SEC issues warning to analysts profiting from “short and distort” schemes, opens the door for civil claims

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Abstract
Purpose – To analyze the evolution of market manipulation and fraud by short-sellers and online bloggers and mechanisms available for addressing and remediating the damage caused by such fraud, including recent activity by the US Securities and Exchange Commission (the “SEC” or “Commission”).

Design/methodology/approach – This article discusses the development of a modern market manipulation and fraud scheme – the “short and distort” – including a review of potential claims by the targeted companies and anticipated impediments to asserting such claims. It further examines the need for regulation and the possibility that the SEC has opened the door for civil claims for this type of fraud.

Findings – Companies wrongfully targeted by illegitimate short-sellers may pursue claims for securities violations, defamation, business interference, securities fraud and extortion, among other claims. However, each of these claims has had, and still has, both business and legal challenges, as the short-seller’s initial defense tends to be to attempt to prove the truth of their statements to the market or establish those statements as legitimate opinion. The SEC has made the pursuit easier but there is still a long way to go.

Originality/value – This article contains valuable information about recent SEC enforcement activity and practical guidance from experienced securities lawyers.

Keywords Market manipulation, Fraud, US Securities and Exchange Commission (SEC), Short and distort scheme, Short seller, Short-selling analyst

Paper type Technical paper

Enter any company name into your favored Internet search engine and look up financial “news.” The result, more often than not, will yield the current stock price and recent articles, blogs, and posts featuring related so-called financial “analysis.” Updated daily or even hourly, these posts come from a variety of sources, some reputable and others unknown “analysts” posting under fictitious names. Amid the digital press in search results, inboxes, and social media platforms—credibility and reliability are at issue. A small handful of savvy short-sellers and possible fraudsters, posing as “analysts,” have taken advantage of this relatively unregulated digital frontier to reap hefty profits at the expense of companies and other shareholders. To be sure, the majority of short selling, including by bona fide market analysts who inject true and correct information into the marketplace based on diligent research, and properly disclose their own positions in the relevant securities, serves an important market function, helping to create an efficient marketplace. Still, there remain some unscrupulous traders who will take a short position in a company, then post, and re-post, false or distorted news (e.g., click-bate styled headlines based on some badly distorted crumb of truth or allegation) under the guise of “financial analysis,” in the hope that it will trigger a market sell-off. It sometimes works.

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Short-Sellers lurking behind anonymous pseudonyms

Negative press can cause some shareholders to immediately liquidate their long positions based on the assertions made by the purported analyst even if those assertions are not true. The resulting downward pressure, or sometimes crash, in the target company’s market capitalization and share price can be devastating. For small and micro-cap companies, particularly those whose stocks are thinly traded, this may cause reputational damage and tens of millions of dollars in harm from which the company – and thereby its shareholders – may never be able to recover (Weiner et al., 2017). For example, in July 2018, a short-seller carried out an attack against a micro-cap company alleging that it had, in part, inflated revenue through loans to related entities (Mitts, 2018). The company’s share price immediately fell 40 per cent and did not recover despite denials by the company (Mitts, 2018). Several self-proclaimed analysts have gained notoriety playing in this murky territory and building out a cottage industry that feeds on market reactions to sensationalized “reports” that are either intentionally, recklessly or negligently misleading.

“Short and distort” Schemes violate federal and state law

The so-called “short and distort” scheme may violate the Securities Exchange Act’s anti-fraud provisions, as well as SEC Rule 10b-5, just like the better known antithetical “pump and dump” scheme. It checks all the boxes:

- Misrepresentation to the market (through articles, blogs, and social media);
- Materiality (often including false statements about a company’s financial condition or viability);
- An intent to deceive (manipulating the market to create downward pressure on the share price to make a profit); and
- Connection to the purchase or sale of securities (initiating a sell-off of securities to allow the short seller masquerading as an analyst to cover its short position).

Likewise, this scheme may violate state securities and consumer protection statutes and the common law. However, until recently these illegitimate types of short-sellers targeting companies have gone largely unchecked because of the difficulty in asserting civil claims and a lack of government oversight.

SEC takes action against Short-Seller for alleged securities fraud

On September 12, 2018, the SEC filed a complaint alleging that George Lemelson and Massachusetts-based Lemelson Capital Management LLC issued false information about a company after Lemelson took a short position in the company on behalf of Amova Fund, a hedge fund he advised and partly owned. According to the SEC, as a result of Lemelson’s short and distort scheme (using written reports, interviews, and social media), the company lost more than one third of its value. The SEC alleges that Lemelson and his cohorts engaged in the following misconduct, which, if true, could be a textbook example of “short and distort” securities fraud:

Lemelson devised and carried out a fraudulent scheme in which he purchased “short positions” in the stock of Ligand Pharmaceuticals, Inc. (“Ligand”) and then sought to manipulate the stock price to make a profit. (Compl. 1).

Lemelson publicly disseminated a series of false statements about Ligand to drive down the price of the stock, while engaging in a series of purchases and sales of Ligand stock that enabled him to profit from the lowered stock price. (Compl. 1).
Lemelson wrote and published multiple “research reports” that contained false statements of material fact about Ligand and that were intended to create a negative view of the company and its value and, consequently, to drive down the price of the company’s stock. (Compl. 4). Each of Lemelson’s false statements was intended to drive down the price of Ligand’s stock [...]. None of these statements was true, none had a reasonable basis in fact, and each concerned significant aspects of Ligand’s financial condition [...]. Lemelson made each of these false statements intentionally or recklessly for the purpose of driving down Ligand’s stock price. (Compl. 5).

As Lemelson intended, the price of Ligand stock fell during his scheme to mislead investors about its value [...]. Also by that time, Lemelson had “covered” the vast majority of Amvona’s short position in Ligand generating approximately $1.3 million in illegal profits. (Compl. 8).

The SEC’s Complaint asserts three claims:

1. Fraud in the Purchase or Sale of Securities in Violation of Section 10(b) of the Exchange Act and Rule 10b-5;

2. Fraudulent, Deceptive, or Manipulative Act or Practice to Investors or Potential Investors in Pooled Investment Vehicle in Violation of Section 206(4) of the Investment Advisers Act and Rule 206(4)-8; and

3. Other Equitable Relief, Including Unjust Enrichment and Constructive Trust.

The SEC seeks injunctive relief, disgorgement, and civil monetary penalties under Section 21(d) (3) of the Exchange Act [15 USAC. § 78u(d)(3)] and Section 209(e) of the Advisers Act [15 USAC. §80b-9(e)]. These Acts provide for civil monetary penalties in a tiered structure, increasing in severity depending on whether the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and/or directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons. If the SEC is successful and given its allegations, such monetary penalties are likely to fall within the Third Tier and require an additional payment equal to the $1.3 million disgorged, for a total of $2.6 million. If successful, this case will pose a significant deterrent to would-be short selling “analysts” seeking to manipulate the market.

Indeed, the SEC has already overcome the first hurdle. On January 23, 2019, the USDC for the District of Massachusetts denied Lemelson’s motion to dismiss, finding as to Count I for violation of Section 10(b) that “the SEC has plausibly alleged that the first three of the four statements are materially false or misleading” and denying the motion to dismiss except as to the fourth statement (with leave to amend)[3]. Further, “because the claimed violations of Section 206(4) and Rule 206(4)-8 and the claim of unjust enrichment depend on the viability of the Commission’s § 10(b) claim,” the court also denied Lemelson’s motion as to Counts II and III[4].

SEC opens the door for civil claims against unscrupulous Short-Sellers

Companies wrongfully targeted by illegitimate short-sellers may pursue claims for securities violations, defamation, business interference, securities fraud and extortion, among other claims. However, each of these claims has had, and still has, both business and legal challenges, as the short-seller’s initial defense tends to be to prove the truth of their statements to the market. Making a difficult case worse, companies must contend with public policy disfavoring restrictions on free speech, in particular anything that could be classified as “news.” This public policy includes anti-SLAPP laws which might be used to prevent companies from developing evidence to support their claims against the short sellers. Claims of fraud also require particularity in their pleading based on specific allegations, which may put companies at a disadvantage when short sellers post under anonymous Internet handles. If a claim is brought under the federal securities laws, the
Private Securities Litigation Reform Act (the “Reform Act”) stay (under 15 USA Code § 78u-4(b)(3)(B)) also prevents discovery into these evidentiary facts while a motion to dismiss is pending. Despite these challenges, wrongfully targeted companies can and are fighting back, and there have been some successes. For example, Lennar Corp., which was the subject of a short and distort campaign conducted by a developer and his associate (causing Lennar’s market cap to decline by nearly half a billion dollars), brought suit for extortion and defamation (Collins, 2013). Lennar was awarded a $1 billion judgment, with the defendant also convicted on criminal charges (Collins, 2013).

Challenges remain but targeted businesses are taking action

There are hundreds of anonymous short and distort attacks every year, which cause billions of dollars in damage (Mitts, 2019). Yet, despite the challenges to pursuing short-sellers for fraud in connection with sensational and defamatory articles and blog posts, there is a growing sentiment against such bad actors and a will to pursue them in litigation. In Farmland Partners Inc. v. Rota Fortunae, et al., No. 1:18-cv-02351, filed in the USDC for the District of Colorado, Farmland brought a civil action against the defendant “for its intentional and malicious scheme to manipulate the securities markets to secure a quick and illegal financial windfall by disseminating false and misleading statements about Farmland Partners.” Complaint (Doc. 3). “Defendant’s false and misleading statements, which [ ] caused reputational and monetary harm to Farmland Partners, were made as part of a ‘short and distort’ campaign to disparage Farmland Partners and profit from trades with legitimate investors as they digested the falsehoods disseminated by [Defendant].” Id. This matter is on-going and Defendant Fortunae is currently seeking dismissal on procedural grounds – while also objecting to disclosure of the “person behind the curtain.” Farmland is representative of the level of frustration and damage from these schemes that are pushing companies to pursue unknown short sellers and anonymous analysts, as well as the challenges of pursuing such claims.

SEC action is a warning to would be fraudsters

Short of legislative intervention the SEC is best positioned to pursue this fraud. Indeed, the SEC may have been late to the game but the Lemelson enforcement action is a warning shot to other would-be short and distort analysts posting false and defamatory news in the hope of a financial windfall. The US District Court for the District of Massachusetts has the opportunity in Lemelson to define the line between fair and honest reporting, on the one hand, and distortions of the truth and unsubstantiated allegations, on the other, which if published amount to securities fraud. By its actions, the SEC also further opens the door for defrauded companies and investors who have been, or may be, targeted by short and distort schemes to pursue civil litigation to recover their damages. Prior difficulties in identifying the real person behind an online alias or obscure entity (the veritable person-behind-the-curtain), may be made easier with the interest of, or assistance from, the SEC. Companies and private investors may also be more willing to pursue such actions, knowing that the SEC or other regulators will likewise pursue bad actors in separate civil or criminal proceedings.

Notes

1. Lemelson Capital made no secret of the fact that it held a short stake in Ligand.
4. Id. at 5.
References


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