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Another Look at Confidentiality Requests

Law360, New York (September 30, 2010) -- The Fifth Circuit's September 2010 opinion reversing a district court dismissal of the U.S. Securities and Exchange Commission's November 2008 securities enforcement action against Mark Cuban, a well-known entrepreneur and current owner of the Dallas Mavericks and Landmark Theaters, could significantly impact what many company executives say when orally sharing with third-parties material, nonpublic information about the company.[1]

In light of the district court decision dismissing the SEC's complaint against Mark Cuban and the Fifth Circuit opinion reversing that dismissal, the best practice might be for a person providing material, nonpublic information to obtain not only an agreement to keep the information confidential, but also an express promise not to trade the company's securities based on the information or otherwise use the information.

The SEC's core allegation was that Cuban received confidential information from the CEO of Mamma.com, a Canadian search engine company in which Cuban was a large minority stakeholder, and agreed to keep the information confidential and acknowledged he could not trade on the information.

The SEC alleged that, armed with the inside information regarding a private investment of public equity (PIPE) offering, Cuban sold his stake in the company in an effort to avoid losses from the inevitable fall in Mamma.com's share price when the offering was announced.

In July 2009, Chief Judge Sidney A. Fitzwater, the highly respected Chief Judge of the U.S. District Court for the Northern District of Texas, dismissed the SEC's complaint.[2]

Chief Judge Fitzwater held that the SEC had failed to state a claim against Cuban because the SEC had alleged neither that Cuban had a fiduciary relationship with Mamma.com (while Cuban owned a 6.3 percent stake in Mamma.com, he was not an officer, employer or director of Mamma.com) nor that Cuban had agreed not to trade based on the information provided by the CEO.

Chief Judge Fitzwater explained that the essence of the misappropriation theory of insider trading on which the SEC had based its complaint "is the trader's undisclosed use of material, nonpublic information that is the property of the source in breach of a duty owed to the source to keep the information confidential and not to use it for personal benefit."[3]

Chief Judge Fitzwater explained that the duty not to use the information for personal benefit can arise by operation of law from a fiduciary relationship. According to Chief Judge Fitzwater, a duty not to trade based on information can also be based on an express or implied agreement between the source of the information and the trader.

Chief Judge Fitzwater stated, however, that “a mere unilateral expectation” that Cuban would not sell was also insufficient to allege an agreement not to trade on the information.[4]

Chief Judge Fitzwater further stated that to form the basis for a misappropriation charge, an agreement including a promise to keep the information confidential is insufficient if the agreement does not also include a promise to refrain from trading based on the information:

"The agreement ... must consist of more than an express or implied promise merely to keep information confidential. It must also impose on the party who receives the information the legal duty to refrain from trading on or otherwise using the information for personal gain. With respect to confidential information, nondisclosure and non-use are logically distinct. A person who receives material, nonpublic information may in fact preserve the confidentiality of that information while simultaneously using it for his own gain."[5]

In seeking reversal of the dismissal, the SEC argued that “Rule 13b5-2(b)(1), case law, logic and experience make clear that an agreement to maintain information in confidence encompasses an agreement not to trade on the information,”[6] and that Cuban therefore had a duty either to disclose to Mamma.com that he was about to trade or to abstain from trading.[7]

As a separate ground for reversal, the SEC also argued that, in light of allegations regarding other communications between Cuban and Mamma.com, the SEC had adequately pled that Cuban had agreed not to trade based on the information.

The court of appeals agreed with the SEC that the SEC had adequately pled that Cuban had agreed not to trade and declined to consider whether a confidentiality agreement was sufficient to support the claim against Cuban and whether the SEC had overstepped its authority under section 10(b) in issuing Rule 10b5-2(b)(1).

In its briefs to the Fifth Circuit, the SEC argued “that no one providing confidential, material information in reliance upon an agreement to keep the information confidential would believe that he was authorizing the recipient to trade on the information. Nor could any recipient of such information reasonably believe that he was authorized to trade.”[8]

Cuban noted a form agreement recommended by two commentators contained not only a promise not to disclose the information and to keep the information in “trust and confidence,” but also promises not to use the information for any “unauthorized purpose” and to not trade for a certain period and pointed to SEC filings in which the recipient of the information had made such promises.[9]

The SEC responded, “The fact that certain agreements, formalized in writing with the benefit of legal counsel, might have both belts and suspenders does not mean an oral agreement to keep material, nonpublic information confidential does not encompass an agreement not to trade.”[10]

The court of appeals opinion notes the adverse inferences that a CEO risks when a CEO provides material, nonpublic information to a major shareholder or, presumably, any other significant constituent, absent an express agreement that the recipient of the information will not trade:

"If the CEO knowingly gave Cuban material, nonpublic information and arranged so he could trade on it, it would not be difficult for a court to infer that the CEO must have done so for some personal benefit — e.g., goodwill from a wealthy investor and large minority stakeholder. 'A reputational benefit that translates into future earnings, a quid pro quo or a gift to a trading friend or relative all could suffice to

show the tipper personally benefitted.' SEC v. Yun, 327 F.3d 1263, 1277 (11th Cir. 2003). This of course is not to suggest any such improprieties occurred; rather, it simply reinforces the plausibility of the interpretation of the alleged facts as evidencing an understanding that the agreement included an agreement by Cuban not to trade."[11]

In light of the SEC having made these arguments, it is unlikely that the SEC would argue that a person providing confidential information pursuant to a confidentiality agreement was unreasonable in believing that the agreement barred the recipient from trading on the basis of that information.

Nevertheless, in light of the distinction drawn by Chief Judge Fitzwater and the decision of the Fifth Circuit not to address that distinction, it might be prudent for providers of material, nonpublic information to obtain both a promise to keep confidential and a promise not to trade based on the information or otherwise use the information.

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[1] SEC v. Cuban, 2010 WL 3633059 (5th Cir. Sept. 21, 2010).

[2] SEC v Cuban, 634 F. Supp. 713 (N.D. Tex. 2009).

[3] 634 F. Supp. at 723.

[4] 634 F. Supp. at 728.

[5] 634 F. Supp. at 735

[6] SEC Brief at 12. Rule 10b5-2 applies to any violation of Rule 10b-5 “that is based on the purchase or sale of securities on the basis of, or the communication of, material nonpublic information misappropriated in breach of a duty of trust or confidence.” Rule 10b5-2(b) specifies a number of circumstances in which for the purpose of Rule 10b-5 a “‘duty of trust or confidence’ exists, including — as specified in SEC Rule 1-b5-2(b)(1) — “[w]henever a person agrees to maintain information in confidence.” The SEC argued that “[t]he commission — in adopting Rule 10b5-2(b)(1) — reasonably viewed an agreement to maintain information ‘in confidence’ as giving rise to a duty of trust or confidence, such that undisclosed trading on the information provided in reliance on that agreement involves deception within the meaning of Section 10(b).” SEC Brief at 21. Interestingly, the SEC did not explain the basis for its position that by providing that a duty of trust or confidence exists if a person agrees to maintain information in confidence person, Rule 10b5-2 provides that trading on the basis of such information is a breach of the duty of trust or confidence.

[7] SEC Brief at 12.

[8] SEC Reply Brief at 6-7.

[9] Cuban Brief at 31.

[10] SEC Reply Brief at 9 n. 4.

[11] 2010 WL 3633059 at 5 n. 38.