequent decisions, commentary, and government briefs have interpreted *O'Hagan* to require proof of use in misappropriation cases, leaving no doubt about the weight to be accorded the decision.[53]

3. Salient Rulings in the Lower Courts

In the years preceding the adoption of Rule 10b5-1 in 2000, courts of appeal rendered three important decisions bearing on the possession versus use issue. The first of the cases on which the Commission focused was a Second Circuit misappropriation case often read as supporting a possession test in dictum.[54] In *United States v. Teicher*, the court stated:

> 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

47. Chiarella v. United States, 445 U.S. 222, 226 (1980) (emphasis added). *See also id.* at 234 (describing the violation in terms of "purchas[ing] . . . on the basis of" MNPI); *id.* at 227 n.8 (referring to "use" in describing the duty owed to both buyers from as well as sellers to an insider). Chief Justice Burger used the phrase "on the basis of" twice in his dissenting opinion. 445 U.S. at 241–42 (Burger, J., dissenting).

48. 463 U.S. 646, 672 nn.7–8 (1983).

49. United States v. O'Hagan, 521 U.S. 642 *passim* (1997). The majority opinion used "on the basis of" four times, exclusive of quotations that used the phrase. *Id.* at 653, 654, 655 n.7, 655.

50. *Id.* at 656 (emphasis added).

51. SEC v. Zanford, 535 U.S. 813, 824 (2002) (emphasis added).

52. *See* Bainbridge, *supra* note 20, at 73 (writing, prior to *Salman*, that "dictum in each of the Supreme Court insider trading opinions also appears to endorse the use standard"). *See also infra* text accompanying note 68 (referring to Supreme Court decisions as possible dictum).

53. In its fourth Rule 10b5-1 insider trading case, Salman v. United States, 580 U.S. 39, 48 (2016), the Court applied the *Dirks* analysis of tipping.

54. *See, e.g.*, *1999 Proposing Release*, *supra* note 18, 64 Fed. Reg. at 72600 n.79.

> nonpublic,—and who did not act in good faith in so doing—did not *also* trade *on the basis of* that information.[55]

This statement, made in affirming the convictions, was dictum on the possession versus use issue because several of the jury instructions on which the conviction was based described the offense in terms of use of MNPI.[56]

Still more important, the quoted language reflects that "on the basis of" *means* "use"—the defendant possessed *and* he traded "on the basis of." In any event, *Teicher* has been superseded by *O'Hagan*, because, as a misappropriation case, satisfaction of a use test is necessary for a conviction.[57] The Commission overstated the strength of *Teicher* as a possession case.

In *SEC v. Adler*, a classical case, a director of the company sold company stock after negative arguably material information was disclosed at a board meeting.[58] That defendant contended that the sales "were part of a preexisting plan to sell [company] stock in order to buy an eighteen wheel truck for his son's business," waiting to sell until the expiration of a lock-up period imposed on the director's stock as part of a registered offering.[59] A second sale occurred after the defendant, no longer affiliated with the company, was allegedly tipped by a director about the discovery of accounting fraud at the company.[60] Defendant contended that his sale in November 1992 "was made pursuant to a preexisting plan to sell 150,000 shares of [the company] after the November 3 presidential election," though the sale was delayed by a death in the family.[61]

After an extensive review of caselaw and other sources,[62] the court concluded:

> [W]e believe that Supreme Court dicta and the lower court precedent suggest that the use test is the appropriate test. The strongest argument that has been articulated in support of the knowing possession test is that a strict use test would pose serious

55. 987 F.2d 112, 120–21 (2d Cir. 1993) (emphasis added).
56. *Id.* at 119.
57. *See infra* Part II.B.2.
58. 137 F.3d 1325, 1328 (11th Cir. 1998).
59. *Id.* at 1328–29.
60. *Id.* at 1329–30.
61. *Id.* at 1330.
62. *Id.* at 1333–37. *Adler* cited, among other authorities, *Horwich Possession*, *supra* note 1, at 268, in support of its holding. *Adler*, 137 F.3d at 1335 n.23. *Adler* also cited two treatises that supported a use test:

> 2 A. Bromberg & L. Lowenfels, Securities Fraud & Commodities Fraud, § 7.4(600), at 7:159, 7:160.14 (1996) (ultimately concluding, after significant analysis, that a corporate insider can introduce evidence of non-use of material nonpublic information as an affirmative defense); 3 Arnold S. Jacobs, Litigation and Practice Under Rule 10b-5, § 66.02[c], at 3-657 (1981) (concluding that one of the "exceptions" to the "general" disclose or abstain rule is that an "insider's decision to buy or sell must be based on his inside information").

Adler, 137 F.3d at 1334 n.23. The leading general securities law treatise, also cited in *Adler*, supported a possession test, based largely on ease of application, without in depth consideration of the legal arguments addressed throughout this Article. 7 Louis Loss & Joel Seligman, Securities Regulation 3503–05 (3d ed. 1991). Quoting *Adler* for the other treatises is necessary because prior versions of treatises other than *Loss* cited in this Article are no longer available. They are published in loose-leaf and (now) online versions. Earlier pages or online text is no longer available when they are updated. *Loss* is available in both hard copy and online.

> difficulties of proof for the SEC. . . . [W]e believe that the SEC's problems in this regard are sufficiently alleviated by the inference of use that arises from the fact that an insider traded while in possession of inside information.[63]

The inference of use can then be rebutted.[64] Because issues of fact precluded summary judgment, the case was remanded for a retrial.[65]

In *United States v. Smith*, the defendant appealed a judgment on a jury verdict that he engaged in insider trading in the stock of the company of which he was a vice president, a classical case.[66] The defendant argued that the jury instructions on the necessary causation issue were confusing.[67] The court held, "[W]e believe that the weight of authority supports a 'use' requirement. Perhaps most significantly, the Supreme Court has consistently suggested, albeit in dictum, that Rule 10b-5 requires that the government prove causation in insider trading prosecutions."[68] The court affirmed the conviction, finding that the instructions sufficiently required proof of a causation element, *i.e.*, use.[69] The court observed that it could *not* apply the *Adler* approach of a rebuttable presumption of use arising from possession of MNPI because in a criminal case the court cannot presume an essential element of the crime.[70] *Smith* thus held that in any criminal insider trading case the government must prove that the trader used MNPI.

In the SEC's initial amicus curiae brief in *Smith*, the Commission stated, "The Supreme Court recently indicated in a misappropriation case that it is the misappropriator's use of the information in his trading that satisfies the § 10(b) requirement that the deception occur 'in connection with the purchase or sale of [a] security.'"[71] Later in the same case, the SEC took the position that in a misappropriation case, a defendant's "'use' of the information in his trading may be relevant because *it is that use that satisfies the Section 10(b) requirement* that deception occur 'in connection with the purchase or sale of a security.'"[72] In its brief,

63. *Id.* at 1337 (footnote omitted). The court also stated that "precedent and common sense indicate that where an inference of possession of inside information arises from the suspicious timing of the sale, a credible and wholly innocent explanation for said sale and timing tends to rebut the inference." *Id.* at 1341.

64. *Id.* at 1337.

65. *Id.* at 1342. The claim against the defendant described in the text was settled on remand. SEC Litigation Release No. 16,477, SEC v. Richard Adler, 94-C-2018-S (D. Ala. Mar. 21, 2000), https://www.sec.gov/litigation/litreleases/lr16477.htm.

66. United States v. Smith, 155 F.3d 1051 (9th Cir. 1998).

67. *Id.* at 1066.

68. *Id.* at 1067 (referring to *O'Hagan* and *Dirks*).

69. *Id.* at 1070. The trial court had "instructed the jury that 'the government must prove that the defendant sold or sold short PDA stock because of material nonpublic information that he knowingly possessed' and cautioned that '[i]t is not sufficient that the government proves that the defendant sold or sold short PDA stock while knowingly in possession of the material nonpublic information.'" *Id.*

70. *Id.* at 1069 (citing Sandstrom v. Montana, 442 U.S. 510, 524 (1979)). *See also* Morisette v. United States, 342 U.S. 246, 275 (1952) (stating that there cannot be any presumption which conflicts with the "overriding presumption of innocence with which the law endows the accused").

71. Brief of the Securities and Exchange Commission, Amicus Curiae, at 8 n.6, United States v. Smith, 155 F.3d 1051 (9th Cir. 1998) (No. 97-50137), 1997 WL 33493584 (Oct. 3, 1997).

72. Supplemental Brief of Securities and Exchange Commission, Amicus Curiae, at 3, United States v. Smith, 155 F.3d 1051 (9th Cir. 1998) (No. 97-50137) (May 8, 1998) (emphasis added) (on file with author).

the DOJ as appellee clung to a knowing possession test, following *Teicher* and noting the relative simplicity of a possession test.[73]

These three cases support some sort of a use test: *Teicher* stating that trading while in possession inevitably leads to trading on the basis of MNPI, meaning use,[74] *Adler* adopting a rebuttable presumption of the required element of use arising from proof of possession, and *Smith* requiring the government to prove use in *every* criminal insider trading case.

4. Commentary After the Judicial Triad

After these three cases, in his insider trading treatise, Professor Langevoort states that in classical cases, "As a formal legal matter, the possession test seems well grounded."[75] He recognizes that a use test applies in all misappropriation cases.[76]

Professor Nagy took a more nuanced position. She argued, convincingly to the present author, that when a "traditional insider," *i.e.*, a director, officer, or controlling shareholder of a company, trades in stock of *that* company knowing MNPI about that company she must first disclose that information to fulfill her fiduciary duty, that a use requirement has no place in that *classical* context.[77] Professor Nagy then stated that all *other* traders

> do not owe fiduciary disclosure duties to the corporation's shareholders by virtue of their status alone, their silence about material nonpublic information cannot be deemed deceptive within the meaning of Rule 10b-5 *unless they affirmatively used that information*. Thus, although "knowing possession" should be the requisite test in the context of securities trading by traditional insiders, a "use" test should be applied in these other types of insider trading cases.[78]

Thus, Professor Nagy concluded, based on language in *O'Hagan*,[79] that a use test is required in *all* misappropriation cases and in all classical cases not involving traditional insiders.[80] She suggested that "[t]he SEC may choose to address this question by rulemaking and, if it does so, the SEC should confine its knowing possession rule to the specific context of securities trading by traditional

73. Appellee's Brief at 52, United States v. Smith, 155 F.3d 1051 (9th Cir. 1998) (No. 97-50137), 1997 WL 33550177 (Oct. 2, 1997).

74. The concept of inevitable use of MNPI is discussed further *infra* text accompanying notes 126–29. In any event, *Teicher* could be ignored, as being superseded by *O'Hagan*.

75. Langevoort Insider Trading, *supra* note 2, § 3:13 (expressing some criticism of the possession test). Another insider trading treatise, which includes an extended discussion of the possession versus use issue, expresses no view on the answer independently of Rule 10b5-1. Ralph C. Ferrara, Donna M. Nagy & Herbert Thomas, Ferrara on Insider Trading and The Wall § 1.05[5] (2022) [hereinafter Ferrara].

76. He states that an essential element of a misappropriation violation is "that the trading was in breach of a duty not to *misuse* the information in question in connection with the purchase or sale of a security." Langevoort Insider Trading, *supra* note 2, § 6 (footnote omitted) (emphasis added).

77. *Nagy Golden*, *supra* note 39, at 1132, 1156–93.

78. *Id.* at 1135 (emphasis added).

79. *Id.* at 1146–47.

80. *Id.* at 1175–76.

insiders."[81] When it adopted Rule 10b5-1, the Commission did not engage with this analysis, nor did it even cite it.

5. Legislation in the 1980s

Amendments to the Exchange Act in the 1980s have been offered as support for an argument that Congress resolved the possession versus use debate. This contention is predicated upon the inclusion of the word "possession" in insider trading penalty provisions added to the Exchange Act in 1984, amended in 1988.[82] This argument is undermined by a careful analysis.

Current section 21A(a)(1)(A) of the Exchange Act, added by ITSA, provides that a penalty may be imposed by a court, upon the application of the SEC, whenever "any person has *violated any provision* of [the Exchange Act] or the rules or regulations thereunder by purchasing or selling a security . . . *while in possession* of material, nonpublic information."[83] First, it is a mystery why the word "possession" was included as a condition to impose a penalty, because under either a possession test or a use test for liability the SEC would have to establish possession on the part of any violator. The SEC proposed the legislation, without any explanation why "possession" was included as an express condition for imposing a penalty.[84] In its supporting memorandum, the SEC stated, "As proposed, H.R. 559 does not define insider trading. It looks to existing law prohibiting trading while in possession of material nonpublic information."[85]

Professor Langevoort asserts that the inclusion of "possession" in these amendments reflected a legislative resolution.[86] His first support for this is a colloquy about including a "knowing possession" requirement for imposing a penalty.[87]

81. *Id.* at 1200.

82. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 2, 98 Stat. 1264, 1264; Insider Trading Sanctions and Enforcement Act of 1988, Pub. L. No. 100-704, § 3, 102 Stat. 4677, 4677 (codified as new and amended subsections of the Exchange Act, notably for present purposes Section 21A, 15 U.S.C. § 78u-1); Ferrara, *supra* note 75, § 4.05[4] (providing a comprehensive account of the history of these enactments).

83. 15 U.S.C. § 78u-1(a)(1)(A) (2018) (emphasis added). Private investors also have damage claims in some circumstances when someone traded on the basis of MNPI. An Exchange Act provision, added by ITSFEA (Pub. L. No.100-704, § 5), grants an express private right of action for someone trading contemporaneously with an inside trader. Exchange Act § 20A, 15 U.S.C. § 78t-1 (2018). *See Nagy Litigation*, *supra* note 15, at 415 (explaining section 21A).

84. H.R. Rep. No. 98-355, at 21 (1983) (Memorandum of the Securities and Exchange Commission in Support of the Insider Trading Sanctions Act of 1982) [hereinafter *1983 House Report*].

85. *Id.* at 31.

86. Langevoort Insider Trading, *supra* note 2, § 3.13 ("the legislative history is clear that this language [in Exchange Act section 21A] was chosen to reflect precedent that makes motivation insignificant in determining insider trading liability"). Loss, at least at one time, expressed that view. *See* 7 Louis Loss et al., Securities Regulation 3505 (3d ed. 1991). This argument does not appear in the current edition of the latter treatise, which focuses on Rule 10b5-1 when addressing this issue. *See* 7 Louis Loss et al., Securities Regulation 604–11 (6th ed. 2022).

87. Hearing on H.R. 559 Before the H. Subcomm. on Telecomm., Consumer Protection & Fin., Comm. on Energy & Commerce, 98th Cong., 1st Sess. 48–49 (Apr. 13, 1983).

The cited passage includes the following statement by the Director of the Division of Enforcement:

> The proposed legislation in my view goes to a remedy. It does not at the present time at all impact the existing case law with regard to insider trading. It is strictly a remedy saying that if a person engages in this insider trading, however defined, that then the amount of disgorgement can be three times the ill-gained profit. And the proposed language that you have before you, presented by the Commission, does not impact the "based on," "in possession of," or a "knowing" standard at all.[88]

In the Director's view, the final legislation, which included the language he addressed, clarified nothing about the elements of insider trading *per se*. As noted later, statements by others concurred in that point.[89]

Professor Langevoort offers an alternative argument based on ITSFEA. "A familiar canon of statutory construction is that when a statute fails to change the prevailing judicial construction of some prior enacted provision, that failure constitutes an implied endorsement of that judicial interpretation," subject to several criteria.[90] In fact, some statements in the legislative history *do* reflect some satisfaction with the state of the law. Professor Langevoort correctly notes, however, the "iron[y]" that there were conflicting lines of judicial authority.[91] One is at left at sea just what it was, at that time, that Congress elected *not* to tamper with.

The text of the amendments thus shed no light on the *substantive* law of Rule 10b-5.[92] If Congress did not want to resolve the possession versus use debate but to leave the issue to the courts—as the present author contends—Congress would have chosen the *same wording* in the statute. If the courts had adopted a pervasive possession test, Congress's adding it in the penalty section accomplished nothing. Including the word "possession" was irrelevant. That ends the inquiry, unless there should be resort to legislative history.[93] That history shows that, after considerable attention to the possession versus use question, Congress *deliberately decided to do nothing* regarding a definition of insider trading.

During consideration of what became ITSA, the Commission opposed including a definition of insider trading.[94] The final House report on ITSA stated, "The

88. *Id.* at 49.

89. *See infra* text accompanying notes 112–13.

90. Langevoort Insider Trading, *supra* note 2, § 2:13.

91. *Id.*

92. Nagy and *Ferrara* concur. *See, e.g.*, *Nagy Golden*, *supra* note 39, at 1154; Ferrara, *supra* note 75, § 1.05[5] n.158 ("the 'in possession of' language . . . is generally regarded as a necessary condition rather than a sufficient condition for the imposition of a penalty" (citing 3 Alan R. Bromberg et al., Bromberg & Lowenfels on Securities Fraud § 7.160 (1996) [hereinafter Bromberg])).

93. Some deem resort to legislative history altogether "illegitimate." *See, e.g.*, Conroy v. Aniskoff, 507 U.S. 511, 519 (1993) (Scalia, J., concurring in the judgment) ("The greatest defect of legislative history is its illegitimacy. We are governed by laws, not by the intentions of legislators.").

94. *1983 House Report*, *supra* note 84, at 19, 27 (Letter, John R. Shad, Chairman of SEC, to Rep. Thomas P. O'Neill, Speaker of the House, Sept. 27, 1982).

legislation is not intended to change current law with respect to the level of awareness required of a violator."[95] The report concluded that "the law with respect to insider trading is sufficiently well-developed at this time to provide adequate guidance" and expressed the concern that "the adoption of a statutory definition could reduce flexibility while "any new definition which might be adopted would be likely to create new ambiguities, thereby increasing rather than limiting uncertainty."[96]

The definitional issue generated much more attention when, a few years later, ITSFEA was under consideration. S. 1380, introduced in the Senate on June 17, 1987, proposed adding a new section 16A to the Exchange Act. Subsection (b)(1) would have made it unlawful "to use" MNPI "if such person knows or is reckless in not knowing that such information has been obtained wrongfully, or if the purchase or sale of such security would constitute a wrongful use of such information."[97] Following the approach adopted later in *Adler*, it would also have provided that "any person who purchases or sells while in possession of [MNPI] shall be presumed to have used that information in connection with such purchase or sale."[98]

Work in the Senate began behind the scenes when Subcommittee Chair Sen. Riegle had asked two eminent members of the insider trading bar, Harvey Pitt (former General Counsel of the Commission, and later Chairman of the Commission) and John Olson (then chair of the American Bar Association task force on the regulation of insider trading), to develop language to amend the Exchange Act to address an "overhaul of the law."[99] Two entire hearing sessions were devoted to a statutory definition of insider trading.[100] Though the SEC expressed support for defining insider trading in legislation, it did not support S. 1380 because ambiguities in it "would create problems for the enforcement program."[101] The Commission opposed "alter[ing] the current relationship between while in possession of inside information and trading on the basis of that information. In the case of individuals, the bill [inappropriately] presumes that the two are indistinguishable, although the presumption can apparently be overcome."[102] This reflected the Commission's recognition that *"on the basis of" meant "to use."* Chairman Cox's written statement elaborated that S. 1380 was "apparently intended to reflect the Commission's *traditional position* that trading while in possession of insider information is itself a violation."[103] He also stated

95. *1983 House Report*, *supra* note 84, at 9.

96. *Id.* at 13 (footnote omitted).

97. S. 1380, 100th Cong. (1987) (§ 16A(b)(1)) (proposed).

98. *Id.* (§ 16A(b)(2)) (proposed).

99. *Proposed Legis. to Clarify the Law of Insider Trading, etc.: H. Before the S. Subcomm. on Securities of the Comm. on Banking, Hous. & Urb. Aff.*, 100th Cong., 1st Sess. 1 (June 17, 1987).

100. *Id.* at 1–145.

101. *Id.* at 109, 109, 120 (statement of Interim Chairman Charles Cox). Cox testified, however, that "a statutory definition is not required for the success of the enforcement program."

102. *Id.* at 120. This reflects that during Chairman Cox's testimony Senator Shelby expressed concern about shifting the burden of proof by a presumption in a criminal case. *Id.* at 123 *passim*. This concern had influenced the later ruling in *Smith*. *See supra* text accompanying note 70.

103. *Id.* at 111, 114 (statement of Chairman Cox at 8) (emphasis added).

that in SEC enforcement cases "it is very important that trading in possession be the standard" because defendants seek to defend by arguing that they did not use the information.[104]

The Senate hearings continued with a focus on a definition of insider trading.[105] The Commission, reluctantly it seems, submitted a suggested definition at the Committee's request.[106] The ensuing debate over what became ITSFEA cannot be squared with any argument that, in 1984, ITSA had *already* added a possession-based definition of the wrong, which should put an end to any argument that adding "possession" then had resolved anything. As explained by Chairman Cox, under the Commission's grudging proposal, the test would be possession, *not* trading on the basis of.[107] The legislation would "remove[] any doubt in people's mind as to whether it's on the basis of or in possession of."[108] The Commission thus *again* expressed definitively that *"on the basis of" is the language of a use test*, which the Commission opposed. The Commission's General Counsel, Daniel Goelzer, cautioned that "defining insider trading in a way contrary to the caselaw would undoubtedly be subject to challenge and we would have to litigate the validity of the rule."[109] Presciently, Goelzer foresaw the very challenge this Article urges.

As the process proceeded, the Commission, speaking through new Chairman David Ruder, continued to favor a possession test were there to be a statutory definition.[110] Again—*if* ITSA had *already* reflected that possession was *sufficient* to establish liability, why did the Commission argue for a (redundant) definition? The answer is obvious—section 21A did not define the violation.

The House Report supported legislation that did not include any definition and did not change the basic approach of ITSA.[111] The House Committee explained its declination to include a definition for the same reasons as in 1984, concluding that "the Committee does not intend to alter the substantive law with respect to insider trading with this legislation."[112] When the bill came up for a floor vote, Rep. Markey, speaking in favor of the bill, stated, "The term

104. *Id.* at 124. Chairman Cox declined to express a view on the issue in criminal cases, being "uninformed on this criminal law issue." *Id.*

105. *Proposed Legis. to Clarify the Law of Insider Trading, etc.: H. Before the S. Subcomm. on Securities of the Comm. on Banking, Hous. & Urb. Aff.*, 100th Cong., 1st Sess. (Aug. 7, 1987).

106. *Id.* at 1.

107. *Id.* at 14.

108. *Id.* at 17.

109. *Id.* at 22 (testimony of Daniel Goelzer).

110. *Id.* at 22, 25 (statement of Davis S. Ruder, Chairman, SEC). *See also id.* at 55, 56, 62, 67 (letter, David S. Ruder, Chairman, SEC, to Senators Riegel and D'Amato, Transmitting Proposed Insider Trading Bill with explanation (Nov. 18, 1987) and Proposed Section 16A(b)(1) of the Exchange Act and explanation thereof, at 2, 3, 8).

111. H.R. Rep. 100-910, at 2 (1988) [hereinafter *1988 House Report*] (reproducing an amended version of the original House Bill, H.R. 5133).

112. *Id.* at 11. *See supra* text accompanying note 96 (recounting the House Committee reasoning in 1984).

[insider trading] is not defined in this act. The case law in this area provides clear parameters."[113] The first was true, the second was not.

Adler correctly rejected the argument that ITSA and ITSFEA provided that possession was a *sufficient* condition for liability, recognizing that "possession" as used in the penalty provision "only sets a condition" to seeking a penalty.[114] The present author has not identified any case that has relied on section 21A in deciding the appropriate standard for *liability*.

III. The Adoption and Amendment of Rule 10b5-1

A. The Adoption of Rule 10b5-1

1. The Provisions of Rule 10b5-1

After the decisions in *Adler* and *Smith* adverse to the government, the SEC sought to "provide greater clarity and certainty" on the "unsettled" possession versus use question.[115] This effort was the adoption of Rule 10b5-1. Original Rule 10b5-1(a)–(b), adopted in 2000, stated:

> (a) General. The "manipulative and deceptive devices" prohibited by Section 10(b) of the Act (15 U.S.C. § 78j) and § 240.10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, *on the basis of* material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.
>
> (b) Definition of "on the basis of." Subject to the affirmative defenses in paragraph (c) of this section, a 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.[116]

Applying Rule 10b5-1, Rule 10b-5 is violated if a person traded while merely "aware" of MNPI, in addition to the other elements of Rule 10b-5.

113. 134 Cong. Reg. E3078 (daily ed. Sept. 23, 1988). This statement was made in Extended Remarks, not on the House floor. H.R. 5133 passed the House by a vote of 410–0. 134 Cong. Rec. H7570 (daily ed. Sept. 15, 1988). H.R. 5133 passed the Senate on a voice vote a few weeks later. 134 Cong. Rec. S17222 (daily ed. Oct. 21, 1988).

114. SEC v. Adler, 137 F.3d 1325, 1337 (11th Cir. 1998).

115. *1999 Proposing Release*, *supra* note 18, 64 Fed. Reg. at 72591, 72607.

116. *See* 2000 *Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51737 (emphasis added). The "affirmative defenses" referred to are described at *infra* text accompanying notes 229–31. Persons who seek to comply with the defenses typically enter into an agreement, customarily referred to as a Rule 10b5-1 Plan (10b5-1 Plan). Rule 10b5-1 became effective October 23, 2000. *Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51716.

2. The Unexplained Disappearance of the Possession Test

The obvious threshold question is why, after several decades of advancing a "possession" test—the Commission's *"traditional position"*[117]—the Commission chose *not* to define the violation in those terms in Rule 10b5-1. There was no explanation in either the 1999 Proposing Release nor in the 2000 Adopting Release. The Commission adopted the awareness test because "in our view, the goals of insider trading prohibitions—protecting investors and the integrity of securities markets—are best accomplished by a standard closer to the 'knowing possession' standard than to the 'use' standard."[118] The Commission did not, however, adopt a "knowing possession" standard either.

3. The Uncertain Meaning of "Aware"

To be "aware" of information appears to mean something more than to "possess" it. It must also mean something less than "knowing possession," because the Commission expressly rejected a "knowing possession" test. In the 2000 Adopting Release, the Commission explained that "aware" is "a commonly used and well-defined English word, meaning 'having knowledge; conscious; cognizant,'" which is "much clearer" than "'knowing possession,' which has not been defined by case law."[119] The Commission did not, however, cite any judicial application of an "awareness" test to demonstrate the contrast with the undefined concept of knowing possession. If "aware" means "having knowledge," to be "conscious" of something,[120] how is that "much clearer" than "knowing possession"? If they are not synonyms, what is the difference?

When the Commission amended Rule 10b5-1 in 2022 in other respects, it stated that "[a] person is aware of material nonpublic information if they know, consciously avoid knowing, or are reckless in not knowing that the information is material and nonpublic."[121] This reconfirmed that the SEC *did not* adopt a "knowing possession" test.[122] Yet Professor Langevoort reads the awareness test to be "essentially the same as knowing possession"[123] and *Loss* states that the SEC "adopted a knowing possession test."[124] Some courts have

117. *See, e.g.*, *supra* text accompanying note 103 (recounting the legislative history of the 1988 amendments to the Exchange Act where the Commission described its "traditional" position that the correct test under Rule 10b-5 is "possession").

118. *2000 Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51721 n.105.

119. *Id.*

120. The Commission offered these synonyms, without any citation, much less to a case applying the concept. *Id.*

121. *2022 Adopting Release*, *supra* note 18, 87 Fed. Reg. at 80363 n.10 (citations omitted).

122. *See supra* text accompanying notes 118–21(explaining that the Commission rejected a "knowing possession" test).

123. Donald C. Langevoort, *What Were They Thinking? State of Mind Puzzles in Insider Trading* 6 (Geo. L. Faculty Pubs. & Other Works, No. 2496, 2023) https://scholarship.law.georgetown.edu/facpub/2496 [hereinafter *Langevoort Thinking*] (emphasis added).

124. 6 Louis Loss et al., Securities Regulation 607 (6th ed. 2022).

concluded that the awareness test is equivalent to "knowing possession."[125] The ultimate result is a *lack* of clarity, albeit the distinctions among the possible formulations may be difficult to draw in deciding a case.

4. The Weakness of the Inevitably Argument

The Commission also stated that Rule 10b5-1 "reflects the commonsense notion that a trader who is aware of inside information when making a trading decision *inevitably* makes use of the information."[126] In fact, it is not at all "inevitable" that MNPI is used if one is aware of MNPI when the trade occurs.[127] Quite the contrary, the Commission *itself* provided a plausible example of someone who makes a decision to trade and, before the trade is executed, becomes "aware" of MNPI. The Commission indicates that he should *not* be held liable.

> Sometimes a person may reach a decision to make a particular trade without any awareness of material nonpublic information, but then come into possession of such information before the trade actually takes place. A rigid "knowing possession" standard would lead to liability in that case. We believe, however, that for many cases of this type, a reasonable standard *would not make such trading automatically illegal*.[128]

It is not apparent what "reasonable standard" the Commission was referring to that would result in a finding of no violation. It is certainly not the adopted awareness test. As shown below, Rule 10b5-1 purports to preclude the trader from making a non-use argument, such as the one suggested here.[129]

B. In the End, What Matters Is Use or Non-use, Especially in Misappropriation Cases

When the Commission amended the rule in 2022, tightening the affirmative defenses, the Commission concluded, "*Taken as a whole*, the revised defense [in the amended rule] is designed to cover situations in which a person can demonstrate that the material nonpublic information *was not a factor in the trading decision*."[130] In other words, taking all elements of Rule 10b5-1 into account,

125. *See* United States v. Royer, 549 F.3d 886, 899 (2d Cir. 2008); SEC v. Lyon, 605 F. Supp. 2d 531, 547 (S.D.N.Y. 2009); United States v. Ying, No. 1:18-cr-00074-AT-RGV, 2018 WL 701634, at *6 n.5 (N.D. Ga. Sept. 17, 2018) (Report of Magistrate Judge), *adopted as modified by* 2018 WL 6322308 (N.D. Ga. Dec. 4, 2018); United States v. Dombrowski, No. 14 CR 41, 2014 WL 345432, at *2 (N.D. Ill. July 15, 2014).

126. 2000 *Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51727 (emphasis added) (footnote omitted). For this proposition, the SEC cited the dictum in *Teicher*.

127. The court in *Adler* rejected a concept of inevitability when it rejected *Teicher*, observing that trading while in possession of material nonpublic information only gives rise to "a strong inference" that the information was "used." SEC v. Adler, 137 F.3d 1325, 1337 (11th Cir. 1998).

128. *1999 Proposing Release*, *supra* note 18, 64 Fed. Reg. at 72600 (emphasis added). *See also Horwich Possession*, *supra* note 1, at 1295 (positing several similar scenarios).

129. *See infra* Part VII (showing that the exclusive defenses in Rule 10b5-1 were intended to preclude an argument that, irrespective of the explicit defenses, a trader did not use the information in deciding to trade).

130. *2000 Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51728 (emphasis added).

the rule is a circuitous route to exonerate a trader if she did not use the information.[131] Thus, in proposing the original rule, the Commission stated:

> In *O'Hagan*, the Supreme Court recognized that under the misappropriation theory of insider trading liability, the fraud is consummated when the defendant, without proper disclosure to the source, "*uses* the information to purchase or sell securities." Proposed Rule 10b5-1 is consistent with this view in that it provides for no liability when a trader can meet one of the stated defenses in paragraph (c) *demonstrating lack of use*.[132]

This apparent candor, implying that "taken as a whole" Rule 10b5-1 is consistent with a use test, should not mask that the Commission went off the rails in several crucial respects. First, Rule 10b5-1 improperly denies the trader *any* opportunity to prove non-use other than using narrow specified affirmative defenses. Second, the rule shifts the burden to the trader to prove non-use. The Commission did not address this nor did it identify its authority to shift the burden, especially in criminal cases. Third, Rule 10b5-1 makes no distinction (A) between classical cases and misappropriation cases—where, as the Commission elsewhere recognized, that the Supreme Court held that use is an element of the government's case—or (B) between civil and criminal claims.

C. The 2022 Amendments of Rule 10b5-1

The Commission became increasingly concerned about abuse of 10b5-1 Plans, based in large part on statistical studies of trading by insiders who had adopted these plans.[133] This resulted in an amended rule, in which the Commission added significant conditions to 10b5-1 Plans.[134] The SEC also adopted new public reporting requirements regarding any 10b5-1 Plans established by directors and certain officers of public companies.[135] Several months later the

131. *See* Carol B. Swanson, *Insider Trading Madness: Rule 10b5-1 and the Death of Scienter*, 52 U. Kan. L. Rev. 147, 200 (2003) [hereinafter *Swanson*] ("the fact that the SEC presents affirmative defenses at all is a concession that when defendants distance themselves from actual use of the inside information, they should not be liable").

132. *1999 Proposing Release*, *supra* note 18, 64 Fed. Reg. at 72601 n.86 (emphasis added).

133. *See 2022 Proposing Release*, *supra* note 18, 87 Fed. Reg. at 8688 & n.15 (footnotes omitted) (citing 2009 article regarding suspected misuse of 10b5-1 Plans).

134. *See 2022 Adopting Release*, *supra* note 18, 87 Fed. Reg. at 80632 *passim*. Among the changes, Amended Rule 10b5-1 requires that there be a cooling off period in any 10b5-1 Plan adopted by directors and certain officers of public companies between adoption of a plan and when the first trade can occur under the plan. The Commission also introduced the concept of a "non-10b5-1 Plan." *See, e.g.*, *2022 Adopting Release*, *supra* note 18, 87 Fed. Reg. at 80382. That is a trading plan that in substance satisfies the original Rule 10b5-1 requirements but not the new ones. *See* Regulation S-K, Item 408(c), 17 C.F.R. § 229.408(c) (2023).

135. *2022 Adopting Release*, *supra* note 18, 87 Fed. Reg. at 80380–93. If a transaction was made pursuant to a 10b-1 Plan, that fact must be reported on the Form 4 required for reporting transactions in company securities. *See Form 4*, U.S. Sec. & Exchange Commission, https://www.sec.gov/files/form4.pdf (last visited Nov. 1, 2023). A public company must disclose any 10b5-1 Plan entered into by a director or officer. "Public company" means a company a class of whose common stock is registered with the SEC for trading under section 12 of the Exchange Act, 15 U.S.C. § 78*l*, or that is required by section 15(d) of the Exchange Act, 15 U.S.C. § 78o(d), to file reports with the SEC.

Commission adopted reporting requirements for issuers that use 10b5-1 Plans when repurchasing their stock.[136]

There was no substantive change to definitional Rules 10b5-1(a) and (b). The substance of the original Preliminary Note was moved to new Rule 10b5-1(a). "The final amendments do not alter the 'awareness' standard."[137] Parts V through VII demonstrate fundamental deficiencies in Rule 10b5-1, as adopted and as amended.

IV. Possession Versus Use After Rule 10b5-1

There has been a lack of consistency in decisions that addressed some aspect of the possession versus use issue after Rule 10b5-1 became effective. The rulings are so disparate that they do not suggest a consensus.

A few points, however, are worthy of note.[138] Some criminal cases expressly required the DOJ to prove use.[139] At least one criminal case, however, applied the Rule 10b5-1 "awareness" test.[140] In one criminal case the indictment referred to Rule 10b5-1.[141] *Adler* was followed in an Eleventh Circuit criminal case.[142] There is no consistency.

Some civil enforcement cases have expressly applied Rule 10b5-1.[143] Some enforcement rulings did not refer to Rule 10b5-1 but applied a test consistent with

136. Share Repurchase Disclosure Modernization, Exchange Act Release No. 97,424, 88 Fed. Reg. 36002 (June 1, 2023). These requirements have been vacated. *See infra* note 259. These requirements were not pertinent to any issues addressed in this Article.

137. *2022 Adopting Release*, *supra* note 18, 87 Fed. Reg. at 80363 n.10.

138. There was no effort for purposes of this Article to identify and assess jury instructions in cases that went to trial where there was no reported decision.

139. *See, e.g.*, United States v. Chan, 981 F.3d 39, 55 (2020) (applying use test in affirming conviction on misappropriation claims); United States v. Steinberg, 21 F. Supp. 3d 309, 313 n.2, 315 (S.D.N.Y. 2014) (stating, in denying post-trial motion for acquittal, that the criteria for liability are much the same in classical and misappropriation cases, and that one test is that "the tippee, while in knowing possession of the material non-public information, used the information by trading or by tipping for his own benefit"). *But see* the Second Circuit cases discussed later—*Teicher, Royer*, and *Rajaratnam* (*see infra* note 200)—where the trial court had given a use instruction, though in each case the court found that a "knowing possession" test should have been applied. *See also* United States v. Yeager, 521 F.3d 367, 374 (5th Cir. 2008) ("'Using' insider information in making trades is not an element of securities fraud."), *vacated & remanded on other grounds*, 557 U.S. 110 (2009).

140. United States v. Dombrowski, No. 14 CR 41, 2014 WL 3454320, at *2 (N.D. Ill. 2014) (declining to apply a use test in a challenge to an indictment, stating "the Court declines to find that the Government must specifically allege in the Indictment use of the inside information when the SEC [in Rule 10b5-1] has determined that the proper standard is awareness"). *Dombrowski* was more focused on how much detail need be included in an indictment, however, as distinguished from the elements of liability. *Id.* at *2–3.

141. Indictment at para. 4.c, United States v. Heron, No. 2:06CR00674, 2006 WL 3703328 (Nov. 30, 2006).

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142. United States v. Ying, Case No. 1:18-CR-74-AT, 2018 WL 6322308, at *5 (N.D. Ga. Dec. 4, 2018) ("The Court sees no reason why *Adler*'s reasoning or its application of the use standard would not apply in the criminal context, consistent with the requirement of willfulness under [Exchange Act section 32].").

143. *See, e.g.*, SEC v. Mozilo, No. CV 09-3994-JFW (MANx), 2010 WL 3656068, at *20 (C.D. Cal. 2010) (applying awareness test of Rule 10b5-1); SEC v. Moshayedi, Case No. SACV 12-01179 JVS (ANx), 2013 WL 12172131, at *14 (C.D. Cal. Sept. 23, 2013) (finding that because

the rule.[144] One of those cases was a misappropriation case where, confusingly, the court quoted the "use" language in *O'Hagan* but applied a knowing possession test, stating, "'[K]nowing possession' only requires the SEC to show [defendant's] awareness of (as opposed to use of) the nonpublic information."[145] In a civil enforcement case the court did not rely on the rule but instead gave an instruction that defendants would not be held liable if the jury believed "the defendant would have made the exact same trade whether or not he possessed" MNPI as in that event the jury could "infer that the defendant did not trade on the basis of" MNPI.[146] In responding to defendants' motion for summary judgment in that case, the SEC argued for a possession test and never cited Rule 10b5-1.[147]

In another case, the court granted the SEC's motion for summary judgment applying a knowing possession test in what was fundamentally a misappropriation case, with no reference to Rule 10b5-1.[148] In the *SEC's* proposed jury instructions, the jury would have been instructed that the SEC must prove "that the defendants deliberately used material, confidential information in order to obtain an unfair advantage."[149] There were also several references to Rule 10b5-1 in the proposed instructions, one of which included a knowing possession test.[150] In another case, according to the court the SEC expressly declined to rely on Rule 10b5-1.[151] In its brief on appeal from a judgment in its favor, the SEC relied on both a possession test and an awareness test—with no reference to Rule 10b5-1.[152]

In an SEC administrative proceeding the insider trading claim against the respondent was dismissed by the Administrative Law Judge (ALJ), finding that the Division of Enforcement had not proved that respondent had been tipped.[153] On review, the Commissioners were evenly divided on the issues appealed by the

the judicial decisions were split, the court should apply Rule 10b5-1); SEC v. Lyon, 605 F. Supp. 2d 531, 547 (S.D.N.Y. 2009) (denying motions for summary judgment, applying Rule 10b5-1 in misappropriation case).

144. *See, e.g.*, SEC v. Suman, 684 F. Supp. 2d 378, 388, 390 (S.D.N.Y. 2010) (stating a knowing possession test and that a use test does not apply), *aff'd*, 421 F. App'x 86 (2d Cir. 2011).

145. 684 F. Supp. 2d at 390.

146. Jury Instructions, SEC v. Steffes, No. 10 C 6266, 2014 WL 4953969 (N.D. Ill. Jan. 14, 2014), ECF Doc. No. 290 (at 29).

147. Plaintiff's Response to Defendants' Motion for Summary Judgment at 20–23, SEC v. Steffes, No. 10-CV-6266 (N.D. Ill. Oct. 28, 2013), 2013 WL 7165818.

148. SEC v. Jantzen, No. 1:10-CV-740-JRN, 2012 WL 13032919, at *5, *7 (W.D. Tex. Feb. 29, 2012).

149. Plaintiff's Proposed Jury Instructions at Instruction No. 8, SEC v. Jantzen, No. 10-CV-6266 (W.D. Tex. Feb. 15, 2012), 2012 WL 1947449. The SEC cited SEC v. Yun, 130 F. Supp. 2d 1348 (M.D. Fla. 2001) (denying defendant's motion for judgment as matter of law or new trial), *vacated*, 327 F.3d 1263 (11th Cir. 2003) (remanding for retrial because tipping jury instruction misstated the law). That case involved events that occurred before Rule 10b5-1.

150. Plaintiff's Proposed Jury Instructions at Instruction No. 19 n.28, SEC v. Jantzen, No. 10-CV-6266 (W.D. Tex. Feb. 15, 2012), 2012 WL 1947449.

151. SEC v. Ferrone, No. 11 C 5223, 2014 WL 5152367, at *8 n.5 (N.D. Ill. Nov. 14, 2014) (granting summary judgment to SEC, ruling that in order to satisfy the scienter requirement the SEC must prove use, allowing inference of use from possession, and ruling that defendants had failed to adduce evidence of non-use), *appeal dismissed*, No. 13-2521 (7th Cir. Jan 22, 2015).

152. Brief of the Securities and Exchange Commission, Appellee *passim*, SEC v. Drucker, 346 F. App'x 663 (2d Cir. 2009) (No. 08-0942), 2008 WL 8017102.

153. Joseph C. Ruggieri, 112 S.E.C. Docket 2469, 2015 WL 5316569 (Sept. 14, 2015). In that misappropriation case the ALJ expressed a use test as the basis for liability of a trading tippee. *Id.* at *8, *29.

Division of Enforcement.[154] Two of the four participating Commissioners filed opinions.[155] Commissioner Stein, writing in opposition to dismissal, referred to an awareness test, albeit without any reference to Rule 10b5-1.[156] Commissioner Pinowar, favoring dismissal, also referred to an awareness test[157] but described one element of tippee liability to be "while in knowing possession of the material non-public information, *used* the information by trading or by tipping for his own benefit."[158]

The inconsistency of the SEC's own application of the rule demonstrates that the rulemaking did not provide clarity to the investing public.[159] The Commission clearly is of two, three, or more minds when it comes to possession (or awareness) versus use even after the adoption of Rule 10b5-1. No wonder the courts are also all over the map. That the rule did not achieve its goal does not mean the rule is invalid. Nevertheless, *none* of this inconsistency—on the part of the courts or the Commission itself—was even noted in passing when the rule was amended in 2022. The Commission might have chosen to ignore the definitional issue in order to keep the focus on its concerns about abuse of 10b5-1 Plans, to avoid impairing that effort by reopening the can of worms on the definition issue. There is no way to know why, but its inaction surely ill served its constituency, the investing public.

V. The Definitional Provisions in Rule 10b5-1 Exceed the Congressional Grant of Power to the SEC in Section 10(b)

A. The Scope of Section 10(b) and Rules Thereunder

"It is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text."[160] In resolving issues under section 10(b) and Rule 10b-5, the starting point is the meaning of the words in the statute.[161] Section 10(b) provides 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 contravention of" rules adopted by the SEC.[162] The terms "use" and "employ" are essentially synonymous.[163] "To "use" or "to employ" means to do something *active,* more than,

154. Joseph C. Ruggieri, Securities Act Rel. No. 10,389, 2017 WL 2984863 (July 13, 2017).

155. There were only four sitting commissioners at the time.

156. *Ruggieri*, 2017 WL 2984863, at *1.

157. *Id*.

158. *Id.* at *2 (quoting SEC v. Obus, 693 F.3d 276, 289 (2d Cir. 2012)). Curiously, Commissioner Panowar's opinion cited Rule 10b5-1 as a "see also"—one would think a Commissioner would view it as controlling. *Id.* at *2 n.6.

159. *See, e.g.*, *2000 Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51733 ("the rule will benefit corporate insiders by providing greater clarity and certainty on how they can plan and structure securities transactions").

160. Cent. Bank v. First Interstate Bank, 511 U.S. 164, 177 (1994). *See also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) (ruling that the scope of any rule adopted under the authority granted by section 10(b) "cannot exceed the power granted the [SEC] by Congress under § 10(b)").

161. *See, e.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975) (Powell, J., concurring) ("The starting point in every case involving construction of a statute is the language itself."), *quoted in Hochfelder*, 425 U.S. at 197; Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977).

162. 15 U.S.C. § 78j(b) (2018) (emphasis added).

163. *See, e.g.*, definition of "employ" in Merriam-Webster Dictionary, https://www.merriam-webster.com/dictionary/employ (last visited Nov. 1, 2023). The definition of "use" is to do something with pur-

for example, doing something when one happens concurrently to be aware of MNPI, whatever "aware" means. To remain within the scope of section 10(b), then, the person must "use" something prohibited by a rule under the section.

Suppose a person is aware that he has the manual for repairing something but in making a repair pays no attention to the contents of the manual or even to the specific instructions for the repair. That is certainly *not* "using" or "employing" the information in the manual that he arguably was "aware of." Perhaps "aware" in the context of Rule 10b5-1 was intended to mean not just knowing there is information in hand but also being cognizant of the relevant provisions—yet the Commission expressly rejected a "knowing possession" test.[164] The awareness test in Rule 10b5-1 exceeds the statutory grant to the SEC.[165]

If the proper focus is not on using MNPI *per se* but instead more broadly on using a "deceptive device" that employs MNPI, the answer is the same. It is not "using" deception, a term of action, to trade while aware of MNPI—unless the trader was aware that the deception involved MNPI. Again, however, the SEC rejected a test of "knowing possession."[166] Others have questioned the authority of the SEC to adopt the rule.[167]

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pose, such as "to carry out a purpose or action by means of." *Id*. In 1934, when the Exchange Act was passed, "to use" meant, among other things, "to employ" and "to act with regard to." WEBSTER'S NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE 2806 (2d ed. 1934). "To employ" means to "make use of" or "to use." MERRIAM-WEBSTER DICTIONARY, https://www.merriam-webster.com/dictionary/use# (last visited Nov. 1, 2023).

164. *See supra* text accompanying notes 119–22.

165. The Administrative Procedure Act requires that when adopting a rule the agency state the authority under which it is acting. 5 U.S.C. § 553(b)(2) (2018). Here the Commission did state that in adopting Rule 10b5-1 it was acting "under the authority set forth in Section 10." *2000 Adopting Release*, *supra* note 18, at 65 Fed. Reg. at 51737. The Commission did not further explain how adopting the rule was within its grant of authority, which is not commonly required.

166. This analysis serves as a reminder that scienter, an intent to deceive, must be proven to sustain liability. *See supra* text accompanying note 15. Some have argued, however, and the present author agrees, that Rule 10b5-1 suggests an end run around the scienter requirement, albeit perhaps not intended. The Commission summarily rejected commenters on the original proposed Rule 10b5-1 who argued that that rule would improperly permit liability in the absence of scienter. *See supra* text accompanying notes 100–01 (footnotes omitted).

The final rule has been criticized for permitting liability under Rule 10b-5 without scienter. *See, e.g.*, John P. Anderson, *Anticipating a Sea Change for Insider Trading Law: From Trading Plan Crisis to Rational Reform*, 2015 UTAH L. REV. 339, 354 ("Though the SEC remains adamant that its adoption of 10b5-1 has done nothing to diminish the element of scienter required for liability under Section 10(b) and Rule 10b-5, it is difficult to reconcile this position with the exclusive nature of the available affirmative defenses." (footnote omitted)); *Swanson*, *supra* note 131, at 196–99 (criticizing Rule 10b5-1 as "duplicitous," (1) questioning whether a trader who is aware of information but does not use it acts with scienter and (2) suggesting that Rule 10b5-1 "eliminates fraud from the liability standard" under Rule 10b-5); BROMBERG, *supra* note 92, § 6:291 ("Hinging the violation on merely being 'aware of' MNPI, the proposed rule appeared to do away with a scienter requirement, throwing in question its validity."); Stuart Sinai, *A Challenge to the Validity of Rule 10b5-1*, 30 SEC. REG. L.J. 261, 264–67, 272, 281 (2002) [hereinafter *Sinai*] (arguing that Rule 10b5-1 removes the scienter requirement for insider trading, effectively imposing strict liability for trading while in possession of material nonpublic information). The present author continues to support the argument that Rule 10b5-1 abrogates the scienter requirement. *See Horwich Validity*, *supra* note 1, at 922. That issue is not addressed further in this Article in order to focus on other fundamental flaws in Rule 10b5-1.

167. Professor Bainbridge stated, "The bulk of the evidence . . . raises serious doubts as to the validity of Rule 10b5-1." BAINBRIDGE, *supra* note 20, at 74. Professor Nagy likewise stated, "[I]f Adler was correct in holding that Section 10(b)'s deception requirement forecloses liability in the absence

Making an argument about the validity of Rule 10b-5 itself, in a Rule 10b-5 insider trading case, Justice Scalia, joined by Justice Thomas, observed that "Congress may make it a crime to violate a regulation, but it is quite a different matter for Congress to give agencies—let alone for us to presume that Congress gave agencies—power to resolve ambiguities in criminal legislation."[168] Moreover, "[o]nly the *legislature* may define crimes and fix punishments. Congress cannot, through ambiguity, effectively leave that function to the courts—much less to the administrative bureaucracy."[169] A rule under section 10(b) imposing liability for mere awareness of MNPI is an invalid overreach by the Commission.

B. Application of Principles of Administrative Law

A related argument is grounded on fundamental principles of administrative law. A principal authority for assessing the validity of agency action interpreting a statute has been *Chevron, U.S.A. Inc. v. Natural Resources Defense Council, Inc.*[170] *Chevron* adopted a two-step process to determine whether an agency rule is valid.[171]

Here, the first *Chevron* step is dispositive:

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.[172]

That is, once the courts, here the Supreme Court, have spoken definitively, there is no leeway for an agency to decide otherwise. *Chevron* deference is premised upon implicit delegation of legislative authority from Congress when a statutory phrase is

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of a causal connection, the SEC would lack the authority under this provision to promulgate a rule with knowing possession as the operative standard." *Nagy Golden*, *supra* note 39, at 1195–96 (footnote omitted).

168. Whitman v. United States, 135 S. Ct. 352, 353 (2014) (statement of Justice Scalia, with whom Justice Thomas joined) (statement on denial of certiorari) (citations omitted).

Earlier, somewhat along the same lines, one author had questioned the constitutionality of Rule 10b5-1, suggesting that the SEC had usurped the legislative power granted exclusively to Congress in Article 1, Section 1, of the Constitution. *Sinai*, *supra* note 166, at 266.

169. *Whitman*, 135 S. Ct. at 354.

170. Chevron, U.S.A. Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837 (1984). *Chevron* has been the subject of much criticism. The Supreme Court has granted certiorari to address the validity of *Chevron*. Loper Bright Enters., Inc. v. Raimondo, 45 F.4th 359 (D.C. Cir. 2022), *cert. granted*, No. 22-451, 143 S. Ct. 2429 (2023). The grant was limited to Question 2, which states:

> Whether the Court should overrule *Chevron* or at least clarify that statutory silence concerning controversial powers expressly but narrowly granted elsewhere in the statute does not constitute an ambiguity requiring deference to the agency.

Petition for Writ of Certiorari at i–ii, Loper Bright Enters., Inc. v. Raimondo, No. 22-451 (U.S. Nov. 10, 2022), 2022 WL 19770137.

171. *See* United States v. Mead, 533 U.S. 218, 226–27 (2001) ("administrative implementation of a particular statutory provision qualifies for *Chevron* deference when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority").

172. 467 U.S. at 842–44 (footnotes omitted).

ambiguous. Because the Supreme Court has definitely determined the meaning of "on the basis of," most certainly in misappropriation cases, there is no room for any residual delegated authority. At the very least, *O'Hagan has decreed, that, (1) without exception, use is required in a misappropriation claim, and (2) "on the basis of" means "to use."* What the SEC feared most in any statutory definition was an "on the basis of" requirement that meant "to use."[173] According to *Chevron*, what the courts have decided cannot be overridden by an SEC rule. Part VI addresses this issue.

VI. The Rule 10b5-1 Definition of "on the Basis of" Is Arbitrary and Capricious and Thus Invalid

For the sake of completeness, it is useful to consider the second *Chevron* step, which provides that "if the statute 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."[174] The second prong of *Chevron* states:

> If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are *arbitrary, capricious*, or manifestly contrary to the statute.[175]

This Part demonstrates that, even if the first prong of *Chevron* is not dispositive, the Rule 10b5-1 definition is invalid because the adoption of it was arbitrary and capricious.

The Commission's view had been unambiguous and consistent, indeed insistent—the phrase "trading on the basis of" meant "to use" MNPI in trading. It so informed Congress in the 1980s.[176] It recognized that *O'Hagan* ruled that, at least in misappropriation cases, the phrase means "to use." Nevertheless, here we are—with the Commission determining in 2000 that it means only to be aware of. Accordingly, this Part VI presents an account of how the phrase was *actually* understood before Rule 10b5-1 was proposed in 1999.

A. The Ordinary Meaning of Acting "on the Basis of" Is Acting Deliberately

The phrase "on the basis of" does not appear in any Exchange Act provision having anything to do with deception, much less insider trading.[177] When the Supreme Court has been faced with defining a statutory word or phrase it

173. *See supra* text accompanying notes 102 and 107 (describing SEC positions during legislative hearings in the 1980s).

174. *Chevron*, 467 U.S. at 843 (footnotes omitted) (emphasis added).

175. *Id.* at 843–44 (footnote omitted).

176. *See supra* text accompanying notes 103–07 (presenting relevant portions of legislative history of ITSFEA).

177. The phrase appears in nine places in the Exchange Act, as determined from a "Find" search of the PDF text of the Exchange Act posted on the SEC website, https://www.govinfo.gov/content/pkg/COMPS-1885/pdf/COMPS-1885.pdf.

often turns to contemporary dictionaries.[178] Dictionaries of the twenty-first century define "on the basis of" to mean to act "on account of," "because," and "due to."[179] This is unmistakably a *conscious act as a result of deliberation*.

B. The Commission Had Recognized that the Phrase "on the Basis of" MNPI Meant to Use it

A recurring theme in the Commission's position in the debates over ITSA and ITSFEA in the mid-1980s was that *no definition of insider trading in the Exchange Act should adopt the phrase "on the basis of" because those are words of a use test*.[180] This brings to mind an image of the Chairman holding up a cross to repel the "on the basis of" vampire at all costs. Now, in Rule 10b5-1, the Commission says that the phrase *does not mean that at all*, it means merely to be aware of MNPI. The Commission has never explained the basis for this linguistic *volte-face*.

In *O'Hagan* the Supreme Court majority employed the phrase "on the basis of," at least in the important misappropriation context, to mean "using" MNPI as a necessary element.[181] As the first prong of *Chevron* teaches, the Commission cannot override that clear construction of the law by the highest court.[182] The SEC nevertheless sought to discount the significance of *O'Hagan*, stating, "Although the Supreme Court has variously described an insider's violations as trading 'on' or 'on the basis of' material nonpublic information, [the Court] has never explicitly addressed the use/possession issue."[183] Yet in the *1999 Proposing Release* the Commission had stated, *without qualification*, "In *O'Hagan*, the Supreme Court recognized that under the misappropriation theory of insider trading liability, the fraud is consummated when the defendant, without proper disclosure to the source, '*uses* the information to purchase or sell securities.'"[184] In an appellate brief in 1998 the Commission urged that very reading on a court of appeals.[185] The DOJ did as well in 1999.[186]

178. *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 nn.20–21 (1976) (citing contemporary dictionaries for the meaning of words used in section 10(b) of the Exchange Act).

179. *See, e.g.*, Entry for "basis" in The Britannica Dictionary, https://www.britannica.com/dictionary/basis (last visited Nov. 1, 2023) (defining "basis" to mean "a reason for doing something").

180. *See supra* text accompanying notes 103–07.

181. *See supra* text accompanying notes 52–53.

182. *See supra* text accompanying notes 171–72.

183. *2000 Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51727.

184. *1999 Proposing Release*, *supra* note 18, 64 Fed. Reg. at 72601 n.86 (quoting *O'Hagan*) (emphasis added).

185. *See* Brief of the U.S. Securities and Exchange Commission at 28, SEC v. Soroosh, 166 F.3d 343 (9th Cir. 1998) (No. 98-35006), 1998 WL 34086220 (June 11, 1998) ("Under the misappropriation theory the defendant must use the information by trading, since it is the conversion of the information by trading that constitutes the fraud on the owner of the information."). The brief was cited for a point other than the one noted here in *1999 Proposing Release*, *supra* note 18, at 72600 n.83.

186. The DOJ stated that under the misappropriation theory the defendant must be shown to have "use[d] [MNPI] in a securities transaction," Brief for the United States of America at 16, United States v. Kosinski, 976 F.3d 135 (2d Cir. 2020) (No. 18-3065), 2019 WL 1932287 (Apr. 29, 2019) (quoting United States v. O'Hagan¸ 521 U.S. 642, 663 (1997), in turn quoting Barbader Bader Aldave,

After Rule 10b5-1 was adopted, Professor Langevoort found a simple answer for what "on the basis of" means. Taking advantage of MNPI that breaches a duty of confidentially "is expressed in the familiar phrase that the insider traded 'on the basis' of the MNPI, *intentionally using* the information to his or her personal benefit."[187] *Loss* recognizes that "on the basis of" means to trade in conscious reliance on MNPI.[188] Both eminent authorities appear to ignore the tension between that understanding and the definition adopted in Rule 10b5-1. Of course, the SEC would claim that "taken as a whole" Rule 10b5-1 employs a use test—a very flawed one indeed.[189]

There is little room for doubt that in misappropriation cases "on the basis of" meant "to use." The analysis in Part V supports the same conclusion in classical cases.

C. The Commission's Adoption of the *Opposite* of What the Courts and the Commission Itself Said "on the Basis of" Means Was Arbitrary and Capricious

In defining "on the basis of" in Rule 10b5-1 the SEC was doing one of two things: either (i) it was interpreting a judicial phrase (notably from *O'Hagan*[190]) or (ii) it was interpreting a phrase it had used in applying Rule 10b-5 (as in *Investors Management*[191]).[192] The latter is highly unlikely. Neither the *1999 Proposing Release* nor the *2000 Adopting Release* cited *Investment Management* on this point, though the SEC did cite the case for other purposes.[193] Here the SEC

Misappropriation: A General Theory for Liability for Trading on Nonpublic Information, 13 Hofstra L. Rev. 101, 122 (1984)).

187. *Langevoort Thinking, supra* note 123, at 5. This view is difficult to reconcile with his explicit support of the possession test, at least in classical cases. *See supra* text accompanying note 75.

188. *Loss* had stated that "it seems natural to speak in terms of . . . trading 'on' or 'on the basis of' the information without necessarily implying that possession alone would not suffice." 7 Louis Loss et al., Securities Regulation 3504–05 (3d ed. 1991). As the present discussion demonstrates, however, the "natural" meaning *is* "to use."

189. *See infra* Part VIII.

190. *See supra* text accompanying notes 49–53.

191. *See supra* text accompanying notes 32–34.

192. In the release in which the Commission adopted Rule 10b5-1, it also adopted Regulation FD. 17 C.F.R. pt. 243 (2023). *See 2000 Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51716–26. One provision in that regulation refers to whether it is reasonably foreseeable that a current holder of the issuer's securities "will purchase or sell the issuer's securities on the basis of" certain MNPI. Regulation FD, Rule 100(b)(1)(iv), 17 C.F.R. § 243.100(b)(1)(iv) (2023). There was no definition of "on the basis of" in that contemporaneous new regulation.

193. In the two proposing and two adopting releases regarding Rule 10b5-1, the Commission cited *Cady, Roberts*—but only for the proposition that: "A significant purpose of the Exchange Act was to eliminate the idea that *use* of inside information for personal advantage was a normal emolument of corporate office" (*see 2022 Proposing Release*, *supra* note 18, 87 Fed. Reg. at 8687 n.3; *2022 Adopting Release, supra* note 18, 87 Fed. Reg. at 80363 n.5 (emphasis added)). The SEC cited *Investors Management* only on the issue of when information becomes public. *See 1999 Proposing Release*, *supra* note 18, 64 Fed. Reg. at 72595 n.39; *2000 Adopting Release, supra* note 18, 65 Fed. Reg. at 51721 n.40. Both *Cady, Roberts* and *Investors Management* contained language suggesting a use test. *See supra* text accompanying notes 28, 30, and 35–36. If these cases were not dead letters, why was the language in them, especially Commissioner Smith's cogent concurrence in *Investors Management*, not even mentioned?

seems to have cherry-picked authorities in support of its adoption of Rule 10b5-1. The Commission implied that it was *changing the law of insider trading* in one respect.[194]

It was the express intent of the SEC to *change the result* in *Adler* and in *Smith* that had construed section 10(b) and Rule 10b-5 to require a finding of "use" in order to establish a violation of Rule 10b-5. The cases construing Rule 10b-5 to require proof of "use" were not ones where the courts had deferred to an agency interpretation, which the agency *might* be free to revise in reinterpreting its own rule, Rule 10b-5. On the contrary, the decisions imposing a "use" element were ones that rejected the arguments of two arms of the federal government, the SEC and DOJ. Moreover, the SEC itself had, on occasion, recognized a use test, especially in misappropriation cases.[195] The SEC thus had limited flexibility, *if any*, to define "on the basis of," something the SEC seems to have done to enhance its prospects in litigation. It certainly had *no* flexibility to change the law in misappropriation cases.[196]

One line of cases may, at first glance, appear to have rejected a use test, perhaps affording the Commission room to choose between lines of authority. Not so. *Teicher*, which pre-dated *O'Hagan* but on which the SEC relied in adopting Rule 10b5-1,[197] stated that when someone trades while in possession of MNPI he knew was "fraudulently obtained" and who did not act in good faith, "trad[ed] on the basis of that information"[198] Post-*O'Hagan* Second Circuit cases relying on *Teicher* may appear to provide support for construing "on the basis of" to mean something *other than* "used." In *United States v. Royer*, the court cited *Teicher* in adopting a "knowing possession" standard.[199] *Royer*, like *Teicher*, however, was dictum, inasmuch as the jury instruction at issue provided for conviction "if the person making the purchase or sale was aware of the material non-public information when the person made the purchase or sale, *and the information in some way informed the investment decision*."[200] In both cases, the defendant was convicted where the jury was instructed to apply a use test.

194. After noting that three cases (*Teicher, Adler,* and *Smith*) had "reached different results," Rule 10b5-1 was adopted to "provid[e] greater clarity in the area of insider trading law." *2000 Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51727 & n.97. This, coupled with the rejection of any use test, can only mean that the SEC sought to *change* the law in those jurisdictions where a use test had been applied.

195. *See supra* Part II.B.1 (describing cases decided by the SEC).

196. *See, e.g.*, *supra* text accompanying notes 184–86 (explaining that a use test must be satisfied in misappropriation cases).

197. *2000 Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51727 & n.104 (citing *Teicher* for the proposition, "The awareness standard reflects the commonsense notion that a trader who is aware of inside information when making a trading decision inevitably makes use of the information.").

198. United States v. Teicher, 987 F.2d 112, 121 (2d Cir. 1993).

199. 549 F.3d 886, 899 (2d Cir. 2008) (Rakoff, J., sitting by designation).

200. United States v. Royer, 549 F.3d 886, 899 n.12 (2d Cir. 2008). *Royer*, a misappropriation case, in favoring a "knowing possession" test, thus departed from *O'Hagan*'s use test in misappropriation cases. *See supra* text accompanying note 199. *See also* United States v. Rajaratnam, 719 F.3d 139, 158–59 (2d Cir. 2013) (stating that *Royer* had "elevated the dicta of *Teicher* to the law of the Circuit" and noting that a jury instruction given at Rajaratnam's trial "went beyond the 'knowing possession' standard because it required that the inside information be 'a factor, however small, in the

The Commission may counter that it was neither changing the law nor resolving a circuit split *per se*. Rather, it might argue, it was merely taking a fresh look at Rule 10b-5—interpreting its own rule, Rule 10b-5, through rulemaking, rather than waiting to do so, for example, in deciding an administrative proceeding.[201] It was accomplishing that, not by taking a different position in a litigated case (either as a litigant or as the decision maker in an administrative proceeding), but by following the preferred course of rulemaking, seriously flawed though it was.[202] That is, the Commission, on reflection, decided to abandon its "traditional" position, argued with much vigor, that a "possession" test applies to all insider trading claims.[203] When an agency changes *its own* interpretation, the agency will not be entitled deference if the new interpretation is "arbitrary and capricious."[204] The Commission did not explain why it had abandoned its "traditional" position.[205] The Commission did not even make note of this. The Supreme Court has held that "the requirement that an agency provide reasoned explanation for its action would ordinarily demand that it display awareness that it is changing position. An agency may not, for example, depart from a prior policy *sub silentio* . . . ."[206]

Applying administrative law decisions of the Supreme Court shows that the adoption of the definition in Rule 10b5-1 exceeded the SEC's discretion. In *Kisor v. Wilkie* the Court "cabined" the scope of so-called *Auer* deference to an agency's interpretation of "genuinely ambiguous regulations."[207] *Kisor* stated guidelines for when to defer to an agency's interpretation of its own rule. The

defendant's decision to purchase or sell stock'") Thus, *Rajaratnam* is also dictum to the extent it is read as rejecting a use test.

201. Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 980 (2005) ("If a statute is ambiguous, and if the implementing agency's construction is reasonable, *Chevron* requires a federal court to accept the agency's construction of the statute, even if the agency's reading differs from what the court believes is the best statutory interpretation."). As shown earlier, however, there is no basis for shifting the burden in any misappropriation case from the government (indeed any plaintiff) to the defendant. *See supra* text following note 132.

202. The Commission has been criticized for making law through litigation, when, it has been argued, that rulemaking, with an opportunity for public comment, is the preferred approach. The history of this debate is recounted briefly in Chris Brummer et al., Regulation by Enforcement 7–9 (2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4405036.

203. *See*, *e.g.*, *supra* text accompanying note 103.

204. *Brand X*, 545 U.S. at 981. Under the Administrative Procedure Act, a rule may be set aside if it is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A) (2018).

205. *See supra* text accompanying note 103.

206. FCC v. Fox Television Stations, Inc., 556 U.S. 502, 515 (2009). *See also Brand X*, 545 U.S. at 981 ("Unexplained inconsistency is a reason for holding an interpretation to be an arbitrary and capricious change from agency practice under the Administrative Procedure Act."). Professor Langevoort would uphold Rule 10b5-1 in the face of a challenge of the type described here. LANGEVOORT INSIDER TRADING, *supra* note 2, § 3:14 n.2 (stating in the chapter on the classical theory, that "in light of the precedent favoring an awareness approach and reasonable grounds for considering this standard fully consistent with the scienter requirement, it is hard to see how this matter is beyond the rulemaking authority of the SEC"). He does not, however, expressly address the arbitrary and capricious test.

207. 139 S. Ct. 2400, 2408 (2019) (referring to Auer v. Robbins, 419 U.S. 492 (1997)) ("*Auer* deference is sometimes appropriate and sometimes not. Whether to apply it depends on a range of considerations that we have noted now and again, but compile and further develop [in *Kisor*].").

inquiry thus begins by determining whether Rule 10b-5 is "genuinely ambiguous" on the issue of possession versus use.[208] Part VI, demonstrating the requirement to apply a use test, most certainly in misappropriation cases, undermines any claim of ambiguity in Rule 10b-5, at least to that extent.[209]

If, however, Rule 10b-5 were ambiguous on what "on the basis of" means, *Kisor* instructs that a court should decline to defer to a merely convenient litigating position or a *post hoc* rationalization advanced to defend past agency action against attack.[210] That is exactly what the SEC did here, however. The Commission having lost *Adler* and the DOJ having lost *Smith* on the legal principle, the SEC adopted a rule to *change the result* in any case presenting a viable non-use argument on the facts—save where an exclusive defense is available.

There are many respects in which the adoption of Rule 10b5-1 was arbitrary and capricious, thus invalid under the Administrative Procedure Act, 5 U.S.C. § 706(2)(A). The following points demonstrate this:

1. The unexplained abandonment of the "traditional" "possession" test, which the SEC had long argued for right up to when it proposed Rule 10b5-1.[211] Where an inconsistency is unexplained, the action may be arbitrary and capricious.[212]

2. The rambling explanation for the adoption of an awareness test and the confused comments on why the SEC did *not* adopt a "knowing possession" test, even though, the SEC claimed, possession was the test applied in *Teicher*, on which the SEC relied in adopting the rule.[213]

3. The absence in the rulemaking process of any pertinent references to the Commission's principal decisions, *Cady, Roberts* and *Investors Management*,

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The quotations to *Kisor* are taken from Part II.A of that opinion in which four justices joined. *Id*. at 2408.

208. The Court stated: "[T]he possibility of deference can arise only if a regulation is genuinely ambiguous. And when we use that term, we mean it—genuinely ambiguous, even after a court has resorted to all the standard tools of interpretation. Still more, not all reasonable agency constructions of those truly ambiguous rules are entitled to deference." 139 S. Ct. at 2414.

209. In the classical context, however, *Adler* observed, "We view the choice between the SEC's knowing possession test and the use test advocated by [defendant] as a difficult and close question of first impression," perhaps suggesting ambiguity. SEC v. Adler, 137 F.3d 1325, 1337 (11th Cir. 1998).

210. *Kisor*, 139 S. Ct. at 2418.

211. In addressing Congress in 1988, the SEC described that test as its "traditional" position. *See supra* text accompanying note 103. The SEC argued for a possession test in its 1998 brief in *SEC v. Soroosh*. Brief of the Securities and Exchange Commission, SEC v. Soroosh, No. 11-28, 166 F.3d 343 (9th Cir. 1998 (No. 98-35006), 1998 WL 34086220. *See also* Brief of the Securities and Exchange Commission *passim*, SEC v. Adler, 137 F.3d 1325 (11th Cir. 1998) (No. 96-6084), 1997 WL 33487156 (arguing for possession test).

212. A recent case overturning SEC action, albeit not rulemaking, applied the arbitrary and capricious standard, holding that the SEC failed to explain why it approved one transaction and disapproved a substantially similar one without explaining why. Grayscale Invs., LLC v. SEC, 82 F.4th 1239, 1242 (D.C. Cir. 2023) ("The denial of Grayscale's proposal was arbitrary and capricious because the Commission failed to explain its different treatment of similar products. We therefore grant Grayscale's petition and vacate the order.").

213. *See supra* Part III.A.3.

at least without any explanation why those decisions were not relevant. The Commission most certainly should have addressed whether its position over the decades was consistent with subsequent Supreme Court decisions. The Commission's use test quotation from *O'Hagan* in adopting the rule betrayed that the rule was *not* consistent.[214]

4. The absence of *any* discussion whether the awareness test applied to criminal cases, especially considering the recent decision in *Smith* that required proof of use in a criminal case.[215]

5. The absence of *any* discussion in proposing or adopting the rule whether the new awareness test applied in misappropriation cases. It cannot—as the SEC had acknowledged in two amicus briefs in *Smith,*[216] in a brief as a party in a later Ninth Circuit case,[217] and in the *1999 Proposing Release*.[218] The SEC cannot be heard to respond that, "taken as a whole,"[219] Rule 10b5-1 employs a use test, when the rule seeks to preclude any general non-use defense and shifts the burden on non-use to the defendant.

6. Rejection of proposals that a trader can defend by proving that he did not use MNPI in deciding to trade *without* relying on the defenses in the rule, contrary to caselaw interpreting Rule 10b-5.[220]

With the benefit of hindsight, the Commission's own lack of reliance on the rule suggests the Commission recognizes that it did not achieve "greater clarity"[221] to "better enable insiders and issuers to conduct themselves in accordance with the law."[222] One commentator, writing soon after Rule 10b5-1 was adopted, did not mince words:

> Rule 10b5-1 may present a well-intentioned effort, but it is a mess. On its face, the rule deceptively suggests that it provides helpful direction through an already convoluted legal quagmire; instead, its construction pushes the participants deeper into the muck. The SEC may have wanted clarity and certainty; unfortunately, the Commission's formulation lacks both.[223]

214. *See 2000 Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51727 (quoting *O'Hagan*'s use of "on the basis of," which the Commission has acknowledged reflects a use test—*see supra* text accompanying notes 102 and 108 (quoting statements made in connection with hearing on ITSFEA)).

215. The principle in *Smith* was not, however, followed uniformly. *See supra* text accompanying notes 140–42. The split in authority does not justify ignoring the criminal context altogether in adopting a facially all-encompassing rule.

216. *See supra* notes 71–72.

217. *See supra* note 185.

218. *See supra* text accompanying note 184.

219. *See supra* text accompanying notes 130 and 189.

220. *See infra* Part VII (demonstrating that Rule 10b5-1 improperly adopted purportedly exclusive defenses).

221. *2000 Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51727 (twice).

222. *Id.*

223. *Swanson*, *supra* note 131, at 200.

A separate line of authority provides for judicial consideration of an agency's interpretations of the law as a "body of experience and informed judgment to which courts and litigants may properly resort for guidance."[224] The definition in Rule 10b5-1(b) cannot be salvaged on that approach, where the question is the validity of a rule purportedly binding on the courts. That is, *if Skidmore* were applied, a court would be free to reject the SEC's position because in Rule 10b5-1 the Commission had abandoned its prior position once so firmly held, without recognizing the about face in some respects, not to mention entirely ignoring the important classical/misappropriation and civil/criminal distinctions.

In the evolving landscape of administrative law, another perspective may be worthy of consideration, the "major questions doctrine." That "refers to an identifiable body of law that has developed over a series of significant cases all addressing a particular and recurring problem: agencies asserting highly consequential power beyond what Congress could reasonably be understood to have granted."[225] "Under that doctrine, administrative agencies must be able to point to 'clear congressional authorization' when they claim the power to make decisions of vast 'economic and political significance.'"[226] The SEC has emphasized the importance of the fairness of the country's securities markets.

> [T]he prohibitions against insider trading in our securities laws play an essential role in maintaining the fairness, health, and integrity of our markets. We have long recognized that the fundamental unfairness of insider trading harms not only individual investors but also the very foundations of our markets, by undermining investor confidence in the integrity of the markets.[227]

If Rule 10b5-1 exercises "highly consequential power beyond what Congress could reasonably be understood to have granted" over a matter of "vast economic and political significance," namely, the "foundations of our [securities] markets," then it was not within the power of the Commission to adopt that rule absent a more clear, specific grant of authority in the Exchange Act. The demonstration in Part V that Rule 10b5-1 exceeds the SEC's power under section 10(b), coupled with the overwhelming role that the securities markets play in the nation's economy, suggest that the terms of a core element of insider trading does present a major question that only Congress can resolve. As the major question doctrine develops, some may suggest that the entire issue of insider trading in all of its aspects should be retrieved from the Commission, considering that section 10(b), and for that matter Rule 10b-5, do not, on their face, address insider trading at all.

The Commission's definition of "on the basis of" in Rule 10b5-1(b) fails to pass muster under established administrative law principles. It ignores *settled* caselaw—which the SEC cannot do—and it acted in an arbitrary and capricious

224. Skidmore v. Swift, 323 U.S. 134, 140 (1944).
225. West Virginia v. EPA, 142 S. Ct. 2587, 2609 (2022).
226. *Id*. at 2616 (Gorsuch, J., concurring, joined by Alito, J., quoting the majority opinion).
227. *2000 Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51727.

manner. The SEC is not entitled to *any* deference with respect to the definition in the rule, especially as it purports to apply to *every* misappropriation case and to *every* criminal case.

VII. Rule 10b5-1 Improperly Adopted "Exclusive" Defenses

The SEC argued that the "awareness" standard in Rule 10b5-1, which assuredly favors the government, was "balance[d]" with "several carefully enumerated affirmative defenses."[228] There are three defenses today, in a much narrowed Rule 10b5-1(c)(1) compared to the original rule. In general terms, sufficient for present purposes, the three alternative affirmative defenses are that "(A) Before becoming aware of [MNPI] the person had: (1) Entered into a binding contract to purchase or sell the security, (2) Instructed another person to purchase or sell the security for the instructing person's account, or (3) Adopted a written plan for trading securities."[229] To perfect one of the defenses, any trade must be made in accordance with the contract, instruction, or plan.[230] A person who has taken steps intended to satisfy one of the defenses, particularly (1) or (3), is relying on a 10b5-1 Plan.[231] The purpose of the defenses was to make lawful the execution of trades when the trader became aware of MNPI *after* establishing the 10b5-1 Plan and before the trade occurred.[232]

These defenses were, without a doubt, intended to be exclusive. They are the *only* defenses a trader can assert. The SEC said so,[233] though the rule itself does not state that. Others so understand the defenses.[234] The SEC was insistent. In

228. *2000 Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51727. Presumably the Commission does not mean that the defenses were carefully numbered, but that the terms of the defenses were clearly specified.

229. *Id.* (setting forth current Rule 10b5-1(1)(i)(A), 17 C.F.R. § 10b5-1(c)(1)(i)(A) (2023)).

230. Rule 10b5-1(c)(1)(C), 17 C.F.R. § 240.10b5-1(c)(1)(C) (2023).

231. A separate defense specifies criteria for when an entity did not trade "on the basis of" MNPI. Rule 10b5-1(c)(2), 17 C.F.R. § 240.10b5-1(c)(2) (2023). *See 2000 Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51737–38 (explaining the entity defense). This was not changed in the 2022 amendments. Nothing in this Article bears on this defense, except insofar as the defense is dependent on the criterion that "[t]he individual making the investment decision on behalf of the [entity] to purchase or sell the securities was not aware of the information." Rule 10b5-1(c)(2)(i), 17 C.F.R. § 240.10b5-1(c)(2)(i) (2023).

232. *2000 Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51727–29. Amended Rule 10b5-1 also provides that:

> The contract, instruction, or plan to purchase or sell securities was given or entered into in good faith and not as part of a plan or scheme to evade the prohibitions of this section, and the person who entered into the contract, instruction, or plan has acted in good faith with respect to the contract, instruction or plan.

Amended Rule 10b5-1(c)(1)(ii)(A), 17 C.F.R. § 240.10b5-1(c)(1)(ii)(A) (2023).

233. *2000 Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51. *See also 1999 Proposing Release*, *supra* note 18, 64 Fed. Reg. at 7601 (referring to the proposed defenses as "exclusive").

234. Commentators recognize that the defenses are exclusive. *See* Ferrara, *supra* note 75, § 1.05[5][c] n.31 and accompanying text (stating that the defenses are exclusive) and *id.* § 1.05[5][c] n.33 and accompanying text (stating that Rule 10b5-1 "recognizes only three affirmative defenses" (footnotes omitted)); Bromberg, *supra* note 92, § 6:289 (Summary) ("Without using the quoted word, the three individual defenses that survive remain exclusive in the final rule . . . . "); 5C Arnold S. Jacobs, Disclosure & Remedies Under the Sec. Laws § 12:219 n.2 (2023) and accompanying text. *Contra* SEC v. Lyon, 605 F. Supp. 2d

responding to comments on the proposed rule that the defenses should be made non-exclusive, the Commission stated, "[A]dding a catch-all defense or redesignating the affirmative defenses as non-exclusive safe harbors would effectively negate the clarity and certainty that the rule attempts to provide."[235] If a transaction was made by someone who was aware of MNPI where the other elements of the violation were present and *none* of the three specified affirmative defenses was satisfied, then the trader *cannot argue that, because the information was not "used" in making the decision to trade, his transaction did not violate Rule 10b-5*.

The Commission recognized this in an example in the *1999 Proposing Release*, conceding that an absolute standard based on knowing possession or awareness could be overbroad in some respects, where a person may reach a decision to make a particular trade without any awareness of material nonpublic information, but then come into possession of MNPI before the trade occurred.[236] The Commission did not recognize that non-use could be argued. *Ferrara* expresses skepticism that courts will honor the exclusivity of the defenses:

> Rule 10b5-1 now mandates liability in any case in which a securities trader, while unable to prove one of the enumerated affirmative defenses, could nonetheless convince a fact-finder that her decision to trade completely lacked any causal connection to the material, nonpublic information of which she was aware at the time of her trade. In such instances, courts may be unwilling to defer to the rule's plain language, which recognizes only three affirmative defenses to liability.[237]

Similarly, *Bromberg* states, "SEC's authority to make its affirmative defenses exclusive is questionable. In our view, traders may show in other ways that their transactions were not made 'on the basis of' MNPI."[238]

Exclusivity as in Rule 10b5-1(c) is contrary to the SEC's customary, arguably uniform, approach of providing *non-exclusive* shields from wrongdoing in the form of "safe harbors."[239] If a person complies with each element of a safe harbor the person will be deemed not to have violated a specific statutory provision.[240] If the person fails to satisfy all elements of the safe harbor, it may nevertheless argue that it did not violate the law, by falling back on the underlying statutory provision for which the safe harbor afforded protection. If the SEC had taken the safe harbor approach in Rule 10b5-1, the trader could prevail if she satisfies one

531, 548–49 (S.D.N.Y. 2009) (suggesting that the defendant could argue proof of non-use that does not satisfy one of the express defenses, that at trial defendants "remain free to present evidence of the six additional trades to the jury and to ask the jury to draw an inference against causation at trial").

235. *2000 Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51727.

236. *See supra* text accompanying note 128.

237. FERRARA, *supra* note 75, § 1.05[5][c] n.233 and accompanying text (footnotes omitted).

238. *See* BROMBERG, *supra* note 92, § 6:289.

239. J. WILLIAMS HICKS, EXEMPTED TRANSACTIONS UNDER SECURITIES ACT 1933 § 1.8 (2023) [hereinafter HICKS] ("Statutory sections creating private and limited offering exemptions from registration requirements under Section 5 of the Securities Act of 1933 are implemented or clarified by 'safe harbor' exemptions detailed in SEC rules or case law.").

240. A "safe harbor" is "[a] provision (as in a statute or regulation) that affords protection from liability or penalty." BLACK'S LAW DICTIONARY (11th ed. 2019), available on Westlaw.

of the defenses *or* otherwise establishes that she did not use the MNPI in deciding to trade.[241]

Securities Act Rule 506 is a clear-cut example of how an SEC safe harbor rule operates.[242] It provides an exemption from the registration requirement of the Securities Act for sales of securities by the issuer. Section 5 of the Securities Act of 1933 requires that all sales of securities must registered.[243] Section 4(a)(2) exempts from section 5 "transactions by an issuer not involving any public offering."[244] Rule 506(b) is a *non-exclusive safe harbor* for compliance with section 4(a)(2).[245] Thus, a transaction that complies with Rule 506(b) will be exempt from section 5. A transaction that failed to comply with all elements of Rule 506(b) might *nevertheless* be exempt under section 4(a)(2), applying the judicially developed criteria for that statutory exemption.[246] The SEC's approach in Rule 10b5-1 was and, in the amended rule remains, notably and deliberately different from the time-honored safe harbor.

The SEC rejected arguments made during the comment period on the original proposed rule that the affirmative defenses be recast as non-exclusive safe harbors or that the SEC add a catch-all defense to allow a person to establish that he did not actually use the information in deciding to trade.[247] The SEC responded, "We believe the approach we proposed is appropriate. In our view, adding a catch-all defense or redesignating the affirmative defenses as non-exclusive safe harbors would effectively negate the clarity and certainty that the rule attempts to provide."[248] Directing a court not to consider any non-use argument that does not comply with the express defenses could result in improperly imposing liability

241. Notwithstanding the SEC's express rejection of adopting the safe harbor approach, many have nevertheless mischaracterized the defenses as "safe harbors." *See, e.g.*, United States v. Nacchio, 519 F.3d 1140, 1167 (10th Cir. 2008); SEC v. Lipson, 278 F.3d 656, 660 (7th Cir. 2002); LANGEVOORT INSIDER TRADING, *supra* note 2, § 3:14 n.10 and accompanying text; JOHN C. COFFEE, JR., HILLARY A. SALE & CHARLES K. WHITEHEAD, SECURITIES REGULATION CASES AND MATERIALS 1217 (14th ed. 2021); *Swanson*, *supra* note 131, at 197–98. While these statements may not have been intended to be a precise description of the defenses, they are misleading to the extent that they imply that a general non-use argument might be entertained in an action under Rule 10b-5.

242. 17 C.F.R. § 230.506 (2023).

243. 15 U.S.C. § 77e (2018).

244. *Id.* § 77d(a)(2).

245. Rule 506(a) provides, "Offers and sales of securities by an issuer that satisfy the conditions in [Rules 506(b) and 506(c)] shall be deemed to be transactions not involving any public offering within the meaning of section 4(a)(2) of the Act." Rule 500(c) provides:

> Attempted compliance with any rule in Regulation D *does not act as an exclusive election*; the issuer can also claim the availability of any other applicable exemption. For instance, an issuer's failure to satisfy all the terms and conditions of rule 506(b) (§ 230.506(b)) *shall not raise any presumption that the exemption provided by section 4(a)(2) of the Act (15 U.S.C. 77d(2)) is not available*.

17 C.F.R. § 230.500(c) (2023) (emphasis added).

246. *See* HICKS, *supra* note 239, ch. 11 (explaining legal requirements to satisfy the section 4(a)(2) exemption).

247. *2000 Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51727. *See* Comments of Stanley Keller, Chair, Fed. Regul. of Sec. Comm., ABA Bus. Law Section 5 (May 8, 2000) (footnote omitted), http://www.sec.gov/rules/proposed/s73199/keller1.htm.

248. *2000 Adopting Release*, *supra* note 18, 65 Fed. Reg. at 51727 (footnote omitted).

under Rule 10b-5 for conduct that is not deceptive.[249] That oversteps the SEC's rulemaking power.[250]

The SEC knows how to create a non-exclusive safe harbor in the context of Rule 10b-5. It adopted Rule 10b-18, which

> provides an issuer (and its affiliated purchasers) with a "safe harbor" from liability for manipulation under sections 9(a)(2) of the [Exchange] Act and [Rule 10b-5] solely by reason of the manner, timing, price, and volume of their repurchases when they repurchase the issuer's common stock in the market in accordance with the section's manner, timing, price, and volume conditions.[251]

The SEC could easily have done something comparable in Rule 10b5-1. That would, of course, have given potential defendants a break that the SEC did not want to provide.

The foregoing attack on the *exclusivity* of the defenses is not a rejection of those defenses if they were recast as safe harbors. If, as argued in Parts V and VI, the definitional subsections are invalid, that does not consign the defenses—as safe harbors—to the legal scrap heap. As reasonable examples of establishing non-use, they are entirely acceptable.[252] The flaw was making them exclusive.

VIII. Can Rule 10b5-1 Be Salvaged?

This Article demonstrates a number of fundamental shortcomings in Rule 10b5-1. Amending Rule 10b5-1 could cure some of the deficiencies, though it would not result in anything like what the SEC wants. At a minimum, the definitions must be amended (1) to state explicitly that they apply *only to civil actions*, not to criminal actions, (2) to state that they apply *only to (some) classical claims* (those involving "traditional insiders"), and not to *any* misappropriation claim, whether civil or criminal, and (3) to state that the plaintiff (i.e., the government) has the burden of persuasion on the issue of use. The rule should expressly acknowledge that a defendant can assert a general non-use defense.[253] The current defenses would be recast as safe

249. As the Court explained in *O'Hagan*, under the misappropriation theory, the *necessary* element of deception "is satisfied because the fiduciary's fraud is consummated . . . when, without disclosure to his principal, he *uses the information* to purchase or sell securities." United States v. O'Hagan, 521 U.S. 642, 656 (1997) (emphasis added). If there is no *use*, the necessary element of deception is absent. Rule 10b5-1 proscribes any approach to proving non-use other than the express affirmative defenses. Let it not be forgotten that the rule improperly shifts the burden on the use issue to the defendant.

250. *See supra* Part V (demonstrating the limitations imposed by section 10(b)).

251. 17 C.F.R. § 240.10b-18 (2023).

252. Those who decry the narrowing of the defenses in the 2022 amendments (*see infra* note 257) would have less to complain about if, say, their client complied with the requirements of one of the express defenses save for one misstep that did not implicate actual use. They would have a very strong non-use argument.

253. One commentator, writing on the possession versus use conundrum, suggested that the options are not binary. Instead, he proposes that in any situation where a trader may have had mixed motives—one pure (a lawful reason to trade), one impure—the better rule is "the primary motive test used in many substantive areas of law. The primary motive test has a salutary balancing feature that affords traders a measure of freedom while respecting the law's goals." Andrew Verstein, *Mixed Motives Insider Trading*, 106 Iowa L. Rev. 1253, 1314 (2021). The article was critiqued in Zachary J. Gubler, *Why Mixed Motives Shouldn't Really Matter in Insider Trading Law: A Reply to Andrew Verstein's*

harbors. These necessary changes would result in a rule of much narrowed application, with the deck much less stacked against the trader. Such a limited rule, arguably subject to the rule of lenity,[254] may not be worth the effort. That is for the Commission to decide.

IX. Conclusion

This Article has shown that core elements of Rule 10b5-1 are invalid. One can reasonably ask what difference that makes in the real world, is it only sport for academics? Someday there may be the *real* case, especially a misappropriation case, where the government cannot prove that the defendant used the information. The defendant should win that case. There are plausible scenarios where that might arise.[255]

Some have speculated that with the narrowing of the defenses in Rule 10b5-1,[256] the use of 10b5-1 Plans will decline.[257] More important, more defendants may find

Mixed Motives Insider Trading, 107 Iowa L. Rev. Online 1 (2022) (preferring an awareness test, making no explicit reference to Rule 10b5-1). Considering whether a court, or SEC rule, could adopt the mixed motive approach is beyond the scope of this Article.

254. *If* section 10(b) and Rule 10b-5 were genuinely ambiguous, serious consideration must be given to the application of the rule of lenity in insider trading cases, whether criminal, civil proceedings in court, or civil proceedings before the SEC. *See* Bittner v. United States, 143 S. Ct. 713, 724 (2023) ("Under the rule of lenity, this Court has long held, statutes imposing penalties are to be 'construed strictly' against the government and in favor of individuals."); Leocal v. Ashcroft, 543 U.S. 1, 11 n.8 (2004) (ruling that where a statute had both criminal and noncriminal applications, "[b]ecause we must interpret the statute consistently, whether we encounter its application in a criminal or noncriminal context, the rule of lenity applies").

This argument has not fared well, however. The rule of lenity does not apply unless there is a grievous ambiguity or uncertainty in the language and structure of the Act. Chapman v. United States, 500 U.S. 453, 463 (1991). Courts have generally found that section 10(b) is not ambiguous. *See, e.g.*, United States v. Finnerty, Nos. 05 Cr. 393 DC, 05 Cr. 397 DC, 2006 WL 2802042, at *7 (S.D.N.Y. Oct. 2, 2006). *But see* United States v. O'Hagan¸ 521 U.S. 642, 679 (1997) (Scalia, J., concurring in part and dissenting in part) (stating that the majority's explanation of the scope of section 10(b) and Rule 10b-5 "does not seem to accord with the principle of lenity we apply to criminal statutes (which cannot be mitigated here by the Rule, which is no less ambiguous than the statute"). A thorough assessment of the application of the rule of lenity to insider trading cases is beyond the scope of this Article. Perhaps this Article will lead courts to re-evaluate the application of the rule of lenity to section 10(b).

255. *See supra* text accompanying notes 127–28.

256. *See supra* note 134 (describing the 2022 changes to the requirements for a 10b5-1 Plan).

257. This issue was raised during the comment period on the 2022 amendments. *See* Comment of Rod Miller, Chair, Sec. Regul. Comm. of the N.Y.C. B. Ass'n 2 (Oct. 28, 2022), https://www.sec.gov/comments/s7-20-21/s72021-20148519-314873.pdf ("The Committee is concerned that a strict 120-day cooling off period (which would span well beyond an entire fiscal quarter without regard to when during a fiscal quarter the plan is adopted or modified) would result in a dramatic decline in the use of plans.").

For commentary to this effect on the final amended rule, see, for example, White & Case LLP, *SEC Adopts Amendments to Rule 10b5-1*, Insights (Dec. 22, 2022), https://www.whitecase.com/insight-alert/sec-adopts-amendments-rule-10b5-1 ("it may become increasingly necessary to allow senior officers to trade without requiring a 10b5-1 plan, in a short window following an earnings release, when there is minimal risk that they are in possession of MNPI"); Foley & Lardner LLP, *SEC Adopts Final Rules Regarding 10b5-1 Trading Plans and Disclosure of Insider Trading Policies and Related Matters*, Insights (Dec. 19, 2022), https://www.foley.com/insights/publications/2022/12/sec-final-rules-10b5-1-trading-plans-insider/ ("Directors and officers may want to reconsider the benefits of 10b5-1 plans due to the new conditions on such plans and instead elect to execute trades during open trading windows."); Morgan, Lewis & Bockius LLP, *SEC Adopts Significant Changes To Rule 10b5-1 Affecting Trading By Insiders*, Our Thinking (Dec. 22, 2022), https://www.morganlewis.com/pubs/2022/12/sec-adopts-significant-changes-to-rule-10b5-1-affecting-trading-by-insiders ("The new cooling-off requirement has the effect

themselves seeking to defend by using a non-use argument, as in *Adler*, because they had no 10b5-1 Plan or their plan was flawed.[258] The law requires that they should be allowed to do so.

More fundamentally, there is no reason to turn a blind eye to the SEC's failure to respect the limitations on its rulemaking power established by *Hochfelder, Chevron, Brand X, Fox,* and *Kisor*. A recognition of the SEC's missteps here might prompt the Commission to think twice about pushing the envelope in pending rulemaking that some have already argued may be *ultra vires*.[259]

of requiring insiders to establish parameters for trades so far in advance of the trade date that they may have difficulty anticipating their financial needs or investing strategies, and thus be unwilling to enter into a plan in the first place.").

258. A vacatur of Rule 10b5-1 would not adversely impact anyone who traded in accordance with a *compliant* Rule 10b5-1 Plan. Those trades would have been made without *using* MNPI, so that awareness of MNPI when the trade was made should not result in liability. It seems unlikely the SEC would sue that person for insider trading.

259. *See, e.g.*, Donald Kochan, *The 2 Doctrines That May Pose a Threat to SEC Climate Rules*, LAW360 (June 27, 2023), https://www.law360.com/assetmanagement/articles/1691494?utm_source=shared-articles&utm_medium=email&utm_campaign=shared-articles (discussing possible application of the major questions doctrine to SEC disclosure rules regarding climate change). *See also* Grayscale Invs., LLC v. SEC, 82 F.4th 1239, 1242 (D.C. Cir. 2023), where the SEC was found to have acted arbitrarily, offering no explanation for treating like cases differently; U.S. Chamber of Commerce v. SEC, 85 F.4d 760 (5th Cir. 2023) (finding that SEC share repurchase disclosure modernization rule was arbitrary and capricious, affording SEC thirty days to correct the defects in the rule); U.S. Chamber of Commerce v. SEC, No. 23-62055, 2023 WL 8747399 (5th Cir. Dec. 19, 2023) (vacating SEC share repurchase disclosure modernization rule after the SEC admitted that it "was not able to 'correct the defects in the rule' within 30 days").