Culpable Intent Required For All Criminal Insider Trading Convictions After United States v O'Hagan

Brian J. Carr

Follow this and additional works at: http://lawdigitalcommons.bc.edu/bclr

Part of the Securities Law Commons

Recommended Citation
Brian J. Carr, Culpable Intent Required For All Criminal Insider Trading Convictions After United States v O'Hagan, 40 B.C.L. Rev. 1187 (1999), http://lawdigitalcommons.bc.edu/bclr/vol40/iss5/3
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 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. 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. 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. 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. 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.

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

3 See O’Hagan, 521 U.S. at 632.
4 See id. at 648.
5 See id. at 650.
securities laws. 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.

The Exchange Act requires that all criminal violations be committed "willfully." 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. This type of "voluntary intent" was necessary to impose administrative sanctions or criminal penalties. 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. 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. 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. In the most egregious cases, culpable intent can be established without significant difficulty.

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.


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.


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. 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. 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. 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. Part II also includes a brief discussion of several methods of proving scienter, or willfulness. 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.

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. 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.

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. 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.
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 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).
rule or regulation if he proves that he had no knowledge of such rule or regulation.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{32} The Exchange Act also grants the SEC power to levy civil penalties against any § 10(b) violator.\textsuperscript{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.\textsuperscript{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.\textsuperscript{35} These

\textsuperscript{29} 15 U.S.C. § 78ff(a).


\textsuperscript{32} 15 U.S.C. § 78o(b)(4)(D) (1999). The 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]." \textit{Id.}

\textsuperscript{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.

\textit{Id.}


are the "traditional" (or "classical") theory and the "misappropriation" theory of insider trading liability. 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. 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." 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. 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.

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. Liability, therefore, is not based on a fiduciary relationship between the trader and a purchaser or seller of a company's stock. 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.

These two theories of insider trading liability, traditional and misappropriation, are often considered complementary. 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(n) (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.


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


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 Aklave, 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. 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. 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." 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."

The validity of the misappropriation theory for criminal liability remained in question until the Supreme Court's decision in O'Hagan. 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. 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. 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.

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).
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).
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. 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].

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." Herlands noted that criminal proceedings, however, are "set into motion by 'willful' violations." 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. Ferdinand Pecora, appointed by President Franklin D. Roosevelt, as chief counsel to the Committee, stated repeatedly that

---


55 Id. at 144.

56 Id. at 145.

the Exchange Act was not intended to punish innocent violators. 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), Herlants 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; Herlants, supra note 54, at 148.

\[60\] Herlants, supra note 54, at 149 (emphasis added).

\[61\] See 15 U.S.C. § 78ff(a) (1999); Herlants, supra note 54, at 149.

\[62\] See 15 U.S.C. § 78ff(a) (1999); Herlants, supra note 54, at 149.
means in a criminal statute. 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.

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). 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. 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. 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. 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.

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. For example, in a 1940 admin-

---

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); *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 (Scheel, 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.
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.
Administrative 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).
79 *Tager*, 344 F.2d at 8, 9.
80 See id. at 8.
81 See id. at 7.
activities were manipulative. 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. 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.

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. 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. 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. 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.

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. The defendant, Dixon, was president of a New York corporation that manufactured voting machines. 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. 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.
86 See generally Dixon, 536 F.2d 1388; Peliz, 433 F.2d 48; Guterman, 281 F.2d 742.
87 See Dixon, 536 F.2d at 1396; Peliz, 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 1992.
for filing proxy statements and for his calculations in the corporate books.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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."\textsuperscript{96}

A 1976 decision by the Ninth Circuit Court of Appeals, \textit{United States v. Charnay}, clearly illustrates the difficulties that courts face in applying the appropriate standard of criminal intent in securities law cases.\textsuperscript{97} \textit{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").\textsuperscript{98} The defendants made an offer to acquire the assets of Air West, a corporation whose stock traded on the American Stock Exchange ("AMEX").\textsuperscript{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.\textsuperscript{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.\textsuperscript{101} The Air West directors then apparently changed their minds and accepted the offer to sell Air West's assets to Hughes Tool.\textsuperscript{102}

\textsuperscript{92} See id. at 1395.
\textsuperscript{93} See id. at 1396, 1402.
\textsuperscript{94} See Dixon, 536 F.2d at 1397.
\textsuperscript{95} See id.
\textsuperscript{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.").
\textsuperscript{97} See generally 537 F.2d 341 (9th Cir. 1976).
\textsuperscript{98} See id. at 344.
\textsuperscript{99} See id.
\textsuperscript{100} See id.
\textsuperscript{101} See id.
\textsuperscript{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.
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. 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. 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.

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. The Court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud." 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. 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. Blackmun reasoned that when Congress wished to impose a state-of-mind requirement, terms such as "willfully" were used in the Exchange Act.

2. Proof of Willfulness

Although the Supreme Court's decision in Aaron arose in a civil context, 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. 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.\textsuperscript{122} Courts also frequently recognize that scienter, or willfulness, is a difficult concept to define and prove.\textsuperscript{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.\textsuperscript{124} The government must prove this violation to the trier of fact beyond a reasonable doubt.\textsuperscript{125} Several courts and commentators have recognized that willfulness can rarely be shown by direct evidence because it is a state of mind.\textsuperscript{126} Rather, willfulness is usually established by drawing reasonable inferences from all of the available circumstantial facts.\textsuperscript{127}

In order to satisfy its burden, the government can rely on several factors that tend to indicate a defendant’s intent to deceive.\textsuperscript{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,\textsuperscript{129} such knowledge does provide sufficient evidence to infer a willful violation.\textsuperscript{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.\textsuperscript{131} This method of proof can be effective in prosecu-

\textsuperscript{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.

\textsuperscript{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).

\textsuperscript{124} See Antolini et al., supra note 30, at 1019.

\textsuperscript{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).


\textsuperscript{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.

\textsuperscript{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).

\textsuperscript{129} See infra notes 201–02 and accompanying text.

\textsuperscript{130} See Spears & Aquilina, supra note 7, at 1.

\textsuperscript{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. 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. Therefore, actual knowledge can be proven using these policies and procedures, and any violations will provide evidence of willfulness or culpable intent. 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.

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. 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. 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.

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. 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.

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. 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.
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. Because a willful violation cannot be "the result of innocent mistake, negligence or inadvertence," defendants may claim that they believed they were conforming with the federal securities laws. 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.

A closely related defense to "good faith" is a defendant's reliance on the advice of an expert. 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. 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. 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.

Additionally, an insider trading defendant may always claim an absolute defense to imprisonment for any criminal violations of § 10(b) and Rule 10b-5. 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." 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.

---

143 See id. at 1021.
144 United States v. Dixon, 536 F.2d 1388, 1396 (2d Cir. 1976) (approving jury instruction regarding willfulness in the district court).
145 See Antolini et al., supra note 30, at 1020.
146 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.
147 See Aiken, supra note 136, at 266; Antolini et al., supra note 30, at 1021.
148 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.
149 See Antolini et al., supra note 30, at 1022; see also Aiken, supra note 136, at 267.
150 See Arthur Lipper Corp. v. SEC, 547 F.2d 171, 181-82 (2d Cir. 1976); Antolini et al., supra note 30, at 1022.
152 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.\textsuperscript{163} By the end of September, O'Hagan owned 2,500 Pillsbury call options, more than any other individual investor.\textsuperscript{164} He also bought 5,000 shares of Pillsbury common stock in September, at a price of $39 per share.\textsuperscript{165} In October, when Grand Met announced its tender offer, the price of Pillsbury stock soared to almost $60 per share.\textsuperscript{166} O'Hagan then sold all of his call options and common stock, and made a profit of more than $4.3 million.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.

\textsuperscript{163} See O'Hagan, 521 U.S. at 647.
\textsuperscript{164} See id.
\textsuperscript{165} See id. at 648.
\textsuperscript{166} See id.
\textsuperscript{167} See id.
\textsuperscript{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.
\textsuperscript{170} See id. at 653 n.5.
\textsuperscript{171} See id. at 648.
\textsuperscript{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.
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.
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).

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. 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. 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. 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."

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. Specifically, he argued that criminal convictions under the misappropriation theory violate due process notions, because an uncodified "theory" cannot provide adequate guidance as to what conduct is illegal.

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.
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." 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. 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.

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." First, to establish a criminal violation of Rule 10b-5, the government must prove that a person "willfully" violated the provision. 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. 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.

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. 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 Id. at 666 (quoting Motor Lines, 342 U.S. at 342).
194 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). 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.

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." 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."

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. 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. 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."

**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.
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. 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. The difficulty that still surrounds all criminal actions under the Exchange Act, however, is deciding what degree of scienter is required for a conviction. 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?

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. 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. 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. 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.

---

205 See Schulz, 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, 1120 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. 1202, 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 & Aquillina, 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,


\(^{215}\) See id.

\(^{216}\) See id.

\(^{217}\) See id.


\(^{219}\) 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.

Congress differentiated between willful and non-willful violations of the Exchange Act. 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. 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. 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.

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. 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. 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. 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.

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. In other words, is it necessary to establish that a defendant specifically intended to violate the language

---

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 (Sriet, J., concurring); Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965).
228 See id.
229 See id.; 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'Hagaty 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 260; 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. 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. This type of “voluntary intent” is not sufficient to support a criminal conviction. 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.”

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. 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.

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...
trading activity based on material, nonpublic information. 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. 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. 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. Criminal penalties, however, could only be imposed on this defendant if she was found to have willfully violated §10(b) and Rule 10b-5. In this case, the burden on the government to prove culpable intent by the defendant could be satisfied without much difficulty. 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. 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. 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. 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. 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. 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.
251 See O'Hagan, 521 U.S. at 652; Dirks, 463 U.S. at 655; Chiarella, 445 U.S. at 228.
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.3d at 647.
256 See O'Hagan, 521 U.S. at 665-66; O'Hagan III, 139 F.3d 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.250

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.250 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.251 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-5.252

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-

250 See Weiner, 578 F.2d at 785-86; Alinuse, 114 F.2d at 39; Aiken, supra note 136, at 236, 265.
251 See id.; O’Hagan, 521 U.S. at 653 n.5.
252 See id.
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. In order to convict, the government must prove that the defendant knew that his activity was wrongful. 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. Additionally, this defendant could successfully argue that he traded without any notion that he was acting wrongfully. 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. 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. 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. 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. 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. The difference in treatment between those defendants with
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.