

Notes and Comments

A MAVERICK ACHIEVES SOMETHING NOBLER THAN SIMPLE REBELLION: WHY SHARESLEUTH IS LEGAL UNDER SECTION 10(b) AND RULE 10b-5, AND WHY IT SHOULD REMAIN THAT WAY

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The whole world loves a maverick and the whole world wants the maverick to achieve something nobler than simple rebellion.†

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† KEVIN PATTERSON, *THE WATER IN BETWEEN: A JOURNEY AT SEA* 63 (1999).

INTRODUCTION

In 2006, Mark Cuban, the mercurial owner of the Dallas Mavericks NBA franchise, announced his most contentious enterprise to date: Sharesleuth.com. Controversy was nothing new to Cuban, who propelled his technology startup Broadcast.com through a legendary 1998 IPO,¹ sold it to Yahoo! for \$5.7 billion the following year,² and subsequently founded a number of hotly followed entrepreneurial ventures.³ In addition to Sharesleuth, his current holdings include HDNet, HDNet Films, 2929 Entertainment, Magnolia Pictures, and Landmark Theaters.⁴ Sharesleuth, however, has proved itself unique. Sharesleuth's mission, though ambitious, is fairly benign on its face: it seeks to provide independent reporting aimed at exposing securities fraud and corporate malfeasance to an online audience.⁵ Cuban hired award-winning *St. Louis Post-Dispatch* reporter Christopher Carey to manage the website⁶ and promised to adopt an anti-fraud, pro-investor stance as the site's foundational journalistic strategy. Cuban heralded Sharesleuth as a new model for Internet journalism and a formidable threat to crooked executives. There was only one catch: Cuban revealed that, in an effort to make the project financially viable, he would take positions in securities on the basis of malfeasance that Carey uncovered prior to publication of those findings.⁷ "There are a million ugly stories in the financial underground. We plan on finding and sharing and profiting from them."⁸ Within moments of the announcement, those listening carefully might have heard a curious sound: the voices of many a secu-

¹ See David Barboza, *Broadcast.com Soars in Opening Day Frenzy*, N.Y. TIMES, July 18, 1998, at D1 (reporting that on July 17, 1998, shares of Broadcast.com more than tripled in value—the largest opening day gain in the history of Wall Street at the time).

² Andrew Ross Sorkin, *Wheeling, Dealing and Reeling*, N.Y. TIMES, Dec. 31, 2006, at 31.

³ See, e.g., 2929 Entertainment, <http://www.2929entertainment.com> (last visited Dec. 28, 2008); HDNet, <http://www.hd.net> (last visited Dec. 6, 2008); IceRocket, <http://www.icerocket.com> (last visited Dec. 6, 2008); see also Mark Glaser, *Mark Cuban's Sharesleuth Takes Business Reporting to Ethical Edge*, MediaShift, Aug. 22, 2006, http://www.pbs.org/mediashift/2006/08/digging_deepermark_cubans_shar.html. Cuban's aggressive disposition has been parodied on a number of occasions by the satirical newspaper *The Onion*. See, e.g., *Mark Cuban Buys Sports*, THE ONION, July 10, 2008, http://www.theonion.com/content/news/mark_cuban_buys_sports; *Mark Cuban to New Maverick Jason Kidd: 'I'm Open'*, THE ONION, Feb. 28, 2008, http://www.theonion.com/content/news_briefs/mark_cuban_to_new_maverick. Cuban even lent his voice to a parody of his disposition on the celebrated satirical television program *The Simpsons* during the 2008 season. Dan Snierson, *'The Simpsons': Denis Leary, Julia Louis-Dreyfus Among Next Season's Guest Stars*, EW.COM, July 2, 2008, <http://hollywoodinsider.ew.com/2008/07/simpsons-castin.html>.

⁴ Sharesleuth.com, *Who We Are / Staff*, <http://sharesleuth.com/staff.html> (last visited Dec. 6, 2008).

⁵ Sharesleuth.com, *About*, <http://sharesleuth.com/about.html> (last visited Dec. 6, 2008).

⁶ Sharesleuth.com, *supra* note 4.

⁷ Mark Hogan, *Cuban's Maverick Stocks Site*, BUSINESSWEEK.COM, June 16, 2006, http://www.businessweek.com/investor/content/jun2006/pi20060615_872931.htm.

⁸ *Id.*

rities lawyer, financial journalist, and market analyst asking in unison, “Can he do that?”

This Comment examines the legality of Cuban’s Sharesleuth venture and demonstrates that Cuban has not engaged in any illegal activity. Part I briefly describes the Sharesleuth business model, its publications to date, the contemporary legal standards for insider trading through an analysis of the doctrinal development of Section 10(b) and Rule 10b-5 under the Securities Exchange Act of 1934, and the arguments cited by Sharesleuth’s critics. Part II defends the legality of Sharesleuth’s business model on the basis of the Supreme Court’s precedent applying Section 10(b) and Rule 10b-5, and concludes that Sharesleuth does not constitute stock manipulation, does not contain misrepresentation or omission, and does not contain findings that qualify as material, nonpublic information. Part III examines whether the Securities and Exchange Commission can prohibit Sharesleuth’s behavior and concludes that it cannot. Part IV examines whether the SEC should regulate Sharesleuth in light of market efficiency considerations and concludes that it should not. A brief conclusion follows.

This Comment offers a novel treatment of the intersection between insider trading law and for-profit online journalism. While much has been written about Cuban and Sharesleuth in the blogosphere,⁹ this is the first treatment of the issue in a scholarly forum. In addition to the attention this analysis pays to a contemporary issue that may give rise to litigation in the future, it also enjoys broader significance in light of the public interest surrounding insider trading cases.¹⁰

I. BACKGROUND

A. *What Is Sharesleuth?*

Sharesleuth describes itself as a “grand experiment”—an independent Internet website “aimed at exposing securities fraud and corporate chicanery.”¹¹ However, the site is a reasonably bare-bones example of the modern blog—one of millions currently available on the Internet.¹² Carey’s wife

⁹ “Blog” is a portmanteau of the term “web log.” “Blogosphere” is a collective term encompassing all blogs on the World Wide Web. Wiktionary—blog, <http://en.wiktionary.org/wiki/blog> (last visited Dec. 6, 2008); Wiktionary—blogosphere, <http://en.wiktionary.org/wiki/blogosphere> (last visited Dec. 6, 2008).

¹⁰ The SEC charged Mark Cuban on November 17, 2008, with committing securities fraud by engaging in illegal insider trading in the securities of Mamma.com, Inc. Complaint, SEC v. Mark Cuban, No. 3-08-CV-2050-D (N.D. Tex. Nov. 17, 2008). The allegations are unrelated to his relationship with Sharesleuth.

¹¹ Chris Carey, Welcome to the Jungle, Sharesleuth.com, July 1, 2006, http://sharesleuth.com/2006/07/welcome_to_the_jungle.html.

¹² As of October 2008, Technorati, known for its analysis of trends involving blogs and blogging, was tracking 112.8 million blogs. See Technorati, <http://technorati.com/about/> (last visited Dec. 6, 2008). Much like The Huffington Post offers an aggregation of syndicated columnists and moderated

designed the webpage using a standard blog template,¹³ which Yahoo! hosts for a monthly fee of \$19.95.¹⁴ All told, the website's annual operating budget in 2007 was just under \$250,000.¹⁵

What distinguishes Sharesleuth from other blogs is its business model. Unlike the vast majority of websites operated for profit, the site neither sells space for advertising nor seeks to generate web traffic to finance its operation via advertising revenue.¹⁶ Instead, Cuban finances the site by investing in and "short-selling" stock of companies Carey investigates prior to publication of his findings on Sharesleuth.¹⁷

Short-selling is a transaction in which an investor establishes a market position by selling a security that she does not own in anticipation of that security falling in price.¹⁸ Short sellers like Cuban essentially bet that a stock's price will decline and borrow that stock from a broker to sell now with the promise to purchase the stock later to return to the broker. If Cuban bets correctly and the stock price falls after his sale of the borrowed stock, he realizes profit by returning the stock to the broker at a lower cost than he sold it.¹⁹

Under a short-selling investment strategy, the attractiveness of possessing advance knowledge of reports that have a high likelihood of driving a stock's price down upon publication is considerable. Cuban reviews and approves all of Sharesleuth's exposés before they are posted online, and therefore enjoys a unique opportunity to realize profit at lower risk than if he lacked compelling predictive knowledge about how a stock's price might move.²⁰ What matters from a fiscal perspective, therefore, is that the information reported is circulated widely enough to depress the price of the

news content, and The Volokh Conspiracy presents an analysis of developments in the legal system, Sharesleuth provides investigative reports on securities fraud and corporate malfeasance. *See generally* The Huffington Post, <http://www.huffingtonpost.com> (last visited Dec. 6, 2008); The Volokh Conspiracy, <http://volokh.com> (last visited Dec. 6, 2008).

¹³ Patricia B. Gray, *The Takedown Artist*, WIREd, Oct. 2007, at 136 (pointing out that the site is comprised of little more, in terms of adornment, than blocks of black and red text against a white background with occasional interruption by a digital photograph to illustrate the material explicated in each piece).

¹⁴ *Id.* at 145.

¹⁵ *Id.*

¹⁶ Sharesleuth draws upwards of 40,000 unique visitors per day in the week following an exposé. *Id.* at 140.

¹⁷ *Id.* at 138.

¹⁸ JOHN C. COFFEE, JR., JOEL SELIGMAN & HILLARY A. SALE, *SECURITIES REGULATION* 20 (10th ed. 2007).

¹⁹ Suppose, for instance, that Cuban borrowed 100 shares of XYZ stock from a broker and then entered into a short sale transaction at the current market price of \$10 a share. Cuban anticipates that the stock's value will soon drop to \$8. If this market drop occurs, Cuban buys back the stock on the market and returns the borrowed XYZ shares to the broker. He will earn \$2 on each share he borrowed, giving him a total profit of \$200 (excluding transaction fees).

²⁰ Gray, *supra* note 13, at 140 (noting that while Cuban has waffled publicly on profit to date, there is reason to believe that he has earned around \$150,000 from his short positions).

shorted security.²¹ The project's continued fiscal viability depends on Sharesleuth's ability to move the market by publishing consistently compelling exposés of overpriced companies.²² It is this unusual twist on the traditional short-selling model that has drawn ire from some corners of the legal community.²³ Carey and Cuban disclose their business model on the website and embed specific disclosures relating to trades in applicable stories.²⁴ However, these measures have failed to satisfy Cuban's critics who question the overall legality of the endeavor.

Sharesleuth did not set out to redefine the relationship between journalism and strategic investment. Carey, disenchanted with traditional newspaper reporting due to its limitations,²⁵ initially intended to create the website in response to what he perceived as the impending marginalization of investigative business reporting in print journalism.²⁶ During his seventeen-year tenure at the *St. Louis Post-Dispatch*, Carey had cultivated an impressive journalism resume. He received acclaim for a series he produced on global stock fraud in 2004,²⁷ was a finalist in 2005 for the Gerald Loeb Award—business journalism's highest honor—and completed a journalism fellowship at the University of Michigan.²⁸ Over the years, Cuban had written extensively about many of the same stock fraud issues on his own blog, *Blog Maverick*.²⁹ It seemed to Carey that Cuban was a compatible philosophical match³⁰ for a project aimed at exposing commercial fraud through diligent investigation.

Carey envisioned the site as a fully integrated, multimedia-rich journalism resource that would disseminate investigative reports on companies engaged in fraud—the type of work that is largely on the decline at major magazines and business publications.³¹ When approached to fund the venture, Cuban suggested the concept of marketing the site as a subscription

²¹ *Id.*

²² *Id.*

²³ See *infra* Part II.C.

²⁴ See, e.g., Chris Carey, *Xethanol Corp.*, Sharesleuth.com, Aug. 7, 2006, http://sharesleuth.com/2006/08/moonshine_blindness.html (“Mark Cuban, the majority member of Sharesleuth.com LLC, sold short 10,000 shares of Xethanol's stock at a time when the price was around \$12.65. Cuban has also sold short about 25,000 shares of UTEK Corp. (UTK: AMEX), a Florida company that is a large Xethanol shareholder.”).

²⁵ Gray, *supra* note 13, at 143 (“Newspapers have abandoned their mission [W]e've taken it on at *Sharesleuth*.” (quoting Chris Carey)).

²⁶ *Id.*

²⁷ See STLtoday.com, Special Reports—Stock Fraud, <http://www.stltoday.com/stockfraud> (last visited Dec. 6, 2008).

²⁸ Hogan, *supra* note 7.

²⁹ See, e.g., Mark Cuban, *Naked Shorting—The Real Bad Guys*, *Blog Maverick*, Feb. 15, 2006, <http://www.blogmaverick.com/2006/02/15/naked-shorting-the-real-bad-guys/>.

³⁰ Gray, *supra* note 13, at 143.

³¹ Glaser, *supra* note 3; E-mail from Chris Carey, Editor and President, Sharesleuth, to Author (Sept. 17, 2008, 18:15:00 CST) (on file with author).

service “newsletter” for money managers and traders.³² However, it quickly became apparent that relying on subscriptions for revenue generation in the absence of an established track record was not a viable business model.³³ The pair ultimately devised a plan: Carey would investigate target corporations to expose corporate malfeasance from an anti-fraud, pro-investor perspective,³⁴ while Cuban would fund the site and its future expansion with proceeds from short positions taken prior to publication.³⁵

B. *What Has Sharesleuth Accomplished?*

In August 2006, Sharesleuth launched with a damning exposé of Xethanol Corp.,³⁶ a New York corporation with principal operations in Iowa, which purported to have developed technology to produce ethanol, a clean-burning, highly efficient fuel source derived from cellulose,³⁷ a carbohydrate found in the cell walls of plants.³⁸ Xethanol also claimed that it had developed a process by which ethanol could be culled from a multitude of unlikely sources, including garbage, old newspapers, and even stale butterscotch candy.³⁹ In addition, Xethanol advertised plans to open plants on the East Coast to derive ethanol from paper milling refuse at an anticipated production rate of 100 million gallons per year.⁴⁰ “Where there’s muck, there’s money,” quipped CEO and founder Christopher d’Arnaud-Taylor, who projected revenues of \$15 million in 2006—a significant increase above revenues of \$2.5 million in 2005.⁴¹

In early 2006, Xethanol experienced a significant increase in its stock price due in large part to President George W. Bush’s State of the Union Address, which announced a federal initiative to develop technology for production of cellulosic ethanol from agricultural materials.⁴² In light of the

³² E-mail from Chris Carey, *supra* note 31.

³³ Hogan, *supra* note 7; E-mail from Chris Carey, *supra* note 31.

³⁴ Hogan, *supra* note 7; E-mail from Chris Carey, *supra* note 31.

³⁵ Gray, *supra* note 13, at 143; E-mail from Chris Carey, *supra* note 31.

³⁶ *See* Carey, *supra* note 24.

³⁷ Gray, *supra* note 13, at 136.

³⁸ THE MERRIAM-WEBSTER DICTIONARY 115 (2004).

³⁹ Justin Martin, *Six Hot Innovations*, CNNMONEY.COM, Feb. 9, 2006, http://money.cnn.com/2006/02/08/magazines/fsb/nextlittle_xethanol/index.htm.

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² President’s Address Before a Joint Session of the Congress on the State of the Union, 42 WEEKLY COMP. PRES. DOC. 5 (Feb. 6, 2006) (“So tonight, I announce the Advanced Energy Initiative—a 22-percent increase in clean-energy research—at the Department of Energy, to push for breakthroughs in two vital areas. To change how we power our homes and offices, we will invest more in zero-emission coal-fired plants, revolutionary solar and wind technologies, and clean, safe nuclear energy. We must also change how we power our automobiles. We will increase our research in better batteries for hybrid and electric cars and in pollution-free cars that run on hydrogen. We’ll also fund additional research in cutting-edge methods of producing ethanol, not just from corn, but from wood

President's proclamation, the Department of Energy announced that it would fund a percentage of the capital costs of several large cellulosic ethanol demonstration plants.⁴³ By April, Xethanol—the only publicly traded cellulosic ethanol producer at the time—saw its share price nearly quadruple against a backdrop of public anxiety about global warming and rising prices at the petroleum pump.⁴⁴ Local newspapers and trade publications reported Xethanol's contention that it would triple capacity at its Blirstown, Iowa production facility,⁴⁵ and the Associated Press reported that the company was developing a process to convert grass clippings into automobile fuel.⁴⁶

On August 7, 2006, however, Sharesleuth revealed in an online posting that individuals connected with Xethanol's secondary stock offering had been sanctioned by the SEC⁴⁷ and that its CEO, d'Arnaud-Taylor, had fabricated credentials on his resume.⁴⁸ Sharesleuth offered photographic evidence that at least one of Xethanol's facilities was in disuse and disrepair,⁴⁹ and highlighted conflicting statements from company officials that the facility was simultaneously "in use" and "being refurbished as we speak."⁵⁰ De-

chips and stalks or switch grass. Our goal is to make this new kind of ethanol practical and competitive within six years.").

⁴³ Press Release, U.S. Dep't of Energy, DOE Selects Six Cellulosic Ethanol Plants for up to \$385 Million in Federal Funding (Feb. 28, 2007), *available at* <http://www.energy.gov/news/4827.htm>.

⁴⁴ Xethanol's share price increased from \$4.17 on Feb. 6, 2006, to \$16.18 on April 18, 2006. BLOOMBERG TERMINAL DATABASE (last visited Nov. 22, 2008) (search: GNH equity HP. Note that as of October 28, 2008, Xethanol Corp. (XNL) changed its name to Global Energy Holdings Group (GNH)).

⁴⁵ Gray, *supra* note 13, at 136.

⁴⁶ *Id.* at 138.

⁴⁷ Carey, *supra* note 24 ("At Xethanol, we discovered that the shareholders whose names appeared in the company's SEC filings over the past year and a half included no fewer than eight current or former stock brokers who have been the subjects of disciplinary actions by the Securities and Exchange Commission, the National Association of Securities Dealers or other regulatory bodies. One of the five biggest shareholders in Xethanol when it went public last year was William Scott Smith, who was charged by the SEC in 1995 with defrauding investors in a Denver-based shell company called Melbourne Capital Corp. The SEC said that Smith installed his nephew and two friends as officers and directors of Melbourne Capital, and that the group—at Smith's direction—misused or misappropriated 70 percent of the \$246,000 that the company raised from investors. The onetime stockbroker settled the charges in 1996, without admitting or denying guilt. The SEC assessed \$256,000 in financial penalties and barred Smith from serving as an officer or director of any public company. Xethanol's SEC filings refer to him as W. Scott Smith and do not mention his past. We confirmed that he was the same person by comparing address records, birthdates, Social Security numbers and other identifying information.").

⁴⁸ *Id.* (noting that d'Arnaud-Taylor's resume claims he gained "global senior corporate executive experience with multinationals including Unilever, Reed Elsevier, Northop [sic] Grumman and TKM Trading" even though "[t]wo of those companies—Reed Elsevier and Northrop Grumman—said they could find no information confirming his employment, in any capacity").

⁴⁹ *Id.* (reporting that one of Xethanol's two conventional ethanol plants, a facility it once called its Biomass Technology Center, had been idle for more than a year and no longer had water or sewer service—prerequisites for testing or production).

⁵⁰ *Id.*

spite the company's claims of possessing the cutting-edge technological capacity to produce ethanol, in two years it had spent just \$239,651 on research and development while similar companies, by contrast, had spent tens of millions annually on innovation.⁵¹ Contrary to the millions of liters of ethanol promised, its research teams had never produced more than a few liters of ethanol in a laboratory setting.⁵² Even Xethanol's original corporate name—FreeRealTime-quote.com—betrayed something less than an obvious historical commitment to the development of alternative energy sources.⁵³ The Sharesleuth post contained a disclosure that prior to or on May 12, 2006, Cuban sold short 10,000 shares of Xethanol's stock when the price was at \$12.65, and that he had also shorted 25,000 shares of UTEK Corp., a large Xethanol shareholder.⁵⁴

Sharesleuth's story was embraced by TheStreet.com,⁵⁵ a financial website that offers breaking market news and commentary,⁵⁶ which reported that its stock analysts had experienced difficulty obtaining information from Xethanol representatives.⁵⁷ An alternative energy analyst at Soleil Securities Group, Inc., an equities research and trading firm,⁵⁸ downgraded Xethanol's rating from hold-target \$10 to sell-target \$1.53.⁵⁹ By the close of business two days after Sharesleuth broke the Xethanol story, Xethanol's shares fell 24%.⁶⁰ Within three months, its shares fell from \$6.91 to \$2.90, taking with them approximately \$100 million in shareholder value.⁶¹

To mitigate the damage, Xethanol's CEO and several other members of the company's board of directors resigned.⁶² Nevertheless, shareholders filed eight class action lawsuits against the besieged company in federal court.⁶³ In September 2006, Xethanol admitted in an SEC filing that it had

⁵¹ Gray, *supra* note 13, at 136.

⁵² *Id.* at 138.

⁵³ *Id.* at 136.

⁵⁴ Carey, *supra* note 24.

⁵⁵ Melissa Davis, 'Gaping Holes' at Xethanol, THESTREET.COM, Mar. 10, 2008, <http://www.thestreet.com/newsanalysis/energy/10304136.html>.

⁵⁶ TheStreet.com, Frequently Asked Questions, <http://www.thestreet.com/tsc/commerce/faq/faq.html> (last visited Dec. 6, 2008).

⁵⁷ Davis, *supra* note 55.

⁵⁸ Soleil Securities Group, Inc., About Us, http://www.soleilgroup.com/index_aboutUs.shtml (last visited Dec. 6, 2008).

⁵⁹ BLOOMBERG TERMINAL DATABASE (last visited Nov. 22, 2008) (search: GNH equity CN).

⁶⁰ BLOOMBERG TERMINAL DATABASE (last visited Nov. 22, 2008) (search: GNH equity HP) (documenting that on August 7, 2006, XNL shares traded at \$6.91 while on August 9, 2006, the share price closed at \$5.25).

⁶¹ Gray, *supra* note 13, at 138.

⁶² *Id.*; Patricia B. Gray & Justin Martin, *A Biofuels Startup Can't Deliver on Its Promises*, CNNMONEY.COM, Feb. 13, 2007, http://money.cnn.com/magazines/fsb/fsb_archive/2007/02/01/8399939/index.htm.

⁶³ *Id.*

misrepresented the scope of its technological ability and warned that it no longer had sufficient financing to complete its research.⁶⁴

The fall of Xethanol resulted in a compelling realization of Sharesleuth's envisioned business model. Carey's report was heralded as "[d]eep, thorough, balanced, objective. Almost heroic."⁶⁵ In addition, Cuban's short position put him in the money.⁶⁶ Those who posted on the Sharesleuth website in response to the story ranged in stature from CEOs of publicly traded companies to securities regulators.⁶⁷ Xethanol claimed that Cuban was merely engaging in stock manipulation by attempting to paint the company in a negative light in order to profit when its stock tanked.⁶⁸

Since the Xethanol takedown, Sharesleuth has published three subsequent exposés.⁶⁹ In October 2006, Sharesleuth inquired into the financial relationship between UTEK and various startups, including Xethanol.⁷⁰ In June 2007, it questioned the functionality of products sold by Orthopedic Development Corp., a privately held medical-procedure marketer.⁷¹ Because that company is private, Cuban was unable to short sell shares prior to Sharesleuth's publication.⁷² And in March 2008, it published a scathing exposé of China Fire & Security Group Inc.,⁷³ a company that describes itself as "a leading total solution provider of industrial fire protection systems

⁶⁴ Gray & Martin, *supra* note 62; Xethanol Corp., Registration Statement Under The Securities Act of 1933, at 4–5 (Sept. 2006) ("The technologies which we are pursuing for ethanol production from biomass have never been utilized on a large-scale commercial basis. All of the tests which we have conducted to date with respect to our biomass technologies, have been performed on limited quantities of feedstocks, and we cannot assure you that the same or similar results could be obtained at competitive costs on a large-scale commercial basis. We have never utilized these biomass technologies under the conditions or in the volumes that will be required to be profitable and cannot predict all of the difficulties that may arise. It is possible that the technologies, when used, may require further research, development, design and testing prior to implementation of a larger-scale commercial application. Accordingly, we cannot assure you that these technologies will perform successfully on a large-scale commercial basis or that they will be profitable to us. . . . Our failure to raise capital as needed would significantly restrict our growth and hinder our ability to compete. We may need to curtail expenses, reduce planned investments in technology and research and development and forgo business opportunities.").

⁶⁵ John Carney, *Okay, Fine. But Let's Not Forget That Sharesleuth Is Actually Pretty Good*, Dealbreaker, Aug. 23, 2006, http://www.dealbreaker.com/2006/08/okay_fine_but_lets_not_forget_1.html.

⁶⁶ Carey, *supra* note 24 ("So I am short 10,000 shares of Xethanol. I would like to short more, but I haven't been able to borrow any more. I am currently in the money on the shares.").

⁶⁷ *Id.*

⁶⁸ Gray & Martin, *supra* note 62.

⁶⁹ Sharesleuth has also published a number of follow-up pieces in conjunction with broader exposés.

⁷⁰ Gray, *supra* note 13, at 145; Christopher Carey, *UTEK Corp.*, Sharesleuth.com, Oct. 25, 2006, http://sharesleuth.com/2006/10/utek_corp.html.

⁷¹ *Id.*

⁷² *Id.*

⁷³ Christopher Carey, *China Fire & Security Group, Inc.*, Sharesleuth.com, Mar. 10, 2008, <http://sharesleuth.com/a/china-fire-security-group-inc/18/>.

in China.”⁷⁴ In his blog posting, Carey described malfeasance on a scale similar to Xethanol, including “evidence of the usual suspects in pump and dumps: exaggerated resumes, disclosure issues, associations with characters of ill repute and a lot of hype combined with little evidence of a strong operating business.”⁷⁵ The story also disclosed that Cuban had taken a short position in the shares of China Fire.⁷⁶ China Fire stock plummeted by more than half following publication of the Sharesleuth exposé.⁷⁷

While some critics see Sharesleuth’s low publication volume as evidence of the project’s failure,⁷⁸ Cuban and Carey argue otherwise.⁷⁹ They have described plans to expand the operation to include four new researchers⁸⁰ to supplement an existing freelance researcher on staff, as well as an independent fact-checker to review stories and ensure that their details are correct and that their conclusions are neither false nor misleading.⁸¹ Their goal is to bolster the site with multimedia content ranging from podcasts to high-definition video.⁸²

In July 2008, Sharesleuth launched a new investor resource, Sharesleuth Matrix, which, in concert with Sharesleuth exposés, will allow readers to track the names of individuals who “pop up frequently in connection with questionable companies, or who always seem to have other issues surrounding them.”⁸³ “We think that covering in detail the backgrounds of these people will help make investors smarter,” the site proclaimed.⁸⁴ Justin McLachlan, a finalist in the Investigative Reports and Editors Awards for

⁷⁴ China Fire & Security Group, Inc., <http://www.chinafiresecurity.com/> (last visited Dec. 6, 2008).

⁷⁵ Zac Bissonette, *Mark Cuban’s Sharesleuth Attacks China Fire & Security Group Inc.*, BloggingStocks, Mar. 20, 2008, <http://www.bloggingstocks.com/2008/03/20/mark-cubans-Sharesleuth-attacks-china-fire-and-security-group-inc/>.

⁷⁶ Christopher Carey, *supra* note 73.

⁷⁷ See CFSG, Yahoo! Finance, <http://finance.yahoo.com/q?s=cfsg>.

⁷⁸ Gray, *supra* note 13, at 145. Imprecise reports estimate Cuban’s to-date-profit from short positions connected with Sharesleuth at \$150,000, though Cuban has said that “I’m not going to give you the correct number.” *Id.*

⁷⁹ E-mail from Chris Carey, Editor and President, Sharesleuth, to Author (Mar. 8, 2008, 17:03:00 CST) (on file with author) (“We have hired one full-time researcher, who has contributed to a new series of stories that will start appearing next week. As he has prior experience as a television reporter . . . we decided we didn’t need a full time videographer. We’re going to keep shooting video . . . on future investigations. . . . We still plan to hire additional researcher/writers this year to strengthen our reporting and generate additional content.”).

⁸⁰ *Id.*

⁸¹ Christopher Carey, *Almost There*, Sharesleuth.com, July 31, 2006, http://sharesleuth.com/2006/07/almost_there.html.

⁸² Gray, *supra* note 13, at 140; E-mail from Chris Carey, *supra* note 31 (“Our latest story, on a privately held oil and gas company called Energy Exploration International, is the first to incorporate video into our journalistic package.”).

⁸³ Christopher Carey & Justin McLachlan, *History and Mystery*, Sharesleuth.com, July 23, 2008, <http://sharesleuth.com/a/history-and-mystery/49/#more>.

⁸⁴ *Id.*

2007, collaborated on Sharesleuth Matrix's inaugural story,⁸⁵ and the story was fact-checked by Saar Research.⁸⁶ "The site could develop into a tremendous resource for investors," announced a Sharesleuth supporter.⁸⁷

For the site to flourish, however, it will require more than mere expansion of its existing online offerings. It will also have to respond to critics who deem the venture an illegal or borderline-illegal form of insider trading and market manipulation, along with possible challenges from the SEC.

C. *What Is the Law?*

1. *Section 10(b) and Rule 10b-5.*—An understanding of the legal implications of Sharesleuth's business model requires an explication of Section 10(b)⁸⁸ of the Securities Exchange Act of 1934, which empowers the SEC to adopt anti-fraud rules, and Rule 10b-5,⁸⁹ a rule the SEC promulgated under Section 10(b) to prohibit deceptive trading practices. While potential legal problems regarding Sharesleuth's financing arrangement stem from the claim that it constitutes insider trading, neither Section 10(b) nor Rule 10b-5 explicitly prohibits trading on the basis of material nonpublic information.⁹⁰ More succinctly, nowhere does Section 10(b) or Rule 10b-5 outline the parameters of insider trading. The courts ultimately established the parameters of prohibited conduct by interpreting Rule 10b-5. Under the aggregate doctrine developed through the caselaw, it is illegal for traders to make trades while they possess material information concerning the traded

⁸⁵ Sharesleuth.com, *supra* note 4.

⁸⁶ Carey & McLachlan, *supra* note 83.

⁸⁷ Bissonnette, *supra* note 75.

⁸⁸ Section 10(b) of the Securities Exchange Act of 1934 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (2006).

⁸⁹ Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2007).

⁹⁰ See Ray J. Grzebielski, *Why Martha Stewart Did Not Violate Rule 10b-5: On Tipping, Piggybacking, Front-Running and the Fiduciary Duties of Securities Brokers*, 40 AKRON L. REV. 55, 57 (2007).

security that has not been made public.⁹¹ “Material information” means information that a reasonable shareholder would consider important when deciding whether to invest in a certain company.⁹² This section explains the pivotal cases that together constitute the law of insider trading.

2. Cady, Roberts.—In 1961, the SEC began to expand Rule 10b-5 to encompass insider trading.⁹³ In the case of *In re Cady, Roberts & Co.*,⁹⁴ the board of directors of Curtiss-Wright Corporation voted to reduce the company’s quarterly dividend.⁹⁵ J. Cheever Cowdin, a director at Curtiss-Wright and partner at stock brokerage Cady, Roberts & Company, advised fellow Cady, Roberts partner Robert M. Gintel of the decision, and Gintel sold thousands of shares held in customer accounts in advance of the public announcement, which was followed by a predictable decline in the stock’s price.⁹⁶

In the ensuing legal action, the SEC held that trading in the open market by corporate insiders on the basis of material nonpublic information constituted a “deceptive” practice in violation of Section 10(b) and Rule 10b-5.⁹⁷

The SEC subsequently came to consider *Cady, Roberts* the quintessential “tippee” case whereby the possessor of inside information does not benefit financially from its admission, but a third party who had been tipped does. Because it deemed the information at issue in *Cady, Roberts* to be the property of the corporation, the SEC reasoned that any use by an individual for personal profit fell within the scope of Rule 10b-5 prohibitions.⁹⁸ Accordingly, the SEC established a rule of “disclose or abstain,” under which insiders must either disclose all material nonpublic information prior to trading or abstain from trading if disclosure is improper or impracticable.⁹⁹

⁹¹ LARRY HARRIS, *TRADING AND EXCHANGES: MARKET MICROSTRUCTURE FOR PRACTITIONERS* 584 (2003).

⁹² *See id.*; *see also* *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (defining an omitted fact as material when “there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote”). Materiality matters both in the investment decision and in the shareholder voting context. The definition is essentially the same, but here the investment context is what matters.

⁹³ *See In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961); *see also* JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 345 (3d ed. 2003).

⁹⁴ 40 S.E.C. 907 (1961).

⁹⁵ *Id.* at 909.

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.* (predicting that in the majority of cases, abstention would be mandatory because insiders in possession of material nonpublic information of a corporation would be precluded from disclosing it for personal gain on the basis of fiduciary duties to their employer).

3. *SEC v. Texas Gulf Sulphur Co.*—In 1968, the Second Circuit expanded the disclose-or-abstain rule in *SEC v. Texas Gulf Sulphur Co.*,¹⁰⁰ wherein the court held that investors trading on impersonal exchanges must have relatively equal access to material information and that all investors “should be subject to identical market risks.”¹⁰¹ Texas Gulf Sulfur, a geological exploration concern, discovered evidence of a sizeable ore deposit in Timmins, Ontario.¹⁰² In order to protect exclusive access to the discovery, TGS issued press releases denying rumors of the ore’s existence.¹⁰³ In the months preceding a formal announcement regarding the find, however, numerous company insiders purchased stock or stock options in TGS and tipped off outsiders who purchased stock in consideration of the likely increase in TGS’s share price.¹⁰⁴

The SEC’s successful contention that the defendant’s press releases constituted materially false and misleading communications effectively extended insider trading sanctions under Rule 10b-5 to “anyone in possession of material inside information”¹⁰⁵—anyone with direct or indirect access to material information that was not publicly available.¹⁰⁶

4. *Chiarella v. United States.*—In 1980, the Supreme Court rejected the Second Circuit’s Rule 10b-5 “equal access to material information” rationale in an attempt to narrow the scope of the disclose-or-abstain rule.¹⁰⁷ In *Chiarella v. United States*,¹⁰⁸ Vincent Chiarella, an employee of a financial printer, purchased stock in the targets of five corporate takeover bids and realized a profit of approximately \$30,000 before the tender offers were publicized.¹⁰⁹ Chiarella was convicted of Rule 10b-5 violations, and the Second Circuit upheld his conviction under the disclose-or-abstain rule articulated in *Texas Gulf Sulphur*, despite the fact that Chiarella was neither an insider nor an agent of the companies in which he took stock positions.¹¹⁰

The Supreme Court reversed, holding that anyone trading in securities must breach a fiduciary duty owed to the other party to the transaction in order to violate Rule 10b-5 for failing to disclose material nonpublic information.¹¹¹ The Court reasoned that “Section 10(b) is aptly described as a

¹⁰⁰ 401 F.2d 833 (2d Cir. 1968).

¹⁰¹ *Id.* at 851–852.

¹⁰² *Id.* at 844.

¹⁰³ *Id.* at 845.

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* at 848.

¹⁰⁶ Kevin V. Haynes, *Insider Trading Under Rule 10b-5* (ALI-ABA Course of Study, June 21–22, 2007).

¹⁰⁷ *Id.*

¹⁰⁸ 445 U.S. 222 (1980).

¹⁰⁹ *Id.* at 224.

¹¹⁰ *Id.* at 225.

¹¹¹ *Id.* at 222–224; *see also* Grzebielski, *supra* note 90, at 58.

catchall provision, but what it catches must be fraud When an allegation of fraud is based on nondisclosure, there can be no fraud absent a duty to speak.¹¹² The Court held that “a duty to disclose or abstain under § 10(b) does not arise from the mere possession of nonpublic market information,” but that the duty arises only where there exists a relationship of trust and confidence between the insider and the party opposite the trader.¹¹³ In overturning Chiarella’s conviction, the Court rejected the Second Circuit’s equal-access rationale for Rule 10b-5 because Chiarella was “a complete stranger who dealt with the sellers only through impersonal market transactions.”¹¹⁴ The charges against him, the Court concluded, amounted to the “legal effect of [his] silence.”¹¹⁵

5. *Dirks v. SEC.*—The Court further narrowed the scope of the disclose-or-abstain rule in 1983 when it clarified the circumstances under which disseminators of material nonpublic information can face liability under Rule 10b-5. In *Dirks v. SEC*,¹¹⁶ Raymond Dirks, a securities analyst, learned from a former officer of Equity Funding of America that the company had engaged in fraud.¹¹⁷ Dirks undertook an investigation of Equity Funding and presented evidence of massive fraud to the SEC and the *Wall Street Journal*.¹¹⁸ He also shared his findings with clients and investors.¹¹⁹ Prior to the SEC’s suspension of trading in Equity Funding, Dirks’s clients had sold between \$15 and \$16 million worth of the company’s stock.¹²⁰ The SEC censured Dirks for violating securities laws prohibiting insider trading, but the Supreme Court reversed in light of *Chiarella*,¹²¹ holding that there was no duty to disclose when the person who traded on inside information “was not [the corporation’s] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.”¹²² Accordingly, the Court recognized that not requiring such a fiduciary relationship would amount to “a general duty between all participants in market transactions to forgo actions based on material, non-public information.”¹²³

¹¹² *Chiarella*, 445 U.S. at 222, 226.

¹¹³ *Id.* at 235–36.

¹¹⁴ *Id.* at 232–33.

¹¹⁵ *Id.*

¹¹⁶ 463 U.S. 646 (1983).

¹¹⁷ *Id.* at 661–65.

¹¹⁸ *Id.*

¹¹⁹ *Id.* at 649.

¹²⁰ *Id.* at 670 (Blackmun, J., dissenting).

¹²¹ Haynes, *supra* note 106, at 527.

¹²² *Dirks*, 463 U.S. at 654 (alteration in original) (quoting *Chiarella v. United States*, 445 U.S. 222, 232 (1980)).

¹²³ *Id.* at 655 (quoting *Chiarella*, 445 U.S. at 233).

Thus the Court once again rejected the SEC's position of requiring equal access to material information, holding that insider trading is not characterized by "one's ability to acquire information because of his position in the market."¹²⁴ In tipping cases, the Court explained, a tippee is liable under Rule 10b-5 only if (1) the tipper breaches a duty by disclosing the information to the tippee for an improper purpose, such as direct or indirect personal benefit, and (2) the tippee knows of that breach.¹²⁵

6. *Carpenter v. United States*.—In 1987, the Court considered insider trading as it pertains to journalists, when a *Wall Street Journal* reporter leaked content from the newspaper's "Heard on the Street" column prior to publication, in contravention of *Wall Street Journal* policy.¹²⁶ In determining culpability, the Court found itself evenly divided with respect to the defendant's conviction under the securities laws, thus allowing the conviction to stand.¹²⁷ The Court affirmed that misappropriation of *Journal* proprietary information for the purposes of stock trading constituted a violation of federal mail and wire fraud statutes.¹²⁸ Although the ruling failed to explicate the defendant's liability under Rule 10b-5, it did explicitly criminalize misappropriation of information under federal fraud statutes.¹²⁹

7. *United States v. O'Hagan*.—In 1997, the Supreme Court confirmed its holdings in *Dirks* and *Chiarella*—that a fiduciary relationship between insiders and shareholders carries with it a duty to either disclose information before trading or to abstain from trading altogether¹³⁰—and updated its doctrine with respect to misappropriation theory.¹³¹ In *United States v. O'Hagan*, James O'Hagan, a partner at the law firm Dorsey & Whitney, purchased call options on stock for the Pillsbury Company while representing Grand Metropolitan PLC in advance of a tender offer for Pillsbury stock.¹³² O'Hagan sold his holdings after the tender offer was announced, which resulted in a profit of \$4.3 million.¹³³ He was subsequently convicted and sentenced to forty-one months based on fifty-seven criminal counts, including securities fraud in violation of Section 10(b) and Rule 10b-5.¹³⁴

¹²⁴ *Id.* at 657–58 (quoting *Chiarella*, 445 U.S. at 231 n.14).

¹²⁵ *Id.* at 660–61.

¹²⁶ *Carpenter v. United States*, 484 U.S. 19, 22–23 (1987) (involving petitioner R. Foster Winans, an investment-advice columnist, who revealed information to a third-party broker in exchange for a share of the return on the broker's investment in light of the information).

¹²⁷ *Id.* at 24.

¹²⁸ *Id.* at 28.

¹²⁹ Grzebielski, *supra* note 90, at 61 n.53.

¹³⁰ Haynes, *supra* note 106, at 528.

¹³¹ *United States v. O'Hagan*, 521 U.S. 642 (1997).

¹³² *Id.* at 647–48.

¹³³ *Id.* at 648.

¹³⁴ *Id.* at 648–49.

The Court held that an individual violates Section 10(b) and Rule 10b-5 when he “misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.”¹³⁵ Rule 10b-5’s deception requirement was satisfied, the Court reasoned, even though the breach of duty was *not* to someone trading securities. Instead, the Court concluded, the misappropriator breached a duty to the *source* of the information by failing to disclose his intention to use the source’s information to trade securities.¹³⁶

In reaching this conclusion, the Court relied on its prior holding in *Santa Fe Industries, Inc. v. Green*,¹³⁷ which reasoned that full disclosure precludes liability under the misappropriation theory. Because the deception necessary for the misappropriation theory involves feigned fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no deceptive device and no Section 10(b) violation.¹³⁸ In *O’Hagan*, in contrast to *Santa Fe*, the defendant did not disclose pertinent facts prior to his stock and options purchase.¹³⁹ Considering the inhibiting impact on market participation of trading on misappropriated information and the congressional purposes underlying Section 10(b), the Court concluded that it was senseless to deem O’Hagan a Section 10(b) violator if he worked for a law firm representing the target of a tender offer but not if he worked for a law firm representing the bidder. “The misappropriation at issue here was properly made the subject of a § 10(b) charge because it meets the statutory requirement that there be ‘deceptive’ conduct ‘in connection with’ securities transactions,” the Court explained.¹⁴⁰

The Court decided that the use of material nonpublic information should constitute a violation of Rule 10b-5 when a defendant owes a duty and breaches that duty to either the other trader involved in the transaction or to the source of the information.¹⁴¹ The Court opined, “Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law.”¹⁴² Trading on

¹³⁵ *Id.* at 652.

¹³⁶ *Id.* at 655–56.

¹³⁷ 430 U.S. 462, 467 (1977) (involving alleged fraudulent appraisal of a stock intended to “freez[e] out minority stockholders at a wholly inadequate price,” in violation of Section 10(b)’s prohibition of manipulative or deceptive devices (alteration in original)).

¹³⁸ *O’Hagan*, 521 U.S. at 655 (holding that under 10(b) and 10b-5, O’Hagan could not be held liable for violating the disclose-or-abstain rule because he was not an insider of Pillsbury, in whose stock he traded; thus his conviction was predicated upon misappropriation of material nonpublic information).

¹³⁹ *Id.*

¹⁴⁰ *Id.* at 659 (quoting 15 U.S.C. § 78j(b) (2006)).

¹⁴¹ Grzebielski, *supra* note 90, at 64.

¹⁴² *O’Hagan*, 521 U.S. at 658 (holding that O’Hagan breached his duty by failing to disclose his intent to purchase Pillsbury stock and options in violation of Rule 10b-5).

misappropriated information, the Court believed, has the effect of undermining the integrity of, and investor confidence in, the securities markets.¹⁴³

8. *The Law as It Stands.*—Together these cases establish three distinct circumstances that constitute unlawful insider trading under Section 10(b) and Rule 10b-5. First, a trader engages in illegal insider trading if he owes a fiduciary duty to those with whom he trades or holds a relationship of trust and confidence and does not abide by the disclose-or-abstain rule articulated in *Chiarella* and *Dirks*. Second, a trader may be liable under Rule 10b-5 if he misappropriates material information for the purposes of trading without disclosing to the owner or source of the material information that he will use it to trade. Third, in tipping scenarios, a person who conveys material nonpublic information to another party for trading purposes may be liable under Rule 10b-5 if the disclosure by the disseminator breaches a duty and is improper. If the recipient of the information knows of the breach and trades, he may also be liable.

D. What Is the Controversy?

Cuban's critics claim that if Sharesleuth predictably produces journalism that depresses stock prices—and Cuban trades on that activity by shorting the stock—then he could be subject to investigation for securities fraud by the SEC.¹⁴⁴ The SEC has not released any comment on Sharesleuth's business model, though commentators contend that the government enforcement agency is aware of the blog and will not take action against it until it establishes a track record.¹⁴⁵ While some critics allege that it is the timing of Sharesleuth's trading schedule that is problematic,¹⁴⁶ others contend that the publication plainly amounts to little more than a short-selling tout sheet.¹⁴⁷ Conventional wisdom from either perspective suggests that Cuban is engaged in illegal manipulation of the securities market.

Does a knee-jerk eristic assessment of illegal activity, however, accurately state the legality of the enterprise? In the days following Sharesleuth's Xethanol exposé, securities blogs and message boards were awash with comments both condemning and defending the venture on legal grounds. Bruce Carton, a former SEC attorney, contended on his own blog, Securities Litigation Watch, that Cuban's trading activity with respect to

¹⁴³ See *id.*

¹⁴⁴ See, e.g., Glaser, *supra* note 3.

¹⁴⁵ *Id.*

¹⁴⁶ Loren Steffy, *Cuban's Made His Agenda Crystal Clear*, HOUSTON CHRON., Aug. 11, 2006, available at <http://www.chron.com/disp/story.mpl/business/steffy/4109641.html> ("What he's trying to do is manipulate the market He's hoping the publication of that information will change the stock price It's the order in which [Cuban's] doing it that's the problem." (quoting Nancy Rapoport, former Dean of the University of Houston Law Center)).

¹⁴⁷ *Id.* ("Sharesleuth is simply a tout sheet for short sellers. It exists primarily to make a billionaire basketball maven even richer.").

Xethanol walked a precarious line that closely resembled a number of high-profile journalism-related insider trading cases.¹⁴⁸ Carton concedes, however, that trading-in-advance cases have traditionally depended on a breach of duty to the publication whose information was ultimately misappropriated for the purposes of trading.¹⁴⁹ In Sharesleuth's case, by contrast, no confidentiality policy exists that would allow the SEC to allege breach of a fiduciary duty to the publication in order to prove that insider trading took place.¹⁵⁰

Even if there is no confidentiality policy, Carton contends that Sharesleuth's model remains borderline-illegal because it has found the "previously unexploited Achilles' Heel of the insider trading laws and fired an arrow deep into it."¹⁵¹ This Achilles' Heel, Carton argues, is the fact that SEC regulations—or, more accurately, judicial interpretation of SEC regulations—do not flatly prohibit insider trading on the basis of material, nonpublic information, but rather couch the prohibition in a breach of a required duty.¹⁵² Carton believes that Sharesleuth exploits a loophole in the insider trading laws that excuses trading on material, nonpublic information if there is no legal duty not to trade.¹⁵³ While such legal insider trading scenarios have traditionally been accepted as products of nonrepeatable circumstances, Sharesleuth represents what one critic has called the first "replicable-on-demand model that avoids the insider trading laws while permitting an investor to trade on nonpublic information."¹⁵⁴

In support of this position, Carton contends that the material, nonpublic information available to Cuban by way of the Sharesleuth venture not only relates to the information actually accumulated by Carey in researching his stories—all of which is generated via due diligence from the public realm—but also to the information about which company or companies will ultimately be subject to investigation and publication on the blog: "The nonpublic element . . . is knowing the specific company about which a market-moving publication [e.g., Sharesleuth] is going to issue a report . . ."¹⁵⁵ By Carton's logic, Cuban is effectively engaged in behavior identical to that of countless defendants who have traded on the basis of market-moving information in advance of its publication and have been found liable for insider trading as a result. Although the SEC concluded in these cases that

¹⁴⁸ Bruce Carton, *Always the Maverick*, Securities Litigation Watch, June 19, 2006, http://slw.riskmetrics.com/2006/06/always_the_maverick.html; see *infra* Part III.

¹⁴⁹ Bruce Carton, *supra* note 148.

¹⁵⁰ *Id.*

¹⁵¹ Bruce Carton, *Sharesleuth.com Exposes Achilles' Heel of Insider Trading Laws*, Securities Litigation Watch, Aug. 11, 2006, http://slw.riskmetrics.com/2006/08/sharesleuthcom_exposes_achille.html.

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ Glaser, *supra* note 3.

¹⁵⁵ Bruce Carton, *What is "Nonpublic?"*, Securities Litigation Watch, Aug. 14, 2006, http://slw.riskmetrics.com/2006/08/what_is_nonpublic.html.

the publications contained no specific material, nonpublic information, it nonetheless found the defendants culpable for trading on the basis of material, nonpublic information.¹⁵⁶

Other critics disagree with Carton's analysis but contend that while Sharesleuth does not violate any prohibition on trading on inside information by virtue of the fact that neither Cuban nor Carey work inside the companies in question—and offer full transparency with respect to their trading practices—anti-fraud statutes nevertheless exist to prevent such manipulation of stock prices.¹⁵⁷

II. SHARESLEUTH'S BUSINESS MODEL IS LEGAL

Popular dissent notwithstanding, Cuban does enjoy a strong claim of legality in response to his critics and in consideration of relevant caselaw explicating the trading practices prohibited by Section 10(b) and Rule 10b-5. Cuban has not broken any securities laws because he owes no fiduciary duty to any party, the information contained in Sharesleuth is not misappropriated, and Cuban has undertaken his short positions in the light of full disclosure. Section A explains why Cuban has not violated the laws against insider trading. The remaining sections argue that Cuban has not otherwise violated Section 10(b) and Rule 10b-5's prohibition of deceptive trading practices.

A. *Sharesleuth Does Not Violate Insider Trading Precedent*

Under the disclose-or-abstain rule promulgated in *Chiarella* and *Dirks*, Cuban would be liable if he owed a fiduciary duty to those with whom he traded in light of his publication's policy. Sharesleuth, however, has enacted a policy that explicitly contradicts that model of liability: the entity has no confidentiality policy whatsoever and has offered full transparency with respect to the fact that its principal will trade on the publication's information in advance of publication. Furthermore, provided that Sharesleuth refrains from publishing information acquired via an insider or a misappropriator who meets the criteria of a tippee, the law protects and

¹⁵⁶ *Id.*

¹⁵⁷ See, e.g., Glaser, *supra* note 3 (“If you wrote scathing reports, and the stock continued to go up, and you were losing money, it would be hard to say you were defrauding somebody On the other hand, if consistently and predictably, your reports caused stocks to go down, even if you told people that, ‘by the way I shorted this yesterday,’ that could get into fraudulent behavior.”). Cuban, for his part, dismisses the criticisms: “Facts are facts. Right is its own defense. If we can uncover companies whose stock is public and that can be bought and sold and that allows us to pay for more in depth research and effort. [I’m] good with that.” Mark Cuban, *Why Journalism Matters*, Blog Maverick, May 31, 2006, <http://www.blogmaverick.com/2006/05/31/why-journalism-matters/>.

even encourages analysts to uncover corporate information and use it for trading purposes.¹⁵⁸

Because Cuban utilizes Sharesleuth as a tool for analysis to generate information on fraud and subsequently trades on that information, he is not guilty of any violation. Under *O'Hagan*, Cuban's conduct may not properly be considered misappropriation because he, as the holder of the information, has explicitly disclosed his intention to trade and therefore does not breach any fiduciary duty to the source of the information necessary for a Rule 10b-5 violation. Simply stated, he never owed a duty at all.

Under *Carpenter*, Cuban's conduct also falls short of legal culpability because no violation of confidentiality can occur when no rule requiring confidentiality exists.¹⁵⁹ In *Carpenter*, the defendant had a fiduciary duty to the *Wall Street Journal* to maintain the confidentiality of information in his column until publication. Cuban, by contrast, does not. If it is the publisher's policy that trading in advance on information that will be published later is not prohibited, it is acceptable so long as it does not qualify as market manipulation.¹⁶⁰

A lack of fiduciary duty combined with disclosure, however, does not necessarily clear Cuban from any potential liability that might arise with respect to the Sharesleuth business model. In the doctrinally flexible and frequently evolving world of securities regulation, Cuban must also respond to concerns about whether the Sharesleuth model constitutes overt stock manipulation or artificial depreciation of stocks.

B. *Sharesleuth Does Not Result in Stock Manipulation*

Section 10(b) of the 1934 Act prohibits manipulative or deceptive conduct in connection with trading in securities.¹⁶¹ In the context of securities trading, "manipulative conduct" is understood as a term of art.¹⁶² The Supreme Court has defined manipulative conduct as conduct that is intended

¹⁵⁸ See *Dirks v. SEC*, 463 U.S. 646, 654–59 (1983). Sharesleuth maintains that publishing insider information is not a part of its business model. See E-mail from Chris Carey, *supra* note 31 ("[W]e would never use material, nonpublic information from any source who could be deemed an insider as the basis for a story on a company in which Mark also had an investment position. We would either take a pass on the story, or ensure that no one connected to Sharesleuth traded on the information.").

¹⁵⁹ Even R. Foster Winans, the defendant in *Carpenter*, weighed in on the Sharesleuth model in Cuban's favor: "[I]n a world of institutional thievery, hidden fees, undisclosed conflicts of interest, legal insider trading, engineered and misleading mutual fund returns, false and rigged analyst rankings, and all the other self-dealing behavior that is business-as-usual in the investment racket, Mark Cuban is by comparison a goddamned Mother Teresa." Gary Weiss, *Winans on Cuban: "At Least You Know He's Screwing You,"* The Gary Weiss Blog, Aug. 10, 2006, <http://garyweiss.blogspot.com/2006/08/winans-on-cuban-at-least-you-know-hes.html>.

¹⁶⁰ See *infra* Part II.B.

¹⁶¹ 15 U.S.C. § 78j(b) (2006).

¹⁶² Alexandra A.E. Shapiro & Robert J. Malione, *Stoneridge & The Meaning of "Deception,"* WALL ST. LAW., Oct. 2007, at 5.

to mislead investors by artificially affecting market activity.¹⁶³ Further, manipulative conduct must actually mislead investors to create liability under Section 10(b).¹⁶⁴ A finding of manipulation does not necessarily require falsity, however, and is generally understood to involve the creation of an appearance of active trading, among other things, or an attempt to increase or decrease stock prices artificially for the purposes of personal gain, even by way of truthful statements.¹⁶⁵ Regardless of whether Sharesleuth's statements are true or untrue, if Cuban attempts to affect market price artificially for personal benefit by creating a misimpression of a given company, he could be liable for stock manipulation.

Cuban claims that he is not out to manipulate the markets, comparing Sharesleuth's practices to those of many other stock traders and fund managers who offer interviews to tout their positions: "We aren't writing reports to move stock We are writing reports to report the facts. . . . If I traded on price movements, then there might be an issue. . . . I don't pump and dump [i.e., tout the stock, then sell it]" ¹⁶⁶ According to Cuban, he does not cover or sell his position in reaction to stock movement that occurs after Sharesleuth publishes an exposé.¹⁶⁷ Carey does not know what stocks Cuban shorts, when he shorts them, or in what quantities, and Cuban does not know specifically when Sharesleuth's stories will be completed.¹⁶⁸ Cuban cannot, therefore, time his trades to the publication of Sharesleuth postings, which means that Cuban's trading decisions are fundamentally predicated upon information uncovered in the course of researching target corporations.

Moreover, Cuban allegedly does not seek short-term gains after publication of stories on Sharesleuth.¹⁶⁹ To some critics, these claims defy logic and credibility insofar as Sharesleuth's profit model is concerned.¹⁷⁰ One

¹⁶³ *Santa Fe Indus. v. Green*, 430 U.S. 462, 476 (1977).

¹⁶⁴ *Shapiro & Malioneck*, *supra* note 162, at 5 (explaining that there is no Section 10(b) liability under a manipulation theory if it is not shown that the defendant's conduct creates an unfulfilled expectation in others).

¹⁶⁵ *See, e.g.*, *SEC v. U.S. Envtl., Inc.*, 155 F.3d 107, 110–12 (2d Cir. 1998) (stating that "deception" does not require any misstatement or omission); *United States v. Mulheren*, 938 F.2d 364, 368–69 (2d Cir. 1991).

¹⁶⁶ *Glaser*, *supra* note 3.

¹⁶⁷ *Id.*

¹⁶⁸ E-mail from Chris Carey, *supra* note 31 (quoting Mark Cuban: "The trades are based on the fundamentals uncovered, not on the story being published.>").

¹⁶⁹ *Glaser*, *supra* note 3.

¹⁷⁰ *The Motley Fool*, for example, points out: "[O]ur understanding of [Sharesleuth's] strategy was that Mr. Cuban would short these stocks to zero or until resolution of the problems that prompted the Sharesleuth report. For example . . . Mr. Cuban remains short Xethanol and has profited as that stock has dropped from \$12.65 per share to just \$0.47 today. In the case of China Fire, however, an updated post of *Sharesleuth* reveals that Mr. Cuban 'has no position in any of the stocks mentioned in this story.' In other words, he's already covered his short . . . a mere four months after Mr. Carey's attack on the company was published. The stock certainly hasn't gone to zero and Brian Lin remains the company's

might reasonably inquire: If Cuban holds short positions in failing companies for the long term, how is Sharesleuth expected to cover its operating costs? Cuban claims that short-term profit does not factor into the model's calculus: "Hopefully I never have to cover [my short trades], if the quality of work is good and we uncover more companies and situations like Xethanol, the return can be lucrative."¹⁷¹

Whatever Cuban's strategy, Sharesleuth ostensibly does not depend on instantaneous generation of profit. Given the site's bare-bones overhead structure and limited staff—not to mention backing by a multibillionaire—the business model has potential to generate revenue whether Cuban covers into a depressed stock or waits for the stock to depreciate over time. While the model may limit immediate or maximum profitability, by refraining from covering into depressed share price as an institutional practice,¹⁷² Cuban has effectively insulated himself from liability for manipulation under Section 10(b).

C. *Sharesleuth Does Not Result in Material Misrepresentation or Omission*

Sharesleuth's legal viability depends on the truth of the statements it makes, even in light of a fiscal model that depends on the generation and dissemination of consistent negative information regarding short-trade targets. The quintessential securities fraud claim under Section 10(b) arises from a material misrepresentation or omission in violation of Rule 10b-5(b). If Sharesleuth publishes material misrepresentations, it exposes itself to 10b-5 liability regardless of its model of revenue generation. Critique of the Sharesleuth model, therefore, is fraught with "what if" hypothetical questions regarding avenues of conceivable liability. For example, what if Cuban shorts an investigative target and then positive information surfaces that exonerates the company? Does Sharesleuth run with the information, or does it downplay its significance to protect Cuban's potential profit?

CEO. . . . That, to us, smacks precisely of the kind of manipulation and executive enrichment at the expense of public shareholders that *Sharesleuth* itself was supposed to root out. And we have a real problem with that." Bill Mann & Tim Hanson, *Mark Cuban Should Be Better Than This*, MOTLEY FOOL, July 29, 2008, <http://www.fool.com/investing/international/2008/07/29/mark-cuban-should-be-better-than-this.aspx>. Chris Carey rejects these contentions, stating: "A few Internet posters have noted that shares of China Fire and Security dropped noticeably in the week preceding the publication of our story on the company, and suggested that the drop was evidence that Mark was shorting shares in advance of our posting. Not true. Mark took his short position late last year, when we initially identified problems with China Fire's reverse merger deal and SEC disclosures I believe that the stock dropped because someone who knew the story was coming dumped shares." E-mail from Chris Carey, *supra* note 31.

¹⁷¹ Glaser, *supra* note 3.

¹⁷² Mark Cuban, *Afterward* to Carey, *supra* note 24 ("My intention is not to cover based on any short-term swing in the price of either stock. I will stay short until there is a material change in the operations of either company. My goal is to never have to cover.").

Carey maintains that Cuban's trading decisions will not affect the focus or content of his reporting. While critics lament the nontraditional nature of Sharesleuth's business structure, Carey and Cuban insist they "are viewing this as a traditional journalistic enterprise" and that their "stories are going to be based on facts."¹⁷³ In Carey's words, "Let's face it, when you write these kinds of stories, it's pretty high-risk stuff. You need to be right—otherwise you're likely to get sued."¹⁷⁴

Naysayers, however, abound, and the persistent buzz surrounding Sharesleuth could contribute to potential future liability. For instance, James Doulgeris, CEO of Orthopedic Development Corporation, currently under investigation by Carey, says that the Sharesleuth article about the company contains "some very small basic facts wrapped up in lies and mischaracterizations."¹⁷⁵ If claims like Doulgeris's are true, as a general rule, Cuban and Carey both could be subject to securities-fraud liability under Section 10(b) for misrepresentation.¹⁷⁶

Cuban, however, has left little to legal chance. Following an interview with *Report on Business Television*,¹⁷⁷ which questioned who would be monitoring Carey's behavior in light of his dual role as reporter and editor,¹⁷⁸ Sharesleuth's launch was delayed along with its report on Xethanol in order to hire an independent fact-checker to review Carey's stories and to ensure that his research was correct and that his conclusions were neither false nor misleading.¹⁷⁹ While the involvement of an independent fact-checker will not provide immunity from Section 10(b) liability if facts contained in a Sharesleuth story are ultimately deemed untrue, it does add a layer of insulation to ensure that mistruths are not published in the first place.

D. Sharesleuth Does Not Rely on Misappropriated Material, Nonpublic Information

Cuban could also be liable under Section 10(b) if the information on which he trades may properly be considered nonpublic and misappropriated.¹⁸⁰ The law prevents traders from profiting on information that is ob-

¹⁷³ Hogan, *supra* note 7 (quoting Christopher Carey).

¹⁷⁴ *Id.* (quoting Christopher Carey).

¹⁷⁵ Gray, *supra* note 13, at 145.

¹⁷⁶ See KENNETH J. BIALKIN, THE 10b SERIES OF RULES 7-9 (1975) (explaining that the quintessential elements of a 10b-5 cause of action include: (1) a misrepresentation of fact, (2) which is knowingly and consciously false, (3) where the defendant intended to deceive and the plaintiff was the intended target of that deception).

¹⁷⁷ *Report on Business Television* (BNN broadcast July 28, 2006).

¹⁷⁸ Chris Carey, *Almost There*, Sharesleuth.com, July 31, 2006, http://sharesleuth.com/2006/07/almost_there.html.

¹⁷⁹ *Id.*

¹⁸⁰ This Comment discusses two types of misappropriation. Above, it discussed a misappropriation theory involving information that the defendant was allowed to possess, but where use of the informa-

tained through misappropriation.¹⁸¹ Litigation under this rule frequently has focused on traders who improperly obtain information written for publication and trade on that information before it is published. A number of individuals have been prosecuted under this theory for stealing pre-publication copies of *BusinessWeek* in order to trade in advance of information to be published in its “Inside Wall Street” column.¹⁸²

In a similar action, on November 1, 2005, the SEC filed suit against employees Kristjan Lepik and Oliver Peek of Lohmus Haavel & Viisemann for generating \$7.8 million in illegal profits during a ten-month period between January and November of that year via trades conducted on the basis of financial information gathered surreptitiously by a spider, an automated data-mining tool.¹⁸³ The spider collected information from more than 360 not-yet-published press releases issued by more than 200 public companies from a leading commercial distributor of business news, *Business Wire*.¹⁸⁴ The SEC alleged that the defendants violated Section 10(b) and Rule 10b-5.¹⁸⁵

Observers have posited that, on the basis of this successful SEC action, Cuban might be liable under a similar misappropriation theory. Unlike Winans in *Carpenter*, Lepik had no fiduciary duty to *Business Wire* that could create liability if breached. Like Winans, Lepik was not an insider of the company on whose information he traded.¹⁸⁶ And while Lepik traded on corporate information and Cuban did not, information obtained by Carey

tion in violation of the policies of the owner of that information constitutes misappropriation. This section discusses a misappropriation theory in which the stealing of information constitutes misappropriation. While the legal implications are the same, the distinction is relevant.

¹⁸¹ HARRIS, *supra* note 91, at 587.

¹⁸² See, e.g., *United States v. Libera*, 989 F.2d 596 (2d Cir. 1993); *United States v. Falcone*, 97 F. Supp. 2d 297 (E.D.N.Y. 2000).

¹⁸³ Press Release, U.S. Sec. & Exch. Comm’n, SEC Files Emergency Action Against Estonian Traders to Stop Ongoing Fraudulent Hacking Scheme (Nov. 1, 2005), available at <http://www.sec.gov/news/press/2005-155.htm> (“Our action today demonstrates that we will seek out and stop securities fraud wherever we find it. Whether in an old-fashioned boiler room or, as in this case, in the high-tech environs of the internet, such conduct will be met with a swift and vigorous enforcement response.”).

¹⁸⁴ *Id.*

¹⁸⁵ *Id.* Daniel M. Hawke, Associate District Administrator for Enforcement of the Commission’s Philadelphia District Office, said in a statement, “We acted today to stop a clever and pernicious securities fraud. . . . This case highlights that even when fraudsters invent new ways to violate the securities laws, the Commission will track them down and stop them. . . .” *Id.* See also *Trader Settles Business Wire Case*, WALL ST. J., Aug. 23, 2006, at C3 (explaining that in 2006, Lepik settled without admitting or denying allegations that he traded on corporate information obtained through sneak peeks at information distributed by *Business Wire*); *SEC Halts Traders’ \$7.8M Hacking Scheme*, CNNMONEY.COM, Nov. 1, 2005, http://money.cnn.com/2005/11/01/markets/scandal_sec_bizwire/index.htm.

¹⁸⁶ Posting of Dave to MediaShift, <http://www.pbs.org/mediashift/2006/08/mark-cubans-sharesleuth-takes-business-reporting-to-ethical-edge234.html> (Aug. 23, 2006, 10:31).

nevertheless constitutes corporate information unavailable to the general public.¹⁸⁷

Criticisms like these miss the point, however. Lepik was culpable because he took sneak peaks at *Business Wire* information prior to publication. The information contained in the misappropriated *Business Wire* releases satisfied the definition of nonpublic information under Section 10(b) because it was, by design, isolated from the public domain, just like the information obtained in *Carpenter* and in the *BusinessWeek* cases.

Sharesleuth, by contrast, generates all of its information through its own due diligence. While its highly detail-oriented analyses may yield some information that is unavailable to the general public—if only because many analysts are unable or unwilling to dig so deep into the minutiae of SEC filings and court documents—no one could reasonably consider the resulting work product nonpublic simply by virtue of the fact that it was difficult to obtain. Additionally, in cases like *Lepik*, trading activity was also conducted in the absence of disclosure. As discussed above, Cuban's trades are conducted only after full disclosure pursuant to Sharesleuth's model in all instances.

Other observers have suggested a more nuanced approach to liability—that Sharesleuth's publications themselves constitute material, nonpublic information upon which Cuban trades in violation of Section 10(b).¹⁸⁸ This theory relies on the notion that while all of the information utilized by Carey is public, the private information—the analysis or composite of all that has been unearthed—that Carey generates and then shares with Cuban is not public, but is, instead, the nonpublic journalistic work product of Sharesleuth:

Does anyone not associated with Sharesleuth.com know which company the next Sharesleuth.com report will be about? Of course not—that's not public information. Would you like to know which company the next report is about in advance so that you could take advantage of the imminent decline in the price of that stock? You tell me.¹⁸⁹

Other commentators have agreed. In the case of Xethanol, some contended that Carey's use of photographs gleaned from on-scene reporting constituted a unique and nonpublic portrait of the company upon which Cuban made trading decisions.¹⁹⁰ The nonpublic element alleged in this scenario is the knowledge of the particular company about which a market-moving publication like Sharesleuth is going to investigate and attack.¹⁹¹ It

¹⁸⁷ *Id.* (“[S]ome will argue that Lepik traded on corporate information and Cuban did not but, it is clear by the [S]haresleuth article that the information obtained by Carey was generally corporate information . . . that would most likely be unavailable to the general public.”).

¹⁸⁸ *See, e.g.,* Carton, *supra* note 155.

¹⁸⁹ *Id.*

¹⁹⁰ *See, e.g.,* Glaser, *supra* note 3.

¹⁹¹ *Id.*

is, in essence, an argument against the use of nonpublic analysis developed from public information.¹⁹²

Countless analysts, however, produce compelling and valuable private information via painstaking analysis of public information. If such analysts base their analyses solely on information that is available to the public, the information they produce is not considered nonpublic information under Section 10(b) nor has it ever been considered nonpublic in an SEC enforcement action.¹⁹³ Trading on the basis of private work product culled from public information is how Goldman Sachs, Bridgewater Associates, D.E. Shaw, and many similar companies stay ahead of the market and legally generate profit for their investors.¹⁹⁴ To subvert Cuban's ability to trade on private information gleaned through analysis of public information would be to subvert the strategic trading practices of a host of legitimate investment concerns. The fact that hedge funds, by way of example, utilize many of the same methods as Cuban but keep their analysis private, while Sharesleuth makes its analysis public, has no bearing on liability in light of applicable precedent. The Supreme Court in *Dirks*, in fact, stressed the benefit of traders creating their own work product by way of careful analysis.¹⁹⁵ With Sharesleuth, the identity of the investigated company is not nonpublic information that should trigger 10b-5 liability when Cuban trades on it. Even if the identity of the investigated company were nonpublic information, however, Cuban still has no duty *not* to trade in light of the aforementioned insider trading doctrine. Ultimately, Cuban has no fiduciary duty to other traders, and no duty to the source of his information.

¹⁹² For example, when asked whether he would be willing to disclose what companies are currently under investigation by Sharesleuth, Carey replied, "While I can't identify the specific companies that we're currently investigating, I can give you an idea of the sectors they're in: One is an Internet company, one is a financial services company and one is a hedge fund. Not all of these stories involve short-selling prior to publication. In fact, to my knowledge, two out of three have no trading associated with them." E-mail from Chris Carey, Editor and President, Sharesleuth, to Author (Nov. 11, 2007, 11:35:00 CST) (on file with author). While the exchange appears to lend support to Carton's theory of liability, given that Cuban may know the names of these companies and can, therefore, make trading decisions accordingly while others cannot, Carton's theory of liability itself remains puzzling.

¹⁹³ HARRIS, *supra* note 91, at 585.

¹⁹⁴ Sharesleuth is somewhat distinct from these enterprises in that broker-dealers are governed by the contractual and common law rules of their organizations, and these rules preclude them from using research information to trade in advance of publication. Such conduct would constitute a clear violation of fiduciary duty. Cuban, by contrast, has no fiduciary duty and no client base, is not a broker-dealer, and is not prohibited from using such information to make trading decisions before it is widely disseminated. This distinction, however, does not speak to the shared practice of legally trading on the basis of private research product gathered from public information. In neither case may such research product be properly considered nonpublic.

¹⁹⁵ *Dirks v. SEC*, 463 U.S. 646, 658 n.18 (1983) ("Dirks' careful investigation brought to light a massive fraud at the corporation. And until the . . . fraud was exposed, the information in the trading market was grossly inaccurate. But for Dirks' efforts, the fraud might well have gone undetected longer.").

*SEC v. Switzer*¹⁹⁶ offers a compelling parallel. In 1984 the SEC brought charges against Barry Switzer, the famed football coach of the University of Oklahoma and the Dallas Cowboys, for profitably trading on the basis of information he overheard at his son's track meet in alleged violation of Section 10(b) and Rule 10b-5.¹⁹⁷ At the meet, Switzer overheard George Platt, the CEO of Phoenix Resources Company, tell his wife about the impending liquidation of the company.¹⁹⁸ Subsequently, Switzer purchased Phoenix Resources Company stock.¹⁹⁹ The court held that Switzer was not liable under Rule 10b-5 because Platt—who claimed he did not know Switzer had overheard the conversation—had violated no duty to Phoenix shareholders.²⁰⁰ Because Switzer's liability as a tippee under Section 10(b) would have been derivative of his tipper's liability, Switzer's trade was legal.²⁰¹ Cuban similarly has no fiduciary duty vis-à-vis his Sharesleuth-related trading activity, nor does he employ any manipulative or deceptive device that would constitute a violation of Section 10(b) or Rule 10b-5.

The legality of the venture notwithstanding, observers who concede that the Sharesleuth model essentially constitutes a legal form of insider trading still fear that if it succeeds in its profit model, others will attempt to replicate its success on similar websites.²⁰² The concern is that a version of what appears to be legal insider trading will be copied by others with the resources to hire an investigative journalist and the ability to generate readership on the Internet.²⁰³ To counteract the supposed proliferation of legal insider trading, these observers have recommended regulation by the SEC.²⁰⁴

III. THE SEC CANNOT REGULATE SHARESLEUTH

One approach the SEC could utilize to stop Cuban and Sharesleuth would be to pursue enforcement actions via an alternative theory of "deception" under Section 10(b). Because Congress did not define "deception" and the majority of Section 10(b) claims are grounded in language of misrepresentation and omission, the Supreme Court has not yet set the outer limits of liability under the term.²⁰⁵ Courts are split, however, on whether

¹⁹⁶ 590 F. Supp. 756 (W.D. Okla. 1984).

¹⁹⁷ *Id.* at 757.

¹⁹⁸ *Id.* at 761–62.

¹⁹⁹ *Id.* at 763.

²⁰⁰ *Id.* at 766.

²⁰¹ *Id.* at 765–66.

²⁰² See, e.g., Carton, *supra* note 151; Bruce Carton, *Legal Insider Trading*, ComplianceWeek, Nov. 20, 2008, <http://www.complianceweek.com/blog/carton/2008/11/20/legal-insider-trading/>.

²⁰³ Carton, *supra* note 151.

²⁰⁴ See, e.g., *id.*

²⁰⁵ See Schapiro & Malionek, *supra* note 162, at 5. See also *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 168 (1994) (explaining the scope of liability that could arise against

the Supreme Court's 1994 holding in *Central Bank* dictates that liability under Section 10(b) extends absent an allegation that the defendant misstated or omitted material information in light of a fiduciary duty to disclose it, or if liability should extend to those parties who are involved in a scheme by which investors are misled, regardless of whether a misstatement or omission was made.²⁰⁶

While an argument for defining "deception" to encompass a trading-in-advance model could likely be made in light of contemporary vagaries surrounding its proper application and lack of clear Supreme Court precedent, such action would be unfounded in light of the foundational structure of the term. Critics such as Gary Weiss suggest that Sharesleuth publication trends betray a "slimy as all hell"²⁰⁷ propensity for reporting stories for the obvious sake of profit.²⁰⁸ But that, of course, is the whole point of the Sharesleuth venture from a fiscal perspective—to generate profit from the publication of stories.²⁰⁹ Polemics on journalistic integrity, of course, have no bearing on legality.

Such arguments also ignore the somewhat obvious fact that despite doctrinal confusion regarding the term, deception's common denominator is understood to denote conduct that is *deceptive* in nature.²¹⁰ The plain meaning of the term requires that the defendant must have engaged in some communication such that a reasonable party standing in privity was misled by the defendant's affirmative conduct.²¹¹ In the absence of such communi-

"secondary actors" in a fraud, stating that "[a]ny person . . . , including a lawyer, accountant, or bank [or, presumably, a journalist] who employs a manipulative device . . . on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5"); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 133, 151–53 (1972) (holding that while Rule 10b-5(b) is founded on making an untrue statement of material fact, 10b-5(a) and (c) are not so restricted). In light of the statute's repetition of the word "any," the *Affiliated Ute* Court held that 10(b) is meant to be broadly interpreted. *Id.* at 151 (the law should be "construed not technically and restrictively, but flexibly to effectuate its remedial purpose").

²⁰⁶ Compare, e.g., *Regents of Univ. of Cal. v. Credit Suisse First Boston (USA) Inc.*, 482 F.3d 372, 386 (5th Cir. 2007) (holding that an act cannot be "deceptive" under Section 10(b), even pursuant to Rule 10b-5(a) or (c), where the actor has no duty to disclose), with *In re Global Crossing, Ltd. Secs. Litig.*, 322 F. Supp. 2d 319, 335–36 (S.D.N.Y. 2004) (holding that allegations that an accounting firm "masterminded the misleading accounting" by a company were sufficient to state a claim under Rule 10b-5(a) and (c) "for behavior that constitutes participation in a fraudulent scheme, even absent a fraudulent statement by the defendant").

²⁰⁷ Gary Weiss, *Mark Cuban's Unfinished Business*, The Gary Weiss Blog, Oct. 27, 2006, <http://garyweiss.blogspot.com/2006/10/mark-cubans-unfinished-business.html>.

²⁰⁸ Following the Xethanol exposé, "Cuban disclosed some unfinished business: he had taken a short position in not just Xethanol, but also a company called UTEK, a Xethanol shareholder. The UTEK short position was 'underwater,' Cuban disclosed at the time. Well, Sharesleuth's second article has come out, and it is about a company called (surprise surprise) UTEK!" *Id.*

²⁰⁹ Cuban, *supra* note 157.

²¹⁰ Shapiro & Malioneck, *supra* note 162, at 9.

²¹¹ *Id.* at 11.

cation by way of statement or omission, conduct may not be properly considered deceptive under Section 10(b).

The question, then, becomes whether the SEC can promulgate a special rule to characterize Sharesleuth's behavior as deception in contravention of the scheme element of Rule 10b-5(a)—a measure that would, effectively, expand Section 10(b) to define certain types of trading in advance as illegal schemes. The Exchange Act empowers the SEC to make such rules and regulations as may be necessary or appropriate to implement the provisions of the Exchange Act, which includes the authority to define terms.²¹² The SEC's authority, however, is not unlimited²¹³ and is determined in large part by a process defined in *Chevron, U.S.A. Inc. v. Natural Resources Defense Counsel, Inc.*, which tests the validity of agency rules in light of congressional intent.²¹⁴ In this context, the relevant inquiry would be Congress's intended meaning of the terms “deceptive” and “manipulative” as they pertain to liability under Section 10(b).

While little history exists to identify what kind of scheme or conduct beyond misrepresentation or omission Congress envisioned as a violation of Section 10(b),²¹⁵ under the *Chevron* test, it seems that a special rule restricting fully disclosed trading in advance cases under the scheme element of 10b-5 would be invalid. Because the Exchange Act does not unambiguously define manipulation or deception, the salient inquiry is therefore predicated upon whether or not the special rule constitutes a permissible construction of the statute. Were the SEC to define “manipulation” or “deception” so broadly as to encompass Sharesleuth's behavior, however, any securities litigation in which an individual or entity's actions could be rationally described as manipulative or deceptive would have merit, regardless of whether the entity was guilty of fraud. This simply does not square with the plain language of the statute.²¹⁶

²¹² Securities Exchange Act of 1934, § 23(a), 48 Stat. 881, 901 (codified as amended at 15 U.S.C. § 78w(a)(1) (2006)).

²¹³ Allan Horwich, *The Origin, Application, Validity, and Potential Misuse of Rule 10b5-1*, 62 BUS. LAW. 913, 945–46 (2007).

²¹⁴ 467 U.S. 837, 842–44 (1983) (“First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute. . . . Rather . . . the question for the court is whether the agency's answer is based on a permissible construction of the statute.” (footnotes omitted)).

²¹⁵ Shapiro & Malione, *supra* note 162, at 4–5.

²¹⁶ In addition, such a construction would be inconsistent with the expressed intent of Congress's 1995 Private Securities Litigation Reform Act that sought to reduce meritless securities litigation brought under the Securities Act of 1933 and the Securities Exchange Act of 1934. *See* S. REP. NO. 104-98, at 10 (1995) (“In crafting this legislation, the Committee has sought to strike the appropriate balance between protecting the rights of victims of securities fraud and the rights of public companies to avoid costly and meritless litigation.”).

If the SEC did endeavor to restrict Sharesleuth through such a vehicle, it would more than likely be met with considerable friction in a court system increasingly skeptical of SEC definitions utilized to promulgate liability under special rules.²¹⁷ In *Goldstein v. SEC*, for example, the D.C. Circuit took the SEC to task for definitions that it used to promulgate a restrictive hedge fund rule, which fell outside the bounds of reasonableness: “If Congress employs a term susceptible of several meanings, as many terms are, it scarcely follows that Congress has authorized an agency to choose *any* one of those meanings.”²¹⁸ As such, it also scarcely follows that any circuit court would uphold a rule expanding scheme liability to instances where no fraud has, in fact, occurred.

IV. THE SEC SHOULD NOT REGULATE SHARESLEUTH

Perhaps more important than whether the SEC *can* regulate Sharesleuth is whether, in light of efficiency concerns, the SEC *should* regulate Sharesleuth. Because Sharesleuth offers a public service to consumers of market information, its prosecution or regulation may have a negative net impact on the market even if its behavior resembles insider trading. While companies frequently hire promoters to boost share prices, there is a relative absence of journalists and regulators who endeavor to determine whether such promotional claims are ultimately grounded in truth. Sharesleuth, by contrast, offers an accessible check on the market.²¹⁹ “We don’t pretend to be *The Wall Street Journal* or *The New York Times*,” says Carey.²²⁰ “But in a world where investigative journalism is being abandoned because it is costly and risky, I think we’re doing a public service.”²²¹

²¹⁷ The SEC would also have to promulgate the rule under notice and comment rulemaking, which would most likely result in opposition from regulated parties, and it is difficult to conceive of a way that a rule characterizing *Sharesleuth*’s conduct as deceptive or manipulative would fail to implicate most hedge funds.

²¹⁸ 451 F.3d 873, 878 (D.C. Cir. 2006) (holding that the reasonableness of an agency’s construction depends, in part, on the construction’s fit with the statutory language, as well as its conformity to statutory purposes); *see also* Fin. Planning Ass’n v. SEC, 482 F.3d 481 (D.C. Cir. 2007) (holding that broker-dealers who use two fee levels or an annual fee are charging special compensation and cannot by rule be added to the exclusions in Section 202(a)(11) of the Investment Advisers Act by means of subsection (F)); Am. Bankers Ass’n v. SEC, 804 F.2d 739, 743 (D.C. Cir. 1986) (holding that a “bank” cannot be framed as a “broker” or a “dealer” for purposes of the exclusions from the definitions for “banks”).

²¹⁹ Gray, *supra* note 13, at 138 (“Sharesleuth provides some of the checks and balances that are missing in the market these days Companies can—and do—hire promoters to boost their stocks all the time, but there are fewer and fewer journalists and regulators who dig deep to find out if these companies are delivering on all their promises.” (quoting a Seattle money manager) (internal quotation marks omitted)).

²²⁰ *Id.* at 140.

²²¹ *Id.*

A. *Sharesleuth Is an Asset to Price Efficiency*

Myriad volumes have been written on the benefits of insider trading to the free market,²²² with the primary arguments in favor of the practice centering on price efficiency.²²³ The theory goes that because insiders are informed traders, the impact that their trading activity has on share price pushes prices toward fundamental values.²²⁴ Insider trading therefore makes prices more informative, which in turn leads to efficient allocation decisions and greater efficiency in production.²²⁵ “You want to give the people most likely to have knowledge about deficiencies of the company an incentive to make the public aware of that,” explained Milton Friedman, the late Nobel Laureate economist.²²⁶ Friedman argued that massive, high-profile instances of corporate malfeasance like Enron and WorldCom were not discovered because of whistleblowers. Rather, the stock market responded to sensitive, inside information about those companies’ wrongdoing, causing their stocks to tank.²²⁷ According to the Efficient Market Hypothesis, the stock market is a very effective mechanism that responds to information, and it therefore reflects all known information by way of the collective beliefs of investors about the future prospects of a stock’s price.²²⁸ A person on the inside of a company who knows about malfeasance, therefore, can make money on that information and at the same time serve the market purpose of driving down the price of the stock in order to alert other investors without requiring formal disclosure.²²⁹

²²² See, e.g., Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Howard M. Friedman, *Efficient Market Theory and Rule 10b-5 Nondisclosure Claims: A Proposal for Reconciliation*, 47 MO. L. REV. 745 (1982).

²²³ See, e.g., Ronald J. Gilson & Renier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 554 (1984). Efficient Market Theory posits that a market is efficient when prices at any time fully reflect all available information.

²²⁴ HARRIS, *supra* note 91, at 594.

²²⁵ *Id.*

²²⁶ *Power Lunch* (CNBC television broadcast Mar. 12, 2003).

²²⁷ *Id.*

²²⁸ See, e.g., Eugene Fama, *The Behavior of Stock Market Prices*, 38 J. BUS. 34 (1965) (describing how stock market prices evolve in accordance with a random walk and are therefore unpredictable); Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970) (describing the refined, and currently accepted, theory of the efficient market hypothesis); Gilson & Kraakman, *supra* note 223, at 549, 559 (explaining that market efficiency exists when prices “fully reflect all available information,” and noting that “of all recent developments in financial economics, the efficient capital market hypothesis . . . has achieved the widest acceptance by the legal culture”); Paul Samuelson, *Proof that Properly Anticipated Prices Fluctuate Randomly*, 6 INDUS. MGMT. REV. 41 (1965) (offering proof for the efficient market hypothesis); Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031, 1031 (1977) (“The empirical evidence overwhelmingly supports the hypothesis that modern American capital markets are efficient.”).

²²⁹ Gilson & Kraakman, *supra* note 223, at 630–31 (explaining how the informed trades of insiders can “derivatively” transmit information to the market as a whole).

While Cuban does not trade on the basis of inside information uncovered by Sharesleuth, the core of his trading strategy is largely identical, from an efficiency perspective, to that which Friedman describes. Carey's painstaking research into a targeted corporation uncovers fraud, publication of his research alerts the market to the wrongdoing, the company's executives are held to account for their malfeasance, and Cuban is incentivized to fund the venture in the first place.

Market information from sources like Sharesleuth also tends to be better than information available elsewhere. Short sellers have been dubbed invaluable sources of truth in a journalistic environment of consolidation and widespread institutional bias.²³⁰ For example, a short seller recently tested textiles made by Lululemon Athletica and discovered that, contrary to product tags that boast the release of "marine amino acids, minerals and vitamins into the skin upon contact with moisture"²³¹ due to the presence of seaweed, its VitaSea line of yoga and workout clothing was not made of seaweed fiber.²³² The analyst took a short position in the stock and released his findings. The *New York Times* adopted the research, conducted its own study, and confirmed the finding: "'Seaweed' Clothing Has None, Tests Show," the resulting headline declared.²³³ The exchange generated profit for the short seller, as well as a compelling lead on corporate fraud for one of the most venerable of print news sources.²³⁴

B. Sharesleuth Encourages Free Exchange of Ideas and Information

Prosecution of Sharesleuth would also have significant negative repercussions within the community of blogs and commercial sites that employ similar techniques to generate profit. Writers for such investment research tools as The Motley Fool, TheStreet.com, and Seeking Alpha frequently disclose ownership or short positions in companies about which they research and report. Draconian regulation is likely to have a chilling effect on dissemination of opinion by parties with economic interests in stocks that are discussed.²³⁵ In essence, there is a valid concern that regulation of Sharesleuth will set a precedent that will damage the free exchange of information.²³⁶

²³⁰ *Another Valuable Role for Short Sellers*, Business Law Prof Blog, Nov. 14, 2007, http://lawprofessors.typepad.com/business_law/2007/11/another-valuabl.html.

²³¹ Louise Story, *'Seaweed' Clothing Has None, Tests Show*, N.Y. TIMES, Nov. 14, 2007, at C1.

²³² *Id.*

²³³ *Id.*

²³⁴ *See id.*

²³⁵ Posting of WC to MediaShift, http://www.pbs.org/mediashift/2006/08/digging_deepermark_cubans_shar.html (Aug. 26, 2006, 17:06) ("Basically, there can be no exchange of information or dissemination of opinions among parties with economic interests in stocks discussed.").

²³⁶ *Id.* ("To be fair, it will have to kill all discourse about investing—about good companies, bad companies, long positions or short positions. All sharing of fact and opinion will have to end.").

Given that all of Cuban's trading positions are fully disclosed and the facts contained in Sharesleuth articles are true, regulation of the site would constitute an alarming manifestation of governmental mistrust of citizens' abilities to absorb and judge available information.²³⁷ This is not to suggest that all types of speech should be legal or that illegal insider trading should be protected under the First Amendment. Regulation of legal speech, however, simply because it is controversial or perceived as contrary to the goals of the regulator, is dangerous because it disincentivizes dissemination of useful information.²³⁸ The venue of expression should not dictate selective regulation. It is therefore necessary to resist any type of paternalistic regulation that would suppress free, efficient, and innovative dissemination of information through a legal vehicle such as Sharesleuth.

CONCLUSION

Ultimately, because Cuban's trading practices have been executed and will presumably continue to be executed in the absence of fiduciary duty, with full disclosure, and without reliance on misappropriated material, non-public information, arguments condemning the legality of the Sharesleuth venture are erroneous and overstated in light of Section 10(b) and Rule 10b-5 of the 1934 Act as well as applicable jurisprudence to date. While the Sharesleuth model may seem, to some, a breach of insider trading prohibitions, Cuban has effectively insulated himself from legal exposure: Sharesleuth's publications contain no apparent misrepresentations or omissions, are not predicated upon misappropriated material, nonpublic information, and are not within the commonly understood definition of "manipulation."

The SEC, however, has demonstrated a propensity toward regulation of activities that fail the agency's smell test. If it can expand the definition of "deception" or "scheme" sufficiently, it could levy an assault on Cuban's trading practices under Rule 10b-5 and throw the long-term viability of Sharesleuth and similar investment vehicles into question. The courts, however, would likely invalidate any such attempt in light of resistance to special SEC rules that fall outside of reasonableness.

Given the positive impact that Sharesleuth and its contemporaries appear to have on market efficiency and on the dissemination of

²³⁷ Cf. Martin H. Redish, *Tobacco Advertising and the First Amendment*, 81 IOWA L. REV. 589, 605–06 (1996) ("The point, in short, is that if our constitutional system allows government to control expression out of a fear that the public cannot be trusted to make proper judgments on the basis of that expression, the only remaining question concerns a determination of which potential public choices the government deems unwise. No meaningful system of free expression can flourish if government is given such a power.").

²³⁸ Cf. Martin H. Redish, *Commercial Speech, First Amendment Intuitionism and the Twilight Zone of Viewpoint Discrimination*, 41 LOY. L.A. L. REV. 67, 69 (2007) (arguing that a rationalist, intuitionist, or ideological argument against protection of commercial speech "constitutes, facilitates, or, at the very least, comes dangerously close to a constitutionally destructive form of viewpoint-based regulation").

compelling consumer information, perhaps this maverick has, indeed, achieved something nobler than simple rebellion against regulatory pressure, journalistic norms, and knee-jerk vociferation. Perhaps he has defined a new boundary for fiscally viable online publishing and a roadmap by which we may measure the future of business journalism.