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Dismissal of SEC's Insider Trading Case Against Mark Cuban
Changes the Guideposts for Investment Managers
And Places Insider Trading Rules Into Question

TO: **Clients and Friends**[1]
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On July 17, 2009, the United States District Court for the Northern District of Texas (the "Court") granted Mark Cuban's motion to dismiss a case brought against him by the Securities and Exchange Commission (the "SEC"). The case raises an important question for investment managers: Can a person impose a duty on you not to trade the securities of an issuer simply by divulging material nonpublic information about the issuer? Mark Cuban's victory indicates that the answer may be "no", but the issue will not be finally resolved until the SEC restates its complaint, or decides not to replead, which must be done within thirty (30) days.

The issue arose when Mamma.com, a Canadian company that operated a search engine, notified Mark Cuban of its decision to raise capital through a PIPE (private investment in public equities) offering. The company's CEO called Cuban to inform him of the planned PIPE and prefaced the call by informing Cuban that he had confidential information to convey to him. Cuban agreed that he would keep the information confidential. When the CEO asked Cuban if he would like to participate in the PIPE, Cuban said, "Well, now I'm screwed. I can't sell." Several hours after this call, Cuban sought and received additional confidential details about the PIPE from the investment bank conducting the offering. Immediately thereafter, Cuban directed his broker to sell all 600,000 of his Mamma.com shares. At the end of that trading day, Mamma.com publicly announced the PIPE offering. Because Cuban sold his shares before the announcement,

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he avoided losses in excess of $750,000 that he would have incurred from the declining price of Mamma.com stock.

Based on these facts, the SEC alleged that Mark Cuban was liable for violating §17(a) of the Securities Act of 1933, as amended, §10(b) of the Securities Exchange Act of 1934, as amended and Rule 10b-5 thereunder and sought an array of remedies, including disgorgement of the losses avoided by selling the Mamma.com shares and a civil monetary penalty. The Court boiled the case down to the following question: did Mark Cuban breach a duty not to use the inside information under the misappropriation theory of insider trading? Under the misappropriation theory, a person commits fraud in connection with a securities transaction, and thereby violates §10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.[2] The misappropriation theory outlaws trading on the basis of nonpublic information by a corporate outsider in breach of a duty owed to the source of the information.

The SEC argued that Cuban was liable under the misappropriation theory based on a duty created by his agreement to keep confidential the information that Mamma.com's CEO provided him about the PIPE offering. One of Cuban's arguments was that merely entering into a confidentiality agreement is inadequate to establish misappropriation theory liability.[3]

The Court dismissed the case against Mark Cuban. Based on its reading of the *O'Hagan* case, the Court reasoned that the ***use*** of material, nonpublic information is conceptually separate from nondisclosure. The Court determined, first, that Cuban did not have a fiduciary relationship with Mamma.com, and a fiduciary relationship was not created merely by Cuban's agreement to keep the information confidential. The Court then concluded that, where there is no fiduciary relationship between the parties, a misappropriation occurs only where the recipient of material, non-public information agrees, either expressly or implicitly, both to keep the information confidential ***and*** to refrain from trading on or otherwise using the information for personal gain. Unless both components of the agreement are present, it is not fraudulent to use the information for personal benefit because there has been no breach of a duty to refrain from trading based on the information that was disclosed.

At first glance, this decision appears to provide some comfort to hedge fund managers and other market participants, who do not otherwise have a fiduciary relationship with an issuer, when they come into possession of material, nonpublic information about such issuer and are asked to maintain it in confidence, for example, in the context of a planned PIPE offering. The Court stated that a person may avoid liability by simply disclosing the intent to use the confidential information. However, this ruling can not yet be relied upon because the SEC has the option to replead its case and the case

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[2] This definition of the misappropriation theory originated in the Supreme Court case, *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997).

[3] Cuban's other arguments in the case are beyond the scope of this discussion and not covered herein.

may not be upheld if it is appealed. Also, the ruling is contrary to an existing SEC rule, as discussed below.

The Court utilizes interesting logic to arrive at its conclusions. For example, the Court stated that a duty to support liability for misappropriation can arise out of a contractual agreement between two parties in the absence of a preexisting fiduciary duty. However, it is not clear how the breach of a contractual obligation not to use information for one's benefit constitutes a deception or fraud in the absence of a fiduciary duty. Under the Court's reasoning, a breach of contract can constitute the basis of a fraud claim. It is questionable, however, whether a fraud claim arises under §10(b) of the Securities Exchange Act and Rule 10b-5 where there is only a breach of a *contractual* duty of non-use, rather than a breach of a *fiduciary* duty.

It is also interesting that the Court stated that Cuban's remark, "Now I can't sell," cannot reasonably be understood as an agreement not to use the information to his own benefit, and the Court characterized the remark as an expression of belief, rather than an agreement. This conclusion is open to debate, as a reasonable person could interpret the remark as a statement of agreement (and emails between Mamma.com employees actually did express such an interpretation).

The Court also threw into doubt the legitimacy of Rule 10b5-2, which provides that agreeing to maintain information in confidence is sufficient to create a duty of trust or confidence for purposes of the misappropriation theory of insider trading. Because the rule lacked a non-use component, the Court held that the SEC cannot rely on it to establish Cuban's liability and, moreover, reliance on the rule to impose liability would exceed the SEC's §10(b) authority to proscribe deceptive conduct. If this decision stands, the SEC may have to discard the rule altogether or revise it to conform to the Court's view of insider trading liability.

Finally, the Court's decision appears to be inconsistent with Regulation FD (the "Regulation"), which prohibits an issuer, or any person such as a corporate officer acting on its behalf, from selectively disclosing material nonpublic information to certain financial professionals, such as investment advisers (as defined in the Investment Advisers Act of 1940, as amended), who expressly agree to maintain the disclosed information in confidence. Because there is no "usage" prong in the Regulation, the Regulation and the Cuban case appear to be incompatible. The premise of the Regulation is that requiring public disclosure of material nonpublic information that has been selectively disclosed to a recipient who is in a position to trade on it for personal gain (other than a person who owes a duty of trust or confidence to the issuer or who agrees to keep the information confidential) protects the investing public from harm. But if the Court in the Cuban case is correct, the recipient's commitment to keep the information confidential does not bar the recipient from trading, thereby potentially undermining the effect of Regulation FD.

Assuming it is not overturned, the Court's decision could force the SEC to reconsider what kind of insider trading activity is subject to enforcement action.

However, inasmuch as the decision is subject to appeal and is inconsistent with both Regulation FD and Rule 10b5-2, it is not yet certain that a person may escape liability for using material nonpublic information for personal gain based on the existence or absence of any particular contractual language.