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Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

A Key Ruling On Materiality In Insider Trading Cases

Law360, New York (September 16, 2008) -- The SEC's efforts to curb what it considers abuses relating to trading in Private Investments in Public Equities (PIPEs) was dealt another serious blow when the Honorable Graham C. Mullen, a federal court judge in Charlotte, North Carolina, granted John F. Mangan Jr.'s motion for summary judgment and dismissed the SEC's insider trading claim against him.

Judge Mullen, in a case of first impression, had earlier dismissed the SEC's Section 5 claim, the only other claim in the case. [Citation: SEC Fails First Test Of Section 5 Claim – Nov. 12, 2007]

The remaining claim against Mr. Mangan centered on a single stock sale for his account less than two hours before the issuer's public announcement of a PIPE offering.

While Judge Mullen's opinion suggests that it was reasonable for Mr. Mangan to believe that the announcement would have been made before his pre-opening order was executed, thus negating the SEC's scienter argument, the Judge did not decide that question, finding as a threshold matter that the information regarding the PIPE was not material as a matter of law.

In ruling on materiality, Judge Mullen had to answer two questions. First, he had to decide as of when the materiality of non-public information about the PIPE offering must be determined. Second, he had to decide whether stock price evidence was conclusive for this determination or whether other evidence raised a genuine issue of fact. The central facts of the case were not in dispute.

CompuDyne Corporation ("the Company"), a company in the public safety and security businesses, saw its shares ("CDCY") rise sharply when markets reopened after Sep. 11, 2001. The Company engaged Friedman, Billings, Ramsey & Co., Inc. ("FBR") to assist it in raising capital. Under the PIPE transaction underwritten by FBR, high net-

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worth investors on Oct. 8, 2001 contracted to buy CDCY shares at a price of $12, a 31% discount from that day's $17.38 market close.

The purchase of those shares was conditioned on the SEC first approving the registration statement, which approval, as expected, occurred several weeks later.

Mr. Mangan, a registered representative of FBR, arranged to purchase 80,000 shares in the PIPE for himself and a business partner. Before the market opened on the morning of Oct. 9, 2001, Mr. Mangan instructed his trader to sell short 25,000 shares of CDCY. The stock's price had started to slip after the previous close and plummeted in early trading, such that when the order was executed, at 9:54 a.m., it was for only $14.16. At 11:44 a.m., with the stock at $14.51, the Company publicly announced the pending PIPE transaction. CDCY closed that day at $14.25.

Arguing that the time for judging materiality was as of when Mr. Mangan instructed his trader to sell short (i.e., placed his order), before the open, the SEC urged the Court to adopt the close-to-close event window employed by its expert, who concluded that the $3.13 price drop over that 24-hour interval was statistically significant.

Mangan's expert conducted two sets of event studies. Those covering the SEC's one-day window yielded mixed results, which she found insufficient to conclude that the price drop was material.

The main reason for the experts' differing opinions on this score is that Mangan's expert used market models estimated over the weeks that followed the terrorist attacks, when volatility was high, whereas the SEC's expert used an estimation period that extended forward into months of lower volatility. Mangan's expert also presented intraday event study evidence.

Finding the drop from just before the 11:44 am announcement to that day's close—$14.51 to $14.25—to be statistically insignificant, she concluded that the PIPE news was not material when publicly disseminated.

Central to the SEC's argument about the appropriate event window was its position that news of the PIPE had leaked into the market and caused the price to decline prior to the public announcement.

The SEC, however, failed to make an adequate showing that any sales of CDCY prior to Mr. Mangan's had anything to do with information concerning the PIPE. In the absence of competent evidence of "leakage," the Court concluded that pre-trade price decline was not relevant to the issue of materiality and therefore rejected the use of the close-to-close event window.

As an aside, the Court also noted that it was illogical for the SEC to argue on the one hand that leakage had caused the pre-announcement price decline and on the other hand argue that the information was nonpublic.

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The Court found persuasive Mangan's argument that the appropriate time for determining materiality is as of the trade, 9:54 am. Citing Mangan's expert's deposition testimony that the relevant event window for such a determination extends from then to the same-day close and that price change over that interval (from $14.33 pre-trade to $14.25 at the close) was immaterial, Judge Mullen ruled that there was no materially negative movement in the price between the trade and the Oct. 9 close.

In fact, the price at which Mr. Mangan sold short, $14.16, was lower than any trade after his through the close that day, the time when both experts agreed any news of the PIPE was fully impounded into the price of CDCY stock.

While the stability of stock prices after Mr. Mangan sold was compelling evidence that PIPE-related information was not material at the time of his trade, Judge Mullen had to analyze whether that evidence was sufficient, by itself, to grant summary judgment.

Only one circuit court, the Third Circuit, has concluded that stock price movement standing alone can be determinative on the question of materiality. Judge Mullen noted that the Fourth Circuit had yet to rule on that question and in the end sidestepped answering it.

In doing so, he found unpersuasive the arguments advanced by the SEC's expert that specific terms of the PIPE, including the alleged dilutive impact of the offering and the large discount to the current market price, posed a significant risk that investors would react negatively to the news.

Judge Mullen concluded that "[s]uch expert speculation as to how the market may have perceived certain pieces of information taken out of the context of the transaction as a whole is insufficient to overcome the fact that the unbiased market of reasonable investors clearly determined that the information was immaterial."

Rather than adopting the Third Circuit view, the Court was careful to say that "on this factual record," price movement was determinative. "Because the efficient market of reasonable investors did not devalue CDCY after the trade at issue and because the SEC fails to otherwise raise a genuine issue of fact as to materiality, summary judgment in favor of the Defendant is appropriate."

Judge Mullen's opinion sets the bar for determining materiality in an insider trading case at the right mark. Arbitrarily beginning an event study at a pre-trade point in time that bears no relationship to provable, relevant facts, and isolating negative aspects of a post-trade announcement without considering the positive aspects, simply will not suffice to get the case to a jury.

The case is Securities and Exchange Commission v. John F. Mangan Jr., United States District Court for the Western District of North Carolina, Charlotte Division, 3:06CV531.

--By Cory Hohnbaum, King & Spalding LLP, and Marcia Kramer Mayer, NERA

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Cory Hohnbaum, a partner at King & Spalding, and Marcia Kramer Mayer, a senior vice president at NERA Economic Consulting, were Mr. Mangan's counsel and materiality expert, respectively, in this litigation.

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