

CULPABLE INTENT REQUIRED FOR ALL CRIMINAL INSIDER TRADING CONVICTIONS AFTER *UNITED STATES V. O'HAGAN*

INTRODUCTION

The United States Supreme Court's decision in *United States v. O'Hagan*¹ has been widely recognized for its departure from the traditional theory of insider trading liability and its validation of an alternative theory of liability that had previously been in question.² This alternative theory is the "misappropriation" theory of insider trading, which forbids a person from trading in securities while using confidential information gained in breach of a fiduciary duty owed to the source of that information.³ In *O'Hagan*, the Court upheld the convictions of a lawyer who traded Pillsbury stock based on his "inside" knowledge of a pending merger transaction involving Pillsbury, the target of a tender offer, which he had obtained through his firm's representation of the acquiring corporation.⁴ With its validation of the misappropriation theory, the Court expanded the federal government's enforcement power under the Securities Exchange Act of 1934 ("Exchange Act") to impose criminal penalties on certain defendants who trade securities based on material, nonpublic information.⁵ This case was, therefore, called a "sweeping victory" by the Solicitor General of the Securities and Exchange Commission ("SEC") for its definitive rulings regarding insider trading laws.⁶

In affirming the government's theory of liability, however, the Court also interpreted the Exchange Act to mean that the government must prove "culpable intent" on the part of insider trading defendants in order to establish criminal liability for violations of the federal

¹ 521 U.S. 642 (1997).

² See *id.* at 650; Kimberly D. Krawiec et al., *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153, 155, 156 (1998); Carol B. Swanson, *Reinventing Insider Trading: The Supreme Court Misappropriates the Misappropriation Theory*, 32 WAKE FOREST L. REV. 1157, 1157 (1997).

³ See *O'Hagan*, 521 U.S. at 652.

⁴ See *id.* at 648.

⁵ See *id.* at 650.

⁶ See Paul Gouson, Securities and Exchange Commission, *Recent Judicial Developments*, Apr. 16, 1998, SC88 A.L.I.-A.B.A. 1, 11.

securities laws.⁷ *O'Hagan*, therefore, was not actually such a sweeping victory, because this standard of intent for criminal liability is more strict than the standard utilized by the government in previous criminal insider trading cases.⁸

The Exchange Act requires that all criminal violations be committed "willfully."⁹ In the past, both the SEC and lower federal courts have frequently interpreted the Exchange Act to mean that a willful violation of the securities laws occurs whenever a defendant voluntarily undertakes an action that happens to be illegal.¹⁰ This type of "voluntary intent" was necessary to impose administrative sanctions or criminal penalties.¹¹ In *O'Hagan*, however, the Court ruled that the term "willful" in the Exchange Act means the defendant took a more purposeful action, knowing it violated the securities laws.¹² This subtle distinction ensures that the government must prove actual culpable intent on the part of an insider trading defendant in the traditional sense required by criminal statutes that penalize "willful" violations.¹³ Although the SEC may still have a relatively easy time obtaining civil injunctions or money damages against an insider trading defendant, this ruling is a positive step because more drastic measures, such as incarceration, are reserved for traders who willfully violate their known legal duties.¹⁴ In the most egregious cases, culpable intent can be established without significant difficulty.¹⁵

⁷ See *O'Hagan*, 521 U.S. at 665-66. The government also will have to prove this intent to impose administrative sanctions, such as suspensions, bars, etc., on individuals registered with the SEC. See David Spears & James M. Aquilina, *Ruling Limits SEC's Sanction Power*, N.Y.L.J., Aug. 27, 1998, at 1.

⁸ See *United States v. Schwartz*, 464 F.2d 499, 509 (2d Cir. 1972); Charles M. Carberry & Harold K. Gordon, *After O'Hagan: Less Expansive Duties and Higher Mental States Restrict Criminal Securities Laws Prosecutions*, in *SECOND ANNUAL FINANCIAL SERVICES INSTITUTE* 165, 172 (PTL Corp. No. 1007, 1997).

⁹ 15 U.S.C. § 78ff(a) (1999).

¹⁰ See *In re New Allied Dev. Corp.*, 52 S.E.C. 1119, 1129 n.31 (1996); see also *Schwartz*, 464 F.2d at 509; *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965); *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949).

¹¹ See *New Allied Dev. Corp.*, 52 S.E.C. at 1129, n.31; see also *Schwartz*, 464 F.2d at 509; *Tager*, 344 F.2d at 8; *Hughes*, 174 F.2d at 977.

¹² See *O'Hagan*, 521 U.S. at 665-66.

¹³ See *Bryan v. United States*, —U.S.—, 118 S. Ct. 1939, 1945 (1998); *Kawaauhau v. Geiger*, —U.S.—, 118 S. Ct. 974, 977 (1998); *Ratzlaf v. United States*, 510 U.S. 135, 141 (1994); *United States v. Pomponio*, 429 U.S. 10, 12 (1976); *United States v. Illinois Cent. R.R. Co.*, 303 U.S. 239, 242-43 (1938); *United States v. Murdock*, 290 U.S. 389, 394 (1933); see also Carberry & Gordon, *supra* note 8, at 179 (stating that "the conclusion that criminal Exchange Act liability under § 32(a) requires at a minimum a state of mind embracing an evil purpose comports with well-settled principles of substantive criminal law.").

¹⁴ See Spears & Aquilina, *supra* note 7, at 1.

¹⁵ See *O'Hagan*, 521 U.S. at 666; Spears & Aquilina, *supra* note 7, at 1.

Part I of this Note sets out the applicable sections of the Exchange Act and Rule 10b-5, which has developed into the primary enforcement mechanism for all insider trading violations.¹⁶ Part I also explains in brief detail the two general theories of proof the federal government uses to establish liability on the part of defendants accused of illegal insider trading of securities.¹⁷ Part II describes how the Exchange Act originally required the government to establish a relatively high level of scienter, or intent to deceive, by a defendant charged with criminal violations of the federal securities laws.¹⁸ Several interpretations of this standard, prior to the *O'Hagan* case, are then explored to show how the original congressional intent has often been distorted.¹⁹ Part II also includes a brief discussion of several methods of proving scienter, or willfulness.²⁰ Part III of this Note examines the United States Supreme Court's *O'Hagan* decision in detail and demonstrates how the Court's statements regarding the intent of an insider trading criminal defendant help illustrate the correct standard for a criminal conviction.²¹ The *O'Hagan* decision on remand to the Eighth Circuit Court of Appeals provides one of the most recent judicial standards for willful violations of the Exchange Act; Part III shows how that court, although using some ambiguous language, reached the correct result in affirming O'Hagan's convictions.²² Part IV then analyzes the correct standard of intent for criminal violations of the Exchange Act and demonstrates how courts and the SEC should apply that standard in the future.²³

I. INSIDER TRADING

A. *Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5*

Section 10(b) of the Exchange Act, entitled "Manipulative and deceptive devices," most directly addresses the problem of fraudulent securities trading.²⁴ Section 10(b) provides, in pertinent part:

¹⁶ See *infra* notes 24-34 and accompanying text.

¹⁷ See *infra* notes 35-52 and accompanying text.

¹⁸ See *infra* notes 53-64 and accompanying text.

¹⁹ See *infra* notes 65-110 and accompanying text.

²⁰ See *infra* notes 111-52 and accompanying text.

²¹ See *infra* notes 153-95 and accompanying text.

²² See *infra* notes 196-203 and accompanying text.

²³ See *infra* notes 204-73 and accompanying text.

²⁴ See 15 U.S.C. § 78j(b) (1999).

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To 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 regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.²⁵

On its face, § 10(b) does not actually make any activity illegal; it merely provides the SEC with rulemaking authority to outlaw certain conduct.²⁶ Pursuant to this statutory grant of authority, the SEC adopted Rule 10b-5, which provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, . . . [or] (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.²⁷

Once a person charged with manipulation or deception in connection with either the purchase or sale of securities is found liable, that person becomes subject to civil penalties, criminal penalties and/or administrative sanctions.²⁸ Criminal liability is covered by § 32(a), which states:

Any person who willfully violates any provision of this chapter . . . or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter . . . shall upon conviction be fined not more than \$1,000,000, or imprisoned not more than 10 years, or both . . . but no person shall be subject to imprisonment under this section for the violation of any

²⁵ *Id.*

²⁶ See *id.*; see also Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 464 n.10 (1990).

²⁷ 17 C.F.R. § 240.10b-5 (1999).

²⁸ See 15 U.S.C. §§ 78u-1(a)(1)(A), 78ff(a), 78o(b)(4)(D) (1999).

rule or regulation if he proves that he had no knowledge of such rule or regulation.²⁹

When the SEC suspects someone of criminal violations under § 32(a), it has discretion to prepare a formal referral to the Department of Justice.³⁰ The SEC may bring civil and administrative proceedings to investigate potential violations, but the Department of Justice has sole jurisdiction to institute criminal proceedings under the Exchange Act.³¹ Administrative sanctions are available under § 15(b)(4) against securities brokers, dealers and others working within the securities industry, who are officially registered with the SEC.³² The Exchange Act also grants the SEC power to levy civil penalties against any § 10(b) violator.³³ Congress, however, purposefully omitted the term "willfully" in the section authorizing civil penalties, whereas criminal liability and the imposition of administrative sanctions against registered persons require a defendant to have willfully violated the relevant sections of the Exchange Act.³⁴

B. Two General Theories of Liability

There are two distinct general theories of insider trading liability that are used to establish a violation of § 10(b) and Rule 10b-5.³⁵ These

²⁹ 15 U.S.C. § 78ff(a).

³⁰ See 15 U.S.C. § 78u(d)(1) (1999); Jennifer D. Autolini et al., *Securities Fraud*, 34 AM. CRIM. L. REV. 983, 1029 (1997).

³¹ See 17 C.F.R. § 202.5(f) (1999).

³² See 15 U.S.C. § 78o(b)(4)(D) (1999). Exchange Act § 15(b)(4)(D) provides that: "The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds, on the record after notice and . . . a hearing, that such censure, placing of limitations, suspensions, or revocation is in the public interest and that such broker or dealer . . . has willfully violated any provision of . . . this title [Exchange Act]." *Id.*

³³ See 15 U.S.C. § 78u-1(a)(1)(A) (1999). The Exchange Act provides that:

Whenever it shall appear to the Commission that any person has violated any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information, or has violated any such provision by communicating such information in connection with, a transaction on or through the facilities of a national securities exchange . . . the Commission (A) may bring an action in a United States district court to seek . . . a civil penalty to be paid by the person who committed such violation.

Id.

³⁴ See 15 U.S.C. §§ 78u-1(a)(1)(A), 78ff(a), 78o(b)(4)(D) (1999).

³⁵ See *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997); *Carpenter v. United States*, 484 U.S. 19, 24 (1987); *United States v. Chestman*, 947 F.2d 551, 566 (2d Cir. 1991) (en banc); Paul H. Dawes, *The Mens Requirement for Criminal Liability Under Section 10(b) and Rule 10b-5*, in SECOND ANNUAL FINANCIAL SERVICES INSTITUTE 515, 521-22 (PLI Corp. No. 1070, 1998).

are the "traditional" (or "classical") theory and the "misappropriation" theory of insider trading liability.³⁶ Under the traditional theory, a violation of § 10(b) and Rule 10b-5 occurs when a corporate insider purchases or sells the securities of his or her corporation on the basis of material, nonpublic information.³⁷ This conduct is illegal because the fiduciary relationship of trust and confidence between shareholders of a corporation and those corporate insiders who have obtained confidential information creates a duty to disclose or abstain from trading because of the "necessity of preventing a corporate insider from . . . taking unfair advantage of uninformed . . . stockholders."³⁸ This theory applies not only to corporate officers, directors, employees and other "permanent insiders," but also to attorneys, accountants and other temporary insiders of a corporation.³⁹ A temporary insider is someone who receives material, confidential information while performing legitimate services for a corporation and, therefore, develops a fiduciary relationship with that corporation.⁴⁰

Under the misappropriation theory, a corporate "outsider" violates § 10(b) and Rule 10b-5 when that person trades in securities using material, confidential information without disclosing such use to the source of information, in breach of a fiduciary duty, or duty of trust and confidence, owed to that source.⁴¹ Liability, therefore, is not based on a fiduciary relationship between the trader and a purchaser or seller of a company's stock.⁴² Instead, the trader is a corporate "outsider" who owes a duty to the source of the nonpublic information to either disclose an intent to trade on the information or abstain from trading on it altogether.⁴³

These two theories of insider trading liability, traditional and misappropriation, are often considered complementary.⁴⁴ The traditional

³⁶ See *O'Hagan*, 521 U.S. at 651-52. Along with these two theories, SEC Rule 14e-3 specifically forbids trading on material, nonpublic information in the context of a tender offer. See 17 C.F.R. § 240.14e-3(a) (1999). In order to violate Rule 14e-3, a trader must be aware that he or she is using information that is nonpublic and has been provided by a corporate insider. See *id.*

³⁷ See *O'Hagan*, 521 U.S. at 651-52; *Chiarella v. United States*, 445 U.S. 222, 228 (1980).

³⁸ *Chiarella*, 445 U.S. at 228-29 (citation omitted).

³⁹ See *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983).

⁴⁰ See *id.* "For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty." *Id.*

⁴¹ See *O'Hagan*, 521 U.S. at 652.

⁴² See *id.* at 653.

⁴³ See *id.* at 652.

⁴⁴ See *id.* Some commentators, however, have stressed that the misappropriation theory actually targets any insider trading activity that could conceivably be covered by the traditional theory. See Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on*

theory targets a corporate insider's breach of duty to shareholders with whom the insider trades.⁴⁵ The misappropriation theory targets trading on the basis of nonpublic information by a corporate "outsider" in breach of a duty owed not to the trading party, but to the source of the information.⁴⁶ The misappropriation theory, therefore, "protect[s] the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect the corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders."⁴⁷ The theory's goal is to promote investor confidence in honest securities markets: "Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law."⁴⁸

The validity of the misappropriation theory for criminal liability remained in question until the Supreme Court's decision in *O'Hagan*.⁴⁹ Prior to that case, the Court had only twice been presented with the question of whether criminal liability for a violation of § 10(b) may be based on the misappropriation theory.⁵⁰ In 1980, a majority of the Court in *Chiarella v. United States* explicitly declined to address the question because the theory had not been submitted to the jury at trial.⁵¹ In a 1987 decision, *Carpenter v. United States*, the Court split evenly (4-4) on whether convictions resting on the misappropriation theory should be affirmed.⁵²

Nonpublic Information, 13 HOFSTRA L. REV. 101, 102 (1984). Instead of the two theories being complementary, therefore, there is actually no real need for the traditional theory of insider trading liability at all. See *id.*

⁴⁵ See *O'Hagan*, 521 U.S. at 652.

⁴⁶ See *id.* at 652-53.

⁴⁷ *Id.* at 653 (citation omitted).

⁴⁸ *Id.* at 658; see Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 356 (1979).

⁴⁹ See generally *O'Hagan v. United States*, 92 F.3d 612 (8th Cir. 1996) [hereinafter *O'Hagan II*]; *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995); *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc); *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991).

⁵⁰ See *Carpenter v. United States*, 484 U.S. 19, 24 (1987); *Chiarella v. United States*, 445 U.S. 222, 235-37 (1980).

⁵¹ See *Chiarella*, 445 U.S. at 236-37. Writing in dissent, however, Chief Justice Burger approved of the misappropriation theory to sustain the petitioner's convictions. *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting).

⁵² See *Carpenter*, 484 U.S. at 24.

II. "WILLFUL" VIOLATIONS OF § 10(B) AND RULE 10B-5

A. *Legislative History of § 32(a)*

Prior to the Supreme Court's 1997 *O'Hagan* decision, the standard for criminal intent necessary to sustain a conviction under § 32(a) was not always consistent with Congress's original intent when it passed the Exchange Act.⁵³ When the Exchange Act was first enacted in 1934, one influential commentator, William B. Herlands (later elevated to the federal bench in the United States District Court for the Southern District of New York), described Congress's motives in adding the term "willfully violate" to the criminal penalties section:

The express requirement of "willfulness" in Section 32 and the seriousness of the possible penalty thereunder warrant the belief that "guilty intent" will be required for prosecutions under this statute. The word "willfully" in the ordinary sense in which it is used in penal statutes means "not merely voluntary but with a bad purpose." And such was the definition which the Congressional Committees intended the word to have in the [Exchange Act].⁵⁴

Herlands also stated that "[w]here violations are not committed 'willfully,' the Securities Exchange Commission . . . may nevertheless institute administrative, injunction, or mandamus proceedings. Aggrieved purchasers may commence civil actions. And the Stock Exchange itself must take action against its delinquent members."⁵⁵ Herlands noted that criminal proceedings, however, are "set into motion by 'willful' violations."⁵⁶ Additional evidence of congressional intent on the subject of criminal liability is found in Senate hearings before the Committee on Banking and Currency in March of 1934.⁵⁷ Ferdinand Pecora, appointed by President Franklin D. Roosevelt, as chief counsel to the Committee, stated repeatedly that

⁵³ See Norwood P. Beveridge, *Is Mens Rea Required for a Criminal Violation of the Federal Securities Laws?*, 52 BUS. LAW. 35, 47-48 (1996); Jonathan Eisenberg, "Willful" Violations of the Federal Securities Laws: Why the SEC's No-Fault Approach is Now Ripe for Rejection, 5 INSIGHTS 13, 13 (1991); Spears & Aquilina, *supra* note 7, at 1.

⁵⁴ William B. Herlands, *Criminal Law Aspects of the Securities Exchange Act of 1934*, 21 VA. L. REV. 139, 147-48 (1934).

⁵⁵ *Id.* at 144.

⁵⁶ *Id.* at 145.

⁵⁷ See *Stock Exchange Practices: Hearings on S. Res. 84, S. Res. 56 & S. Res. 97 Before the Senate Comm. on Banking and Currency*, 73d Cong. 6965-69, 7455-66, 7572-74, 7623-24 (1934) [hereinafter *1934 Hearings*]; Beveridge, *supra* note 53, at 46; Carberry & Gordon, *supra* note 8, at 179.

the Exchange Act was not intended to punish innocent violators.⁵⁸ During the hearings, Howard Butcher, Jr., President of the Philadelphia Stock Exchange, expressed concerns about the lack of difference in penalties (civil and criminal) between innocent violators of the Act and "willful" violators. Pecora responded:

Mr. Pecora: [If] you are fearful that directors may be sent to jail for unwitting violations . . . [§ 32] specifically says: "Any person who willfully violates any provision of this act or any rule . . . [is] subject to the penalties prescribed in the bill." That is something far different from an unwitting or innocent violation, isn't it?

Mr. Butcher: That is what the language appears to say, but—

Mr. Pecora: Oh, no. It is not a technicality at all. It is a very substantial provision, and it is intended to mean just what it says. There is a great difference between a willful violation of a penal statute and an innocent violation of it. Yes; there is all the difference in the world between the two.⁵⁹

In his interpretation of the language and history behind § 32(a), Herlands also contrasted one's actual knowledge of a specific rule or regulation, with a general knowledge of wrongdoing: "[T]he defendant need not be shown to have had knowledge of the particular statute or rule which he violated, provided the prosecution establishes a *realization on the defendant's part that he was doing a wrongful act*."⁶⁰ This distinction is extremely important when looking at the potential punishment imposed under § 32(a), because a defendant can escape imprisonment if he or she did not have knowledge of the rule or regulation allegedly violated.⁶¹ Therefore, a person can be criminally convicted of a § 10(b) and Rule 10b-5 violation, if that person acted with the realization that he or she was committing a wrongful act, but may avoid a jail sentence if he or she can prove a lack of specific knowledge as to § 10(b) and Rule 10b-5.⁶²

Several commentators have also pointed out that the Exchange Act was passed into law on the heels of a recent United States Supreme Court decision that clearly explained what the term "willfully" actually

⁵⁸ See 1934 Hearings, *supra* note 57 at 6966-67, 7465; Beveridge, *supra* note 53, at 46; Carberry & Gordon, *supra* note 8, at 179.

⁵⁹ 1934 Hearings, *supra* note 57, at 7465; see also Carberry & Gordon, *supra* note 8, at 179; Herlands, *supra* note 54, at 148.

⁶⁰ Herlands, *supra* note 54, at 149 (emphasis added).

⁶¹ See 15 U.S.C. § 78ff(a) (1999); Herlands, *supra* note 54, at 149.

⁶² See 15 U.S.C. § 78ff(a) (1999); Herlands, *supra* note 54, at 149.

means in a criminal statute.⁶³ In *United States v. Murdock*, decided in 1933, just a few months prior to Congress's use of the term "willfully" in § 32(a) of the Exchange Act, the Court held that when the word "willful" is used in a penal statute, it means that an act is done with a "bad purpose" or "evil intent," not merely an act which is voluntarily undertaken by a defendant.⁶⁴

B. Interpretations of § 32(a) After 1934

Almost immediately after the Exchange Act was passed, however, the SEC began to erode the distinction between willful and non-willful violations of § 10(b).⁶⁵ Until *O'Hagan* in 1997, the federal government consistently took the position that a person was criminally liable for § 10(b) and Rule 10b-5 violations if that person intentionally or voluntarily engaged in acts that were prohibited by that section.⁶⁶ The test was not whether an individual knew that his or her actions violated the Exchange Act, but merely whether or not that individual had acted voluntarily and without coercion.⁶⁷ The SEC, therefore, transformed all violations in criminal and administrative proceedings into willful violations: a person "willfully violates" the securities laws as long as that person is merely "aware of all that [he or she] is doing," without any regard to whether that person is aware that the particular action is against the law.⁶⁸ This approach led one commentator, Jonathan Eisenberg, to describe the SEC as an organization that simply holds a person liable for willful violations of the Exchange Act as long as that person was not "insane, unconscious, or sleepwalking" at the time of the conduct in question.⁶⁹

This policy regarding "voluntary intent" was evident in several SEC administrative decisions and in judicial cases involving the criminal aspects of insider trading of securities.⁷⁰ For example, in a 1940 admin-

⁶³ See *United States v. Murdock*, 290 U.S. 389, 394 (1933); Beveridge, *supra* note 53, at 47; Eisenberg, *supra* note 53, at 13.

⁶⁴ See *Murdock*, 290 U.S. at 394.

⁶⁵ See *United States v. Charnay*, 537 F.2d 341, 357 (9th Cir. 1976); *United States v. Schwartz*, 464 F.2d 499, 509 (2d Cir. 1972), *cert. denied*, 409 U.S. 1009 (1972); *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965); *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949); *In re Thompson Ross Sec.*, 6 S.E.C. 1111, 1122-23 (1940); Eisenberg, *supra* note 53, at 13.

⁶⁶ See *Charnay*, 537 F.2d at 357; *Schwartz*, 464 F.2d at 509; *Tager*, 344 F.2d at 8; *Hughes*, 174 F.2d at 977; *Thompson Ross Sec.*, 6 S.E.C. at 1122-23.

⁶⁷ See *Charnay*, 537 F.2d at 357 (Sneed, J., concurring); *Schwartz*, 464 F.2d at 509; *Tager*, 344 F.2d at 8; *Hughes*, 174 F.2d at 977; *Thompson Ross Sec.*, 6 S.E.C. at 1122-23.

⁶⁸ See Eisenberg, *supra* note 53, at 13.

⁶⁹ *Id.* at 17.

⁷⁰ See *Charnay*, 537 F.2d at 357; *Schwartz*, 464 F.2d at 509; *Tager*, 344 F.2d at 8; *Hughes*, 174 F.2d at 977; *Thompson Ross Sec.*, 6 S.E.C. at 1122-23.

istrative hearing before the SEC, *In re Thompson Ross Securities*, the SEC considered the meaning of "willfully violates" in the Exchange Act for the first time.⁷¹ This action arose in the context of a proceeding initiated pursuant to § 15(b) which provides for administrative sanctions against a defendant upon proof of willful violations of the Exchange Act.⁷² Thompson Ross Securities was charged with selling unregistered securities.⁷³ Upon finding that the firm, in fact, acted illegally, the SEC considered a defense raised by Thompson Ross that it had not acted "willfully," as required by the statute, because the firm relied on the advice of counsel and acted in good faith.⁷⁴ The SEC rejected this defense and held that the firm acted willfully because "[it] was fully aware of all that it was doing."⁷⁵ The SEC reasoned that it was enough that Thompson Ross had voluntarily undertaken to sell the securities in question, even though the firm did so with the belief that it was in full compliance with the applicable laws.⁷⁶ One of the Commissioners dissented from this ruling and stated that "since the company acted upon advice from counsel on a matter that was not entirely free from doubt, I doubt whether the violation was willful"⁷⁷

This broad standard of "voluntary intent" was validated by the Court of Appeals for the Second Circuit in 1965, in *Tager v. SEC*.⁷⁸ There, the court upheld the revocation of the registration of a securities broker-dealer (Tager), as provided in § 15(b), stating that the term "willfully" in the Exchange Act means simply "intentionally committing the act which constitutes the violation."⁷⁹ The SEC charged the appellant broker-dealer with unlawfully giving a false appearance of market activity in a corporation's stock that he was underwriting.⁸⁰ Tager had inserted false quotations into sheets published by the National Quotations Bureau ("NQB"), which gave investors an impression that the stock was trading more often than its actual volume indicated.⁸¹

Tager argued that to show willful violations of the Exchange Act, the SEC would have to establish that he had an understanding that his

⁷¹ See 6 S.E.C. at 1122-23.

⁷² See 15 U.S.C. § 78o(b); *Thompson Ross Sec.*, 6 S.E.C. at 1112.

⁷³ See *Thompson Ross Sec.*, 6 S.E.C. at 1112.

⁷⁴ See *id.* at 1122.

⁷⁵ *Id.* at 1123.

⁷⁶ See *id.*

⁷⁷ *Id.* at 1123-24 (Healy, C., dissenting).

⁷⁸ See 15 U.S.C. § 78o(b)(4)(D); *Tager v. SEC*, 344 F.2d 5, 7 (2d Cir. 1965).

⁷⁹ *Tager*, 344 F.2d at 8, 9.

⁸⁰ See *id.* at 8.

⁸¹ See *id.* at 7.

activities were manipulative.⁸² The Second Circuit's Chief Judge Lumbard, however, dismissed this claim as "wholly lacking in merit," and ruled that an individual acts willfully if he intentionally or voluntarily undertakes an act constituting a securities law violation.⁸³ In other words, the court took the position that there is no requirement that the defendant also be aware that his or her conduct violates a provision of the Exchange Act or SEC Rule.⁸⁴

The SEC's position that "voluntary" intent equals "willful" intent to violate the Exchange Act, however, was undermined by case law prior to the Supreme Court's decision in *O'Hagan*.⁸⁵ The most influential decisions involving § 32(a) of the Act were written in the Court of Appeals for the Second Circuit by Judge Henry Friendly.⁸⁶ Judge Friendly repeatedly supported the notion that in order for an individual to be held criminally liable for violating the Exchange Act, it is necessary to prove that the individual acted not merely voluntarily, but with a bad purpose.⁸⁷ Judge Friendly explicitly relied on Judge Herlands' ideas about the term "willfully" in the criminal context of the Act, and was in fact a New York neighbor of Judge Herlands in the 1960s.⁸⁸

Judge Friendly clearly expressed his ideas regarding criminal intent in *United States v. Dixon*, a 1976 Second Circuit decision, which involved the criminal conviction of a defendant for violating § 14(a) of the Exchange Act by filing a false proxy statement and annual report.⁸⁹ The defendant, Dixon, was president of a New York corporation that manufactured voting machines.⁹⁰ Dixon was convicted at trial for violations of § 14(a) for "willfully and unlawfully devising a scheme or artifice to defraud" his corporation's stockholders by making false entries in the corporate books.⁹¹ Dixon defended on the grounds that he believed that he had honestly fulfilled the legal requirements both

⁸² See *id.* at 8.

⁸³ See *id.*

⁸⁴ See *Tager*, 344 F.2d at 8; see also *Schwartz*, 469 F.2d at 508 (holding that proof of a specific intent to violate the law is not necessary to uphold a conviction under § 32(a) of the Exchange Act, provided that "satisfactory proof is established that a defendant intended to commit the act prohibited"); Carberry & Gordon, *supra* note 8, at 173-74.

⁸⁵ See *United States v. Dixon*, 536 F.2d 1388, 1396 (2d Cir. 1976); *United States v. Peltz*, 433 F.2d 48, 55 (2d Cir. 1970); *United States v. Guterman*, 281 F.2d 742, 753 (2d Cir. 1960).

⁸⁶ See generally *Dixon*, 536 F.2d 1388; *Peltz*, 433 F.2d 48; *Guterman*, 281 F.2d 742.

⁸⁷ See *Dixon*, 536 F.2d at 1396; *Peltz*, 433 F.2d at 55; *Guterman*, 281 F.2d at 753.

⁸⁸ See *Beveridge*, *supra* note 53, at 64 n.146.

⁸⁹ See 536 F.2d at 1391.

⁹⁰ See *id.*

⁹¹ See *id.* at 1392.

for filing proxy statements and for his calculations in the corporate books.⁹²

Writing for the Second Circuit's majority, Judge Friendly affirmed these criminal convictions under § 32(a) of the Exchange Act because Dixon had willfully violated the securities laws.⁹³ The court held that a "willful" act under § 32(a) is one that is done intentionally, deliberately and not the result of innocent mistake.⁹⁴ Judge Friendly stated that although a specific intent to disregard or disobey a law is not required, the defendant must be shown to have had some evil purpose, or mens rea.⁹⁵ He went further to rule that in a criminal conviction for violations of any section of the Exchange Act, or any rule promulgated thereunder, the prosecution must establish "a realization on the defendant's part that he was doing a wrongful act under the securities laws and that such an act involved a significant risk of effecting the violation that occurred."⁹⁶

A 1976 decision by the Ninth Circuit Court of Appeals, *United States v. Charnay*, clearly illustrates the difficulties that courts face in applying the appropriate standard of criminal intent in securities law cases.⁹⁷ *Charnay* involved criminal indictments brought against Howard Hughes and several of his associates in their capacity as managers and directors of Hughes Tool Company ("Hughes Tool").⁹⁸ The defendants made an offer to acquire the assets of Air West, a corporation whose stock traded on the American Stock Exchange ("AMEX").⁹⁹ After a majority of Air West directors voted to reject the Hughes offer, the defendants threatened to depress the price of Air West stock on the AMEX, by having Charnay, a private Air West stockholder, sell his large block of Air West shares.¹⁰⁰ This threat was carried out, and Air West stock dropped from \$18 per share to \$15.75 per share in one day of trading activity.¹⁰¹ The Air West directors then apparently changed their minds and accepted the offer to sell Air West's assets to Hughes Tool.¹⁰²

⁹² See *id.* at 1395.

⁹³ See *id.* at 1396, 1402.

⁹⁴ See *Dixon*, 536 F.2d at 1397.

⁹⁵ See *id.*

⁹⁶ See *id.* at 1395; see also Jed S. Rakoff, "Willful" Intent in Criminal Securities Cases, N.Y.L.J., May 11, 1995, at 3 (stating that "In other words, what was required [in *Dixon*] was classic criminal mens rea, no more and no less.").

⁹⁷ See generally 537 F.2d 341 (9th Cir. 1976).

⁹⁸ See *id.* at 344.

⁹⁹ See *id.*

¹⁰⁰ See *id.*

¹⁰¹ See *id.*

¹⁰² See *Charnay*, 537 F.2d at 344.

The defendants were subsequently charged with criminal violations of § 10(b) of the Exchange Act and Rule 10b-5 for artificially manipulating the market price of a security.¹⁰³

The Ninth Circuit held that the indictment in *Charnay* was sufficient to allege a criminal offense and rejected the defendant's argument that the indictment was fatally defective because it failed to allege any specific intent to defraud.¹⁰⁴ Relying heavily on Judge Friendly's prior rulings regarding the meaning of the term "willfully violate" in the Exchange Act, the majority held that the prosecution had met its burden of establishing that the defendants knowingly participated in an act that they realized was wrongful.¹⁰⁵ The court also held that knowledge of the specific section or rule was not necessary.¹⁰⁶ The indictment, therefore, sufficiently alleged "willful" violations of § 10(b) and Rule 10b-5.¹⁰⁷

One Circuit Judge concurring in *Charnay*, however, wrote that the indictment was valid because, under § 32(a), the intent necessary to support a conviction is merely that of intending to do the acts prohibited, rather than intent to violate the statute.¹⁰⁸ In stark contrast to the court's majority, this concurring opinion stated that "[p]roof of an 'evil motive' appears unnecessary" to support a conviction under § 32(a).¹⁰⁹ The concurrence further stated that no degree of scienter or mens rea is part of a criminal violation of the Exchange Act.¹¹⁰

C. "Willfulness" in General

1. *Aaron v. SEC* Defines Scienter as an Element of a § 10(b) Violation

In 1980, the United States Supreme Court, in *Aaron v. SEC*, made definitive statements regarding scienter as an element of a § 10(b) and Rule 10b-5 violation.¹¹¹ *Aaron* involved an employee of a broker-dealer firm who was accused both of violating and aiding and abetting viola-

¹⁰³ See *id.*

¹⁰⁴ See *id.* at 351.

¹⁰⁵ See *id.* at 351-52.

¹⁰⁶ See *id.* at 352.

¹⁰⁷ See *Charnay*, 537 F.2d at 352.

¹⁰⁸ See *id.* at 357 (Sneed, J., concurring); Bryan S. Schultz, Note, *Feigning Fidelity to Section 10(b): Insider Trading Liability After United States v. O'Hagan*, 66 U. CIN. L. REV. 1411, 1442 (1998).

¹⁰⁹ See *Charnay*, 537 F.2d at 357 (Sneed, J., concurring).

¹¹⁰ See *id.*

¹¹¹ See 446 U.S. 680, 691 (1980).

tions of § 10(b) and Rule 10b-5, in connection with his firm's campaign for certain securities.¹¹² Specifically, the employee was accused of failing to prevent other employees under his control from making false and misleading statements to potential investors regarding a certain stock for sale even though he knew of this deceptive practice.¹¹³ The SEC sued this employee for injunctive relief and succeeded at both the trial and appellate levels, without proving that the defendant actually intended to violate the securities laws.¹¹⁴

The United States Supreme Court vacated the order for an injunction against the defendant and held that scienter is a necessary element of a § 10(b) and Rule 10b-5 violation, regardless of the plaintiff's identity or of the nature of the relief sought.¹¹⁵ The Court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud."¹¹⁶ It ruled that anyone seeking to prove a violation of § 10(b) and Rule 10b-5 must establish this mental state on the part of the defendant at the time of the alleged wrongful conduct.¹¹⁷ Justice Blackmun filed a dissenting opinion in *Aaron*, partly because Congress specifically omitted the word "willfully" from the statutory provision authorizing the SEC to sue for an injunction.¹¹⁸ Blackmun reasoned that when Congress wished to impose a state-of-mind requirement, terms such as "willfully" were used in the Exchange Act.¹¹⁹

2. Proof of Willfulness

Although the Supreme Court's decision in *Aaron* arose in a civil context,¹²⁰ it is generally recognized that there is no functional difference between the requirement of scienter in civil cases and the requirement of willfulness in criminal cases.¹²¹ Courts often use both of these terms when referring to the required mental state of criminal defen-

¹¹² See *id.* at 684.

¹¹³ See *id.* at 683.

¹¹⁴ See *id.* at 683-84.

¹¹⁵ See *id.* at 691, 702.

¹¹⁶ See *Aaron*, 446 U.S. at 686 n.5.

¹¹⁷ See *id.* at 691.

¹¹⁸ See *id.* at 713-14 (Blackmun, J., dissenting).

¹¹⁹ See *id.*

¹²⁰ See *id.* at 682.

¹²¹ See Antolini et al., *supra* note 30, at 993 (stating that although civil actions require scienter and criminal actions require willfulness, it is unclear whether this semantic distinction has any practical significance); Carol B. Silver, *Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984*, 1985 Duke L.J. 960, 1021 (1985) (arguing that, "courts have interpreted the term 'willfully' as used in § 32, to mean that only ordinary scienter is necessary to support a criminal conviction.");

dants being prosecuted under the federal securities laws.¹²² Courts also frequently recognize that scienter, or willfulness, is a difficult concept to define and prove.¹²³ In order to understand how the element of willfulness is established in a criminal trial under the Exchange Act, it is necessary to explore briefly the allocation of the burden of proof and some factors that tend to show willfulness on the part of a defendant.

In all criminal insider trading cases, the government bears the initial burden of proving that a particular defendant (or group of defendants) willfully violated § 10(b) and Rule 10b-5.¹²⁴ The government must prove this violation to the trier of fact beyond a reasonable doubt.¹²⁵ Several courts and commentators have recognized that willfulness can rarely be shown by direct evidence because it is a state of mind.¹²⁶ Rather, willfulness is usually established by drawing reasonable inferences from all of the available circumstantial facts.¹²⁷

In order to satisfy its burden, the government can rely on several factors that tend to indicate a defendant's intent to deceive.¹²⁸ Although a defendant's actual knowledge of a particular section of the Exchange Act or SEC Rule is not necessary for a criminal conviction,¹²⁹ such knowledge does provide sufficient evidence to infer a willful violation.¹³⁰ Actual knowledge of the illegality of one's activity can be shown by proof that, at some point prior to an allegedly illegal trade, an individual received actual notice of the applicable law or regulation that was violated.¹³¹ This method of proof can be effective in prosecu-

¹²² See *United States v. O'Hagan*, 521 U.S. 642, 665 (1997); *Antolini et al.*, *supra* note 30, at 993; *Silver*, *supra* note 121, at 1021.

¹²³ See *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 393 (2d Cir. 1973) (Gurfein, J., concurring) ("I do not think a litmus paper test of scienter will ever be found."); *id.* at 397 (Mansfield, J., concurring and dissenting) (stating that: "Scienter, like obscenity, [is] simply . . . something recognized when seen, but not otherwise definable" in Rule 10b-5 cases).

¹²⁴ See *Antolini et al.*, *supra* note 30, at 1019.

¹²⁵ See *United States v. Swink*, 21 F.3d 852, 855 (8th Cir. 1994); *United States v. Benjamin*, 328 F.2d 854, 861 (2d Cir. 1964).

¹²⁶ See *United States v. Wells*, 766 F.2d 12, 20 (1st Cir. 1985); Robert F. Koets, *What Constitutes "Willfulness" for Purposes of Criminal Provisions of Federal Securities Laws*, 136 A.L.R. FED. 457, 466 (1997).

¹²⁷ See *Wells*, 766 F.2d at 20; *Tarvestad v. United States*, 418 F.2d 1043, 1047 (8th Cir. 1969) (holding that knowledge and willfulness of a defendant need not be proved by direct evidence, but may be established by circumstantial evidence); *Gates v. United States*, 122 F.2d 571, 575 (10th Cir. 1941); Koets, *supra* note 126, at 466.

¹²⁸ See *Swink*, 21 F.3d at 855 (holding that the determination of whether a defendant, charged with violating § 32 of the Exchange Act, knew that his conduct was illegal should be based on the totality of the circumstances).

¹²⁹ See *infra* notes 201-02 and accompanying text.

¹³⁰ See *Spears & Aquilina*, *supra* note 7, at 1.

¹³¹ See *id.*; *Carberry & Gordon*, *supra* note 8, at 184.

tions of individuals with experience in the securities industry, but is not likely to apply to those with no such experience.¹³² In the insider trading context, market professionals are generally governed by their employer's written policies and procedures on trading and using material, nonpublic information.¹³³ Therefore, actual knowledge can be proven using these policies and procedures, and any violations will provide evidence of willfulness or culpable intent.¹³⁴ A general lack of knowledge of securities laws prohibitions, however, is a viable argument against prosecuting non-market professionals who have no actual notice of what activities are illegal.¹³⁵

The government may also use the common trading practices of a particular defendant's occupation or industry as evidence of that defendant's willful violations.¹³⁶ If the prosecution can show that a defendant's trading activity is recognized within the industry as a violation of the federal securities laws, a trier of fact may consider as evidence that the defendant knew or should have known the activity was illegal.¹³⁷ Conversely, if the defendant traded in a manner that is common among others within his or her field, this may demonstrate a lack of culpable intent.¹³⁸

Additionally, to demonstrate willfulness on the part of an insider trading defendant, the government can rely on certain customary indicia of guilty knowledge in criminal cases.¹³⁹ The indicia include deceit or misrepresentation in connection with the allegedly unlawful conduct, a defendant's efforts at concealment and false exculpatory statements made to explain prior conduct.¹⁴⁰

If the government succeeds in upholding its burden to prove that a defendant willfully violated § 10(b) and Rule 10b-5, the defendant can still raise several affirmative defenses.¹⁴¹ For example, defendants accused of securities fraud typically raise the defense of "good faith," or the absence of an intent to defraud, to rebut a showing of willful-

¹³² See Carberry & Gordon, *supra* note 8, at 184.

¹³³ See *id.*

¹³⁴ See *id.*

¹³⁵ See *id.*

¹³⁶ See *United States v. Weiner*, 578 F.2d 757, 785-86 (9th Cir. 1978); *United States v. Minuse*, 114 F.2d 36, 39 (2d Cir. 1940); William E. Aiken, Jr., *Element of Scienter as Affecting Criminal Prosecutions for Violation of Federal Securities Law*, 20 A.L.R. Fed. 227, 236, 265 (1974).

¹³⁷ See Aiken, *supra* note 136, at 236, 265.

¹³⁸ See *id.*

¹³⁹ See Spears & Aquilina, *supra* note 7, at 1.

¹⁴⁰ See *id.*

¹⁴¹ See Antolini et al., *supra* note 30, at 1019.

ness.¹⁴² Because a willful violation cannot be "the result of innocent mistake, negligence or inadvertence,"¹⁴³ defendants may claim that they believed they were conforming with the federal securities laws.¹⁴⁴ The trier of fact will weigh any evidence presented by the defendant and the prosecution to determine whether the defendant did, in fact, act in good faith.¹⁴⁵

A closely related defense to "good faith" is a defendant's reliance on the advice of an expert.¹⁴⁶ Reliance on expert advice prior to allegedly illegal conduct, such as advice of counsel or of an expert accountant, is not a complete defense, but such demonstrated reliance can rebut a showing of criminal intent and willfulness.¹⁴⁷ In order to claim this defense a person must have honestly and in good faith sought the advice of counsel, or other expert, fully disclosed all relevant facts to the expert, received assurance from the expert that the proposed activity was legal, and relied in good faith on the advice.¹⁴⁸ This defense is not available, however, if the expert was an interested party to the proposed activity, or if the defendant knowingly withheld facts from the expert that would have indicated the illegal nature of the activity.¹⁴⁹

Additionally, an insider trading defendant may always claim an absolute defense to imprisonment for any criminal violations of § 10(b) and Rule 10b-5.¹⁵⁰ As previously noted, § 32(a) of the Exchange Act mandates 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."¹⁵¹ This clause of § 32 is particularly useful to non-market professionals, who may not have difficulty showing a lack of knowledge of an SEC rule or regulation,

¹⁴² See *id.* at 1021.

¹⁴³ *United States v. Dixon*, 536 F.2d 1388, 1396 (2d Cir. 1976) (approving jury instruction regarding willfulness in the district court).

¹⁴⁴ See Antolini et al., *supra* note 30, at 1020.

¹⁴⁵ See *Weiner*, 578 F.2d at 786, 787 (holding that for defendants charged with violating § 32 of the Exchange Act, proof of good faith constitutes a complete defense to the charges); Antolini et al., *supra* note 30, at 1021.

¹⁴⁶ See Aiken, *supra* note 136, at 266; Antolini et al., *supra* note 30, at 1021.

¹⁴⁷ See *United States v. United Med. & Surgical Supply Corp.*, 989 F.2d 1390, 1403 (4th Cir. 1993) (holding good faith reliance on counsel is only one factor for a jury to consider when it determines the defendant's intent and is not a complete defense to willful misconduct); Aiken, *supra* note 136, at 266; Antolini et al., *supra* note 30, at 1021.

¹⁴⁸ See Antolini et al., *supra* note 30, at 1022; see also Aiken, *supra* note 136, at 267.

¹⁴⁹ See *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 181-82 (2d Cir. 1976); Antolini et al., *supra* note 30, at 1022.

¹⁵⁰ See 15 U.S.C. § 78ff(a) (1999).

¹⁵¹ *Id.*

especially in situations where no attempt to conceal the trading activity or other evidence of a wrongful purpose is present.¹⁵²

III. THE O'HAGAN CASE

A. The Supreme Court's Ruling in *United States v. O'Hagan*

The United States Supreme Court's 1997 decision in *United States v. O'Hagan* further defined the boundaries of the federal government's enforcement power under the Exchange Act in cases involving the trading of securities based on material, nonpublic information.¹⁵³ This case also clarified the standard of criminal intent necessary to sustain a conviction under § 32(a) of the Exchange Act.¹⁵⁴ The Court, in a majority opinion authored by Justice Ginsburg, held that criminal liability under § 10(b) of the Exchange Act may be predicated on the misappropriation theory of liability.¹⁵⁵ In doing so, the Court resolved a division between several federal courts of appeal.¹⁵⁶

This case began with a potential tender offer for the common stock of Pillsbury Co., a Minneapolis, Minnesota-based corporation.¹⁵⁷ In July 1988, Grand Metropolitan PLC ("Grand Met"), a London-based company, hired a Minneapolis law firm, Dorsey & Whitney, as local counsel to represent Grand Met in the prospective transaction.¹⁵⁸ James O'Hagan was a senior litigation partner in Dorsey & Whitney, specializing in medical malpractice and securities law cases.¹⁵⁹ At no time, however, did O'Hagan perform any work on the Grand Met representation.¹⁶⁰ On September 9, 1988, Dorsey & Whitney withdrew from representing Grand Met, and about one month later Grand Met publicly announced its tender offer for Pillsbury stock.¹⁶¹

While Dorsey & Whitney was still representing Grand Met, however, O'Hagan began to purchase call options for Pillsbury stock.¹⁶²

¹⁵² See Carberry & Gordon, *supra* note 8, at 187-88.

¹⁵³ See 521 U.S. at 650.

¹⁵⁴ See *id.* at 665-66.

¹⁵⁵ See *id.* at 650.

¹⁵⁶ See *O'Hagan II*, 92 F.3d at 612; *United States v. Bryan*, 58 F.3d 933, 943-59 (4th Cir. 1995); *United States v. Chestman*, 947 F.2d at 551, 566 (2d Cir. 1991); *SEC v. Cherif*, 933 F.2d 403, 410 (7th Cir. 1991).

¹⁵⁷ See *O'Hagan*, 521 U.S. at 647.

¹⁵⁸ See *id.*

¹⁵⁹ See *id.*; Brief for the United States, 1997 WL 86306 at *2, *O'Hagan* (No. 96-842).

¹⁶⁰ See *O'Hagan*, 521 U.S. at 647.

¹⁶¹ See *id.*

¹⁶² See *id.* A "call option" is a contract between the seller of an option and the purchaser of that option (option holder), under which the purchaser buys the right to have the underlying

Each option gave him a right to buy 100 shares of the stock by a specified date in September 1988.¹⁶³ By the end of September, O'Hagan owned 2,500 Pillsbury call options, more than any other individual investor.¹⁶⁴ He also bought 5,000 shares of Pillsbury common stock in September, at a price of \$39 per share.¹⁶⁵ In October, when Grand Met announced its tender offer, the price of Pillsbury stock soared to almost \$60 per share.¹⁶⁶ O'Hagan then sold all of his call options and common stock, and made a profit of more than \$4.3 million.¹⁶⁷ According to the subsequent indictment against him, however, O'Hagan actually had to put the profits from this trading into his law firm's trust account, because he had previously embezzled an unrelated client's trust funds that were under his exclusive care.¹⁶⁸

The SEC began an investigation into O'Hagan's trading activity after he sold the Pillsbury stock, leading to a fifty-seven count indictment charging O'Hagan with, among other crimes, securities fraud in violation of § 10(b) and Rule 10b-5.¹⁶⁹ Because O'Hagan was not an "insider" of Pillsbury and, therefore, owed that company no fiduciary duties, the government needed to proceed with a claim based on the misappropriation theory of liability.¹⁷⁰ Specifically, the indictment alleged that O'Hagan had breached a duty of trust and confidence he owed to his firm, Dorsey & Whitney, and to its client, Grand Met, by trading on the basis of material, nonpublic information regarding Grand Met's planned tender offer for Pillsbury stock.¹⁷¹ O'Hagan was convicted of all fifty-seven criminal counts by a jury in the United States District Court for the District of Minnesota, but the Court of Appeals for the Eighth Circuit reversed all of the convictions.¹⁷² The Eighth

security delivered at a fixed price anytime prior to a specified date. *See* Chicago Mercantile Exch. v. SEC, 883 F.2d 537, 543 (7th Cir. 1989). In order to profit from the deal, the option holder hopes that the price of the security will rise above the fixed price in the contract. *See id.*

¹⁶³ *See O'Hagan*, 521 U.S. at 647.

¹⁶⁴ *See id.*

¹⁶⁵ *See id.* at 648.

¹⁶⁶ *See id.*

¹⁶⁷ *See id.*

¹⁶⁸ *See O'Hagan*, 521 U.S. at 648; *State v. O'Hagan*, 474 N.W.2d 613, 615, 623 (Minn. Ct. App. 1991); Brief for the United States, 1997 WL 86306, at *6, *O'Hagan* (No. 96-842).

¹⁶⁹ *See O'Hagan*, 521 U.S. at 648. Along with these securities fraud violations, O'Hagan was also indicted for mail fraud, violating federal money laundering statutes, and fraudulent trading in connection with a tender offer under § 14(e) of the Exchange Act and Rule 14e-3. *See id.* at 648-49.

¹⁷⁰ *See id.* at 653 n.5.

¹⁷¹ *See id.* at 648.

¹⁷² *See id.* at 649; *O'Hagan II*, 92 F.3d at 613.

Circuit held that liability under § 10(b) and Rule 10b-5 could not be based on the misappropriation theory of securities fraud.¹⁷³

The United States Supreme Court reversed the Eighth Circuit's rulings and upheld all fifty-seven convictions.¹⁷⁴ The Court held that criminal liability under § 10(b) and Rule 10b-5 may be predicated on the misappropriation theory, which permits imposition of liability on anyone who trades in securities using material, nonpublic information without disclosing such use to the source of the information, in breach of a fiduciary duty owed to that source.¹⁷⁵ The Court reasoned that O'Hagan had a duty to both his own law firm and to Grand Met to disclose his trading activity based on nonpublic information, and his failure to do so constituted a "deceptive device or contrivance" used "in connection with" the purchase or sale of securities.¹⁷⁶ The Court based this ruling, in large part, on its view that the Exchange Act requires the government to prove that a person "willfully" violated Rule 10b-5 in order to establish a criminal violation.¹⁷⁷ Additionally, the Court recognized that under § 32(a), a defendant cannot be imprisoned for violating Rule 10b-5 if that defendant proves that he or she had no knowledge of the rule.¹⁷⁸ Therefore, the Court ruled that Congress required culpable intent on the part of a defendant charged with criminal liability under § 10(b).¹⁷⁹ This requirement ensures that criminal prosecutions brought under the misappropriation theory can only succeed if a defendant intended to violate the law.¹⁸⁰

Writing for a 6-3 majority, Justice Ginsburg first detailed the deceptive nature of nondisclosure as it relates to the misappropriation theory, stating that, "it [was O'Hagan's] failure to disclose his personal trading to Grand Met and Dorsey, in breach of his duty to do so, that ma[de] his conduct 'deceptive' within the meaning of [Sec-

¹⁷³ See *O'Hagan II*, 92 F.3d at 613.

¹⁷⁴ See *O'Hagan*, 521 U.S. at 652.

¹⁷⁵ See *id.* at 650-52.

¹⁷⁶ See *id.* at 653.

¹⁷⁷ See 15 U.S.C. § 78ff(a) (1999); *O'Hagan*, 521 U.S. at 665-66.

¹⁷⁸ See 15 U.S.C. § 78ff(a) (1999); *O'Hagan*, 521 U.S. at 666.

¹⁷⁹ See 15 U.S.C. § 78ff(a) (1999); *O'Hagan*, 521 U.S. at 665-66.

¹⁸⁰ See *O'Hagan*, 521 U.S. at 665-66; Spears & Aquilina, *supra* note 7, at 1. Three months after the Supreme Court's decision in *O'Hagan*, the SEC issued a consent decree, entitled *In re Christopher LaPorte and Gov't Sec. Corp.* See No. 1262, 1997 WL 600677, *3 n.2 (Sept. 30, 1997). In applying the term "willful" in administrative proceedings brought under § 15(b) of the Exchange Act, the SEC stated that it would "evaluate on a case-by-case basis whether the respondent knew or reasonably should have known under the particular facts and circumstances that his conduct was improper." See *id.* This interpretation of the term "willful" indicated that the SEC recognized the analytical flaws inherent with its previous use of a "voluntary intent" standard for all willful violations of the Exchange Act. See *id.*; Spears & Aquilina, *supra* note 7, at 1.

tion] 10(b)."¹⁸¹ Turning to the requirement in § 10(b) that a trader's deceptive use of information be "used in connection with the purchase or sale of [a] security," the Court held that this element was satisfied because the fiduciary's (O'Hagan's) fraud was consummated, not when the fiduciary gained the confidential information, but when he used the information to purchase or sell securities without disclosing this trading to the principals (Grand Met and Dorsey & Whitney).¹⁸² The Court stated that "the securities transaction and the breach of duty thus coincide," even if the party defrauded is not the other party to the trade, but is the source of the nonpublic information.¹⁸³ The misappropriation theory, the Court held, comports with the language of § 10(b), because it requires deception in connection with the purchase or sale of any security.¹⁸⁴ The Court stated that this theory also achieves one of the major goals of the Exchange Act: to insure honest securities markets and thereby promote investor confidence.¹⁸⁵ Comparing the misappropriation theory to the classical theory of liability, the Court stated that:

[C]onsidering the inhibiting impact on market participation of trading on misappropriated information, and the congressional purposes of § 10(b), it makes scant sense to hold a lawyer like O'Hagan a § 10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a law firm representing the bidder. The text of the statute requires no such result.¹⁸⁶

One of the major arguments that O'Hagan asserted against the validity of the misappropriation theory was that the theory itself was too "indefinite" to permit the imposition of criminal liability.¹⁸⁷ Specifically, he argued that criminal convictions under the misappropriation theory violate due process notions, because an uncoded "theory" cannot provide adequate guidance as to what conduct is illegal.¹⁸⁸

¹⁸¹ *O'Hagan*, 521 U.S. at 660.

¹⁸² *Id.* at 656.

¹⁸³ *See id.*; Aldave, *supra* note 44, at 120.

¹⁸⁴ *See O'Hagan*, 521 U.S. at 653.

¹⁸⁵ *See id.* at 659.

¹⁸⁶ *Id.* (citation omitted). Justice Ginsburg was paraphrasing a 1951 decision by Judge Learned Hand involving § 16(b) of the Exchange Act. *See Gratz v. Claughton*, 187 F.2d 46, 49 (2d Cir. 1951); Joel Seligman, *A Mature Synthesis: O'Hagan Resolves "Insider" Trading's Most Vexing Problems*, 23 DEL. J. CORP. L. 1, 22 (1998).

¹⁸⁷ *See O'Hagan*, 521 U.S. at 666; *Boyce Motor Lines, Inc. v. United States*, 342 U.S. 337, 342 (1952).

¹⁸⁸ *See* Brief for Respondent, 1997 WL 143801, at **30-33, *O'Hagan* (No. 96-842).

O'Hagan pointed out that it is axiomatic that "due process requires that a criminal statute provide adequate notice to a person of ordinary intelligence that his contemplated conduct is illegal, for 'no man shall be held criminally responsible for conduct which he could not reasonably understand to be proscribed.'"¹⁸⁹ Therefore, he contended that § 10(b) and Rule 10b-5 afforded him no notice that his trading in Pillsbury stock based on nonpublic information was illegal.¹⁹⁰ O'Hagan argued that:

Released from the statutory constraints which once restricted § 10(b)'s reach to conduct involving participants in a securities transaction, the misappropriation theory now extends the statute to encompass any breach of fiduciary duty, the fruits of which can be shown, however tenuously, to have 'touched' a subsequent securities transaction.¹⁹¹

In response to this argument, the Court emphatically declared, "[v]ital to our decision that criminal liability may be sustained under the misappropriation theory . . . are two sturdy safeguards Congress has provided regarding scienter."¹⁹² First, to establish a criminal violation of Rule 10b-5, the government must prove that a person "willfully" violated the provision.¹⁹³ Second, a defendant may not be imprisoned for violating Rule 10b-5 if he or she proves that he had no knowledge of the rule.¹⁹⁴ Therefore, the Court rejected O'Hagan's argument that the misappropriation theory was too indefinite to permit the imposition of criminal liability and that the statute's "requirement of the presence of culpable intent as a necessary element of the offense did much to destroy any force in the argument that application of the [statute]" in circumstances such as O'Hagan's was unjust.¹⁹⁵

B. O'Hagan on Remand

Following the Supreme Court's decision to uphold the convictions of James O'Hagan, the case was remanded back to the Eighth Circuit Court of Appeals to determine, in part, if O'Hagan had indeed willfully violated § 10(b) and Rule 10b-5.¹⁹⁶ O'Hagan then argued to the Eighth

¹⁸⁹ See *id.* at *30 (quoting *Buckley v. Valeo*, 424 U.S. 1, 77 (1976) (per curiam)).

¹⁹⁰ See Brief for Respondent, 1997 WL 143801, at *30, *O'Hagan* (No. 96-842).

¹⁹¹ *Id.* at *31.

¹⁹² *O'Hagan*, 521 U.S. at 665.

¹⁹³ See 15 U.S.C. § 78ff(a) (1999); *O'Hagan*, 521 U.S. at 665.

¹⁹⁴ See 15 U.S.C. § 78ff(a) (1999); *O'Hagan*, 521 U.S. at 666.

¹⁹⁵ *O'Hagan*, 521 U.S. at 666 (quoting *Boyce Motor Lines*, 342 U.S. at 342).

¹⁹⁶ See *United States v. O'Hagan*, 139 F.3d 641, 645 (8th Cir. 1998) [hereinafter *O'Hagan III*].

Circuit that he could not be held criminally liable because the government had not sufficiently proved that he had "willfully" violated these provisions as required by § 32(a).¹⁹⁷ He claimed that the government needed to establish both that he specifically knew which acts Rule 10b-5 prohibited and that he intentionally committed acts in violation of the rule.¹⁹⁸

The Eighth Circuit rejected this narrow reading of Justice Ginsburg's opinion in *O'Hagan*, stating "the Supreme Court was simply explaining that the statute provides that a negligent or reckless violation of the securities laws cannot result in criminal liability; instead the defendant must act willfully."¹⁹⁹ In dismissing O'Hagan's claim that seemingly innocent trading activity might result in a conviction under § 32, the court stated that: "Criminal conviction for violation of rules and regulations implementing § 10(b) necessarily involves fraudulent conduct and breaches of duty by the defendant. Such acts do not involve conduct that is often innocently undertaken."²⁰⁰

Additionally, the court held that there is no burden on the government to prove that a criminal defendant actually knew that his or her actions specifically violated Rule 10b-5.²⁰¹ The Eighth Circuit ruled that the Supreme Court had stated simply that there is an affirmative defense to imprisonment if a defendant proves that he or she had no knowledge of the rule or regulation allegedly violated.²⁰² In interpreting what type of intent constitutes a "willful violation" of § 10(b) and Rule 10b-5, the Eighth Circuit held that "'willfully' simply requires the intentional doing of the wrongful acts—no knowledge of the rule or regulation is required."²⁰³

IV. ANALYSIS

This Note has shown that a mere "voluntary intent" standard for insider trading criminal convictions cannot be supported by either the text of the Exchange Act, the legislative intent behind that text or the United States Supreme Court's rulings on scienter as a necessary element of all criminal prosecutions brought under the Exchange Act.²⁰⁴

¹⁹⁷ See *id.* at 646.

¹⁹⁸ See *id.*

¹⁹⁹ See *id.* at 647.

²⁰⁰ See *id.*

²⁰¹ See *O'Hagan III*, 139 F.3d at 647.

²⁰² See *id.*

²⁰³ *Id.*

²⁰⁴ See 15 U.S.C. § 78ff(a) (1999); *O'Hagan*, 521 U.S. at 665-66; *Aaron*, 446 U.S. at 691; Herlands, *supra* note 54, at 147-48.

The distinction between "voluntary" intent and actual "willful" intent may seem somewhat trivial, but the practical effects of applying the appropriate standard can become extremely important to those defendants who stand accused of criminal insider trading violations.²⁰⁵ No longer can a defendant be found to have willfully violated any section of the Exchange Act simply upon proof that he or she intentionally committed an act which turns out to constitute a violation.²⁰⁶ The difficulty that still surrounds all criminal actions under the Exchange Act, however, is deciding what degree of scienter is required for a conviction.²⁰⁷ A defendant must act with some evil purpose to be convicted under § 32(a) of the Exchange Act, but how much knowledge of the applicable laws on the part of that defendant is actually necessary?²⁰⁸

In the criminal insider trading context, analysis of the *O'Hagan* case and two hypothetical situations will illustrate that it is not necessary to prove specific intent by a defendant to violate § 10(b) and Rule 10b-5.²⁰⁹ The government is required at a minimum, however, to establish that a defendant purchased or sold securities on the basis of material, nonpublic information and that the defendant knew that this activity was wrongful because it involved a significant risk of violating the federal securities laws.²¹⁰ This standard for willful violations of § 10(b) and Rule 10b-5 will guide both the courts and the SEC in determining when defendants can be subjected to criminal penalties under the Exchange Act for insider trading violations.²¹¹ Proof that a defendant realized his or her trading was wrongful is not easily established, but the government can rely on factors such as receipt of actual notice regarding prohibited activity by a defendant and common trading practices within that defendant's industry.²¹²

²⁰⁵ See Schultz, *supra* note 108, at 1442.

²⁰⁶ Compare *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965) and *In re New Allied Dev. Corp.*, 52 S.E.C. 1119, 1129 n.31 (1996), with *O'Hagan*, 521 U.S. at 665-66, and *O'Hagan III*, 139 F.3d at 646.

²⁰⁷ See Dawes, *supra* note 35, at 523-24.

²⁰⁸ See *O'Hagan III*, 139 F.3d at 646; *United States v. Dixon*, 536 F.2d 1388, 1395 (2d Cir. 1976).

²⁰⁹ See *O'Hagan*, 521 U.S. at 665-66; *O'Hagan III*, 139 F.3d at 647.

²¹⁰ See *O'Hagan III*, 139 F.3d at 647; *Dixon*, 536 F.2d at 1395; *In re Christopher LaPorte & Gov't Sec. Corp.*, No. 1262, 1997 WL 600677, *3 n.2 (Sept. 30, 1997).

²¹¹ See *O'Hagan III*, 139 F.3d at 647; *Dixon*, 536 F.2d at 1395; *LaPorte*, 1997 WL 600677, at *3 n.2.

²¹² See Aiken, *supra* note 136, at 266; Carberry & Gordon, *supra* note 8, at 154; Spears & Aquilina, *supra* note 7, at 1.

The United States Supreme Court's holding in *O'Hagan* signals a definitive end to the use of a mere "voluntary intent" standard for criminal liability under the Exchange Act.²¹³ The Court placed specific emphasis on the two "sturdy safeguards" in § 32(a) of the Exchange Act regarding scienter, namely that a defendant must willfully violate the statute and that defendants can avoid imprisonment if they prove a lack of knowledge of Rule 10b-5.²¹⁴ These important statutory provisions technically create a type of "ignorance of the law" excuse for defendants accused of criminal insider trading violations.²¹⁵ By upholding all of the convictions in *O'Hagan*, however, the Court held that James O'Hagan had, in fact, willfully violated § 10(b) of the Exchange Act and Rule 10b-5.²¹⁶ Justice Ginsburg's statements regarding scienter in *O'Hagan* demonstrate that, in order to obtain a criminal conviction under § 10(b) and Rule 10b-5, the government must prove that the defendant knew that he or she was committing a wrongful act at the time of the alleged violation.²¹⁷ This requirement of culpable intent, while serving as a basis for upholding the criminal convictions in *O'Hagan*, specifically refutes the notion that a party can willfully violate the Exchange Act by simply voluntarily undertaking an action that constitutes a violation.²¹⁸ The Court's emphasis on culpable intent also reinforced the holdings of cases such as *Dixon* and *Charnay*, which stressed that criminal defendants must have participated in an act that they knew was wrongful in order to be convicted.²¹⁹ In effect, the Court in *O'Hagan* recognized Jonathan Eisenberg's characterization of the government's prior "voluntary intent" standard as holding defendants liable for willful violations as long as they were not "insane, unconscious, or sleepwalking" at the time of the alleged wrongful conduct.²²⁰ The Court's ruling in *O'Hagan* shows that this standard for criminal convictions is no longer viable in federal court or in SEC enforcement hearings.²²¹

The Supreme Court's *O'Hagan* decision also makes the standard of intent for criminal violations of the Exchange Act consistent with the original intent of Congress in enacting the statute.²²² In 1934,

²¹³ Compare *O'Hagan*, 521 U.S. at 665-66, with Eisenberg, *supra* note 53, at 13.

²¹⁴ See *O'Hagan*, 521 U.S. at 665-66.

²¹⁵ See *id.*

²¹⁶ See *id.*

²¹⁷ See *id.*

²¹⁸ Compare *O'Hagan*, 521 U.S. at 665-66, with Eisenberg, *supra* note 53, at 13.

²¹⁹ See *United States v. Charnay*, 537 F.2d 341, 352 (9th Cir. 1976); *Dixon*, 536 F.2d at 1395.

²²⁰ See *O'Hagan*, 521 U.S. at 665-66; Eisenberg, *supra* note 53, at 17.

²²¹ See *O'Hagan*, 521 U.S. at 665-66; Eisenberg, *supra* note 53, at 17.

²²² See *O'Hagan*, 521 U.S. at 665-66; Herlands, *supra* note 54, at 147-48.

Congress differentiated between willful and non-willful violations of the Exchange Act.²²³ In actions seeking criminal penalties, such as fines or imprisonment, or administrative sanctions, Congress mandated that the government would have to prove that a person willfully violated the statute.²²⁴ On the other hand, for those violations of the Exchange Act that can only lead to civil injunctions or money damages, there is no requirement of willful conduct on the part of a defendant.²²⁵ In reaffirming this important distinction, the Supreme Court's holding in *O'Hagan* corrected the inaccurate interpretation of the Exchange Act by the SEC and various courts over the last forty-five years.²²⁶

Additionally, the Court in *O'Hagan* pointed out that the requirement of culpable intent in § 32(a) provides adequate protection against the possibility that a person could be convicted of a crime which is not sufficiently well-defined so as to provide notice of what type of conduct is actually prohibited.²²⁷ In the insider trading context, Justice Ginsburg reasoned that James O'Hagan had adequate notice that his trading on the basis of misappropriated nonpublic information was a criminal violation of § 10(b) and Rule 10b-5, because he had willfully breached his duties to his law firm and its client.²²⁸ There can be no validity to the argument that the crime of insider trading, whether prosecuted under the traditional theory or the misappropriation theory, is too vague and ambiguous to afford a trader with notice of what type of activity is considered illegal.²²⁹ In order to be convicted under § 32(a), a trader must either know that his or her activity specifically violates § 10(b) and Rule 10b-5 or realize that it presents a significant risk of constituting a violation, because such knowledge places a defendant on notice of their illegal activity.²³⁰

Once it is established that a particular criminal insider trading defendant acted with the realization that his or her conduct was indeed wrongful, there is still some question as to the minimum degree of intent necessary for a conviction.²³¹ In other words, is it necessary to establish that a defendant specifically intended to violate the language

²²³ See 15 U.S.C. § 78ff(a) (1999); Eisenberg, *supra* note 53, at 13.

²²⁴ See 15 U.S.C. § 78ff(a) (1999).

²²⁵ See 15 U.S.C. § 78u-1(a)(1)(A) (1999).

²²⁶ See 15 U.S.C. §§ 78ff(a), 78u-1(a)(1)(A) (1999); *O'Hagan*, 521 U.S. at 665-66; Charnay, 537 F.2d at 357 (Sneed, J., concurring); Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965).

²²⁷ See *O'Hagan*, 521 U.S. at 665-66.

²²⁸ See *id.*

²²⁹ See *id.*; see also Brief for Respondent, 1997 WL 143801, at **30-33, *O'Hagan* (No. 96-842).

²³⁰ See *O'Hagan*, 521 U.S. at 665-66; *O'Hagan III*, 139 F.3d at 647; Dixon, 536 F.2d at 1395.

²³¹ See *O'Hagan III*, 139 F.3d at 647; Dawes, *supra* note 35, at 523.

of § 10(b) and Rule 10b-5, or is it enough to show that the defendant acted with a more general intent to violate these provisions?²³²

In his case on remand from the Supreme Court to the Eighth Circuit, James O'Hagan attempted to convince the court that the government bore the burden of proving both that he knew what acts Rule 10b-5 specifically prohibited and that he intentionally committed such illegal acts.²³³ The Eighth Circuit, however, refused to apply this strict standard of "specific intent" to § 32(a) of the Exchange Act, and instead provided useful guidelines as to the degree of scienter needed to sustain an insider trading conviction.²³⁴

The Eighth Circuit interpreted the Supreme Court's holding in *O'Hagan* to mean that the requisite level of scienter to violate Rule 10b-5 lies somewhere beyond mere negligence or recklessness, but short of specific intent.²³⁵ The court reasoned that because § 32(a) allows lack of knowledge of a specific rule to constitute an affirmative defense only to imprisonment following conviction, such a lack of knowledge cannot be considered a defense to the conviction itself.²³⁶ Therefore, the standard of intent for willful violations of § 10(b) and Rule 10b-5 is merely that of a general intent to commit a wrongful act.²³⁷ As previously stated, this general intent can be shown by proof that a defendant acted with knowledge that the conduct was significantly likely to violate the law.²³⁸ Such knowledge can be shown by any receipt of actual notice of the applicable securities laws, the common trading practices to which a defendant was exposed, and by evidence of deceit, concealment or the making of false exculpatory statements.²³⁹

The Eighth Circuit's holding in *O'Hagan III*, therefore, seems to provide the most recent and accurate guidelines regarding the standard for willful violations of § 10(b) and Rule 10b-5.²⁴⁰ The final statement made by the court on this subject, however, used slightly ambiguous language that could possibly lead to further confusion.²⁴¹ The court stated its conclusion that "willfully" simply requires the intentional

²³² See *O'Hagan III*, 139 F.3d at 647; Dawes, *supra* note 35, at 523.

²³³ See *O'Hagan III*, 139 F.3d at 646.

²³⁴ See *id.* at 647.

²³⁵ See *id.*

²³⁶ See *id.*

²³⁷ See *id.*

²³⁸ See *O'Hagan III*, 139 F.3d at 647; Dixon, 536 F.2d at 1395; *LaPorte*, 1997 WL 600677, at *3 n.2.

²³⁹ See Aiken, *supra* note 136, at 266; Carberry & Gordon, *supra* note 8, at 184; Spears & Aquilina, *supra* note 7, at 1.

²⁴⁰ See *O'Hagan III*, 139 F.3d at 647.

²⁴¹ See *id.*

doing of the wrongful acts" and cited the Second Circuit's holding in *Dixon* and the Ninth Circuit's majority opinion in *Charnay* as precedent for this statement.²⁴² This language is ambiguous because it could easily be interpreted as stating that an individual can willfully violate the Exchange Act by simply acting intentionally, without being aware of the illegal nature of his or her activity.²⁴³ This type of "voluntary intent" is not sufficient to support a criminal conviction.²⁴⁴ Although it does not appear that this erroneous standard was intended by the Eighth Circuit's statement, the court's conclusion might be better said as: "'willfully' requires an intent on the part of the defendant to commit a wrongful act."²⁴⁵

The practical consequences of distinguishing between culpable and non-culpable violations of § 10(b) and Rule 10b-5 are extremely important, and can be illustrated by two distinct hypothetical situations involving criminal prosecutions of insider trading defendants.²⁴⁶ In each of the following situations, a defendant has likely violated § 10(b) and Rule 10b-5, but may or may not have acted with the requisite level of culpable intent to be criminally convicted.²⁴⁷

In the first hypothetical prosecution, the defendant is a certified public accountant who is employed by an accounting firm that was hired by Corporation X to audit its most recent financial statements. While the defendant was performing work for Corporation X, she had direct contact with several of the company's officers and managers. Through conversations with some of these employees, the defendant learned that Corporation X was about to become the subject of a cash tender offer, made by Corporation Y, for all of the common stock of Corporation X. The defendant knew that Corporation Y's stock was trading on a national exchange for \$30 per share, and that Corporation X's stock was trading for \$10 per share. After hearing the news of the proposed tender offer, the defendant arranged to purchase 500 shares of Corporation X's common stock. Subsequently, the tender offer was made, and Corporation X's stock price rose to \$18 per share. At this point, defendant sold her 500 shares of Corporation X stock for a \$4000 profit.

Given the limited facts of this admittedly simple hypothetical, it appears that the defendant has violated § 10(b) and Rule 10b-5 for her

²⁴² See *id.*

²⁴³ See *id.*

²⁴⁴ See *O'Hagan*, 521 U.S. at 665-66; *LaPorte*, 1997 WL 600677, at *3 n.2.

²⁴⁵ Cf. *O'Hagan III*, 139 F.3d at 647.

²⁴⁶ See Carberry & Gordon, *supra* note 8, at 170; Spears & Aquilina, *supra* note 7, at 1.

²⁴⁷ See 15 U.S.C. § 78j(b) (1999); 17 C.F.R. § 240.10b-5 (1999).

trading activity based on material, nonpublic information.²⁴⁸ This defendant would likely be considered to be a temporary insider of Corporation X and, therefore, be prosecuted under the traditional theory of insider trading liability.²⁴⁹ Her trading was illegal because as an insider of Corporation X, the defendant was prohibited from purchasing the stock of that company on the basis of material, nonpublic information.²⁵⁰ Her knowledge regarding the proposed tender offer placed her at an unfair advantage over the shareholders of Corporation X, who were without this critical inside information.²⁵¹ Criminal penalties, however, could only be imposed on this defendant if she was found to have willfully violated § 10(b) and Rule 10b-5.²⁵² In this case, the burden on the government to prove culpable intent by the defendant could be satisfied without much difficulty.²⁵³ It is likely that as a certified public accountant and knowledgeable stock trader, this defendant probably knew exactly what type of activity § 10(b) and Rule 10b-5 prohibit.²⁵⁴ Even if specific intent to violate these provisions could not be sufficiently established, the government would certainly be able to show general intent to break the law on the part of this defendant.²⁵⁵ Much like the prosecution of the defendant-lawyer in *O'Hagan*, the government could successfully argue that this accountant acted with culpable intent because she knew that her trading was wrongful.²⁵⁶ At a minimum, her training and experience provided this defendant with knowledge that trading on the basis of material, nonpublic information of this type was likely to violate the federal securities laws.²⁵⁷ The government could introduce evidence of any notice of the insider trading laws that the defendant had received from either her professional training or from her employer.²⁵⁸ Evidence of common trading practices by other accountants with similar job qualifications and re-

²⁴⁸ See 15 U.S.C. § 78j(b) (1999); 17 C.F.R. § 240.10b-5 (1999); see also *O'Hagan*, 521 U.S. at 652.

²⁴⁹ See *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983).

²⁵⁰ See *O'Hagan*, 521 U.S. at 652; *Dirks*, 463 U.S. at 655; *Chiarella v. United States*, 445 U.S. 222, 228 (1980).

²⁵¹ See *O'Hagan*, 521 U.S. at 652; *Dirks*, 463 U.S. at 655; *Chiarella*, 445 U.S. at 228.

²⁵² See 15 U.S.C. § 78ff(a) (1999); *O'Hagan*, 521 U.S. at 665-66.

²⁵³ See *O'Hagan*, 521 U.S. at 665-66; Antolini et al., *supra* note 30, at 1019; Spears & Aquilina, *supra* note 7, at 1.

²⁵⁴ See *United States v. Weiner*, 578 F.2d 757, 785-86 (9th Cir. 1978); *United States v. Minuse*, 114 F.2d 36, 39 (2d Cir. 1940); Aiken, *supra* note 136, at 236, 265.

²⁵⁵ See *O'Hagan III*, 139 F.2d at 647.

²⁵⁶ See *O'Hagan*, 521 U.S. at 665-66; *O'Hagan III*, 139 F.2d at 647.

²⁵⁷ See *Weiner*, 578 F.2d at 785-86; Carberry & Gordon, *supra* note 8, at 184.

²⁵⁸ See Carberry & Gordon, *supra* note 8, at 184.

sponsibilities could also be used to establish the defendant's knowledge of her wrongful conduct.²⁵⁹

In a second hypothetical prosecution, the defendant is a low-level employee of Corporation Y, who works in the mailroom. He is responsible for sorting incoming and outgoing mail, and for delivering mail to other employees while picking up their outgoing letters and packages. While riding in an elevator at work, the defendant had a friendly conversation with two officers of Corporation Y, who both knew the defendant as a mailroom employee. When the defendant asked these officers how business was going, they responded by telling him that Corporation Y's business was expanding more and more each day. One officer asked the defendant if he was familiar with Corporation X, to which the defendant replied that he had heard of that company before. "Well," said the officer, "we are seriously considering taking over Corporation X as soon as we can." As these officers departed the elevator, one said to the other, "Their stock price should go through the roof after that!"

This defendant proceeded to purchase 200 shares of Corporation X's common stock at \$10 per share, from his computer at home that night. After Corporation Y publicly announced its cash tender offer for the stock of Corporation X, the price of Corporation X's shares rose to \$18, at which point the defendant sold his 200 shares for a \$1600 profit.

This defendant would be prosecuted for violating § 10(b) and Rule 10b-5 under the misappropriation theory, since he was not an insider of Corporation X, and owed no fiduciary duties to shareholders of that company.²⁶⁰ Additionally, this defendant could be found liable under the misappropriation theory, because he obtained material, nonpublic information from his employers, and traded on the basis of that information.²⁶¹ Assuming that a court would find that the defendant owed a duty to the source of this misappropriated information either to abstain from trading based on the information or to disclose such intentions to trade, this defendant violated § 10(b) and Rule 10b-5.²⁶²

Although this defendant would probably be liable for civil injunctions and monetary fines under the Exchange Act, the government would probably not be able to impose criminal penalties on the defen-

²⁵⁹ See *Weiner*, 578 F.2d at 785-86; *Minuse*, 114 F.2d at 39; Aiken, *supra* note 136, at 236, 265.

²⁶⁰ See *O'Hagan*, 521 U.S. at 653 n.5.

²⁶¹ See *id.*

²⁶² See *id.*

dant.²⁶³ Based on the limited facts of the hypothetical, it does not appear that he acted with the requisite culpable intent when trading in the securities of Corporation X.²⁶⁴ In order to convict, the government must prove that the defendant knew that his activity was wrongful.²⁶⁵ The defendant, as a low-level mailroom employee, is not likely to have had any knowledge regarding the types of trading activity prohibited by § 10(b) and Rule 10b-5.²⁶⁶ Additionally, this defendant could successfully argue that he traded without any notion that he was acting wrongfully.²⁶⁷ If this defendant could establish that, in fact, he was not aware of any risk of violating the federal securities laws, and that he had no reason to know of any possible risk, he should be able to avoid criminal conviction under § 32(a) of the Exchange Act.²⁶⁸ For example, he might raise the "good faith" defense and claim that he had placed his trades with the belief that he was acting legally, and that any resulting violation was simply the result of an innocent mistake or negligence.²⁶⁹ These facts present a good case for this defendant to succeed on such a defense.

These two hypothetical situations demonstrate that the *O'Hagan* Court's emphasis on the scienter requirements of § 32(a), will afford defendants greater protection from criminal prosecution, provided that the defendants lack sufficient knowledge of the federal securities laws to realize that their trading is likely to be in violation of those laws.²⁷⁰ In a case such as *O'Hagan*, or the first hypothetical, the government is not faced with significant hardship in sustaining its burden to prove that a defendant charged with criminal insider trading acted with culpable intent.²⁷¹ In a case involving a defendant with little or no knowledge regarding the federal securities laws, however, the government cannot criminally convict that defendant under § 10(b) or Rule 10b-5.²⁷² The difference in treatment between those defendants with

²⁶³ See 15 U.S.C. § 78u-1(a)(1)(A) (1999); see also Spears & Aquilina, *supra* note 7, at 1.

²⁶⁴ See Antolini et al., *supra* note 30, at 1021; Carberry & Gordon, *supra* note 8, at 184.

²⁶⁵ See *O'Hagan*, 521 U.S. at 665-66; *Dixon*, 536 F.2d at 1396.

²⁶⁶ See Carberry & Gordon, *supra* note 8, at 187-88.

²⁶⁷ See *Weiner*, 578 F.2d 786-87 (holding that for defendants charged with violating § 32 of the Exchange Act, proof of good faith constitutes a complete defense to the charges); Antolini et al., *supra* note 30, at 1021.

²⁶⁸ See 15 U.S.C. § 78ff(a) (1999); Carberry & Gordon, *supra* note 8, at 187-88.

²⁶⁹ See *Weiner*, 578 F.2d 786-87; Antolini et al., *supra* note 121, at 1021.

²⁷⁰ See *O'Hagan*, 521 U.S. at 665-66; Carberry & Gordon, *supra* note 8, at 172; Spears & Aquilina, *supra* note 7, at 1.

²⁷¹ See *O'Hagan*, 521 U.S. at 665-66.

²⁷² See *In re Christopher LaPorte & Gov't Sec. Corp.*, No. 1262, 1997 WL 600677 at *3 n.2 (Sept. 30, 1997); Carberry & Gordon, *supra* note 8, at 189; Spears & Aquilina, *supra* note 7, at 1.

knowledge of, and experience with, the federal securities laws and those without such knowledge or experience, results directly from the congressional choice made in 1934 to distinguish between culpable and non-culpable violations of the Exchange Act.²⁷³

CONCLUSION

The Supreme Court's holding in *O'Hagan*, while recognizing the validity of the misappropriation theory of insider trading liability, also stressed the element of culpable intent as a requirement for sustaining any conviction under § 32(a) of the Exchange Act. This aspect of the Court's decision, regarding scienter as a necessary element of criminal insider trading prosecutions, ensures that the Exchange Act will be interpreted according to Congress's original intent. That is, in order for any investor to be subject to criminal penalties for violations of § 10(b) of the Exchange Act and Rule 10b-5, that person must act with knowledge that his or her trading is a wrongful activity. This culpable intent can be demonstrated by proof that a trader actually knew what activity § 10(b) and Rule 10b-5 prohibit, or that the trader was aware that his or her actions presented a significant risk of violating the federal securities laws. No person may be criminally convicted for insider trading violations without proof of culpable intent.

BRIAN J. CARR

²⁷³ See 1934 Hearings, *supra* note 57, at 7465; Carberry & Gordon, *supra* note 8, at 179; Herlands, *supra* note 54, at 147-48.