SEC Actions

Trends Analysis

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**AGGRESSIVE SEC INSIDER TRADING ENFORCEMENT:
CHECK YOUR COMPLIANCE PROCEDURES**

Insider trading has long been a priority for Securities and Exchange Commission enforcement. Two recent Commission cases suggest the aggressive manner in which the Commission is now policing the markets for insider trading. One is *SEC v. Cuban*, No. 08-2050, Slip op. (N.D. Tex. Jul. 17, 2009) the high profile insider trading case against the owner of the Dallas Mavericks. The other is *SEC v. Dorozhko,* No. 08-0201, 2009 U.S. App. LEXIS 16057 (2nd Cir. July 22, 2009), the so-called "computer hacker" case.

Cuban and *Dorozhko* both focus on a key question of whether a fiduciary duty is required under the Supreme Court's decisions in *Chiarella v. United States*, 445 U.S. 222 (1980) and *United States v. O'Hagan*, 521 U.S. 642 (1987). *Dorozhko* also considers *SEC v. Zandford*, 535 U.S. 813 (2002) for the same proposition. Both decisions answer that question in the negative, but for different reasons. Together, these cases suggest that public companies, along with their directors, officers and counsel, would be well advised to carefully review their insider trading procedures, ensuring that they are effective and continuously updated.

Cuban: A promise of confidentiality

The facts of *Cuban* are straight forward. Mamma.com, Inc. was planning a private investment in public equity or PIPE offering. At the time, Mr. Cuban was a large shareholder in the company, with a 6.3% stake. As the PIPE offering progressed toward closing, the company contacted Mr. Cuban and asked if he would like to participate. Before extending the invitation, however, the CEO of Mamma.com told Mr. Cuban that he would have to keep the information confidential.

Mr. Cuban reacted angrily to the news of the PIPE, stating that he did not like PIPE offerings because they dilute the holdings of existing shareholders. At the conclusion of the conversation, Mr. Cuban stated "Well, now I'm screwed. I can't sell." Two internal e-mails at the company note that Mr. Cuban recognized he could not sell his shares until after the announcement of the offering.

There were two subsequent contacts between Mr. Cuban and the company about the PIPE. In the first, the CEO sent Mr. Cuban an e-mail telling him who to contact in the event he wanted further information about the offering. The second occurred when Mr. Cuban telephoned the sales representative. During the conversation, Mr. Cuban questioned the representative about the pricing for the offering, which he learned was at a discount to market.

At the conclusion of that telephone call with the company representative on June 28, 2004, Mr. Cuban contacted his broker and directed him to sell the 600,000 shares of Mamma.com he owned. A small portion of the shares were sold that day and the remainder the next. After the end of trading on June 29, 2004, the company announced the PIPE. Mr. Cuban did not inform the company that he was selling his shares just prior to the announcement. Mr. Cuban avoided a loss of $750,000 by shelling his shares, according to the SEC.

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Dorozhko: Tricking a microchip

Dorozhko centers on a claim that the defendant, Oleksandr Dorozhko, a Ukrainian national and resident, traded on inside information in the securities of IMS Health, Inc. According to the SEC, in early October 2007 IMS announced it would release its third-quarter earnings during a conference call after trading on October 17, 2007. The company hired Thomson Financial to provide investor relations and web-hosting services.

In the early afternoon of October 17, after several attempts, a computer hacker succeeded in breaking into the secure server at Thomson and located the data regarding IMS. Shortly before 3:00 pm that afternoon, the defendant, who had opened a brokerage account at Interactive Brokers, purchased over $41,000 work of IMS put options set to expire on October 25 and 30, 2007. These were about 90% of all such purchases.

After the close of the market, IMS announced its EPS were 28% below street expectations. The next morning, IMS shares opened down 28%. Within six minutes of the market opening, the defendant sold all of his options, realizing a profit of over $286,000.

The SEC brought a civil injunctive action against Mr. Dorozhko on October 29, 2007. The district court granted a freeze order over the trading profits but later denied the SEC's request for a preliminary injunction. The court concluded that the required breach of a fiduciary duty had not occurred. *SEC v. Dorozhko,* 660 F. Supp. 2d 321 (S.D.N.Y. 2008).

The decisions: No fiduciary duty required

The court granted Mr. Cuban's motion to dismiss. It did not, however, adopt Mr. Cuban's position that there had to be a fiduciary duty or a similar duty as a predicate for Section 10(b) liability. Rather, the key question, according to the court, is whether a breach of a legal duty arising by agreement can be the basis for the misappropriation theory and, if so, what are the essential components of the agreement.

In the classical theory of insider trading, a person who fails to disclose material information prior to trading commits fraud only when he or she is under a duty of disclosure. That duty, under the Supreme Court's decision in *Chiarella*, arises from the specific relationship between the parties. Likewise, under the misappropriation theory in *O'Hagan*, "the essence of the misappropriation theory 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."

Deception under the misappropriation theory stems from the fact that the trader is under a legal duty to refrain from trading on, or otherwise using, the information for personal benefit. If the trader is in a fiduciary relationship, the court held, this obligation arises by operation of law, as *O'Hagan* made clear. Contrary to Mr. Cuban's contention, however, the relationship between the parties need not be that of a fiduciary. Rather, the duty can also be supplied by an express agreement between the parties. In this regard, the court concluded that "[i]ndeed, the duty that arises by agreement can be seen as conferring a stronger footing for imposing liability for deceptive conduct than does the existence, without more, of a fiduciary or similar relationship of trust and confidence. In the context of an agreement, the misappropriator has committed to refrain from trading on material, nonpublic information. The duty is thus created by conduct that captures the person's obligation with greater acuity than does a duty that flows more generally from the nature of the parties' relationship."

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In *Cuban,* the SEC's complaint failed to allege an adequate agreement between the parties. While the complaint stated that Mr. Cuban agreed to keep the information confidential, this is not sufficient. Rather, the parties must agree that the information will be kept confidential and that it will not be used for trading purposes. It is the duty from this express agreement which becomes the predicate for the breach and the deception which flows from that breach in an omission case such as this the court held.

The Second Circuit reversed and remanded *Dorozhko.* In its opinion, the court rejected the district court's conclusion that *Chiarella* and *O'Hagan* required that there be a fiduciary or similar relationship as a predicate for Section 10(b) liability.

The circuit court concluded that *Chiarella, O'Hagan* and *Zandford* do not require a fiduciary duty as an element of every violation of Section 10(b). The theory of fraud in each of these cases was silence or nondisclosure. Thus, while the three decisions stand for the proposition that nondisclosure in breach of a fiduciary duty meets the Section 10(b) deception requirement, that does not mean that a fiduciary duty is required in every case. To the contrary, where the theory of fraud is based on an affirmative misrepresentation, such a duty is not necessary or required.

In the circuit court, the SEC argued that the defendant affirmatively misrepresented himself to gain access to inside information which was then used to trade. Specifically, the Commission contended that the fraud consisted of the defendant's alleged computer hacking which involves misrepresentations, not omissions as in *Chiarella* and *O'Hagan.* Thus, the SEC "argues that defendant affirmatively misrepresented himself in order to gain access to material, nonpublic information, which he then used to trade." The misrepresentations occurred because computer hacking "means to trick, circumvent, or bypass computer security in order to gain unauthorized access to computer systems…" *Id*. at *23. The hacker either uses a false identification to masquerade as another user or exploits a weakness in an electronic code to cause it to malfunction.

The second circuit went on to note that "[a]bsent a controlling precedent that 'deceptive' has a more limited meaning than its ordinary meaning, we see no reason to complicate the enforcement of Section 10(b) by divining new requirements." Since the district court did not determine whether the ordinary meaning of deceptive covers computer hacking as argued by the SEC, the case was remanded for further proceedings.

Aggressive enforcement

Dorozhko and *Cuban* are similar in two fundamental ways. First, both cases read *Chiarella* and *O'Hagan* as not requiring a breach of fiduciary duty. In a silence case, *Cuban* holds that an agreement incorporating certain features may supply the necessary relation between the parties, the breach of which results in Section 10(b) deception. In a misrepresentation case, *Dorozhko* raises the question of whether computer hacking is a misrepresentation that constitutes Section 10(b) deception, a question the district court will analyze on remand.

Second, both illustrate the aggressive posture of SEC enforcement in this area. *Cuban* pushes the edge regarding the kind of relationship required. In bringing the *Cuban* case, the Commission was not attempting to allege a fiduciary duty or anything similar to such a duty. Rather, the predicate for the complaint is the fact that the information is material, non-public and there is a request that it be confidential. Starting with the *Chiarella-O'Hagan* duty, *Cuban* reflects the SEC pushing the edge of the required legal obligation far down the road toward a parity of information theory. That theory of course has long been rejected. *See, e.g., Chiarella,* 445 U.S. at 233 ("neither the Congress nor the Commission ever has adopted a parity-of-

information rule."). Viewed in this context however, *Cuban* represents and aggressive effort to police insider trading which, according to the court here, went over the line in this instance. Whether that line will hold remains to be seen.

Dorozhko pushes the limits of the misappropriation theory from the other direction. In this case, the Commission pushed the edge regarding what constitutes a misrepresentation. Theorizing that an electronic break-in which tricks a computer chip to circumvent a security device is clearly a novel theory of misrepresentation. Whether this push of the limits will prove to be over the line as in *Cuban* will have to await the decision of the district court on remand.

Precautions

The aggressive posture of SEC enforcement in these two cases cannot be doubted regardless of the ultimate outcome of each action. This should serve as a caution to all issuers about the handling of material non-public information. Issuers and their directors, officers and counsel should take care to have adequate procedures for handling such information. Accordingly a careful review should be made of:

1. All insider trading policies;
2. Trading programs such as 10b-5-1 plans, including procedures for amendments;
3. Procedures for handling and restricting confidential information; and
4. Procedures for ensuring that officers and directors make the required filings.

Cuban counsels that before material non-public information is furnished to others, steps should be taken to make sure that there is an appropriate agreement in place to prevent the misuse of the information. At a minimum the company should consider including in the agreement provisions that:

1. The information conveyed under it is material, non-public and confidential;
2. The information can not be used for any purpose other than that provided in the agreement;
3. The information can not be furnished or conveyed to anyone not a party to the agreement; and
4. The recipient will not use the information for personal purposes or trade in the securities of the company until the information becomes public.

This is a publications of SECACTIONS.com. For further information please contact Thomas O. Gorman. He will be pleased to discuss this matter or other securities issues with you or provide a presentation on SEC enforcement or securities litigation topics for you and your company. He can be contacted at 202-778-2004 or at tgorman@porterwright.com

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