**ANNOTATIONS AND COMMENTS**

Insider Trading, Classical Theory: The language of this charge comes directly from the leading cases on insider trading, *United States v. O’Hagan*, 521 U.S. 642 (1997) and *Chiarella v. United States*, 445 U.S. 222, 228 (1980). In *O’Hagan* the Supreme Court held that trading on material non-public information is a “device” within the meaning of § 10 of the Securities Exchange Act and Rule 10b-5. *O’Hagan*, 521 U.S. at 655-56. Additionally, the Eleventh Circuit has held that mere possession of material, non-public information is insufficient to establish a 10b-5 violation. Rather, the Plaintiff must show that the Defendant actually *used* that information in trading with an intent to defraud. *SEC v. Adler*, 137 F.3d 1325, 1337 (11th Cir. 1998). In a footnote in *Adler*, the Eleventh Circuit noted that the SEC could adopt a different standard by rule. *Id*. at 1337 n.33. Subsequent to the Eleventh Circuit’s decision in *Adler*, the SEC adopted Rule 10b5-1(b), quoted above, which establishes an “awareness” standard more closely analogous to the “knowing possession” standard adopted by the Second Circuit in *United States v. Teicher*, 987 F.2d 112, 120-21 (2nd Cir. 1993), and rejected by the Eleventh Circuit in *Adler*. In adopting Rule 10b5-1, the SEC explained that, “The awareness standard 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.” 65 Fed. Reg. 51716-01, 51727 (Aug. 24, 2000) (codified at C.F.R. pts. 240, 243, 249). Answering commentators’ criticisms regarding the imprecision of the awareness standard, the SEC stated, “’Aware’ is a commonly used and well-defined English word, meaning ‘having knowledge; conscious; cognizant.’” *Id*. at 51727 n.105. Since the amendment of Rule 10b-5 in 2000, the Eleventh Circuit has reaffirmed the “use” requirement previously set forth in *Adler*. *SEC v. Ginsburg*, 362 F.3d 1292, 1297-98 (11th Cir. 2004). Thus, despite Rule 10b-5’s “awareness” standard, the Eleventh Circuit continues to interpret Rule 10b-5 as requiring the plaintiff to prove that the defendant not only possessed the material, non-public information, but also that the defendant used the information in trading. However, “[p]roof of knowledge of such information at the time of a trade ‘gives rise to a strong inference of use.’” Ginsburg, 362 F.3d at 1298, *quoting Adler*, 137 F.3d at 1340.

Insider Trading, Misappropriation Theory: *O’Hagan* answered the question of whether someone in possession of inside information can violate 10b-5 when he trades in another company’s stock. Traditional insider trading occurs when the insider trades in his own company’s stock and is derived from breach of fiduciary duty concepts. The Court held that trading in any securities based upon information as a result of a fiduciary duty violates Rule 10b-5. Under *O’Hagan*, a person violates Rule 10b-5 when that person trades on any information obtained in violation of a fiduciary duty. Probably the most common application of the misappropriation theory occurs where corporate insiders know that their company is about to launch a takeover of another company. Under the classical theory, they cannot trade in shares of their own company and under the misappropriation theory they cannot trade in the target’s shares.

In August of 2000, the SEC adopted Rule 10b5-2 [17 C.F.R. § 240.10b5-2] to clarify when a duty of trust or confidence arises between a source and recipient of material nonpublic information. Such a duty arises in three circumstances: where the person agrees to maintain the information in confidence; where the source and recipient have a history, pattern, or practice of sharing confidences such that the recipient knew or reasonably should have known the source expected the information to be kept in confidence; and where the source is the parent, child, spouse, or sibling of the recipient. In the latter case, Rule 10b5-2 establishes a presumption that a duty of trust or confidence arises, which may be rebutted by showing that, based on the circumstances surrounding the relationship, the source reasonably would not have expected the recipient to keep the information confidential. In a case whose events occurred prior to the adoption of Rule 10b5-2 (to which the new rule was inapplicable), *SEC v. Yun*, 327 F.3d 1263, 1273 (11th Cir. 2003), the Eleventh Circuit held that a duty of trust or confidence arises between spouses only where there was “a history or practice of sharing business confidences.” The *Yun* court conceded that the Rule 10b5-2 “goes farther than we do in finding a relationship of trust and confidence.” *Id*. at 1273 n. 23.

Tipper-Tippee Liability: In *Dirks v. SEC*, 463 U.S. 646, 662 (1983), the Supreme Court held that in order for a tippee to be liable, the tipper (in that case a corporate insider) must have intended to benefit personally from his or her disclosure of the confidential information to the tippee. In *SEC v. Yun*, 327 F.3d 1263 (11th Cir. 2003), the Eleventh Circuit held that a tipper who is an outsider-misappropriator must also intend to benefit from the tip in order for the tippee to be liable. Thus, in a case seeking to hold a tippee liable, regardless of whether the source of the information is an insider or an outsider-misappropriator, the plaintiff must prove that the tipper intended to personally benefit from the disclosure.

Scienter: In order to establish liability under Section 10 and Rule 10b-5, the inside trader must have acted with “scienter,” which is defined as “a mental state embracing intent to deceive, manipulate, or defraud.” *Aaron v. SEC*, 446 U.S 680, 686 n.5 (1980). In the Eleventh Circuit, “scienter” may also consist of “severe recklessness” by the defendant, *see, e.g., Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc.*, 594 F.3d 783, 790 (11th Cir. 2010); however, the Supreme Court has left open the question whether recklessness may satisfy the scienter requirement. *See Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1323 (2011) (“We have not decided whether recklessness suffices to fulfill the scienter requirement.”); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 n.3 (2007) (declining to decide issue because “whether and when recklessness satisfies the scienter requirement is not presented in this case”)

Materiality: Information is considered material if there is a substantial likelihood that a reasonable investor would consider it important in making a decision to buy or sell a security. *See Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). Information relating to a potential merger may be material even before the final merger agreement has been reached. The materiality of information relating to a merger depends on the probability that the transaction will be consummated and its significance to the issuer of the securities. *Basic, Inc.*, 485 U.S. at 250. *See also, SEC v. Mayhew*, 121 F.3d 44, 51 (2nd Cir. 1997); *SEC v. Geon Indus., Inc.*, 531 F.2d 39, 47-48 (2nd Cir. 1976). In insider trading cases, materiality of the non-public information is frequently established by a substantial change in the company’s stock upon the public disclosure of the information. *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 166 (2nd Cir. 1980) (reaction of investors to the information is an indication of materiality).

Non-Public: Information becomes public when disclosed to achieve a broad dissemination to the investing public generally and without favoring any special person or group, *Dirks*, 463 U.S. at 653 n. 12, or when, although known only to a few persons, trading on it “has caused the information to be fully impounded into the price of the particular stock…” *United States v. Libera*, 989 F.2d 596, 601 (2nd Cir.1993); *Mayhew*, 121 F.3d at 50.

Definition of a “Security”: For additional examples of what is a security, see Exchange Act Section 3, 15 U.S.C. § 78c. The issue of whether a particular investment is a “security” is frequently a question of law for the court. *Robinson v. Glynn*, 349 F.3d 166, 170 (4th Cir. 2003); *Ahrens v. American-Canadian Beaver Co.*, 428 F.2d 926, 928 (10th Cir. 1970). In those cases where the court determines that the investment at issue is a security, it should so instruct the jury.

Affirmative Defenses: Note that 17 C.F.R § 240.10b5-1 provides for certain affirmative defenses where the purchase or sale of securities was made pursuant to the terms of a contract, instruction to another person, or written plan that was made or given prior to the person’s becoming aware of the material nonpublic information. Where such an affirmative defense is raised, these instructions should be modified to incorporate the asserted defense.