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Can Disclosure Set You Free?

SEC v. Rocklage *and the Misappropriation Theory's Disclosure Defense*

By Jeremy Freeman

The misappropriation theory of insider trading, which was first recognized by the Supreme Court in *United States v. O'Hagan*, 521 U.S. 642 (1997), establishes liability for individuals who are not typical "insiders" of companies and also appears to offer such defendants a specific defense to insider trading charges. The *O'Hagan* Court based the misappropriation theory on a duty owed by the defendant to the source of non-public material information, rather than to the shareholders of the company whose stock was being traded. Because a defendant prosecuted under the misappropriation theory had a duty only to his source, the Court explained that a defendant's disclosure to the source of information prior to trading or tipping could neutralize the acts of deception necessary for a securities fraud claim. *O'Hagan*, 521 U.S. at 655.

This "disclosure to the source" defense remained untested until a recent SEC action against Patricia Rocklage, the wife of a pharmaceutical executive. Mrs. Rocklage defended against the SEC's allegations of insider trading by arguing, in part, that she disclosed to the source of her information — her husband — her intent to use the material non-public information she had obtained in confidence. *SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006).

The First Circuit, expressing uncertainty and reservations about the scope and application of the "disclosure to the source" defense, distinguished *O'Hagan* and found that Mrs. Rocklage could be held liable for insider trading despite her disclosure. The *Rocklage* decision raises doubts about the defense and exposes a structural weakness in the misappropriation theory that should be of great significance to criminal-defense attorneys and prosecutors alike.

The Expansion of Insider Trading Liability

There are currently two theories used to prosecute insider trading under § 10(b) and SEC Rule 10b-5: the classical theory and the misappropriation theory. The "classical theory" applies to an actual insider who violates the antifraud provisions of the federal securities laws by trading in the securities of his corporation on the basis of material, non-public information. Liability under the classical theory is based upon the breach of a duty of trust that the insider *owes the shareholders* of the corporation. *O'Hagan*, 521 U.S. at 651-52.

The misappropriation theory was borne of the desire to extend the same liability to those who were not corporate insiders but nevertheless possessed material non-public information. So the Supreme Court adopted a theory imposing insider trading liability on someone who "misappropriates confidential information for securities trading purposes, in a breach of duty *owed to the source* of the information."

The *O'Hagan* 'Loophole'

Because the misappropriation theory rests on a duty to the source of information rather than to the shareholders of the company, the misappropriation theory sprouted a defense, or "loophole." The misappropriation theory results in part from an earlier Supreme Court decision that set limits on the classical theory of insider trading, *Chiarella v. United States*, 445 U.S. 222, 231-35 (1980). In *Chiarella*, the insider trading conviction of a financial printer responsible for preparing documents in a corporate takeover was reversed on the basis that the defendant owed no duty to the company or its shareholders and thus could not be prosecuted under the classical theory. Seventeen years later, the Supreme Court in *O'Hagan* confronted another case where a non-insider, a lawyer, was criminally prosecuted for trading on inside information he obtained through his employer. This time, however, the Court found liability even in the absence of any duty to the shareholders.

In *O'Hagan*, the defendant lawyer worked for an independent law firm representing the bidder in a tender offer. Because O'Hagan's firm represented the bidder and not the issuer, O'Hagan owed no fiduciary duty to the target's stockholders and could not be prosecuted under the classical theory. The Supreme Court, however, did not give O'Hagan a pass, but instead recognized and formulated the now ubiquitous misappropriation theory, holding that O'Hagan could be properly prosecuted for insider trading because he had deceived both his law firm and its client by pretending to be loyal to them while secretly profiting from information obtained from them.

But the Court also articulated a defense: "Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation." 521 U.S. at 655. This "disclosure to the source" defense, which the First Circuit in *Rocklage* said was arguably dictum because O'Hagan did not disclose his trading to the firm or its client, ultimately came home to roost in *Rocklage*.

SEC v. Rocklage: The Legacy of the Disclosure Defense

In January 2005, the SEC filed an action against Mrs. Rocklage, her brother, and one of his friends for insider trading under the misappropriation theory. *SEC v. Rocklage*, 470 F.3d 1,3 (1st Cir. 2006). The complaint alleged that Mrs. Rocklage, who had learned negative information about her husband's pharmaceutical company, Cubist, tipped her brother, a Cubist shareholder, about the bad news. This allowed the brother and the friend, who was also a Cubist shareholder, to avoid hundreds of thousands of dollars in losses. Before she obtained the inside information from her husband, Mrs. Rocklage had an agreement with her brother that she would "signal" him about any bad news regarding Cubist before it became public. Her husband was apparently unaware of this arrangement. He told her the information was confidential and that she was not to tell anyone. Nevertheless, after hearing the negative information, Mrs. Rocklage told her husband that she was going to tip her brother. The husband tried to dissuade her but was unsuccessful. Mrs. Rocklage's brother and his friend sold their shares ahead of the public disclosure.

The defendants moved to dismiss on the basis of the *O'Hagan* "disclosure to the source" defense, but the district court found *O'Hagan* distinguishable. In its initial opinion, the district court had misread the facts of *O'Hagan,* mistakenly believing that O'Hagan's firm had a duty to the target shareholders when actually the firm represented the bidder. Despite this error, which the district court acknowledged on defendants' motion for reconsideration, it reaffirmed its denial, distinguishing *O'Hagan* because the marital relationship in *Rocklage* did not give the husband the same ability to take "remedial action" against his wife as could a law firm against O'Hagan. The district court certified the issue for interlocutory appeal to the First Circuit.

On appeal, the defendants argued that Mrs. Rocklage could not be liable for securities fraud because she fell within the *O'Hagan* disclosure defense. The First Circuit rejected this argument and affirmed the lower court's decision on the basis that *O'Hagan* was indeed distinguishable from the facts of *Rocklage*, but for completely different reasons than those expressed by the district court.

The First Circuit explained that the "defendants' position is really that because some of Mrs. Rocklage's actions may have been non-deceptive, her scheme as a whole had no deceptive elements. We do not believe that *O'Hagan* requires such an understanding of § 10(b)." Mrs. Rocklage committed at least two deceptive acts, one when she acquired the information, and the other when she tipped her brother. Consequently, unlike O'Hagan, who only committed one act of deception by trading on information he had *properly* obtained through his firm, Mrs. Rocklage's disclosure cured only part of her previous deception but not all of it. Despite her disclosure to her husband, "her overall scheme was still deceptive: it had as part of it at least one deceptive device."

Although the First Circuit engaged in substantial hair-splitting to distinguish the facts of *O'Hagan* from those in *Rocklage* and thus skirt any interpretation of the *O'Hagan* "disclosure" defense, the panel urged the Supreme Court to shed light on the confusion created by *O'Hagan*. The "import and reach of the Supreme Court's language in *O'Hagan* about disclosure as a cure for deception has created uncertainty in the courts. … Until the Supreme Court has clarified its language about disclosure, this uncertainty is an important factor in why we are unwilling to state generalized rules."

Until the Supreme Court accepts the First Circuit's invitation, courts may be inclined to go to exceptional lengths to prevent defendants from using what appears to be a clear and logical defense to insider trading charges. If this becomes the trend, then disclosure may not set you free or shield you from civil liability.

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