No. 06-1571

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff-Appellee,

v.

PATRICIA B. ROCKLAGE, WILLIAM M. BEAVER, and DAVID G. JONES,
Defendants-Appellants.

On Appeal from the United States District Court
for the District of Massachusetts

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE

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COMMISSION, APPELLEE

ISSUES PRESENTED FOR REVIEW

The complaint filed by the Securities and Exchange Commission alleged that defendant Rocklage, the wife of the CEO of Cubist, Inc., had an agreement to tip defendant Beaver, her brother, if she learned negative information about Cubist, so that Beaver could sell his stock. A. 9.[1] Rocklage's husband did not know of this agreement, and reasonably expected his wife to keep any non-public

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[1] "A." refers to the Appendix; "Br." refers to the joint brief filed by defendants-appellants Rocklage, Beaver, and Jones.

information he told her about Cubist confidential. A. 12-13. On the afternoon of December 31, 2001, Rocklage's husband told her material non-public information about Cubist. *Id*. That evening, New Year's Eve, Rocklage told her husband that she would tip her brother, and she did so over his objection prior to 10:02 a.m. on January 2, 2002. A. 14. Her brother tipped a close friend, defendant Jones. A. 14-15. At approximately 10:02 a.m. on January 2, 2002, Beaver sold all his Cubist stock, and the next day, Jones sold all his Cubist stock. Beaver and Jones thereby avoided losses of approximately $233,000. *Id*.

The issues presented are:

1. Whether the Commission's complaint states a claim against Rocklage under the misappropriation theory of insider trading where – although prior to acting on inside information, Rocklage disclosed her intentions to the source of that information – her disclosure served no useful purpose under the circumstances.

2. Whether, in the alternative, the Commission's complaint states a claim against Rocklage as a "temporary insider" of Cubist under the classical theory of insider trading.

STATEMENT OF THE CASE

A. Nature of the case

The Commission filed a complaint on January 12, 2005, alleging that defendants engaged in insider trading in violation of Section 17(a) of the Securities Act, 15 U.S.C. 77q(a), and Section 10(b) and Rule 10b-5 of the Securities Exchange Act, 15 U.S.C. 78j(b) and 17 C.F.R. 240.10b-5. A. 9-20. In a memorandum and order dated August 23, 2005, the district court denied defendants' motions to dismiss. A. 21-43. On December 14, 2005, the district court denied defendants' motions for reconsideration and granted their motions for certification of its August 23, 2005 order pursuant to 28 U.S.C. 1292(b). A. 44-51. On April 4, 2006, this Court granted defendants' petition for permission to appeal. A. 52.

B. Facts

The following statement is drawn from the factual allegations in the Commission's complaint, which are taken as true for purposes of this appeal.

Scott Rocklage, at all relevant times, was the Chairman of the Board and CEO of Cubist, a biotechnology company whose common stock trades principally on the Nasdaq National Market System. A. 9,12.

In 2001, Cubist's leading drug candidate was an antibiotic named Cidecin. In September 2001, Cubist began a clinical trial on the effectiveness of Cidecin. On Friday, December 28, 2001, individuals at Cubist learned that the trial results were negative. Scott Rocklage, who was out of the office that day, first learned of the negative results when he returned to the office on Monday, December 31. A. 12.

On the afternoon of December 31, Scott Rocklage spoke by telephone to his wife, defendant Patricia Rocklage, who was in a limousine on her way home from the airport. During that call, Scott Rocklage told her that Cubist would be making a public announcement concerning the trial results and that, until then, the results were nonpublic. When Patricia Rocklage asked how this news would affect Cubist's stock price, her husband told her that the stock price would drop significantly. Unbeknownst to her husband, Patricia Rocklage had a pre-existing understanding with her brother, defendant William M. Beaver, that if she ever became aware of bad news about Cubist that might affect its stock price, she would signal him to sell his stock with "a wink and a nod." A. 12-13.

At the time Scott Rocklage conveyed this information to his wife, he had a reasonable expectation that he could communicate information to her about Cubist and that she would keep it confidential. From the time that Scott Rocklage joined

Cubist in 1994, he had routinely communicated material nonpublic information concerning Cubist to her and she had always kept such information confidential. In addition, prior to initially telling Patricia Rocklage about the trial results, Scott Rocklage specifically instructed her not to react to what he was about to tell her and not to talk about the results in front of the limousine driver. Patricia Rocklage agreed to these instructions. In so doing, Patricia Rocklage understood, before her husband told her the confidential information, that her husband expected that she would not disclose the information to anyone. A. 13.

On the evening of December 31, Patricia Rocklage told her husband that she intended to signal her brother to sell his Cubist stock. Scott Rocklage responded by urging her not to do so. Nonetheless, Patricia Rocklage said that she intended to warn her brother about the results. A. 14.

Prior to 10:02 a.m. the next business day, January 2, 2002, Patricia Rocklage spoke to Beaver by telephone and induced him to sell his Cubist stock by saying, in effect, "[a]s far as Cubist is concerned, I'm giving you a wink and a nod." In doing so, Patricia Rocklage was providing a gift of confidential information to a relative and thereby intended to benefit personally from the disclosure. A. 14.

Given their pre-existing understanding, Beaver correctly interpreted Patricia Rocklage's statement to mean that she knew negative nonpublic information about Cubist that was going to affect its stock price and that she was encouraging him to sell the company's stock. A. 14.

After receiving the signal from Patricia Rocklage, Beaver sold all 5,583 shares of Cubist stock he owned or controlled for approximately $196,000. Beaver executed the sale at approximately 10:02 a.m. on January 2, 2002, the first possible trading day after receiving the tip. A. 14.

Beaver also told his close friend and neighbor, Jones, the negative news about Cubist. In so doing, Beaver was providing a gift of confidential information to a close friend and intended to personally benefit from the disclosure. At that time, Jones knew that Beaver's brother-in-law was Scott Rocklage, Cubist's Chairman and CEO. On the morning of January 3, 2002, after Beaver told Jones the news about Cubist, Jones sold all 7,500 Cubist shares he owned for approximately $262,000. A. 14-15.

On January 16, 2002, after the market closed, Cubist publicly announced the negative Cidecin trial results. Following the announcement, Cubist's stock price dropped 46%. By selling when they did, Beaver had avoided a loss of $99,527 and Jones had avoided a loss of $133,222. A. 15.

C. Proceedings in the district court

In a memorandum and order filed August 23, 2005, the district court denied defendants' motions to dismiss for failure to state a claim. With respect to Rocklage's motion, the court stated that the misappropriation theory of liability for insider trading under Section 10(b) and Rule 10b-5 "extends liability to outsiders who have no fiduciary duty to shareholders, but who are otherwise entrusted with confidential information and then tip or trade on that information." A. 25, citing *United States v. O'Hagan*, 521 U.S. 642, 652 (1997). The court rejected Rocklage's argument that her disclosure to her husband that she intended to tip her brother negated the deception required under the misappropriation theory, holding that, "[o]n the alleged facts of this case * * * Rocklage's disclosure to her husband did not remove the deceptive device from Rocklage's conduct and accordingly does not insulate her from liability under [the] misappropriation theory." A. 32. [2]

The court denied Beaver's and Jones' motions to dismiss on the ground that "to the extent that Rocklage is ultimately found liable, that liability attaches to downstream tippees if they knew or should have known of Rocklage's breach of

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[2] Although not needing to reach the issue, the court expressed its disagreement with the Commission's alternative argument that, under the classical theory of insider trading, which requires a breach of duty owed to the company whose shares are traded (*see Dirks v. SEC,* 463 U.S. 646 (1983)), Rocklage could be liable as a "temporary insider" of Cubist. A. 35-37.

duty. Whether they knew or should have known * * * is * * * a question of fact, the existence of which precludes dismissal on this motion." A. 38-39. The court also rejected Jones' argument that the Commission's complaint failed to allege fraud with particularity as required by Fed. R. Civ. P. 9(b). A. 39-43.

On December 14, 2005, the district court denied defendants' motions for reconsideration. A. 44-47. The court also certified for interlocutory appeal pursuant to 28 U.S.C. 1292(b) its order denying defendants' motions to dismiss. A. 47-51.

SUMMARY OF ARGUMENT

The Commission's complaint states a claim against Rocklage for insider trading under the misappropriation theory. There is no merit to appellants' argument that Patricia Rocklage, the misappropriator, did not owe a duty of confidentiality to the source of the information, her husband. The duty is well-established under Commission Rule 10b5-2(b).

In addition, there is no merit to appellants' main argument that the complaint does not allege deception in connection with a securities transaction as required by *United States v. O'Hagan*, 521 U.S. 642 (1997). Rocklage deceived her husband, the CEO of Cubist, Inc., prior to receiving material non-public information from him by failing to disclose her pre-existing agreement to tell her

brother any negative information she learned about Cubist so that her brother could sell Cubist stock. Rocklage's subsequent disclosure to her husband, after he told her the information, but before she tipped her brother, does not negate the deception required under the misappropriation theory because the disclosure served no useful purpose. Rocklage's husband apparently had no remedy under state law against his wife. Even if a potential remedy existed, it is not reasonable to expect that he would risk marital discord by suing his wife. And even if Rocklage's husband were willing to sue his wife, her disclosure to him on New Year's Eve, followed by her tip to her brother prior to 10:02 a.m. the next business day, did not give her husband a reasonable opportunity to prevent the information from being used.

Alternatively, the complaint states a claim against Rocklage under the classical theory of insider trading as a "temporary insider" of Cubist. A "temporary insider" is a person who temporarily becomes a fiduciary of a corporation. Rocklage, in view of her prior practice of maintaining in confidence information her husband told her about Cubist, and of the corporate purpose such disclosures served in allowing her husband, Cubist's CEO, to harmonize the demands of his professional and personal life, and thereby perform better as the leader of his company, temporarily became a fiduciary of Cubist.

ARGUMENT

THE COMMISSION'S COMPLAINT STATES A CLAIM AGAINST APPELLANTS FOR INSIDER TRADING LIABILITY

Standard of review. Dismissal for failure to state a claim is reviewed *de novo*. The reviewing court accepts as true the well-pleaded factual allegations of the complaint, draws all reasonable inferences in the plaintiff's favor, and determines whether the complaint, so read, sets forth facts sufficient to justify judgment for the plaintiff on any applicable legal theory. *SEC v. SG Ltd.*, 265 F.3d 42, 46 (1st Cir. 2001)(citing authorities). This Court can affirm an order denying a motion to dismiss on any basis supported by the record. *See*, *e.g.*, *Carroll v. Xerox Corp*. 294 F.3d 231, 241 (1st Cir. 2002). The scope of review is not limited to the controlling question of law that the district court identified when it certified its order for interlocutory appeal pursuant to 28 U.S.C. 1292(b). *Yamaha Motor Corp. v. Calhoun*, 516 U.S. 199, 205 (1996)(the court of appeals "may address any issue fairly included within the certified order").

A. The Complaint States a Claim Against Rocklage for Insider Trading Liability under the Misappropriation Theory.

Under the misappropriation theory of insider trading liability, the Commission is required to prove that Rocklage, who tipped her brother but did not trade herself, communicated, with scienter, material non-public information in

breach of her duty to the source of the information. *See SEC v. Sargent*, 229 F.3d 68, 74-75 (1st Cir. 2000)(citing *O'Hagan,* 521 U.S. at 652); *see also SEC v. Yun*, 327 F.3d 1263, 1269-1270 (11th Cir. 2003). In addition, the misappropriation theory requires "deceptive use of information * * * 'in connection with the purchase or sale of [a] security.'" *O'Hagan*, 521 U.S. at 655-656. Some courts also require that the tipper in a misappropriation case receive a personal benefit, which can include making a gift to a relative or friend. *See Yun*, 327 F.3d at 1280. The complaint alleges facts satisfying all these elements.

Rocklage challenges only two of these elements – duty to source, and deceptive use of information.

1. With respect to duty, Rocklage asserts (Br. 15 n.5) that a "significant threshold question exists whether the spousal relationship may give rise here to the type of duty triggering liability under the misappropriation theory." No such question exists. Under Rule 10b5-2(b)(3), 17 C.F.R. 240.10b5-2(b)(3), a duty exists "[w]henever a person receives or obtains material nonpublic information from his or her spouse" (subject to a defense not relevant at this stage of the proceedings). The complaint alleges that Rocklage received the information from her spouse. This establishes the required duty.

In addition, the complaint alleges facts that establish a duty under Rule 10b5-2(b)(1), since Rocklage agreed to maintain the information in confidence (*see* A. 13), and under Rule 10b5-2(b)(2), 17 C.F.R. 240.10b5-2(b)(2), since there was a pattern or practice of sharing information about Cubist between Scott and Patricia Rocklage and a reasonable expectation that the information would be kept confidential. *See* A. 13.

Moreover, even absent the rule, the case law supports finding a duty here. *See Yun*, 327 F.3d at 1272-73 (a duty sufficient to support liability under the misappropriation theory exists between spouses having a past practice of sharing confidences). Appellants' reliance (Br. 15 n.5) on *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991), and *United States v. Kim,* 184 F. Supp. 2d 1006 (N.D. Cal. 2002), is misplaced. *Chestman* recognized that "repeated disclosure of business secrets between family members" may suffice to establish the "functional equivalent of a fiduciary relationship." 947 F.2d at 569. *Kim* did not involve spouses, but rather members of a private club.

2. Appellants' main argument (Br. 12-21) is that the complaint does not sufficiently allege the deception in connection with a securities transaction required by *United States v. O'Hagan*, 521 U.S. 642 (1997). This argument fails also. Rocklage deceived her husband prior to receiving the information by failing

to disclose her pre-existing agreement to tell her brother any negative information she learned about Cubist so that he could sell Cubist stock. Appellants argue (Br. 15-16) that Rocklage's disclosure to her husband after he told her the information, but before she tipped her brother, "plac[es] her outside the reach of the misappropriation theory." Appellant's view of the scope of the misappropriation theory as applied to this case is wrong. It is a reasonable inference from the allegations in the complaint that Patricia Rocklage's disclosure – made to her husband on New Year's Eve – served no useful purpose because her husband did not have a meaningful opportunity to prevent the information from being used. Disclosure that is useless should not be held to be sufficient to negate deception.

Rocklage's disclosure to her husband served no useful purpose for several reasons. First, it appears that Massachusetts law has not provided a cause of action by one spouse against the other spouse for breach of duty in this context. Although a possible cause of action might be based on tortious breach of duty, or on breach of an implied contract, we are not aware of any Massachusetts case on point. Moreover, such a lawsuit would necessarily involve testimony by Scott Rocklage and Patricia Rocklage about their private conversations. Massachusetts law recognizes a policy against allowing such testimony. *See* Mass. Gen. L. Ch. 233, Section 20 (subject to certain exceptions, including cases arising out of a

contract, "neither husband nor wife shall testify as to private conversations with the other"). In addition, although Massachusetts has abrogated interspousal immunity under tort law in some circumstances, (*see Lewis v. Lewis*, 370 Mass. 619, 351 N.E.2d 526 (1976)), such immunity still exists where the conduct at issue touches upon "the privileged or consensual aspects of married life." *Cook v. Hanover Ins. Co*., 32 Mass. App. Ct. 555, 558, 592 N.E. 2d 773, 775 (1992)(citation omitted).

Even assuming *arguendo* that a cause of action did exist, it is not reasonable to expect that Scott Rocklage would have risked disrupting the marital relationship in order to protect confidential business information. The context of this case is starkly different from the hypothetical situation contemplated by *O'Hagan*, which involved principal-agent relationships in a business context. In that setting, it is reasonable to expect the principal to take vigorous legal action to protect information from being used without consent. Here, in contrast, Scott Rocklage urged his wife not to tip her brother, but took no further steps to stop her. Had he attempted to do so, he may have jeopardized the harmony of a marriage in which confidential information had been discussed and kept secret in the past.

Furthermore, even if Scott Rocklage was able, and willing, to take legal action against his wife, the timing of Patricia Rocklage's disclosure would have made such action extremely difficult. Rocklage told her husband on New Year's Eve that she would tip her brother. She then tipped her brother prior to 10:02 a.m. on January 2. While it may not have been impossible to seek and obtain emergency relief on New Year's Day in these circumstances (assuming a cause of action existed), there hardly was a reasonable opportunity to protect the information.

Nothing in the Supreme Court's opinion in *O'Hagan* requires this Court to adopt the position urged by appellants. Appellants rely on the following statement in *O'Hagan:* "if the fiduciary discloses *to the source* that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no Section 10(b) violation." Br. 12, quoting *id*. at 655 (emphasis added in appellants' brief). However, the Supreme Court stated, when it first mentioned disclosure as a potential defense to liability, that "*full disclosure* forecloses liability under the misappropriaton theory." 521 U.S. at 655 (emphasis added). Although in subsequent places in the opinion, the Court simply says "disclosure" rather than repeating "full disclosure," nothing in the opinion indicates that the Court

intended any difference in meaning. Thus, the critical question is the meaning of "full disclosure."

O'Hagan did not address under what circumstances disclosure would negate deception, since in that case the misappropriator made no disclosure prior to trading. [3] However, the Supreme Court could not have meant to create a broad loophole for evading insider trading prohibitions by allowing disclosure that serves no useful purpose to negate deception. For example, if O'Hagan had told his law firm and its client of his intent to use information belonging to them fifteen seconds before trading, under appellants' view, he would have escaped liability under the misappropriation theory, even though the law firm and its client would not have had any effective means of protecting the information. Allowing such a loophole would undermine investor confidence and honest securities markets, contrary to a central purpose of the Exchange Act. *See O'Hagan*, 521 U.S. at 658-659 (emphasis added):

> an animating purpose of the Exchange Act [is] to insure honest securities markets and thereby promote investor confidence * * *. Although informational disparity is inevitable in the securities markets, *investors likely would hesitate to venture their capital in a*

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[3] The defendant, James O'Hagan, breached a duty to his law firm (of which he was a partner) and the firm's client by trading based on material non-public information related to the client's planned acquisition of another company. *O'Hagan*, 521 U.S. at 647.

> *market where trading based on misappropriated nonpublic information is unchecked by law. An investor's informational disadvantage vis-a-vis a misappropriator * * *stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill.*

Under appellants' view, persons who obtain an informational advantage by deceptively gaining access to material non-public information, but then make some disclosure under circumstances that, as in this case, do not allow the source of the information a meaningful chance to protect the information, would be able to trade "unchecked" by the misappropriation theory. That cannot be a plausible interpretation of *O'Hagan*. Appellants even suggest that it is difficult to connect the investor protection purpose of the statute to the misappropriation theory. (Br. 20, citation omitted.) The passage from *O'Hagan* quoted above squarely rejects that contention.

To comport with the policies identified in *O'Hagan,* "full disclosure" should be interpreted to mean disclosure that serves a useful purpose. Disclosure serves a useful purpose where the source of material non-public information reasonably could be expected to, and reasonably could, prevent the unauthorized use of the information for securities trading. Such an interpretation would minimize the potential damage to the securities markets and to honest investors caused by persons who deceive others into conveying material non-public

information, and then seek to escape liability by making a disclosure that serves no useful purpose. [4]

Moreover, the Supreme Court recognized the importance of the source of information having a meaningful opportunity to prevent the information from being used without consent. The Court stated (*id*. at 652) that a misappropriator defrauds the principal of the "exclusive use" of the information. This concern over the source's right to protect information is reflected in a response made by the *O'Hagan* majority to a dissenter's statement that persons trading in the market are equally harmed when a misappropriator makes full disclosure as they are in a case where no such disclosure is made. 521 U.S. at 689-690 (Thomas, J., dissenting). The Court, after acknowledging that the misappropriation theory "is only a partial antidote to the problems it was designed to alleviate," pointed out that "once a disloyal agent discloses his imminent breach of duty, his principal may seek appropriate equitable relief under state law." 521 U.S. at 659 n.9. *See*

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[4] In a different context, the Commission has stated that disclosure made at the last minute may not be effective disclosure. *See Selective Disclosure and Insider Trading*, Rel. 33-7881 (Aug. 24, 2000), 2000 WL 1201556, at *17 ("[I]f an issuer typically discloses its quarterly earnings results in regularly disseminated press releases, we might view skeptically an issuer's claim that a last minute webcast of quarterly results, made at the same time as an otherwise selective disclosure of that information, provided effective broad, non-exclusionary public disclosure of the information.").

also id. at 655 ("[I]f the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no Section 10(b) violation–although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty."). This suggests that the Court contemplated that the source of the information would reasonably be expected to, and reasonably could, prevent the information from being used for securities trading without the source's consent. [5]

This interpretation of *O'Hagan* is consistent with the Supreme Court's decision in *Santa Fe Indus. v. Green*, 430 U.S. 462, 474 (1977), holding that no deception exists where there is disclosure of all material facts. In *Santa Fe*, minority shareholders brought an action under Section 10(b) and Rule 10b-5 objecting to the terms of a merger. The Court found no deception on the part of the majority shareholders, who "fairly presented" information about the merger to the minority shareholders in time for the minority shareholders to "either accept the price offered or reject it and seek an appraisal" in state court. *Id.* at 474. The

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[5] Appellants argue (Br. 19-20) that "the Supreme Court mentioned state law relief simply to indicate * * * that other avenues might be available to address conduct left uncovered by its statutorily-compelled rule that disclosure to the source precludes insider trading liability." Appellants' contention should be rejected as contrary to the policies underlying the misappropriation theory recognized by *O'Hagan*, as discussed above.

disclosure in *Santa Fe* thus allowed the minority shareholders to pursue a remedy to protect their interests. *Id.* at 474 & n.14. Here, in contrast, Rocklage's disclosure to her husband that she intended to tip her brother did not provide her husband with a meaningful opportunity to protect his interest in preventing use of the information.

Appellants' reliance (Br. 12-13) on statements made by the government at the *O'Hagan* oral argument is misplaced. Appellants assert (Br. 12) that "[n]otably, the United States itself advocated in *O'Hagan* for adoption of the relevant limitation on liability under the misappropriation theory." There is no basis for appellants' suggestion that the Commission's position in this case is inconsistent with the government's argument in *O'Hagan*. The import of the portion of the oral argument quoted by appellants (Br. 13) is simply the obvious point that deception is required under the misappropraiton theory. The colloquy quoted by appellants (Br. 13) concerns the following hypothetical question from the Court: "suppose [O'Hagan] * * * told his superiors in the law firm that he was going to use this information." The Deputy Solicitor General responded that O'Hagan would not have deceived his employer, and that a violation of Section 10(b) requires deception. The hypothetical question did not involve a situation

such as in this case where, although some disclosure was made, the disclosure did not serve a useful purpose.

Appellants also incorrectly rely (Br. 16-17) on a law review article titled "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 (2003). The article, consistent with the position taken by the Commission in this case, states that "[d]eception cannot exist if there is *full disclosure* by the misappropriator or consent by the source or owner of the information." *Id*. at 893-894 (emphasis added). The article does not address the situation presented in this case involving disclosure made to a spouse at the last minute, much less suggest that such disclosure is "full disclosure." [6]

In sum, Rocklage's disclosure, which on the facts alleged in this case served no useful purpose, was not the "full disclosure" contemplated by *O'Hagan* as sufficient to negate deception.

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[6] Although appellants point out (Br. 16 n.7) that the article's author "is the SEC's attorney of record in this case and was Assistant General Counsel of the SEC at the time the article was published," they omit that the article states that it "expresses the author's views and does not necessarily reflect the views of the Commission, or other members of the staff." *Id*. at 865.

B. Alternatively, the Complaint States a Claim Against Rocklage as a Temporary Insider under the Classical Theory of Insider Trading.

Under the classical theory of insider trading, a company's insiders are liable if they trade, or tip others who trade, their own corporation's securities on the basis of material, non-public information. *See O'Hagan,* 521 U.S. at 651-652; *Sargent,* 229 F.3d at 77. [7] The concept of 'insider' is not limited to a company's officers, directors or permanent employees, but also includes "attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation." *O'Hagan*, 521 U.S. at 652, citing *Dirks*, 463 U.S. at 655 n.14.

The complaint states a claim against Rocklage as a temporary insider. Rocklage and her husband had a past practice of discussing confidential business information. As a matter of common sense, it can be valuable to a company for its CEO to be able to discuss such information with his or her spouse. By sharing company developments with their spouses, CEOs are better able to harmonize the demands of their professional and personal lives. Further, a company reasonably would expect that a CEO would engage in such discussions. Thus, such disclosure

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[7] A personal benefit to the tipper is required in a case under the classical theory. *See Dirks*, 463 U.S. at 663. There is no dispute that the complaint sufficiently alleges personal benefit.

serves a corporate purpose, and the recipient of such information should be viewed as a temporary insider.

Appellants do not directly address this argument, which the Commission made below. Their only mention of this issue is to state (Br. 4 n.3) that "the District Court reasoned (correctly) that Rocklage did not meet the requirements for 'temporary insider' status * * * because the SEC had not alleged that the relevant conversations with her husband were 'solely for corporate purposes' and because there was no case law recognizing close relatives as temporary insiders."

The district court's dicta expressing disagreement with the Commission's temporary insider theory (*see* A. 35-36) incorrectly relied on the phrase "solely for corporate purposes."[8] From the perspective of the company, the disclosure *was* solely for a corporate purpose – the purpose of helping the company's CEO harmonize the demands of his professional and personal life, and thereby perform better as the leader of his company. It is not relevant that, from Scott Rocklage's perspective, the disclosure may have had the dual purpose of benefitting both his professional and his personal life.

[8] The district court did correctly note that no case has found a spouse to be a temporary insider based solely on marriage to a corporate official. A. 35. On the other hand, no case has stated that the spouse of a CEO, who receives confidential corporate information from the CEO, should not be viewed as a temporary insider.

Even if the disclosure is viewed as having a dual purpose from the company's perspective, the phrase "solely for corporate purposes" should be construed broadly. It is true that the Supreme Court, when it first articulated the temporary insider principle, stated that temporary insider status exists where a person "[h]as entered into a special confidential relationship in the conduct of the business of the enterprise and [is] given access to information *solely for corporate purposes*. *Dirks*, 463 U.S. at 646 n.14)(emphasis added). However, *O'Hagan* did not use the phrase "solely for corporate purposes," but stated that temporary insiders are those who temporarily become fiduciaries of a corporation. 521 U.S. at 652. Rocklage, in view of her prior practice of maintaining in confidence information her husband told her about Cubist, and of the corporate purpose such disclosures served, did temporarily become a fiduciary of the company.

The Supreme Court's use of the word "solely" in *Dirks* should not be read so restrictively as to preclude temporary insider status on the facts alleged in this case. In an analogous context, the courts of appeals have rejected a narrow reading of language used by the Supreme Court. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-299 (1946), in interpreting the term "investment contract" used in the statutory definition of a security, held that an investment contract was a "contract, transaction, or scheme whereby a person invests his money in a common

enterprise and is led to expect profits *solely from the efforts of* the promoter or a third party" (emphasis added). The courts of appeals have uniformly interpreted "solely" flexibly to avoid creating a loophole for promoters of investment schemes to evade regulation. *See*, *e.g.*, *SG Ltd*., 265 F.3d at 55 (citing cases).

Finally, assuming that Rocklage is a temporary insider, her disclosure to her husband would not negate her deceptive conduct under the classical theory. Even though her husband is Cubist's Chairman and CEO, Rocklage's duty under this theory is owed to the Cubist shareholders, and Rocklage did not disclose anything to them. [9]

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[9] Even if the complaint against Rocklage were dismissed, the complaint would still state a claim against Beaver and Jones as tippees of Rocklage. The district court's dicta stating that "a tippee's liability" is "derivative of and dependent upon the *liability* of the tipper" is incorrect. A. 49 (emphasis added). Tippee liability exists where there is a *breach of duty* by the tipper and the tippee knows or should know that there has been a breach. *See*, *e.g.*, *Dirks*, 463 U.S. at 659-660; *Sargent,* 229 F.3d at 77. Rocklage breached a duty of confidentiality owed to her husband by using information he told her in confidence without his consent. Her disclosure does not cure her breach of duty. *See O'Hagan*, 521 U.S. at 665. In addition, the complaint sufficiently alleges that Beaver and Jones knew or were reckless in not knowing that there had been a breach of duty. A. 13-15. Thus, Beaver and Jones may be liable whether or not Rocklage herself is liable.

CONCLUSION

For the foregoing reasons, the order of the district court should be affirmed.

Respectfully submitted,

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June 2006

CERTIFICATE OF SERVICE

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