4-1-2003

Eighteenth Survey of White Collar Crime: Securities Fraud

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Published version. *American Criminal Law Review*, Vol. 40, No. 2 (Spring 2003): 1041-1107.

SECURITIES FRAUD

I. INTRODUCTION

The Securities Act of 1933 ("1933 Act"), the first of seven statutes enacted to regulate the federal securities transactions,[1] was a congressional response to fraud in securities markets and the perceived lack of public information about the stock markets.[2] The Securities and Exchange Commission (SEC) came into being with the enactment of the Securities Exchange Act of 1934 ("1934 Act"), one of the stated aims of which is to ensure vigorous market competition by mandating full and fair disclosure of all material information in the marketplace.[3] The 1933 Act regulates the primary market, whereas the 1934 Act regulates the secondary market.

Practitioners should note that this article is limited to federal securities law. Any

1. Securities Act of 1933 (Truth in Securities Act), 15 U.S.C. §§ 77a to 77aa (2002) (regulating distribution of securities); Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa to 77bbbb (2002) (regulating public offering of debt securities to protect capital markets, investors and general public); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a to 78mm (2002) (providing for regulation and control of transaction in securities to protect national public interest therein); Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa to 78lll (2002) (creating nonprofit membership corporation that covers loss when securities firm cannot pay its customer accounts); Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6 (2002) (correcting abuses in financing and operation of public utility holding companies); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64 (2002) (governing activity of publicly owned companies that invest and trade securities); Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 to 80b-21 (2002) (providing for regulation and registration of those in business of advising others on securities investments).

2. H.R. REP. NO. 73-85, at 1 (1933) (discussing purposes for enacting Securities Act of 1933 and Securities Exchange Act of 1934).

3. 15 U.S.C. § 78b (2002) (stating one purpose of securities law is "to insure the maintenance of fair and honest markets").

securities law issue must be analyzed in conjunction with applicable state "blue sky"[4] laws that regulate the offering and sale of securities in each state.[5]

II. ELEMENTS OF THE OFFENSE

Both the 1933 Act and the 1934 Act prohibit various types of criminal conduct.[6]

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4. The term "blue sky" refers to the practice of land salesmen who were so fraudulent that they would "sell building lots in the blue sky in fee simple." *See* Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 359 n.59 (1991) (quoting Thomas Mulvey, *Blue Sky Law*, 36 CAN. L. TIMES 37, 37 (1916)). After extensive etymological research, Macey & Miller concluded that this term originated in pioneer-era Kansas land swindles. *Id.*

5. *E.g.*, ALA. CODE §§ 8-6-1 to 8-6-33 (Alabama Securities Act) (2002); ALASKA STAT. §§ 45.55.010 to 45.55.995 (Alaska Securities Act) (Michie 2001); ARIZ. REV. STAT. ANN. §§ 44-1801 to 44-2055 (West 2002); ARK. CODE ANN. §§ 23-42-101 to 23-42-509 (Arkansas Securities Act) (Michie 2001); CAL. CORP. CODE §§ 25000 to 31516 (West 2002); COLO. REV. STAT. ANN. §§ 11-51-101 to 11-51-908 (Colorado Securities Act) (West 2002); CONN. GEN. STAT. ANN. §§ 36b-2 to 36b-33 (Connecticut Uniform Securities Act) (West 2002); DEL. CODE ANN. tit. 6, §§ 7301 to 7330 (Delaware Securities Act) (2001); D.C. CODE ANN. §§ 31-5601.01 to 31-5608.04, *amended by* Securities Amendment Act of 2002, D.C. Law 14-150 Act 14-328 (2002); FLA. STAT. ANN. §§ 517.011 to 517.32 (Florida Securities and Investor Protection Act) (West 2002); GA. CODE ANN. §§ 10-5-1 to 10-5-24 (Georgia Securities Act of 1973) (2002); HAW. REV. STAT. ANN. §§ 485-1 to 485-25 (Michie 2001); IDAHO CODE §§ 30-1401 to 30-1458 (Idaho Securities Act) (Michie 2002); 810 ILL. COMP. STAT. ANN. 5/1 to 5/19 (Illinois Securities Law of 1953) (West 2002); IND. CODE ANN. §§ 23-2-1-1 to 23-2-1-24 (West 2002); IOWA CODE ANN. §§ 502.101 to 502.701 (Iowa Uniform Securities Act) (West 2001); KAN. STAT. ANN. §§ 17-1252 to 17-1275 (2001); KY. REV. STAT. ANN. §§ 292.310 to 292.991 (Banks-Baldwin 2002); LA. REV. STAT. ANN. §§ 51:701 to 51:724 (West 2002); ME. REV. STAT. ANN. tit. 32, §§ 10101 to 10713 (Revised Maine Securities Act) (West 2001); MD. CODE ANN., CORPS. & ASS'NS §§ 11-101 to 11-805 (Maryland Securities Act) (2002); MASS. GEN. LAWS ANN. ch. 110A, §§ 101 to 417 (West 2002); MICH. COMP. LAWS ANN. §§ 451.501 to 451.818 (West 2002); MINN. STAT. ANN. §§ 80A.01 to 80A.31 (West 2002); MISS. CODE ANN. §§ 75-71-101 to 75-71-735 (Mississippi Securities Act) (2002); MO. ANN. STAT. §§ 409.101 to 409.418 (Missouri Uniform Securities Act) (West 2002); MONT. CODE ANN. §§ 30-10-101 to 30-10-326 (Securities Act of Montana) (2002); NEB. REV. STAT. §§ 8-1101 to 8-1123 (Securities Act of Nebraska) (2002); NEV. REV. STAT. 90.211 to 90.860 (2002); N.H. REV. STAT. ANN. §§ 421-B:1 to 421-B:34 (2002); N.J. STAT. ANN. §§ 49:3-47 to 49:3-76 (West 2002); N.M. STAT. ANN. §§ 58-13B-1 to 58-13B-57 (New Mexico Securities Act of 1986) (Michie 2002); N.Y. GEN. BUS. LAW §§ 352 to 359-h (McKinney 2002); N.C. GEN. STAT. §§ 78A-1 to 78A-65 (2002); N.D. CENT. CODE §§ 10-04-01 to 10-04-20 (Securities Act of 1951) (2001); OHIO REV. CODE ANN. §§ 1707.01 to 1707.99 (West 2002); OKLA. STAT. ANN. tit. 71, §§ 1 to 17, 101, 102, 201 to 204, 301 to 307, 401 to 413, 501, 701 to 703 (Oklahoma Securities Act) (West 2002); OR. REV. STAT. §§ 59.005 to 59.451, 59.991, 59.995 (Oregon Securities Law) (2001); PA. STAT. ANN. tit. 70, §§ 1-101 to 1-704 (Pennsylvania Securities Act of 1972), §1-704 *repealed by* 2002, July 4, P.L. 721, No. 108, §21, effective in 60 days (West 2002); R.I. GEN. LAWS §§ 7-11-101 to 7-11-806 (Rhode Island Uniform Securities Act (1990)) (2001); S.C. CODE ANN. §§ 35-1-10 to 35-1-1590 (Law. Co-op. 2002); S.D. CODIFIED LAWS §§ 47-31A-101 to 47-31A-420 (South Dakota Uniform Securities Act) (Michie 2002); TENN. CODE ANN. §§ 48-2-101 to 48-2-126 (Tennessee Securities Act of 1980) (2002); TEX. REV. CIV. STAT. ANN. tit. 19. art. 581-1 to 581-42 (Vernon 2001); UTAH CODE ANN. §§ 61-1-1 to 61-1-30 (2002); VT. STAT. ANN. tit. 9, §§ 4201 to 4241 (2002); VA. CODE ANN. §§ 13.1-501 to 13.1-527.3 (Michie 2002); WASH. REV. CODE ANN. §§ 21.20.005 to 21.20.940 (The Securities Act of Washington) (2002); W. VA. CODE §§ 32-1-101 to 32-4-418 (2002); WIS. STAT. ANN. §§ 551.01 to 551.67 (Wisconsin Uniform Securities Law) (West 2001); WYO. STAT. ANN. §§ 17-4-101 to 17-4-129 (Michie 2002); 10 P.R. LAWS ANN. § 851 to 898 (2000).

6. *See* 15 U.S.C. § 77e(a) (2002) (defining unlawful sale of unregistered securities); 15 U.S.C. §§ 78g(c), 78h, 78q(a) (2002) (defining unlawful conduct of broker-dealers); 15 U.S.C. § 78j(a) (2002) (defining unlawful short selling of securities); 15 U.S.C. § 78n(a) (2002) (defining unlawful proxy solicitation); 15 U.S.C. § 78n(e) (2002) (defining false statements and fraudulent practices in connection with tender offers); 15 U.S.C. § 78o (2002) (defining unlawful conduct of broker-dealer); 15 U.S.C. § 78p(a) (2002) (defining failure to file or filing false

Section 10(b) of the 1934 Act,[7] Rule 10b-5 promulgated thereunder,[8] and section 32(a) of the 1934 Act are the sections utilized in a criminal prosecution for the purchase or sale of securities.[9]

To state a valid claim for securities fraud under section 10(b) and Rule 10b-5, the plaintiff must allege that the defendant (i) made a misstatement or an omission of a material fact;[10] (ii) with scienter;[11] (iii) in connection with the purchase or the sale of a security;[12] (iv) upon which the plaintiff reasonably relied;[13] and (v) the plaintiff's reliance was the proximate cause of his or her jury.[14]

Securities fraud causes of action may be criminal, civil, or administrative in nature.[15] The SEC can initiate civil and administrative proceedings to investigate, rectify, and prevent violations.[16] However, only the Department of Justice ("DOJ")

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inside ownership reports by owner of ten percent or more of class of securities); 15 U.S.C. § 77q(b) (2002) (defining unlawful use of interstate commerce for purpose of offering securities for sale).

7. 15 U.S.C. § 78j(b) (2002).

8. 17 C.F.R. § 240.10b-5 (2002). Section 17(a), the general fraud provision of the 1933 Act, is also used occasionally in criminal prosecutions. 15 U.S.C. § 77q(a) (2002). Section 17(a) essentially follows the language of Rule 10b-5, creating similar obligations. *See* Sharp v. I.S. Inc., 685 F. Supp. 688, 690 (S.D. Ill. 1988) (noting alleged violation of § 17(a) of 1933 Act and Rule 10b-5 of 1934 Act presents one cause of action); *cf.* Singer v. Livoti, 741 F. Supp. 1040, 1044-45 (S.D.N.Y. 1990) (requiring scienter element under Rule 10b-5 while noting that § 17(a) contains scienter requirement under only one subsection). *But see* Finkel v. Stratton Corp., 962 F.2d 169, 175 (2d Cir. 1992) (holding private right of action under § 17(a) is not justified on grounds that Rule 10b-5 provides same cause of action).

9. 15. U.S.C. § 78ff(a) (2002).

10. 17 C.F.R. § 240.10b-5 (2002); *see In re* NAHC, Inc. Sec. Litig., 306 F.3d 1314, 1328 (stating that in order to state a valid securities fraud claim under Rule 10b-5, plaintiff is required to first establish that defendant made a materially false or misleading statement or omitted to state a material fact necessary to make a statement not misleading in connection with the purchase or sale of a security); *see also* Graham v. SEC, 222 F.3d 994, 1000 (D.C. Cir. 2000) (explaining substantive fraud is an element of Rule 10b-5 action).

11. *See* Wharf (Holdings) Ltd. v. United Intern Holdings, Inc., 532 U.S. 588, 592 (2001) (requiring scienter to succeed in Rule 10b-5 suit); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976); *In re* Phillips Petroleum Sec. Litig., 881 F.2d 1236, 1244 (3d Cir. 1989).

12. 17 C.F.R. § 240.10b-5 (2002); *see* United States v. O'Hagan, 521 U.S. 642, 658 (1997) (holding deceit "in connection with" purchase of sale of securities is necessary element of Rule 10b-5 action).

13. 17 C.F.R. § 240.10b-5; *see* Ganono v. Citizens Util. Co., 228 F.3d 154, 161 (2d Cir. 2000) (requiring plaintiff to plead that his reliance on defendant's action caused plaintiff's injury); Florida State Bd. of Admin. v. Green Tree Financial Corp., 270 F.3d 645, 654 (8th Cir. 2001) (stating that Rule 10b-5 is governed by special pleading rules, one of which is to state with particularity fact giving rise to strong inference that defendant acted with scienter required for cause of action); Harsco Corp. v. Segui, 91 F.3d 337, 342 (2d Cir. 1996) (stating reliance is necessary element of Rule 10b-5 action).

14. *See* Tse v. Ventana Medical Systems, Inc., 297 F.3d 210, 218 (3d Cir. 2002) (affirming summary judgment on Rule 10b-5 claim because plaintiffs did not allege actual loss and thus have failed to adduce evidence establishing genuine issues of material fact on causation); Pinker v. Roche Holding Ltd., 292 F.3d 361, 373 (3d Cir. 2002) (citing Securities Act of 1934, section10(b); 15 U.S.C.A. § 78j(b); 17 C.F.R. §240.10b-5); *see also* ABC Arbitrage Plaintiffs Group v. Tchuruk, 291 F.3d 336, 348 (5th Cir. 2002); Caiola v. Citibank, N.A., 295 F.3d 312, 321 (2d Cir. 2002); DSAM Global Value Fund v. Altris Software, Inc., 288 F.3d 385, 388 (9th Cir. 2002); *In re* IKON Office Solutions, Inc. Secs. Litig., 288 F.3d 658, 666 (3d Cir. 2002); Helwig v. Vencor, Inc., 251 F.3d 540, 554 (6th Cir. 2001); Ziemba v. Cascade Intern, Inc., 256 F.3d 1194, 1202 (11th Cir. 2001).

15. 17 C.F.R. § 202.5(b) (2002). *See generally infra* Section IV of this Article (discussing enforcement mechanisms utilized in securities fraud actions).

16. 17 C.F.R. § 202.5(a) (2002).

has jurisdiction over criminal prosecutions.[17] Most criminal prosecutions result from an SEC investigation and subsequent referral to the DOJ.[18]

A. *Substantive Fraud*

The following subparts address two types of fraud that can be bases for securities violations: (i) Rule 10b-5 material misrepresentations and omissions and (ii) insider trading.[19]

1. *Material Misrepresentations and Omissions*

Material misrepresentations and omissions give rise to the most common securities fraud actions. Rule 10b-5 proscribes any false statements made in connection with the purchase or sale of securities.[20] Any person "who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies" may be criminally or civilly[21] liable under Rule 10b-5.[22] Once the elements of the Rule 10b-5 cause of action are met, a criminal penalty can be imposed under section 32(a) if the government satisfacto-

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17. 17 C.F.R. § 202.5(f) (2002).

18. *See infra* Section IV.B.1 of this Article (discussing criminal referrals in securities fraud cases).

19. In the past, this article has included a separate discussion of broker-dealer fraud. As professionals in the securities market, broker-dealers' exposure to fraud actions is necessarily greater than that of other participants in the market. *See* 5B ARNOLD S. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 § 210.01 (2d ed. 1988) (noting broker may violate Rule 10b-5 when others engaging in same conduct would not). In this issue, the prosecution of broker-dealers is considered in the various sections of this article on misrepresentations and omissions. *See infra* Section II.A.1 of this Article (material misrepresentations) and Section II.A.2 of this Article (insider trading).

The "churning" section of this Article was deleted in 1999. "Churning" is the excessive buying and selling of securities, without regard to the customer's investment objectives, solely to generate commissions. *See* Olson v. E.F. Hutton & Co., 957 F.2d 622, 628 (8th Cir. 1992) (discussing churning); *see also* Rizek v. SEC, 215 F.3d 157, 164 (1st Cir. 2000) (affirming permanent bar and civil penalty for president of investment company convicted of churning). While broker-dealers in theory can be criminally prosecuted under section10b and Rule 10b-5 for what is normally a civil offense, few or no criminal actions for churning have been prosecuted. Despite the viability of such an action in theory, DOJ has not indicated that it will pursue churning as a crime. Therefore, the body of law on churning is and will continue to remain focused upon churning as a civil violation. *See Olson*, 957 F.2d at 628.

The "parking" section of this Article was deleted in 2000. "Parking" refers to the practice of selling securities with the understanding that the seller will buy them back at a later date for the same or similar price. This is done to circumvent securities regulations that mandate the reporting of considerable securities activity to the SEC. Parking, like churning, is rarely prosecuted and has thus been removed from this issue.

20. 17 C.F.R. § 240.10b-5 (2001). In addition, the federal jurisdictional requirement that the purchase or sale be made using interstate commerce must be met. 15 U.S.C. § 78j(b) (1996).

21. 15 U.S.C. § 78ff(a)-(b) (2002) (stating civil and criminal liability).

22. *See also* SEC v. U.S. Envtl., Inc., 155 F.3d 107, 108 (2d Cir. 1998) (holding broker liable for manipulation even though he did not share promoter's specific overall purpose to manipulate market for that stock). *But cf.* Cent. Bank v. First Interstate Bank, 511 U.S. 164, 191 (1994) (holding Rule 10b-5 creates liability for making material misstatements and omissions, but does not include giving aid to person who commits deceptive acts).

rily proves a willful violation of the 1934 Act.[23]

Under Rule 10b-5, the elements of a civil cause of action and a criminal prosecution are similar. Both require a false statement or an omission of a material fact; however, scienter is required for criminal liability to attach.[24] For civil liability, the plaintiff need only prove reliance that is causally related to the plaintiff's injury.[25]

a. Misstatements and Omissions

In recent years the SEC and DOJ have vigorously prosecuted individuals who misrepresent or omit material information in securities filings.[26] In the landmark decision *Securities Exchange Comm'n v. Texas Gulf Sulphur Co.*,[27] the Second Circuit defined a misrepresentation or omission as an act that conveys a false impression of the facts or is misleading.[28] The court explained that this determination is made by inquiring "into the meaning of the statement to the reasonable investor and its relationship to the truth."[29]

Prosecutions by the SEC and DOJ for misstatements or omissions are not limited to filings. Any form of publicized misstatement or omission can create liability.[30] Courts have read Rule 10b-5 as prohibiting any deceit that materially affects the purchase or sale of securities—the deception need not necessarily

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23. *See* United States v. Larrabee, 240 F.3d 18 (1st Cir. 2001) (upholding conviction of a person for willful violation of securities laws when he misappropriated information from his employer).

24. *See* Theoharous v. Fong, 256 F.3d 1219, 1224 (11th Cir. 2001) (holding scienter is a necessary element of Rule 10b-5).

25. *See Graham*, 222 F.3d at 1000 (listing elements of Rule 10b-5 cause of action); *see also* Malone v. Microdyne Corp., 26 F.3d 471, 476 (4th Cir. 1994) (same); Rubinstein v. Collins, 20 F.3d 160, 166 n.6 (5th Cir. 1994) (same); Rosen v. Cascade Int'l Inc., 21 F.3d 1520, 1524 (11th Cir. 1994) (same).

26. *See* SEC v. Fehn, 97 F.3d 1276, 1280 (9th Cir. 1996) (ruling company and attorney violated securities laws by failing to correctly describe promoter's role and to disclose contingent liability stemming from earlier securities law violations in SEC disclosure documents); *In re* Ashanti Goldfields Sec. Litig., 184 F. Supp. 2d 247 (2002) (holding that shareholders sufficiently stated securities fraud claims based on allegations that company's disclosures failed to reveal extent of risk taken by company and impact of significant rise in price of gold).

27. 401 F.2d 833 (2d Cir. 1968) (en banc).

28. *Id.* at 862.

29. *Id.*

30. *See, e.g., In re* Carter-Wallace Sec. Litig., 150 F.3d 153, 156-57 (2d. Cir. 1998) (holding company may be liable for false advertisements in technical journal); SEC v. Eurobond Exch. Ltd., 13 F.3d 1334, 1341 (9th Cir. 1994) (upholding conviction of a defendant who tried to sell non-existent foreign bonds and failed to disclose his previous conviction and fugitive status); United States v. Gibbons, 968 F.2d 639, 641 (8th Cir. 1992) (holding impersonation of broker and false statements sufficient evidence for conviction); SEC v. Softpoint, Inc., 958 F. Supp. 846, 851 (S.D.N.Y. 1997) (granting summary judgment against defendant on omission theory, holding company and its officers participated in sale of unregistered common stock, deceived public investors as to true financial status of corporation, and falsified accounting records). Courts have also addressed other misstatements and omissions. *See* Ambassador Hotel Co. v. Wei-Chuan Inv., 189 F.3d 1017, 1026 (9th Cir. 1999) (holding misstatements contained false information regarding construction loan and cost of building hotel, even though venture was not called "security" by participants). *But see* Oran v. Stafford, 226 F.3d 275, 278 (3d Cir. 2000) (holding defendant not liable for omission of drug research results).

concern the value of the stock.[31]

b. Materiality

Securities fraud occurs only when omitted or misstated information is material.[32] In *TSC Industries, Inc. v. Northway, Inc.*,[33] the Supreme Court explained that determining materiality "requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of these inferences to him."[34] The Court thus required a showing of substantial likelihood that, in light of all the circumstances, the omitted fact would have had actual significance in the deliberations of the reasonable shareholder.[35] In other words, a substantial likelihood must exist that a reasonable investor would have viewed the disclosure of the omitted fact as having significantly altered the "total mix" of information available.[36] However, not all omissions or misrepresentations in connection with the purchase or sale of a security are fraudulent.[37]

There is a growing body of case law that treats general expressions of optimism

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31. *See O'Hagan*, 521 U.S. at 658 (holding for liability to attach, the deceit need only be "in connection with" the purchase or sale of securities, not with a particular purchaser or seller); *see also* Semerenko v. Cendant Corp., 223 F.3d 165, 169 (3d Cir. 2000) (holding class of investors may establish "in connection with" element simply by showing misrepresentations in proposed merger were disseminated to public in medium upon which reasonable investor would rely); Press v. Chem. Inv. Serv. Corp., 166 F.3d 529, 537 (2d Cir. 1999) (holding treasury-bill proceeds met "in connection with" element); SEC v. Jakubowski, 150 F.3d 675, 679 (7th Cir. 1998) (holding defendant's misrepresentations to issuer as to the identity of the purchaser were "in connection with" the purchase or sale of securities).

32. *See* TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976).

33. *Id.* at 441. Plaintiffs brought the *TSC Industries* action, a civil suit, under section 14(a) of the 1934 Act, 15 U.S.C. § 78n(a) (2002), claiming that certain statements made in TSC Industries' proxy statement were false and misleading. The same materiality standard developed in this case applies to Rule 10b-5 actions. *See* Basic Inc. v. Levinson, 485 U.S. 224, 232 (1988) (adopting section 14(a) standard of materiality for cases brought under Rule 10b-5).

34. 426 U.S. at 450; *see also Press*, 166 F.3d at 538 (holding plaintiff could not show that one-day delay in availability of funds would have been material in decision to purchase treasury-bill); Feinman v. Dean Witter Reynolds, Inc., 84 F.3d 539, 541 (2d Cir. 1996) (holding that customers failed to show misrepresentations of transaction fees were material to their securities transactions).

35. *See* United States v. Cannistraro, 800 F. Supp. 30, 82 (D.N.J. 1992) (holding omitted fact is material if there is substantial likelihood that investor would consider it important in making investment decision (citing *Basic*, 485 U.S. at 231)).

36. *TSC Indus.*, 426 U.S. at 449 (stating information is material if reasonable shareholder would consider it important in deciding how to vote, but proof that shareholder would change vote not required).

37. *See, e.g., In re* Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1427-28 (3d Cir. 1997) (stating prospective statements may be actionable if they lack reasonable basis, but holding "general, non-specific statement of optimism or hope" regarding projected net earnings and per share earnings released by defendants was too vague to support cause of action). *But see Semerenko*, 223 F.3d at 176-77 (holding announcement that company expected to restate its past earnings was material, despite included warnings on danger of relying on specific numbers identified); United States v. Smith, 155 F.3d 1051, 1065 (9th Cir. 1998) (holding "soft," forward-looking information may be material within Rule 10b-5).

by a company as immaterial per se.[38] Courts have distinguished between (i) generally optimistic statements and (ii) numerically specific predictions.[39] The former is considered no more than "puffery," and thus immaterial as a matter of law,[40] while the latter is considered an actionable claim.[41] Thus, the specificity with which a company predicts its financial performance can determine the issue of materiality.[42]

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38. *See generally* Jennifer O'Hare, *The Resurrection of the Dodo: The Unfortunate Re-emergence of the Puffery Defense in Private Securities Fraud Actions*, 59 OHIO ST. L.J. 1697, 1707-15 (1998) (discussing situations in which courts have disallowed causes of action based on general statements made by a company and collecting cases); *see also*, *In re* Advanta Corp. Sec. Litig., 180 F.3d 525, 538-39 (3d Cir. 1999) (holding expressions of confidence in company's prospects for future growth too vague to give rise to claim of action).

39. *See* O'Hare, *supra* note 38, at 1711.

40. *In re Advanta Corp. Sec. Litig.*, 180 F.3d at 539 (holding vague and general statements of optimism constitute no more than "puffery" and are understood by reasonable investors as such); *see also* Longman v. Food Lion, Inc., 197 F.3d 675, 683-84 (4th Cir. 1999) (holding corporation's public statements that it provided employees with job security, good work conditions, and "some of the best benefits in the supermarket industry" and statements expressing belief that it was one of best-managed high-growth operations in food retail industry were immaterial as puffery); Parnes v. Gateway 2000, Inc., 122 F.3d 539, 547 (8th Cir. 1997) (holding company's statement that it expected "significant growth" was mere puffery, and hence immaterial as a matter of law).

41. Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1090-93 (1991) (holding that opinion by board members to minority stockholders that stock price of forty-two dollars was "high value" and represented "fair" transaction could be both factual and material if plaintiff proved directors did not believe what they said); Suna v. Bailey Corp., 107 F.3d 64, 70 (1st Cir. 1997) (explaining numerical specificity is highly probative in materiality determination); Weiner v. Quaker Oats Co., 129 F.3d 310, 320 (3d Cir. 1997) (holding 7% prediction sufficiently specific to constitute an actionable claim).

42. In *Basic*, the Supreme Court articulated the standard for materiality with respect to contingent or speculative information. After adopting the *TSC Industries* standard of materiality for cases arising under Rule 10b-5, the Court noted the application of the *TSC Industries* standard to determine if *speculative information* is material. 485 U.S.at 232 ("We now expressly adopt the *TSC Industries* standard of materiality for the section 10(b) and Rule 10b-5 context.") (emphasis added). The court held that one should balance the probability that the event will occur with the "anticipated magnitude of the event in light of the totality of the company activity." *Basic*, 485 U.S. at 238 (quoting SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc)). *Texas Gulf Sulphur* also incorporated into its definition the idea that information that "might" affect reasonable investors' decisions to buy or sell stock is material. "The basic test of materiality . . . is whether a reasonable man would attach importance . . . in determining his choice of action in the transaction in question." *Tex. Gulf Sulphur*, 401 F.2d at 849 (quoting RESTATEMENT (FIRST) OF TORTS § 538(2)(a) (1938)). "This, of course, encompasses any fact . . . which in reasonable and objective contemplation might affect the value of a corporation's stock or securities." *Id.* at 849 (quoting List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965)). Former Basic shareholders had sold their stock based upon Basic's public statements that it was not engaged in merger negotiations, and they alleged that the corporation had issued materially false or misleading statements when they released "no corporate developments" statements.

Basic, 485 U.S. at 224, 229. The November 1978 report of Basic, Inc. to shareholders stated: "With regard to the stock market activity in the Company's shares we remain unaware of any present or pending developments which would account for the high volume of trading and price fluctuations in recent months." *Id.* at 227-28. When the denied merger discussions ultimately succeeded, the former shareholders brought a class action suit. *Id.* at 228. In applying its standard for contingent or speculative information, the Court held that the materiality of the particular merger discussions was a question of fact to be assessed in light of "indicia of interest in the transaction at the highest corporate levels." *Id.* at 239. In deciding what factors might serve as indicia of interest, the Court listed: "board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries." *Id.* However, the Court went on to say that, "[n]o particular event or factor short of closing the transaction need be either necessary or sufficient by itself to render merger discussions material." *Id.*

c. *Intent*

After establishing the existence of a material omission or misrepresentation, a plaintiff must prove requisite intent in order to establish a violation of section 10(b) and Rule 10b-5.[43] Civil plaintiffs must meet a scienter requirement, discussed in subsection (i), while criminal cases, discussed in subsection (ii), are judged by a standard of willfulness.

i. *Scienter*

In civil causes of action, scienter must be proved to establish intent.[44] Scienter is defined as an intent to deceive, manipulate, or defraud on the defendant's part. A private cause of action for damages under section 10(b) and Rule 10b-5 cannot stand without an allegation of scienter.[45] The Seventh Circuit has permitted a defendant's reckless action to meet the scienter requirement, and most circuits have followed suit; however, courts have narrowly limited the definition of recklessness to a lesser form of intent that does not encompass ordinary negligence.[46]

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43. *Ernst & Ernst*, 425 U.S. at 193 (holding scienter is required to prove private civil action 10b-5 violation).

44. *See* Maldonado v. Dominguez, 137 F.3d 1, 9 (1st Cir. 1998) (defining scienter as "a mental state embracing intent to deceive, manipulate or defraud" (quoting *Ernst & Ernst*, 425 U.S. at 193 n.12)); Lovelace v. Software Spectrum, Inc., 78 F.3d 1015, 1018 (5th Cir. 1996) ("In order to adequately plead scienter, a plaintiff must set forth specific facts to support inference of fraud." (citing Tuchman v. DSC Communications Corp., 14 F.3d 1061, 1068 (5th Cir. 1994)); *cf. In re* Silicon Graphics Inc. Sec. Litig., 183 F.3d 970, 1001 (9th Cir. 1999) (holding strong inference of fraud when vice-presidents sold 95% and 99.8% of their shares, vested options excluded); Stevelman v. Alias Research Inc., 174 F.3d 79, 84-86 (2d Cir. 1999) (holding strong inference of fraud where CEO sold 40% of his shares and two vice-presidents sold "thousands" of shares).

45. *Ernst & Ernst*, 425 U.S. at 193; *see also* AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 221 (2d Cir. 2000) (holding accounting company "intentionally engaged" in "manipulative conduct" when they initially protested and then agreed to client company's accounting abuse knowing others would rely on manipulated financial reports); *U.S. Envtl., Inc.*, 155 F.3d at 111 (holding sufficient evidence for scienter when defendant "intentionally engaged" in "manipulative conduct").

46. *See* Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977) (holding actionable reckless omission of material facts on which parties justifiably rely to be actionable); *see also* Alpern v. Utilicorp United, Inc., 84 F.3d 1525, 1534 (8th Cir. 1996) (agreeing with majority rule that recklessness can also satisfy scienter requirement); Provenz v. Miller, 102 F.3d 1478, 1490 (9th Cir. 1996) (allowing scienter to be proved through defendant's reckless actions that showed extreme departure from standard of ordinary care); SEC v. Steadman, 967 F.2d 636, 641-42 (D.C. Cir. 1992) (adopting the *Sundstrand* definition of recklessness); *cf. In re* Time Warner, Inc. Sec. Litig., 9 F.3d 259, 268-69 (2d Cir. 1993) (recognizing recklessness, but requiring "strong inference" of scienter as either (i) facts establishing a motive and opportunity to commit fraud or (ii) facts constituting circumstantial evidence of either reckless or conscious behavior). *But see Alpern*, 84 F.3d at 1534 (accepting *Sundstrand* limited definition of recklessness); *Provenz*, 102 F.3d at 1490 (defining reckless conduct as an extreme departure from ordinary standards of care and not merely simple, or even inexcusable negligence); Bd. of County Comm'rs of San Juan County v. Liberty Group, 965 F.2d 879, 883 (10th Cir. 1992) (recognizing reckless behavior is an extreme departure from ordinary care that is much more than mere negligence); *Steadman*, 967 F.2d at 641-42 (describing recklessness as not merely a heightened form of ordinary care, but rather an extreme departure from ordinary care); *In re Phillips Petroleum Sec. Litig.*, 881 F.2d at 1244 (recognizing that reckless behavior can satisfy scienter requirement, but defining it as an extreme departure from ordinary care); McDonald v. Alan Bush Brokerage Co., 863 F.2d 809, 814-15 (11th Cir. 1989) ("Severe recklessness is limited to

ii. Willfulness

Whereas the SEC uses section 10(b) and Rule 10b-5 in civil and administrative cases, DOJ utilizes section 32(a) of the 1934 Act in criminal proceedings. Section 32(a) provides criminal penalties for willful violations of the Act or its rules[47] and therefore, a willful violation of "section 10(b) of the Act and the Commission's Rule 10b-5 thereunder . . . admittedly qualify" under section 32(a).[48]

A defendant acts willfully when he acts intentionally and deliberately and his actions are not the result of an innocent mistake, negligence, or inadvertence.[49] While proof of specific intent is not needed, the government must establish that the defendant had some evil purpose[50] and intended to commit the prohibited act.[51]

Section 32(a) confirms that an individual who lacks awareness of the existence of an applicable section or rule may still be convicted of willfully violating the 1934 Act.[52] Penalties for such a conviction, however, do not necessarily entail imprisonment.[53]

While civil actions require scienter and criminal actions require willfulness, it is unclear whether there is a meaningful distinction between the terms. In other words, it is debatable whether willfulness in criminal cases requires something above the ordinary scienter required in civil cases. At least one commentator has argued that "courts have interpreted the term 'willfully,' as used in [section] 32, to mean that only ordinary scienter is necessary to support a criminal conviction."[54] This may be because "[section] 32 was drafted before [section] 10(b) was

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those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it." (quoting Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961-62 (5th Cir. 1981) (en banc)); *Sundstrand*, 553 F.3d at 1045 (holding reckless standard for scienter not met by mere simple or even inexcusable negligence).

47. 15 U.S.C. § 78ff(a) (2002).

48. United States v. Peltz, 433 F.2d 48, 53 (2d Cir. 1970) (holding false statement concerning stock ownership criminally punishable even if fraud not related to investment value of security).

49. *See Ernst & Ernst*, 425 U.S. at 215 (holding defendant not liable under section 10(b) and Rule 10b-5 because negligence not sufficient to prove intent requirement); *see also* Messer v. E.F. Hutton, 847 F.2d 673, 678-79 (11th Cir. 1988) (holding plaintiff did not prove willful intent on basis of defendant's arguably mistaken business judgment); *cf.* United States v. Gross, 961 F.2d 1097, 1102 (3d Cir. 1992) (upholding the conviction of a former company CEO who willfully falsified company records to inflate prices of its securities).

50. *See Gross*, 961 F.2d at 1102 (noting defendant inflicted enormous harm on many people purposely).

51. *See* United Statses v. Schlei, 122 F.3d 944, 967 (11th Cir. 1997) (finding intent where the defendant falsified financial records to sell forged Japanese government bond to investors).

52. *See* United States v. Dixon, 536 F.2d 1388, 1397 (2d Cir. 1976) (stating that proof of a specific intent to violate the law is not necessary to uphold a conviction under section 32(a)).

53. *See* 15 U.S.C. § 78ff(a) (2002); *Dixon*, 536 F.2d at 1397. The provision in section 32(a) only applies to knowledge of *rules* or *regulations*, and does not apply to knowledge of the original sections, such as section 10(b), under the 1934 Act.

54. Carole B. Silver, *Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984*, 1985 DUKE L.J. 960, 1021 (1985) (concluding that partly because section 32 was drafted before section 10(b) was interpreted to require scienter, the "courts have not considered the possible anomaly that the same degree of culpability applies in both criminal actions under [section] 32 and civil actions").

interpreted to require a showing of scienter."[55] Until a court interpreting section 32(a) addresses the meaning of "willfully" in that provision, this question remains unresolved.

d. Reliance

Although reliance is an essential element of a civil cause of action under Rule 10b-5,[56] the government need not demonstrate specific reliance by the investor in a securities fraud prosecution.[57] Instead, the government must show "impact of the scheme on the investor."[58]

The Supreme Court has adopted the "fraud on the market" theory of reliance for material public misrepresentations.[59] In *Basic*, the Court held that "[b]ecause most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action."[60] Five elements must be met for a presumption of reliance to be shown:

> (i) the defendant made public misrepresentations, (ii) the misrepresentations were material, (iii) the shares were traded on an efficient market, (iv) the misrepresentations would induce a reasonable relying investor to misjudge the value of the shares, and (v) the plaintiff traded the shares between the time of the misrepresentations and the time the truth was revealed.[61]

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55. *Id.* at 1021 (citing to the Hearing of the Comm. on Interstate and Foreign Commerce of the House of Representatives on H.R. 7852, 73rd Cong., 2d Sess. 113 (1934), reprinted in 8 I. ELLENBERGER & E. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE OF 1934, at 113 (1973)).

56. *See e.g.*, United States v. Naftalin, 441 U.S. 768 (1979); Twiss v. Kury, 25 F.3d 1551, 1558 (11th Cir. 1994).

57. United States v. Ashdown, 509 F.2d 793, 799 (5th Cir. 1975) (ruling that investor need not show specific reliance under statute prohibiting fraudulent sale of securities by mail; instead, he or she must show that defendant's actions had impact on investor). Although the *Ashdown* court was interpreting section 17(a) of the 1933 Act, the language of section 17(a) regarding fraudulent conduct is almost identical to the language of section 10(b) and Rule 10b-5.

58. United States v. Schaefer, 299 F.2d 625, 629 (7th Cir. 1962) (holding no crime occurred when alleged misrepresentations were not made to the named investors and no connection was established between the alleged victims and the scheme).

59. *Basic*, 485 U.S. at 241-49 (affirming lower courts' application of rebuttable presumption of reliance partially supported by fraud-on-the-market theory because the presumption is consistent with, and supports, the congressional policy of the 1934 Securities Exchange Act). The *Basic* Court adopted the Third Circuit's "fraud on the market" theory, which hypothesized that misleading statements will defraud stock purchasers even if they do not directly rely on the misstatements because, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. *Id.* at 241-42 (citing Peil v. Speiser, 806 F.2d 1154, 1160-61 (3d Cir. 1986)).

60. *Id.* at 247; *see also infra* Section III.B.1. of this Article (discussing "truth on the market" defense).

61. *Id.* at 248 n.27 (citing lower court test and holding that after decision, second and fourth criteria can be collapsed into one). A recklessness standard is used to determine whether the plaintiff justifiably relied on a misrepresentation or omission. *See* Molecular Tech. Corp. v. Valentine, 925 F.2d 910, 918 (6th Cir. 1991) (concluding that reasonable juror could find that plaintiffs were not reckless in relying on misrepresentations and omissions of defendant because plaintiffs did not have special knowledge of the transactions, access to any revealing information about the fraud, a fiduciary or personal relationship with defendants, or a superior

In addition to the "fraud on the market" doctrine, the Fifth Circuit articulated the "fraud created the market" doctrine.[62] In *Shores v. Sklar*, the court permitted a plaintiff to maintain an action under section 10(b) by proving that the defendant's fraud allowed securities that otherwise would have been unmarketable to come into and exist in the market.[63] The Sixth Circuit has articulated two methods of proving unmarketability: economic and legal.[64] Economic unmarketability occurs when a security is patently worthless.[65] Legal unmarketability occurs when a regulatory or municipal agency would have been required by law to forbid or prevent the issuance of a security.[66] The key to the "fraud created the market" doctrine is that the securities are unmarketable; to prove that, plaintiffs must point to either economic or legal reasons.[67]

e. Entanglement Liability

Corporations may also be liable for misstatements or omissions in the written reports of investment analysts if the company was "sufficiently entangled" in the production of the reports.[68] The Second Circuit altered traditional Rule 10b-5 liability and developed the "entanglement liability" doctrine in *Elkind v. Liggett & Myers, Inc.*,[69] where the executives from Liggett & Myers, Inc. were not held

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negotiating position). One case has held that an investor in a new issue of securities cannot rely on the integrity of the market to determine a price for the new securities; therefore, in a new issue case, a purchaser must show reliance by demonstrating that "the bonds were not entitled to be marketed at any price." Dalton v. Alston & Bird, 741 F. Supp. 1322, 1327 (S.D. Ill. 1990).

62. Shores v. Sklar, 647 F.2d 462, 469 (5th Cir. 1981).

63. *Id.* (holding plaintiff is entitled to presumption of reliance if he could establish that defendants knowingly conspired to bring bonds on the market that were not entitled to be marketed). *See also,* Joseph v. Wiles, 223 F.3d 1155, 1163 (10th Cir. 2000) (holding that presumption of reliance requires proof that securities never would have been issued absent massive fraud).

64. Ockerman v. May Zima & Co., 27 F.3d 1151, 1160 (6th Cir. 1994) (articulating economic and legal unmarketability); *see also Joseph*, 223 F.3d at 1164 (discussing economic and legal unmarketability).

65. *Ockerman*, 27 F.3d at 1160 (explaining economic unmarketability); *see Shores*, 647 F.2d at 470 (holding that plaintiff cannot recover if he "proves no more than that bonds would have been offered at a lower price or a higher rate, rather than that they would never have been issued or marketed").

66. *Ockerman*, 27 F.3d at 1160 (explaining legal unmarketability); *see T.J. Raney & Sons*, 717 F.2d at 1333 (holding plaintiff reasonably relied on availability of bonds as indicative of their lawful issuance when defendant issued bonds without being a public trust in violation of state law).

67. *See* Ross v. Bank South, 885 F.2d 723, 729 (11th Cir. 1989) (holding "fraud must be so pervasive that it goes to the very existence of the bonds and the validity of their presence on the market to prove fraud-created-the-market"); *cf. Joseph*, 223 F.3d at 1164 (holding plaintiff did not prove "fraud created the market" doctrine because debentures did not lack all economic value nor were debentures issued without legal authority).

68. Elkind v. Liggett & Meyers, Inc., 635 F.2d 156, 163 (2d Cir. 1980) (holding corporation can be liable for misstatements when "sufficiently" entangled to render predictions "attributable to it"). Traditionally, liability only attached for statements or misinformation by the parties themselves. *See* Elec. Specialty Co. v. Int'l Controls Corp., 409 F.2d 937, 949 (2d Cir. 1969) (holding corporation has no liability to correct misstatements in documents produced by another party for corporation).

69. 635 F.2d at 163 (upholding district court's finding that company did not expressly or impliedly place its imprimatur on the analysts' projections because the company assumed no duty to warn analysts that their views were different than the company's views).

liable for failing to correct or comment on the overly optimistic earnings forecasts pursuant to a policy of not commenting on analyst report forecasts.[70] However, the court also held that a company might be liable for the misstatements or omissions of an analyst report if the company has "sufficiently entangled itself with the analyst's forecasts to render those predictions attributable to it."[71]

Following *Elkind*, courts have differed on what level of action is necessary to be "sufficiently" entangled.[72] Generally, courts have held that merely providing the misleading information upon which the allegedly false forecast in the analyst report is based does not satisfy the entanglement requirement.[73] Instead, courts have sought to determine whether the degree of interaction between the analysts and the corporate officers resulted in the corporate officers putting their "imprimatur, express or implied, on the projections."[74] Thus, many courts have required a "two way" flow of information for the corporate officers to be held liable for the false report.[75] To prove the existence of a "two way" flow of information, the Ninth Circuit has required that (i) a corporate insider provided misleading information to an analyst, (ii) the analyst relied on the information, and (iii) the insider endorsed or approved the report prior to or after its publication.[76]

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70. The Liggett executives reviewed a number of analyst reports prior to their publication. Following the company's long-standing policy, the executives corrected factual apparent mistakes in analysis reports, but did not correct or comment on the overly optimistic earnings forecasts. When the stock price fell, a group of shareholders filed suit, claiming that Liggett should be held liable because Liggett reviewed and approved the analyst report and the shareholders relied upon the misinformation in making their investments. *Id.*

71. *Id.* at 163.

72. *See* Eisenstadt v. Allen, 113 F.3d 1240, at *14 (Table) (9th Cir. 1997) (stating that entanglement requires two-way flow of information between corporate insider and analyst preparing challenged forecast); *In re* Syntex Corp., 95 F.3d 922, 934 (9th Cir. 1996) (finding statements made by analysts were "culmination of a one-way flow of information" because defendants never adopted or endorsed analysts' statements); Stack v. Lobo, 903 F. Supp. 1361, 1371 (N.D. Cal. 1995) (discussing factors necessary to prove entanglement). *But see In re* Cirrus Logic Sec. Litig., 946 F. Supp. 1446, 1467 (N.D. Cal. 1996) (explaining that two-way flow of information should not be necessary when the company deliberately or recklessly provides misinformation to analyst).

73. While merely providing the information itself will not satisfy the entanglement theory, courts may find the company liable if it provided false and misleading statements to the securities analysts with the intent that the analysts communicate those statements to the market. *See* Cooper v. Pickett, 137 F.3d 616, 624 (9th Cir. 1997) (holding that if defendant intentionally misled securities analyst and the press, third-party reports would be relevant to determining defendant's fraud liability). This theory of liability is referred to as the "conduit theory" of liability. *Id.*

74. *In re Syntex Corp.*, 95 F.3d at 934 (concluding that defendant must have knowledge that statement he made to analyst was false).

75. *See Eisenstadt*, 113 F.3d 1240, at *15 (Table). For other cases rejecting entanglement claim for failure to show two-way flow of information, see Powers v. Eichen, 977 F. Supp. 1031, 1042 (S.D. Cal. 1997); *In re Syntex Corp.*, 95 F.3d at 934. *See also* Schaffer v. Timberland, 924 F. Supp. 1298, 1312 (D.N.H. 1996) (holding that plaintiffs, in meeting the two-way flow standard, pled with sufficient particularity that the defendants were liable for the fraudulent analysts' statements).

76. *Eisenstadt*, 113 F.3d 1240, at *14 (Table); *see also* Novak v. Kasaks, 216 F.3d 300, 314 (2d Cir. 2000) (holding defendants liable when they originally made misstatements incorporated in analyst reports and subsequently adopted contents of analyst reports implicitly).

2. *Insider Trading*

Insider trading regulation[77] protects the integrity of the securities market[78] by prohibiting material, non-public information from being used to purchase or sell any security in breach of a fiduciary duty.[79] The Supreme Court in *United States v. O'Hagan*[80] stated that this fiduciary duty could refer to the relationship between corporate "insiders" and the corporation's shareholders – the classical theory[81] – or the relationship between corporate "outsiders" and the source of the material, non-public information – the misappropriation theory.[82] The classical and misap-

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77. Insider trading activity is regulated in the antifraud provision of section 10(b), which makes it unlawful for any person:

> [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulation as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (2000). Currently, section 10(b) and Rule 10b-5 are the Government's primary means of regulating insider trading. *See* Micah A. Acoba, *Insider Trading Jurisprudence After* United States v. O'Hagan: *A Restatement (Second) of Torts § 551(2) Perspective*, 84 CORNELL L. REV. 1356, 1363 (1999) (discussing section 10(b) and Rule 10b-5 in regulating cases of insider trading). Insider trading is directly addressed under section 16 of the Securities Exchange Act and requires insiders (i.e. directors and officers) to report any of their purchases or sales in their company's stock to the SEC. This section also makes short swing profits recoverable by the company. 15 U.S.C. § 78p (2000). However, critics argue section 16 is too under-inclusive to meaningfully aid the SEC in most cases. C. EDWARD FLETCHER, MATERIALS ON THE LAW OF INSIDER TRADING 99 (1991).

78. 15 U.S.C. § 78b (2000) (stating one of its purposes is "to insure the maintenance of fair and honest markets"); *see also* 45 Fed. Reg. 60410 (1980) (stating that trading on misappropriated confidential information undermines investor confidence and integrity of securities market); *cf.* Carol Vinzant, *The New Improved Game of Insider Trading*, FORTUNE MAGAZINE, Jun. 7, 1999, at 115 (regulatory organizations are "five years behind the times" allowing insider trading to go undetected). *But see* M. Breene Haire, Note, *The Uneasy Doctrinal Compromise of the Misappropriation Theory of Insider Trading Liability*, 73 N.Y.U. L. REV. 1251, 1255 (1998) (noting the argument that insider trading should be exempt from regulation based upon three principals: (i) insider trading improves efficiency of securities markets by "communicating important information to traders," ensuring that stock prices more accurately reflect the stocks' true value; (ii) insider trading is reliable method to compensate management; and (iii) insider trading may not harm other traders because they would have traded in securities regardless).

79. *See O'Hagan*, 521 U.S at 652-55 (holding that a person violates section 10(b) and Rule 10b-5 when she uses information in breach of a fiduciary duty to trade securities for personal profit); *see also* 17 C.F.R. § 240.10b5-1 (2000) (defining trade "on the basis of" material, non-public information).

80. 521 U.S. at 652.

81. *O'Hagan*, 521 U.S. at 652-653 (explaining classical theory and providing examples of insiders).

82. *Id.* (distinguishing misappropriation theory from classical theory). The Court's articulation of the misappropriation theory and the prerequisite fiduciary relationship necessary for a finding of insider trading has "given additional guidance to market participants." Phyllis Diamond, *U.S. Supreme Court: Misappropriation Theory Validated in Criminal Action Against Bidder's Attorney*, 29 SEC. REG. & L. REP. (BNA) 873 (June 26, 1997) (quoting SIA President Marc Lackritz). The Court's decision may have silenced critics who claimed that there was no clear definition of insider trading. *See* John R. Beeson, *Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*, 144 U. PA. L. REV. 1077, 1142 (1996) ("The desire of the judiciary to craft a tool in the absence of a clear [legislative] definition of insider trading . . . has led to an inadequate and unworkable doctrine."). *See generally* Michael H. Dessent, *Joe Six-Pack*, United States v. O'Hagan, *and Private Securities Litigation Reform: A Line Must Be Drawn*, 40 ARIZ. L. REV. 1137, 1140 (1998)

propriation theories provide the theoretical underpinnings for criminal liability in most insider trading cases.[83]

This Section discusses these two complementary[84] theories and reviews Rule 14e-3, which specifically prohibits insider trading of tender offers. The section concludes with an analysis of a recently endorsed standard of causation in insider trading liability.

a. The Classical Theory

Under the classical theory of insider trading, a Rule 10b-5 violation exists when a corporate insider purchases or sells securities on the basis of material, non-public information.[85] Under this theory, only corporate insiders who have a fiduciary duty to the corporation's shareholders are criminally liable.[86] This duty requires insiders either to disclose the non-public information or refrain from trading on the information.[87] Courts consider non-disclosure a "deceptive device" when insiders take advantage of uninformed stockholders by buying or selling securities on the

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(arguing misappropriation theory allows for more aggressive criminal pursuit of inside traders, but Court's articulation of theory in *O'Hagan* is vague and will not restrict the theory's use).

83. In addition, the Insider Trading Sanctions Act of 1984 ("ITSA"), 15 U.S.C. § 78u-1(b)(1)(A) (2000), authorizes the SEC to seek civil penalties against employers who "knew or recklessly disregarded the fact" that a company insider was likely to engage in insider trading "and failed to take appropriate steps to prevent such act or acts." *See, e.g., In Re* Fox-Pitt, Kelton, Inc., 63 S.E.C. Docket 452, 1996 WL 657769, at *2 (Nov. 12, 1996) (fining broker-dealer Fox-Pitt, Kelton $50,000 for failure to "have procedures and policies reasonably designed" to prevent insider trading under ITSA). A high number of insider trading investigations result in criminal prosecution for obstruction of justice and perjury. Phyllis Diamond, *Insider Trading: McLucas Hails O'Hagan Ruling, But Says Issues Over Reach of Theory Remain*, 29 SEC. REG. & L. REP. (BNA) 1097, 1098 (Aug. 8, 1997) (quoting SEC Enforcement Director William McLucas).

84. *O'Hagan*, 521 U.S. at 652-53 (describing misappropriation theory as complementing classical theory of insider trading because the former protects market from corporate "outsiders," whereas the latter only protects market from corporate "insiders"). *But see* Haire, *supra* note 78, at 1253 (arguing that the misappropriation theory "marks a fundamental departure" from the classical theory because the wrongful activity to which misappropriation theory attaches liability is so attenuated from the securities trade at issue that it fails to retain the fiduciary duty framework of the classical theory).

85. *E.g.*, Chiarella v. United States, 445 U.S. 222, 227 (1980) (defining classical theory). This theory applies equally to tipees. *Id.* at 230 n.12.

86. *Id.*at 227. The courts have taken a broad view of who constitutes an "insider" and will include majority stockholders and corporate officers. *See, e.g.*, *Tex. Gulf Sulphur*, 401 F.2d at 852 (extending liability to corporate officers and employees who traded on undisclosed information regarding successful result of mining exploration); SEC v. Hoover, 903 F. Supp. 1135, 1139-40 (S.D. Tex. 1995) (extending liability to directors, officers and principal shareholders).

87. *O'Hagan*, 521 U.S. at 652; *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting) (explaining how to avoid Rule 10b-5 violations). *Chiarella* holds that non-disclosure is not actionable unless a duty to disclose exists. Such a duty arises when there is a fiduciary or other similar relation of trust and confidence between the person possessing the information and the person entitled to it. *Chiarella*, 445 U.S. at 228. Yet *Chiarella* does not provide protection to those who decide to speak voluntarily but do so in bad faith or without a reasonable basis. *See* Cyber Media Group, Inc. v. Island Mortgage Network, 183 F. Supp. 2d 559, 572-73 (E.D.N.Y. 2002); *see also* First Va. Bankshares v. Benson, 559 F.2d 1307, 1314 (5th Cir. 1977) (noting silence or omission is proscribed when the "defendant has revealed some relevant, material information even though he had no duty [to speak]").

basis of confidential information.[88] Thus, if the insider discloses to the corporation's shareholders his or her intention to trade in the securities market based on the non-public information, there would be no "deceptive device" or Rule 10b-5 violation.[89]

The classical theory applies to both "temporary" insiders and "tippees."[90] "Temporary" insiders, such as underwriters, attorneys, accountants, consultants, or others who temporarily gain access to any "inside" information, have a duty to disclose or refrain from trading on that information because they are temporary fiduciaries of the corporation.[91] "Tippees" are individuals who trade based on the non-public information gained from insiders.[92] A tippee is liable for insider trading under § 10(b) if: "(i) tipper possessed material, non-public information regarding corporation; (ii) tipper disclosed this information to tippee; (iii) tippee traded in corporations' securities while in possession of that non-public information provided by tipper; (iv) tippee knew or should have known that tipper violated relationship of trust by relaying the information; and (v) tipper benefited by the disclosure to tippee."[93]

Despite courts' broad interpretation of "insiders" under the classical theory, prosecutors were unable to prosecute many cases involving insider trading.[94] In

88. *Chiarella*, 445 U.S. at 228 (finding relationship of trust between shareholders of corporation and those insiders who have obtained confidential information through their position in corporation creates a fiduciary duty such that their silence constitutes fraud (citing *In re* Cady, Roberts & Co., 40 S.E.C. 907, Release No. 34-6668 (1961))). The majority in *Chiarella* concluded that a duty to disclose is created only when "the other [party] is entitled to know [the information] because of a fiduciary or other similar relation of trust and confidence between them." *Id.*

89. *Id.* (explaining purpose of duty to disclose is to prevent insider from taking unfair advantage of uninformed shareholder).

90. *See* Dirks v. SEC, 463 U.S. 646 (1983) (discussing liability of temporary insiders and tippees).

91. *Dirks*, 463 U.S. at 655 n.14. The court stated that:

> [u]nder 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 . . . [because] they have entered into a special confidential relationship . . . and are given access to information solely for corporate purposes. When such a person breaches his fiduciary relationship, he may be treated more properly as a tipper than a tippee. For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed non-public information confidential, and the relationship at least must imply such a duty.

Id.

92. *Id.* at 660 n.19 (defining tippee liability).

93. SEC v. Warde, 151 F.3d 42, 47 (2d Cir. 1998) (finding tippee liable for insider trading when he purchased warrants while in possession of non-public information regarding takeover threat with the knowledge that tipper was violating relationship of trust as director of corporation and tipper benefited from trades). *But see In re* Mego Fin. Corp. Sec. Litig., 213 F.3d 454, 458-59 (9th Cir. 2000) (finding defendants did not benefit from false disclosure because none sold stock to earn inflation price).

94. *O'Hagan*, 521 U.S. at 653 n.5 (finding government could not have prosecuted O'Hagan under classical theory because O'Hagan was not attorney for target corporation in whose stock he traded and was not a "temporary insider," even when he had intimate association with confidential information from his employer, who was counsel for the acquiring corporation). However, a recent Second Circuit decision may have relaxed the *Dirks*

response, prosecutors urged courts to adopt the "misappropriation theory."[95]

b. The Misappropriation Theory

In *United States v. O'Hagan*,[96] the Supreme Court resolved a conflict among the circuits by adopting the misappropriation theory.[97] Under the misappropriation theory, a party who trades on wrongfully obtained non-public information is liable solely for the trader's act of "misappropriating" such information. Although Chief Justice Burger set forth a version of the misappropriation theory in his *Chiarella* dissent,[98] the *O'Hagan* Court adopted a version more akin to the Second Circuit's reasoning in *United States v. Newman*.[99] In *O'Hagan*, the Supreme Court found that the misappropriation theory falls within the provisions of Rule 10b-5, which requires (i) a deceptive device; (ii) breach of a fiduciary duty; (iii) use of material, non-public information in connection with the purchase or sale of a security; and (iv) willfulness on the part of the defendant.[100]

The misappropriator's secret use of the confidential information for personal gain while feigning loyalty to the source of the information fulfills the "deceptive device or contrivance" requirement.[101] "Deception through non-disclosure is central to [this] theory of liability."[102] The misappropriation theory preserves the rule that there is no general duty among security market participants prohibiting

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standard by finding that the personal benefit prong may be satisfied by personal friendship. *See Warde*, 151 F.3d at 48.

95. The Second Circuit was the first court of appeals to expressly accept the misappropriation theory. *See* United States v. Newman, 664 F.2d 12, 16-17 (2d Cir. 1981) ("[D]eceitful misappropriation of confidential information by a fiduciary" is fraudulent under Rule 10b-5 and is "in connection with the purchase or sale of any security" because Newman's "sole purpose in participating in the misappropriation of confidential takeover information was to purchase shares of the target companies").

96. 521 U.S. 642 (1997).

97. The misappropriation theory had been adopted by the Second, Third, Seventh, and Ninth Circuits, but rejected by the Fourth and Eighth circuits.

98. *Chiarella*, 445 U.S. at 243 (Burger, C.J., dissenting). In dissent, the Chief Justice set forth the unprecedented view that anytime an investor obtains confidential information by unlawful means, he or she owes a fiduciary duty (owed directly to the contemporaneous traders) to disclose or abstain from trading. The *Chiarella* majority expressly reserved judgment on the misappropriation theory because the theory was not presented to the jury. *Id.* at 240.

99. 664 F.2d 12 (2d Cir. 1981); *see also* United States v. Teicher, 987 F.2d 112, 120 (2d Cir. 1993) (following the principles set forth in *Newman*). The Second Circuit's decision in *Newman* differs somewhat from the Supreme Court's decision in *O'Hagan*. In *Newman*, the court found that the source of the confidential information suffered real damage by "sullying" its reputation because of Newman's trading, whereas the Supreme Court recognized that the harm may be suffered by someone other than the target of the fraud. *Compare Newman*, 664 F.2d at 17, *with O'Hagan*, 521 U.S. at 645.

100. *O'Hagan*, 521 U.S. at 666 (finding willful intent requirement for Rule 10b-5 justifies criminal prosecution of defendant under misappropriation theory).

101. *Id.* at 653. O'Hagan feigned loyalty to his employer while he secretly traded on confidential information about the acquisition of a company by a client of his law firm. *Id.*

102. *Id.* "To satisfy the requirement of the Securities Act that there be no deception, there would only have to be disclosure." *Id.* (citing Tr. of Oral Arg. 12). The Supreme Court warned that if there is a duty to more than one principal, there must be disclosure to all principals in order to avoid violating Rule 10b-5. *Id.* at 655 n.7.

trades based upon material, non-public information. The misappropriation theory only bars trading on confidential information that a defendant uses for his or her own gain in breach of a fiduciary, contractual, or similar obligation to the owner or rightful possessor of the information.[103] This fiduciary relationship most frequently exists between employers and employees,[104] but it has also been found between attorneys and clients[105] as well as between psychiatrists and patients.[106]

Although the presence of a fiduciary relationship is well established in business situations, it is less clear whether personal relationships establish fiduciary duties that satisfy the misappropriation theory's requirement. In *United States v. Chestman*, the Second Circuit held that marriage by itself does not create a fiduciary relationship.[107] In response to the uncertainty of the law in this area, the SEC adopted Rule 10b5-2 in 2000.[108] Rule 10b5-2 provides a non-exclusive list of three situations in which a duty can satisfy the misappropriation theory's requirement: (i) when a person explicitly agrees to maintain information in confidence; (ii) when the history or practice of the relationship demonstrates an implicit understanding between the parties that the information will be held in confidence; or (iii) when the information comes from spouses, parents, children, or siblings, unless it can be demonstrated that, under the circumstances of a particular relationship, no duty of

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103. *See* Barbara B. Aldave, *Misappropriation: A General Theory of Liability for Trading on Non-public Information*, 13 HOFSTRA L. REV. 101, 122 (1984) (discussing necessary elements of liability under misappropriation theory). This theory contrasts with the classical theory under which a corporate insider breaches a duty owed to the corporation's stockholders by trading on confidential information. However, both theories require a breach of a fiduciary duty, and neither theory presents a ban on all trading based on non-public information without disclosure. For example, broker-dealers can trade on and advise their clients on lawfully obtained non-public information, in part because Congress recognized that their informational advantage contributes to a fair and orderly marketplace. *See Chiarella*, 445 U.S. at 234 n.16 (explaining congressional exemption from prohibition for brokers); *see also* 17 C.F.R. § 240.10b5-2 (2001) (defining duties of trust and confidence in insider trading). *See generally* A.C. Pritchard, United States v. O'Hagan: *Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13 (1998) (tracing the development of insider trading jurisprudence with comparative discussions of the classical and misappropriation theories).

104. 17 C.F.R. § 240.10b5-2 (2001) (using broad language to include employer and employee relationship); *e.g.*, SEC v. Cherif, 933 F.2d 403, 411 (7th Cir. 1991) (extending fiduciary duty past termination of employment when bank employee forged document to authorize continued access to bank building after termination because employee was under common law duty to safeguard bank's "integrity policy"); SEC v. Clark, 915 F.2d 439, 449-50 (9th Cir. 1990) (holding employee's misappropriation and use of employer's material, non-public information regarding acquisition of another firm was violation of section 10(b) and Rule 10b-5); *cf.* SEC v. Falbo, 14 F. Supp. 2d 508, 522-23 (S.D.N.Y. 1998) (finding a contractor breached a duty, although not inherently fiduciary, to a company when he used information acquired by him during his employment for personal gain).

105. *O'Hagan*, 521 U.S. at 660-66 (imposing liability on lawyer for trading on confidential client information, even though it was not defendant's own client); *see also* 17 C.F.R. § 240.10b5-2 (2001) (stating breach can occur "whenever person agrees to maintain information in confidence").

106. United States v. Willis, 737 F. Supp. 269, 273-74 (S.D.N.Y. 1990) (imposing liability on psychiatrist who traded upon information received during counseling session); *see also* 17 C.F.R. § 240.10b5-2 (2001) (using broad language that would include confidentiality between patient and doctor).

107. 947 F.2d 551, 568 (2d Cir. 1991).

108. 17 C.F.R. § 240.10b5-2 (2001).

trust existed.[109]

Fraudulent use of material, non-public information creates criminal liability under the Securities Exchange Act only if it is used in connection with the purchase or sale of a security.[110] The misappropriation theory satisfies this requirement because courts consider the fraud to be "consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities."[111] If a misappropriator uses the information for any other purpose, Rule 10b-5 is not implicated.[112]

The scienter requirement of this statute prevents it from being too vague to impose criminal liability.[113] Both the government's burden of proving the fiduciary's willfulness and the Act's provision that defendants cannot be imprisoned if they had no knowledge of the rule provide "sturdy safeguard[s]" against unjust application of the statute.[114] However, the *O'Hagan* Court failed to define a standard of proof for a willful violation[115] and to determine whether the same "willful" standard applies to civil cases.[116]

In sum, the Supreme Court held that the misappropriation theory is consistent with appropriate application of Rule 10b-5.[117] In addition, the Supreme Court found the misappropriation theory furthers the policy reasons behind the statute: it helps to ensure honest securities markets and accordingly promotes investor confidence by "inhibiting the impact on market participation of trading on misappropriated information."[118] However, because the Court did not clearly define the type of relationship needed to create a fiduciary duty or the scienter standard necessary for litigation, these issues will continue to be contested in future court decisions.[119] The SEC hopes that the recently promulgated federal

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109. *Id.*; United States v. Kim, 184 F. Supp. 2d 1006, 1014 (N.D. Cal. 2002) (finding membership in a young professionals' organization created a "duty" among members for purposes of the "misappropriation theory").

110. *See supra* note 10 (setting forth elements of Rule 10b-5 violation). However, "[t]he SEC has consistently adopted a broad reading of the phrase 'in connection with the purchase or sale of any security.'" *See* SEC v. Zandford, 122 S. Ct 1899, 1903 (2002). Accordingly, the *Zandford* Court found that for these purposes "[i]t is enough that the scheme to defraud and the sale of securities coincide." *Id.* at 1904.

111. *O'Hagan*, 521 U.S. at 655 (defining misappropriation deception as feigning fidelity to source of information while not disclosing plan to trade on non-public information).

112. Rule 10b-5 is not a "catchall" for all types of fraud. *Id.* at 656.

113. *See id.* at 665 (stating due process requirement of notice is satisfied by requiring willful violation).

114. *Id.* (finding criminal prosecution under misappropriation theory consistent with willful intent requirement of Rule 10b-5).

115. *See* Diamond, *supra* note 83 (discussing SEC Enforcement Director's concern that Court's language requiring disputed transaction be "on the basis of " non-public, material information may be interpreted as a tougher standard than currently employed standard of "while in possession of," even though SEC will argue that standard remains unchanged).

116. *Id.* However, the SEC has recently attempted to provide a standard of scienter in insider trading. 17 C.F.R. § 240.10b5-1 (2001).

117. *See O'Hagan*, 521 U.S. at 666.

118. *Id.* at 659.

119. *See generally* Michael A. Snyder, Note, United States v. O'Hagan, *The Supreme Court and the Misappropriation Theory of Securities Fraud and Insider Trading: Clarification or Confusion?*, 27 CAP. U. L.

regulations 10b5-1 and 10b5-2 will aid the courts in establishing consistent precedence in insider trading.[120]

c. Strict Regulation Under Rule 14e-3 of Non-public Information Regarding Tender Offers

In direct response to the Supreme Court's holding in *Chiarella*,[121] the SEC promulgated Rule 14e-3[122] to prohibit insider trading in connection with tender offers. This Rule prohibits anyone in possession of material, non-public information concerning a tender offer from trading on or "tipping" that information.[123] This activity is criminal when the trading party knows the forbidden nature of the conduct.[124] Rule 14e-3 imposes an absolute duty to disclose the confidential information or to abstain from trading, regardless of whether or not a trader obtained the information through a breach of a fiduciary duty.[125] In *O'Hagan*, the Court ruled in a 7–2 decision that Rule 14e-3 constituted a valid exercise of the SEC's rulemaking authority.[126] There may be a simultaneous violation of Rules 14e-3 and 10b-5; the government has prosecuted cases brought for both violations.[127]

d. Use Versus Knowing Possession of Inside Information

Considerable disagreement developed in the courts about whether possession of material, non-public information was enough for Rule 10b-5 liability or whether a defendant's use of that information had to be demonstrated.[128] The Second Circuit

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REV. 419, 447 (1999) (contending *O'Hagan* Court failed to adequately define the "scope and validity" of the misappropriation theory "and its ruling will only serve to increase the cloud of confusion surrounding the application of the theory"). *But see* 17 C.F.R. §§ 240.10b5-1, 240.10b5-2 (2001) (seeming to partially define scope of misappropriation theory).

120. 17 C.F.R. §§ 240.10b5-1, 240.10b5-2 (2001) (defining trade "on the basis of" material, non-public information and duties of trust in insider trading).

121. *Chiarella*, 445 U.S. at 245 (finding printer's employee not insider and therefore not subject to section 10b and Rule 10b-5).

122. 17 C.F.R. § 240.14e-3 (2001).

123. *Id.*; *see also* SEC v. Sargent, 229 F.3d 68, 79 (1st Cir. 2000) (holding Rule 14e-3 does not require a defendant to have knowledge that the non-public information in his possession relates to a tender offer).

124. United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (finding sophisticated stockbroker knew his conduct was criminal).

125. SEC v. Maio, 51 F.3d 623, 631 (7th Cir. 1995); *see also O'Hagan*, 521 U.S. at 667 (holding Rule 14e-3 constituted a valid exercise of the SEC's rulemaking authority).

126. *O'Hagan*, 521 U.S. at 666-68 (finding Rule 14e-3 did not exceed the SEC's rulemaking authority and is a "'means reasonably designed to prevent' fraudulent trading on material, non-public information in the tender offer context").

127. *See* United States v. Ruggiero, 56 F.3d 647, 650 (5th Cir. 1995) (upholding convictions of auditor and his friend who violated Rules 10b-5 and 14e-3 when they traded securities that yielded over $8 million in profits).

128. *Compare Teicher*, 987 F.2d at 120 (adopting the "knowing possession" test) *with Smith*, 155 F.3d at 1066 (adopting the "use" test) *and* SEC v. Adler, 137 F.3d 1325, 1337-39 (11th Cir. 1998) (same).

adopted the "knowing possession" standard in *United States v. Teicher*.[129] The possession standard is based on the idea that it is difficult for a person to possess material, non-public information and purchase or sell a security without using that information.[130]

Both the Ninth Circuit, in *United States v. Smith*,[131] and the Eleventh Circuit, in *Securities Exchange Comm'n v. Adler*,[132] endorsed the "use" test, instead of the "knowing possession" standard, for insider trading liability under Rule 10b-5.[133] Under the "use test," the SEC must prove that the insider used the inside information when he traded, and not merely that the insider traded while in possession of inside information.[134] The government bears the burden of proving that the inside information was actually used by the defendant in the transaction.[135] The inside information need not be the sole cause of the trade, but only a "'significant factor' in the insider's decision to buy or sell."[136]

In 2000, the SEC responded to *Smith* and *Adler* by adopting Rule 10b5-1,[137] which states that a purchase or sale of a security is "on the basis of " material, non-public information when the person making the purchase or sale is aware of the material, non-public information.[138] The Rule provides an affirmative defense in certain situations where a person who possesses material, non-public information enters into a transaction under a contract that preexisted the possession of the

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129. 987 F.2d at 119.

130. *Id.* at 120 ("[B]ecause the advantage [over other traders here] is in the form of information, it exists in the mind of the trader" and cannot simply remain unused).

131. 155 F.3d 1051 (9th Cir. 1998).

132. 137 F.3d 1325 (11th Cir. 1998).

133. *Smith*, 155 F.3d at 1067 (endorsing the "use" test); *Adler*, 137 F.3d at 1337 (same). Under a knowing possession standard, causation is established when an insider is in possession of insider information and later trades. *Teicher*, 987 F.2d at 120 (delineating several factors that support a possession standard in the context of criminal insider trading prosecutions). This standard is consistent with first, the flexible requirement that the deceptive practice merely be "in connection with the purchase or sale of a security," and second, with the fiduciary's duty to "disclose or abstain." Third, it recognizes the difficulty in not using material information held in one's mind.

134. *See generally* Bryan C. Smith, Comment, *Possession Versus Use: Reconciling the Letter and the Spirit of Insider Trading Regulation Under Rule 10b-5*, 35 CAL. W. L. REV. 371, 373-75 (1999) (stating that the actual use test is a "more strict standard of proof for plaintiffs and prosecutors" compared to the "broader enforcement scheme . . . promoted by the SEC" under the possession standard).

135. *Smith*, 155 F. 3d at 1069 (recognizing that a "use" requirement makes it "marginally more difficult" for the government to prove insider trading violations).

136. *Id.* at 1070 n. 28.

137. SEC Manipulative and Deceptive Devices Rule, 17 C.F.R. § 240.10b5-1 (2000). The SEC adopted the "knowing possession" or "awareness" standard because it believed that standard more effectively protects investor confidence in market integrity than does the "use" standard - it "reflects the common sense notion that a trader who is aware of inside information when making a trading decision inevitably makes use of the information." Selective Disclosure and Insider Trading, Exchange Act Release Nos. 33-7881, 34-43154, IC-24599, pt. III.A.2 (Aug. 15, 2000), *available at* http://www.sec.gov/rules/final/33-781.html.

138. 17 C.F.R § 240.10b5-1; *see* SEC v. Lipson, 278 F.3d 656, 660 (3d. Cir. 2002).

information.[139] This affirmative defense contains a good faith element, which requires that the contract not have been entered into for the purpose of evading the Rule.[140]

B. Defining Offer, Purchase, or Sale of a Security

Only a transaction can create a criminal charge of securities fraud. The accurate definitions of security, offer, purchase, and sale are fundamental to determining whether a transaction has taken place and whether the government can charge someone with fraud. As the Supreme Court has noted:

> [i]n defining the scope of the market that it wished to regulate, Congress painted with a broad brush. It recognized the virtually limitless scope of human ingenuity, especially in the creation of "countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[141]

Employing the broad statutory definitions has enabled the government to attack investment schemes not explicitly within the statute. It has also resulted in confusing and often conflicting interpretations by the courts.

1. Definition of "Security"

Federal securities law defines a security broadly.[142] Congress intended the

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139. *Id.* The contract must have adequately specified the terms of the transaction before the material information was obtained. 17 C.F.R. § 240.10b5-1 (c)(1)(i)(B). Also, the purchase or sale must have been pursuant to this contract. 17 C.F.R. § 240.10b5-1 (c)(1)(i)(C). *See Lipson*, 278 F.3d at 660-61 (noting Rule 10b5-1 has a "safe harbor" for transactions committed to prior to possession of inside information).

140. 17 C.F.R. § 240.10b5-1 (c)(1)(ii).

141. Reves v. Ernst & Young, 494 U.S. 56, 60–61 (1990) (citations omitted).

142. Section 2(1) of the 1933 Act provides:

> [u]nless the context otherwise requires ... [t]he term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganzation certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group of index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1) (2000); *cf.* § 3(a)(10) of the 1934 Act (15 U.S.C. § 77c(a)(10) (2000)). The definitions of a "security" in the 1933 and 1934 Acts are "virtually identical." *E.g.*, Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 n.1 (1985); *see also* Pollack v. Laidlaw Holdings, Inc., 27 F.3d 808, 811 (2d Cir. 1994) (holding that "[w]hile the definitions of securities in the 1933 and 1934 Acts are not identical, the definitions are treated as identical in 'decisions dealing with the scope of the term'" (citing *Landreth Timber*, 471 U.S. at 681, 686 n.1)); Great Rivers Cooperative of Southeastern Iowa v. Farmland Indus., Inc., 198 F.3d 685, 698 (8th Cir. 1999) (explaining that "Congress broadly defined the term security 'so as to include within that definition the many

definition of the term "security" in the 1933 Act to include "instruments that in our commercial world fall within the ordinary concept of a security."[143] The expansive language and generous interpretation of "security" includes any of the following: notes; stocks; debentures; oil, gas or other mineral rights; investment contracts; insurance products; bank products; employee benefit plans; voting trust certificates; certificates of deposits; equipment trust certificates; and warrants, options and commodity futures.[144]

The definitions of "security" found in section 2(1) of the 1933 Act and section 3(a)(10) of the 1934 Act are used consistently in civil suits, SEC enforcement actions, administrative proceedings, and criminal proceedings.[145] Neither the prosecution in a criminal case nor the plaintiff in a civil case need to show that the defendant knew of the existence of a security.[146] However, in a criminal action, whether a security existed is a question of fact for the jury.[147]

The case law is inconsistent and confusing with respect to the definition of a security. The Supreme Court has admitted that its "cases have not been entirely

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types of instruments that in our commercial world fall within the ordinary concept of a security'" (citing United Hous. Found. Inc. v. Forman, 421 U.S. 837, 847-48 (1975))); SEC v. Infinity Group Co., 212 F.3d 180, 185 (3d Cir. 2000) (same).

143. *United Hous. Found., Inc.*, 421 U.S. at 847-48 (quoting H.R. REP. NO. 73–85, at 11 (1933)). The same passage is cited more recently in *Reves*, 494 U.S. at 61.

144. *See, e.g.*, Bass v. Janney Montgomery Scott, Inc., 210 F.3d 577, 584-85 (6th Cir. 2000) (holding promissory notes bore some similarities to enumerated categories of notes that are not securities, and notes were not securities as a matter of law under four factor *Reves* test). "Investment contract" has been the catchall phrase that most non-traditional securities fall under. *See* Lehman Bros. Commercial Corp. v. Minmetal Int'l Non-Ferrous Metals Trading, 179 F. Supp. 2d 159, 163-64 (S.D.N.Y. 2001). For extensive treatment of these various instruments, see generally LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 169-238 (1995).

145. *See* JACOBS, *supra* note 19, § 38.03(a)(i) (discussing the application of the term "security").

146. *See* United States v. Brown, 578 F.2d 1280, 1284 (9th Cir. 1978) (holding government was not required to prove criminal defendant knew offered object was security); Mueller v. Sullivan, 141 F.3d 1232, 1236 (7th Cir. 1998) (holding defendants could be convicted of securities fraud if they knew what they were doing, regardless of whether they knew or should have known their acts were unlawful). *But see* Hood v. Smith's Transfer Corp., 762 F. Supp. 1274, 1289 (W.D. Ky. 1991) (holding expectations of party with interest in security, i.e., whether party holding interest believes that securities laws apply, is a factor in determining whether instrument is security (citing *Landreth Timber*, 471 U.S. at 687 (1985))). In *Hood*, both the defendant and the plaintiff claimed that they expected the securities laws to apply. *Id.*

147. United States v. Morse, 785 F.2d 771, 775-76 (9th Cir. 1986) (holding whether investment is security is question for jury to determine in criminal prosecution); *see also* Teague v. Bakker, 35 F.3d 978 (4th Cir. 1994) (holding that whether a lifetime partnership could be considered a security was question for jury); Zolfaghari v. Sheikholeslami, 943 F.2d 451, 455 (4th Cir. 1991) (holding that whether interests in mortgage pools sold to investors were securities was question of fact). A court instructing a jury on the existence of a security generally recites the definition as it appears in the 1933 and 1934 Acts. The judge informs the jury that this definition should be "construed broadly." EDWARD J. DEVITT ET AL., FEDERAL JURY PRACTICE AND INSTRUCTIONS § 52.12 (4th ed. 1990) (finding intent of Congress was that Security Act and term "security" should be construed broadly (citing United States v. Austin, 462 F.2d 724, 736 (10th Cir. 1972))). *Compare* Goodman v. Epstein, 582 F.2d 388, 406 (7th Cir. 1978) (holding that existence of security is question for judge), *with* United Cal. Bank v. THC Fin. Corp., 557 F.2d 1351, 1355 (9th Cir. 1977) (stating jury can determine existence of security interest as matter of fact). *See generally Infinity Group*, 212 F.3d at 187 (holding even if parties to a civil securities enforcement action agree a "security" exists, court must still determine that transaction at issue is indeed a security because it is a jurisdictional inquiry).

clear on the proper method of analysis for determining when an instrument is a 'security.'"[148] The relevant case law creates three categories of interpretive questions:[149] (i) whether certain stocks and notes, while securities in form, are considered securities for the purpose of the statute when they were not acquired to invest for profit;[150] (ii) whether certain financial instruments are securities when they are covered by other federal legislation;[151] and (iii) whether an investment scheme, not in the form of a "security," amounts to an "investment contract" or a "certificate of interest or participation in any profit-sharing agreement" because money was invested in a common enterprise with the expectation of profits to be derived solely from the efforts of others, specifically from the efforts of the promoter or a third party.[152]

a. *Stocks and Notes Lacking a Profit Motive*

Any security having attributes commonly associated with traditional stock falls under the category of a section 2(1) "stock" in the 1933 Act. Pre-1985 Supreme Court decisions assert that, in certain instances, instruments having stock-like characteristics would not be considered securities unless the underlying purpose of

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148. *Landreth Timber*, 471 U.S. at 688.

149. The task of defining a security should not be confused with determining whether a security is exempt from regulation and disclosure requirements. Section 3(a) of the Securities Act and section 3(a)(12) of the Securities Exchanges Act provide lists of exempt securities. These sections exempt a security from registration and disclosure requirements, but do not provide shelter from the criminal anti-fraud protection of Rule 10b-5 or other civil anti-fraud provisions. Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 565 n.18 (1979) (noting "the antifraud provisions of the ... [Securities] Acts continue to apply to interest that come [sic] within the exemptions"); Sonnenfeld v. City of Denver, 100 F.3d 744, 746 n.1 (10th Cir. 1996) (noting that securities exempted from regulatory burdens are still subject to civil fraud causes of action). In the realm of criminal fraud, many instruments exempted from regulatory burdens, such as municipal securities, intrastate offerings, small offerings, and other categories under section 3(a) of the Securities Act and section 2(a)(12) of the Securities Exchanges Act, are still subject to criminal penalties even when they are not termed a security for purpose of the regulation and disclosure requirements. *See* United States v. Charnay, 537 F.2d 341, 348 (9th Cir. 1976) (holding civil precedent concerning Rule 10b-5 applies in criminal context).

150. The term "security" means any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited. 15 U.S.C. § 78c(a)(10)(10) (2000).

151. *See Reves*, 494 U.S. at 66.

152. *See* SEC v. Howey Co. 328 U.S. 293, 298-300 (1946) (asserting definition of "investment contract" is based upon economic reality and not mere form; an investment contract is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or third party").

the transaction was profit-based.[153] However, the Court held that instruments bearing some of the significant attributes of traditional stock—stock plainly within the definition of a security under the Acts—would be treated as securities regardless of the underlying economic reality of the transaction.[154] The Court has asserted that instruments bearing the name and traditional attributes of stock provide "the clearest case for coverage by the plain language of the definition."[155] A typical stock, therefore, is presumed to be a security under the Acts, unless the instrument lacks the usual characteristics of a stock as set forth by the Supreme Court.[156]

In contrast to stocks, promissory notes still require an inquiry into the underlying transaction to determine whether a particular "note" is a security under the Acts.[157] In *Reves v. Ernst & Young*[158] the Court held that the determination of whether a note is a security depends on the underlying economic realities of the transaction.[159] The *Reves* Court applied the "family resemblance" test, which it

153. *See United Hous. Found.*, 421 U.S. at 848-52 (holding instruments providing low-cost subsidized living space were not securities under 1933 and 1934 Acts, despite being described as "stock" in transaction, because instruments lacked significant characteristics of traditional stock). *But see* Golden v. Garafolo, 678 F.2d 1139, 1144 (2d Cir. 1982) (holding conventional stock in business corporations is security within meaning of Act's definition, regardless of its underlying transaction).

154. *Landreth Timber* at 691-92 (holding the sale of all stock in a business involved a security transaction, notwithstanding the fact that sale amounted to transfer of entire business, because stock possessed the usual characteristics of corporate stock). *See generally*, Kyle M. Globerman, *The Elusive and Changing Definition of a Security: One Test Fits All*, 51 FLA. L. REV. 271, 298-302 (1999) (discussing holding in *Landreth Timber*).

155. *Landreth Timber*, 471 U.S. at 693-94. According to the Supreme Court:

> [i]t is one thing to say that the typical cooperative apartment dweller has bought a home, not a security; or that not every installment purchase 'note' is a security .... But *stock*, (except for the residential wrinkle) is so quintessentially a security as to foreclose further analysis.

Id. at 693-94 (citing L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 212 (1983)); *see also* SEC v. SG Ltd., 265 F. 3d 42, 48 (1st Cir. 2001) (holding that virtual securities sold over Internet were nonetheless securities because it is "immaterial whether the promoter depicts the enterprise as a serious commercial venture or dubs it as a game" because securities at issue had intrinsic nature of investment contracts).

156. Characteristics typically associated with common stock include: "(i) the right to receive dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated; (iv) the conferring of voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value." *Landreth Timber*, 471 U.S. at 686 (citation omitted).

157. *See, e.g.*, *Bass*, 210 F.3d at 584 (explaining that while stock is quintessence of a security, same presumption does not hold true for notes; therefore, court must determine whether promissory notes at hand bore resemblance to one of seven categories identified as non-securities and whether an additional category should be added to list (citing *Reves*, 494 U.S. at 62-63)).

158. 494 U.S. 56 (1990) (finding that demand promissory notes constitute securities under 1934 Act).

159. *Id.* at 61 (holding only notes that are issued in an investment context are securities under the Acts; notes issued in a commercial context are not); United States v. Faulhaber, 929 F.2d 16, 19 (1st Cir. 1991) (stating Congress intended determination of a "security" to rest on economic realities); *see also* Great Lakes Chem. Corp. v. Monsanto Co., 96 F. Supp. 2d 376, 393 (D. Del. 2000) (finding that because interests were not stocks, an inquiry into underlying transaction was necessary; holding that interests in limited liability company were not securities because they did not have intrinsic characteristics of securities as enumerated by Supreme Court in *Landreth Timber* and *Howey*).

adopted from the Second Circuit,[160] to determine whether certain promissory notes met the statutory definition of "securities."[161] The Court first acknowledged the presumption that any note offering a term greater than nine months is a security,[162] but went on to list specific categories of notes that will not be deemed securities.[163] The family resemblance approach, therefore, creates a rebuttable presumption that all notes are securities, but allows the issuer to challenge the note's classification as a security if the note bears a strong "family resemblance" to a set of judicially-delineated non-security notes.[164]

If the note in question does not bear an obvious "family resemblance" to any judicially excluded category of notes, *Reves* provides a second chance at demonstrating that the note is not a security by analyzing four aspects of the economic reality of the transaction: (i) the motivation for entering the transaction, (ii) the plan of distribution, (iii) the reasonable expectations of the investing public, and (iv) whether any risk-reducing factors exist that would make the application of the securities laws unnecessary.[165]

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160. *See* Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 939 (2d Cir. 1984) (asserting that a note that does not bear "family resemblance" to judicially-specified exclusions and has a maturity exceeding nine months will generally fall under "security"); *see also* Leemon v. Burns, 175 F. Supp. 2d 551, 559 (S.D.N.Y. 2001) (explaining that party asserting that note of more than nine months is not a security has burden of proving that 1934 Act does not apply (citing *Exch. Nat'l Bank of Chicago*, 544 F.2d at 1137-38)).

161. *See Reves*, 494 U.S. at 65. The Court based its determination that the demand notes at issue were securities on the following: (i) the notes were sold in effort to raise capital for general business operations, (ii) the plan of distribution was over extended period of time and reached out to broad segment of public, (iii) the public's reasonable perception was that notes were an investment, and (iv) there were no risk-reducing factors. However, in contrast to the treatment of stocks in *Landreth Timber*, the *Reves* Court did not devise a parallel per se rule that all "notes" are covered under the Securities Acts. Because notes, unlike stock, may have certain functions as non-instruments, the broad *Landreth Timber* formula was inapplicable. *Id.* at 63.

162. This presumption is based on the statutory definition of a security in the 1934 Act, which excludes those "notes" that are nine months or less in duration. *See* 15 U.S.C. § 78c(a)(10) (2000).

163. *See Reves*, 494 U.S. at 63-64. The judicially crafted list of notes that are not securities originated in the Second Circuit. This list includes: (i) notes delivered in consumer financing, (ii) notes secured by a mortgage on a home, (iii) short-term notes secured by a lien on a small business or its assets, (iv) notes evidencing a "character" loan to a bank customer, (v) short-term notes secured by an assignment of accounts receivable, and (vi) notes that simply formalize an open-account debt incurred in the ordinary course of business. *See Exchange Nat'l Bank*, 544 F.2d at 1138. This list is not "graven in stone," and a plaintiff can attempt to convince the court to add a new instrument to the list. *See Chemical Bank*, 726 F.2d at 939 (adding to the list of non-securities "notes evidencing loans by commercial banks for current operations"); *Bass*, 210 F.23d at 585 (adding to list of non-securities a transaction incorporating "inclusion of stock purchase warrants along with a promissory note given in consideration of a loan").

164. *See Reves*, 494 U.S. at 63; *cf.* SEC v. R.G. Reynolds Enter., Inc., 952 F.2d 1125, 1131-32 (9th Cir. 1991) (applying "family resemblance" test to hold that promissory notes at issue constituted securities, notwithstanding the fact that some of the notes had a maturity of less than nine months).

165. *Reves*, 494 U.S. at 63-67. *Reves* states that courts consider: (i) that where motivation for the transaction is other than profit for the buyer or raising corporate funds for the seller, the instrument involved is not clearly a "security"; (ii) whether the instrument being distributed is one in which there is "common trading for speculation or investment"; (iii) whether the investing public reasonably expects the instrument to be a security; and (iv) whether another factor, such as the existence of another regulatory scheme, reduces the risk of the instrument. *Id.* at 66-67.

The Second Circuit's subsequent application of the "family resemblance" test in *Pollack v. Laidlaw Holdings, Inc.*[166] illustrates the predominant analytical framework embraced by courts to determine whether a particular instrument constitutes a "note." The *Pollack* Court examined whether notes secured by a mortgage on a home were "notes" within the meaning of federal securities law. Applying the four factors set forth in *Reves*, the court found that (i) the buyers' motivation was "clearly to invest"; (ii) the plan of distribution was broad-based; (iii) it was reasonable for the investors to expect that this plan was a conservative investment strategy, rather than a commercial loan transaction; and (iv) state regulations regulating mortgages did not afford adequate protection to investors in the case of "uncollateralized, speculative participations in mortgages."[167] In sum, because the notes were more similar to traditional securities than to any judicially defined category of non-securities, the court held that the federal securities laws applied to notes secured by a mortgage on a home.[168]

The *Reves* "family resemblance" test has been adopted in other circuits and applied in lower federal court opinions.[169] Among the types of notes that have been deemed non-securities under this test are: short-term unsecured notes issued by a bank to institutional investors,[170] notes based on viatical contracts,[171] notes packaged essentially as consumer loans with enhancements,[172] and notes issued to

166. 27 F.3d 808 (2d Cir. 1994).

167. *Id.* at 813-15.

168. *Id.* at 815.

169. *E.g.*, *Bass*, 210 F.3d at 583 (applying *Reves* "family resemblance" test to find that promissory notes for a loan were not securities); *Great Rivers Coop. of Southeastern Iowa*, 198 F.3d at 699 (finding capital credits lacked essential characteristics of a security under *Reves* test); Stoiber v. SEC, 161 F.3d 745, 750-54 (D.C. Cir. 1998) (employing *Reves* factors to conclude that promissory notes given by broker to customers were "securities" when the broker used the loaned money primarily for commodities trading in his personal account); Trust Company of La. v. N.N.P., Inc., 104 F.3d 1478, 1489 (5th Cir. 1997) (holding that notes fraudulently represented to be collateralized by Government National Mortgage Association are "securities" under *Reves*); SEC v. R.G. Reynolds, 952 F.2d 1125, 1131 (9th Cir. 1991) (holding that promissory notes issued by promoter of investment program are "securities" under *Reves*); Holloway v. Peat, Marwick, Mitchell & Co., 900 F.2d 1485, 1489 (10th Cir. 1990) (applying *Reves* factors to thrift certificates issued by a trust company and remanding to district court for consideration in context of the underlying transaction).

170. *See* Banco Espanol de Credito v. Sec. Pac. Nat'l Bank, 973 F.2d 51, 54 (2d Cir. 1992) (following "well-settled" proposition that "certificates evidencing loans by commercial banks to their customers for use in the customers' current operations are not securities").

171. *See* SEC v. Life Partners, 87 F.3d 536, 548-49 (D.C. Cir. 1996) (holding that because viatical contracts are not "securities," neither are notes based on these contracts because their "essential characteristics" are identical). "A viatical settlement is an agreement under which an insured sells a life insurance policy for an immediate payment approximating the discounted face value of the policy. An investor acquires an interest in a life insurance policy of a terminally ill person at a discount, depending upon the insured's life expectancy." Gander v. Livoti, 250 F.3d 606, 607 n.2 (8th Cir. 2001).

172. *See* Resolution Trust Corp. v. Stone, 998 F.2d 1534, 1539 (10th Cir. 1993) (holding "enhanced automobile receivables" consisting of car loans purchased from car dealers and resold on secondary market were not "securities" because holder received specialized interest payments rather than dividends).

investors in exchange for bridge loans.[173]

b. Instruments Protected by Other Federal Legislation

Certain instruments covered by federal legislation other than the securities laws are not considered securities.[174] Protection under another regulatory scheme reduces the risk of these instruments, thereby making application of the Securities Acts unnecessary.[175]

In *International Brotherhood of Teamsters v. Daniel*,[176] the Supreme Court held that a noncontributory, compulsory pension plan is not a security because the Employee Retirement Income Security Act of 1974 undercut the need for securities regulation.[177] Similarly, in *Marine Bank v. Weaver*,[178] the Court held that a certificate of deposit issued by a federally regulated bank is not a security because certificate of deposit holders were "abundantly protected under the federal banking laws."[179] The crucial factor in both cases was the existence of federal regulation that served the same investor protection objective as the federal securities law.[180] One circuit has extended the application of this reasoning to instruments protected by foreign regulatory schemes.[181] However, state banking regulations akin to the federal banking laws do not suffice to supplant the protection of the Securities Acts.[182]

Finally, some courts have also held that contracts for future delivery of securities are not subject to the 1933 and 1934 Acts, but rather are regulated under

173. *See Bass*, 210 F.3d at 585-86 (holding promissory notes received by investor in bridge loan transaction were not securities as a matter of law).

174. For extensive treatment of instruments protected by other federal legislation, see LOSS & SELIGMAN, *supra* note 144, at 171.

175. *See Reves*, 494 U.S. at 67 (finding that demand notes were securities under 1933 and 1934 Acts because, *inter alia*, there was no other risk reducing factor such as another regulatory scheme).

176. 439 U.S. 551 (1979).

177. *Id.* at 569-70; *see also* Cunha v. Ward Foods, Inc., 545 F. Supp. 94, 99 (D. Haw. 1982) (following *Daniel* to hold that "contributory, noncompulsory pension plan was not a security within the meaning of the Securities Acts"). *But see* Uselton v. Commercial Lovelace Motor Freight, Inc., 940 F.2d 564, 581 (10th Cir. 1991) (holding that ERISA failed to displace Security Act's applicability to stock ownership plan because it did not render all fiduciaries amenable to lawsuit).

178. 455 U.S. 551 (1982).

179. *Id.* at 559; *see also* Durbach v. Weitzel, 135 F.3d 590, 592 (8th Cir. 1998) (holding that a certificate of deposit issued by a Mexican bank to a U.S. resident did not constitute a security and did not call for the protection of the federal securities law because Mexican banking regulations provided adequate protection).

180. *See Stoiber*, 161 F.3d at 751 (finding that creditor/debtor laws of Indiana were not an adequate substitute for protection of federal law because, unlike securities laws, creditor/debtor laws do not provide oversight over initiation of transactions or handling of funds.). *See generally* LOSS & SELIGMAN, *supra* note 144, at 171.

181. *See Olson*, 957 F.2d at 628 (acknowledging finding that Mexican banks were sufficiently regulated to prevent any risk of the investment's devaluation).

182. *See Holloway*, 900 F.2d at 1488 (holding that the existence of state regulations akin to federal regulations in *Marine Bank* do not remove an instrument from the definition of a security); Bradford v. Moench, 809 F. Supp. 1473, 1483-84 (D. Utah 1992) (following *Holloway* to determine that thrift certificates and passbook accounts are securities under federal securities law).

the Commodity Futures Trading Commission Act.[183]

c. *Instruments Deemed Investment Contracts or Certificates of Interest*

In cases where a money-raising instrument is not expressly enumerated under section 2(1) of the 1933 Act or section 3(a)(10) of the 1934 Act, the Supreme Court has adopted an "economic reality" test to determine whether the instrument is a security for purposes of the Acts.[184] The four-prong test announced in *SEC v. W.J. Howey Co.*[185] is reserved for investment contracts and other instruments that are not readily identifiable as securities.[186] "[A]pplying the *Howey* test to traditional stock and all other types of instruments listed in the statutory definition would make the Acts' enumeration of many types of instruments superfluous."[187] Where a facial examination of the instrument can easily determine whether the instrument is a security, courts generally do not use the *Howey* economic reality test.[188]

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183. The distinction between puts, calls, futures, and options (securities) and commodities, (not securities) is an uncertain area of case law. *Compare* Chicago Mercantile Exch. v. SEC, 883 F.2d 537, 550 (7th Cir. 1989) (holding that index participations consisting of contracts of indefinite duration based on value of basket of securities were futures contracts subject to the exclusive jurisdiction of Commodities Futures Trading Commission rather than SEC), *with* Christensen Hatch Farms v. Peavey Co., 505 F. Supp. 903, 907 (D. Minn. 1981) (holding discretionary commodity futures accounts are subject to the 1934 Act).

184. *See Howey*, 328 U.S. at 298 (adopting a four prong test for instruments that are not readily identifiable as securities); *Great Rivers Coop. of Southeastern Iowa*, 198 F.3d at 699 (rejecting use of family resemblance test because investment instrument at issue was not included in statutory definition of security; instead, court applied the "more general test" of *Howey* and concluded that "capital credits" lack the essential characteristics of a "security").

185. 328 U.S. 293 (1946).

186. *See* Matassarin v. Lynch, 174 F.3d 549, 560 (5th Cir. 1999) (holding that an employee stock ownership plan did not fall under that protections of securities acts, notwithstanding fact that language in the defendant's documents described it as "stock" and "security," because economic realities of transaction suggested the plan was not a security); Adena Exploration, Inc. v. Sylvan, 860 F.2d 1242, 1249 (5th Cir. 1988) (holding that economic reality test does not apply to undivided oil and gas interests that fall "squarely within" the definition of "security"); Sulkow v. Crosstown Apparel, 807 F.2d 33, 37 (2d Cir. 1986) (declining to apply economic reality test to corporate stock when transaction concerned "the paradigm of a security" (citation omitted)). *But see Wolf*, 739 F.2d at 1461 (declining to apply economic realities test to certificates of deposit issued by foreign bank because precedent had already identified such instruments as "securities").

187. *Landreth Timber*, 471 U.S. at 692.

188. *See* Gould v. Ruefenacht, 471 U.S. 701, 704 (1985) (holding that inquiry into economic substance of instrument is unnecessary where instrument bears label "stock" and possesses all characteristics associated with stock); Cascade Energy & Metals Corp. v. Banks, 896 F.2d 1557, 1580-81 (10th Cir. 1990) (finding that working interests in mining claims were "securities" because there was "no ambiguity in the statutory definitions involved" and "no evidence that [they] were anything other than what they purported to be"); Secon Serv. Sys., Inc. v. St. Joseph Bank & Trust Co., 855 F.2d 406, 411 (7th Cir. 1988) (denying use of economic reality test because instruments "aren't labeled securities, nor do they have the primary characteristic of securities," and hence it is facially clear that they are not securities); Penturelli v. Spector, Cohen, Gadon & Rosen, Attorneys at Law, P.C., 779 F.2d 160, 164-67 (3d Cir. 1985) (holding that because fractional undivided working interests at issue were specifically enumerated in Acts as "securities," the economic reality test was inappropriate). *But see* Matassarin 174 F.3d at 560 (applying *Howey* test to employee stock ownership plan, even though the ESOP document itself used the terms "stock" and "security"); Kyle M. Globerman, Note, *The Elusive and Changing Definition of a Security: One Test Fits All*, 51 FLA. L. REV. 271, 306-18 (1999) (suggesting that *Howey* test should

Howey involved an investment scheme in which purchasers were offered orange grove land together with warranty deeds and service contracts.[189] Although sales contracts for orange grove land are not enumerated under either the 1933 or 1934 Act, the Supreme Court concluded that the combination of the land and service contracts produced a transaction that essentially created an "investment contract" under federal securities law.[190] The Court identified four elements of the transaction that established it as an investment contract: (i) the investment of money, (ii) in a common enterprise, (iii) with an expectation of profits, (iv) derived solely through the efforts of others.[191] In a civil action under the anti-fraud provisions of the 1933 and 1934 Acts, if the instruments in question are not readily identifiable as securities, the government must satisfy all four elements to prove that the investment contract is a security.[192]

i. Investment of Money

The first prong of the *Howey* test requires that the contract involved an investment of money. In *Howey*, the plaintiffs made cash investments, but courts have found that goods and services[193] and promissory notes[194] also satisfy the money requirement. Courts apply a liberal construction of "investment of money" and generally look to whether the investor has subjected herself to financial loss by committing assets to the enterprise.[195]

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be uniformly applied in all instances to determine whether an instrument of transaction is a security under the 1933 and 1934 Acts).

189. *Howey*, 328 U.S. at 300.

190. *Id.*

191. *Id.*

192. Many circuits compress the four factors from *Howey* into three so that the third factor requires that the investment contract is entered into "with an expectation of profits to be derived solely from the efforts of the promotor or a third party." *SG Ltd.*, 265 F. 3d at 46.

193. *See Int'l Bhd. of Teamsters*, 439 U.S. at 560 n.12 (stating that the investment is not required to "take the form of cash only, rather than of goods and services" to constitute an investment contract). This principle, however, does not apply to services rendered as active involvement in the subject of investment. *See Howey*, 328 U.S. at 298-99 (holding that investment contract requires, *inter alia*, that investor expect profit "solely from the efforts of the promoter or a third party").

194. *See* Hector v. Wiens, 533 F.2d 429, 432-33 (9th Cir. 1976) (holding that plaintiff's investment in livestock and feed by promissory note constituted "investment in money").

195. *Id.* at 433 (holding that plaintiff made "investment in money" by giving promissory note to bank because when investment failed, plaintiff was still liable on note and subject to financial loss). *See also SG Ltd.*, 265 F. 3d at 48-49 (rejecting defendant corporation's defense that "investment of money" prong was not satisfied because share purchasers were paying for an entertainment commodity to play an interactive Internet game, rather than investing money in return for rights in virtual shares); *Matassarin*, 174 F.3d at 561 (holding that an employee stock ownership plan did not satisfy "investment of money" prong because ownership plan was "not a voluntary investment choice, but instead a mandatory, employer-funded program" (citing *Uselton v. Commercial Lovelace Motor Freight*, 940 F.2d 564, 576-77 (10th Cir. 1991))).

ii. A Common Enterprise

The second prong of the *Howey* test focuses on the extent to which the success of an individual investor is intertwined with the success or failure of the other parties involved in the enterprise. The circuit courts have struggled to define what is necessary to satisfy the common enterprise element and differ in their approaches to this prong of the test. The First, Third,[196] Sixth, Seventh, and the District of Columbia Circuits[197] have adopted the horizontal approach, under which the investors' funds must be pooled or their returns must fluctuate together for the investment to constitute a common enterprise.[198] As one commentator notes, "the horizontal test finds a common enterprise if multiple investors pool their funds in an investment, and the profits of each investor correlate with those of the other investors."[199]

Other circuits have adopted the less demanding vertical commonality approach to the analysis of common enterprise. Vertical commonality does not require the existence of multiple investors whose interests are pooled, nor does it require that investors' fortunes rise and fall together. Rather, vertical commonality "focuses on the relationship between the promoter and the body of investors."[200]

Vertical commonality is either narrow or broad. The narrow vertical approach requires that the fortunes of the investor be "interwoven with and dependent on the

196. The Third Circuit has yet to decide whether it will also adopt a vertical commonality analysis. *Infinity Group*, 212 F.3d at 188 n.8 (using horizontal commonality, but declining to address whether to also adopt vertical commonality).

197. The D.C. Circuit has likewise consistently applied the horizontal commonality test, but has not explicitly rejected vertical commonality. *See* SEC v. Banner Fund Int'l, 211 F.3d 602, 615 (D.C. Cir. 2000) (finding a common enterprise based on pooled investments and profit and loss sharing); *Life Partners, Inc.*, 87 F.3d at 544 (holding that because transaction was common enterprise under horizontal commonality test, court need not inquire whether it satisfied vertical commonality test "recognized in some circuits").

198. *See SG Ltd.*, 265 F.3d at 52-53 (adopting expressly horizontal commonality test, but declining "to resolve . . . fact-sensitive questions in the context of a Rule 12(b)(6) motion" and instead finding that SEC's claim that virtual stocks were part of a Ponzi scheme provides the "requisite profit-and-risk sharing to support a finding of horizontal commonality"); *Infinity Group*, 212 F.3d at 191 (adopting a "totality of the circumstances" approach to find that, because property transfer contract investment schemes satisfied horizontal commonality and because contracts possessed intrinsic characteristics of securities, such contracts were securities); *Banner*, 211 F.3d at 614 (finding that an investment scheme where investors' funds were placed in individual trusts before being pooled satisfied the horizontal commonality requirement under *Howey*); Wals v. Fox Hills Dev. Corp., 24 F.3d 1016, 1018 (7th Cir. 1994) (requiring horizontal commonality, in addition to vertical commonality, in time-share condominium scheme); Newmyer v. Philatelic Leasing Ltd., 888 F.2d 385, 394 (6th Cir. 1989) (holding that "there must also be a horizontal relationship between or among investors, with the funds of two or more investors going into a common pool from which all may benefit"); *see also Matassarin*, 174 F.3d at 561 (using horizontal commonality test to reject the plaintiff's claim that an employee stock ownership plan was a security).

199. Marc G. Alcser, Comment, *The Howey Test: A Common Ground for the Common Enterprise Theory*, 29 U.C. DAVIS L. REV. 1217, 1226 (1996) (discussing the different approaches to the *Howey* test's common enterprise element and advocating a uniform definition to ensure consistent enforcement).

200. Revak v. SEC Realty Corp., 18 F.3d 81, 87 (2d Cir. 1994) (finding condominium transaction was not investment contract (citing SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 479 (5th Cir. 1974))).

efforts and success of those seeking the investment or of third parties."[201] In other words, it must be possible to infer that both the manager's and the investor's fortunes would increase if the venture proved successful and decrease if the venture suffered a setback. The Ninth and Eleventh Circuits follow the narrow vertical approach.[202]

The Fifth Circuit has adopted the broad vertical approach, also known as the "resilient standard."[203] Under this approach, a "common enterprise" exists whenever the investor's success is linked to the promoter's expertise or efforts, but not necessarily to the promoter's success.[204] Some courts have criticized broad vertical commonality because it essentially eliminates the need for the fourth element of the *Howey* test, which requires that profits be derived from the efforts of others.[205]

In the Second Circuit, horizontal commonality remains a viable test, but narrow vertical commonality is also acceptable.[206] The Fourth Circuit permits plaintiffs to use the horizontal commonality test to prove a common enterprise, but the status of the vertical commonality test remains unclear.[207]

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201. Villeneuve v. Advanced Bus. Concepts Corp., 698 F.2d 1121, 1124 (11th Cir. 1983) (finding that common enterprise element exists where promoter's failure to provide certain services would determine the success or failure of the investment (quoting SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476, 482 n.7 (9th Cir. 1973))), *aff'd*, 730 F.2d 1403 (11th Cir. 1984) (en banc).

202. *See* SEC v. Unique Fin. Concepts, 196 F.3d 1195, 1200 (11th Cir. 1999) (acknowledging the circuit's adoption of the vertical approach and stating that non-pooling of funds is not decisive); *Eurobond Exch.*, 13 F.3d at 1339 (holding that transaction involving purchase of foreign treasury bonds and low interest loans constituted investment contract regulated under federal securities law).

203. *See* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 478 (5th Cir. 1974) (holding that "the critical factor is not the similitude or coincidence of investor input, but rather the uniformity of impact of the promoter's efforts"); SEC v. Continental Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974) (holding pooling ingredient is not necessary to establishing common enterprise). *But see Matassarin*, 174 F.3d at 561 (adopting horizontal commonality test to find that employee stock ownership plans were not securities).

204. *See* Long v. Shultz Cattle Co., 881 F.2d 129, 141 (5th Cir. 1989) (holding that common enterprise may be demonstrated by investors' collective reliance on promoter's expertise, even where promoter receives flat fee rather than share of profits). There is reason to believe, however, that the Fifth Circuit may soon adopt a more narrow approach to the common enterprise prong. *See* Long v. Shultz Cattle Co., Inc., 896 F.2d 85-86 (5th Cir. 1990) (noting that Fifth Circuit's approach to determining "common enterprise" is "at odds with the stricter approaches taken in other circuits," but denying rehearing for reconsideration of this issue).

205. *See Revak*,18 F.3d at 89 ("If a common enterprise can be established by the mere showing that the fortunes of the investors are tied to the efforts of the promoter, two separate questions posed by *Howey* . . . are effectively merged into a single inquiry."); Copeland v. Hill, 680 F. Supp. 466, 468 (D. Mass. 1988) (rejecting broad vertical commonality approach because its effect is to merge the second and third prongs of *Howey* test).

206. *See Revak*, 18 F.3d at 87 (2d Cir. 1994) (recognizing strict vertical commonality, but asserting that horizontal commonality is ordinarily sufficient to satisfy enterprise requirement).

207. *See Teague*, 35 F.3d at 986 (holding horizontal commonality existed and noting that district court need not determine vertical commonality once horizontal commonality is found); SEC v. Pinckney, 923 F. Supp. 76, 82 (E.D.N.C. 1996) (surveying law on commonality issue in Fourth Circuit and finding that vertical commonality is sufficient to establish existence of common enterprise).

District courts in the Eighth[208] and Tenth Circuits[209] have used various approaches; therefore, it is uncertain which test or tests will be adopted in these circuits. The Tenth Circuit, however, has indicated that horizontal commonality is not a rigid requirement in that circuit.[210]

iii. Expectation of Profits

To meet the third prong of the *Howey* test, the investor must lay out some form of consideration with the expectation to gain a profit or return on that investment. This "expectation of profits" element can be satisfied by either capital appreciation or participation in earnings on invested funds.[211] While tax benefits from losses are insufficient to satisfy this prong,[212] if an expectation of profits exists apart from any prospect of tax benefits, then the element is met.[213] Investment schemes with no risk of loss usually fail this prong of the *Howey* test.[214] Plans to restructure pre-existing obligations, for example, do not constitute an underwriting of new risk for profit, and are therefore not investment contracts.[215]

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208. *Compare* Marshall v. Lamson Bros. & Co., 368 F. Supp. 486, 489 (S.D. Iowa 1974) (applying broad vertical commonality approach), *with* Fargo Partners v. Dain Corp., 405 F. Supp. 739, 742–43 (D.N.D. 1975) (applying narrow vertical commonality approach).

209. *Compare* Rother v. La Renovista Estates, Inc., 603 F. Supp. 533, 538 (W.D. Okla. 1984) (applying horizontal commonality approach), *with* Walsh v. Int'l Precious Metals Corp., 510 F. Supp. 867, 871 (D. Utah 1981) (applying narrow vertical commonality).

210. *See* McGill v. Am. Land & Exploration Co., 776 F.2d 923, 925 (10th Cir. 1985) (rejecting notion that horizontal commonality is required by *Howey*).

211. *See United Hous. Found.*, 421 U.S. at 853 (finding "expectation of profits" prong of the *Howey* test was not satisfied and thus cooperative housing transaction was not covered by securities laws because investors were motivated by prospect of acquiring place to live, not return on their investments); *cf. SG Ltd.*, 265 F.3d at 54 (finding that "[w]hile SG's use of gaming language is roughly analogous to the cooperative's emphasis [in *Forman*] on the nonprofit nature of the . . . endeavor, SG made additional representations on its website that . . . fueled expectations of profit" so that the "expectation of profit" prong was satisfied).

212. *See* Newmyer v. Philatelic Leasing, Ltd., 888 F.2d 385, 394 (6th Cir. 1989) (holding that deductions and credits promised under tax shelter scheme do not satisfy *Howey*'s profit requirement).

213. *See* SEC v. Goldfield Deep Mines Co., 758 F.2d 459, 464 (9th Cir. 1985) (finding that prospect of tax benefits resulting from initial losses does not necessarily detract from expectation of profits).

214. *See* Guidry v. Bank of LaPlace, 954 F.2d 278, 284 (5th Cir. 1992) (addressing situation where plaintiff gave operator of scheme a check in return for two post-dated checks, one in amount of investor's check and another representing return on that amount); First Citizens Fed. Sav. & Loan Ass'n v. Worthen Bank & Trust Co., 919 F.2d 510, 515 (9th Cir. 1990) (using "risk capital" approach in determining status of investment contract as security); Banghart v. Hollywood Gen. P'ship, 902 F.2d 805, 808 (10th Cir. 1990) (holding that presumption against finding security exists when partnership agreement allocates powers to general partners to extent that they can protect their own investment); Gordon v. Terry, 684 F.2d 736, 741 (11th Cir. 1982) (holding contract that left investor in control of probability of investment was not security); Heine v. Colton, Hartnick, Yamin & Sheresky, 786 F. Supp. 360, 370 (S.D.N.Y. 1992) (ruling *Howey* test not satisfied in scheme where investor made payments in return for series of post-dated checks amounting to return on investment and return of principal risked no loss).

215. *See* Allen v. Lloyd's of London, 94 F.3d 923, 930–31 (4th Cir. 1996) (finding that plan to reinsure prior obligations was not investment contract because offerees could not expect profit).

iv. Solely Through the Efforts of Others

The fourth prong of the *Howey* test requires that efforts put forth in the transaction come primarily from the promoter or third party.[216] In *Howey*, for example, the purchase of orange groves together with service contracts was ultimately deemed a security because the promoters had committed to making the orange groves productive.[217] If the investors had been required to tend the orange groves themselves, the Court would not have found the land contracts to be an "investment contract" under the securities laws.[218]

Despite early judicial emphasis on adhering to a literal application of the *Howey* test,[219] most courts have since adopted a functional and realistic approach to the definition of "solely," and find the term satisfied by significant managerial efforts on the part of the promoter.[220] Notably, the Supreme Court has tacitly omitted the word "solely" from its restatement of the *Howey* test in subsequent opinions.[221] The critical inquiry has thus become "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[222]

To determine whether investors expected profits solely from the efforts of a promoter or third party, courts look at general partnership documents, incorporation documents, or contractual documents because these materials often elucidate

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216. *See* SEC v. Int'l Loan Network, Inc., 968 F.2d 1304, 1318 (D.C. Cir. 1992) (finding the fourth prong satisfied because investors in pyramid sales program expected profits to accrue predominantly from the efforts of the downline members and operators of the program). *Compare Eurobond Exch*, 13 F.3d at 1341 (finding that the efforts of the promoter, not market movements, were responsible for any profits derived from an interest-rate sensitive scheme), *with* SEC v. Belmont Reid & Co., 794 F.2d 1388, 1390-91 (9th Cir. 1986) (failing to find that profits from sale of gold coins were through the efforts of others, but rather were a result of movements in the market).

217. *Howey*, 328 U.S. at 300.

218. *Id.* A dispositive factor in the case was that the purchasers "reside[d] in distant localities and . . . lack[ed] the equipment and experience requisite to the cultivation, harvesting and marketing of the citrus products." *Id.*

219. *See* Hirsch v. du Pont, 396 F. Supp. 1214, 1218-20 (S.D.N.Y. 1975) (applying *Howey*'s fourth prong literally).

220. *See* Steinhardt Group Inc. v. Citicorp, 126 F.3d 144, 153 (3d Cir. 1997) (refusing to read term "solely" literally); *Int'l Loan Network*, 968 F.2d at 1308 (requiring only that efforts be "predominantly" made by others); Bailey v. J.W.K. Props., Inc., 904 F.2d 918, 920-21 (4th Cir. 1990) (requiring that the "most essential functions or duties must be performed by others and not the investor"); *Morse*, 785 F.2d at 776 (rejecting narrow construction of "solely through the efforts of others"); Union Planters Nat'l Bank of Memphis v. Commercial Credit Bus. Loans, Inc., 651 F.2d 1174, 1181 n.9 (6th Cir. 1980) (omitting word "solely" from its restatement of *Howey's* fourth prong); *Goodman*, 582 F.2d at 408 n.59 (stating that "solely" "should not be read as a strict or literal limitation on the definition of an investment contract" (quoting SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476 (9th Cir. 1973))); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 479 (5th Cir. 1974) ("[A] literal application of the *Howey* test would frustrate the remedial purposes of the Act.").

221. *E.g.*, *United Hous. Found.*, 421 U.S. at 858 ("What distinguishes a security transaction . . . is an investment where one parts with his money in the hope of receiving profits from the efforts of others.").

222. SEC v. Glenn W. Turner Enters., Inc. 474 F.2d 476, 482 (9th Cir. 1973) (holding that fourth prong is met even though investor "must himself exert some efforts if he is to realize a return on his initial case outlay"); *see also SG Ltd*, 265 F.3d at 55 (explaining that "courts of appeals have been unanimous in declining to give literal meaning to the word 'solely'").

the relationship between promoters and investors and demonstrate whether the promoter's efforts will create a profit for all parties or whether the purchaser's own efforts will be generating the profit.[223] Courts may also look beyond written agreements with investors to promotional materials, oral representations by promoters at the time of investment, and/or the practical possibility of investors exercising powers pursuant to agreements with investors.[224]

2. *Definitions of "Offer" and "Sale": The 1933 Act*

The 1933 Act does not restrict the definitions of "offer" and "sale" to the actual negotiation and transfer of title to stock.[225] Section 2(3) of the 1933 Act reads in pertinent part:

> [t]he term "sale" or "sell" shall include every contract of sale or disposition of a security, or interest in a security, for value. The term "offer to sell," "offer for sale," or "offer" shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.[226]

The Supreme Court attempted to clarify the meanings of these terms in *Rubin v. United States*.[227] The issue in *Rubin* was whether a pledge of stock as collateral for a bank loan was an offer or sale within the meaning of section 17(a) of the 1933 Act.[228] The Court concluded that, although title to the stock never actually

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223. *See id.* (finding the fourth element satisfied when defendant issuer advertised lack of investor effort required to make profits on share purchases of a virtual privileged company); Albanese v. Fla. Nat'l Bank of Orlando, 823 F.2d 408, 410 (11th Cir. 1987) (stating that "the crucial inquiry is the amount of control that the investors retain under their written agreements"). With certain limited exceptions, general partnerships are not considered securities. *See* Goodwin v. Elkins & Co., 730 F.2d 99 (3d Cir. 1984) (holding that general partnership agreement formed pursuant to Uniform Partnership Act does not constitute security). In *Williamson*, the Fifth Circuit stated that:

> [a] general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (i) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (ii) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (iii) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.

645 F.2d at 424; *see also* Hocking v. Dubois, 885 F.2d 1449, 1460 (9th Cir. 1989) (adopting *Williamson* test).

224. *See Eurobond Exch.*, 13 F.3d at 1341 (noting promotional materials for the transaction stressed that profits would come from expertise and efforts of promoter); Koch v. Hankins, 928 F.2d 1471, 1478 (9th Cir. 1991) (holding that in determining whether investors in general partnerships expected profits solely from efforts of promoters, court's inquiry can extend into "other factors" beyond the scope of formal agreements).

225. 15 U.S.C. § 77q(a) (2000) (making it unlawful for "any person in the offer or sale of any securities" to engage in fraud or deceit).

226. 15 U.S.C. § 77b(3) (2000).

227. 449 U.S. 424 (1981).

228. *Id.* at 425-27. Rubin was convicted of conspiracy to violate the fraud provision of section 17(a) of the 1933 Act by making misrepresentations to a bank concerning the value of stock pledged as collateral for loan. *Id.*

changed hands, the stock pledge "unmistakably involve[d] a 'disposition of interest in a security, for value,'" and therefore, constituted a "sale" under the 1933 Act.[229] Thus, under section 2(3), a transfer of title need not occur for the transaction to be deemed a "sale."[230]

3. Definitions of "Purchase" and "Sale": The 1934 Act[231]

The definitions of "purchase" and "sale" in the 1934 Act are broader than the definitions of "offer" and "sale" in the 1933 Act.[232] Section 78c(a)(13) of the 1934 Act defines the terms "buy" and "purchase" to include "any contract to buy, purchase or otherwise acquire" a security.[233] Similarly, section 78c(a)(14) defines "sell" and "sale" to include "any contract to sell or otherwise dispose of" a security.[234] Courts construe these terms broadly to reflect the congressional intent in adopting the 1934 Act, while still adhering to the language of the section.[235] Moreover, in determining the meaning of "purchase" or "sale" in particular cases, courts have focused on the economic substance of the transaction, not its form.[236]

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at 424. Rubin represented the stock as having $1.7 million in value when, in fact, the stock was practically worthless. *Id.* at 426.

229. *Id.* at 429 (holding that although pledges transferred less than absolute title, interest pledge transferred was nonetheless "interest in a security"); *see also* Pinter v. Dahl, 486 U.S. 622, 643 (1988) (stating potential liability under federal securities acts is not limited to persons who pass title). *But see* Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 179 (1994) ("[N]one of the express causes of action in [the federal securities acts] further imposes liability on one who aids or abets a violation.").

230. *Rubin*, 449 U.S. at 429-30.

231. 15 U.S.C. § 78a (2000). The issues surrounding what constitutes a "purchase" or "sale" are most common in civil suits because only actual buyers and sellers of securities have standing under section 10(b) and Rule 10b-5 to bring private suits. *See O'Hagan*, 521 U.S. at 664 (discussing standing under section 10(b) for civil actions). This confined standing requirement for civil suits was instituted for policy reasons. The Supreme Court recognized "the abuse potential and proof problems inherent in suits by investors who neither bought nor sold, but asserted they would have traded absent fraudulent conduct." *Id.* (discussing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)). However, the purchaser/seller requirements for standing in private actions have "no import in criminal prosecutions for willful violations" of section 10(b) or Rule 10b-5. *Id.* (O'Connor, J. concurring in part and concurring in the judgment (quoting Holmes v. Sec. Investor Prot. Corp., 503 U.S. 258, 280 (1992))).

232. *See Chemical Bank*, 726 F.2d at 940 n.17 (discussing drafting and construction of broad definition of terminology in 1934 Act that gives same legal effect to conversation and action resulting from conversation).

233. 15 U.S.C. § 78c(a)(13) (2000).

234. 15 U.S.C. § 78c(a)(14) (2000). The term "sale," defined in this manner, embraces the concept of an offer. *See* Pfohl v. Pelican Landing, 567 F. Supp. 134, 138 (N.D. Ill. 1983).

235. *See Reves*, 494 U.S. at 61 (holding Congress did not intend Securities Acts "to provide a broad remedy for all fraud" (quoting Marine Bank v. Weaver, 455 U.S. 551, 556 (1982))); *Pinter*, 486 U.S. at 653 (stating ultimate question for court is one of congressional intent; nevertheless, the Securities Acts' broad remedial goals are insufficient justification for interpreting specific provision more broadly than its language and statutory scheme reasonably permit).

236. *See Reves*, 494 U.S. at 61 (holding court is not bound by legal formalisms, but rather, should take into account economics of transactions); *Pinter*, 486 U.S. at 653 (stating securities law provisions should be construed flexibly, not technically or restrictively, to effectuate their remedial intent); *cf. Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. at 558-59 (holding courts must look at substance and economic realities of transaction and not formal labels employed by parties themselves in deciding whether financial relationship constitutes investment contract).

Unlike the 1933 Act, the words "for value" do not appear in the 1934 Act definition of a "sale," indicating that consideration is not required for a transaction to be deemed a sale under the 1934 Act.[237] To determine whether a sale has taken place in transactions falling outside of the traditional "cash-for-stock" purview, courts have inquired as to whether the particular transaction is one that gives rise to speculative abuse.[238]

Courts have reviewed numerous transactions to determine whether a purchase or sale has occurred. For example, the purchase or sale by a corporation of its own securities constitutes a purchase or sale under the Act.[239] Similarly, interests acquired through mergers,[240] acquisitions,[241] and other forms of corporate reorganization[242] are also deemed securities. However, the spin-off of a subsidiary into a

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But cf. Commodity Futures Trading Com'n v. Vartuli, 228 F.3d 94, 101 (2d Cir. 2000) (holding fraud was not "in connection" with a sale of security to meet Rule 10b-5 requirement because plaintiff was deceived about investment in commodity futures, but not about the value of securities sold or consideration received in return (citing Saxe v. E.F. Hutton & Co., 789 F.2d 105, 108 (2d Cir. 1986))); *Chemical Bank*, 726 F.2d at 943 (focusing on form of transaction where misrepresentations were made in course of securities transaction but did not directly pertain to securities, and finding not actionable under Rule 10b-5).

237. *See* Broad v. Rockwell Int'l Corp., 614 F.2d 418, 437-38 (5th Cir. 1980) (omitting consideration from factors used to analyze "purchase or sale" requirement); Int'l Controls Corp. v. Vesco, 490 F.2d 1334, 1346 (2d Cir. 1974) (holding rote emphasis on consideration is inconsistent with broad protections afforded by section 10-b); Gelles v. TDA Industries, Inc., 1993 WL 275216, at *5-*6 (S.D.N.Y. July 16, 1993); Seolas v. Bilzerian, 951 F. Supp. 978, 985 (D. Utah 1997) ("However, following the lead of several other jurisdictions, the court concludes that an exchange of value or consideration, while helpful to establish a purchase or sale, is not determinative."). *But see* 7547 Corp. v. Parker & Parsley Dev. Partners, 38 F.3d 211, 223 (5th Cir. 1994) (explaining that definition of sale under Act is "generally incorporated to include exchanges of one security for another" under 1933 Act). *See generally* Phillips v. LCI Int'l, Inc., 190 F.3d 609, 614 (4th Cir. 1999) (finding that violation of securities laws should not rest on technical and narrow definitions of sale).

238. "Speculative abuse" refers to the potential for abuse of inside information. *See, e.g.*, Gwozdzinsky v. Zell/Chilmark Fund, L.P., 156 F.3d 305, 310 (2d Cir. 1998) (explaining speculative abuse is a threshold matter because it is not necessary to determine if transaction falls within scope of section 16(b) if speculative abuse is not found).

239. *See* Frankel v. Slotkin, 984 F.2d 1328, 1333-34 (2d Cir. 1993) (finding corporation, as seller of its own securities, suffers independent injury sufficient to support action for damages under section 10(b) and Rule 10b-5 when fraudulently induced to issue stock for less than fair market value); Pittsburgh Terminal Corp. v. Balt. & Ohio R.R., 680 F.2d 933, 940 (3d Cir. 1982) (holding conversion option in convertible debentures qualifies as contract for purchase or sale of securities); Rochelle v. Marine Midland Grace Trust Co., 535 F.2d 523, 528 (9th Cir. 1976) (holding the same for reacquisition of debentures). *But see* Page Mill Asset Mgmt. v. Credit Suisse First Boston Group, 2000 WL 335557, at *11 (S.D.N.Y. Mar. 30, 2000) (claiming that as to convertible bonds, *Pittsburgh Terminal Corp.* does not state majority rule (citing Lorenz v. CSX Corp., 1 F.3d 1406, 1417 (3d Cir. 1993))); Northland Capital Corp. v. Silver, 735 F.2d 1421, 1427 (D.C. Cir. 1984) (holding no purchase of securities occurs in absence of agreement over essential terms of purchase).

240. *See* SEC v. Nat'l Sec. Inc., 393 U.S. 453, 467 (1969) (holding shareholders "purchase" shares in the new entity by exchanging them for their old stock when merger occurs). *But see* Goldberg v. Hankin, 835 F. Supp. 815, 817 (E.D. Pa. 1993) (finding Rule 10b-5 inapplicable if merger involves only internal corporate reorganization), *aff'd*, 30 F.3d 1486 (3d Cir. 1994).

241. *See Seolas*, 951 F. Supp. at 984–85 (finding transfer of securities from security holder to issuing corporation constitutes purchase or sale).

242. *See* JACOBS, *supra* note 19, § 117.02 (discussing corporate reorganizations).

separate company is not considered a sale of securities.[243] Furthermore, courts have held that conditional obligations to purchase or sell are not actionable.[244] Inducement to *retain* a security is generally not actionable, regardless of whether the inducement was fraudulent.[245]

C. *Use of Interstate Commerce or the Mails*

The jurisdictional requirement necessary to bring a violation within the scope of federal securities law is the "use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange."[246] To satisfy this requirement for section 17(a) of the 1933 Act, the transaction must be "in interstate commerce."[247] For section 10(b) of the 1934 Act, the requirement is more easily met through "intrastate use of . . . [an] interstate means of communication, or any other interstate instrumentality."[248] Interstate communications can be between any persons involved in the fraudulent act, including between codefendants.[249] Use of any means of interstate transportation will satisfy either statute.[250] Finally, this use need only be incidental to bring the action within federal jurisdiction.[251]

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243. *See* Isquith v. Caremark Int'l Inc., 136 F.3d 531, 534 (7th Cir. 1998) (holding defendants not liable for misrepresenting purpose of spin-off because it was merely an involuntary change in the form of their original investment, not the purchase or sale of securities).

244. *See* Atari Corp. v. Ernst & Whinney, 970 F.2d 641, 645 (9th Cir. 1992) (finding a party under federal securities law is not committed to purchasing securities while the party's obligation to perform under the purchase agreement remains conditional), *amended on reh'g*, 981 F.2d 1025, 1029 (9th Cir. 1992).

245. *See* Krim v. BancTexas Group, 989 F.2d 1435, 1443 (5th Cir. 1993) (holding mere retention of securities in reliance on material misrepresentations or omissions does not form basis for section 10(b) or Rule 10b-5 claim). *But cf.* Marbury Mgmt., Inc. v. Kohn, 629 F.2d 705, 709-10 (2d Cir. 1980) (finding false statements made by defendant that he was broker and portfolio management specialist were actionable under section 10(b) upon showing they led to purchase and retention of stock in reliance on defendant's expertise).

246. 15 U.S.C. § 78j (2000); *see* United States v. Kunzman, 54 F.3d 1522, 1527 (10th Cir. 1995) (holding use of interstate highways, air travel, and checks deposited and drawn from bank involved in interstate commerce all met jurisdiction requirements for section 78j).

247. 15 U.S.C. § 77q(a) (2000); *see Ashdown*, 509 F.2d at 799 (holding mail must be used in employing fraudulent act, although such use may be incidental (citing *Schaefer*, 299 F.2d at 629-30)).

248. 15 U.S.C. § 78c(a)(17) (2000); *see* Gower v. Cohn, 643 F.2d 1146, 1151 (5th Cir. 1981) (holding one intrastate telephone call is sufficient to constitute use of interstate instrumentality).

249. *See* McLaury v. Duff & Phelps, Inc., 691 F. Supp. 1090, 1095 (N.D. Ill. 1988) (holding that fraud need not be committed during use of interstate commerce so long as use is in connection with fraudulent scheme). *See generally* United States v. Gilbert, 181 F.3d 152, 158 (1st Cir. 1999) (citing *Kunzman* for proposition that Congress can regulate intrastate activities involving use of instrumentality under federal securities laws as long as instrumentality used is itself an integral part of an interstate system).

250. *See Kunzman*, 54 F.3d at 1527 (finding use of interstate highways and air travel constitute interstate commerce).

251. *See McLaury*, 691 F. Supp. at 1095 (holding clearance of check used to purchase stock satisfied interstate commerce requirement even though check never left the state, because system of clearing checks is sufficiently integrated into the national banking system); *see also* Kline v. Henrie, 679 F. Supp. 464, 469 (C.D. Pa. 1988) (finding use of interstate commerce element met even though first alleged use of the mails did not occur until after plaintiff purchased stock).

The Acts' jurisdictional requirements also play a role in determining the number of counts that may be brought against a violator. Under section 78j(b) of the 1933 Act, defendants making several mailings all based on one transaction are not subject to multiple charges.[252] However, under section 77q(a), a defendant may be charged multiple times for the same fraudulent scheme if more than one offer or sale was made as part of that scheme.[253]

III. DEFENSES

There are two broad categories of securities fraud defenses: intent-based defenses and reliance-based defenses. Intent-based defenses attempt to show that the defendant acted without scienter,[254] while reliance-based defenses attempt to show that no market participant relied upon the defendant's omissions or misrepresentations in deciding to purchase or sell a security.[255]

A. *Intent-Based Defenses*

To successfully prosecute a securities fraud action under section 32(a) of the 1934 Act, the government must prove that a defendant willfully committed a particular act.[256] Thus, a typical defense to a securities fraud charge begins with a denial that the defendant carried out any violations with a criminal or fraudulent purpose.[257]

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252. *Schlei*, 122 F.3d at 978 ("[E]ach count of the indictment must be based on a separate purchase or sale of securities and each count must specify a false statement of material fact—not a full-blown scheme to defraud—in connection with that purchase or sale." (citing United States v. Langford, 946 F.2d 798, 804 (11th Cir. 1991))). *But see* United States v. Mackay, 491 F.2d 616, 619 (10th Cir. 1973) (finding similarity between requirements of securities and mail fraud and holding that "each mailing is regarded as a separate crime even though it relates to essentially the same fraudulent scheme").

253. *See Schlei*, 122 F.3d at 978 (stating the appropriate unit for prosecution under section 77q(a) is each separate "offer or sale of a security in connection with an instrumentality of interstate commerce").

254. *See, e.g., Teicher*, 987 F.2d at 121 (describing defendants' intent-based defense as an assertion that "they either did not *know* the information was material or non-public or did not *know* the information to be wrongfully obtained").

255. *See, e.g.*, Glassman v. Computervision Corp., 90 F.3d 617, 626 (1st Cir. 1996) (holding because price is only a forecast of future performance, an investor cannot rely on price that in hindsight is not realized (citing Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 516 (7th Cir. 1989) (applying ex ante approach to find that failure to disclose fact that application for nuclear reactor license was pending did not violate federal securities law because market had in its possession all significant information about electric utility))).

256. 15 U.S.C. § 78ff(a) (2000).

257. *See* Jed S. Rakoff & Stanley S. Arkin, *Defense of a Securities Case, in* 3 CRIMINAL DEFENSE TECHNIQUES § 56.02[3] (Steven W. Allen et al. eds., 1991). Jed S. Rakoff is a judge on the United States Court of Appeals for the Second Circuit who has decided many leading securities fraud cases. *See, e.g., In re* Int'l Bus. Machs. Corp. Lit., 163 F.3d 102, 109 (2d Cir. 1998) (holding defendant's statements regarding future dividends not actionable under "bespeaks caution" doctrine).

1. *Lack of Fraudulent Intent*

A defendant may vitiate a government securities fraud allegation by arguing that she did not "willfully" violate the securities laws and, therefore, lacked the requisite fraudulent intent.[258] Acting willfully has been defined as acting "deliberately and intentionally . . . [where] acts, statements or omissions were not the result of innocent mistake, negligence or inadvertence or other innocent conduct."[259] Defendants relying on a "lack of fraudulent intent" defense portray the alleged offenses as technical violations of a complex statutory scheme, rather than willful violations of law.[260] Deliberate ignorance of the true nature of the activity, however, is not a defense to a securities law violation.[261]

To satisfy the willfulness requirement, the prosecution must show "that the act [was] wrongful under the securities laws and that the knowingly wrongful act involve[d] a significant risk of effecting the violation that has occurred."[262] However, the prosecution does not have to prove a specific intent to violate the law; a violation may be willful regardless of whether the defendant knew of the particular rule or regulation that she violated.[263] Finally, some cases suggest that

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258. *See* United States v. Berger, 188 F. Supp. 2d 302 (S.D.N.Y. 2002) ("[I]t is clear that the Government would have to prove that Berger 'willfully' violated Rule 10b-5 to obtain a conviction."). *See generally* Brian J. Carr, Note, *Culpable Intent Required for All Criminal Insider Trading Convictions After* United States v. O'Hagan, 40 B.C. L. REV. 1187 (1999) (discussing Supreme Court's emphasis on "culpable intent" as requirement for criminal conviction under securities regulations).

259. *See* United States v. Lincecum, 225 F.3d 647 (2d Cir. 2000) (finding that government need not prove a defendant intended to cause harm to victim of securities fraud, but government must show that defendant intended to deceive, manipulate, or defraud (citing *Dixon*, 536 F.2d at 1396 (approving lower court's jury instructions defining willfulness))).

260. *See* Rakoff & Arkin, *supra* note 257, § 56.02[3]. The irony of a securities fraud prosecution centering on the intent of the defendant is that an intent-based defense mirrors the common law fraud defense, but the securities laws were promulgated to ease the restrictiveness of common law fraud prosecutions. *See* United States v. Harris, 185 F.3d 999, 1005 (9th Cir. 1999) (example of common law fraud defense); Rakoff & Arkin, *supra* note 257, § 56.02[3]. *See generally* John F.X. Peloso, *The Criminalization of Securities Laws*, N.Y. L.J., May 28, 1987, at 1 (discussing distinction between criminal and civil violations of securities laws).

261. *See Schlei*, 122 F.3d at 973 ("[D]eliberate ignorance [jury] instruction is appropriate where the facts . . . support the inference that the defendant was aware of a high probability of existence of the fact in question and purposely contrived to avoid learning all of the facts in order to have a defense in the even of prosecution."); *see also* United States v. DeVeau, 734 F.2d 1023, 1028 (5th Cir. 1984) (holding deliberate ignorance may constitute willfulness); United States v. Natelli, 527 F.2d 311, 323 (2d Cir. 1975) (holding defendants may not plead ignorance "when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess" (citation omitted)).

262. Metromedia Co. v. Fugazy, 983 F.2d 350, 364 (2d Cir. 1992) (determining willfulness standard for criminal liability under section 24 of 1933 Act the same as that for section 32(a) of 1934 Act (quoting *Peltz*, 433 F.2d at 55)).

263. *See* Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (rejecting suspended broker's claim that he did not engage in "willful" conduct because he did not know his conduct was breaking the law); United States v. DeSantis, 134 F.3d 760, 764 (6th Cir. 1998) (holding defendant must have intent to defraud, meaning misrepresentations and omissions must be made knowingly and for purpose of inducing action that otherwise would not have been taken); *Peltz*, 433 F.2d at 54 ("[A] person can willfully violate an SEC rule even if he does not know of its existence.").

the government's burden of proving intent may be met using only circumstantial evidence.[264]

Alternatively, defendants may demonstrate a lack of intent by presenting evidence of a pre-existing plan to trade in the securities prior to possession of insider information.[265] The pre-existing plan defense is dependent upon an initial finding by the court that it is the use, and not merely "knowing possession," of material non-public information "that gives rise to an informational advantage and the requisite intent to defraud" and establishes a sufficient basis for an insider trading conviction.[266] The Ninth and Eleventh Circuits have adopted the "use test,"[267] and both of these circuits have explicitly ruled in favor of the pre-existing plan defense. Courts that prefer the "knowing possession" standard over the "actual use" standard have either not addressed the validity of the pre-existing plan defense or have disallowed it.[268]

2. *"No Knowledge" of the Substantive Rule*

A defendant may assert a "no knowledge" defense. Section 32(a) of the 1934 Act provides that "no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation."[269] A successful "no knowledge" defense, however, does not eliminate the possibility of a conviction or imposition of a fine; proving lack of knowledge simply means that, if convicted, the defendant will not be imprisoned.[270] Because there is a penalty limitation, the defendant bears the burden of proof for demonstrating lack of knowledge.[271] This defense has met with limited success because only the defendant who did not know her conduct was "contrary

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264. *See* Nathenson v. Zonagen Inc., 267 F.3d 400, 407 (5th Cir. 2001) (finding Congress intended circumstantial evidence to support a strong inference of scienter in the Private Securities Litigation Reform Act of 1995, discussed *infra* Section III.B.2 of this article); United States v. Plache, 913 F.2d 1375, 1381-82 (9th Cir. 1990) (holding circumstantial evidence is sufficient to establish requisite intent in securities mail fraud).

265. *See Smith*, 155 F.3d at 1068 (finding that government must demonstrate "actual use" of information by insider trading in making transaction); *Adler*, 137 F.3d at 1332-39 (requiring actual use, but allowing courts to employ an evidentiary presumption of "strong inference" of use when a trader buys or sells securities while possessing insider information). *But see Teicher*, 987 F.2d at 119 (stating, in dicta, that proof by government of "knowing possession" of inside information is sufficient to sustain insider trading prosecution).

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

267. *See supra* Section II.A.2.d of this Article.

268. *E.g.*, *Teicher*, 987 F.2d at 119-21 (rejecting "actual use" standard in favor of "knowing possession" standard).

269. 15 U.S.C. § 78ff(a) (2000); *Peltz*, 433 F.2d at 54 ("[L]ack of knowledge of a rule or regulation prevents imprisonment but not a fine.").

270. *Id.*; *see also* United States v. O'Hagan, 139 F.3d 641, 647 (8th Cir. 1998) ("[T]he statute specifically provides that lack of knowledge of a rule or regulation is an affirmative defense to imprisonment, rather than conviction.").

271. 15 U.S.C. § 78ff(a) (2000); *see also* United States v. Frayler, 229 F.3d 1136 (2d Cir. 2000) (holding "no knowledge" defense lacks merit if defendant failed to affirmatively prove he lacked knowledge of any applicable rule or regulation); *O'Hagan*, 139 F.3d at 647; United States v. D'Honau, 459 F.2d 73, 75 (9th Cir. 1972) (holding

to law" may use it.[272] The defendant cannot avoid conviction simply by claiming that she was unaware her conduct violated a specific securities regulation.[273]

3. *Good Faith*

A defendant may offer the defense of "good faith" to rebut a showing of willfulness.[274] Good faith is more aptly described as a "quasi-defense" because the defendant has no burden to produce evidence of good faith.[275] Government has the burden to prove willful intent to defraud.[276] Good faith does not refer to a defendant's belief in the ultimate success of the venture,[277] but to the defendant's honest belief in the truth of the allegedly fraudulent statements.[278]

After the jury determines that fraud exists, it may weigh any evidence presented by the defendant and the prosecution to determine whether the defendant acted in good faith.[279] However, a defendant's failure to exercise due diligence in ascertain-

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§ 78ff(a) clearly places burden of proof for lack of knowledge on defendant; prosecution has no duty to raise this issue).

272. *See D'Honau*, 459 F.2d at 75 (finding "no knowledge" defense a "frivolous argument for . . . counsel to raise, let alone attempt to prove" where defendant was experienced in the stock market and most likely aware that his actions were contrary to law). However, some commentators believe that "culpable intent" language in the Court's *O'Hagan* opinion has given this defense life for non-market professionals who made no attempt to conceal wrongful conduct. *See* Charles M. Carberry & Harold K. Gordon, *After* O'Hagan*: Less Expansive Duties and Higher Mental States Restrict Criminal Securities Law Prosecutions*, CORP. L. & PRAC. COURSE HANDBOOK SERIES, 1007 PLI/CORP. 165, 185-89 (1997) (arguing that the "no knowledge" clause has "been resurrected as a hurdle to incarceration").

273. *See D'Honau*, 459 F.2d at 75 (rejecting defendant's "no knowledge" defense because it was improbable that he was unaware his actions were prohibited by a separate securities regulation); United States v. Sloan, 399 F. Supp. 982, 984 (S.D.N.Y. 1975) (holding Congress did not intend "no knowledge" provision to protect those who knew their conduct was in violation of law, but did not know it was in violation of particular SEC regulation).

274. *See* Howard v. Everex Systems, Inc., 228 F.3d 1057, 1065 (9th Cir. 2000) (explaining a defendant may assert a good faith defense by showing lack of scienter); *Alpern*, 84 F.3d at 1537 (same); United States v. Weiner, 578 F.2d 757, 787 (9th Cir. 1978) (stating proof of good faith is defense to scienter); Sparrow v. United States, 402 F.2d 826, 828-29 (10th Cir. 1968) ("[G]ood faith of the defendant in the plan or scheme and good faith intention to carry out the promises and representations constitutes a defense . . . [under] . . . fraud portions of the Securities Act.").

275. *See* United States v. Peterson, 101 F.3d 375, 383 & n.8 (5th Cir. 1996) (holding valid a lower court's jury instruction of "the Defendant has no burden to come forward with evidence to establish a defense of good faith").

276. *See Gross*, 961 F.2d at 1102-03 (holding failure to instruct jury on good faith not reversible error where court did instruct on government's burden to show knowledge of wrongful act).

277. *See* United States v. Koh, 199 F.3d 632, 641 (2d Cir. 1999) (upholding jury instruction stating that good faith defense is not met by defendant's belief that scheme would ultimately be profitable if fraudulent actions were taken to obtain initial investors), *cert. denied*, 530 U.S. 1222 (2000).

278. *See* United States v. Dunn, 961 F.2d 648, 650-51 (7th Cir. 1992) (finding defendant's knowing misrepresentation to prospective investors regarding financial well-being of company was grounds for mail fraud conviction, despite his claimed good faith belief that company would ultimately be successful); United States v. Alkins, 925 F.2d 541, 550 (2d Cir. 1991) (holding in mail fraud prosecution, if defendant believes that information in mailing is true, he does not possess requisite "intent to defraud").

279. *See* Schwartz v. Sys. Software Assocs., 32 F.3d 284, 289-90 (7th Cir. 1994) (affirming judgment for defendant where jury decided that forward-looking statement had reasonable basis and was made in good faith). For more on forward-looking statements, see Alan J. Berkeley, *Securities Law Requirements Relating to*

ing the truth of any representations will militate against a finding of good faith.[280]

4. *Reliance on Advice of Counsel*

A defendant may invoke the "advice of counsel" defense. Like the good faith defense, advice of counsel is not a complete defense, but instead a factor for the jury to consider while determining willfulness.[281] For this defense to be successful, the defendant must show the following: (i) a request for advice of counsel regarding the legality of the proposed action, (ii) full disclosure of all relevant facts to counsel, (iii) assurance by counsel of the action's legality, and (iv) good faith reliance on counsel's advice.[282]

To warrant a jury charge on advice of counsel, the defendant must show that her reliance on counsel was reasonable and predicated on a full accounting of the facts to counsel by the defendant.[283] It is no defense to claim that counsel failed to discover or "ferret out" proof of wrongdoing from defendant's disclosure of the facts.[284] The advice of counsel defense requires actual reliance on the advice given; the defendant "cannot hide now behind legal advice which it chose to ignore."[285] Furthermore, a defendant may not assert reliance upon non-legal

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Forward-Looking Statements, SE13 ALI-ABA 227 (1999) (describing forward looking statements as "safe harbor" from liability); *see also* United States v. Crosby, 294 F.2d 928, 947 (2d Cir. 1961) (stating jury may weigh fact of fraud when considering good or bad faith of defendants).

280. *See Infinity Group*, 212 F.3d at 192 (holding that even though defendants may have believed that investments were sound, they may still be liable if belief was based on reckless disregard for the truth); Sorrell v. SEC, 679 F.2d 1323, 1327 (9th Cir. 1982) (holding broker violated securities laws, despite assurances from other brokers and counsel, when he ignored obvious need for further inquiry); United States v. Meyer, 359 F.2d 837, 839 (7th Cir. 1966) (finding jury may not excuse "defendant's ignorance of the falsity of his representations" if exercise of reasonable care would have led to discovery of true facts). *See generally* Sara Beth Brody, *The Due Diligence Defense in Public Offering Litigation*, 1176 PLI/CORP 273 (2000) (describing due diligence as "an affirmative duty to verify the accuracy of disclosure concerning securities offerings").

281. *See* Markowski v. SEC, 34 F.3d 99, 104 (2d Cir. 1994) (finding that even if prerequisites for reliance on counsel are satisfied, such reliance is not a complete defense); United States v. United Med. & Surgical Supply Corp., 989 F.2d 1390, 1403-04 (4th Cir. 1993) (stating good faith reliance on counsel is not complete defense to willful misconduct, but rather one factor for jury's consideration).

282. *See Markowski*, 34 F.3d at 104-05 (discussing requirements for reliance defense).

283. *See* United States v. Lindo, 18 F.3d 353, 356 (6th Cir. 1994) (holding defendant who presents evidence in support of conclusion that she fully disclosed relevant information to counsel and relied on counsel's advice in good faith is entitled to a reliance jury instruction); C.E. Carlson, Inc. v. SEC, 859 F.2d 1429, 1436 (10th Cir. 1988) (finding defense not available in absence of full disclosure to attorney); *cf. Provenz*, 102 F.3d at 1491 (holding defendants could not rely on their accountants' advice as proof of good faith if they withheld information from accountants). *See generally* Rubin v. Schottenstein, Zox & Dunn, 143 F.3d 263, 269 (6th Cir. 1998) (holding that determination of whether plaintiffs were reckless in relying on their counsel's misrepresentations is a fact-specific inquiry difficult to dispose of at summary judgment stage).

284. United States v. Stirling, 571 F.2d 708, 735 (2d Cir. 1978) (holding that lack of information on the part of appellants' experts, including attorneys, auditors, and labor experts, could not be used as defense by those who kept them uninformed).

285. SEC v. Blinder, Robinson & Co., 542 F. Supp. 468, 481 (D. Colo. 1982), *aff'd*, 1983 WL 2081 (10th Cir. June 23, 1983); *see also* SEC v. Senex Corp., 399 F. Supp. 497, 507 (E.D. Ky. 1975) (holding defense is not available where there is no reliance on advice given), *aff'd*, 534 F.2d 1240 (6th Cir. 1976).

advice given by her counsel.[286] Finally, counsel's interest in the allegedly violative conduct renders the defense unavailable.[287]

B. Reliance-Based Defenses

1. Truth on the Market

Generally, the government must prove direct reliance on an omission or misstatement in order to convict a criminal defendant for securities fraud. One exception to this rule is the "fraud on the market" theory analyzed in *Basic Inc. v. Levinson.*[288] The "fraud on the market" theory of reliance can be countered by the complicated defense of "truth on the market."[289]

In *Basic*, pursuant to the "fraud on the market" theory, the Court held that the price of a security in an open and developed securities market will accurately reflect all information available, including any misstatements or misrepresentations.[290] Thus, if a victim relied on the price as an accurate reflection of the security's worth, she has established a presumption of reliance on the original misstatement.[291]

The *Basic* Court acknowledged that this presumption could be refuted by "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the [victim], or his decision to trade at a fair market price."[292] This severance occurs when information correcting the original misrepresentation "has been made credibly available to the market by other sources."[293]

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286. *Markowski*, 34 F.3d at 104-05 (finding defense unavailable because counsel's assurances were of non-legal nature).

287. *C.E. Carlson*, 859 F.2d at 1436 (holding counsel must be independent); Sorrell v. SEC, 679 F.2d 1323, 1327 (9th Cir. 1982) (concluding advice of counsel defense unavailable because counsel was interested party).

288. 485 U.S. 224 (1988); *see supra* notes 59-61 and accompanying text (discussing "fraud on the market" theory).

289. In private securities litigation, the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, created a defense known as the "bespeaks caution" doctrine. S. REP. No. 104-98, at 16-17, *reprinted in* 1995 U.S.C.C.A.N. 679, 695-96 (describing "bespeaks caution" safe harbor doctrine).

290. *See Basic*, 485 U.S. at 241-42 (explaining basis of "fraud on the market theory").

291. *See id.* at 247 (concluding where "materially misleading statements have been disseminated into . . . [the] . . . market . . . the reliance of [the victim] on the integrity of the market price may be presumed"); *see also* Grossman v. Novell, Inc., 120 F.3d 1112, 1118 (10th Cir. 1997) (stating where claim is based upon fraud on market, investor's reliance is presumed); *In re* One Bancorp Sec. Litig., 136 F.R.D. 526, 530 (D. Me. 1991) (finding misleading statements "will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements" (quoting *Basic*, 485 U.S. at 241-42)).

292. *Basic*, 485 U.S. at 248; *see* Tolan v. Computervision Corp., 696 F. Supp. 771, 774 (D. Mass. 1988) (holding defendants may rebut presumption of reliance).

293. *In re* Apple Computer Sec. Litig., 886 F.2d 1109, 1115 (9th Cir. 1989). The market must receive significant correct information in order to diffuse the damage of the alleged misrepresentation. *See In re* Philip Morris Sec. Litig., 872 F. Supp. 97, 102 (S.D.N.Y. 1995) (holding fraud on market can only be found if the "market does not have material information or has incomplete or inaccurate information"), *aff'd in part, rev'd in part*, San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos., 75 F.3d 801 (2d Cir. 1996).

This defense has been entitled "truth on the market."[294]

The Second, Fourth, Fifth, Seventh, and Ninth Circuits have expressly recognized the "truth on the market" defense.[295] Other circuits do not explicitly recognize the "truth on the market" theory. However, some courts have held that a defendant may rebut "fraud on the market" by proof that information controverting the misrepresentation was readily available.[296]

Similarly, if the purchasers obtained the stock for reasons unrelated to its price, the theory of "fraud on the market" will fail.[297] Because the purchaser obtained the stock for reasons independent of its price, the misrepresentation did not affect the purchaser's actions.[298]

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294. *See* Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 516 (7th Cir. 1989) (finding prompt incorporation of news into stock price supports "truth on the market" defense).

295. *See* Ganino v. Citizens Util. Co., 228 F.3d 154, 167 (2d Cir. 2000) (recognizing truth on market defense can render a misrepresentation immaterial, but explaining that because the defense is "intensely fact-specific [it] is rarely an appropriate basis for dismissing a section 10(b) complaint"); *Provenz*, 102 F.3d at 1492 (explaining if the market has become aware of concealed information, the facts omitted by defendant would already be reflected in stock's price, and the market will not be misled); Cooke v. Manufactured Homes, Inc., 998 F.2d 1256, 1262-63 (4th Cir. 1993) (affirming summary judgment where the market was fully aware of true information despite misrepresentation); Associated Randall Bank v. Griffin, Kubik, Stephens, & Thompson, Inc., 3 F.3d 208, 213-14 (7th Cir. 1993) (stating "truth-on-the-market" is a corollary to the "fraud-on-the-market" theory); Fine v. Am. Solar King Corp., 919 F.2d 290, 299 (5th Cir. 1990) (stating presumption of reliance is rebuttable by showing market was unaffected by misrepresentation); *In re* Apple Sec. Litig., 886 F.2d at 1115 (recognizing possibility of rebutting presumption of reliance); *see also* Seibert v. Sperry Rand Corp., 586 F.2d 949, 952-53 (2d Cir. 1978) (affirming summary judgment where material information was widely distributed by third parties).

296. *See Ganino*, 228 F.3d at 165 (stating a "defendant may rebut the presumption that its misrepresentations have affected the market price of its stock by showing that the truth of the matter was already known"); *In re* Newbridge Networks Sec. Litig., 962 F. Supp. 166, 178-79 (D.D.C. 1997) (disallowing "truth-on-the-market" defense where a reasonable jury might find that single report was not "transmit[ted] to the public with the degree of intensity and credibility sufficient to effectively counter-balance any misleading impression created by the insiders' one-sided representations" (quoting *In re* Apple Sec. Litig.,886 F.2d at 1116)); *In re* Biogen Sec. Litig., 179 F.R.D. 25, 37 (D. Mass. 1997) (stating if corrective information had already "entered the market and dissipated the effects of the misstatements, those who traded [in the securities of the defendant] after the corrective statements would have no direct or indirect connection with the fraud" (quoting Rand v. Cullinet Software, 847 F. Supp. 200, 205 (D. Mass. 1994))).

297. *See* Eckstein v. Balcor Film Investors, 58 F.3d 1162, 1170-71 (7th Cir. 1995) (affirming summary judgment where plaintiffs' class was defined as investors not relying on offering material); Kaplan v. Rose, 49 F.3d 1363, 1376 (9th Cir. 1994) (allowing rebuttal of reliance where defendant could show information entered the market through other channels); *Peil*, 806 F.2d at 1161 (stating defendant may rebut presumption of reliance by asserting that plaintiffs would have bought the stock even if they were aware of defendants' misrepresentation); *In re* Bank of Boston Corp. Sec. Litig., 762 F. Supp. 1525, 1533 (D. Mass. 1991) (noting *Basic* majority precluded recovery where plaintiff purchased stock for reasons "unrelated to its price" (quoting *Basic*, 485 U.S. at 251-52 (White, J. concurring in part, dissenting in part))).

298. *See* Dowling v. Narragansett Capital Corp., 735 F. Supp. 1105, 1120 (D.R.I. 1990) (holding presumption of reliance is rebutted if evidence shows alleged misinformation had no effect on action taken (citing *Basic*, 485 U.S. at 248)); *see also* Banca Cremi, S.A. v. Alex. Brown & Sons, 132 F.3d 1017, 1035-37 (4th Cir. 1997) (granting summary judgment in favor of defendants because plaintiff—a sophisticated "investor"—had failed to show justifiable reliance regarding its undisclosed excessive markup claim because it did not rely on a presumption that defendants were charging a fair markup when deciding to purchase securities).

2. *Bespeaks Caution Doctrine*

An alternative reliance-based defense is the "bespeaks caution doctrine," which recognizes that securities issuers cannot guarantee predictions made in forward-looking statements.[299] This doctrine, applicable to civil actions only,[300] operates to protect issuers from liability that might otherwise stem from forward-looking statements when those statements are framed in cautionary terms.[301]

Courts utilize this doctrine to dismiss securities fraud claims based on two fact-dependent approaches.[302] The first approach, followed by the Ninth Circuit, protects defendants when the cautionary language is so strongly worded that the statement could not mislead a reasonable investor. In *In re Syntex Corp. Securities Litigation*,[303] the defendant pharmaceutical company entered into a consent decree with the Food and Drug Administration.[304] In its Annual Report, the defendant stated that it did not anticipate the consent decree having an adverse effect on operations. The court held that the defendant's Annual Report "bespoke caution" because the "[d]efendants expressly acknowledged that the precise effect of the consent decree could not be known and that the company was merely stating its opinion that the consent decree would not have any material adverse effect."[305]

The second approach treats cautionary language as removing the plaintiff's right to rely upon the allegedly fraudulent statements as a matter of law. If predictive statements are made in the context of cautionary language or accompanied by "risk disclosures that negate the alleged misrepresentation or omission," then the

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299. *See In re* Worlds of Wonder Sec. Lit., 35 F.3d 1407, 1415 (9th Cir. 1994) ("[B]espeaks caution doctrine helps to minimize the chance that a plaintiff with a largely groundless claim will bring a suit and conduct extensive discovery in hopes of obtaining an increased settlement." (citation omitted)).

300. *See generally In re* Donald J. Trump Sec. Litig. 7 F.3rd 357, 371 (3rd Cir. 1993) (applying the "bespeaks caution" doctrine).

301. *See* Luce v. Edelstein, 802 F.2d 49, 56 (2d Cir. 1986) (adopting "bespeaks caution" doctrine to refuse to "impose liability" where defendant's Offering Memorandum clearly stated that "its projections ... were 'necessarily speculative,'" and thus bespoke caution); *see also* Gasner v. Bd. of Supervisors of the County of Dinwiddie, Virginia, 103 F.3d 351, 357 (4th Cir. 1996) (holding cautionary language in an offering document negated materiality of an alleged misrepresentation under "bespeaks caution" doctrine).

302. *See* EP Medsystems, Inc. v. Echocath, Inc., 235 F.3d 865, 873 (explaining under "bespeaks caution" doctrine, if sufficient cautionary language exists, alleged omissions or misrepresentations will be rendered immaterial as a matter of law); Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1278 (11th Cir. 1999) (adopting bespeaks caution doctrine); *In re* Merrill Lynch Ltd. P'shps Litig., 154 F.3d 56, 60 (2d Cir. 1998) (same); Franklin High Yield Tax-Free Income Fund v. County of Marin, Minn., 152 F.3d 736, 740 (8th Cir. 1998) (same); *In re* Nationsmart Corp. Sec. Litig., 130 F.3d 309, 317 (8th Cir. 1997) (same); Grossman v. Novell, Inc. 120 F.3d 1112, 1121 (10th Cir. 1997) (same); *In re* Westinghouse Sec. Litig., 90 F.3d 696, 707 (3d Cir. 1996) (same); *In re Syntex Corp.*, 95 F.3d at 929 (same); *Gasner*, 103 F.3d at 358 (same); Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1213 (1st Cir. 1996) (superceded by statute on other grounds) (same); *Provenz*, 102 F.3d at 1493 (same); *Rubinstein*, 20 F.3d at 167-68 (same); *see also* Donald C. Langevoort, *Disclosures That "Bespeak Caution"*, 49 BUS. LAW. 481, 487 (1994) (describing two rationales articulated by courts in applying the doctrine).

303. 95 F.3d 922 (9th Cir. 1996).

304. *Id.* at 929.

305. *Id.* (internal quotation marks omitted).

bespeaks caution doctrine renders the alleged misrepresentation immaterial.[306]

The Tenth Circuit adopted this method in *Grossman v. Novell, Inc.*[307] In *Grossman*, the defendant announced its planned merger with a leading software company and issued stock for shares of the company with whom it planned to merge.[308] In registration statements filed with the SEC, the defendant included several warnings regarding the ability of the two companies to successfully integrate, its inexperience in the word-processing industry, and the software company's financial difficulties.[309] On motion for summary judgment, the district court ruled in favor of the defendant because the defendant's predictive statements "bespoke caution."[310] On appeal, the Tenth Circuit approved the trial court's ruling and expressly adopted the bespeaks caution doctrine.[311] The Court of Appeals found that the optimistic statements complained of were accompanied by disclosures that were "highly specific" and "very factual."[312] Because the disclosures accompanying the optimistic statements complained of were "highly specific" and "very factual," "those cautions cannot be ignored in construing the materiality of optimistic predictions" in fraud cases.[313]

Congress created a corollary to the bespeaks caution doctrine when it passed the Private Securities Litigation Reform Act of 1995 ("PSLRA").[314] The PSLRA provides a safe harbor for forward-looking statements.[315] The PSLRA does not, however, supersede the bespeaks caution doctrine. Although the two safeguards are similar, the differences are significant enough to allow both to operate.[316]

C. *Other Defenses*

Criminal defendants have unsuccessfully challenged the criminalization of insider trading under section 10(b) and Rule 10b-5. In *United States v. Lang*,[317] the

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306. THOMAS EARL PATTON & TERRY ROSE SAUNDERS, SECURITIES FRAUD: LITIGATING UNDER RULE 10B-5 §11.6 (1999) ("[F]or the doctrine to apply as a matter of law, cautionary statements must be sufficiently clear so that reasonable minds could not find the optimistic statement misleading."); *see, e.g.*, *Gasner*, 103 F.3d at 357.

307. 120 F.3d 1112 (7th Cir. 1997).

308. *Id.* at 1115.

309. *Id.* at 1115-17.

310. *Id.* at 1117.

311. *Id.* at 1119-23.

312. *Grossman*, 120 F.3d at 1121; *see also* Karacand v. Edwards, 53 F. Supp. 2d 1236, 1242 (D. Utah 1999) (applying *Grossman* to find that statements regarding production and sales of new computers, as well as statements saying that company did not expect surprises in fourth quarter, were immaterial under "bespeaks caution" doctrine).

313. *Grossman*, 120 F.3d at 1112.

314. Pub. L. No. 104-67, 109 Stat. 737 (codified as amended within 15 U.S.C. §§77, 78 (1994 & Supp. 1998)).

315. *Id.* (codified in 15 U.S.C. § 77z-2(c)(1)(A)(i) (2000)) (protecting projections that are "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement").

316. The difference between the PSLRA and the "bespeaks caution" doctrine is that the "bespeaks caution" doctrine requires a higher level of specificity than does the PSLRA.

317. 766 F. Supp. 389 (D. Md. 1991).

defendants based their defenses on the absence of language in the legislative history of section 10(b) and Rule 10b-5 concerning insider trading, as well as the fact that Congress did not criminalize "short-swing trading"[318] by insiders in section 16(b), but merely imposed strict civil liability.[319] The *Lang* court rejected the defendants' claim, stating that section 16(b) applies as a strict liability civil statute and did not foreclose criminalization of insider trading in other contexts.[320] Thus, "Congress' failure to impose criminal sanctions for nonfraudulent conduct under section 16(b) does not mean that it intended to immunize insider trading that is fraudulent under section 10(b) and Rule 10b-5."[321]

More recently, the defendant in *SEC v. SG Ltd.*[322] asserted the defense that purchases of shares in "virtual companies" listed on SG's "virtual stock exchange" were not purchases of securities because no reasonable participant could have expected guaranteed profits from a mere game.[323] The court did not reject this defense outright, but reserved a finding on the merits of the so-called "this was only a game" defense to the fact-finder.[324] Specifically, the fact-finder had to assess whether SG's representations satisfied the expectation of profit requirement from *Howey*.[325] While the court depicts the claim with extreme cynicism, it explains, "SG may well have colorable arguments anent materiality and reliance (i.e., that . . . no reasonable investor should have been deceived or misled)."[326] The success of this defense is yet unknown, but SG has presented a potentially successful defense and inevitably a creative cyber-related loophole in the definition of a security.

IV. ENFORCEMENT MECHANISMS

Federal law provides three categories of remedies for violations of federal securities law: administrative, civil, and criminal.[327] Congress has vested the SEC

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318. "Short-swing trading" is the profitable trade of securities of a corporation by a "beneficial owner, director, or officer" of the corporation, where the purchase and sale of the securities are separated by less than six months. 15 U.S.C. § 78p(b) (1994). The trader is strictly liable to the trading partner, even "without proof of actual abuse of insider information, and without proof of intent to profit on the basis of such information." Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 595 (1973).

319. *Lang*, 766 F. Supp. at 401 (explaining Congress "chose not to impose criminal sanctions for the broad range of conduct in Section 16(b)").

320. *Id.* at 401 (rejecting defendants' claim as failing to recognize that section 16(b) and Rule 10b-5 apply to different conduct).

321. *Id.* at 402.

322. 265 F.3d 42 (1st Cir. 2001).

323. *Id.* at 44.

324. *Id.* at 53.

325. *Id.* at 53-54.

326. *Id.* at 53.

327. 17 C.F.R. § 202.5(b) (2001); *see also* 15 U.S.C. § 77l (2000) (covering civil liabilities in connection with prospectuses and communications); 15 U.S.C. § 77h(b) (2000) (authorizing administrative stop order against registration statements with untrue or omitted material facts); 15 U.S.C. §§ 77t(b) (2000) (empowering SEC to

with the authority to initiate investigations regarding potential violations and prevent future violations through the civil and administrative enforcement of those laws.[328] The DOJ has sole jurisdiction over criminal proceedings.[329] Attorneys at the DOJ generally initiate criminal proceedings as a result of SEC investigations. The courts have no power to compel the SEC to investigate potential violations.[330] In 2000, the SEC disgorged illegal profits of $445 million, applied civil penalties totaling more than $43 million, and initiated over 500 enforcement actions against securities violators.[331]

A. SEC Enforcement

1. Development of an Enforcement Action

Enforcement actions generally begin with a preliminary investigation into a possible violation of federal securities law.[332] Leads on possible violations come from many sources, including SEC Division of Enforcement oversight, securities related organizations, and individual complaints filed with the SEC, and other divisions of the SEC.[333] During these initial investigations, the SEC does not have

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bring actions for injunction or criminal prosecution in district court); 15 U.S.C. § 78o(b)(4) and (6) (2000) (discussing disciplinary actions against broker-dealers and other professionals); 15 U.S.C. §§ 77x, 77yyy, 78ff, 79z-3, 80a-48, 80b-17 (2000) (providing for criminal penalties). Courts have upheld the constitutionality of the criminal penalties. *See* United States v. Charnay, 537 F.2d 341, 356-57 (9th Cir. 1976) (rejecting claim that statute is unconstitutionally vague); United States v. Persky, 520 F.2d 283, 287-88 (2d Cir. 1975) (same).

328. *See* SEC. EXCH. COMM'N, THE INVESTOR'S ADVOCATE: HOW THE SEC PROTECTS AND MAINTAINS MARKET INTEGRITY (1999), *available at* http://www.sec.gov/about/whatwedo.shtml (last visited Feb. 28, 2003).

329. 17 C.F.R. § 202.5(f) (2001) (stating that it is SEC policy to devolve responsibility for criminal prosecutions to the DOJ).

330. 15 U.S.C. § 77t(a)-(b) (2000) (giving SEC discretion in investigating); *see also* Kixmiller v. SEC, 492 F.2d 641, 645-46 (D.C. Cir. 1974) (noting discretion of SEC to investigate and institute actions); Dyer v. SEC, 291 F.2d 774, 781 (8th Cir. 1961) (stating that statutory grant of authority gives SEC "absolute discretion as to exercise and exclusive judgment as to field and scope"); Crocker v. SEC, 161 F.2d 944, 949 (1st Cir. 1947) (stating statute is "permissive merely, conferring administrative discretion upon the [SEC] to institute such a proceeding 'if it appears . . . ' that a registration statement is false or misleading"); Las Vegas Hawaiian Dev. Co. v. SEC, 466 F. Supp. 928, 933 (D. Haw. 1979) (concluding that district court does not have power to determine breadth of SEC examination under 1933 Act "because this is a matter committed to the discretion of the Commission").

331. SEC. EXCH. COMM'N, 1999 ANNUAL REPORT: ENFORCEMENT (1998), *available at* http://www.sec.gov/pdf/annrep00/enforce.pdf (last visited Feb. 28, 2003).

332. *See* SEC. EXCH. COMM'N, ABOUT THE DIVISION OF ENFORCEMENT, *available at* http://www.sec.gov/divisions/enforce.shtml (last modified Aug. 1, 2002) (outlining procedures of SEC investigations); *see also* SEC v. Jerry T. O'Brien, Inc., 467 U.S. 735, 738 (1984) (describing a preliminary investigation).

333. *See* SEC. EXCH. COMM'N, SEC COMPLAINT CENTER, *at* http://www.sec.gov/complaint.shtml (last modified May 7, 2002) (describing complaint procedures). These leads come from a combination of sources. Rule 5(a) of the SEC's Rules of Practice states that "complaints received from members of the public, communications from federal or state agencies, examination of filings made with the Commission, or otherwise" can initiate the preliminary inquiry, but leads can come from many other unofficial sources. MARC I. STEINBERG & RALPH C. FERRARA, SECURITIES PRACTICE, FEDERAL AND STATE ENFORCEMENT § 3:02 (1992 & Supp. 2000); *see also Smith*, 155 F.3d at 1054 (describing initiation of formal investigation through anonymous informant's tip alleging insider trading).

the authority to issue subpoenas or to compel testimony.[334] If a preliminary investigation indicates that a violation occurred, the SEC then initiates a formal order of investigation to determine the validity of the accusations.[335] A showing of probable cause is not necessary for the SEC to issue a formal order. Rather, the SEC need only demonstrate general noncompliance with securities law.[336] The formal order of investigation outlines the scope of the investigation and is deemed purely investigatory.[337] Upon initiation of a formal investigation, the SEC may use its subpoena power to compel testimony and the production of evidence.[338]

Formal SEC investigations are generally non-public,[339] as they are designed to protect the integrity of the investigation and the reputation of those accused.[340] The existence or nonexistence of an investigation and any known information is not made public unless it becomes a matter of public record in a proceeding brought before the SEC or a court of law.[341] In addition, federal law does not require the SEC to notify the target of an initial investigation that it has issued subpoenas to third parties.[342] Otherwise, a notice requirement might burden the discretionary powers of the SEC or hinder the investigation by tipping off the targets who may

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334. *See Jerry T. O'Brien*, 467 U.S. at 738 n.1 (citing 17 C.F.R. § 202.5(a) and noting that no subpoenas are issued in preliminary inquiry); *see also* STEINBERG & FERRARA, *supra* note 333, § 3:03 (quoting Rule 202.5 of SEC's Rules of Practice, 17 C.F.R. § 202.5(a)).

335. *See Jerry T. O'Brien*, 467 U.S. at 738 n.1 (noting timing and purpose of Formal Order of Investigation); *see also* A. A. SOMMER JR., SECURITIES LAW TECHNIQUES §§ 87.02, 87.03 (1994) [hereinafter SOMMER I] (discussing informal inquiries and issuance of Formal Orders of Investigation).

336. *See* A. A. SOMMER, JR., FEDERAL SECURITIES ACT OF 1933 § 10.05[3] (1996) [hereinafter SOMMER II] (noting nonadversarial nature of investigation as reason for lowered standard).

337. *See Jerry T. O'Brien*, 467 U.S. at 738 n.1 ("The purposes of [the formal] order seem to be to define the scope of the ensuing investigation and to establish limits within which the staff may resort to compulsory process." (quoting H.R. REP. NO. 96-1321, pt. 1, p.2 (1980))). The Commission may investigate "to determine whether any person has violated, is violating, or is about to violate any provision of the federal securities laws or the rules of a self-regulatory organization of which the person is a member or participant." 17 C.F.R. § 202.5(a) (2001).

338. This power, although vested in the SEC, must be enforced in the courts. *See* SOMMER II, *supra* note 336, § 10.08[1] (explaining that "to enforce its subpoenas, the Commission must go to the courts"); *see also Smith*, 155 F.3d at 1054 (demonstrating use of SEC administrative subpoena power to obtain documentary evidence and compel witness testimony); RNR Enters., Inc. v. SEC, 122 F.3d 93, 98 (2d Cir. 1997) (upholding SEC use of subpoena power despite challenge on administrative law and due process grounds, and discussing when administrative subpoena is enforceable).

339. 17 C.F.R. § 202.5(a) (2001) (noting that "[u]nless otherwise ordered by the Commission, the investigation or examination is non-public and the reports thereon are for staff and Commission use only").

340. *See* SEC. EXCH. COMM'N, *supra* note 331.

341. *Id.* This policy is nonetheless subject to the provisions of the Freedom of Information Act, 5 U.S.C. § 552(a)(6)(c)(b)(1)-(9) (2000) (requiring that agency make available for examination any agency record that does not fit one of nine exemptions).

342. SEC v. Rivlin, 1999 WL 1455758, at *4 (D.D.C. Dec. 20, 1999) (rejecting defendant's claim that SEC's failure to notify defendant of depositions taken during preliminary investigation violated his due process rights (citing *Jerry T. O'Brien*, 467 U.S. at 742). The *Jerry T. O'Brien* Court found that Congress has never indicated that it did not wish to grant the SEC the power to issue subpoenas without notifying the target of a non-public investigation. *Jerry T. O'Brien*, 467 U.S. at 744-45.

then attempt to evade or impede the investigation.[343]

2. *Administrative Proceedings*

SEC administrative proceedings are heard either by administrative law judges or the Commission itself.[344] Such proceedings allow the SEC to impose sanctions to protect the public interest.[345] If the SEC concludes, based on a preponderance of evidence, that a violation of federal securities law occurred, The Securities Exchange Act of 1934 grants the SEC authority to impose administrative sanctions.[346]

Before 1990, the SEC was limited to court applied sanctions, including injunctions and disgorgement of illegal profits, to remedy securities violations.[347] However, the Securities Enforcement Remedies and Penny Stock Reform Act of 1990[348] gave the SEC administrative power to issue cease and desist orders and monetary penalties in response to violations of federal securities law by securities professionals.[349] These SEC sanctions are subject to the federal five-year statute of limitation period requiring that enforcement proceedings commence within five years of the violation.[350]

343. *Jerry T. O'Brien*, 467 U.S. at 749-51 (discussing effects of requiring notice).

344. *See* SEC. EXCH. COMM'N, *supra* note 331.

345. For a discussion of considerations mentioned in the Remedies Act for use when determining whether monetary penalties are in the public interest, see STEINBERG & FERRARA, *supra* note 333, § 5A:10-11 (stating that factors include: (i) whether fraud, deceit or manipulation was used; (ii) the harm resulting to other persons; (iii) the extent of unjust enrichment; (iv) the respondent's prior history of securities law violations; (v) the need for a deterrent; and (vi) other matters that justice may require).

346. 15 U.S.C. § 75o(c)(4) (2000) (granting SEC the authority to undertake administrative proceedings against broker-dealers); *see* Ralph C. Ferrara & Philip S. Khinda, *SEC Enforcement Proceedings: Strategic Considerations For When the Agency Comes Calling*, 51 ADMIN. L. REV. 1143, 1186-91 (1999) (explaining that various provisions of securities laws permit the SEC to institute administrative actions and impose sanctions against certain securities professionals, including broker-dealers, investment advisors, persons associated with investment companies, persons subject to sections 12, 13, 14, or 15(d) of the Act, and lawyers, accountants, and engineers who practice before the Commission). The Commission also may institute administrative proceedings against self-regulatory organizations such as the New York Stock Exchange. *Id.* at 1191.

347. *See* Matthew Scott Morris, *The Securities Enforcement Remedies and Penny Stock Reform Act Of 1990: By Keeping Up With the Joneses, the SEC's Enforcement Arsenal is Modernized*, 7 ADMIN. L.J. AM. U. 151, 166 n.67 (1993) (citing Dennis J. Block and Nancy E. Barton, *SEC Enforcement Actions—Time for the Self-Dissolving Injunction*, 11 SEC. REG. L.J. 163 (1983)).

348. 15 U.S.C. § 77g (2000).

349. Administrative proceedings include: stop order proceedings under section 8 of the 1933 Act, 15 U.S.C. § 77h (d)-(e) (2000); proceedings against broker-dealers under section 15(c)(4) of the 1934 Act, 15 U.S.C. § 78o(c)(4) (2000); proceedings against investment advisors, 15 U.S.C. § 80b-3(e) (2000), and investment companies, 15 U.S.C. § 80a-8(e) (2000); and sanctions against attorneys, accountants, and other professionals practicing before the SEC, pursuant to Rule 2(e) of the Commission's Rules of Practice. SOMMER I, *supra* note 335, § 87.05.

350. 28 U.S.C. § 2462 (2000) (defining time period in which civil actions for fines, penalties or forfeitures must be brought).

a. Cease and Desist Authority

Under the SEC's cease and desist authority, the Commission may prohibit a person or business from continuing a particular course of conduct after the agency shows the target has violated federal securities law.[351] The SEC may issue temporary or permanent cease and desist orders against regulated persons.[352] The standard for issuing a cease and desist order is the likelihood of "significant dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest."[353] Cease and desist orders require notice and opportunity for a hearing, unless the order is temporary and such notice and opportunity would be impracticable or contrary to the public interest.[354]

b. Monetary Penalties in Administrative Proceedings

The Securities Enforcement Remedies and Penny Stock Reform Act of 1990 gives the SEC the power to impose monetary penalties, including fines and disgorgement,[355] against securities professionals if after a formal hearing it finds that the penalty is in the public interest[356] and that the person willfully violated federal securities law.[357] These penalties are assessed using a three-tier scale based on the nature of the crime and the potential for harm from the actions.[358] Generally, the more egregious the violation, the greater the fine imposed.[359]

3. Civil Remedies

In a civil action against an entity that violates federal securities law, the SEC has the authority to petition the court to grant injunctions, impose monetary penalties, and disgorge illegal profits.[360] Unlike administrative proceedings, where the agency or administrative law judge adjudicates claims, the SEC files these actions in a federal district court, which has broad equitable discretion to craft a remedy under the 1934 Act.[361]

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351. 15 U.S.C. § 77h-1 (2000) (granting SEC authority to issue cease-and-desist orders).

352. The 1990 Act amended several of the major securities statutes. The amendments to the 1933 and 1934 Acts are the same in every aspect relevant to this discussion. These amendments are 15 U.S.C. § 77h-1 (2000) (adding new section 8A to 1933 Act) and 15 U.S.C. § 78u-3 (2000) (adding new section 21C to 1934 Act).

353. 15 U.S.C. §§ 77h-1(c)(1), 78u-3(c)(1) (2000).

354. *Id.*

355. The 1990 Act authorizes the SEC to require accounting and disgorgement in administrative proceedings where the SEC has the power to impose monetary penalties. 15 U.S.C. §§ 78u-2(a-b), (e), 80a-9(e), 80b-3(j) (2000).

356. 15 U.S.C. § 78u (a)(2); *see* SOMMER I, *supra* note 335, § 87.05 (discussing the powers of the SEC after the Reform Act).

357. 15 U.S.C. §§ 78u-2(a), 80b-3(i) (2000); STEINBERG & FERRARA, *supra* note 333, at §§ 4:16.50, 5A:10; SOMMER II, *supra* note 336, at § 10.10(9)(a).

358. *See* STEINBERG & FERRARA, *supra* note 333, §§ 4:16.50, 5A:10.

359. For a discussion of factors and penalties, see SOMMER II, *supra* note 336, § 10.10(9)(b).

360. 5 U.S.C. § 78u-2 (2000).

361. SEC v. Fischbach Corp., 133 F.3d 170, 175 (2d Cir. 1997) (noting court's broad equitable discretion to fashion remedy).

a. Injunctive Actions and Ancillary Measures

The SEC has historically used injunctions as one of its principle enforcement tools and may seek discretionary injunctive relief[362] against both the perpetrators of securities fraud and those who aid and abet violators of securities fraud.[363] Injunctive relief is not designed to punish, but rather to prevent individuals from perpetrating future violations of federal securities law.[364] Injunctions may be temporary or permanent,[365] and the SEC may request temporary restraining orders or preliminary injunctions in emergency situations.[366]

To receive injunctive relief, the SEC must offer positive proof of the likelihood of further violations. In determining whether a likelihood of future violations exists, the court considers several factors: (i) the severity of the violations,[367] (ii) the degree of scienter involved,[368] (iii) the defendant's recognition of the wrongful nature of his conduct,[369] and (iv) his sincerity in refraining from future violations.[370] No one factor is controlling.[371] Any failure to cooperate with the SEC to

362. 15 U.S.C. § 77t(b) (2000).

363. In *Fehn* the court ruled that, under the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 104, 109 Stat. 737 (1995) (amending 15 U.S.C. § 78t(f)), the SEC can bring injunctive actions against those who aid and abet securities violations. *Fehn*, 97 F.3d at 1280. The Ninth Circuit held that Central Bank v. First Interstate Bank, 511 U.S. 164 (1994), which barred private actions against those who aid and abet securities violations, did not extend to the SEC. *Id.*; *cf.* Dinsmore v. Squadron, 135 F.3d 837, 842 (2d Cir. 1998) (holding that pursuant to *Central Bank*, a private litigant may not maintain claim for aiding and abetting or claim for conspiracy under section 10(b)).

364. *See* STEINBERG & FERRARA, *supra* note 333, § 4:17.52 (summarizing the impact of the Act).

365. *See Fehn*, 97 F.3d at 1295 (requiring SEC to show "reasonable likelihood" of future violations for permanent injunction).

366. *See* SEC v. Cavanagh, 155 F.3d 129, 132 (2d Cir. 1998) (stating preliminary injunctions are reviewed for abuse of discretion and upheld unless issuing court applies legal standards incorrectly or relies upon erroneous findings of fact). Preliminary injunctions are appropriate if the SEC makes a "substantial showing of likelihood of success as to both a current violation and the risk of repetition." *Id.*

367. *See* SEC v. Lorin, 76 F.3d 458, 461 (2d Cir. 1996) (holding it is not an abuse of discretion for a court to consider the frequency and egregious nature of an offense); *see also* SEC v. Jakubowski, No. 94 C 4539, 1997 WL 598108, at *1 (N.D. Ill. Sept. 19, 1997) (stating "gravity of harm caused by the offense" as one of the factors considered in a totality-of-the-circumstances assessment of whether to grant an SEC motion for permanent injunctive relief).

368. *See* Jones v. SEC, 115 F.3d 1173, 1184 (4th Cir. 1997) (finding scienter based on defendant's disregard of advice of counsel and requirements of offering materials).

369. *See Jakubowski*, 1997 WL 598108, at *1 (explaining that courts may consider a culpable defendant's professions of innocence as a reason in favor of granting an injunction); *Lorin*, 76 F.3d at 461 (including refusal to recognize wrongdoing among factors to consider as indication of likelihood of future violations); *Fehn*, 97 F.3d at 1295-96 (viewing lack of remorse as one factor among many that indicate likelihood of future violations).

370. *See Fehn*, 97 F.3d at 1295-96 (noting that "sincerity of [defendant's] assurances against future violations" is a factor). However, sincere promises to avoid future violations are insufficient if other factors indicate likelihood of future violations, and "the fact that the defendant is currently complying with the securities laws does not preclude an injunction." *Id.*

371. *See id.* (discussing weight given to each factor).

remedy the violations may suggest a propensity to engage in future violations.[372] Consideration of hardship and equitable factors may also be appropriate, but the court must weigh such factors against the public's interest in preventing future violations.[373]

Additionally, courts have the power to bar securities law violators from serving as officers or directors of public companies. The 1990 Act provides that a court may enter an order barring or suspending an officer or director of a company if the SEC has brought an injunctive action.[374]

The SEC may also seek ancillary relief in addition to injunctions, including appointment of a receiver.[375] The SEC's power to seek ancillary relief is extensive. In fashioning the relief, the SEC need only ensure that the measure is appropriate to protect investors and effectuate the purposes of federal securities law.[376]

b. Disgorgement and Monetary Penalties

Disgorgement is an equitable remedy that returns profits a defendant received through the securities fraud.[377] The primary purposes of this remedy are to discourage securities law violations "by depriving violators of ill-gotten gains" and to prevent unjust enrichment; it is typically not used for restitution purposes.[378] The court need not find that the defendant is likely to violate securities laws in the future, only that he "has no right to retain the funds illegally taken from the victims."[379] Prejudgment interest may also be imposed at the discretion of the

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372. *See Cavanagh*, 155 F.3d at 135 (describing factors court looks to before granting injunction); SEC v. First Jersey Secs., Inc., 101 F.3d 1450, 1477 (2d Cir. 1996) (finding persistent refusal to desist from violations and to abide by penalties previously ordered is indication of likelihood of future wrongdoing).

373. 15 U.S.C. § 78j(b) (2000).

374. 15 U.S.C. §§ 77t(e), 78u(d)(2) (2000); *see* STEINBERG & FERRARA, *supra* note 333, § 5A:18 (discussing officer and director bars).

375. *See* SEC v. Amer. Bd. of Trade, Inc., 830 F.2d 431, 436 (2d Cir. 1987) (acknowledging neither 1933 Act nor 1934 Act explicitly gives courts power to appoint a receiver, but stating "courts have consistently held that such power exists").

376. *See* STEINBERG & FERRARA, *supra* note 333, § 5.09 (noting that "the range of remedies available" is limited only by these two objectives).

377. *See* SEC v. Patel, 61 F.3d 137, 139 (2d Cir. 1995) (holding where stock purchased on basis of insider information, proper measure of damages is difference between price paid and price shortly after disclosure of information); *Softpoint, Inc.*, 958 F. Supp. at 867 ("[T]he proper measure of disgorgement is the amount of the wrongdoer's unjust enrichment."), *aff'd*, 159 F.3d 1348 (2d Cir. 1998); *see also Fischbach*, 133 F.3d at 175 (stating district court's plan to distribute disgorged funds will not be disturbed on appeal absent abuse of discretion).

378. *See Fischbach*, 133 F.3d at 175 (stating primary purpose of disgorgement is to deter violations by depriving violators of their profits); *see also Banner Fund Int'l*, 211 F.3d at 617 (explaining disgorgement is not a punitive measure, but rather an equitable remedy to prevent unjust enrichment); *Warde*, 151 F.3d at 50 (describing the proper level of disgorgement as "the difference between the price of [the stock] when purchased on inside information and [its] price after the disclosure of the inside information").

379. SEC v. Colello, 139 F.3d 674, 679 (9th Cir. 1998) (stating requirement that court find future violations likely only applies to permanent injunctions); *Warde*, 151 F.3d at 49 (stating that a district court's disgorgement order is reviewed for abuse of discretion).

trial court.[380] Once the profits have been disgorged, it remains in the court's discretion to determine how the money is distributed.[381] There is no requirement that the SEC return these funds to those harmed by the transaction or that the court tie the level of the penalty to the losses suffered.[382]

If the SEC demonstrates that the defendant has violated either the securities law or a cease and desist order, the court has the power to impose civil monetary penalties on the person committing the violation.[383] These penalties are applied on the basis of a three-tiered structure that examines the nature of the crime and the potential for harm from the actions.[384] These monetary penalties are similar to the monetary penalties the SEC may apply in administrative actions.

4. *International Enforcement*

Courts have held that nearly any securities violation, occurring within or outside the United States borders, and having a real impact on investors or markets in the United States, is subject to federal securities law.[385] The Commission has vigorously pursued both violators of foreign securities law and foreign citizens who have violated United States securities law domestically or abroad.[386] The SEC action to sanction international violations of federal securities law takes several forms, including arrangements for the exchange of information and assistance, enforcement cooperation, and technical assistance.[387]

In response to the increased internationalization of the world's securities markets and greater instances of international securities fraud, Congress enacted

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380. SEC v. Yun, 148 F. Supp. 2d 1287, 1293 (M.D. Fla. 2001) (stating the interest rate usually imposed in disgorgement cases is the IRS underpayment rate).

381. *Fischbach*, 133 F.3d at 175.

382. *See id.* at 175-76 (discussing disgorgement payment theories); *see also Warde*, 151 F.3d at 50 (requiring amount of disgorgement to be reasonable, but leaving risk of any uncertainty on offender). However, in some cases the SEC may decide that returning the disgorged profits to the investors is appropriate. *See* SEC v. Johnston, 143 F.3d 260, 263 (6th Cir. 1998) (agreeing that returning disgorged profits to investors was "best use for the money").

383. 15 U.S.C. § 78u-2(a) (2000) (amending various securities statutes to provide SEC with authority to seek civil penalties); *see* SEC v. Moran, 944 F. Supp. 286, 296 (S.D.N.Y. 1996) (stating that Congress allows civil penalties to achieve dual goals of punishment and deterrence); STEINBERG & FERRARA, *supra* note 333, § 5A:08 (discussing monetary penalties in civil actions).

384. 15 U.S.C. §§ 77t(d)(2) (2000); *see generally* Morris, *supra* note 347, at 160 n.35 (describing three-tier structure and penalties for each).

385. *See* SEC v. Carrillo, 115 F.3d 1540, 1544-47 (11th Cir. 1997) (ruling sale of fraudulent securities to U.S. residents by alien corporation constituted sufficient minimum contacts for SEC to bring suit against alien corporation in federal court).

386. *See* OFFICE OF INT'L AFFAIRS, *The SEC's Int'l Enforcement Program and Bilateral Multilateral Initiatives*, 980 PLI/CORP 747, 753-58 (1997) (describing recent SEC international enforcement developments); *see also* INTERNATIONAL AFFAIRS, THE SEC'S INTERNATIONAL PROGRAM, 1297 Pli./Corp. 747, 759 (2002) (describing the International Organization of Securities Commissions' creation of a task force, in which members of the SEC are participating, that will focus on developing policies to expand cooperation and information-sharing between securities regulators in response to the events of September 11, 2001).

387. Office of International Affairs, *supra* note 386, at 753-58.

the International Securities Enforcement Cooperation Act of 1990 ("International Enforcement Act").[388] Congress intended the International Enforcement Act to improve existing efforts to expand the reach of the SEC abroad.[389]

The SEC currently has entered into over 30 agreements, known as Memoranda of Understanding (MOU), with foreign counterparts, most recently India and Singapore for information-sharing and cooperation.[390] These MOUs are governed by section 202 of the International Enforcement Act, which amends section 24 of the 1934 Act,[391] to improve the flow of information between the SEC and foreign authorities. Section 24(c) grants the SEC the discretionary authority, upon the showing of need, to provide non-public documents to domestic and foreign persons.[392] Section 24(d) exempts confidential documents provided by foreign authorities from the disclosure requirements of the Freedom of Information Act.[393] However, section 24(e) places certain limitations on these provisions. Specifically, the SEC may not withhold information from Congress, and the SEC must comply with an order from a court of the United States as long as the SEC or the United States initiated the proceeding.[394]

Congress enacted section 203 of the International Enforcement Act to empower the SEC to take action on the basis of convictions by foreign courts and authorities. Section 203 amends section15(b) of the 1934 Act[395] to give the SEC the power to impose sanctions on brokers, dealers, their associated persons, and individuals seeking to become associated persons[396] on the basis of a conviction within the past ten years by a foreign court of competent jurisdiction for a crime substantially equivalent to a felony or misdemeanor.[397] Similarly, the SEC may impose

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388. International Securities Enforcement Cooperation Act of 1990, Pub. L. No. 101-550, 104 Stat. 2713 (codified at scattered subsections of 15 U.S.C. §§ 77-80, 780, 789).

389. These include Memoranda of Understanding into which the SEC and foreign authorities have entered into since 1982. 15 U.S.C. § 78x(d)(2)(B) (2000).

390. *See, e.g,* Press Release, Sec. Exch. Comm'n, SEC, CFTC, and Jersey Financial Services Commission Sign MOU Information Sharing Arrangement, *available at* 2002 WL 1068601 (May 30, 2002); Press Release, Sec. Exch. Comm'n, *SEC , CFTC, and Monetary Authority of Singapore Sign Memorandum of Understanding, available at* 2000 WL 626839 (May 16, 2000); *SEC and Indian SEBI Sign Memorandum of Understanding,* Release No. IS-1124, 66 S.E.C. Docket 1893 (Mar. 18, 1998), *available at* 1998 WL 119924.

391. 15 U.S.C. § 78x (2000).

392. 15 U.S.C. § 78x(c) (2000).

393. 15 U.S.C. § 78x(d). The Freedom of Information Act is codified at 5 U.S.C. § 552 (2000).

394. 15 U.S.C. § 78x(e)(2) (2000). The responsibilities of the SEC under the Right to Financial Privacy Act (12 U.S.C. §§ 3401-3420, 3422 (2000)) do not change. *See* 15 U.S.C. § 78x(e)(1) (2000).

395. 15 U.S.C. § 78o(b)(4) (2000).

396. Section 205(a) of the 1990 Act amends the Investment Company Act of 1940 and section 205(b) of the 1990 Act amends the Investment Advisors Act of 1940 to grant the SEC similar authority with respect to investment advisors. *Id.* §§ 80a-9(b), 80b-3(e). The recently enacted 1999 Gramm-Leach-Bliley Financial Modernization Act adds "bank" to the category of statutorily disqualified persons. Pub. L. No. 106-102 § 222, 113 Stat. 1388 at *1401 (1999).

397. 15 U.S.C. §§ 80a-9(b), 80b-3(e) (1994).

sanctions on the basis of findings by a "Foreign Securities Authority."[398]

Section 203 of the International Enforcement Act also amends section 3(a)(39) of the 1934 Act[399] to expand the number of situations in which a broker may be statutorily disqualified from a self-regulating organization ("SRO"). As a result of the amendment, section 3(a)(39)(A) of the 1934 Act authorizes statutory disqualification from an SRO if the person did not participate in the foreign equivalent of an SRO.[400] Statutory disqualification also results from a "Foreign Financial Regulatory Authority"[401] order prohibiting or restricting permission to trade.

Section 207 of the International Enforcement Act amended section 4 of the 1934 Act[402] and allows the SEC to accept reimbursement for necessary expenses it incurs while carrying out any investigation in assistance of a foreign security authority.[403]

Finally, section 21(a)(2) of the Securities Exchange Act of 1934, added by Congress in 1988, allows the SEC, upon its discretion, to initiate an investigation on behalf of foreign securities enforcement authorities.[404] In deciding whether to initiate an investigation on behalf of a foreign entity, the SEC must consider "(A) whether the requesting authority has agreed to provide reciprocal assistance in securities matters to the Commission; and (B) whether compliance with the request would prejudice the public interest of the United States."[405] However, the matter need not constitute a violation of the laws of the United States.[406]

Cooperation between the SEC and foreign governments has expanded the reach of federal securities law by empowering the SEC to use foreign government resources to reach United States securities law violators. In 1998, for example, the SEC made 275 requests to foreign governments for enforcement assistance. In some of these cases, the SEC used the foreign governments to help secure incriminating documents; in others, the foreign governments assisted by helping the SEC to prosecute violators overseas.[407]

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398. 15 U.S.C. §§ 80a-9(b)(4)(A), 80b-3(e)(8)(a) (2000). Section 206 of the 1990 Act adds "Foreign Securities Authority" to the lists of definitions in the Investment Company and Investment Advisors Acts. 15 U.S.C. §§ 80a-2(a)(49), 80b-2(a)(23) (2000).

399. 15 U.S.C. § 78c(a)(39) (2000).

400. 15 U.S.C. § 78c(a)(39)(A) (2000).

401. Section 204 of the 1990 Act adds the term "foreign financial regulatory authority" to the list of definitions in the 1934 Act. 15 U.S.C. § 78c(a)(52) (2000).

402. 15 U.S.C. § 78d (2000).

403. 15 U.S.C. § 78d(f) (2000).

404. 15 U.S.C. § 78u(a)(2) (2000); *see also* Office of International Affairs, *The SEC's International Enforcement Program and Bilateral Multilateral Initiatives*, 980 PLI/CORP 747, 753-58 (1997) (describing cooperation with foreign enforcement entities).

405. *Id.* at 755 (describing section 21(a)(2) to Securities Exchange Act of 1934).

406. *Id.*

407. *See* Office of International Affairs, *The SEC's International Enforcement Program and Bilateral Multilateral Initiatives*, 980 PLI/CORP 747, 753-58 (1997) (describing cooperation with foreign enforcement entities).

B. *Criminal Violations*

1. *Criminal Referrals*

Although the SEC is the principal agency responsible for the enforcement of federal securities law, its enforcement authority does not include criminal sanctions; this authority is vested in the DOJ.[408] The standard method for determining whether a violation warrants criminal prosecution requires the SEC to prepare and forward a referral to the DOJ.[409] When considering whether to refer a case to the DOJ, the SEC has traditionally focused on four types of violations: (i) those involving organized crime, (ii) those committed by chronic violators, (iii) those where the schemes pose a significant threat to investors, and (iv) those involving corruption of SEC staff or other government officials.[410]

SEC referrals can be informal or formal. The two types of referrals differ significantly in form and in the degree of influence the SEC plays in the prosecution. Formal referrals are detailed written reports prepared by Commission staff outlining the evidence and making recommendations on future actions. The SEC plays a more active role in these investigations.[411] In contrast, for informal referrals, the SEC makes its files available to the DOJ, which then takes the initiative on criminal action.[412] Informal referrals are far more common than the cumbersome formal referrals.[413] However, because SEC rules permit the United States Attorney's Office access to SEC investigatory files, the United States Attorney's Office may bypass the referral procedures and commence criminal actions independent of SEC action.[414]

Even without a formal referral requirement, the United States Attorney's Office decides independently when a violation of federal securities law necessitates criminal prosecution.[415] Consequently, violations of technical reporting requirements can form the bases of criminal prosecutions, as can making false statements

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408. *See* STEINBERG & FERRARA, *supra* note 333, § 6:14 (describing authority of the Attorney General).

409. *See* Arthur F. Mathews, *Criminal Prosecutions Under the Federal Securities Laws and Related Statutes: The Nature and Development of S.E.C. Criminal Cases*, 39 GEO. WASH. L. REV. 901, 914 (1971) (discussing genesis of SEC criminal case); *see also* 15 U.S.C. § 78u(d)(1) (2000) (giving SEC discretionary power to refer cases to Attorney General); *SEC is Stretched to Limit*, NAT'L. L.J., May 18, 1998, at A12 (stating that the SEC does not have any standard procedure for referring cases to the DOJ; instead the agency looks for people who are careless, reckless, and intentionally breaking the law). Federal securities laws each include a provision that allows the SEC to transmit evidence to the attorney general who has the discretion to initiate an investigation. *See* SOMMER II, *supra* note 336, § 10.16(3).

410. STEINBERG & FERRARA, *supra* note 333, § 6:15 (discussing decision to refer cases to DOJ).

411. *Id.* § 6:17 (describing case referral process).

412. *Id.* ("The formal criminal reference requires extensive review" by the Commission).

413. *Id.*

414. *See* United States v. Fields, 592 F.2d 638, 646 (2d Cir. 1978) (endorsing and encouraging informal sharing of information between SEC and DOJ for preliminary investigations).

415. Peloso, *supra* note 260, at 1.

to the SEC.[416] Presumably, this could occur even in cases where the SEC itself, in its discretion, declined to bring civil or administrative proceedings. Under the more formal procedure, only more serious violations will result in criminal prosecutions.[417]

Another difference between SEC and criminal investigations is the opportunity for discovery. The subject of an administrative subpoena issued by the SEC for fact-gathering purposes can negotiate the scope of the subpoena. However, the government can obtain criminal evidence with search warrants, negating any attempt to limit the scope of an investigation.[418] Furthermore, while counsel may be present during SEC investigations, a client must testify alone before a grand jury.[419] Finally, SEC administrative proceedings require that the party under investigation be permitted to introduce relevant evidence.[420]

2. *Parallel or Subsequent Suits*

The SEC may pursue both civil and administrative proceedings with an eye toward possible criminal prosecution.[421] The SEC also may refer a matter to DOJ before the conclusion of its own proceedings.[422] Challenges to simultaneous civil

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416. *See Fehn*, 97 F.3d at 1282-83 (allowing SEC to bring action against aider and abettor for violation of reporting requirements); United States v. Wiles, 102 F.3d 1043, 1066-67 (10th Cir. 1996) (finding that making of false statements to SEC can be prosecuted under either 15 U.S.C. § 78ff or 18 U.S.C. § 1001), *rev'd on other grounds sub nom.*, United States v. Schleibaum, 522 U.S. 945 (1997).

417. *See* Peloso, *supra* note 260, at 1. These cases include organized crime, chronic offenders, promotional schemes that significantly threaten investors, and situations involving corruption of the SEC and other governmental employees. *Id.*

418. *See Remedies Act to Be Enforced on a Case-by-Case Basis, McLucas Says*, 23 SEC. REG. & L. REP. (BNA) 1557, 1558 (Oct. 25, 1991) (providing information for attorneys with clients subject to such investigations).

419. *See id.* (discussing differences between SEC and criminal investigations).

420. *See* Blinder, Robinson & Co. v. SEC, 837 F.2d 1099, 1112 (D.C. Cir. 1988) (holding the SEC erred by refusing to permit introduction of evidence and therefore was unable to weigh adequately factors necessary for reasoned consideration).

421. *E.g.*, United States v. Teyibo, 877 F. Supp. 846, 855-56 (S.D.N.Y. 1995) (ruling use of evidence from SEC civil proceeding was admissible in subsequent criminal trial because SEC did not bring action solely to obtain evidence for criminal trial, U.S. Attorney's Office conducted its own investigation, and SEC properly informed defendant that his testimony could be used against him in subsequent criminal proceeding and that he therefore had Fifth Amendment right to refuse to testify), *aff'd*, 101 F.3d 681 (2d Cir. 1996). The Supreme Court has also recognized that parallel criminal and civil suits might be needed to protect the public interest. *See* Standard Sanitary Mfg. Co. v. United States, 226 U.S. 20, 52 (1912) (explaining a bright-line rule requiring "that the civil suit must await the trial of the criminal action might result in injustice"); *see also* SEC v. First Fin. Group of Tex., Inc., 659 F.2d 660, 666-67 (5th Cir. 1980) (stating that there is no constitutional, statutory, or common law rule barring parallel suits and that these procedures are needed to vindicate government interests).

422. *See* SEC v. Dresser Indus., Inc., 628 F.2d 1368, 1377 (D.C. Cir. 1980) (stating that effective enforcement of securities law requires SEC and DOJ to be able to investigate possible civil and criminal violations simultaneously); *see also* SEC v. Incendy, 936 F. Supp. 952, 956 (S.D. Fla. 1996) ("[T]he Dresser court noted that effective enforcement of the securities laws may require prompt civil and criminal enforcement, and that neither proceeding can always await the completion of the other without jeopardizing the public interest in protection of the efficient working of the securities markets and of investors from the dissemination of false or misleading information.").

and criminal prosecutions as violations of the Constitution's double jeopardy clause have failed.[423] Similarly, courts have struck down the contention that simultaneous prosecutions would result in an infringement of the defendant's Fifth Amendment right to silence privileges.[424]

Generally, courts will not stay SEC administrative or injunctive proceedings even if the defendant has learned of the possibility of future criminal proceedings.[425] As long as the SEC continues its investigation in good faith and for its own purposes, courts will not grant a stay even when the subject matter overlaps with a concurrent grand jury investigation.[426] Nevertheless, the SEC often requests a stay on behalf of the DOJ to preserve the DOJ's discovery advantages in the criminal prosecution.[427]

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423. *See* United States v. Polichemi, 219 F.3d 698, 711 (7th Cir. 2000) (holding that injunctive relief received by the SEC was not criminal in nature and, therefore, did not bar criminal prosecution under the Double Jeopardy Clause of the Eighth Amendment); SEC v. Palmisano, 135 F.3d 860, 866 (2d Cir. 1998) (upholding the combination of civil and criminal sanctions for defendant's operation of a fraudulent investment scheme because purpose of disgorgement and money penalties is not punitive); SEC v. Bilzerian, 153 F.3d 1278,1283 (11th Cir. 1998) (stating that an SEC disgorgement order limited to profits gained through illegal conduct is not so severe or so unrelated to remedial goals that it amounts to a second criminal punishment); United States v. Perry, 152 F.3d 900, 904 (8th Cir. 1998) (holding that the SEC disgorgement remedies are not criminal punishments); United States v. Gartner, 93 F.3d 633, 635-36 (9th Cir. 1996) (holding disgorgement, civil penalties and contempt charges did not raise double jeopardy implications); *see also* United States v. Andrews, 146 F.3d 933, 942 (D.C. Cir. 1998) (holding that SEC civil penalties against a corporation did not preclude criminal penalties against the corporation's CEO even though both actions arose from essentially the same conduct); United States v. Merriam, 108 F.3d 1162, 1164-65 (9th Cir. 1997) (stating that civil penalties in securities fraud cases were intended to be civil and that defendant did not make showing that they were criminal in nature); SEC v. McCaskey, 2002 WL 850001, at *4 (S.D.N.Y. Mar. 26, 2002) (stating that "it is well established that disgorgement is remedial rather than punitive, since a fundamental policy underlying disgorgement is to prevent the unjust enrichment of the wrongdoer rather than to punish him").

424. SEC v. Power Sec. Corp., 142 F.R.D. 321, 322-23 (D. Co. 1992) ("[During simultaneous prosecution] there is no violation of due process where a party is faced with the choice of testifying or invoking the Fifth Amendment.").

425. *See Jones*, 115 F.3d at 1183 (holding SEC disciplinary proceedings do not implicate double jeopardy because they are not designed to punish defendant, but are basically remedial in nature); *Merriam*, 108 F.3d at 1164 (ruling that lifetime bar imposed by SEC in administrative proceeding does not preclude criminal sanction for same securities violation); *cf.* R.J. O'Brien & Assoc. v. Pipkin, 64 F.3d 257, 262-63 (7th Cir. 1995) (finding that defendant could not invoke privilege against self-incrimination because investigation by New York Stock Exchange was not same as interrogation by United States).

426. *Cf.* SEC v. Dresser Indus., Inc., 453 F. Supp. 573, 575-77 (D.D.C. 1978) (refusing to quash SEC subpoena where SEC investigation conducted in good faith and independent of criminal investigation), *aff'd*, 628 F.2d 1368 (D.C. Cir. 1980). However, the Supreme Court has said that in "special circumstances where parallel proceedings could cause a party irreparable harm and prejudice," the court should grant a stay. These circumstances include: "(1) if the Government brought the civil action solely to obtain evidence for its criminal prosecution, (2) if the Government failed to advise the defendant in the civil proceeding that it contemplates his criminal prosecution; (3) if the defendant is without counsel or reasonably fears prejudice from adverse pretrial publicity or other unfair injury; or (4) any other special circumstances indicating unconstitutionality or even impropriety." *Incendy*, 936 F. Supp. at 956 (citing United States v. Kordel 397 U.S. 1, 11 (1970)).

427. *See* SEC v. Oakford Corp., 181 F.R.D. 269, 270 (S.D.N.Y. 1998) (describing stay of discovery in parallel proceedings). Defendants usually do not oppose this motion; otherwise they face the prospect of "expensive dual litigation and the dilemma either of having to testify in a pretrial deposition or, by invoking the privilege against self-incrimination, subjecting [themselves] to permissible adverse inference in the civil case." *Id.* (citing Baxter v.

3. *Contempt Proceedings*

The injunction is one of the most effective and important tools in the SEC's enforcement arsenal, and a defendant who violates the terms of an SEC injunction will likely face criminal or civil contempt proceedings.[428] When faced with the need to initiate a contempt action, the SEC must choose between initiating a civil or criminal action. The main purpose behind an SEC contempt action is enforcement of the injunction, not necessarily punishment of the violator. Thus, when possible, the SEC prefers to initiate civil rather than criminal contempt proceedings.[429]

Civil contempt sanctions are remedial, rather than punitive, and serve one of two functions: "(1) to compensate the party injured as a result of the violation of the injunction, or (2) to coerce compliance with the injunction terms."[430] If the SEC decides that criminal contempt proceedings are not needed, a court may issue an order of civil contempt, enforceable by fine or arrest, for willful disobedience of a specific order of the court.[431] Foreign citizens convicted of violating securities law also risk the imposition of injunctions and contempt orders, and the SEC may seek assistance from the relevant foreign court for enforcement.[432]

Criminal contempt proceedings are designed to force the party to follow the

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Palmigiano, 425 U.S. 308, 318 (1976)). At the same time, the *Oakford* court did admonish the SEC, warning that the use of the federal courts for filing serious civil suits that one has no intention of pursuing until a parallel criminal case is completed is a misuse of the processes of these courts and that this doubtful practice will face strict scrutiny in the future. *Id.* at 272-73.

428. *See, e.g.*, SEC v. Bilzerian, 112 F. Supp. 2d 12, 12-13 (D.D.C. 2000) ("A court has both an inherent and a statutory power to enforce compliance with its orders through the remedy of civil contempt."); SEC v. Dunlap, 253 F.3d 768, 776 (4th Cir. 2001) (failure of a defendant to follow a court order to produce business records can and will result in contempt proceedings); SEC v. Bilzerian, 145 F. Supp. 2d 65, 66 (D.D.C. 2001) (holding refusal of defendant to follow a court order for disgorgement is grounds for civil contempt proceedings).

429. *See* STEINBERG & FERRARA, *supra* note 333, § 6:20. This is consistent with the Court's view of criminal and civil contempt proceedings stated in Yates v. United States, 355 U.S. 66 (1957), where the Court stated "[i]ndeed, the more salutary procedure would appear to be that a court should first apply coercive remedies in an effort to persuade a party to obey its orders, and only make use of the more drastic criminal sanctions when the disobedience continues." *Id.* at 75. *See also* United States v. Winter, 70 F.3d 655, 662 (1st Cir. 1995) (stating differences between civil and criminal contempt charges).

430. STEINBERG & FERRARA, *supra* note 333, § 6:20 (citing *Yates*, 355 U.S. at 74-5); *see also* Quilling v. Funding Resource Group, 227 F.3d 231, 234 (5th Cir. 2000) (holding that contemnor's inability to pay civil contempt sanctions does not render the sanctions punitive, and stating that the purpose of a civil contempt sanction "is to coerce the contemnor into compliance with a court order, or to compensate another party for the contemnor's violation" (quoting Lamar Financial Corp. v. Adams, 918 F.2d 564, 566 (5th Cir. 1990))).

431. *See* Levine v. Comcoa, Ltd., 70 F.3d 1191, 1194 (11th Cir. 1995) (upholding civil contempt order against defendant's attorney for violating temporary restraining order against transferring client's funds, even though order had lapsed); SEC v. Int'l Swiss Inv. Corp., 895 F.2d 1272, 1277 (9th Cir. 1990) (holding court has power to find civil contempt for individual's willful disregard of specific order requiring performance of or abstention from act).

432. *See Int'l Swiss Inv. Corp.*, 895 F.2d at 1276 (affirming district court's decision enjoining defendants, residents of Mexico, from further sale of unregistered securities in United States and holding defendants in contempt, freezing their assets, and ordering accounting).

orders of the court issuing the injunction.[433] Unlike other criminal penalties, the SEC may bring criminal contempt proceedings in court under Rule 42(b) of the Federal Rules of Criminal Procedure without DOJ intervention.[434] This provides the SEC with significant power to compel compliance with injunctions. Another difference between original criminal prosecution and prosecution for contempt is the severity of the penalty imposed. The 1933 and 1934 Acts limit the number of years of imprisonment for criminal violations of their provisions.[435] In contrast, the judge's discretion determines the sentence for a defendant guilty of contempt.[436]

V. PENALTIES

Any person convicted of the violations under the 1934 Act is subject to a maximum fine of $5,000,000 ($25,000,000 for corporations) and a maximum of twenty years imprisonment.[437] Under the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA"),[438] the maximum criminal penalties for insider trading are a $1,100,000 fine ($2,500,000 for corporations) and ten years imprisonment.[439] Criminal penalties may be imposed in addition to civil penalties[440] and disgorgement.[441]

Convictions for violating the 1933 Act lead to sentencing in accordance with section 2B1.1 of the United States Sentencing Guidelines ("Guidelines").[442] Violations start at a base offense level of six under section 2B1.1.[443] Convictions for insider trading under the 1934 Act also lead to sentences in accordance with

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433. *See Yates*, 355 U.S. at 74 (explaining that the purpose of criminal contempt is punitive, while the purpose of civil contempt is coercive).

434. *See* STEINBERG & FERRARA, *supra* note 333, § 6:21 (citing Thomas J. Andre, *The Collateral Consequences of SEC Injunctive Relief: Mild Prophylactic or Perpetual Hazard?*, 1981 U. ILL. L. REV. 625, 628 (1996)).

435. 15 U.S.C. § 77x (2000) (providing five-year limitation under 1933 Act); 15 U.S.C. § 78ff(a) (2000) (10-year limitation under 1934 Act).

436. *See* United States v. Corn, 836 F.2d 889, 893 (5th Cir. 1988) (discussing district court's broad discretion to determine penalty for contempt). *Corn* also discussed the right of a court to impose a greater penalty under a contempt order than might otherwise have been imposed. *Id.* at 892.

437. 15 U.S.C. § 78ff(a) (2000).

438. 15 U.S.C. § 78a (2000).

439. 15 U.S.C. § 78ff(a) (2000).

440. 15 U.S.C. § 77t(d)(2)(A)-(C) (2000) (civil penalties under 1933 Act); 15 U.S.C. § 78u-1 to -2 (2000) (civil penalties under 1934 Act generally and for insider trading).

441. 15 U.S.C. § 78u-2(e) (2000).

442. U.S.S.G. MANUAL app. A (2002). Note that as of November 1, 2001, section 2F1.1 was deleted and its provisions were combined with a new section 2B1.1. *See* United States v. Vargas, 67 F.3d 823, 824, 826 (9th Cir. 1995) (upholding sentence based on defendant's role in creating, selling, and marketing bogus municipal bonds); United States v. Lilly, 37 F.3d 1222, 1227 (7th Cir. 1994) (applying section 2F1.1 for sentencing of 1933 Act violation (18 U.S.C. § 77(q)(a))); United States v. Arutunoff, 1 F.3d 1112, 1120-21 (10th Cir. 1993) (overruling district court's restitution order for defendant involved in unregistered securities dealings). For additional information on organizational sentencing, see the CORP. CRIM. LIABILITY article in this issue.

443. U.S.S.G. MANUAL § 2B1.1(a) (2002).

section 2B1.1 of the Guidelines,[444] Courts increase this offense level by the number of levels from the table in section 2B1.1 corresponding to the gain resulting from the offense.[445] The other offenses discussed in this Article under the 1934 Act are subject to sentencing in accordance with section 2B1.1.[446]

VI. RECENT DEVELOPMENTS

With the growth of technology and increasing interdependence among countries, the opportunities for those looking to commit securities fraud has increased. The Internet has facilitated this trend and presents challenges to the SEC in many ways, including: "(1) the offer and sale of securities over the Internet, (2) the possible manipulation of securities prices through communications over news groups and various bulletin board services; (3) 'spamming' over the Internet—a boiler-room-like tactic by which investment promoters use e-mail to send [fraudulent messages] to large numbers of potential investors; and (4) foreign financial service providers using the Internet to offer services to U.S. investors."[447]

To counter the threats that the Internet poses, the SEC created the Internet Enforcement Office to deal exclusively with fraud conducted over the Internet. The most common problem the SEC has encountered in Internet cases is microcap fraud, or the manipulation of small company stock, committed through the spread of misleading or false information.[448] According to the SEC's enforcement director, the Internet allows people to "get the misrepresentations out globally with the push of a button."[449] This false information is usually spread through the posting of bulletins on the World Wide Web or through e-mail spamming.[450]

Over the past several years, the SEC has begun conducting Internet fraud sweeps aimed at apprehending companies and individuals who use the Internet to

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444. U.S.S.G. MANUAL app. A. (2002); United States v. Pedersen, 3 F.3d 1468, 1469 (11th Cir. 1993); United States v. Cherif, 943 F.2d 692, 702-03 (7th Cir. 1991) (applying insider trading guidelines to other crimes with misappropriation components).

445. U.S.S.G. MANUAL § 2B1.1(b)(1) (2002); *see Vargas*, 67 F.3d at 823 (upholding district court's increase of offense level to reflect defendant's culpability and "extraordinary amount of loss"); *Kunzman*, 54 F.3d at 1532 (stating that court increased sentence to reflect "intended" loss of securities fraud scheme).

446. U.S.S.G. MANUAL app. A (referencing applicable guidelines provisions for §§ 78j & 78ff violations); *see also Kunzman*, 54 F.3d at 1526 (applying guideline provisions for § 78j violation).

447. Thomas C. Newkirk, et al., *Recent S.E.C. Enforcement Cases*, Advanced Securities Law Workshop, 1005 PLI/CORP 429, 548 (1997) (looking at ways in which the Internet can be used to take advantage of people).

448. Suzanne Manning & Phyllis Diamond, *Microcap Fraud over Internet*, 30 SEC. REG. & L. REP. (BNA) 1224 (Aug. 14, 1998) (discussing the formation of an Internet Enforcement office and its focus).

449. Rebecca Buckman, *SEC Formalizes Focus on the Internet with New Office*, WALL ST. J., July 29, 1998, at B12 (quoting SEC enforcement director Richard Walker).

450. Press Release, Securities Exchange Comm'n, *SEC Charges 23 Companies and Individuals in Cases Involving a Broad Spectrum of Internet Securities Fraud, available at* http://www.sec.gov/news/press/2001-24.txt (last visited Feb. 28, 2003). In one cited case, a private company used "spamming" and Internet bulletin boards to announce that its upcoming, SEC-approved IPO was imminent and that it would realize at least $1 billion through the sale of online eyewear. In reality, the company never received SEC approval and the company had no inventory, offices, products or services. *Id.*

defraud investors.[451] While microcap fraud continues to make up a large portion of Internet cases, other common securities fraud techniques involve using the world wide web to post false promises of imminent IPO, baseless financial projections, false track records, inflated performance claims, and fake testimonials.[452] In March of 2001, the SEC launched its fifth sweep, bringing the number of Internet cases filed since 1998 to over 200.[453] The SEC has also taken other steps such as proposing new legislation[454] and issuing recommendations to warn investors about fraud on the web.[455]

One of the unique characteristics of the Internet is its users' capacity to send information across national boundaries; this has made international enforcement efforts even more important. Specifically, regulators are now concerned about "legal jurisdiction, choice of law, enforcement of contracts, liability and other issues."[456] The primary focus of regulators is to balance the need for the prevention of fraud against the need to facilitate easy and efficient use of the Internet.[457] However, it appears that international securities regulators will continue to use traditional methods of international enforcement to combat securities fraud on the Internet.[458]

Courts have also begun to hear calls from securities lawyers and violators to force the SEC to develop clearer standards surrounding securities law before bringing enforcement actions.[459] In *Checkosky v. SEC*,[460] the court considered the SEC suspension of two accountants for improperly advising a client to categorize certain costs as start-up costs. This categorization was counter to Generally Accepted Accounting Principles ("GAAP"), and effectively deferred the costs of research and development.[461] The SEC claimed that the accountants engaged in improper professional conduct and suspended them from practicing before the Commission for five years. In making the suspension, the SEC relied on Rule

451. *See id.*

452. *See id.* (citing several recently filed cases describing particular violations).

453. *See id.*

454. *See* Rachel Witmer McTague, *Antifraud: Bill to Create Antifraud Network Clears House Judiciary Committee* (Oct. 11, 2001), *available at* 10/11/2001 SLD d2 in Sec. Law. Daily.

455. Press Release, Securities Exchange Comm'n, *Survivor Checklist*, *available at* http://www.sec.gov/investor/pubs/fraudsurvivor.htm (last visited Feb. 28, 2003). SEC has issued recommendations encouraging investors to take three steps before investing online: (i) check the EDGAR database to ensure that an investment is registered; (ii) research the person or firm in order to determine whether they have a record of complaints or fraud; (iii) be skeptical of online offerings until independent research proves that the investment is legitimate.

456. Michael D. Mann, et al., *The Internet: Identifying and Responding to International Jurisdictional and Regulatory Compliance Issues*, 1046 PLI/CORP 241, 248 (1998).

457. *See id.* at 249 (discussing the focus of regulators in the rare cases where they have discussed the Internet).

458. *See id.* (stating that although regulators recognize that Internet is new medium to perpetuate fraud, they are not eager to regulate in this area).

459. *See* Dominic Bencivenga, *SEC Report Addresses Bar's Chronic Complaints*, N.Y. L.J., Aug. 6, 1998, at 5.

460. 139 F.3d 221, 222-23 (D.C. Cir. 1998).

461. *Id.* at 222.

2(e)(1)(ii).[462] Upon review, the court found that SEC regulations "provide no clear mental state standard to govern" certain securities laws and that "it seems at times almost deliberately obscurantist on the question."[463] The court continued, "[a]lthough we owe substantial deference to an agency's interpretation of its own regulations,[464] we cannot defer to an agency when 'we are at a loss to know what kind of standard it is applying or how it is applying that standard to this record.'"[465] In response to these criticisms, Commissioner Laura Unger, after concluding a review of the agency's actions, recommended more creative and flexible remedies considering the full range of options available to help clarify the agency's message on particular issues.[466]

Another issue of interest that has come to the forefront of securities fraud law in recent years concerns the independence of brokerage analysts. The majority of the debate has been over whether investors can or should expect complete disinterest from analysts employed by firms "whose principal source of income comes from investment banking fees and other activities dependent on the sale of securities."[467] To confront this issue, a House of Representatives Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises held hearings throughout the past year.[468] In July of 2001, the SEC formally issued an alert that stated that investors should not rely solely on analysts' reports when buying and selling stock.[469] Despite the federal government's growing interest in this area, few cases alleging misinformation or fraud on the part of analysts have actually been filed.[470]

The Enron and Worldcom debacles have led to significant new developments in

462. *Id.*

463. *Id.* at 225.

464. *Id.* (quoting Thomas Jefferson Univ. v. Shalala, 512 U.S. 504, 512 (1994)).

465. *Id.* (quoting United Food and Commercial Workers Int'l Union v. NLRB, 880 F.2d 1422, 1435-36 (D.C. Cir. 1989)).

466. Commissioner Unger recommended (i) shortening internal deadlines and expediting cases involving current industry trends; (ii) using more creative sanctions and remedies in order to send clear messages; (iii) intensifying coordination with regional offices; (iv) implementing an expanded staff training program; and (v) working more closely with federal, state, and local law enforcement. *See* Press Release, Securities Exch. Comm'n, *Unger Enforcement Review Finds Ways to Leverage Commission Resources*, *available at* http://www.sec.gov/news/press/pressarchive/1998/98-64.txt (last visited Feb. 28, 2003).

467. *See* Securities Law Daily, *Becker Asks Whether Independence Of Sell-Side Analysts Is Achievable Aim* (August 13, 2001), *available at* 8/13/2001 SLD d3.

468. In trying to determine whether analysts are so conflicted that they put their firm's relationship with clients above the interests of the investors, the committee found evidence of "gradual trend of grade inflation" in analyst recommendations over the last few years and the "conflicts of interest compromising the independence and integrity of market research." *See* Securities Law Daily, *New Merrill Lynch Policy Prohibits Analysts From Buying Shares in Companies They Cover* (July 11, 2001), *available at* 7/11/2001 SLD d4.

469. Press Release, Securities Exchange Comm'n, *SEC Cautions Investors About Analyst Recommendations*, *available at* www.sec.gov/investor/pubs/analysts.htm (last visited Nov. 11, 2002).

470. A class of investors brought suit against Mary Meeker of Morgan Stanley Dean Witter Co., alleging fraud and divulgence of misleading recommendations on Internet stocks. The action was swiftly dismissed in a federal court in Manhattan for lack of substance. Generally, investors have found it difficult to successfully bring an

the area of enforcement and disclosure.[471] First, pursuant to the Sarbanes-Oxley Act enacted July 30, 2002, the SEC must adopt a rule within six months of the enactment that requires "an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof)."[472] The rule must also stipulate that if the chief counsel or the CEO fail to respond appropriately by adopting remedial measures or sanctions, the attorney must report the securities violations or breaches of fiduciary duties to (i) the audit committee of the board of directors, (ii) another board committee not comprised solely of inside directors (those directors that are employed by the corporation), or (iii) the board as whole.[473] Thus, as indicated by the wording of the statute, in the absence of appropriate action by the CEO, the attorney must disclose the violations to at least some outside directors, possibly in an effort to avoid the problems associated with structural bias. However, the SEC has postponed action on a rule that would require attorneys to resign and report wrongdoing to the SEC.[474]

Second, in an attempt to increase the currency of information disclosed to the public in the periodic forms that must be filed by reporting companies, the SEC has amended its rules to accelerate the filing of the annual 10K and the quarterly 10Q.[475] These amendments are effective November 15, 2002 and adopt a phase-in acceleration of the filings such that for the fiscal year ending on or after December 15, 2005, a corporation with at least a $75 million public float must file its 10-K within sixty days after the end of the fiscal year, instead of within the ninety days currently allowed, and must file its 10-Q within 35 days after the end of the fiscal quarter, instead of within the forty-five days currently allowed.[476] Moreover, the SEC will require corporations subject to the accelerated filing to disclose in their annual report where an investor can obtain access to the corporations filings and whether the corporation provides access to its 10K, 10Q, and 8K reports on its website, "free of charge, as soon as reasonably practicable after those reports are

action alleging analyst fraud. *See Suit Over Meeker's Bullish Recommendations Swiftly Dismissed*, 11 No. 1 ANPLLR 16 (2001).

In response, the federal government has been encouraging broker-dealer firms to self-regulate analyst independence. Companies including Merrill Lynch & Co. and Credit Suisse First Boston (CSFB) have instituted policies prohibiting analysts from buying shares in the companies they cover. Securities Law Daily (BNA), *CSFB Cites New Policy Barring Analysts from Owning Stocks They Cover* (July 26, 2002), *available at* 7/25/2001 SLD d1.

471. *See* Securities Law Daily, *Attorneys: SEC WILL Be Required to Mandate That Lawyers Report Securities Violations of Corporate Clients* (July 26, 2002), *available at* 7/26/2002 SLD d7.

472. 15 U.S.C. 1745 (2002).

473. *Id.*

474. *See* Michael Schroeder, *The SEC Modifies New Attorney Rules*, WALL ST. J., Jan. 24, 2003, at C11, *available at* 2003 WL-WSJ 3957375.

475. *See* 67 Fed. Reg. 58480-01 (Sept. 16, 2002) (to be codified at 17 C.F.R. pts. 210, 229, 240, and 249).

476. *See id.*

electronically filed with or furnished to the Commission."[477]

Third, the SEC has also proposed a rule change that would increase both the frequency and the currency of information disclosed to the public by increasing the number of events that would trigger the filing of an 8K by a corporation.[478] Currently a corporation must file an 8K after the occurrence of certain material events. Currently, these events are: (i) a change in control of the company, (ii) the company's disposition of a significant amount of assets, (iii) the company's bankruptcy or receivership, (iv) a change in the company's certifying accountant, (v) the resignation of a company's director, and (vi) a change in the company's fiscal year.[479] Also, depending on which event triggers the filing of the 8K, a company currently must file within either five or fifteen days.[480] The proposed rule changes would add eleven additional triggering events[481] and would require the corporation to file the 8K within two days of any triggering event.[482] Thus, with the adopted amendment to the rules governing the filing of the 10K and 10Q and the proposed amendment to the rule governing the filing of the 8K, the SEC is expressing a clear desire to increase the frequency and speed with which company's disclose information to the public.

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477. *Id.*

478. Herbert S. Wander, *Developments in Securities Law Disclosure*, 1324 PLI/CORP 9 (2002).

479. *See* Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, 67 Fed. Reg. 42914-01 (June 25, 2002).

480. *See id.*

481. *See id.*

482. *See id.*