

How Cuban Scored A Home Court Win Against The SEC

Law360, New York (November 14, 2013, 11:08 PM ET) -- On Oct. 17, 2013, a Dallas, Texas, jury dealt the U.S. Securities and Exchange Commission a stunning defeat in federal court by finding Mark Cuban, the entrepreneur and owner of the Dallas Mavericks, not liable for insider trading.[1] While the verdict may have resulted from adverse evidentiary rulings, reliance on a reluctant, foreign witness and jury nullification for a hometown celebrity, this loss may cause the agency to reevaluate its approach to trials and to seek friendlier venues for insider trading cases.

Pretrial Background

The Misappropriation Theory Of Insider Trading[2]

The SEC charged Cuban with insider trading under the misappropriation theory. According to the SEC, Cuban sold his shares of stock in Mamma.com Inc., a now defunct internet search engine, after receiving material, nonpublic information concerning a planned private investment in public equity offering by the company.[3]

Under the misappropriation theory of insider trading, a non-insider is liable when he receives material, nonpublic information lawfully but trades on the basis of such information in a breach of a duty of trust or confidence owed to the source of the information.[4] Misappropriation unlawfully deprives the source of the information of its exclusive use and harms the investing public by providing the trader with an advantageous market position acquired through deception. The duty of trust or confidence owed by the non-insider to the source can be created by an implicit or explicit agreement to maintain the information in confidence, that is, not to trade on the information or disclose it. Full disclosure to the source of an intention to trade on that information forecloses insider trading liability.

The SEC's Theory Of Insider Trading With Respect To Mr. Cuban

The SEC alleged that Cuban agreed to maintain the confidentiality of the PIPE information and violated that agreement through the sale of his Mamma.com position before the PIPE information became publicly available. The SEC did not allege that Cuban executed a written nondisclosure and nontrading agreement with Mamma.com. Rather, the core of the SEC's case concerned a short, unrecorded phone call between Cuban and Guy Fauré, the former CEO of Mamma.com.

In a pretrial deposition, Fauré testified that on June 28, 2004, he told Mr. Cuban, "I've got confidential information." According to Fauré, Cuban said, "[O]kay, uh-huh, go ahead." After he informed Cuban of the planned PIPE offering, Fauré testified that Cuban became upset at the prospect of the PIPE diluting his investment and said, "[N]ow I'm screwed. I can't sell." According to the SEC, Cuban's alleged

statements and subsequent actions represented an agreement not to disclose and not to trade on the PIPE information. The SEC charged Cuban with illicitly selling his Mamma.com shares before the public announcement of the PIPE offering to avoid \$750,000 in losses.

Pretrial Warning Signs

The trial court signaled skepticism toward the SEC's case when it denied Cuban's motion for summary judgment. The trial court stated that its decision was a "close one" and made clear that the case would likely turn on the pivotal phone call. According to the court, Fauré's testimony left much to be desired: "Fauré has a spotty memory in crucial respects, and sometimes only recalls Cuban's using ambiguous forms of non-verbal communication (e.g., 'um hum' and 'uh huh')." In addition, the court stated that "[e]ven the statement Fauré does remember Cuban making — 'Now I'm screwed. I can't sell' — requires supporting context, because in isolation it can plausibly be read to express Cuban's view that learning the confidences regarding the PIPE forbade his selling his stock before the offering but to express no agreement not to do so."

Why the SEC Lost

The SEC failed to prove multiple required elements, including that the information relating to the PIPE offering was material, nonpublic information, that Cuban agreed to keep the information confidential and not to trade on the information, and that Cuban deceived Mamma.com with respect to his intent to sell his shares. The SEC's case likely foundered due to the testimony of Fauré, Cuban and Erik Sirri, Cuban's expert witness.

Taking A Knife To A Gunfight

Despite a multiyear investigation, the SEC went into the most important battle of the trial at a disadvantage. The SEC needed to persuade the jury to believe Mr. Fauré's explanation of the phone call over Cuban's conflicting account. But Fauré, a Canadian resident, was immune to subpoena for live testimony and refused to testify at the trial. Thus, the SEC was forced to play Fauré's videotaped deposition which was unclear, uncertain and inconsistent with prior statements.

Fauré's absence likely impaired the credibility and weight accorded by the jury to his testimony. In closing arguments, defense counsel highlighted Fauré's refusal to testify: "You're going to base a finding for the government on that testimony, from that witness, who won't even show up?" Fauré's failure to appear in court allowed defense counsel to question his motives without effective rebuttal, contending that the SEC's investigation of Mamma.com provided Fauré with an ulterior motive to provide testimony against Cuban and that Fauré first mentioned Cuban's alleged inculpatory statements when the SEC supposedly dropped an investigation into Mamma.com. Cuban's lawyers also told the jury that Fauré refused to appear because he was scared of cross-examination: "[W]e offered to buy him a plane ticket on a direct flight from Montreal to Dallas. ... Unlike Mr. Cuban, Guy Fauré didn't want you to look him in the eye."

In addition, Fauré's testimony may have wilted under close scrutiny. The SEC had to establish both that Fauré accurately recalled what Cuban said and that those statements were an agreement to keep the PIPE information confidential and not to trade. Yet, Fauré did not mention Cuban's alleged statements in his first two SEC interviews. Moreover, Cuban's alleged statements appear to be unclear and capable of multiple interpretations. And, Fauré hedged and caveated his testimony, saying "I don't remember his exact words."

Critically, the court allowed defense counsel to impeach Fauré's testimony with excerpts from a "transcript" of an unsworn and unrecorded interview of Fauré conducted by defense counsel outside the presence of the SEC. Over the SEC's objection, the court allowed publication of the hearsay transcript pursuant to Rule 806 of the Federal Rules of Evidence. Rule 806 provides that a hearsay statement (here, Fauré's videotaped deposition) may be impeached by evidence of an inconsistent statement, "regardless of when it occurred and whether the declarant had an opportunity to explain or deny it." According to the interview transcript, Fauré allegedly told defense counsel that he did not recall Cuban's response following Fauré's statement that he had confidential information.

Cuban testified for two days and disputed Fauré's recollection. Cuban testified that, while he did not remember the specifics of the call, he did not agree to keep the PIPE information confidential. According to Cuban, "I'm not going to agree to keep something confidential when I had no idea what the subject was." Cuban testified that he did not, as a practice, enter into oral confidentiality agreements and that he often refused to enter into written nondisclosure agreements before hearing a pitch. Cuban also testified that he told Mamma.com's investment banker that he intended to sell his position.

Expert Analysis

In addition, the SEC did not rebut the testimony of Cuban's expert witness, Dr. Erik Sirri, former director of the SEC's Division of Trading and Markets. Dr. Sirri walked the jury through public documents, including SEC filings and posts on Internet forums, and opined that the possibility of a PIPE offering was publicly known before Cuban's phone call with Fauré. Dr. Sirri also opined, based on the trial record, that there were no confidentiality restrictions in place to prohibit investors from discussing or trading on the PIPE information.

Home Court Advantage

The SEC may have faced an uphill battle convincing a Texas jury to side with it against Cuban. In closing arguments, defense counsel exhorted the jury: "Not even Mark Cuban can make the government admit it is wrong. Only you, the jury, have that power. Standing up to the government is not easy ... but tell the government enough is enough." Even if Fauré had testified in person with consistency and clarity, the SEC may have faced the risk of nullification. In short, the verdict may have been due to jury nullification for the home court Maverick rather than a loss on the merits.

The Road Ahead for the SEC

While Cuban's total victory has inspired predictable chatter about alleged SEC overreach, the question is not whether but where the SEC will bring high-profile insider trading actions. In particular, the SEC may choose to avoid federal court and instead bring administrative actions, which impose numerous disadvantages on defendants and provide the SEC with an increased likelihood of success while preserving litigation resources.

The SEC enjoys home field advantage in an administrative action. The presiding officer, an administrative law judge, is an employee of the SEC, and appellate review of an administrative order is conducted by the same body that authorized the enforcement action, the SEC. There is no right to trial by jury, eliminating jury nullification concerns.

Administrative actions operate on an accelerated schedule, initiated and determined by the SEC. A

hearing and an initial decision must be completed by the administrative judge within 120 to 300 days of the filing of the SEC's order instituting proceedings. Whether the action is subject to a 120, 210 or 300 day schedule is determined by the commission. A complex matter subject to the 300 day schedule is subject to a hearing within four months of the commencement of proceedings.

The accelerated pace favors the SEC. Prior to the commencement of an action, the SEC typically has the benefit of a multi-year investigation to develop an evidentiary record, including testimony, interviews and documents received from multiple witnesses. A defendant, in contrast, may have access only to his own documents and recollections. The defendant may be flooded with millions pages of documents with only months to prepare before a hearing.

Moreover, parties in an administrative proceeding are precluded from taking depositions for discovery purposes. While the SEC is required to turn over its investigative file, including witness testimony, interview notes and exculpatory information, defense counsel is unable to cross-examine such witnesses before the hearing.

These procedural advantages have raised due process concerns. Indeed, in the Galleon investigation, the SEC commenced actions against 28 defendants in federal court and brought one administrative proceeding, against Rajat Gupta. Gupta sued the SEC, claiming that the disadvantages he faced as an administrative defendant deprived him of equal protection. After denial of its motion to dismiss, the SEC dismissed the administrative proceeding and commenced an action against Gupta in federal court.

The circumstances of Gupta's successful challenge to the administrative action are unique and unlikely to deter the SEC from bringing future administrative actions. To the contrary, the next high-profile defendant likely will defend his insider trading action not in federal court but on the SEC's home court — an administrative proceeding.

—By Bradley J. Bondi, Martin L. Seidel, Nathan Bull, Karen Woody and Brett Sisto, Cadwalader Wickersham & Taft LLP

Bradley Bondi leads Cadwalader's securities enforcement and investigations practice and is a partner in the firm's business fraud & complex litigation practice and securities litigation practice, residing in the Washington, D.C., and New York offices.

Martin Seidel, a partner in the litigation department of Cadwalader's New York office, focuses his practice on complex commercial litigation and arbitration, with an emphasis on multiparty class and derivative suits, and corporate control contests.

Nathan Bull is special counsel in New York.

Karen Woody and Brett Sisto are both associates in the firm's Washington, D.C., office.

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[1] Jury Charge/Verdict [ECF No. 278] at 7:156-8:165, SEC v. Cuban, No. 08-cv-2050-D (N.D. Tex. Oct. 16, 2013) ("Verdict").

[2] See Bradley J. Bondi & Steven D. Lofchie, *The Law of Insider Trading: Legal Theories, Common Defenses, and Best Practices for Ensuring Compliance*, 8 N.Y.U. J. L. & Bus. 151 (2011), available at <http://www.cadwalader.com/uploads/books/e5aa079bcd4be2816c4c330aaa24f380.pdf>.

[3] The SEC alleged that Mr. Cuban violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder. Complaint [ECF No. 1] ¶¶ 2, 28-33, SEC v. Cuban, No. 08-cv-2050-D (N.D. Tex. Nov. 17, 2008) (“SEC Complaint”).

[4] *United States v. O’Hagan*, 521 U.S. 642, 652 (1997).

[5] *Id.* at 656.

[6] *Id.* at 654.

[7] *Id.* at 655.

[8] Memorandum Opinion and Order Denying Summary Judgment [ECF No. 178] at 8, SEC v. Cuban, No. 08-cv-2050-D (N.D. Tex. Mar. 5, 2013) (“Summary Judgment Order”).

[9] *Id.* (citation omitted).

[10] *Id.* (citation omitted).

[11] SEC Complaint ¶¶ 14-27.

[12] *Id.* ¶¶ 1, 19-24.

[13] Summary Judgment Order at 11-13.

[14] *Id.* at 12.

[15] *Id.* (internal quotation omitted).

[16] Verdict at 9:183-202.

[17] See *Kinsella v. Krueger*, 351 U.S. 470, 479 n.12 (1956).

[18] David Koenig, *Lawyers for SEC, Mark Cuban Make Closing Arguments*, *Houston Chron.*, Oct. 15, 2013, available at <http://www.chron.com/news/texas/article/Lawyers-for-SEC-Cuban-begin-trial-wrap-up-4897184.php>.

[19] Natalie Posgate & Mark Curriden, *Mark Cuban Cleared Of All Insider Trading Charges: The Full Story – SEC and Cuban Team Close Strong*, *Texas Lawbook*, Oct. 15, 2013, available at <http://texaslawbook.net/mark-cuban-cleared-of-all-insider-trading-charges-the-full-storyx/>.

[20] *Id.*

[21] Natalie Posgate & Mark Curriden, *SEC Witness Says Cuban responded “Now I’m Screwed” In Pivotal Call*, *Dallas Morning News*, Oct. 2, 2013, available at

<http://www.dallasnews.com/business/headlines/20131002-sec-witness-says-cuban-responded-now-im-screwed-in-pivotal-call.ece>

[22] Fed. R. Evid. 806.

[23] Natalie Posgate, Cuban: I Had Concerns About Mamma.com's Ties to Stock Swindler, Dallas Morning News, Oct. 8, 2013, available at <http://www.dallasnews.com/business/headlines/20131007-cuban-i-had-concerns-about-mamma.coms-ties-to-stock-swindler.ece>.

[24] Id.

[25] Id.

[26] Posgate & Curriden, Mark Cuban Cleared Of All Insider Trading Charges: The Full Story – SEC and Cuban Team Close Strong, *supra* n.19.

[27] SEC Rules of Practice (codified at 17 C.F.R. Pt. 201), R. 360(a)(2) (as amended and corrected Mar. 2006), available at <http://www.sec.gov/about/rulesprac2006.pdf> ("SEC Rules of Practice").

[28] Id.

[29] Id.

[30] SEC Rules of Practice, R. 233.

[31] SEC Rules of Practice, R. 221, 222, 230, 231.

[32] *Gupta v. SEC*, 796 F. Supp. 2d 503, 506 (S.D.N.Y. 2011).

[33] Id. at 506-07.

[34] Id. at 510-14.

[35] Complaint [ECF No. 1], *SEC v. Gupta*, No. 11-cv-7566 (S.D.N.Y. Oct. 26, 2011).