

Lessons From the Cuban Insider Trading Decision

Mark Cuban scored a significant victory July 17 when a federal district court dismissed an SEC insider trading case focused on his 2004 trading in Mamma.com. See *SEC v. Cuban*, Civil Action No. 3:08-CV-2050-D (N.D. Tex. July 17, 2009) (“*Cuban*”). While the opinion provides a thorough analysis of important securities law issues, the outcome should not cause significant changes in how public companies and their investors address the risks associated with access to material, nonpublic information.

The SEC alleged that Cuban illegally avoided \$750,000 in losses through his 2004 sale of Mamma.com stock. Specifically, the crux of the SEC’s case was that: (a) Cuban was advised by management that Mamma.com would sell shares in a private investment in public equity (“PIPE”) transaction; (b) Cuban agreed to keep this information confidential; and (c) he sold his entire 600,000 share position before the PIPE transaction was announced. Cuban moved to dismiss the complaint (and was supported by an amicus brief filed by a group of law professors).

The opinion in *Cuban* centered on an interpretation of the misappropriation theory of insider trading liability. The misappropriation theory provides that a person commits fraud when he misappropriates confidential information for securities trading purposes in breach of a duty owed to the source of that information. The legal issue in this case was whether Cuban’s alleged agreement to keep the information confidential was sufficient for purposes of a securities fraud case.

Federal District Court Judge Sidney Fitzwater’s decision stressed that deception is central to the misappropriation doctrine; the misappropriator’s misconduct lies not just in the use of the material, nonpublic information but also “because he does not disclose to the source that he intends to trade on or otherwise use the information.” *Cuban* at 18. The court emphasized that an agreement that forms the basis of a misappropriation prosecution must impose more than a duty to keep the information confidential. “It must also impose on the party who receives the information the legal duty to refrain from trading on or otherwise using the information for personal gain.” *Id.* at 20. As the SEC complaint did not allege that Cuban agreed to refrain from trading while aware of the pending PIPE, the court ruled that this agreement could not form the basis of an insider trading prosecution.

Significantly, the court ruled further that SEC Rule 10b5-2(b)(1) could not provide the predicate for a proceeding against Cuban. Adopted by the SEC in 2000, Rule 10b5-2(b)(1) lists, as one

example of duties of trust and confidence relevant to the misappropriation doctrine, “whenever a person agrees to maintain information in confidence.” As this rule bases misappropriation theory liability “on a mere confidentiality agreement lacking a non-use component,” the court ruled that the SEC could not rely on it to establish Cuban’s liability under the misappropriation theory. *Cuban* at 33.

For counsel, the court’s opinion is important because it addresses the type of issuer/investor contact that is made routinely for legitimate business purposes. There are practical considerations from both sides of these contacts.

First, *Cuban* does not alter the confidentiality agreement that public companies should secure before selectively discussing material, nonpublic information with investors. In evaluating a capital markets transaction, it is natural for an issuer’s management to consider contacting its largest investors to, among other things, evaluate their interest in participating in the transaction. At the same time, if this nonpublic information is material, Regulation FD forbids certain selective disclosures by public companies and their designated spokesmen.

Regulation FD also provides a solution to this balancing act. These rules provide that an issuer can share material information with a significant stockholder if that shareholder has agreed to keep the information confidential. The rules do not require anything more than a confidentiality commitment. Mamma.com’s management followed this course; they were neither charged by the SEC nor were they criticized in the court’s opinion.

Second, investors must be clear when they intend to remain “public” in an investment. There are multiple situations – a PIPE is just one example – in which issuers and/or their advisors may want to contact buy-side investors to test their reaction to a possible course of action (e.g., a capital markets transaction, a restructuring). If an investor wishes to remain free to trade the issuer’s securities, its representatives should be clear in such contacts that they plan to remain “public” – free to trade and not subject to any confidentiality agreement with the issuer. The outcome in *Cuban* reinforces this principle.

The SEC’s case against Cuban was similar to several insider trading cases against institutional investors in which the Commission alleged that an investor was aware of material, nonpublic information subject to a confidentiality agreement. The misappropriation theory historically has been a malleable tool for the SEC to proceed against investors who are not traditional corporate insiders. It would be imprudent to conclude that the setback in the *Cuban* case will deter the Commission’s staff from continuing to target such cases.

Judge Fitzwater’s opinion may not be the last word in the *Cuban* case. The opinion affords the SEC an opportunity to file an amended complaint; an appeal to the Fifth Circuit Court of Appeals is another possibility. The risks that gave rise to *Cuban* remain in the marketplace, regardless of the final outcome of this proceeding.

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