

# The Legal Intelligencer

## Lesson of Not Conceding Materiality in Insider Trading Cases

by John C. Grugan and Andrew E. Kampf

Since the jury found him not liable for insider trading in *Securities and Exchange Commission v. Cuban*, No. 09-10996, commentators have focused on many aspects of Mark Cuban's defense. As is widely known, the U.S. Securities and Exchange Commission accused Cuban of trading stock in Mamma.com in 2004 based on material, nonpublic information. Specifically, the SEC claimed that, within 24 hours of receiving allegedly confidential information from then-CEO Guy Faure that the company planned a private investment in a public equity (PIPE) offering, Cuban sold 600,000 shares of his Mamma.com stock before the PIPE offering was made public, thereby avoiding a loss of \$750,000. The lessons that may be drawn from his defense are, in some ways, very limited. For example, it is not often that the government's key witness is beyond the subpoena power of the SEC and refuses to appear in person at trial, but Faure, a Canadian, did just that. Similarly, the SEC does not often bring insider trading cases where the defense is able to present substantial evidence that the information traded on was publicly available and therefore not confidential. But in Cuban's case he was able to rely on documents filed with the SEC to demonstrate that the information he later learned was not confidential.

One critically important but largely overlooked aspect of *Cuban's* victory is his challenge to the materiality of the information Faure provided. The standards to establish materiality are well known. As U.S. District Chief Judge Sidney A. Fitzwater of the Northern District of Texas instructed the jury in *Cuban*, "information is 'material' if there is a substantial likelihood that disclosure of the information would be viewed by the reasonable investor as having significantly altered the total mix of information made available." Fitzwater further instructed: "Materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information. Materiality is not judged in the abstract, but in light of the surrounding circumstances. Information is material if there is a substantial likelihood that, under all the circumstances, the information would have assumed actual significance in the deliberations of the reasonable shareholder."

The SEC claimed it could meet the materiality threshold in a number of different ways. First, the SEC argued it could prove materiality based on the fact that Cuban had traded. The SEC argued that the information he received from Faure was material to Cuban based on his public attribution of his sale to that information. According to the SEC, if these facts affected Cuban, they also would have affected a reasonable investor's decision regarding whether to trade. The SEC further argued that the sale itself, involving an investor who had never sold shares of a company in which he had taken an interest of more than 5 percent, was "highly aberrational" and further showed the materiality of the information. In a related argument, the SEC pointed to the company's trading blackout before the finalization of the PIPE as, according to the SEC, showing that the company considered the information to be material.

Second, the SEC attempted to establish that the PIPE was quantitatively material, relying on the fact that it generated \$16.6 million in cash, "far more cash than either operations or financing activities in any of the preceding four years." Third, the SEC relied on an event study performed by its expert, Dr. Clemens Sialm. Sialm's report focused on the precise characteristics of the information that Cuban obtained, namely that PIPE participants would receive warrants and discounts that would dilute existing shareholder value. Sialm concluded, based on findings of a statistically significant price reaction in 35 out of 355 PIPE transactions presenting similar incentives to investors, that the information Cuban received was material.

Cuban challenged each of the SEC's arguments. With regard to his own reaction to learning the information about the PIPE, Cuban argued that, under relevant case law, testimony from individual investors is not probative of materiality and, even if it were, the SEC's proof would not support a finding of materiality here. Testimony that a defendant traded, Cuban argued, can never be used as a "proxy for a 'reasonable investor'" because, if that evidence alone were sufficient, the government would never be required to present its case on that element. In any event, Cuban introduced evidence that he was in possession of other information that informed his decision to trade: before he traded: two sources, including an FBI agent, contacted him to inform him that a known stock swindler was involved with Mamma.com. Cuban also presented the evidence of participants in the PIPE on the ground that, unlike him, were reasonable proxy investors. Each of these investors testified that they believed the information was not material.

With regard to the SEC's remaining arguments on materiality, Cuban offered his own expert, Dr. Erik Sirri, who concluded that Sialm's analysis was incorrect because it was not industry-specific. When the relevant industry was taken into account, Cuban's expert showed that the announcement of PIPEs like the Mamma.com PIPE was immaterial and unlikely to lead to statistically significant negative stock price reaction. Further, Cuban argued that even under Sialm's evaluation, a finding that only 10 percent of 355 PIPE transactions resulted in a statistically significant price reaction when announced could not support materiality.

Cuban also pointed out that, "in contravention of its frequent practice, [the SEC] chose not to provide this court with an event study examining how the market reacted to the disclosure of the Mamma PIPE transaction." Nevertheless, Cuban's expert executed such a transaction-specific study and determined that "the price reaction of Mamma.com stock to the announcement of the PIPE [including Cuban's own avoidance of a \$750,000 loss] was not statistically significant" in light of the "volatility of the price of Common Stock from March 8, 2004, to June 25, 2004, and the statistical relationship of the Common Stock and the Nasdaq Composite Index over that same period." As Cuban summarized, Sialm's opinion ultimately went to how Mamma.com investors would have reacted based on non-Mamma.com information, while Cuban's expert focused on how Mamma investors did react to the Mamma.com transaction itself.

Cuban's materiality arguments provided a critical basis for the jury to find in his favor. Indeed, Cuban's materiality arguments alone provided a sufficient basis for the jury to reject the SEC's case. In many cases, the government assumes it can establish materiality; the defense should exploit the government's lack of rigorous analysis. Even where the government has dedicated substantial resources to meeting this element of its insider trading case, Cuban's defense provides a critical reminder of the necessity of requiring the government to make its case.

*John C. Grugan, a partner at Ballard Spahr, advises clients in investigations and litigations conducted by the SEC, DOJ, self-regulatory organizations and state securities regulators. He can be reached at 215-864-8226 or gruganj@ballardspahr.com.*

*Andrew E. Kampf is a litigation associate at the firm focusing on complex civil litigation, securities litigation and intellectual property litigation. He can be reached at 215-864-8999 or kampfa@ballardspahr.com.*

Reprinted with permission from the December 31, 2013, issue of *The Legal Intelligencer*.

(c) 2013 ALM Media Properties, LLC. Further duplication without permission is prohibited. All rights reserved.