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, primacy and recency have become more important than credibility and reliability. 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 short positions, 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 (eg, buzz-feed styled headlines based on some badly abused crumb of truth or allegation) under the guise of “financial analysis,” in the hope that it will trigger a market selloff. It sometimes works.

**Short sellers lurking behind anonymous pseudonyms**
Negative press causes many 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 crash in the target company’s market capitalization and share price can be devastating. For small and mid-cap companies, 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. For example, in July 2018, a short seller carried out an attack against a company alleging that it had, in part, inflated revenue through loans to related entities. The company’s share price immediately fell 40 percent and did not recover despite denials by the company. 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, negligently or recklessly misleading.

Short-and-distort schemes violate federal and state law

The so-called short-and-distort scheme may violate the Securities Exchange Act 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: (1) misrepresentation to the market (through articles, blogs and social media); (2) materiality (often including false statements about a company's financial condition or viability); (3) an intent to deceive (manipulating the market to create downward pressure on the share price to make a profit); and (4) connection to the purchase or sale of securities (initiating a selloff of securities to allow the short seller turned analyst to cover their short position). Likewise, this scheme may violate state securities and consumer protection statutes and common law.

However, 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 – until now.

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 the Lemelson defendants 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. and then sought to manipulate the stock price to make a profit.
- 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.
- Lemelson authored 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.
- 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.
- 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.

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, against the Lemelson defendants for misleading investors in the Amvona Fund; and (3) other equitable relief, including unjust enrichment and constructive trust against the Amvona Fund, which benefited from
Lemelson’s alleged short and distort campaign.


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 against the Lemelson defendants, 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.

**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 had, and still has, both business and legal challenges, as the short seller’s initial defense will 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," including anti-SLAPP laws. 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. The Private Securities Litigation Reform Act stay (under 15 U.S. 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. Lennar was awarded a $1 billion judgment, with the defendant also convicted on criminal charges.

The SEC may be late to the game but this enforcement action is a warning shot to other would be short and distort analysts posting false and defamatory news in the hope of a 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 (albeit, at significant expense), knowing that the SEC or other regulators will likewise pursue bad actors in separate civil or criminal proceedings.

Learn more about the implications of this case by contacting any of the authors.

An earlier version of this article appeared on Law360 on September 26, 2018.