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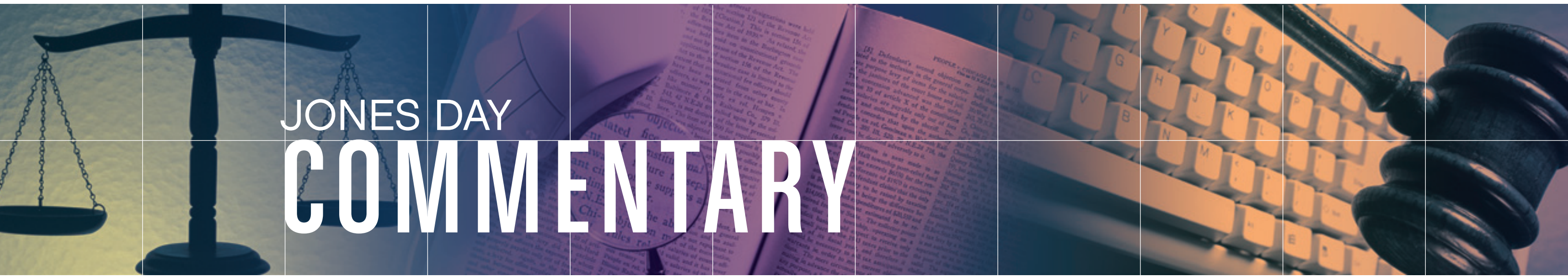

THE *CUBAN* INSIDER TRADING CASE

On July 17, 2009, the U.S. District Court for the Northern District of Texas dismissed the U.S. Securities and Exchange Commission's insider trading case against Mark Cuban, the owner of the Dallas Mavericks. The case involved a discussion between the CEO of a public company and Cuban in which the CEO gave Cuban material, nonpublic information and Cuban agreed to keep it confidential. However, he did not agree explicitly to refrain from trading based on that information, which he did. Based on these facts, the court dismissed the SEC's complaint, reasoning that merely agreeing to keep the information confidential was insufficient to create a claim of insider trading, without an agreement to refrain from trading.

The decision has drawn attention because it appears contrary to the general understanding of insider trading that, while in possession of material, nonpublic information, one must either refrain from trading or disclose the material, nonpublic information. Although that statement is too simplistic to describe the complex case law of insider trading, it remains a good rule of thumb for securities trading.[1]

THE SEC'S COMPLAINT

The SEC's complaint alleged the following facts:

- In 2004, Cuban purchased 600,000 shares, or approximately 6.3 percent, of the outstanding common stock of Mamma.com Inc., a Nasdaq-listed company.
- Shortly thereafter, Mamma.com decided to raise capital through a PIPE transaction (a private investment in public equity). At that time, Cuban was Mamma.com's largest shareholder, and the company's CEO called him to give him advance notice about the offering. "'The CEO prefaced the call by informing Cuban that he had confidential information to convey to him, and Cuban agreed that he would keep whatever information the CEO intended to share with him confidential.'"[2]

1 *See* Ted Kamman and Rory T. Hood, "With the Spotlight on the Financial Crisis, Regulatory Loopholes and Hedge Funds, How Should Hedge Funds Comply with the Insider Trading Laws?" 2009 Colum. Bus. L. Rev. 357 (2009). The views set forth in that article are the personal views of the authors and do not reflect those of Jones Day.

2 *SEC v. Cuban*, No. 08-cv-2050 (slip op. at 2) (N.D. Tex. July 17, 2009) (quoting Complaint ¶ 14, *SEC v. Cuban*, No. 08-cv-2050 (N.D. Tex. Nov. 17, 2008)).

- News of the PIPE upset Cuban, who did not want to see his stake in the company diluted. At the end of the call, he added, "Well, now I'm screwed. I can't sell."[3] Notwithstanding that remark, Cuban disposed of all of his shares in open-market sales over the next 24 hours.
- When the PIPE was publicly announced following the close of the next day's trading, the company's stock price declined sharply. Cuban avoided losses of more than $750,000 by selling in advance of that public announcement.

The SEC filed a civil complaint against Cuban, alleging insider trading in violation of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 thereunder. The complaint alleged that Cuban unlawfully misappropriated material, nonpublic information about the PIPE transaction for personal gain after he had agreed to maintain the information in confidence. Cuban moved to dismiss the complaint on the ground that the SEC failed to state a claim on which relief could be granted.

THEORIES OF INSIDER TRADING

Section 10(b) of the Exchange Act prohibits the use of any deceptive device in connection with the purchase or sale of securities. Rule 10b-5 of the Exchange Act prohibits not only affirmative misrepresentations but also nondisclosure of material information in connection with the purchase or sale of any security. As compared to a Rule 10b-5 claim for affirmative misrepresentations, a claim for nondisclosure is more difficult for a plaintiff to establish, because the latter requires a finding of a duty to disclose. In interpreting Section 10(b) and Rule 10b-5 in the context of insider trading, the U.S. Supreme Court has developed the "classical" and "misappropriation" theories of insider trading.

Under the classical theory, trading on material, nonpublic information does not give rise to a Rule 10b-5 claim unless a duty to disclose arises from the existence of a fiduciary relationship. A clear example of the classical theory is "when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information" because the fiduciary relationship between insiders and the shareholders of a corporation gives rise to a duty to disclose or abstain from trading.[4] This prohibition has been extended to constructive fiduciaries or temporary insiders, such as investment bankers, lawyers, accountants, and financial printers.[5]

Under the misappropriation theory, a person violates Rule 10b-5 if he or she "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[6] The misappropriation theory is designed to protect against "abuses by 'outsiders' to a corporation who have access to confidential information that will affect the corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders."[7]

In addition to these theories developed by the courts, the SEC has promulgated Regulation FD to prevent selective disclosure to, among others, securities market professionals, as well as Rule 10b5-2 to clarify certain aspects of the insider trading laws.[8]

3 *Id.* at 3 (quoting Complaint ¶ 14, *SEC v. Cuban*, No. 08-cv-2050 (N.D. Tex. Nov. 17, 2008)).
4 *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997).
5 *Id.* at 652 (citing *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983)). In addition to the classical and misappropriation theories of insider trading, under the Supreme Court's "tippee" theory of insider trading, a tippee assumes an insider's duty if inside information was made available to him improperly and he knew, or should have known, of such impropriety.
6 *Id.*
7 *Id.* at 652-53.
8 Generally, Regulation FD imposes an obligation on issuers to make public material, nonpublic information if the issuer, or any person acting on its behalf, reveals such information to, among others, certain enumerated securities market professionals and does not obtain their agreement to maintain such information in confidence. Rule 10b5-2 provides a nonexclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the "misappropriation" theory of insider trading under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

THE COURT'S ANALYSIS

In *Cuban*, the court concluded that the SEC's complaint failed to allege facts that supported a claim of insider trading because the complaint alleged only that Cuban had agreed to keep the information confidential, not that he had agreed to refrain from trading. The court interpreted Cuban's remark that he was "screwed" because he "[couldn't] sell" as descriptive rather than promissory. That is, Cuban did not make a promise to refrain from trading, but only gave his mistaken view of what the law required.[9] Because the complaint alleged only that Cuban had promised nondisclosure, and not that he also promised to refrain from trading, the court held Cuban did not breach a duty of non-use and therefore did not commit a deceptive act punishable by Rule 10b-5.

The court also rejected the SEC's argument based on Rule 10b5-2 of the Exchange Act. Rule 10b5-2 sets forth a non-exclusive list of circumstances under which an individual is deemed to owe a duty of trust or confidence, the breach of which can support insider trading liability under the misappropriation theory. Rule 10b5-2(b)(1) provides that such a duty arises "[w]henever a person agrees to maintain information in confidence." Notwithstanding that, the court concluded that the breach of a nondisclosure obligation alone could not support insider trading liability under the misappropriation theory. In the court's view, any rule that purported to base liability solely on a confidentiality undertaking, rather than the deceptive act of breaching a nondisclosure and non-use obligation, exceeded the SEC's rulemaking authority under Section 10(b) of the Exchange Act.[10]

Cuban also argued that the predicate duty on which liability depended could arise only from a fiduciary (or "fiduciary-like") relationship between the trader and the source of the information, the existence of which is governed exclusively by state law. The court agreed that the misappropriation theory "involves the undisclosed breach of a duty not to use another's information for personal benefit,"[11] but it found no support for Cuban's contention that the source of the duty was limited to a fiduciary relationship or to state law. The court reasoned that the duty could arise through contract if a party agreed, in exchange for access to confidential information, to refrain from using that information for personal benefit. Nonetheless, based on the facts alleged in the *Cuban* case, the court found no support that would give rise to such duty.

FINAL OBSERVATION

The *Cuban* decision appears to permit trading on material, nonpublic information in certain instances absent an agreement to refrain from trading. We do not believe that the decision will alter the law on insider trading or that it will change the SEC's enforcement practices. The court granted the SEC 30 days to amend its complaint and maintained the possibility that an implied duty to refrain from trading would be sufficient. The SEC could also appeal the court's decision.

LAWYER CONTACTS

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9 *SEC v. Cuban*, No. 08-cv-2050 (slip op. at 27) (N.D. Tex. July 17, 2009).
10 *See id.* at 33-34.
11 *Id.* at 19.