

SEC V. CUBAN, ROUND 2

A Legal Analysis

by Steven Siesser, Matthew Oliver, and Bernard Cooney

In September, the 5th Circuit Court of Appeals handed the Securities and Exchange Commission a major victory in its highly publicized insider-trading fight with Mark Cuban, the billionaire entrepreneur/investor and owner of the Dallas Mavericks. Cuban had previously persuaded the trial court to dismiss the SEC's lawsuit, but the reversal by the appellate court means that the case will proceed to discovery and, barring settlement, a possible trial.

Case Background

The SEC alleges that Cuban violated federal securities laws by selling his stake in a public company after being informed by the company's CEO of an impending capital raise through a private investment in public equity. According to the SEC, while a large minority shareholder of **Mamma.com**, Cuban received confidential information from its CEO, agreed to keep the information secret, and acknowledged that he could not trade on the information. In a brief telephone conversation described in the SEC's complaint, the CEO informed Cuban that the company was planning to raise capital through a PIPE. The CEO gave Cuban this information only after receiving a promise from Cuban to maintain confidentiality. Rather than expressing interest, Cuban became very upset and informed the CEO that the PIPE would dilute his holdings and those of other existing shareholders. Cuban allegedly expressed frustration that, as a result of having come into possession of material, non-public information, he would not be able to sell any stock until the company publicly announced the offering. The next day, Cuban sold all his shares in the company. The company later announced the PIPE and the price

of its shares dropped. As a result of his sale, Cuban allegedly avoided losses of \$750,000. Cuban informed the SEC of his sale and, according to the complaint, publicly stated that he sold his shares because the company was conducting the PIPE, which issued shares at a discount to the market price and would have diluted his ownership interest.

The district court concluded that the SEC failed to allege "facts that reasonably suggest that the CEO intended to obtain from Cuban an agreement to refrain from trading on the information." Instead, the complaint merely described an agreement to keep the information confidential, which was legally insufficient to impose a duty on Cuban to disclose or abstain from trading under the securities laws.

The 5th Circuit disagreed, ruling that the "allegations, taken in their entirety, provide more than a plausible basis to find that the understanding between the CEO and Cuban was that he was not to trade, that it was more than a simple confidentiality agreement." The court emphasized that after his conversation with the CEO, Cuban allegedly contacted Mamma.com's investment bank and learned confidential details about the PIPE, including that it was being sold at a discount to the market price. The court found that by obtaining the pricing information, "Cuban was able to evaluate his potential losses or gains from his decision to either participate or refrain from participating in the PIPE offering." Based on the SEC's allegations, the court concluded it was plausible that the company and Cuban "understood, if only implicitly" that Mamma.com would convey the terms and conditions of the PIPE to Cuban so that he could determine whether or not to participate, and that he could not trade on the information for

his own benefit. Notably, the 5th Circuit explained, had the company conveyed the nonpublic information to Cuban so that he could trade on it before the PIPE, it "would raise serious tipper/tippee liability concerns" and "it would not be difficult for a court to infer that the CEO must have done so for some personal benefit."

Cuban argued that he was permitted to trade on the information but prohibited from telling others of the imminent PIPE. The court rejected this argument and characterized such an arrangement as "an exclusive license to trade on the nonpublic material information." In the eyes of the 5th Circuit, the most plausible reading of the allegations in the SEC's complaint led to the conclusion that both Cuban and the CEO understood that Cuban could not trade on the information in advance of the PIPE.

Lessons Learned

The 5th Circuit's decision restores a bit of stability to the marketing process for securities offerings.

The federal insider-trading rules prohibit people from trading on material non-public information in violation of a duty to the public company. When marketing a securities offering before its public announcement, companies or their agents, such as investment bankers, "bring people over-the-wall" in order to share information about the offering or the company. This over-the-wall process is a compliance driven effort specifically designed to ensure adherence to the insider-trading rules (as well as the selective-disclosure rules under Regulation FD). Before any sensitive information is shared, the company or its agent first seeks to create the legally recognizable duty. Once the duty is established, trading on that information

is deemed a breach of that duty and thus insider trading. In order to create the duty, the well settled and virtually uniform method for doing so was to simply ask the prospective recipient to keep the information confidential, as the confidentiality obligation was deemed to create a contractual duty to the issuer.

The process is so particularized that investment banks use prepared scripts which are customarily reviewed and approved by counsel, to ensure strict compliance. Very few, if any, over-the-wall scripts or written confidentiality agreements contain trading restrictions beyond the basic agreement to keep the information confidential. Often times, the script or the confidentiality agreement will contain an acknowledgment of the recipient's obligations under federal securities laws while in possession of material non-public information instead of a trading restriction. Trading restrictions typically only enter such agreements when additional material non-public information about the issuer, such as financial projections, is shared with the recipient.

Following the trial court's decision, many of the scripts changed to add the trading restriction out of an abundance of caution. However, there was a widespread recognition in the market that the trial court misunderstood the over-the-wall process, or simply ignored it in order to carry out "celebrity justice" given the defendant's fame. In either case, the 5th Circuit seems to have

recognized the very well settled practice of bringing potential investors "over-the-wall" and its derivation from the insider-trading rules. Thus, consistency appears to have been restored.

Shortly after the trial court decision, many investors inquired whether they were now free to trade some of their positions since they only agreed to keep material non-public information confidential, and did not agree to any trading restrictions. Most advisors urged these investors not to change their practice, viewing the trial court decision as an aberration likely to be reversed on appeal. While it may have sounded like overly cautious and risk-averse, lawyerly advice at the time, this one was fairly easy to spot because the trial court's decision was so at odds with custom and practice.

So, where does this leave us? Frankly, it leaves us right where we were immediately before the trial court ruled: agreeing to keep information about a PIPE (or any other material non-public information) confidential creates a duty and the recipient cannot trade until either the information has been adequately released to the public or has become stale. The one exception is that some over-the-wall scripts and confidentiality agreements, as a result of the trial court, may still seek the trading restriction. While the 5th Circuit seems to make this added requirement unnecessary, some compliance officers may nevertheless view it as good practice. The challenge with this practice, however,

is that many prospective recipients who have existing positions in the issuer may not agree to a lock-up, and may forego receiving the information, thereby decreasing, in the case of a PIPE or other securities offering, the universe of potential buyers. Under current law, an obligation to keep the information confidential, together with an acknowledgment that the recipient understands its obligations under the federal securities law while in possession of material non-public information, should be, as it historically has been, sufficient for compliance purposes.

The ultimate outcome of this case will either continue the over-the-wall practice as it has been conducted for decades, or, if Mr. Cuban prevails, require the additional negotiation of a trading restriction. A settlement, however, will likely not lead to any changes in the process, since the 5th Circuit favored the historical approach. ■

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