

**Securities Law—First Circuit Limits Scope of “Safe Harbor” Disclosure Loophole Under Misappropriation Theory of Insider Trading—*SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006)**

In Oliver Stone’s film *Wall Street*, Gordon Gekko’s philosophy that “greed is good” exposed the widespread corporate culture of excess and ruthlessness that defined the 1980s.<sup>1</sup> Decades before this era, Congress and the Securities and Exchange Commission (SEC) enacted § 10(b) of the 1934 Securities and Exchange Act (‘34 Act)<sup>2</sup> and Rule 10b-5<sup>3</sup> to limit the impact of greed in corporate America.<sup>4</sup> Despite Congress, the SEC, and the Supreme Court’s regulatory frameworks, what constitutes insider trading, especially misappropriation-based insider trading, remains unclear.<sup>5</sup> Despite this ambiguity, the scope of insider trading prohibition has narrowed with time.<sup>6</sup> In *SEC v. Rocklage*,<sup>7</sup> the United States Court of Appeals for the First Circuit clarified what constitutes misappropriation-based insider trading by considering whether a pre-tip disclosure eliminated liability where an alleged misappropriator deceptively acquired information.<sup>8</sup> The court affirmed the district court’s denial of the defendant’s motion to dismiss for failure to state a claim and remanded the SEC’s § 10(b) claim, explaining that a pre-tip disclosure does not always render the acquisition of information non-deceptive and eliminate liability, thus limiting the scope of the “safe harbor” loophole for misappropriation-based insider trading.<sup>9</sup>

On December 31, 2001, Mr. Rocklage, the Chairman and Chief Executive Officer (CEO) of Cubist Pharmaceuticals (Cubist) relayed private and material

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1. WALL STREET (20th Century Fox 1987) (quoting Gordon Gekko regarding value of greed in capitalist economy). Gordon Gekko continued his speech stating, “Greed works, greed is right. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit. Greed in all its forms . . . has marked the upward surge of mankind.” *Id.* Wall Street portrayed a profit-obsessed culture that dominated Wall Street through portraying the story of an insider trading scandal. *Id.* See generally MICHAEL LEWIS, LIAR’S POKER (1989) (portraying experiences of Wall Street bond salesman and economic climate of 1980s).

2. 15 U.S.C. § 78j(b) (2006).

3. 17 C.F.R. §240.10b-5 (2004).

4. See *infra* text accompanying notes 23-25 (explaining statutory and regulatory basis for securities fraud and modern insider trading prohibition).

5. See *infra* text accompanying note 36 (explaining misappropriation theory); *infra* note 39 and accompanying text (noting ambiguity for when one can escape insider trading liability via “safe harbor” loophole).

6. See *infra* note 28 and accompanying text (illustrating shift from broad to narrow prohibition of federal insider trading).

7. 470 F.3d 1 (1st Cir. 2006).

8. *Id.* at 11-14 (considering whether Mrs. Rocklage’s pre-tip disclosure eliminated her liability under misappropriation-based theory).

9. *Id.* at 12-14 (affirming district court decision and remanding case for further proceedings).

information to his wife.<sup>10</sup> He told her that one of Cubist's key drugs failed a clinical trial and that the company's stock price would drop upon public announcement of such news.<sup>11</sup> Mr. and Mrs. Rocklage had a mutual agreement to keep this information confidential, but Mrs. Rocklage also had a preexisting agreement to relay any negative news about Cubist to her brother, William M. Beaver (Beaver).<sup>12</sup> Shortly thereafter, Mrs. Rocklage told her husband that she intended to tip Beaver to sell his shares of Cubist stock.<sup>13</sup> Despite Mr. Rocklage's insistence that information regarding the clinical trial remain confidential, Mrs. Rocklage gave her brother a "wink and a nod," their prearranged indicator, signaling negative news about Cubist.<sup>14</sup> On January 2, 2002, Beaver sold all of his Cubist stock and also prompted his neighbor, David G. Jones (Jones), to do the same.<sup>15</sup>

Three years later, the SEC filed a civil complaint against Mrs. Rocklage, Beaver, and Jones in the United States District Court for the District of Massachusetts alleging § 10(b) and Rule 10b-5 violations under a misappropriation-based theory of insider trading.<sup>16</sup> The three defendants filed a Rule 12(b)(6) motion to dismiss for failure to state a claim, arguing that, pursuant to the Supreme Court's disclosure loophole in *United States v. O'Hagan*,<sup>17</sup> Mrs. Rocklage's pre-tip disclosure to her husband negated all liability under a misappropriation-based insider trading theory.<sup>18</sup> The district

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10. *Id.* at 3.

11. 470 F.3d at 3 (explaining exchange of nonpublic information between Mr. Rocklage to Mrs. Rocklage). On the afternoon of December 31, Mr. Rocklage's initial disclosure to his wife regarding the drug's clinical failure was unsolicited. *Id.* at 3-4. The second disclosure, that a public announcement would adversely affect Cubist's stock, however, occurred that evening after Mrs. Rocklage questioned her husband about the anticipated effects of the drug's clinical failure. *Id.* at 4.

12. *Id.* at 3 (describing Mr. Rocklage's expectation of privacy and Mrs. Rocklage's agreement with her brother). Upon the initial disclosure on December 31, Mr. Rocklage unequivocally expressed his intention that Mrs. Rocklage keep the clinical trial results confidential. *Id.* For approximately seven years, Mr. Rocklage routinely communicated material, nonpublic information to his wife, which she always kept confidential. *Id.* Based on Mrs. Rocklage's history of keeping material, nonpublic information confidential, coupled with her promise to keep the clinical trial results confidential, Mr. Rocklage had a reasonable expectation of confidentiality. *Id.* at 3-4.

13. *Id.* at 4 (disclosing intention of signaling material, nonpublic information with brother to allow him to trade securities).

14. *Id.* at 4 (describing Mrs. Rocklage's arrangement with Beaver).

15. 470 F.3d at 4 (illustrating securities trades resulting from Mrs. Rocklage's tip). Beaver sold all of his 5,583 shares of Cubist stock, thereby avoiding a loss of \$99,527, and Jones sold all of his 7,500 shares of Cubist stock, thus preventing a \$133,222 loss. *Id.*

16. *Id.* at 3-4 (filing misappropriation-based insider trading action against defendants).

17. 521 U.S. 642 (1997).

18. 470 F.3d at 5 (articulating defendants' defense to misappropriation-based insider trading action). The Supreme Court, in *O'Hagan*, explained the disclosure loophole to insider trading:

[F]ull disclosure forecloses liability under the misappropriation theory: 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 nonpublic information, there is no "deceptive device" and thus no § 10(b) violation.

court held that although the defendants were not liable based on a classical theory of insider trading, because Mrs. Rocklage was not an insider of Cubist, they were, however, liable under a misappropriation theory, despite *O'Hagan's* disclosure loophole.<sup>19</sup> The defendants then moved for the district court to reconsider, arguing the district court misread *O'Hagan*; but the district court denied the motion despite its concession that it misapplied *O'Hagan*.<sup>20</sup> In the alternative, the defendants requested that the district court certify the issue for an interlocutory appeal, which the district court did after denying the defendant's motion for reconsideration.<sup>21</sup> The United States Court of Appeals for the First Circuit accepted the appeal and held that Mrs. Rocklage deceptively acquired nonpublic information from her husband and that her pre-tip disclosure to her husband did not preclude liability under a misappropriation-based insider trading theory.<sup>22</sup>

Congress enacted the '34 Act in response to the collapse of the stock market in 1929, the Great Depression, and the public's general distrust of greed-induced Wall Street businessmen.<sup>23</sup> Despite the absence of an explicit statutory reference, the origins of insider trading prohibition can be traced to § 10(b) of the '34 Act.<sup>24</sup> Eight years after the passage of the '34 Act, Congress enacted

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United States v. O'Hagan, 521 U.S. 642, 655 (1997).

19. 470 F.3d at 5 (citing United States v. O'Hagan, 521 U.S. 642 (1997)) (explaining district court's basis for defendants' liability). The court explained that liability under a classical theory occurs when the "trader or tipper is an insider of the traded-in corporation . . . [and] breaches a fiduciary duty owed to the corporation's shareholders." *Id.* On the other hand, the misappropriation theory applies "when a tipper or trader misappropriates confidential information from his source of the information . . . [and] breaches a fiduciary duty owed to the source." *Id.* Mrs. Rocklage could not be held liable under a classical theory because she was not a traditional insider of Cubist, and thus owed no duty to the corporation's shareholders. *Id.* The district court, however, held that Mrs. Rocklage did owe a fiduciary duty to her husband and was liable under a misappropriation theory despite her pre-tip disclosure. *Id.* The district court denied Beaver and Jones's motion to dismiss as downstream tippees. *Id.*

20. *Id.* at 5-6 (explaining district court's denial of motion for reconsideration). The district court admitted its misreading of *O'Hagan*, but maintained that the error did not affect its decision. *Id.*

21. *Id.* (describing procedural posture of case).

22. *Id.* at 12-14 (articulating First Circuit's holding). The First Circuit affirmed the district court's denial of the defendants' 12(b)(6) motion and their motion for reconsideration holding that the defendants were liable under a misappropriation-based theory of insider trading and remanded the case back to the district court. *Id.* at 14.

23. STEPHEN M. BAINBRIDGE, *SECURITIES LAW: INSIDER TRADING* 23 (1999) (detailing criteria leading to promulgation of '34 Act); ELIZABETH SZOCKYJ, *THE LAW AND INSIDER TRADING: IN SEARCH OF A LEVEL PLAYING FIELD* 6 (1993) (explaining factors contributing to '34 Act becoming one of Franklin Roosevelt's New Deal initiatives). The goals of the '34 Act and other similar statutes enacted around the same time were to: "protect[] investors engaged in securities transactions and assur[e] public confidence in the integrity of the securities markets." BAINBRIDGE, *supra*, at 23.

24. 15 U.S.C. § 78j(b) (2006) (providing basis for SEC regulation securities fraud). Section 10(b) provides that:

It shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . 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

Rule 10b-5, the basis for modern federal insider trading prohibition.<sup>25</sup> Despite enacting § 10(b) of the '34 Act and Rule 10b-5, the plain text of these laws created more questions than answers in terms of what constitutes insider trading.<sup>26</sup> This ambiguity resulted in a long progeny of cases interpreting § 10(b) and Rule 10b-5's impact on insider trading.<sup>27</sup>

The rapid broadening and subsequent narrowing of the scope of insider trading prohibition has distinguished federal insider trading law since its enactment.<sup>28</sup> The scope of Rule 10b-5 expanded in 1961 when an SEC enforcement action stated that Rule 10b-5 applied to insider trading cases, thereby establishing the predicate for the "disclose or abstain" rule.<sup>29</sup> Insider

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the protection of investors.

*Id.* Section 10(b) does not explicitly prohibit insider trading and was not originally designed to serve the purpose of prohibiting insider trading despite articulated concerns in its legislative history. *See SZOCKYI, supra* note 23, at 6, 15. Further, § 10(b) of the '34 Act "is not self-executing," but rather grants the SEC authority to promulgate regulations to prohibit "any manipulative or deceptive device or contrivance." BAINBRIDGE, *supra* note 23, at 25 (quoting 15 U.S.C. §78j(b) (2006)).

25. 17 C.F.R. § 240.10b-5 (2004) (prohibiting securities fraud in secondary market). The rule states:

It shall be unlawful for any person . . . (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, 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.

*Id.*

The SEC enacted rule 10b-5 in accordance with its rulemaking authority under § 10(b). *See* 15 U.S.C. § 78j(b) (2006). Rule 10b-5, like § 10(b), does not explicitly reference insider trading. *See* BAINBRIDGE, *supra* note 23, at 28. Rule 10b-5 was not used by the SEC as an enforcement device against insider trading in the secondary markets until 1961. *See id.* at 28.

26. *See* BAINBRIDGE, *supra* note 23, at 29-30 (noting § 10(b) and Rule 10b-5 failed to clarify scope of insider trading prohibition); SZOCKYI, *supra* note 23, at 15 (explaining § 10(b) and Rule 10b-5 established "vague legislative standards for insider trading"); Carol Swanson, *Insider Trading Madness: Rule 10b-5 and the Death of Scierter*, 52 U. KAN. L. REV. 147, 158 (2004) (recognizing Congress acknowledged ambiguity in Rule 10b-5). After Congress enacted § 10(b) and Rule 10b-5, insider trading liability remained a "muddy area permitting unscrupulous traders to continue dealing in stock within the law." Swanson, *supra*, at 158. Section 10(b) and Rule 10b-5's broad prohibition on fraudulent securities transactions and failure to explicitly reference insider trading made insider trading liability a "murky," "fuzzy," and "confusing" area of the law. SZOCKYI, *supra* note 23, at 15.

27. *See* BAINBRIDGE, *supra* note 23, at 29-30 (recognizing case law addressing insider trading issues § 10(b) and Rule 10b-5 failed to clarify).

28. *See* BAINBRIDGE, *supra* note 23, at 3-4 (noting large doctrinal shifts of federal insider trading prohibition); Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 87, 90-91 (1998) (surveying transformation from broad to narrow scope of insider trading prohibition from 1960s to 1980s); Mark J. Loewenstein, *The Supreme Court, Rule 10b-5 and the Federalization of Corporate Law*, 39 IND. L. REV. 17, 17 (2005) (explaining Supreme Court's limitation of federal insider trading prohibition since 1975); Swanson, *supra* note 26, at 154-57 (discussing Supreme Court's retrenchment of Rule 10b-5 beginning in 1970s).

29. *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961) (articulating basis for "disclose or abstain" rule and applying Rule 10b-5 to insider trading). The "disclose or abstain" rule outlines two courses of action. *Id.* The rule places an affirmative duty on corporate insiders to either disclose material, nonpublic information

trading prohibition continued to broaden in 1968 when the Second Circuit endorsed the SEC's "disclose or abstain rule."<sup>30</sup> The Supreme Court, however, limited Rule 10b-5's broad scope from 1975 until 1983.<sup>31</sup> Arguably the most influential case resulting from this progeny was *Chiarella v. United States*,<sup>32</sup> where the Supreme Court established the classical theory of insider trading by requiring a fiduciary duty in order for the "disclose or abstain" rule to yield insider trading liability.<sup>33</sup>

Nonetheless, the dissenting opinion in *Chiarella* illustrated that a minority of the Court's justices intended to reverse course and instead broaden the scope of federal insider trading prohibition.<sup>34</sup> Nearly two decades later, a majority of the

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prior to trading on the information, or, if disclosure would be improper or unrealistic, to abstain from trading. *Id.* *In re Cady, Roberts & Co.* marked the first instance where Rule 10b-5 applied to insider trading. *See* Swanson, *supra* note 26, at 154 n.29. Thus, modern insider trading prohibition began with *In re Cady, Roberts & Co.* *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961); *see* BAINBRIDGE, *supra* note 23, at 41; Swanson, *supra* note 26, at 154 n.29.

30. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (clarifying SEC's "disclose or abstain" rule). The precedential value of *In re Cady, Roberts & Co.* was originally uncertain, but *Texas Gulf Sulphur* is regarded as a "seminal insider trading case[]" because it endorsed and clarified the "disclose or abstain" rule for the first time. *See* BAINBRIDGE, *supra* note 23, at 42-43. The Second Circuit, in *Texas Gulf Sulphur*, accepted the "disclose or abstain" rule by stating "anyone in possession of material inside information must either disclose it to the investing public, or . . . must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968). *Texas Gulf Sulphur* thus "establish[ed] Rule 10b-5 as the federal government's most significant weapon against insider" trading. Swanson, *supra* note 26, at 154 n.29.

31. *Dirks v. SEC*, 463 U.S. 646, 654-55 (1983) (reaffirming requirement of breach of fiduciary duty for imposition of insider trading liability); *Chiarella v. United States*, 445 U.S. 222, 227-35 (1980) (recognizing fiduciary duty established duty to disclose, not mere possession of information); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 475-76 (1977) (requiring plaintiff to prove deceptive or manipulative conduct to invoke insider trading liability under Rule 10b-5); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976) (holding negligence cannot be basis for Rule 10b-5 action); *Blue Chips Stamps v. Manor Drug Stores*, 421 U.S. 723, 754-55 (1975) (requiring private plaintiffs in Rule 10b-5 action be buyers or sellers of securities). The Court limited the reach of federal insider trading prohibition by narrowly interpreting Rule 10b-5 and § 10(b) of the '34 Act; the section on which Rule 10b-5 is based. *See* Loewenstein, *supra* note 28, at 17-18. The Supreme Court narrowed the scope of the "disclose or abstain" rule in *Chiarella* and *Dirks*. *See* BAINBRIDGE, *supra* note 23, at 49, 55.

32. 445 U.S. 222 (1980).

33. *Chiarella v. United States*, 445 U.S. 222, 227-35 (1980) (articulating classical theory of federal insider trading prohibition). The classical theory of insider trading imposes liability when a person owes a fiduciary duty to a corporation's shareholders and trades in that corporation's securities based on material, nonpublic information. *See id.* at 228-30. The classical theory of insider trading limited the scope of the "disclose or abstain" rule to "relationship[s] of trust and confidence." *See id.* at 230, 235. Thus, a fiduciary relationship must exist in order for insider trader liability. *See id.* at 230. The Court noted that there is no general duty to disclose under § 10(b) resulting from the mere possession of material, nonpublic information. *Id.* at 235. *Chiarella*, therefore, significantly reduced the scope of the "disclose or abstain" rule and the federal insider trading prohibition. *See* BAINBRIDGE, *supra* note 23, at 49, 52.

34. *Chiarella v. United States*, 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting) (recognizing misappropriation-based theory of insider trading liability); *see* Karmel, *supra* note 28, at 92 (noting articulation of misappropriation theory by dissent in *Chiarella*); Rebecca S. Smith, *O'Hagan revisited: Should a Fiduciary Duty Be Required Under the Misappropriation Theory?*, 22 GA. ST. U. L. REV. 1005, 1007-09 (2006) (explaining Chief Justice Burger's articulation of misappropriation-based insider trading). Chief Justice Burger read § 10(b) and Rule 10b-5 "to mean that a person who has misappropriated nonpublic information has an

Court adopted this minority view by endorsing a new theory of insider trading in *United States v. O'Hagan*, referred to as misappropriation-based insider trading.<sup>35</sup> Misappropriation-based insider trading applies when a person trades on material, nonpublic information in breach of a fiduciary duty owed to the source of the information, as opposed to the corporate shareholders.<sup>36</sup> Although the misappropriation theory broadened the scope of insider trading prohibition, it also provided a "safe harbor" loophole through which brazen misappropriators could escape liability by disclosing their deceptive trading plans to the source of the information prior to initiating the fraudulent trade.<sup>37</sup> The safe harbor loophole troubled legal scholars, including the lone dissenter in *O'Hagan*, Justice Thomas, who noted the lack of justification for the exception.<sup>38</sup> This loophole resulted in a debate as to when misappropriators can escape insider trading liability by making a pre-tip or pre-trade disclosure.<sup>39</sup>

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absolute duty to disclose that information or to refrain from trading." See *Chiarella v. United States*, 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting). Chief Justice Burger concluded that the federal securities law should not require a breach of a fiduciary duty to the source of the information in order for there to be insider trading liability. See *id.* at 240-42.

35. *United States v. O'Hagan*, 521 U.S. 642, 652-53 (1997) (formulating misappropriation-based insider trading framework). The *Chiarella* decision opened the door for the SEC and lower courts to adopt the misappropriation theory of insider trading. See BAINBRIDGE, *supra* note 23, at 94-95.

36. *United States v. O'Hagan*, 521 U.S. 642, 652 (1997) (articulating misappropriation-based insider trading theory). Misappropriation theory involves an undisclosed use of material, nonpublic information—in breach of a fiduciary duty owed to the source of the information—for personal gain in connection with the purchase or sale of a security. *Id.* at 652-53. Misappropriation theory bases liability on the deception of the source of the information, as opposed to the classical theory that involves deception of shareholders. *Id.* at 652. "Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information." *Id.* Accordingly, in order to be held liable under a misappropriation theory, one must communicate material, nonpublic information in breach of a fiduciary duty owed to the source of such information. *Id.* Further, the breach of this fiduciary duty satisfies § 10(b)'s requirement that the insider's conduct involve a "manipulative or deceptive device" that is "in connection with the purchase or sale of any security." *Id.* at 653. Acquisition or conveyance of material, nonpublic information constitutes a "manipulative or deceptive device" under § 10(b). *Id.* at 653-55; see 15 U.S.C. §78j(b) (2006). The "in connection with the purchase or sale of any security" element is satisfied once the fiduciary uses the information by trading the security. *United States v. O'Hagan*, 521 U.S. 642, 656 (1997).

37. *United States v. O'Hagan*, 521 U.S. 642, 655 (stating that full disclosure precludes liability under misappropriation theory); see also Business Associations Blog, [http://www.businessassociationsblog.com/lawandbusiness/comments/sec\\_v\\_rocklage\\_interpreting\\_the\\_ohagan\\_safe\\_harbor\\_for\\_brazen\\_misappropriat](http://www.businessassociationsblog.com/lawandbusiness/comments/sec_v_rocklage_interpreting_the_ohagan_safe_harbor_for_brazen_misappropriat) (Dec. 6, 2006) (discussing application of "safe harbor" loophole). The Court reasoned that disclosure forecloses liability because "the deception essential to the misappropriation theory involves feigning fidelity to the source of information, [and] if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no manipulative or 'deceptive device' and thus no § 10(b) violation." *United States v. O'Hagan*, 521 U.S. 642, 655 (1997).

38. *United States v. O'Hagan*, 521 U.S. 642, 689-90 (Thomas, J., dissenting) (explaining problems with "safe harbor" loophole); see BAINBRIDGE, *supra* note 23, at 112-14 (noting inconsistent and bizarre nature of "safe harbor" loophole); JESSE H. CHOPER ET AL., *CASES AND MATERIALS ON CORPORATIONS* 496 (6th ed. 2004) (insinuating "safe harbor" loophole frustrates purpose of insider trading prohibition); Karmel, *supra* note 28, at 95 (positing weakness of "safe harbor" loophole).

39. See BAINBRIDGE, *supra* note 23, at 112-14 (illustrating lack of clarity as to when disclosure to source precludes liability); Karmel, *supra* note 28, 94-95 (explaining Supreme Court limited application of

In *Rocklage*, the First Circuit limited the scope of the “safe harbor loophole” by extending insider trading liability to Mrs. Rocklage despite her pre-tip disclosure.<sup>40</sup> The court acknowledged that Mrs. Rocklage communicated material, nonpublic information in breach of a fiduciary duty she owed her husband.<sup>41</sup> The First Circuit then turned to the “heart” of the § 10(b) cause of action and considered whether Mrs. Rocklage engaged in a “manipulative or deceptive device . . . in connection with the purchase and sale of any security.”<sup>42</sup> With regard to the “manipulative or deceptive device” element, the court explained that Mrs. Rocklage participated in two deceptive acts, acquiring confidential information from her husband and tipping Beaver to sell his Cubist stock.<sup>43</sup> Second, the court found that both devices were “in connection with” the sale of a security.<sup>44</sup> Accordingly, all of the defendants were liable under § 10(b) and Rule 10b-5, notwithstanding their argument that the “safe harbor” loophole, namely the pre-tip disclosure, precluded misappropriation-based insider trading liability.<sup>45</sup>

The First Circuit noted that the “safe harbor” loophole in *O’Hagan* excuses a deceptive trade or tip only when there is a legitimate acquisition of confidential information but not when a deceptive acquisition of information occurs before a deceptive trade or tip.<sup>46</sup> The court explained that while Mrs. Rocklage’s

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misappropriation theory and weakness of disclosure exception); Donald C. Langevoort & G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 VAND. L. REV. 1639, 1675-77 (2004) (noting “confusion” in law for when disclosure to source eliminates insider trading liability); Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O’Hagan Suggestion*, 59 OHIO ST. L.J. 1223, 1256-59 (1998) (articulating different scenarios when “safe harbor” loophole may apply); Randall W. Quinn, *The Misappropriation Theory of Insider Trading in the Supreme Court: A (Brief) Response to the (Many) Critics of United States v. O’Hagan*, 8 FORDHAM J. CORP. & FIN. L. 865, 893-95 (2003) (recognizing *O’Hagan* and “safe harbor” loophole “creat[ed] gaps in . . . coverage of insider trading”). In addition to the ambiguity *O’Hagan* created as to when liability arises under a misappropriation-based insider trading theory, the Supreme Court has also been criticized for not adequately protecting investors. See Quinn, *supra*, at 894.

40. 470 F.3d at 11-14 (considering whether Mrs. Rocklage’s pre-tip disclosure precludes insider trading liability).

41. *Id.* at 7 (explaining basis for misappropriation-based insider trading cause of action).

42. *Id.* at 8 (listing issues addressed by court); see also 15 U.S.C. §78j(b) (2006).

43. 470 F.3d at 8 (illustrating two deceptive devices involved in case). The court distinguished *Rocklage* from *O’Hagan* because *Rocklage* involved both the deceptive acquisition and tipping of confidential information, while *O’Hagan* did not involve the deceptive acquisition of information. *Id.* at 9.

44. *Id.* at 8-11 (articulating basis for finding deceptive devices “in connection with” a securities transaction). First, the tipping of Beaver allowed him and Jones to trade their Cubist securities. *Id.* at 8. Thus, the deceptive device of tipping was “in connection with” security transaction). *Id.* at 9. Second, Mrs. Rocklage’s acquisition of the confidential information from her husband satisfies the “in connection with” element because the acquisition was part of a broader scheme to enable her brother to trade his Cubist securities. *Id.* at 10.

45. See *id.* at 11 (explaining misappropriation-based insider trading liability despite disclosure loophole).

46. *Id.* at 12 (distinguishing application of “safe harbor” loophole in *O’Hagan* from facts in *Rocklage*). The court implies that the “safe harbor” loophole does not excuse the defendants in *Rocklage* of insider trading liability because the exception does not apply to information deceptively acquired. *Id.* The First Circuit limited the scope of the “safe harbor” loophole by interpreting *O’Hagan* as holding that a person escapes liability only when the “alleged deception is in the undisclosed trading or tipping of information.” *Id.* The

disclosure to Beaver may have been non-deceptive because of her pre-tip disclosure to her husband, it did not excuse the deceptive acquisition of company information from her husband.<sup>47</sup> To escape insider trading liability, Mrs. Rocklage's disclosure to her husband needed to occur prior to any deceptive or manipulative scheme.<sup>48</sup> While the court refused to articulate a general standard for when disclosure would negate deception and preclude insider trading liability, the court urged the Supreme Court, Congress, and the SEC to resolve the uncertain application of the "safe harbor" loophole.<sup>49</sup> By distinguishing *Rocklage* from *O'Hagan*, the First Circuit limited the scope of the "safe harbor" loophole and held that Mrs. Rocklage's pre-tip disclosure did not excuse her, or the other defendants, from insider trading liability.<sup>50</sup>

Although *Rocklage* failed to articulate a general test for the "safe harbor" loophole, it limited *O'Hagan*'s scope by refusing to find an exception when an insider discloses plans prior to participating in the deceptive acquisition of confidential information.<sup>51</sup> Under a misappropriation theory, even an insider who makes a disclosure and partakes in a deceptive or manipulative scheme prior to disclosure will not be excused from liability.<sup>52</sup> *Rocklage* will have a significant impact on insider trading jurisprudence because the First Circuit placed qualifications on the "safe harbor" loophole, thereby clarifying *O'Hagan*'s otherwise ambiguous articulation of the misappropriation-based theory of insider trading.<sup>53</sup>

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First Circuit stated that *O'Hagan* stands for the principle that the "safe harbor" loophole will not exempt insider trading liability when the deceptive trading or tipping is subsequent to the deceptive acquisition of confidential information. *Id.* The rationale of the "safe harbor" loophole is that disclosure of intent to trade or tip eliminates the deception. *Id.* The court noted that "[i]t makes little sense to assume that disclosure of an intention to tip using deceptively acquired information would necessarily negate the original deception." *Id.*

47. 470 F.3d at 12 (explaining differences between *Rocklage* and *O'Hagan* and why loophole did not automatically preclude liability).

48. *Id.* at 12 (requiring disclosure before any deceptive act for loophole to preclude liability). The court also recognized that "*O'Hagan* seemed to contemplate that any liability-avoiding disclosure would come *before* the defendant engaged in the deceptive activity." *Id.* (citing *United States v. O'Hagan*, 521 U.S. 642, 655 (1997)). The "safe harbor" loophole does not act as a defense to insider trading liability once a party partakes in a deceptive scheme or act. *Id.*

49. *Id.* at 14 (declining to state general rule for when disclosure negates deception). The Supreme Court's articulation of the disclosure loophole in *O'Hagan* has sparked debate over when disclosure negates deception leading to § 10(b) insider trading liability. *Id.* Only the Supreme Court, Congress, and the SEC can clear up the ambiguity surrounding the application of the "safe harbor" loophole. *Id.*

50. *Id.* at 12-13 (refusing to hold *O'Hagan*'s "safe harbor" loophole rendered Mrs. Rocklage's acquisition of information "non-deceptive"). The First Circuit concluded that Mrs. Rocklage's pre-tip disclosure to her husband, informing him of her plan to tell Beaver of Cubist's clinical drug failure did not preclude liability under § 10(b) because Mr. Rocklage did not have sufficient time to take precautions. *Id.* at 11-13.

51. See *supra* notes 46-48 and accompanying text (articulating First Circuit's limitation of "safe harbor" loophole).

52. See *supra* note 46-48 and accompanying text (explaining limited scope of "safe harbor" loophole).

53. See BAINBRIDGE, *supra* note 23, at 112-14 (criticizing "safe-harbor" loophole); Karmel, *supra* note 28, at 94-95; Langevoort & Gulati, *supra* note 39, at 1675-77 (illustrating ambiguity of "safe-harbor" loophole); Quinn, *supra* note 39, at 893-95 (noting "safe-harbor" loophole's inadequacy for prohibiting insider trading); *supra* text accompanying notes 46-49 (refusing to articulate general test but clarifying instance when

Through limiting *O'Hagan*, *Rocklage* illustrated the federal judiciary's commitment to broadening the scope of insider trading prohibition.<sup>54</sup> Although *O'Hagan* broadened the scope of insider trading prohibition by endorsing a theory of misappropriation-based insider trading, the court also narrowed such prohibition by creating an expansive loophole allowing misappropriators to escape liability by mere disclosure.<sup>55</sup> By placing boundaries on the application of this broad loophole, the First Circuit illustrated its unwillingness to return to the narrowed insider trading regime of the 1970s and 1980s.<sup>56</sup>

The First Circuit's decision in *Rocklage* confirmed that Justice Thomas's attacks on the "safe harbor" loophole in *O'Hagan* and criticisms by other legal scholars were warranted.<sup>57</sup> While *Rocklage* further increased insider trading prohibition, the Supreme Court, Congress, and the SEC must clarify when an alleged insider can escape liability under a misappropriation-based theory.<sup>58</sup> The Supreme Court should follow the First Circuit by further limiting and qualifying the scope of the "safe harbor loophole."<sup>59</sup> The Court should endorse the First Circuit's limitation to promote investor confidence and prevent an over-expansive loophole from hindering the integrity of the securities markets.<sup>60</sup>

In *Rocklage*, the First Circuit considered whether the "safe harbor" loophole precludes liability under a misappropriation-based insider trading regime when a person is involved in the deceptive acquisition of information prior to any liability-escaping disclosure. By limiting and qualifying the "safe harbor"

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*O'Hagan's* loophole does not apply).

54. See *United States v. O'Hagan*, 521 U.S. 642, 652 (1997) (endorsing misappropriation-based insider trading theory); *supra* text accompanying notes 34-36 (discussing how federal judiciary expanded insider trading prohibition with articulation of misappropriation-based insider trading theory); *supra* note 46-48 and accompanying text (limiting scope of *O'Hagan*).

55. See *United States v. O'Hagan*, 521 U.S. 642, 652-53 (1997) (narrowing scope of insider trading prohibition).

56. See *supra* note 31 and accompanying text (discussing narrowing of insider trading prohibition via qualifications placed on "disclose or abstain" rule); *supra* text accompanying notes 46-48 (placing qualifications on "safe harbor" loophole resulting in expansion of insider trading prohibition).

57. See *United States v. O'Hagan*, 521 U.S. 642, 689-90 (1997) (Thomas, J., dissenting) (noting inadequacy of "safe-harbor" loophole); BAINBRIDGE, *supra* note 23, at 112-14 (illustrating discrepancies of "safe-harbor" loophole); CHOPER ET AL., *supra* note 38, at 496 (explaining "safe-harbor" loophole hinders insider trading prohibition); Karmel, *supra* note 28, at 94-95 (articulating insufficiency of "safe-harbor" loophole); Quinn, *supra* note 39, at 893-95 (revealing inconsistent nature of "safe-harbor" loophole). The First Circuit in *Rocklage* clarified that the disclosure exception is not a *carte blanche* liability waiver, as feared by legal scholars. 470 F.3d at 1; see *supra* text accompanying notes 46-48.

58. See 470 F.3d at 13 (calling for Supreme Court, Congress, or the SEC to define application of "safe harbor" loophole).

59. See *United States v. O'Hagan*, 521 U.S. 642, 652 (1997) (adopting misappropriation-based insider trading); *supra* text accompanying note 34 (noting increase in insider trading prohibition stemming from misappropriation-based insider trading framework).

60. See BAINBRIDGE, *supra* note 23, at 112-13 (explaining difficulties with *O'Hagan's* "safe harbor loophole" and rationale for limiting exception); Quinn, *supra* note 39, at 894 (noting *O'Hagan* does not adequately protect investors because of "safe harbor loophole").

loophole, the First Circuit further expanded the scope of insider trading prohibition. The First Circuit in *Rocklage* clarified that greed should not be allowed to escape through the trap door that is the “safe harbor” loophole, and the Supreme Court should adopt this rule to ensure widespread protection of investors.

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