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THE WAY IT IS AND THE WAY IT SHOULD BE: LIABILITY UNDER §10(b) OF THE EXCHANGE ACT AND RULE 10b-5 THEREUNDER FOR MAKING FALSE AND MISLEADING STATEMENTS AS PART OF A SCHEME TO “PUMP AND DUMP” A STOCK

BY: DAVID B. KRAMER*

“There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy.”¹

I. INTRODUCTION

Section 10(b) of the Securities Exchange Act of 1934 (“Exchange Act”) provides in relevant part that, “[i]t shall be unlawful for any person ... [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange ... any manipulative or deceptive device....”² Courts have held that in order to state a claim under §10(b), a plaintiff must allege, among other things, “material misstatements or omissions” indicating an intent to fraudulently induce a person into either

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¹ Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (quoting H. R. Rep. No. 73-1383, at 11 (1934)).

² Section 10(b) of the Exchange Act provides that:

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—

(b) To 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 (as defined in section 206B of the Gramm-Leach-Bliley Act), 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) (2004). For a more detailed discussion of how this statute relates to the subject matter of the instant article, see *infra* Part II.B. and the accompanying footnotes.

buying or selling a security.³ Over the past seventy years since the enactment of the Exchange Act, no court has ever visited the issue of whether distinctions should be drawn between the classifications of individuals who provide false and misleading information to the market and the subsequent punishment that they receive. The most probable explanation for this judicial silence is the unambiguous language of the law that uniformly applies equally to *anyone* who violates it. Nonetheless, people ranging from high ranking Wall Street analysts to high school students have seen (and later realized) the potential to make immense profits in the market by manipulating the price of various securities that they own.

Since the inception of the securities markets, there has been an element of unsavory individuals who unlawfully use or fabricate information to their own financial advantage. One of the first and most infamous securities frauds involved Charles Ponzi.⁴ Mr. Ponzi devised a scheme whereby he borrowed money from various investors who believed that he was using the money to purchase stamps in foreign countries that he later claimed to sell elsewhere for a substantial profit.⁵ In exchange for capital that allegedly enabled him to purchase more stamps, Ponzi issued his investors short term notes (securities) that promised a 50% return.⁶ In reality, Ponzi was making no such investments and merely paid off one investor with another investor's money.⁷ When Ponzi was unable to find enough new investors

³ See *I. Meyer Pincus & Assoc., P.C. v. Oppenheimer & Co.*, 936 F.2d 759, 762 (2d Cir. 1991) (quoting *McMahan & Co. v. Warehouse Entm't, Inc.*, 900 F.2d 576, 581 (2d Cir. 1990) (quoting *Luce v. Edelstein*, 802 F.2d 49, 55 (2d Cir. 1986)).

⁴ *Cunningham v. Brown*, 265 U.S. 1 (1924).

⁵ *Id.*

In December, 1919, with a capital of \$150, [Ponzi] began the business of borrowing money on ... promissory notes [that he wrote]. ... [Ponzi] spread the false tale that on his own account he was engaged in buying international postal coupons in foreign countries and selling them in other countries at 100[%] profit, and that this was made possible by the excessive differences in the rates of exchange following the war. He was willing ... to give others the opportunity to share with him this profit. By a written promise in [ninety] days to pay them \$150 for every \$100 loaned, he induced thousands to lend him [money]. He stimulated their avidity by paying his [ninety]-day notes in full at the end of [forty-five] days, and by circulating the notice that he would pay any unmatured note presented in less than [forty-five] days at 100[%] of the loan. Within eight months he took in \$9,582,000 for which he issued his notes for \$14,374,000. He paid his agents a commission of 10[%]. With the 50[%] promised to lenders, every loan paid in full with the profit would cost him 60[%]. He was always insolvent and became daily more so, the more his business succeeded. He made no investments of any kind, so that all the money he had at any time was solely the result of loans by his dupes.

Id. at 7-8.

⁶ *Id.*

⁷ *Id.*

to support the payments on maturing notes already issued to older investors, his scheme collapsed and he was left with no choice but to file for bankruptcy.⁸

In more recent years, a common securities fraud that has been perpetrated countless times with resounding financial success is a scheme known as a “pump and dump.” The scheme itself is quite simple. The person carrying out the fraud first targets a publicly traded company that is generally small in size and thinly traded on either the Over The Counter Bulletin Board or the NASDAQ market and then purchases large quantities of this stock. After obtaining a sizeable position in the chosen stock, the perpetrator then launches a large scale campaign to disseminate as much false and misleading information about the company as possible to effectuate the desired result.

In a “pump and dump” scheme, the perpetrator generally touts⁹ (“pumps”) a stock by making baseless projections about its future share price and/or unjustified forecasts about the company’s future earnings. To enhance the legitimacy of their claims, the perpetrator often alludes to fictitious contracts or non-existent merger talks.¹⁰ With the exponential growth in the number of people using the internet over the past decade, the World Wide Web has become the most popular medium for the perpetrator to communicate with the investing public. As the market digests the false and misleading information, the share price of the targeted company usually moves dramatically in the direction intended by the scheme’s architect. When the perpetrator believes that the market has reached the ceiling (or floor) based on the false and misleading information that he supplied, the perpetrator sells (“dumps”) their entire position and realizes a substantial gain.¹¹ In the hours and days after the scheme’s initiation, the share price of the targeted stock almost always returns to within pennies of the price that

⁸ *Id.* at 8-9.

⁹ To “tout” is to “[a]ggressively promote a particular security. Usually done by someone with a vested interest in seeing the stock’s price rise, such as a company employee, public relations firm, analyst, or large shareholder. Illegal in certain circumstances.” WebFinance, Inc., *investorwords.com*, at <http://www.investorwords.com/5009/tout.html> (last visited Jan. 5, 2005).

¹⁰ Some “pump and dump” schemes work in reverse, whereby the perpetrator makes negative comments about a company that are untrue. In these cases, the perpetrator intends to drive down the share price of the targeted company so that they can either sell their shares short or create a buying opportunity knowing that the stock will later rebound once the market has cleansed itself of the false information.

¹¹ In a typical “pump and dump scheme,” the perpetrators buy and sell transactions in the targeted stock are opposite those of the investing public. Thus, the perpetrator generally either sells his position while others are buying the targeted security and driving up the share price or buys his position while others are selling and driving down the share price.

it was before the perpetrator made false and misleading statements about it because the market has cleansed itself of the erroneous information.

“Pump and dump” schemes, which are most often perpetrated over the internet, are simply a variety of illegal market manipulation. Internet securities frauds, however, fall within one of three general categories.¹² In addition to market manipulation schemes, securities frauds also include offering frauds and illegal touting.¹³ An offering fraud “involves perpetrators creating sophisticated web sites and/or mass emails offering securities that either do not exist or are misleading.”¹⁴ Illegal touting occurs when newsletters, web sites, or email publications, which appear to be independent to the internet user, accept payment for favorably reporting upon a stock.¹⁵ The payment to the internet promoter often comes in the form of stock from the company being touted.¹⁶

This article will focus on market manipulation frauds by examining five recent “pump and dump” schemes that were orchestrated by individuals ranging from the manager of the world’s largest mutual fund to a fifteen-year-old high school student.¹⁷ All five schemes were designed and then executed with resounding financial success. Although the law is presently designed to treat each of these “pump and dump” perpetrators identically, this article will question the utility and necessity in doing so.

In addressing the scrutiny that should be applied to individuals who disseminate false and misleading or omitted information about securities with the intent to induce others into buying or selling them, this article will propose a three-tiered analysis to determine whether liability should apply. Although this analysis is primarily targeted at offering a discretionary guide to the SEC and the manipulation cases that it brings through its Division of Enforcement, its utility as a legal doctrine has the potential to be wide reaching by serving as a bar to private civil suits brought by aggrieved plaintiffs. The vast majority of securities manipulation scheme cases are pre-

¹² Constance Z. Wagner, *Securities Fraud in Cyberspace: Reaching the Outer Limits of the Federal Securities Laws*, 80 NEB. L. REV. 920, 927 (2001); see also Byron D. Hittle, *An Uphill Battle: The Difficulty of Detering and Detecting Perpetrators of Internet Stock Fraud*, 54 FED. COMM. L.J. 165, 169 (Dec. 2001).

¹³ Wagner, *supra* note 12, at 927.

¹⁴ Hittle, *supra* note 12, at 169-170 (“The subject matter of [sham] offerings tends to be exotic, offering interests in, for example, eel farms, coconut plantations, and projects to explore near earth asteroids. With the availability of advanced, yet inexpensive, software, fraudsters can design web sites that present the facade of a legitimate investment opportunity.”).

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ As discussed in detail below, some “pump and dump” schemes are built upon an illegal touting scheme. See *infra* Part II.B. and the accompanying footnotes. Nonetheless, unless otherwise indicated, the use of the word “fraud” in this article refers to a market manipulation variety of securities fraud.

sently brought by the SEC as opposed to private litigants because demonstrating actual damages can be difficult, individual losses are often extremely small, and recovery against the perpetrator is nearly impossible.¹⁸ The SEC brings manipulation cases, however, because the fraudsters often make substantial profits and their failure to bring such cases would result in extensive public criticism that the Commission was failing to perform its regulatory duty. Accordingly, if the standards for imposing liability for securities manipulation schemes were changed pursuant to §10(b) and Rule 10b-5 thereunder, the SEC could focus its attention to more pressing matters that stand a greater chance of having a favorable outcome¹⁹ and the investing public would be forced to be more diligent with its investing decisions because the SEC would no longer be working to protect them in this area.²⁰

As this article establishes, courts should first look at the materiality of the statement. If the statement is not material, liability should not be imposed. While the question of materiality is and has always been a defense to making false and misleading statements about a security, this article will deviate from the traditional analysis by proposing two additional steps in the analytical process.

Where a statement is found to be material, courts should next determine whether the speaker is an investment adviser under the Investment Advisers Act of 1940.²¹ When an investment adviser makes materially false and misleading statements about a security, liability should be imposed. Where materially false and misleading statements are made by someone who is not an investment adviser, however, courts should then consider a third step consisting of a number of additional factors, no single one being dispositive, for determining liability. Some of these factors include the size of the company being discussed and its share price, the quantity of presumably accurate information that the company has made available to the market, the

¹⁸ For a discussion of private securities litigation and the merits of such claims, see generally Charles M. Yablon, *A Dangerous Supplement? Longshot Claims and Private Securities Litigation*, 94 NW. U.L. REV. 567 (Winter 2000). Furthermore, establishing a plaintiff's reliance on the misstatement or fraud can be difficult. See generally Norman S. Poser, *Stock Market Manipulation and Corporate Control Transactions*, 40 U. MIAMI L. REV. 671, n.273 (March 1986) (discussing various conclusions by numerous Courts of Appeals relating to the "Fraud on the Market" theory's effect on investor reliance).

¹⁹ For example, the ongoing investigations into Enron, WorldCom, Tyco, and mutual fund late trading.

²⁰ In the five manipulation cases discussed below, this article will suggest that only one case, *DeMarco v. Robertson Stephens, Inc.*, 318 F. Supp. 2d 110 (S.D.N.Y. 2004), warrants SEC prosecution due to the egregious nature of the fraud.

²¹ See generally 15 U.S.C. 80(b) (2004). For a complete discussion of the Investment Advisers Act of 1940 as it relates to this article, see *infra* Part III.B. and the accompanying footnotes.

medium for the perpetrator's false and misleading communications with the investing public, and the speaker's reputation and track record as an analyst. In cases where the perpetrator has little or no record as an analyst and makes baseless projections about little known companies over the internet, this article will argue that the principles of *caveat emptor* should govern and liability should not be imposed on the supposed fraudster.

II. THE PERPETRATORS OF RECENT "PUMP AND DUMP" SCHEMES RANGE FROM HIGH-LEVEL MARKET ANALYSTS TO UNKNOWN TEENAGERS.

*A. Analysts At Well-Known And Highly Respected Brokerage Firms Are Not Immune From The Temptation To Engage In Pump And Dump Schemes. One Way That Such Individuals Can Make Substantial Profits Is To Issue A Public Buy Recommendation For A Stock That They Are Concurrently Selling In Their Own Personal Accounts: DeMarco v. Robertson Stephens, Inc.*²²

DeMarco v. Robertson Stephens, Inc. is the most recent case to address an analyst's liability for perpetrating a pump and dump scheme on a stock that he covered. The facts relevant to this matter began in the 1990s when Robertson Stephens, Inc. ("Robertson Stephens"),²³ created three limited partnerships known as the Bayview Partnerships for the purpose of investing in companies prior to their initial public offering of stock.²⁴ The Bayview Partnerships purchased approximately \$5 million dollars worth of Corvis stock in November of 1999 upon the recommendation of Defendant Paul Johnson, who was at the time a managing director and senior equity analyst with Robertson Stephens.²⁵ Prior to the public offering, Johnson invested his own personal funds in the Bayview Partnerships and also invested in a separate venture capital fund that purchased Corvis shares.²⁶

Corvis conducted its initial public offering of stock on July 27, 2000 at \$36 per share.²⁷ Shortly thereafter, the plaintiffs allege that Johnson engaged in a scheme to manipulate the price of Corvis stock by publishing false and

²² *Robertson Stephens*, 318 F. Supp. 2d at 110.

²³ Robertson Stephens is a nationally renowned broker-dealer that also engages in various financial services. Specifically, Robert Stephens participates in securities underwriting efforts, investment banking, and equity analysis. *Id.* at 114.

²⁴ *Id.*

²⁵ *Id.* Corvis manufactures optical networking equipment. *Id.*

²⁶ *Id.* "[The] Corvis shares [that] were privately issued prior to the Corvis initial public offering ("pre-IPO [stock]") ... [were] subject to a "lock-up" restriction that prevented the purchaser from selling the stock for 180 days after the initial public offering." *Id.* at 115.

²⁷ *Id.*

misleading statements of opinion about the company in its research reports.²⁸ On January 23, 2001, following three separate public “buy” recommendations by Robertson Stephens in a six month period following Corvis’s initial public offering,²⁹ Johnson informed the Bayview investment committee that he would purchase the Corvis stock at a price of \$12-14 per share.³⁰ The next day, which was the earliest point at which the defendants were allowed to sell their Corvis stock, Johnson sold 6,550 of his 8,175 personal shares and Robertson Stephens sold the shares that it held through the Bayview Partnerships.³¹ On January 26, 2001, just one day after Corvis reported a loss of \$89.7 million, Robertson Stephens issued a fourth public “buy” recommendation for Corvis as it closed at \$20.50 per share.³² Three days later, on January 29, 2001, Johnson sold additional shares of Corvis that he personally held, and the stock closed at \$19.43 per share.³³ Finally, on April 27, 2001, Robertson Stephens published a fifth and final report on Corvis stock, which once again recommended that investors purchase the stock.³⁴

The reports written by Johnson concerning the Corvis stock did not provide the investors with the information that Robertson Stephens had already sold off the majority of their Corvis holdings.³⁵ On May 27, 2001, the *New York Times* ran an article reporting that Johnson and other executives at Robertson Stephens had been selling Corvis stock while advising the public to purchase it.³⁶ The plaintiffs then filed suit on January 27, 2003 alleging that the defendants attempted to artificially inflate the share price of Corvis stock until they could sell their own pre-IPO shares by

²⁸ *Robertson Stephens*, 318 F. Supp. 2d at 115.

²⁹ Robertson Stephens issued its first report on Corvis on August 22, 2000. At that time, Robertson Stephens issued a “buy” recommendation when the closing price that day was \$90.81 per share. On October 20, 2000, Robertson Stephens issued a second report on Corvis which again contained a “buy” recommendation. The closing price for Corvis stock on that day was \$67.13 per share, an increase from the day’s opening price of \$59.61 per share. Robertson Stephens then issued a third report on Corvis on January 16, 2001 when the share price closed at \$23.94. Like the two earlier reports, this report also contained a “buy” recommendation for Corvis. *Id.*

³⁰ *Id.* Johnson’s comment essentially advised the Bayview investment committee against buying Corvis stock at the then market price of approximately \$24.50 per share. *Id.*

³¹ *Id.* Corvis stock closed on January 24, 2001 at \$23.06 per share. *Id.*

³² *Id.*

³³ *Id.*

³⁴ *Robertson Stephens*, 318 F. Supp. 2d at 115.

³⁵ *Id.* (“However, on January 29, 2001, Johnson filed a Form 144 statement with the SEC disclosing his January 24th sale of 6,550 shares [of Corvis stock].”).

³⁶ *Id.*

encouraging investors to purchase Corvis stock even though they believed it to be overvalued.³⁷ The defendants then moved to dismiss.³⁸

Stating the legal standards of §10(b) of the Exchange Act and Rule 10b-5 thereunder,³⁹ the court outlined the heightened pleading standards that are applicable to securities fraud cases under the Private Securities Litigation Reform Act of 1995 (“PSLRA”).⁴⁰ Under the PSLRA, complaints alleging securities fraud must first, “specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed,”⁴¹ and second, “with respect to each act or omission alleged ..., state with particularity facts giving rise to a strong inference that the

³⁷ *Id.* at 115. The defendants responded “that trading in Corvis stock was always volatile, that the plaintiffs did not read or rely on [Robertson Stephens] reports, and that the market’s overall disenchantment with telecommunications stock was the intervening cause responsible for plaintiffs’ losses.” *Id.* at 115-116.

³⁸ *Id.* On a motion to dismiss, “[e]very defense, in law or fact, to a claim for relief in any pleading ... shall be asserted in the responsive pleading thereto if one is required, except that the following defenses may at the option of the pleader be made by motion . . . failure to state a claim upon which relief can be granted.” FED. R. CIV. P. 12(b)(6). “[T]he Court must accept as true all well-pleaded factual allegations in the complaint and view them in the light most favorable to the plaintiff, drawing all reasonable inferences in its favor. *Robertson Stephens*, 318 F. Supp. 2d at 116. (quoting *Leeds v. Meltz*, 85 F.3d 51, 53 (2d Cir. 1996)). “The Court will not dismiss a complaint for failure to state a claim ‘unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim that would entitle him to relief.’” *Robertson Stephens*, 318 F. Supp. 2d at 116 (citing *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957)). Beyond the facts in the complaint, the court may consider “any written instrument attached to it as an exhibit or any statements or documents incorporated in it by reference.” *Robertson Stephens*, 318 F. Supp. 2d at 116 (quoting *Cortec Indus., Inc. v. Sum Holding, L.P.*, 949 F.2d 42, 47 (2d Cir. 1991)). While the Federal Rules of Civil Procedure generally require only notice pleading, where, as here, the plaintiff alleges fraud, “the circumstances constituting fraud ... shall be stated with particularity.” *Robertson Stephens*, 318 F. Supp. 2d at 116 (quoting FED. R. CIV. P. 9(b)). See *Stern v. General Electric Co.*, 924 F.2d 472, 476 (2d Cir. 1991) (“Allegations of fraud must be supported by particular statements indicating the factual circumstances on which the theory of fraud is based”). “Rule 9(b) is designed to further three goals: (1) providing a defendant fair notice of plaintiff’s claim, to enable preparation of defense; (2) protecting a defendant from harm to his reputation or goodwill; and (3) reducing the number of strike suits.” *Robertson Stephens*, 318 F. Supp. 2d at 116 (quoting *DiVittorio v. Equidyne Extractive Indus., Inc.*, 822 F.2d 1242, 1247 (2d Cir. 1987)).

³⁹ *Robertson Stephens*, 318 F. Supp. 2d at 116. See also 17 C.F.R. §240.10b-5; SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (explaining that the SEC “promulgated [Rule 10b-5] pursuant to the grant of authority given the SEC by Congress in Section 10(b) of the Securities Exchange Act of 1934,” by which Congress sought “to prevent inequitable and unfair practices and to insure fairness in securities transactions generally, whether conducted face-to-face, over the counter, or on exchanges.”).

⁴⁰ *Robertson Stephens*, 318 F. Supp. 2d at 116-117.

⁴¹ *Id.*

defendant acted with the required state of mind,"⁴² which under §10(b) of the Exchange Act and Rule 10b-5 thereunder is scienter.⁴³

In their defense, Robertson Stephens and Johnson offered a number of arguments why the plaintiffs failed to meet the heightened pleading standard required by the PSLRA. First, the defendants argued that the plaintiffs did not allege facts demonstrating that Robertson Stephens or Johnson had misrepresented their opinion that investors should purchase Corvis stock in any of the reports that they publicly released (other than the January 26, 2001 report).⁴⁴ Rejecting this argument, the court stated that there was little doubt that the statements made by the defendants in their reports dated January 16 and 26, 2001 misrepresented their true belief about the investment quality of Corvis stock.⁴⁵ In support of this conclusion, the court noted that, "[a] one-week or three-day lag between public statements advising purchase and an internal statement essentially advising sale supports the inference that defendants actually believed the stock was overvalued on January 16 and 26, when they publicly recommended that investors purchase the stock."⁴⁶ The court also pointed to the fact that the defendants sold their Corvis stock at the earliest possible time, which was contrary to the advice to purchase Corvis stock publicly provided by the defendants.⁴⁷ Moreover, the court noted that the earlier buy recommendations were made at a time when the defendants had a motive to keep the price of Corvis stock inflated because it was during the lock-up period when they were unable to sell their shares.⁴⁸

The defendants next argued that even if the published reports misrepresented their opinion about Corvis stock, such statements were not material.⁴⁹ Stating the steadfast rule on materiality, the court noted that, "[t]o be material, the information need not be such that a reasonable investor would necessarily change his investment decision based on the information, as long as a reasonable investor would have viewed it as

⁴² *Id.*

⁴³ *Id.* at 117. See also 15 U.S.C. §78u-4(b)(1)(B); 15 U.S.C. §78u-4(b)(2); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976); *Kalnit v. Eichler*, 264 F.3d 131, 138 (2d. Cir. 2001) (quoting *Novak v. Kasaks*, 216 F.3d 300, 310 (2d Cir. 2000) and stating that the PSLRA "did not change the basic pleading standard for scienter in this circuit."). Both before and after the PSLRA, the law required plaintiffs bringing claims under §10(b) of the Exchange Act and Rule 10b-5 thereunder, to allege scienter with particularity. *Id.*

⁴⁴ *Robertson Stephens*, 318 F. Supp. 2d at 117.

⁴⁵ *Id.*

⁴⁶ *Id.* at 118.

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

significantly altering the 'total mix' of information available."⁵⁰ The court, therefore, concluded that, "Robertson Stephens was in the business of speaking to the market about stock values, it chose to speak about Corvis, and it is entirely reasonable that investors would consider analyst recommendations as part of the 'total mix' of information available when making purchases."⁵¹ Accordingly, the court concluded that the facts as alleged in the complaint, if proved, were "amply sufficient to permit a reasonable factfinder to conclude that the misrepresentations were material."⁵²

Addressing the scienter element of the defendants' actions, the court stated that, "[t]o survive a motion to dismiss, a §10(b) complaint must allege facts that give rise to a strong inference of fraudulent intent by alleging either '(a) ... facts to show that defendants had both motive and opportunity to commit fraud, or (b) ... facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.'"⁵³ Here, the plaintiffs alleged scienter under either standard.⁵⁴ First, the defendants had both a motive and an opportunity to commit fraud.⁵⁵ Second, the complaint alleged facts about the opinions Johnson expressed to the Bayview Partnerships' investors at the January 23, 2001 meeting, which provided direct evidence that the defendants consciously misrepresented their opinion about the true value of Corvis stock in the reports that they issued.⁵⁶

Finally, the court addressed the defendants' claim that there was no causal link between their actions and the plaintiffs' alleged injuries.⁵⁷ The court noted that in order to survive a motion to dismiss, a plaintiff must allege "that the violations in question caused the plaintiff to engage in the

⁵⁰ *Robertson Stephens*, 318 F. Supp. 2d at 117 (citing *TSC Indus., Inc. v. Northway*, 426 U.S. 438, 449 (1976)).

⁵¹ *Id.* at 118.

⁵² *Id.*

⁵³ *Id.* (citing *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 52 (2d Cir. 1995)).

⁵⁴ *Id.*

⁵⁵ *Id.* at 118-119. The defendants had a motive to keep the price of Corvis stock inflated until after they were able to sell their pre-IPO shares. As a means to perpetrate their fraud, the defendants utilized the research reports that they issued to publicly encourage investors to purchase Corvis stock at a time when they privately believed that it was overvalued. *Id.*

⁵⁶ *Robertson Stephens*, 318 F. Supp. 2d at 119.

⁵⁷ *Id.* See also *Press v. Chem. Inv. Serv. Corp.*, 166 F.3d 529, 534 (2d. Cir. 1999). This causation requirement has two elements: "a plaintiff must allege both transaction causation, i.e., that but for the fraudulent statement or omission, the plaintiff would not have entered into the transaction; and loss causation, i.e., that the subject of the fraudulent statement or omission was the cause of the actual loss suffered." *Robertson Stephens*, 318 F. Supp. 2d at 119 (quoting *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 95 (2d Cir. 2001) (emphasis removed from original)).

transaction in question.”⁵⁸ Under the holding in *Basic, Inc. v. Levinson*,⁵⁹ individual investors need not show direct reliance on the fraudulent statement because “it is assumed that in an efficient market, all public information is reflected in [a] share price, including any misrepresentations concerning the value of the company or its stock.”⁶⁰ Thus, “it is sufficient that [the investor] bases her transaction on the market trends or securities prices that are altered by the fraud.”⁶¹ The court espoused that an underwriter like Robertson Stephens clearly intends for the market to take its analysis about a given company into account as evidenced by the fact that it has a research department engaged in the business of analyzing companies for the primary purpose of publicly disseminating such information.⁶² The court, therefore, concluded that, “[i]t is axiomatic that prices in an open market reflect supply and demand, and it is disingenuous, to say the least, for defendants to now argue that their published purchase recommendations are somehow excluded from the information available to market actors when valuing securities.”⁶³

To counter the previously addressed “Fraud on the Market Theory” relied upon by the plaintiffs, the defendants raised the “Truth on the Market” defense.⁶⁴ The defendants claimed that “Robert Stephens

⁵⁸ *Robertson Stephens*, 318 F. Supp. 2d at 119 (citing *Grace v. Rosenstock*, 228 F.3d 40, 45 (2d Cir. 2000)). Although the plaintiffs fail to allege that they ever read or even saw a Robertson Stephens report on Corvis stock prior to purchasing it, that is not fatal to their claim because the plaintiffs’ allegation of transaction causation relies on the “Fraud on the Market Theory.” *Id.* The “‘Fraud on the Market Theory’ [is] based on the hypothesis that, in an open and developed securities market the price of a company’s stock is determined by the available material information regarding the company and its business ... Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.” *Id.* (citing *Basic, Inc. v. Levinson*, 485 U.S. 224, 241-42 (1988) (internal citations omitted)). The court noted that, “[t]his theory of transaction causation takes into account the difference between face-to-face negotiated transactions contemplated by traditional common-law fraud doctrines, and modern securities markets where multiple sellers and buyers engage in transactions at prices determined by an impersonal market, while remaining mutually anonymous.” *Id.* (internal citations omitted). The presumption of reliance may be rebutted by “any showing that severs the link between the alleged misrepresentation and ... the price received (or paid) by the plaintiff, because in that case the basis for finding that the fraud had been transmitted through market price would be gone.” *Id.* at 120 (quoting *Basic*, 485 U.S. at 248 (internal quotation marks omitted)).

⁵⁹ 485 U.S. 224 (1988).

⁶⁰ *Robertson Stephens*, 318 F. Supp. 2d at 119.

⁶¹ *Id.* (citing *In re Initial Public Offerings Sec. Litig.*, 241 F. Supp. 2d 281, 375 (S.D.N.Y. 2003)).

⁶² *Id.* at 120.

⁶³ *Id.*

⁶⁴ *Id.* at 121. To establish the “Truth on the Market” defense, the defendants must show that the public received accurate, “corrective information” from an alternative source “with a degree of intensity and credibility sufficient to counter-balance effectively any misleading impression created by the alleged misstatements.” *Id.* (quoting *Ganino v. Citizens Utilities Co.*, 228 F. 3d 154, 167 (2d Cir.

repeatedly disclosed that it might own stock in Corvis and provided investment banking services to Corvis, and the Corvis prospectus indicated that the defendants owned pre-IPO shares.⁶⁵ To bolster their “Truth on the Market” defense, the defendants argued that the market was aware of the conflicting role of sell side analysts from extensive media coverage.⁶⁶ The court dismissed this argument and concluded that it was unlikely that general market concerns about analysts’ conflicts would “have sufficiently apprised the market of this specific scheme to dupe investors into purchasing securities that defendants allegedly believed to be greatly overvalued so that defendants could sell their personal shares at an artificial profit.”⁶⁷ In addition, the court found that regardless of what information the defendants disclosed and the press revealed about potential analysts’ conflicts, the fact remains that Johnson’s privately held views of Corvis stock were not a matter of public record.⁶⁸

Finally, the defendants argued that the plaintiffs failed to meet the loss causation requirement because a complaint must do more than allege that the misrepresentations caused a discrepancy between the transaction price and the actual value of the stock.⁶⁹ The defendants contended that the plaintiffs must allege that their loss is a direct consequence of the misrepresentation⁷⁰ and opined that the plaintiffs’ losses were actually attributable

2000) (internal citations and quotation marks omitted)). “As the Second Circuit has noted, ‘the truth on the market defense is intensely fact-specific and is rarely an appropriate basis for dismissing a §10(b) complaint for failure to plead materiality.’” *Id.*

⁶⁵ *Id.* The court also suggests that the submission of Johnson’s Form 144 to the SEC, which disclosed the sale of his Corvis stock, could be used to support the defendants’ “Truth on the Market” defense. *Id.*

⁶⁶ *Id.* For example, “[o]n Sunday, May 27, 2001, the New York Times ran an article reporting that Johnson and other executives at Robertson Stephens had been selling Corvis stock while advising the public to purchase the stock. The article did not reveal that Johnson had advised the Bayview committee to sell its shares.” *Id.* (citing Gretchen Morgenson, *Buy, They Say. But What Do They Do?; I.P.O. Conflicts Bedevil Analysts*, NEW YORK TIMES, May 27, 2000, Sec. 3, p. 1).

⁶⁷ *Id.* at 122.

⁶⁸ *Id.*

⁶⁹ *Id.* The Second Circuit has “likened loss causation to the tort concept of proximate cause, because, similar to proximate cause, in order to establish loss causation, a plaintiff must prove that the damage suffered was a foreseeable consequence of the misrepresentation.” *Id.* (quoting *Citibank, N.A. v. K-H Corp.*, 968 F.2d 1489, 1495 (2d Cir. 1992)). *But see* *AUSA Life Ins. Co. v. Ernst and Young*, 206 F.3d 202, 233 (2d Cir. 2000) (noting that “the pertinent requirements of proximate cause in a statutory case are those intended by the legislature” and warning that courts not “overwork the analogy between proximate cause in common law negligence and proximate cause in federal securities law violations”) (internal citations and punctuation omitted). If the loss was caused by an intervening event not related to the fraud, then the §10(b) claim must fail. *Robertson Stephens*, 318 F. Supp. 2d at 122 (citing *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 96 (2001)).

⁷⁰ *Robertson Stephens*, 318 F. Supp. 2d at 122. *See* *Emergent Capital Inv. Mgmt, LLC v. Stonepath*

to a general downturn in the telecommunications market.⁷¹ Dismissing this theory, the court stated that “the publication of the intentionally false opinions that allegedly distorted the market price of Corvis stock contained the seeds of loss causation. Unless an intervening event were to occur first, the author of the false opinion will be appropriately held responsible when the market eventually corrects the artificially inflated price. . . .”⁷²

The defendants’ primary argument against loss causation in *Robertson Stephens* was that “the ‘Fraud on the Market Theory’ should apply only to transaction causation and never to loss causation under any circumstance.”⁷³ However, the court astutely observed that, “it is unlikely that loss causation could be adequately alleged in every fraud-on-the-market case that success-

Group, Inc., 343 F.3d 189, 198 (2d Cir. 2003) (an “allegation of a purchase-time value disparity, standing alone, cannot satisfy the loss causation pleading requirement”). “It is not enough to claim that the price was artificially inflated when plaintiffs purchased the stock, because if some event not related to the misrepresentation caused the loss, then there is no §10(b) liability.” *Robertson Stephens*, 318 F. Supp. 2d at 122. “To establish loss causation, in other words, plaintiffs ‘must also show that the misstatements were the reason the transaction turned out to be a losing one.’” *Id.* (citing *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763, 769 (2d Cir. 1994)).

⁷¹ *Id.* at 123. The defendants interpret the “bursting of the telecommunications stock bubble” as the intervening cause of the plaintiffs’ alleged loss. *Id.*

⁷² *Id.*

⁷³ *Id.* at 124. The Second Circuit has not addressed whether, in the context of a class action relying on a “Fraud on the Market Theory,” the plaintiffs sufficiently plead loss causation by alleging that they purchased at an inflated price created by the misrepresentations, and the price declined as the market corrected the distortion. *Id.* There is a division of authority on the subject. *Id.* The Ninth Circuit has rejected defendants’ position, holding in *Knapp v. Ernst & Whinney* that “in a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation.” *Id.* (citing 90 F.3d 1431, 1438 (9th Cir. 1996)). Other circuits have also found that loss causation was adequately pled in fraud-on-the-market cases where defendants’ misrepresentations led to an artificially altered stock price, which was followed by a market correction. *Id.* (citing *Semerenko v. Cendant Corp.*, 223 F.3d 165, 184 (3d Cir. 2000) (“where the claimed loss involves the purchase of a security at a price that is inflated due to an alleged misrepresentation, there is a sufficient causal nexus between the loss and the alleged misrepresentation to satisfy the loss causation requirement”); *In re Control Data Corp. Sec. Litig.*, 933 F.2d 616, 619 (8th Cir. 1991)). Opinions of the Second Circuit have also followed *Knapp*. *Id.* (citing *In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d 281, 377, note 145 (2003); *Fellman v. Electro Optical Systems Corp.*, 2000 U.S. Dist. LEXIS 5324 (S.D.N.Y. 2000)). Defendants find support for their position, however, in the Eleventh Circuit, and The United States District Court for the Southern District of New York’s recent decision in *Merrill Lynch*. *Id.* (citing *Robbins v. Koger Props.*, 116 F.3d 1441, 1448 (11th Cir. 1997) (“the fraud on the market theory, as articulated by the Supreme Court, is used to support a rebuttable presumption of reliance, not a presumption of causation”); *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 273 F. Supp. 2d 351, 365 (S.D.N.Y. 2003) (applying *Robbins* and reasoning that “to permit plaintiffs to allege artificial inflation through the fraud on the market theory to satisfy loss causation would improperly conflate both the ‘but for’ transaction causation and the loss causation elements into one.”)).

fully pleads transaction causation because in cases where an unforeseeable intervening event causes the plaintiffs' loss, there is no causal nexus between the loss and the misrepresentation."⁷⁴ In denying the defendants' motion to dismiss the plaintiffs' claim that Robert Stephens and Johnson engaged in a scheme to defraud or manipulate the stock price of Corvis, the court concluded that, "[the] plaintiffs have adequately alleged loss causation because the decline in stock price was a foreseeable consequence of [the] defendants' fraudulent statements that allegedly inflated the price, because in an efficient market, revelation of the misrepresentations will lead inexorably to a price correction."⁷⁵

B. *Classic Internet Pump And Dump Schemes Committed By Greedy Analysts Who Made Big Profits By Manipulating The Market In Penny And Small Capitalization Stocks: SEC v. Huttoe.*⁷⁶

SEC v. Huttoe is one of, if not the first, case brought by the United States Securities and Exchange Commission ("SEC") against individuals who distributed false and misleading information through the internet about stocks that they owned as part of a scheme to artificially inflate the share price of those companies by encouraging others to buy them.⁷⁷ Shannon Terry, age 28, was an independent contractor employed by SGA Goldstar Research, Inc. ("SGA") from August, 1993 until November, 1996.⁷⁸ The SGA Goldstar Whisper Stocks newsletter, also known as, the 'Whisper Newsletter,' was published by SGA.⁷⁹ Moreover, the only shareholder of SGA stock, Theodore Melcher, served as the editor and publisher of the Whisper Newsletter.⁸⁰ SGA's business was conducted out of Melcher's

⁷⁴ *Id.* at 125 (emphasis in original). In *First Nationwide Bank v. Gelt Funding Corp.*, the court stated, however, that it did not "mean to suggest that in all cases a fraud plaintiff will be unable to plead proximate causation when the claim follows a market collapse." 27 F.3d 763, 772 (2d Cir. 1994).

⁷⁵ *Robertson Stephens*, 318 F. Supp. 2d at 125.

⁷⁶ *SEC v. Huttoe*, No. 96-2543GK, 1998 U.S. Dist. LEXIS 23211 (D.D.C. Sept. 14, 1998).

⁷⁷ The SEC brought charges against named Defendant Charles O. Huttoe, Chairman of the Board and Chief Executive Officer of Systems of Excellence, Inc. ("SOE") for fraud in connection with the registration and sale of SOE common stock. *Id.* at *4-5. A final judgment was entered, under seal, against Huttoe in November, 1997. *Id.* at *5, n.2. The instant opinion only relates to Defendants Shannon Terry and Dunbar Holdings, and Relief Defendant J.S. Holdings. *Id.* at *5.

⁷⁸ *Id.* at *6.

⁷⁹ *Id.* Whisper Newsletter charged its subscribers a subscription fee. *Id.* at *7.

⁸⁰ *Id.* at *6. SGA Goldstar Research, Inc. and Theodore Melcher were also named defendants in the original SEC complaint against Charles Huttoe. *Id.* at *6, n.3.

home, and it is important to note that for most of Terry's tenure only he and Melcher were working at SGA.⁸¹

The Whisper Newsletter profiled "high risk aggressive growth" companies that were either "largely unknown and untested penny stocks or small capitalization companies."⁸² Every night SGA subscribers received the Whisper Newsletter by facsimile or download from SGA's web page.⁸³ As many as half of the articles published in the Whisper newsletter were written by Terry, who also handled many of SGA's administrative tasks.⁸⁴ For his work, Terry received a base compensation and a share of all subscription revenue.⁸⁵ In addition, companies paid SGA with company stock in exchange for articles promoting their stock in the Whisper Newsletter.⁸⁶ SGA would in turn give Terry stock in the companies that he promoted in the articles he wrote.⁸⁷ Terry's trading in these stocks either coincided with the publication of articles about these stocks in the Whisper Newsletter or took place shortly thereafter.⁸⁸ Although Terry's articles recommended that readers buy stock in the companies being promoted, he would often turn around and sell his position in the recommended stock within a few days of publication.⁸⁹ Not surprisingly, the price of the featured stocks generally rose soon after the Whisper Newsletter made strong buy recommendations to its subscribers, and Terry was able to realize substantial profits for himself.⁹⁰

The SEC brought an action against Terry alleging that he violated §10(b)⁹¹ of the Exchange Act and Rule 10b-5⁹² thereunder. This action was based on the facts and circumstances suggesting that Terry had: "(1) touted

⁸¹ *Huttoe*, 1998 U.S. Dist. LEXIS 23211, at *6.

⁸² *Huttoe*, 1998 U.S. Dist. LEXIS 23211, at *6-7.

⁸³ *Id.* at *7. In 1996, there were approximately 280 subscribers to the Whisper Newsletter. In addition to receiving compensation from its subscribers, SGA also obtained revenue through the companies that it publicized. *Id.*

⁸⁴ *Id.* at *7-8.

⁸⁵ *Id.* at *8. Terry's base compensation was \$25,000 plus 12.5% of all new and renewal subscription revenue. *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.* Although the stock was not given to Terry directly by the companies that he covered in his articles for the Whisper Newsletter, it came from the issuing company to SGA and then was passed on by SGA to Terry. *Id.* Between October, 1994 and September, 1996, Terry received stock in eighteen companies that were later promoted in the Whisper Newsletter. *Id.* The value of the stocks that he received from his allegedly illegal activities was \$828,448. *Id.*

⁸⁸ *Huttoe*, 1998 U.S. Dist. LEXIS 23211, at *9.

⁸⁹ *Id.* at *10-11.

⁹⁰ *Id.* at *11.

⁹¹ See *supra* note 2 for the complete text of §10(b) of the Securities Exchange Act of 1934.

⁹² For the relevant text of Rule 10b-5 of the Exchange Act, see *supra* note 39.

publicly traded securities to potential investors in articles he wrote for the Whisper Newsletter in return for undisclosed compensation from the issuers of those securities; (2) traded his personal share holdings in stocks even as he was writing articles in the Whisper Newsletter recommending their purchase; and (3) failed to disclose either of these practices when he solicited subscriptions to the Whisper Newsletter.⁹³ The SEC then moved for summary judgment of all charges.⁹⁴

Under Rule 10b-5, "it is a fraud for *any person* to make any statement in connection with a securities transaction that is materially false or misleading."⁹⁵ A statement is deemed to have been made "in connection with the sale of any security whenever it may be reasonably expected that a publicly disseminated document will cause reasonable investors to buy or sell securities in reliance thereon, regardless of the motive or existence of contemporaneous transactions by or on behalf of the violator."⁹⁶ A statement is materially misleading "if there is a substantial likelihood that a reasonable investor would consider an omitted fact significant in making his or her investment decision."⁹⁷ As previously discussed, "a material

⁹³ *Huttoe*, 1998 U.S. Dist. LEXIS 23211, at *13-14. The SEC also alleged Terry committed violations of §17(a) of the Securities Act which is an anti-fraud provision. *Id.* at *13. A discussion of these charges is not germane to the subject matter of this article.

⁹⁴ *Id.* at *12-13. Rule 56(b)-(c) of the Federal Rules of Civil Procedure provide the standard of review for a motion for summary judgment. The rule provides in relevant part that, "[a] party against whom a claim ... is asserted ... may, at any time, move with or without supporting affidavits for a summary judgment in the party's favor as to all or any part thereof. ... The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." The *Huttoe* Court also noted that, "[t]he party seeking summary judgment bears the initial burden of demonstrating an absence of a genuine issue of material fact." *Id.* at *12 (citing *Celotex Corp. v. Catrett*, 477 U.S. 317, 322 (1986)). In determining whether the movant has met this burden, a court must consider all factual inferences in the light most favorable to the non-moving party. *Id.* (citing *McKinney v. Dole*, 765 F.2d 1129, 1135 (D.C. Cir. 1985)). Once the moving party makes its initial showing, however, the nonmoving party must demonstrate "specific facts showing that there is a genuine issue for trial." *Id.* (citing *Celotex*, 477 U.S. at 324; *McKinney*, 765 F.2d at 1135). Moreover, "in determining a motion for summary judgment, the court may assume that facts identified by the moving party in its statement of material facts are admitted, unless such a fact is controverted in the statement of genuine issues filed in opposition to the motion." *Id.* at *12-13 (quoting Local Rule 108(h)).

⁹⁵ *Id.* at *15. See *supra* note 39 for the relevant text of Rule 10b-5.

⁹⁶ *Huttoe*, 1998 U.S. Dist. LEXIS 23211, at *16. See also *SEC v. Savoy Industries, Inc.*, 587 F.2d 1149, 1171 (D.C. Cir. 1978).

⁹⁷ *Huttoe*, 1998 U.S. Dist. LEXIS 23211, at *16. See also *Basic, Inc. v. Levinson*, 485 U.S. 224, 232 (1988) (holding that an omitted fact is material if a reasonable shareholder would consider it important in making their vote and this standard should be applied to all § 10(b) and Rule 10b-5 actions. The Court also held that materiality requires a case by case review of the facts, and a rebuttable presumption exists that stockholders relied on available information when buying or selling securities).

misstatement violates §10(b) of the Exchange Act and Rule 10b-5 when made with scienter....”⁹⁸

In its analysis, the court noted that Terry’s receipt of stock in exchange for writing articles appearing in the Whisper newsletter was “‘material’ so long as there [was] a ‘substantial likelihood’ that a reasonable investor would consider the motivations of the person recommending the purchase of a stock a significant factor in making an investment decision.”⁹⁹ Furthermore, the “[s]uppression of information material to an evaluation of the disinterestedness of investment advice operate[s] as a deceit on purchasers.”¹⁰⁰ Therefore, the court concluded that “the paid promotional nature of the articles was clearly a *material* fact for subscribers of the Newsletter who were potential investors.”¹⁰¹

Terry did not argue that the stock compensation that he and Melcher received was not a “material” fact requiring disclosure.¹⁰² Rather, he claimed that his compensation was disclosed to subscribers in the Whisper Newsletter.¹⁰³ The court stated that the issue to be resolved was “whether the statements that SGA personnel (1) ‘may own shares’ in stock featured in the Whisper Newsletter and (2) ‘may act as’ paid consultants for issuers of stock featured in the Newsletter are, separately or together, equivalent to a disclosure that Terry and Melcher were paid with stock by issuers to promote that very same stock.”¹⁰⁴ Concluding that the statements were not equivalent, the court found that Whisper Newsletter’s disclaimer that

⁹⁸ *Huttoe*, 1998 U.S. Dist. LEXIS 23211, at *16-17. See *supra* text accompanying note 42 for a definition of scienter.

⁹⁹ *Huttoe*, 1998 U.S. Dist. LEXIS 23211, at *19. See also *Basic*, 485 U.S. at 232.

¹⁰⁰ *Huttoe*, 1998 U.S. Dist. LEXIS 23211, at *19 (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 198 (1963) (internal citations omitted)).

¹⁰¹ *Id.* (emphasis added).

¹⁰² *Id.*

¹⁰³ *Id.* The full text of the (amended) disclaimer appearing in the Whisper Newsletter reads as follows:

SGA Goldstar Research is not an investment adviser! Information contained in SGA Goldstar is obtained from sources believed to be reliable; however, in certain instances such information involves rumors or other time sensitive materials which cannot adequately be verified. SGA makes no representation or warranty as to the accuracy or adequacy of the information and recommendations provided. This material is not deemed as a solicitation for the purchase or sale of a security or commodity. Use of the information and recommendations is at the subscriber’s sole risk. Personnel associated with SGA may own shares in the companies mentioned herein or may act as consultants thereto for compensation. Prudent investors are advised to use mental stop losses to protect their gains or limit their losses. All stocks priced under \$5 per share are deemed “penny stocks” and are extremely risky and speculative!

Id. at *20, n.11.

¹⁰⁴ *Id.* at *20.

“personnel ... may own shares” or “provide consulting advice” suggested that personnel at SGA were unaware of when they had a personal financial interest in the companies recommended in its newsletter and thus, was ambiguous.¹⁰⁵ The impression left by this disclaimer was that Terry and Melcher were being compensated for writing and publishing and not consulting. However, in addition to owning shares in the company, both were actually provided with shares as compensation for promoting the company in the newsletter. The court, therefore concluded that “[i]t is inherently misleading to present articles as objective reporting when they are in fact promotions paid for by the company featured. Whisper Newsletter subscribers simply could not tell from the disclaimer that Terry was paid to promote the stocks about which he wrote and, thus, were deprived of information substantially likely to affect their investment decision.”¹⁰⁶

Thus, the court found that Terry violated §10(b) of the Exchange Act by consistently touting stock for over two years, which establishes the requisite scienter.¹⁰⁷ The court also stated that “[t]he ineffectiveness of the Newsletter’s disclosure was not merely negligent. These statements were so likely to mislead subscribers that it was ‘either known to the defendant or [was] so obvious that the actor must have been aware of it.’”¹⁰⁸ Moreover, the court found that Terry “clearly must have known that a footnote in the Newsletter could not have adequately alerted subscribers to the fact that he and Melcher received free stock for promoting the companies they urged subscribers to buy.”¹⁰⁹

The court then proceeded to discuss three additional defenses raised by Terry, all of which were quickly dismissed as being invalid. First, Terry argued that “the information appearing in the Whisper Newsletter was not *in connection with* the offer or sale of securities within the meaning of the federal securities laws.”¹¹⁰ In support of his position, Terry pointed to the disclaimer which read that, “[t]his material is not deemed as a solicitation for the purchase or sale of a security or commodity.”¹¹¹ The court concluded that in light of the disclaimer, it was clear that the stocks promoted in the Whisper Newsletter were “designed to provide subscribers with information that would cause a reasonable investor to buy or sell securities in reliance

¹⁰⁵ *Id.* at *21.

¹⁰⁶ *Id.* (citations omitted). See *supra* note 9 for a definition of “tout.”

¹⁰⁷ *Huttoe*, 1998 U.S. Dist. LEXIS 23211, at *22.

¹⁰⁸ *Id.* (citing SEC v. Steadman, 967 F.2d 636, 641-42 (1992)).

¹⁰⁹ *Id.*

¹¹⁰ *Id.* at *22-23 (emphasis added).

¹¹¹ *Id.* at *23.

thereon.”¹¹² Second, Terry maintained that “he did not commit fraud because he wrote only some of the articles appearing in the Whisper Newsletter and because Melcher exercised final editorial control over its content.”¹¹³ In response, the court simply noted that a fraud committed by Melcher does not excuse a fraud committed by Terry.¹¹⁴ Lastly, Terry argued that he did not commit a fraud because the SEC failed to prove the inaccuracy of the information contained within the articles that he authored.¹¹⁵ On this point, the court espoused that the fraud at issue was Terry’s failure to disclose that some of the articles appearing in the Whisper Newsletter were paid promotions and concluded that the SEC made its case in this regard through Terry’s own admissions.¹¹⁶ Moreover, assuming *arguendo* that every word that Terry wrote was, in fact, true, Terry would still be in violation of §10(b) of the Exchange Act and Rule 10b-5 thereunder for failing to disclose the paid promotional nature of the articles that he published in the Whisper Newsletter.¹¹⁷

Also at issue was Terry’s nondisclosure of sales contrary to the Whisper Newsletter’s buy recommendations. The uncontested facts demonstrate that Terry received stock as compensation for the companies that he recommended in the Whisper Newsletter.¹¹⁸ In addition, the record showed that Terry sold the stocks of eighteen different companies shortly after the Whisper Newsletter made strong buy recommendations to its subscribers for those very same stocks.¹¹⁹ The court concluded that Terry’s practice of selling when the Whisper Newsletter recommended buying has long been recognized as a fraud or deceit.¹²⁰ Known as the practice of “scalping,” the

¹¹² *Id.* (quoting *SEC v. Savoy Industries, Inc.*, 587 F.2d 1149, 1171 (D.C. Cir. 1978)).

¹¹³ *Huttoe*, 1998 U.S. Dist. LEXIS 23211, at *23.

¹¹⁴ *Id.* at *24.

¹¹⁵ *Id.* The crux of Terry’s argument on this point lies in the fact that as a journalist, he should be able to rely on the press releases and other sources of information that he relied upon while writing his articles for the Whisper Newsletter. Specifically, he alleges that any inaccuracies about SOE were the result of Huttoe’s fraud of which he had no knowledge or other basis for suspicion. *Id.*

¹¹⁶ *Id.* at *25.

¹¹⁷ *Id.*

¹¹⁸ *Id.* at *26.

¹¹⁹ *Huttoe*, 1998 U.S. Dist. LEXIS 23211, at *26-27.

¹²⁰ *Id.* at *27-28. For example:

In *SEC v. Capital Gains Research Bureau, Inc.*, the Supreme Court held that “scalping,” a known practice whereby the owner of shares of a security recommends that security for investment and then immediately sells it at a profit upon the rise in the market price which follows the recommendation, was a violation of the Investment Advisors Act.

Id. (citing 375 U.S. 180, 181 (1963)). “Section 206 of the Investment Advisers Act (“IAA”) provides in relevant part that, ‘it shall be unlawful for any investment adviser ... to engage in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client.’” *Id.* at *28 (quoting 15 U.S.C. §80b-6(2)).

court espoused that scalping is an “extreme departure from the standard of care.”¹²¹ The court also stated that, “[t]o be clear, the fraud lies not in Terry’s practice of selling stocks contrary to Whisper’s recommendations, but in the failure to disclose that practice to potential investors and readers. The practice reflects on the objectiveness of the investment advice and is therefore material.”¹²²

Finding that Terry was cognizant of the danger in misleading subscribers of the Whisper Newsletter, the court noted that he continued to increase the number of stocks that he recommended and then sold over a two year period.¹²³ Moreover, Terry had actual knowledge of his inappropriate trading activities based on the fact that he attempted to keep his trading activities secret by trading the stocks that he scalped in the name of a shell Bahamian corporation that he owned through a Canadian brokerage account.¹²⁴ Again, Terry’s assertion that he disclosed the paid promotional nature of the articles was met with a similarly unsuccessful result.¹²⁵

In its holding, the court permanently enjoined Terry and the other defendants from further violations of the securities laws.¹²⁶ First, the court found that Terry’s conduct was not isolated, but part of a prolonged pattern of behavior that persisted for two years.¹²⁷ Second, the court noted that the nature of the fraud was not merely technical because: (1) Terry acted with

In *Capital Gains Research*, the Supreme Court recognized that this language mirrors that used in §17(a)(3) of the Securities Act, which also appears in Rule 10b-5(3) under §10(b) of the Exchange Act. *Id.* (citing *Capital Gains Research*, 375 U.S. at 197-98). “While the basis of liability under the IAA results from the fiduciary relationship between the investment adviser and the advisee, the Supreme Court understood that Congress intended that both Acts reflect a general proscription against fraudulent or deceptive practices such as the material nondisclosure involved in scalping.” *Huttoe*, 1998 U.S. Dist. LEXIS 23211, at *28.

¹²¹ *Huttoe*, 1998 U.S. Dist. LEXIS 23211, at *29-30 (quoting *SEC v. Steadman*, 967 F.2d 636, 641 (1992)).

¹²² *Id.* at *29 (citations omitted).

¹²³ *Id.* at *30.

¹²⁴ *Id.*

¹²⁵ *Id.* at *30-35. See *supra* notes 105-112 and accompanying text for a discussion of the disclaimer and the court’s analysis of it.

¹²⁶ *Huttoe*, 1998 U.S. Dist. LEXIS 23211, at *44.

Upon a finding of violation of the securities laws, the court may permanently enjoin the defendants from further violations. Under the *Savoy Industries* test, the court considers whether the defendant’s conduct was (1) isolated or part of a pattern, (2) flagrant and deliberate or merely technical in nature, and (3) whether the defendant’s business will present opportunities to violate the law in the future. *Id.* at *44-45 (citing *SEC v. Savoy Indus.*, 587 F.2d 1149, 1168 (D.C. Cir. 1978)); see also *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1228 (D.C. Cir. 1989). “The determination should focus on the propensity for future violations based on the totality of the circumstances.” *Id.* at *45 (citing *First City Fin. Corp.*, 890 F.2d at 1228).

¹²⁷ *Huttoe*, 1998 U.S. Dist. LEXIS 23211, at *45.

scienter to deliberately mislead subscribers of the Whisper Newsletter about the stocks that he scalped; (2) Terry purposefully attempted to conceal his scalping activities; and (3) Terry never acknowledged his misconduct.¹²⁸ Finally, the court determined that Terry's youth, educational experience related to stock promotions, and the use of a Bahaman holding company to place his trades support a strong likelihood that Terry is prone to violate the securities laws again in the future if given an opportunity to do so.¹²⁹ The court also ordered Terry to pay disgorgement of \$828,448 in profits realized from his unlawful activities.¹³⁰

*C. A Stock Manipulation Scheme Committed By A Mutual Fund Executive Who Drove Up The Share Price Of One Of His Fund's Largest Holdings To Create A Selling Opportunity: In re Fidelity/Micron Securities Litigation.*¹³¹

In the case of *In re Fidelity/Micron Securities Litigation*, the United States District Court for the District of Massachusetts addressed the issue of whether the plaintiffs' complaint that the defendants violated §10(b) of the Exchange Act was sufficient to survive a motion to dismiss under Rule 9(b) of the Federal Rules of Civil Procedure.¹³² In their complaint, the plaintiffs alleged that the defendants "deceived the investing public ... concerning [their] intentions to maintain their large holdings of technology stocks in general, and Micron common stock in particular, when in fact defendants ... intended to [and were] divesting their technology stocks, particularly Micron stock."¹³³ In support of their claim, the plaintiffs point to statements

¹²⁸ *Id.* See *supra* notes 110-117 and accompanying text for a discussion of Terry's defenses.

¹²⁹ *Huttoe*, 1998 U.S. Dist. LEXIS 23211, at *45-46.

¹³⁰ *Id.* at *46.

¹³¹ 964 F. Supp. 539 (D. Mass. 1997).

¹³² *Id.* at 542. The plaintiffs are investors who purchased Micron Technologies stock ("Micron") in October and November, 1995. *Id.* at 540. The defendants are FMR Corporation ("FMR Corp."), Fidelity Management and Research Company ("FMR"), Fidelity Magellan Fund ("Magellan"), and Jeffrey Vinik, then the portfolio manager of Magellan. Magellan is the largest mutual fund in the United States. Its investment portfolio was valued at \$53.5 billion on September 30, 1995. FMR is the registered investment adviser for Magellan. FMR provides Magellan with shareholder and managerial services, making all of the Fund's trading decisions and handling all of its communications with shareholders and the public. FMR Corp. is FMR's parent company. Jeffrey Vinik, an employee of FMR, was a Vice President and the portfolio manager of Magellan from July of 1992 until June 3, 1996. *Id.* See *supra* note 38 and accompanying text for a complete discussion of Rule 9(b) of the Federal Rules of Civil Procedure.

¹³³ *Fidelity/Micron*, 964 F. Supp. at 541 (citations omitted). As of August 31, 1995, approximately 5,600 shareholders owned some 200 million shares of Micron common stock. On September 30, 1995, FMR owned 19,620,445 shares of Micron stock, or 9.52% of the issued and outstanding shares. Magellan held 11,769,400 of these shares, or 5.7% of Micron's publicly traded stock. Micron was Magellan's third largest holding. In October of 1995, Magellan sold 1.3 million of its Micron shares. In November of 1995, Magellan sold nearly all of its remaining 11.8 million shares of Micron stock. *Id.*

made by Jeffrey Vinik, Fidelity's Magellan Fund manager, in the Magellan Semiannual Report ("Report") that was released on November 9, 1995.¹³⁴ In an interview appearing in the Report, Vinik attributed Magellan's out-performance of its competitors to its heavy investment in technology stocks.¹³⁵ Specifically mentioning Micron, Vinik stated that, "[t]he valuations of semiconductor stocks were quite depressed entering the [six month] period [preceding September 30, 1995]. Micron Technology is a good example of these dynamics at work. Its stock price more than doubled during that period, yet earnings grew so quickly that, in my view, the stock is still relatively cheap."¹³⁶ The plaintiffs alleged that, "Vinik's statements were intended to deceive investors and the market [into believing], by this Report, that Micron continued to be one of the long-term investments favored by Magellan."¹³⁷

On December 1, 1995, The Washington Post published an article disclosing that Vinik "had been quietly been selling off most of [Magellan's] shares in [Micron]."¹³⁸ In addition, the article reported that the pace of the sell-off had accelerated to coincide with the release of the Report.¹³⁹ On the day the article ran, Micron stock dropped from \$54.25 per share down to a closing price of \$51.875 per share.¹⁴⁰ The plaintiffs also alleged in their

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ *Id.* (citations omitted). Vinik also made the following statements in the Report in response to a scripted question:

[Regarding a reported reduction of Magellan's technology portfolio from 42.6% of its total holdings to 39.9%] This reduction does not represent a change in my long-term view of the technology sector. My outlook on technology spending in the U.S. and around the world over the next several years continues to be very positive. My bottom-up analysis of companies with the best earnings prospects and stock valuations—prices relative to earnings—kept pointing time and time again to technology companies.... But to reiterate, as I build the fund on a stock-by-stock basis, I continue to find that the majority of stocks with excellent long-term earning prospects and attractive valuations fall into the technology group ... because the long-term business and economic elements that have driven the technology sector are unlikely to change, I anticipate that the fund will remain overweighted in technology relative to the broad market for the foreseeable future.

[With regard to his investment philosophy] As to questions about the fund's manageability—or how the fund impacts the overall market—it's important to remember that I invest with a long-term horizon. I acquire stock positions slowly, over a period of time, and sell positions slowly, over a period of time, in seeking the maximum value for the fund's shareholders.

Id. at 541, n.4 (citations omitted).

¹³⁷ *Id.*

¹³⁸ *Id.* at 542 (citations omitted).

¹³⁹ *Fidelity/Micron*, 964 F. Supp. at 542.

¹⁴⁰ *Id.* This one day decline is most likely attributable to the fact that Micron's share price was inflated due to the market's erroneous belief that Vinik liked it. *See id.*

complaint that “Vinik’s influence on the stock market is second only to that of the Federal Reserve Chairman.... [W]hen Vinik buys or sells shares, the market feels the effects, [the] buy-and-sell decisions of Vinik ... can have a life-and-death impact on the stock price of many high-tech companies.... [E]verybody on the Street is looking to figure out what [Vinik] is doing.”¹⁴¹

Addressing the legal standard for its analysis of the defendants’ motion to dismiss, the court stated that “we must accept the allegations of the complaint as true, and if, under any theory, the allegations are sufficient to state a cause of action in accordance with the law, we must deny the motion to dismiss.”¹⁴² In addition, the court noted that the complaint must contain “factual allegations, either direct or inferential, respecting each material element necessary to sustain a recovery under some actionable theory.”¹⁴³ Therefore, assertions and legal conclusions that are unsupported may be disregarded by the court.¹⁴⁴

Under Rule 9(b) of the Federal Rules of Civil Procedure, the court noted that, “in all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity.”¹⁴⁵ Where securities fraud is alleged, however, the court stated that the particularity requirements are even more stringent.¹⁴⁶ In such cases, the court espoused that, “[g]eneral averments of the defendants’ knowledge of material falsity [of disclosures] will not suffice. Consistent with Fed. R. Civ. P. 9(b), the complaint must set forth specific facts that make it reasonable to believe that defendant[s] knew that a statement was materially false or misleading. The rule requires that the particular times, dates, places or other details of the alleged fraudulent involvement of the actors be alleged.”¹⁴⁷

The court then proceeded to analyze the plaintiffs’ allegations in the context of §10(b) of the Exchange Act and Rule 10b-5 thereunder.¹⁴⁸ The

¹⁴¹ *Id.* (internal quotation marks omitted).

¹⁴² *Id.* (quoting *Vartanian v. Monsanto Co.*, 14 F.3d 697, 700 (1st Cir. 1994)).

¹⁴³ *Id.* (quoting *Glassman v. Computervision Corp.*, 90 F.3d 617, 628 (1st Cir. 1996) (further internal citations omitted)).

¹⁴⁴ *Id.* (citing *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1216 (1st Cir. 1996)).

¹⁴⁵ *Fidelity/Micron*, 964 F. Supp. at 542. For a complete discussion of Rule 9(b) of the Federal Rules of Civil Procedure, see *supra* note 38 and accompanying text.

¹⁴⁶ *Fidelity/Micron*, 964 F. Supp. at 542.

¹⁴⁷ *Id.* (citing *Serabian v. Amoskeag Bank Shares, Inc.*, 24 F.3d 357, 361 (1st Cir. 1994) (citations and internal quotation marks omitted)). The First Circuit has “been especially rigorous in demanding such factual support in the securities context, particularly where the possibility exists that plaintiffs are seeking to use discovery as a settlement device rather than as a tool for marshaling evidence to support the merits of their claims. For this reason, heightened pleading is required even when the fraud relates to matters peculiarly within the knowledge of the opposing party.” *Id.* (quoting *Romani v. Shearson Lehman Hutton*, 929 F.2d 875, 878 (1st Cir. 1991)).

¹⁴⁸ *Id.* For the relevant provisions of §10(b) of the Exchange Act and Rule 10b-5 thereunder see

court first addressed the issue of whether Magellan could be held liable for statements made by Vinik and the other co-defendants.¹⁴⁹ In doing so, the court noted that, “[t]o bring a defendant within the ambit of Rule 10b-5, [the] plaintiffs must allege a misleading or manipulative representation or omission attributable to that defendant.”¹⁵⁰ The plaintiffs advanced three reasons to justify why Magellan shared primary liability for the other co-defendants’ false and misleading statements.¹⁵¹ First, they claimed that when Vinik spoke, the market understood that he was speaking for Magellan.¹⁵² Second, the plaintiffs argued that some of the false and misleading statements appeared in the Report.¹⁵³ Finally, they asserted that “Magellan directly benefited from the scheme to manipulate the price of Micron stock.”¹⁵⁴

In response, Magellan contended that, as an entity, it made no statements, and that all of the statements about which the plaintiffs complained fell under the investment management and communications responsibilities delegated to FMR and Vinik.¹⁵⁵ The plaintiffs acknowledged

supra notes 2 and 39, respectively.

¹⁴⁹ *Fidelity/Micron*, 964 F. Supp. at 543.

¹⁵⁰ *Id.* (citing *Cent. Bank of Denver v. First Interstate Bank*, 511 U.S. 164 (1994)). The issue in *Central Bank of Denver* was whether §10(b) covered persons who aid and abet a securities violation. The Court concluded that the statute prohibits “only the making of a material misstatement (or omission) or the commission of a manipulative act” and therefore applied only to those who in fact engage in prohibited conduct, whether “directly or indirectly.” *Id.* (quoting *Cent. Bank of Denver*, 511 U.S. at 176-177). “Only primary violators, i.e., those who *make* a material misstatement or omission or commit a manipulative act, are subject to private suit under Section 10(b).” *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26, 28 (D. Mass. 1994).

¹⁵¹ *Fidelity/Micron*, 964 F. Supp. at 543.

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

A mutual fund is a “mere shell,” a pool of assets consisting mostly of portfolio securities that belongs to individual investors holding shares in the fund. The management of this asset pool is largely in the hands of an investment adviser, an independent entity which generally organizes the fund and provides it with investment advice, management services, and office space and staff. The adviser either selects or recommends the fund’s investments and rate of portfolio turnover, and operates or supervises most of the other phases of the fund’s business. *Id.* (quoting *Tannenbaum v. Zeller*, 552 F.2d 402, 405 (2d Cir. 1977) (citations omitted)). *See also* *Burks v. Lasker*, 441 U.S. 471, 480-481 (1979) (stating that the principal purpose of the Investment Company Act [15 U.S.C. §§80a-10(a)-(b), 80a-15(a)-15(a)-(c)] is to protect mutual fund investors by maintaining the fund as an entity independent of its adviser). In the same vein, the Senate Committee overseeing the passage of the Securities Law Enforcement Remedies Act of 1990 stated:

[T]he Committee also expects that the SEC will not ordinarily seek penalties against registered investment companies. Generally, an investment company is a managed portfolio of liquid assets, with all the expenses passed on to shareholders. While the legislation permits

in their complaint that “Magellan was [is] registered under the Investment Company Act and that FMR by contractual delegation was [is] responsible for all of the Fund’s trading decisions and communications.”¹⁵⁶ The court noted that because this responsibility was exclusive to FMR, “Vinik’s statements could only have been made in his capacity as an employee of FMR” and thus, “statements by Vinik and other FMR employees could not be imputed to Magellan.”¹⁵⁷ However, the plaintiffs argued that *Central Bank*¹⁵⁸ does not preclude the liability of a principal for the acts of its agent.¹⁵⁹ In dismissing the §10(b) fraud claim against Magellan, the court stated that, “[t]o hold Magellan liable under Rule 10b-5 on a theory of *respondeat superior* would impose liability without any showing that the market relied on statements or actions directly or indirectly attributable to Magellan in evaluating Micron shares.”¹⁶⁰

The court next addressed liability under a duty to disclose theory.¹⁶¹ In *Chiarella v. United States*,¹⁶² the Supreme Court stated that “a duty to disclose arises when one party has information ‘that the other party is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.’”¹⁶³ The court then noted that in their complaint, the

civil penalties based on violations of the Investment Company Act, the penalties generally would be assessed against the responsible individuals.

Fidelity/Micron, 964 F. Supp. at 543-44 (quoting S. REP. NO. 337, 101st Cong., 2d Sess., at 17 (1990)).

¹⁵⁶ *Fidelity/Micron*, 964 F. Supp. at 544.

¹⁵⁷ *Id.*

¹⁵⁸ 511 U.S. at 175 (1994).

¹⁵⁹ *Fidelity/Micron*, 964 F. Supp. at 544. In *Central Bank of Denver*, the Supreme Court held that Congress’s omission of “aiding and abetting” from the language of §10(b) concluded the issue of the statute’s reach and coverage.” *Fidelity/Micron*, 964 F. Supp. at 544 (quoting *Cent. Bank of Denver*, 511 U.S. at 175 (1994)). “The proscription [of the statute] does not include giving aid to a person who commits a manipulative or deceptive act. We cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute” *Id.* at 544 (quoting *Cent. Bank of Denver*, 511 U.S. at 177-78). As the Court pointed out, a critical element of Rule 10b-5 liability, reliance on a defendant’s misstatement or omission, would be missing if liability were to be imposed on aiders and abettors. *Id.* (citing *Cent. Bank of Denver*, 511 U.S. at 180).

¹⁶⁰ *Fidelity/Micron*, 964 F. Supp. at 544 (citing *In re Prudential Ins. Co.*, 1983 U.S. Dist. LEXIS 16397 (D.N.J. May 10, 1996) (*Central Bank* strongly implies that *respondeat superior* liability is not available under §10(b)); *ESI Montgomery County, Inc. v. Monteny Int’l Corp.*, 1996 U.S. Dist. LEXIS 592 (S.D.N.Y., Jan. 23, 1996) (holding that defendant found not liable under Rule 10b-5 for alleged misrepresentations of its managers in light of the holding of *Central Bank*).

¹⁶¹ *Fidelity/Micron*, 964 F. Supp. at 544-545; see also *Cent. Bank of Denver*, 511 U.S. at 174 (stating that to make out a cause of action for an omission, or failure to speak, in a securities case, a plaintiff must plead an affirmative duty of disclosure).

¹⁶² 445 U.S. 222 (1980).

¹⁶³ *Fidelity/Micron*, 964 F. Supp. at 545 (quoting *Chiarella*, 445 U.S. at 228) (internal citations omitted).

plaintiffs made no allegation that any such duty or relationship existed, and acknowledged that the fiduciary duty Vinik owed was to Magellan's shareholders and not to the investing public at large.¹⁶⁴

In cases where the allegations are of affirmative misrepresentations, the court stated that the law imposes broader liability.¹⁶⁵ Corporate insiders are, therefore, held to fiduciary standards to prevent them from taking unfair advantage of uninformed investors.¹⁶⁶ Under such standards, "[a] duty derivative of that imposed on insiders is also applied to 'tippees'¹⁶⁷ and to 'scalpers.'¹⁶⁸ In addition, a viable §10(b) claim can be successfully pled without any allegations that a fiduciary relationship existed.¹⁶⁹ The court, therefore, concluded that this case was the direct opposite of a scalping case because Vinik's alleged purpose was to encourage the public to believe that he had an interest which he did not actually have, rather than to hide any investment in Micron.¹⁷⁰ Nonetheless, the court found the plaintiffs' analysis of the defendants' actions under a classical model of scalping to be persuasive.¹⁷¹

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*; see generally *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1220 (1st Cir. 1996); *Backman v. Polaroid Corp.*, 910 F.2d 10, 16 (1st Cir. 1990) (en banc); *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22, 26 (1st Cir. 1987).

¹⁶⁶ *Fidelity/Micron*, 964 F. Supp. at 545 (citing *Chiarella*, 445 U.S. at 229).

¹⁶⁷ *Id.* (citing *SEC v. Maio*, 51 F.3d 623, 631-33 (7th Cir. 1995)). A "tippee" is someone who acquires nonpublic information from someone who enjoys a fiduciary relationship with the firm to which such information pertains. Jonathan R. Macey, *Policy Analysis: SEC's Insider Training Proposal: Good Politics, Bad Policy*, CATO POLICY ANALYSIS 101, n. 18 (1988) available at <http://www.cato.org/cgi-bin/scripts/printtech.cgi/pubs/pas/pa101.html> (last visited Jan. 5, 2005).

"[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."

Dirks v. SEC, 463 U.S. 646, 660 (1983).

¹⁶⁸ *Fidelity/Micron*, 964 F. Supp. at 545 (citing *SEC v. Blavin*, 760 F.2d 706, 711 (6th Cir. 1985)) (showing ostensibly disinterested investment advisers recommending stocks without revealing their personal stake in the transaction). "A scalper seeks to profit by taking advantage of changing market conditions which will affect prices of options before those conditions become manifest in the market." *Schultz v. SEC*, 614 F.2d 561, 566, n.6 (1980).

¹⁶⁹ *Fidelity/Micron*, 964 F. Supp. at 545.

¹⁷⁰ *Id.*

¹⁷¹ *Id.* Vinik publicly stated or implied that Magellan would not sell its substantial holding in Micron, which he communicated as a "buy," knowing that his power and influence over the market was such that investors would respond by buying Micron, and thereby allow defendants to dump Micron at prices inflated by his favorable statements. There is authority supporting the plaintiffs' contention that "the 'scalping' theory of manipulation is not premised on the making of misrepresentations that only relate to the giving of investment advice, as suggested by defendants." See also *Abelson v. Strong*, 644 F. Supp. 524, 527-528 (D. Mass. 1986).

Finally, the plaintiffs alleged that the defendants engaged in a securities manipulation scheme under a “Fraud on the Market Theory.”¹⁷² As noted above, in a “Fraud on the Market” case, the statements identified by plaintiffs as actionably misleading are alleged to have caused injury by impacting the market price of the purchased security and not through the plaintiffs’ direct reliance upon them.¹⁷³ The defendants, in response to the plaintiffs’ allegation that their statements “artificially inflate[d], manipulate[d] and support[ed] the demand for . . . Micron,” argued that the complaint failed to demonstrate that any of Vinik’s statements were false and thus were incapable of misleading the market.¹⁷⁴ The court dismissed this defense and stated that “[s]ome statements, although literally accurate, can become, through their context and manner of presentation, devices which mislead

¹⁷² *Fidelity/Micron*, 964 F. Supp. at 546; see *supra* note 58 and accompanying text for a discussion of the “Fraud on the Market Theory.” In the plaintiffs’ complaint, they allege that:

- Prior to the beginning of the Class Period, the defendants embarked upon a plan, scheme, and course of conduct which was intended to and, throughout the Class Period, did;
- (a) deceive the investing public, including plaintiffs and the other Class members, concerning the defendants’ intentions to maintain their large holdings of technology stocks in general, and Micron common stock in particular, when in fact defendants not only intended to but were in fact divesting or selling their technology stocks, particularly Micron stock;
 - (b) artificially inflate, manipulate and support the demand for the volume of trading in, and the market price of technology stocks, particularly Micron common stock, so that defendants could secretly dump most of their investment in technology stocks, and in particular nearly all of their Micron investment, in order to realize greater proceeds on those investments than they would have had the market become aware of defendants’ intent to sell or actual selling of such stock;
 - (c) cause plaintiffs and other members of the Class to purchase Micron stock at artificially inflated and manipulated prices while Magellan and other Fidelity Funds were secretly liquidating their investments in Micron at those prices;
 - (d) allow Magellan and other Fidelity Funds to attract both additional investors and monetary contributions from existing customers as Magellan and the other Fidelity Funds reported gains in their technology holdings and Micron stock, which absent the course of conduct specified herein, they would not otherwise have obtained;
 - (e) allow Vinik to increase his substantial salary, and any bonus based on Magellan’s performance; and
 - (f) allow Fidelity Management to increase its substantial management or other fees from Magellan, which fees were specifically pegged to Magellan’s asset size and its performance relative to the S&P 500 index.

Fidelity/Micron, 964 F. Supp. at 546.

¹⁷³ *Fidelity/Micron*, 964 F. Supp. at 546 (internal citations omitted). When the truth is revealed and the market self-corrects, investors who bought at the inflated price suffer losses. Those losses are attributable to the defendants’ statements, even without direct reliance by plaintiffs, because the statements were presumptively absorbed into and reflected by the security’s price. See *supra* note 58 and accompanying text for a discussion of the “Fraud on the Market Theory.”

¹⁷⁴ *Fidelity/Micron*, 964 F. Supp. at 546-547.

investors. For that reason, the disclosure required by the securities laws is measured not by literal truth, but by the ability of the material to accurately inform rather than mislead prospective buyers.¹⁷⁵ The court determined that the import of the defendants' words was a question of fact, and therefore denied the defendants' motion to dismiss the plaintiffs' charge of fraud under §10(b) of the Exchange Act and Rule 10b-5 thereunder as it applied to defendants FMR, FMR Corp. and Vinik.¹⁷⁶

D. Infamous Internet Pump And Dump Schemes Committed By Greedy "Nobodies" Who Caused The Share Price Of Several Penny And Micro-Capitalization Stocks To Be Artificially Inflated While They Cashed In And "Laughed All The Way To The Bank."

1. DOUGLAS W. COLT

In late January, 1999, Douglas W. Colt created Fast-Trades.com ("Fast-Trades"), an internet stock selection website.¹⁷⁷ Fast-Trades offered its subscribers a free "six month trial period," which the website stated was a "limited time offer."¹⁷⁸ Subscribers were notified about stock selections

¹⁷⁵ *Id.* at 547 (quoting *McMahan & Co. v. Wherehouse Entm't, Inc.*, 900 F.2d 576, 579 (2d Cir. 1990)). "Emphasis and gloss can, in the right circumstances, create liability." See also *Jones v. Bowman*, 694 F. Supp. 538, 547 (quoting *Isquith v. Middle South Utilities, Inc.*, 847 F.2d 186, 203 (5th Cir. 1988)). "When a corporation does make a disclosure—whether it be voluntary or required—there is a duty to make it complete and accurate." (quoting *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22, 16 (1st Cir. 1987)). "A corporation, in other words, has a duty to ensure that material information is disclosed in such a way that it can be understood by the investing public in essentially the same way as it would be perceived by corporate insiders."

¹⁷⁶ *Jones*, 694 F. Supp. at 549.

¹⁷⁷ *In re Kenneth Terrell*, Securities Exchange Act of 1934 Release No. 42483, 2000 SEC LEXIS 394, at *6 (Mar. 2, 2000). Douglas Colt began trading stocks in the summer of 1998, when he opened a margin account at Charles Schwab & Co. SEC v. Colt, No. CV-1:00CV00423, ¶¶14-17 (D.D.C. 2002), available at <http://www.johnreedstark.com/ClassMaterials/Complaints.Colt%20Complaint.htm> (last visited Nov. 2, 2004). Through 1998 and early 1999, Colt predominately traded technology and penny stocks in which he held positions for only a few days or weeks. In total, Colt bought and sold approximately thirteen positions before he began making recommendations on the Fast-Trades website. Colt's trading in these thirteen stocks yielded a total net profit of approximately \$24. In light of Colt's unfavorable record for picking stocks, Fast-Trades posted a "track record" that listed alleged previous picks, the highest price the stock reached after that pick, and a "stable high" price supposedly showing a price at which the stock settled after Fast-Trades recommended it. In its Complaint, the SEC alleged that, "[t]he 'track record' of alleged previous stock picks that Colt included on the Fast-Trades website was materially false and misleading. In his posted track record, Colt included the names and short term performance of some stocks that had never been selected by Fast-Trades. He did this in order to artificially enhance Fast-Trades' stock-picking credibility with substantial subscribers.

¹⁷⁸ *Terrell*, 2000 SEC LEXIS 394, at *6 (stating that in light of Fast-Trades' claim that its services

from Fast-Trades in one of two ways: either through a password protected area of the website that enabled subscribers to learn of selections one day in advance of its release to the public; or by having the selection emailed to them at the same time that it was posted to subscribers on the website.¹⁷⁹ Colt was the lone “researcher” for Fast-Trades and made all of the website’s stock recommendations.¹⁸⁰

Following an increase in the price of Electrosorce, Inc. after his “test” recommendation, Colt and his participants in the Fast-Trades scheme began to purchase other stocks prior to their disclosure as a Fast-Trades selection.¹⁸¹ For all four recommendations, purchases made by Fast-Trades increased the price and volume of the selections prior to disclosing the chosen stock to subscribers.¹⁸² Fast-Trades’ first recommendation was Apache Medical Systems.¹⁸³ On February 16, 1999, less than an hour before the selection of Apache Medical Systems was sent to subscribers, Colt purchased 5,000 shares at \$1.0625 per share.¹⁸⁴ Shortly thereafter, but before

were being offered without charge for the first six months, no subscriber ever paid a fee).

¹⁷⁹ *Id.* at *6. Prior to engaging in any trades based on a recommendation from Fast-Trades, Colt decided to test what impact the release of his stock selection would have on the Market. On February 1, 1999, Colt recommended Electrosorce, Inc., and watched its price increase by thirty-five percent shortly after the selections announcement. *Id.* at *6-7.

¹⁸⁰ *Id.* at *6. Colt was also joined in the Fast-Trades scheme by Kenneth Terrell and Jason Wyckoff, his law school roommates during the 1998-99 academic year. Shortly after Colt started the Fast-Trades website, he offered his roommates the opportunity to participate in Fast-Trades. Colt advised them that he had posted a stock recommendation on the website and monitored the market to see how his selection affected the stock. If they agreed to help, Colt agreed to permit them to trade on Fast-Trades’ selections through his account. Terrell and Wyckoff agreed to participate with Colt, and during February and March, 1999, the two spent extensive amounts of time posting materially false and misleading messages on several hundred different Yahoo! internet message boards promoting Fast-Trades to potential subscribers. Colt’s roommates each gave Colt money to purchase shares on their behalf in Colt’s brokerage account. *Id.* at *7.

¹⁸¹ *Id.* at *8. As the chart below illustrates, participants in the Fast-Trades scheme and their two friends collectively purchased an increasing number of shares with each selection.

Security	Fast-Trades Related Purchase	Average Daily Volume	% of Average Daily Volume
Apache Medical	5,000	11,694	43%
Option Care	24,000	13,823	174%
American Education	36,283	3,454	1050%
Artecon	51,512	33,341	154%

Id. at *8; Colt, No. CV-1:00CV00423, ¶¶14-17 (D.D.C. 2002), available at <http://www.johnreedstark.com/ClassMaterials/Complaints.Colt%20Complaint.htm> (last visited Nov. 2, 2004).

¹⁸² Terrell, 2000 SEC LEXIS 394, at *8.

¹⁸³ *Id.* at *9.

¹⁸⁴ *Id.* at *9. Of the 5,000 shares of Apache Medical Systems that Colt purchased, 4,000 were for

the selection was released, Colt placed a sell limit order¹⁸⁵ of \$4.00 per share for his newly acquired Apache Medical Systems stock.¹⁸⁶ In the twenty minute period between Colt's purchase and the time the Fast-Trades selection was sent out, Apache Medical Systems' price increased by 41% to \$1.50 per share.¹⁸⁷ In the time shortly thereafter, the price of Apache Medical Systems stock reached an intraday high of \$6.785 per share, an increase of more than 600% above the price of Colt's purchase only hours earlier.¹⁸⁸ As Colt sat at his computer and watched the price of Apache Medical Systems soar, he adjusted his sell limit twice in a matter of minutes.¹⁸⁹ In the end, Colt and his colleagues at Fast-Trades managed to make a collective profit of \$27,937.50 by trading the stock of Apache Medical Systems that they owned in just a thirty minute span.¹⁹⁰

On February 24, 1999, Fast-Trades selected Option Care as its second recommendation.¹⁹¹ Prior to sending an email to Fast-Trades' subscribers advising them of the latest selection, Colt purchased 10,000 shares of Option Care at \$1.625 per share and then placed a sell limit order to dispose of the stock at \$5.00 per share.¹⁹² After sending notification of the selection to Fast-Trades' subscribers, the price of Option Care rose to an intraday high of \$5.875 per share, a price movement of \$4.25 per share more than Colt's first purchase.¹⁹³ Colt's sell limit order was filled at \$5.375 per share shortly after Fast-Trades' announcement.¹⁹⁴ As a result of manipulating the price of

himself and 500 each were for Terrell and Wyckoff. Colt's purchase represented over 40% of the 11,700 share total average daily volume of Apache Medical Systems. *Id.* at *8.

¹⁸⁵ A sell limit order is "an order to a broker to sell a specified quantity of a security at or above the specified price." WebFinance, Inc., *investorwords.com*, at http://www.investorwords.com/4479/sell_limit_order.html (last visited November 22, 2004).

¹⁸⁶ *Terrell*, 2000 SEC LEXIS 394, at *9.

¹⁸⁷ *Id.* at *9-10.

¹⁸⁸ *Id.* at *10.

¹⁸⁹ *Id.*

¹⁹⁰ *Id.* Apache Medical Systems reported a trading volume of 1,085,600 shares on February 6, 1999. Within a few hours of being recommended by Fast-Trades, Apache Medical Systems' stock price collapsed. Only days later, Apache Medical Systems was trading within pennies of its price at the time of its recommendation on Fast-Trades. *Id.* at *10-11.

¹⁹¹ *Id.* at *11.

¹⁹² *Terrell*, 2000 SEC LEXIS 394, at *11. Colt purchased 8,000 shares for himself and another 1,000 each for Terrell and Wyckoff. When Colt purchased his 10,000 shares at 11 A.M. on February 24, 1999, there were no prior trades in Option Care on that day. In addition, Colt's purchase amounted to approximately 70% of the 14,000 share total average daily volume of Option Care. *Id.*

¹⁹³ *Id.* at *11-12.

¹⁹⁴ *Id.* at *12.

Option Care, Colt and his Fast-Trades associates made a collective profit of \$37,500.¹⁹⁵

The third Fast-Trades recommendation for American Education Corporation stock was released on March 5, 1999.¹⁹⁶ Before this selection was revealed to Fast-Trades' subscribers, Colt purchased 19,000 shares of American Education Corporation stock.¹⁹⁷ Shortly thereafter, Colt placed a sell limit order for \$6.50 per share.¹⁹⁸ Following the release of American Education Corporation as a Fast-Trades selection, the stock achieved an intraday high of \$10.00, an increase of \$8.75—or more than 700% above the price of Colt's purchase.¹⁹⁹ As a result of their trading in American Education Corporation stock, Colt, Terrell and Wyckoff reaped a net profit of \$41,093.75 and Joanne Colt made \$59,984.37.²⁰⁰

The fourth and final recommendation made by Fast Trades, Artecon, Inc., was purchased by Colt, his associates, and their friends.²⁰¹ Immediately before this selection was announced to Fast-Trades' subscribers, Colt purchased 18,282 shares of Artecon on March 10, 1999.²⁰² Prior to the disclosure of the selection, sell limit orders were placed on the 51,512 total Artecon shares purchased by Colt, his Fast-Trades associates and their friends.²⁰³ Both Colt and Joanne Colt knew that their purchases of Artecon

¹⁹⁵ *Id.* Option Care reported a trading volume of 1,290,100 shares on February 24 1999. Within a few hours of being recommended by Fast-Trades, Option Care's stock price collapsed. Only days later, Option Care was trading within pennies of its price at the time of its recommendation on Fast-Trades. *Id.* at *11-12.

¹⁹⁶ *Id.* at *14.

¹⁹⁷ *Id.* Of the shares of American Education Corporation stock that Colt purchased, 10,000 were for himself, 4,000 each were purchased for Terrell and Wyckoff and another 1,000 shares were purchased for another of Colt's law school friends who became a participant in the Fast-Trades scheme. In addition, Colt advised his mother, Joanne Colt, to purchase shares of American Education Corporation in advance of its disclosure as a Fast-Trades selection. Acting on the advice, Joanne Colt purchased 10,750 shares of American Education Corporation stock and entered sell limit orders ranging from \$4.50 and \$7.00 per share. Joanne Colt then passed the tip to purchase American Education Corporation stock on to her friend who subsequently purchased 4,533 shares and then entered sell limit orders staggered between \$4.00 and \$5.00 per share. *Id.* at *14-15.

¹⁹⁸ *Terrell*, 2000 SEC LEXIS 394, at *14.

¹⁹⁹ *Id.* at *16.

²⁰⁰ *Id.* In addition, Colt's law school friend made a profit of \$3,500 selling American Education Corporation stock while Joanne Colt's friend made a profit of \$15,899. On March 5, 1999, American Education Corporation reported a trading volume of 842,600 shares. Within a few hours of being recommended by Fast-Trades, American Education Corporation's stock price collapsed. Only days later, American Education Corporation was trading within pennies of its price at the time of its recommendation on Fast-Trades. *Id.* at *14-15.

²⁰¹ *Id.* at *16-17.

²⁰² *Id.*

²⁰³ *Id.*

stock were increasing its share price because over the course of a few hours the price they paid had increased from \$1.125 per share to \$1.34 per share.²⁰⁴ As with the previous three Fast-Trades' selections, the price of Artecon increased dramatically following its recommendation.²⁰⁵ Artecon achieved an intraday high of \$6.00 per share, an increase of \$4.875 per share from the price of Colt's first purchase.²⁰⁶ The result of Colt's trading in Artecon stock yielded him, Terrell, and Wyckoff a profit of \$66,516.36 and Joanne Colt made \$47,081.25.²⁰⁷

All of the participants in the Fast-Trades scheme had little or no knowledge about stocks and the securities markets.²⁰⁸ Despite their lack of investing experience, Colt, Terrell, Wyckoff and their friend from law school posted hundreds of false or misleading messages on internet message boards.²⁰⁹ Most of these messages were advertisements for Fast-Trades to prospective subscribers.²¹⁰ In addition to posting advertisements for Fast-

²⁰⁴ Terrell, 2000 SEC LEXIS 394, at *18. On March 10, before Colt began buying Artecon (ARTE), only 800 shares were traded and the price remained steady at \$ 1.125 per share. From 10:11 a.m., when Colt's first trade was reported, until 11:30 a.m. when the Fast-Trades recommendation went out, total trading volume of Artecon, Inc. increased to 164,500 shares and the price rose to \$1.375, a 22% increase in two hours. *Id.* at *17-18.

²⁰⁵ *Id.*

²⁰⁶ *Id.*

²⁰⁷ *Id.* at *19. In addition, Colt's law school friend received a profit of \$15,474.37 while Joanne Colt's friend earned \$34,937.00. On March 10, 1999, Artecon reported a trading volume of 4,581,000 shares. Within a few hours of being recommended by Fast-Trades, Artecon's stock price collapsed. Only days later, Artecon was trading within pennies of its price at the time of its recommendation on Fast-Trades. *Id.* at *18-19.

²⁰⁸ *Id.*

²⁰⁹ *Id.* at *21. In an April 29, 1999 online message board posting criticizing an unrelated stock picking website, and again using an alias, Colt set forth an eleven-point blueprint for a price manipulation scheme:

Colt's blueprint posting stated: (1) screen for thinly traded stocks in the \$1 to \$2 range; (2) get rid of all the oil and gas stocks because "they're not trendy"; (3) modify the screen to find companies that have shown revenue increases in the last quarter, "so you can justify this gem to the world"; (4) of the remaining stocks, look for one with very low average volume and low float; (5) pull together information from optimistic company press releases; (6) "throw in some bull**** about the company being an internet wonder"; (7) "buy a bunch of this garbage stock"; (8) "tell your idiot subscribers about how great the stock is, and, like sheep, they will run out and buy it"; (9) "dump the shares you bought a few hours ago to all of these suckers"; (10) "watch the stock steadily tank for the next month"; and (11) "laugh all the way to the bank."

Colt, No. CV-1:00CV00423, at ¶18, available at <http://www.johnreedstark.com/ClassMaterials/Complaints/Colt%20Complaint.htm> (last visited November 22, 2004).

²¹⁰ Terrell, 2000 SEC LEXIS 394, at *21. The purpose of these messages was to build the subscriber base by inducing readers of the message boards to visit Fast-Trades.com, to review its recommendations and to become subscribers, so that they would in turn purchase its recommendations

Trades, Terrell also posted messages on internet web boards defending investor allegations that the website engaged in price manipulation.²¹¹ Terrell misrepresented his identity in those messages and cited securities law statutes which he believed demonstrated that Fast-Trades' activities were legal.²¹²

As a means to evade liability for their fraudulent trading scheme, Colt and his Fast-Trades associates posted various disclaimers on the website.²¹³ However, the Commission concluded that these disclaimers were materially misleading as to the real trading intent of the Fast-Trades participants.²¹⁴ The Commission noted that Fast-Trades participants had already purchased shares in the recommended stock before subscribers even received the recommendation and Colt and his associates had already placed orders to sell the stock and expected those orders to be filled by the increase in price and volume caused by the purchases of their subscribers.²¹⁵ The Commission noted that, "[i]f Fast-Trades had accurately disclosed their trading intentions, subscribers would have been able to deduce that the only reason Colt offered his 'free' service was so he could further influence the market price movement initiated by his purchase of the recommended stock just before the announcement."²¹⁶ Colt was, therefore, able to "condition the market and then profit at the expense of his subscribers by executing pre-set

and in turn, drive up the price of the selection. Colt, Terrell, Wyckoff and their friend from law school all made such postings. Colt taught each of them how to create on-line "identities," and how to post messages to internet message boards at financial websites such as Yahoo.com and RagingBull.com. As they had been instructed by Colt, they did not disclose their affiliation with Fast-Trades and they used multiple identities to enhance the credibility of their messages. Colt also encouraged them to misrepresent substantive information, such as their investment successes from following Fast-Trades' recommendations, to draw readers of the message boards to the Fast-Trades site. *Id.* at *21-22.

²¹¹ *Id.*

²¹² *Id.* at *22-23. In a message posted to the Yahoo! message board related to Option Care, Terrell falsely stated that he had "tried to get the SEC to take a look into [Fast-Trades], but apparently they can't do anything about it." *Id.* at *23.

²¹³ *Id.* at *23. At the time that the Apache Medical Systems recommendation was made, Fast-Trades contained a disclaimer that, "[w]e may buy or sell our picks at any time." Following that recommendation, Colt, Terrell, Wyckoff and their law school friend, revised various aspects of the disclaimer, including the portion addressing their trading in Fast-Trades' selections. From that point on, through the other three recommendations they traded in, the disclaimer read, in relevant part: "FastTrades representatives may, and in many cases do, invest or hold positions in the companies that FastTrades recommends; FastTrades representatives reserve the right to buy or sell securities recommended by FastTrades at any time." *Id.* at *23-24.

²¹⁴ *Id.* at *24.

²¹⁵ *Id.*

²¹⁶ Terrell, 2000 SEC LEXIS 394, at *23-24.

sales of the recommended stock at inflated prices to a market that was likely to include subscribers.²¹⁷

In an offer of settlement that was formally accepted by the SEC on March 2, 2000, the Commission made the following observations about the type of fraud committed by Colt and his associates through Fast-Trades:

The internet today affords investors unprecedented access to information about investment opportunities. Yet the innovative technology of the internet has created new opportunities for individuals to deceive investors. Information placed on the internet instantaneously reaches thousands of individuals, and may have an unwarranted aura of legitimacy. Thus, those willing to break the law have a very effective medium to perpetrate fraud on the securities markets. The type of activity involved in this case was not new—it was a variation of a “pump and dump” scheme. What was novel was the way that internet technology was used to promote the stocks and deceive investors. Attempts to deceive investors or disrupt the securities markets, whether such schemes are perpetrated on the internet or by more traditional means, will not be tolerated.²¹⁸

The Commission also noted that investors should be skeptical of internet websites that proclaim expert stock recommendations.²¹⁹ In cautioning the investing public about bulletin board messages and chat rooms that hype either a particular stock or a recommendation website, the Commission stated that, “[i]nvestors must continue to rely on the hallmarks of good investing practices: diligence, analysis and research.”²²⁰ Accordingly, Terrell, Wyckoff, Colt’s law school friend and Joanne Colt all consented to cease and desist from committing or causing any violations or future violations of §10(b) of the Exchange Act and Rule 10b-5 thereunder pursuant to §21C of the Exchange Act²²¹ for causing Colt’s violation of the same.²²² In addition,

²¹⁷ *Id.*

²¹⁸ *Id.* at *25-26.

²¹⁹ *See id.* at *26.

²²⁰ *Id.*

²²¹ *Terrell*, 2000 SEC LEXIS 394, at *26-27. Section 21C of the Exchange Act provides in relevant part that:

If the Commission finds, after notice and opportunity for hearing, that any person is violating, has violated, or is about to violate any provision of this title, or any rule or regulation thereunder, the Commission may publish its findings and enter an order requiring such person, and any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation of the

Colt consented, while neither admitting nor denying the allegations of the complaint, to the entry of the injunction, and, based on his demonstrated financial inability to pay, the SEC waived payment of disgorgement and prejudgment interest and did not seek the imposition of a civil penalty.²²³

2. JONATHAN G. LEBED

Jonathan Lebed, a fifteen-year-old high school student from Cedar Grove, New Jersey, is the youngest person ever to be prosecuted by the SEC for securities fraud.²²⁴ On eleven separate occasions between August 23, 1999 and February 4, 2000, Lebed engaged in a scheme to manipulate the price of thinly traded microcap stocks that he had just purchased by sending numerous false or misleading messages over the internet touting their performance.²²⁵ All of Lebed's trades were placed through custodial accounts that were located at two broker-dealers and titled in his father's name.²²⁶

same provision, rule, or regulation. Such order may, in addition to requiring a person to cease and desist from committing or causing a violation, require such person to comply, or to take steps to effect compliance, with such provision, rule, or regulation, upon such terms and conditions and within such time as the Commission may specify in such order. Any such order may, as the Commission deems appropriate, require future compliance or steps to effect future compliance, either permanently or for such period of time as the Commission may specify, with such provision, rule, or regulation with respect to any security, any issuer, or any other person.

15 U.S.C. § 77h-1(a) (2004). Despite fining Terrell, Wysckoff, and Joanne Colt the sums of \$10,314.87, \$4,500, and \$157,901.62, respectively, the Commission waived the payments because each Respondent demonstrated a financial inability to pay. See *Terrell*, 2000 SEC LEXIS 394, at *28.

²²² The Commission noted that Terrell, Wyckoff, Altman and Joanne Colt "knew or should have known that their acts or omissions to act would contribute to such violations" based on the nature of their activities. *Id.* at *25.

²²³ *Terrell*, 2000 SEC LEXIS 394, at *3. See generally *SEC Sues Washington, DC-Area Law Students for Internet Price Manipulation; Scheme Architect's Mother—a Colorado Springs, CO City Councilwoman—Also Charged*, 1, 2 (Mar., 2, 2000) (providing a summary of the events in the form of a press release), available at <http://www.sec.gov/news/press/2000-20.txt> (last visited Nov. 7, 2004).

²²⁴ See Michael Lewis, *Jonathan Lebed's Extracurricular Activities*, NY TIMES MAGAZINE, Feb. 25, 2001, at 26. See also In re Jonathan G. Lebed, Exchange Act Release No. 43307, 2000 SEC LEXIS 1964, at *1-2 (Sept. 20, 2000) (admin. proceeding).

²²⁵ *Lebed*, 2000 SEC LEXIS 1964, at *2. The stocks manipulated by Lebed included: Manchester Equipment Company, Inc.; Just Toys, Inc.; Yes Entertainment, Inc.; Fotoball USA, Inc.; Man Sang Holdings, Inc.; West Coast Entertainment, Inc.; Havana Republic, Inc.; Classica Group, Inc.; and Firetector, Inc. *Id.* at *2 n.1.

²²⁶ However, Lebed made all of the trading decisions. *Id.* at *3.

Lebed's internet postings and their subsequent effect on the market all mirrored the same pattern.²²⁷ First, Lebed would target a thinly traded microcap stock that was usually traded on the NASD Electronic Bulletin Board of the NASDAQ National Market.²²⁸ Next, he would acquire a position in that company, buying between 17% and 46% of the daily trading volume on the date of his purchase.²²⁹ The momentum of Lebed's purchase alone would usually cause the price of the stock to rise.²³⁰ Within hours of making his purchase, but after the market had closed for the day, Lebed would usually begin posting false and misleading messages about the stock.²³¹ During his initial round of postings, Lebed would post between 200 and 300 identical messages to Yahoo! Finance message boards using multiple fictitious names.²³² The morning after acquiring his position in the targeted stock, but before or concurrent with the market opening, Lebed would post another wave of false and/or misleading messages.²³³ The posted messages always caused the price and volume of the touted stocks to increase dramatically.²³⁴ On that day, as the stock price was rising in reaction to the hundreds of messages he had posted, Lebed would sell his entire position in

²²⁷ See *id.*

²²⁸ *Id.*

²²⁹ *Id.*

²³⁰ *Id.*

²³¹ See *Lebed*, 2000 SEC LEXIS 1964, at *3-4. For example, Lebed logged onto the Internet and posted 200 separate times the following plug for a company called Firetector (ticker symbol FTEC):

Subj: THE MOST UNDERVALUED STOCK EVER

Date: 2/03/00 3:43pm Pacific Standard Time

From: LebedTG1

FTEC is starting to break out! Next week, this thing will EXPLODE

Currently FTEC is trading for just \$2 1/2! I am expecting to see FTEC at \$20 VERY SOON. Let me explain why

Revenues for the year should very conservatively be around \$20 million. The average company in the industry trades with a price/sales ratio of 3.45. With 1.57 million shares outstanding, this will value FTEC at ... \$44.

It is very possible that FTEC will see \$44, but since I would like to remain very conservative ... my short-term target price on FTEC is still \$20!

The FTEC offices are extremely busy. ... I am hearing that a number of HUGE deals are being worked on. Once we get some news from FTEC and the word gets out about the company ... it will take-off to MUCH HIGHER LEVELS!

I see little risk when purchasing FTEC at these DIRT-CHEAP PRICES. FTEC is making TREMENDOUS PROFITS and is trading UNDER BOOK VALUE!!!"

Lewis, *supra* note 224, at 28.

²³² *Lebed*, 2000 SEC LEXIS 1964, at *4.

²³³ *Id.*

²³⁴ Lebed's liquidation would cause the trading volume in the stock to reach either record or near record highs. On occasion, the stock would reach a 52-week high for both volume and price. *Id.* at *5.

the particular stock, each time realizing a profit.²³⁵ The gross profits of the eleven transactions ranged from more than \$11,000 to nearly \$74,000.²³⁶

In its Order, the SEC only described one of Lebed's fraudulent transactions, which it stated was representative of his others. On January 5, 2000, Lebed purchased 18,000 shares of Man Sang Holdings, Inc. (ticker symbol "MSHI") at prices ranging from \$1.375 to \$2.00 per share.²³⁷ While the trading volume of MSHI on December 30, 1999 was 100 shares with a closing price of \$1.125 per share, on January 5, 2000, the volume was 60,700 shares at a closing price of \$1.8125 per share.²³⁸ On the evening of January 5, 2000, Lebed posted messages on Yahoo! Finance message boards claiming that MSHI was "the most undervalued stock in history" and would be trading at more than \$20 per share "very soon."²³⁹ On January 6, 2000, in response to the messages posted by Lebed, the volume of trading skyrocketed to 1,074,900 shares at a high of \$4.6875 per share.²⁴⁰ Lebed sold all 18,000 of his shares of MSHI on January 6, 2000 at prices ranging from \$3.8125 to \$4.00 per share at a net profit of \$34,959.²⁴¹ MSHI issued no press releases and there was no news in the marketplace during this time period to account for the rise in price and volume.

Three weeks later, Lebed again manipulated the price of MSHI stock. From January 27, 2000, the date he purchased MSHI and posted messages touting the stock (again predicting a price of \$20 "very soon"), until the following day, January 28, 2000, the date he liquidated his entire position, the volume of the stock increased from 71,500 to 1,879,000 shares, and the price jumped from \$2.25 per share to a high of \$5.125 per share.²⁴² Both the price and volume were 52-week highs,²⁴³ and upon selling his holdings, Lebed realized a net profit of \$37,901.²⁴⁴

In the end, Lebed made in excess of \$800,000 manipulating the share price of the various stocks that he touted, yet he only had to pay \$272,826 in disgorgement and \$12,174 in prejudgment interest for a total amount of \$285,000.²⁴⁵ When asked why the SEC allowed Lebed to retain over

²³⁵ *Id.* at *4.

²³⁶ *Id.*

²³⁷ *Id.* at *5.

²³⁸ *Lebed*, 2000 SEC LEXIS 1964, at *5.

²³⁹ *Id.* It appears that Lebed's bulletin board messages all contained the same or similar context.

See Lewis, *supra* note 224, at 28, for an example of his postings.

²⁴⁰ *Lebed*, 2000 SEC LEXIS 1964, at *5.

²⁴¹ *Id.* at *5-6. MSHI issued no press releases, and there was no news in the marketplace during this time period to account for the rise in price and volume.

²⁴² *Id.* at *6.

²⁴³ *Id.*

²⁴⁴ *Id.*

²⁴⁵ *Id.* at *7. See also Lewis, *supra* note 224, at 26.

\$500,000 of his ill-gotten gains, then Chairman of the SEC, Arthur Levitt, stated that, “[w]e determined that those profits were different from the profits he made on the 11 trades we defined as illegal.”²⁴⁶ Levitt, however, refused to differentiate between Lebed’s legal trades and his allegedly illegal one, saying that to do so “wouldn’t be appropriate.”²⁴⁷ In a now infamous article about this case, author Michael Lewis, discussing Lebed’s settlement with the SEC, noted:

[T]he S.E.C. let Jonathan Lebed walk away with 500 grand in his pocket because it feared that if it didn’t, it would wind up in court and it would lose. And if the law ever declared formally that Jonathan Lebed didn’t break it, the S.E.C. would be faced with an impossible situation: millions of small investors plugging their portfolios with abandon, becoming in essence professional financial analysts, generating embarrassing little explosions of unreality in every corner of the capital markets. No central authority could sustain the illusion that stock prices were somehow “real” or that the market wasn’t, for most people, a site of not terribly productive leisure activity. The red dog would be off his leash.²⁴⁸

Nonetheless, Lebed’s penalty remains one of the largest ever collected by the SEC for a lay persons’ perpetration of a “pump and dump” scheme.

III. ANALYSIS

A. *Step One: Determining Materiality*

Chairman William O. Douglass, speaking about the SEC, once noted that “[w]e are the investor’s advocate.”²⁴⁹ This sentiment is clearly reflected in §10(b) of the Exchange Act and Rule 10b-5 thereunder.²⁵⁰ Although the anti-fraud provisions of the securities laws were enacted to apply equally to anyone who violates them, the question remains as to whether they should be so broad as to encompass all individuals regardless of experience and qualifications as an analyst or securities professional. And, if they should,

²⁴⁶ Lewis, *supra* note 224, at 59.

²⁴⁷ *Id.*

²⁴⁸ *Id.*

²⁴⁹ The exact citation for the quote is unknown. The quote appears on a sign hanging outside of the William O. Douglass Room at the United States Securities and Exchange Commission and is readily understood to be attributable to him. .

²⁵⁰ See *supra* text accompanying note 2.

one must consider whether the costs associated with enforcing those securities laws aimed at curtailing fraud are worth it in light of the fact that many of the sources of market information (or misinformation) have little or no credibility whatsoever. In those cases where an investor is willfully blind to the warning signs that would otherwise cause a “reasonable investor” to ignore the advice being offered, the securities laws should not punish those who make materially false and misleading statements about various securities in violation of §10(b) of the Exchange Act. As the government cannot serve as a guard against the use of ordinary common sense, a three-step analysis should be utilized in determining for which investors the SEC must serve as an advocate.

1. IS THE STATEMENT MATERIAL?

The first step that should be utilized in determining whether an individual has violated §10(b) of the Exchange Act and Rule 10b-5 thereunder is analyzing the individual’s statements to see if they contain any material misstatements of fact or omissions. Those statements that are found to be immaterial are clearly not in violation of §10(b) of the Exchange Act and Rule 10b-5 thereunder and thus, no further analysis is required. Materiality is a “fact-specific inquiry,” which “depends on the significance the reasonable investor would place on the withheld or misrepresented information.”²⁵¹ In cases with “contingent or speculative information or events,” materiality “will depend ... upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.”²⁵² This step focuses on the actual alleged misstatement as opposed to looking at the totality of the circumstances surrounding the statement. An examination of additional factors that are traditionally taken into account as part of a materiality analysis provides the basis for Step Three discussed below.²⁵³

²⁵¹ Hillson Partners, L.P. v. Adage, Inc., 42 F.3d 204, 209 (4th Cir. 1994) (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 240 (1988)).

²⁵² *Id.* at 209 (quoting *Basic*, 485 U.S. at 238 (internal citations omitted)).

²⁵³ As this article suggests, these additional factors such as the source of the information and factors relating to the company being misrepresented should be viewed aside from a determination as to whether the actual misstatement is material because most misstatements in a securities manipulation scheme are on their face clear indications of the perpetrator’s intent to induce the investing public into buying the stock in violation of §10(b) and Rule 10b-5 thereunder. For example, a statement such as, “This is the next stock to go up 500 percent” is in and of itself a material misstatement; however, the attempted securities manipulation may be deemed immaterial in light of an analysis under the additional factors.

In *TSC Industries, Inc. v. Northway, Inc.*,²⁵⁴ the Supreme Court considered the definition of a material fact under the proxy rules promulgated by the SEC²⁵⁵ and the appropriateness of resolving the question of materiality by summary judgment.²⁵⁶ In its analysis, the Court stated that:

The question of materiality, it is universally agreed, is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor. Variations in the formulation of a general

²⁵⁴ 426 U.S. 438 (1976). The facts are as follows:

The dispute in this case centers on the acquisition of TSC Industries, Inc., by National Industries, Inc. In February 1969 National acquired 34% of TSC's voting securities by purchase[ing them] from ... TSC's founder and principal shareholder.... Thereafter, five National nominees were placed on TSC's board.... On October 16, 1969, the TSC board, with the attending National nominees abstaining, approved a proposal to liquidate and sell all of TSC's assets to National. The proposal in substance provided for the exchange of TSC common and Series 1 preferred stock for National Series B preferred stock and warrants. On November 12, 1969, TSC and National issued a joint proxy statement to their shareholders, recommending approval of the proposal. The proxy solicitation was successful, TSC was placed in liquidation and dissolution, and the exchange of shares was effected. This is an action brought by respondent Northway, a TSC shareholder, against TSC and National, claiming that their joint proxy statement was incomplete and materially misleading in violation of §14(a) of the Securities Exchange Act of 1934 and the rules promulgated thereunder.

Id. at 440-41.

²⁵⁵ Although an understanding of the proxy rules is not germane to the issue presented in this article, at the time *TSC v. Northway* was decided, Rule 14a-9(a) promulgated by the SEC under the Exchange Act provided that:

No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

Id. at 443.

²⁵⁶ *Id.* at 440.

The issue of materiality may be characterized as a mixed question of law and fact, involving as it does the application of a legal standard to a particular set of facts. In considering whether summary judgment on the issue is appropriate, we must bear in mind that the underlying objective facts, which will often be free from dispute, are merely the starting point for the ultimate determination of materiality. The determination requires delicate assessments of the inferences a "reasonable shareholder" would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact. Only if the established omissions are 'so obviously important to an investor, that reasonable minds cannot differ on the question of materiality' is the ultimate issue of materiality appropriately resolved 'as a matter of law' by summary judgment.

Id. at 450 (quoting *Johns Hopkins Univ. v. Hutton*, 422 F. 2d 1124, 1129 (4th Cir. 1970)).

test of materiality occur in the articulation of just how significant a fact must be or, put another way, how certain it must be that the fact would affect a reasonable investor's judgment.²⁵⁷

Guided by this belief, the Court concluded that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."²⁵⁸ The Court also noted that its test for materiality considers a demonstration of a substantial likelihood that, under all the circumstances, the omitted fact (or material misstatement) actually played a significant role in the reasonable shareholder's decision.²⁵⁹

In *Basic, Inc. v. Levinson*,²⁶⁰ the Supreme Court considered the standard of materiality applicable to preliminary merger discussions.²⁶¹ Referring to its earlier decision in *TSC Industries*, which was one of the earliest cases to define "material" within the context of the federal securities laws, the Court noted that it was careful not to set too low a standard of materiality.²⁶² In addition, the Court stated that it was concerned that a minimal standard might bring an overabundance of information within its reach, and lead management "simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision

²⁵⁷ *Id.* at 445.

²⁵⁸ *Id.* at 449.

²⁵⁹ *Id.* ("Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.")

²⁶⁰ 485 U.S. 224 (1988). The facts of the case follow:

Beginning in September 1976, Combustion [Engineering, Inc.] representatives had meetings and telephone conversations with Basic [Inc.] officers and directors including [the] petitioners, concerning the possibility of a merger. During 1977 and 1978, Basic made three public statements denying that it was engaged in merger negotiations. On December 18, 1978, Basic asked the New York Stock Exchange to suspend trading in its shares and issued a release stating that it had been 'approached' by another company concerning a merger. On December 19, Basic's board endorsed Combustion's offer of \$46 per share for its common stock, and on the following day publicly announced its approval of Combustion's tender offer for all outstanding shares. The Respondents are former Basic shareholders who sold their stock after Basic's first public statement of October 21, 1977, and before the suspension of trading in December, 1978.

Id. at 227-28.

²⁶¹ *Id.* at 230. Although the Court also addressed the question of whether the courts below properly applied a presumption of reliance in certifying the class, rather than requiring each class member to show direct reliance on Basic's statements, a discussion of this issue is not germane to the subject matter of this article.

²⁶² *Id.* at 231.

making.”²⁶³ The Court, therefore, decided to “expressly adopt the *TSC Industries* standard of materiality for the §10(b) and Rule 10b-5 context.”²⁶⁴

When analyzing the statements made by each of the defendants in the five cases discussed above, there can be little doubt that they were all material as defined by the Supreme Court in *TSC Industries* and *Basic*.²⁶⁵ Defendant Paul Johnson, in *DeMarco v. Robertson Stephens*, issued a number

²⁶³ *Id.* (quoting *TSC Industries*, 426 U.S. at 448-49).

²⁶⁴ *Id.* at 232.

²⁶⁵ As noted in the discussion of the cases above, the following misstatements were alleged to be made by the defendants.

Defendant	False and/or Misleading Statement
Paul Johnson (<i>DeMarco v. Robertson Stephens, Inc.</i>)	Following three separate public “buy” recommendations in a six month period following Corvis’s initial public offering, Paul Johnson told a meeting of the Bayview investment committee that he would buy Corvis stock at a price of \$12 to \$14 per share when it had closed that day at approximately \$24.50 per share. The following day, Johnson sold 6,550 of the 8,175 shares that he personally owned and Robert Stephens sold the shares that it held through the Bayview Partnerships. <i>See supra</i> text accompanying notes 29-34.
Shannon Terry and Theodore Melcher (<i>SEC v. Huttoe</i>)	(1) Touting of publicly traded securities to potential investors in articles that he wrote for the Whisper Newsletter in return for undisclosed compensation from the issuers of those securities; (2) Sale of his personal holdings in stocks as he was writing articles in the Whisper Newsletter recommending their purchase; and (3) Failure to disclose either of these practices when he solicited subscriptions to the Whisper Newsletter. <i>See supra</i> text accompanying notes 93-94.
Jeffrey Vinik (<i>In re: Fidelity/Micron Securities Litigation</i>)	“The valuations of semiconductor stocks were quite depressed entering the [six month] period [preceding September 30, 1995]. Micron Technology is a good example of these dynamics at work. Its stock price more than doubled during that period, yet earnings grew so quickly that, in my view, the stock is still relatively cheap.” <i>See supra</i> text accompanying note 136.
Douglas W. Colt	Although the actual text of the false or misleading statements made by Colt and his Fast-Trades associates are not known, their postings on internet bulletin boards and their recommendations to buyers about particular stocks in which they held an interest were sufficient for demonstrating the requisite intent of the participants and satisfied the requirements for Section 10(b) and Rule 10b-5 violations. <i>See supra</i> Part II.D.1 and text accompanying notes 177-223 (discussing these postings in general).
Jonathan G. Lebed	“FTEC is starting to break out! Next week, this thing will EXPLODE.... Currently FTEC is trading for just \$2 ½! I am expecting to see FTEC at \$20 VERY SOON.” <i>See supra</i> note 231.

of public buy recommendations for Corvis while he and a few of his colleagues secretly sold their positions.²⁶⁶ His statements promoting Corvis were material because his contradictory action of selling his shares exhibited an intent to encourage the market to purchase a stock that he conversely sold for his own benefit.

In *Fidelity/Micron*, although Defendant Jeffrey Vinik did not actually make false statements about Micron, such as baseless projections about its future share price, his actions of selling the stock were contrary to the high level of praise that he gave the stock in various public statements that he made.²⁶⁷ As the manager of the world's largest mutual fund, his positive statements about Micron were material because the investing public is deemed to look to such highly esteemed market professionals in making their own investment decisions and his words were contrary to his deeds. Vinik's alleged motive for promoting Micron, which was one of the fund's largest holdings, was to increase its share price prior to selling it.

Defendants Douglas Colt's and Jonathan Lebed's nearly identical conduct of purchasing a thinly traded company, disseminating mass quantities of otherwise false information about the company, and then selling their position while others bought the targeted stock and drove up its share price is a classic example of a "pump and dump" scheme. There is no question that their sole motive for releasing false information about the companies that they targeted was material because they desired to use it to profit at the hands of their unsuspecting victims. Similarly, the defendants in *Huttoe* failed to disclose to subscribers of their newsletter that the companies gave them stock in exchange for their recommendations. This information was material because the victims of this scheme were misled into believing that the recommendations they were receiving were based exclusively on the independent research and analysis of the newsletter's authors. Like Colt and Lebed, the *Huttoe* defendants sold their positions in the targeted stock at substantial profits while their victims purchased it and artificially inflated the share price.²⁶⁸

Once a finding about the materiality of a statement has been made, one must consider whether to proceed to the second step of the analysis in determining whether to impose liability for false and misleading statements or omissions. While statements deemed immaterial are clearly not actionable and thus require no further analysis, statements found to be material are

²⁶⁶ See *supra* Part II.A. and accompanying footnotes for a discussion of Johnson's "buy" recommendations for Corvis, which ran contrary to his actions of selling the stock.

²⁶⁷ See *supra* text accompanying note 136 (discussing of Vinik's public praise of *Micron*, 964 F. Supp. 539).

²⁶⁸ See generally *SEC v. Huttoe*, No. 96-2543GK, 1998 U.S. Dist. LEXIS 23211 (D.D.C. Sept. 14, 1998).

potentially actionable and mandate additional considerations. In the second phase of analysis, one must determine whether the source of materially false and misleading or omitted information is subject to the Investment Advisers Act of 1940.

B. Step Two: Is The Speaker Subject to the Investment Advisers Act of 1940?

The Investment Advisers Act of 1940 (“’40 Act”) defines, in relative part, an investment adviser as “any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.”²⁶⁹ In *Lowe v. SEC*, the Supreme Court stated that “[t]he [‘40] Act was designed to apply to those persons engaged in the investment-advisory profession—those who provide personalized advice attuned to a client’s concerns, whether by written or verbal communication. The mere fact that a publication contains advice and comment about specific securities does not give it the personalized character that identifies a professional investment adviser.”²⁷⁰ The ’40 Act, however, most notably excludes from

²⁶⁹ Investment Advisers Act of 1940 §202(a)(11), 15 U.S.C. §80b-2(a)(11) (2004).

²⁷⁰ 472 U.S. 181, 207-08 (1985). The facts are as follows:

Petitioner Lowe [was] the president and principal shareholder of a corporation (also a petitioner) that was registered as an investment adviser under the Investment Advisers Act of 1940 (Act). Because Lowe was convicted of various offenses involving investments, the United States Securities and Exchange Commission, after a hearing, ordered that the corporation’s registration be revoked and that Lowe not associate with any investment adviser. Thereafter, the SEC brought an action in Federal District Court, alleging that Lowe, the corporation, and two other unregistered corporations (also petitioners) were violating the [‘40] Act, and that Lowe was violating the SEC’s order, by publishing, for paid subscribers, purportedly semimonthly newsletters containing investment advice and commentary. After determining that [P]etitioners’ publications were protected by the First Amendment, the District Court, denying for the most part the SEC’s requested injunctive relief, held that the Act must be construed to allow a publisher who is willing to comply with the Act’s reporting and disclosure requirements to register for the limited purpose of publishing such material and to engage in such publishing. The Court of Appeals reversed, holding that the [‘40] Act does not distinguish between person-to-person advice and impersonal advice given in publications, that [P]etitioners were engaged in business as “investment advisers” within the meaning of the [‘40] Act, and that the exclusion in §202(a)(11)(D) of the [‘40] Act from the [‘40] Act’s definition of covered “investment advisers” for “the publisher of any bona fide newspaper, news magazine, or business or financial publication of general and regular circulation” did not apply to petitioners. Rejecting [the P]etitioners’ constitutional claim, the court further held that Lowe’s history of criminal conduct justified the characterization of petitioners’ publications “as potentially deceptive commercial speech.” [On appeal, the

its definition of an investment adviser, “the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation.”²⁷¹ Discussing this exception, the Supreme Court

Supreme Court reversed and held that the] Petitioners’ publications fall within the statutory exclusion for bona fide publications [because the publications did] [“not offer individualized advice attuned to any specific portfolio or to any client’s particular needs.” *Lowe*, 472 U.S. at 208.] [In addition, the Court concluded that] none of the petitioners is an “investment adviser” as defined in the [‘40] Act, and therefore neither [the P]etitioners’ unregistered status nor the SEC order against *Lowe* provides a justification for restraining the future publication of their newsletters.

Id. at 181.

²⁷¹ Section 202(a)(11) of the ‘40 Act states:

(a) When used in this title [15 USCS §§80b-1 et seq.], unless the context otherwise requires, the following definition shall apply:

....

(11) “Investment adviser” means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include (A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956, which is not an investment company, except that the term “investment adviser” includes any bank or bank holding company to the extent that such bank or bank holding company serves or acts as an investment adviser to a registered investment company, but if, in the case of a bank, such services or actions are performed through a separately identifiable department or division, the department or division, and not the bank itself, shall be deemed to be the investment adviser; (B) any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession; (C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefore; (D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation; (E) any person whose advice, analyses, or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of the Treasury, pursuant to section 3(a)(12) of the Securities Exchange Act of 1934 [15 USCS §78c(a)(12)], as exempted securities for the purposes of that Act; or (F) such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order.

Investment Advisers Act of 1940 §202(a)(11), 15 U.S.C. §80b-2(a)(11) (2004). In discussing the exclusion of the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation from the definition of investment adviser, the Supreme Court stated that:

Although neither the text of the [‘40] Act nor its legislative history defines the precise scope of this exclusion, two points seem tolerably clear. Congress did not intend to exclude publications that are distributed by investment advisers as a normal part of the business of servicing their clients. The legislative history plainly demonstrates that Congress was primarily interested in regulating the business of rendering personalized investment advice,

stated that, “[p]resumably a ‘bona fide’ publication would be genuine in the sense that it would contain disinterested commentary and analysis as opposed to promotional material disseminated by a ‘tout.’ Moreover, publications with a ‘general and regular’ circulation would not include ‘people who send out bulletins from time to time on the advisability of buying and selling stocks.’”²⁷² Those deemed to be investment advisers under the ’40 Act are expressly prohibited from using the “mails or any means or instrumentality of interstate commerce, directly or indirectly” to engage in a fraudulent scheme.²⁷³

Defendant Paul Johnson in *DeMarco v. Robertson Stephens* and the defendants in *SEC v. Huttoe* were not investment advisers under the ’40 Act. Although Johnson “as part of a regular business, issues or promulgates analyses or reports concerning securities,” his buy recommendations for Corvis were not specifically targeted at any particular investor.²⁷⁴ Rather, his advice regarding Corvis was a general opinion aimed at any investor who was willing to listen.²⁷⁵ Likewise, the defendants in *Huttoe* were not

including publishing activities that are a normal incident thereto. On the other hand, Congress, plainly sensitive to First Amendment concerns, wanted to make clear that it did not seek to regulate the press through the licensing of nonpersonalized publishing activities.

Lowe, 472 U.S. at 204.

²⁷² *Lowe*, 472 U.S. at 206.

²⁷³ Investment Advisers Act of 1940 §206, 15 U.S.C. §80b-6 (2004). Section 206 of the Investment Advisers Act of 1940 states in its entirety that:

It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

- (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
- (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
- (3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;
- (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

Id.

²⁷⁴ Investment Advisers Act of 1940 §202(a)(11), 15 U.S.C. §80b-2(a)(11) (2004).

²⁷⁵ The distinction between targeting a specific investor as opposed to a general recommendation is dispositive because targeting specific investors provides the personalized character that identifies a professional investment adviser under the Investment Advisers Act. See Investment Advisers Act of 1940 §202(a), 15 U.S.C. §80(b) (2004).

investment advisers because of the broad nature of their recommendations. Although subscribers of the Whisper Newsletter were small in number and paid a fee for the service, the advice rendered was not specifically tailored to any particular subscriber.²⁷⁶

In *Fidelity/Micron*, Defendant Jeffrey Vinik was not an investment adviser pursuant to the '40 Act. First, Vinik was not advising anyone about Micron. Rather, he was stating his opinion about a stock that was a substantial portion of the mutual fund that he managed. More than likely, Fidelity, Vinik's employer, actually had one or more analysts covering Micron. Second, Vinik was not compensated by any investor who received his "advice." While Vinik was paid to advise and manage the Fidelity Magellan Fund, he was not paid to advise either the fund's shareholders or the investing public. Those who attempted to mirror Vinik's transactions in their own personal accounts were merely doing so by their own accord, which was incidental to Vinik's actions on behalf of Magellan because his duty was owed to Magellan and not those individuals. Finally, Vinik's statements about Micron were not targeted at any specific investor. Instead, his alleged material misstatements were made in either a Magellan annual report that was presumably sent to all of the funds' shareholders or on nationally broadcast television programs.²⁷⁷

Defendants Douglas Colt and Jonathan Lebed were not investment advisers as defined by the '40 Act. No defendant received any fee specifically for the "advice" that they rendered to their victims.²⁷⁸ In addition, neither Colt nor Lebed offered "individualized advice attuned to any specific portfolio or to any client's particular needs."²⁷⁹ The "advice" was broadly targeted on the internet at anyone who was willing to read it. While materially false and misleading statements made by investment advisers are unquestionably actionable and thus, require no further analysis, statements found to be made by parties who are not considered investment advisers under the '40 Act, such as Colt and Lebed, require further examination. In the third phase of determining whether to impose liability for false and misleading statements, one must weight a number of additional factors.

²⁷⁶ See *supra* text accompanying note 83 (discussing the limited number of subscribers to the Whisper newsletter).

²⁷⁷ See *supra* text accompanying note 136 (discussing Vinik's alleged misstatements).

²⁷⁸ See *supra* Part II.D.1 and accompanying notes 177-223 (discussing the six month complementary trial offer that subscribers of Fast-Trades were given and the fact that no subscriber actually paid Douglas Colt or any of his Fast-Trades associates a subscription fee).

²⁷⁹ *Lowe*, 472 U.S. at 208.

C. Step Three: Additional Factors

In those cases where a party who is not considered an investment adviser under the '40 Act has made materially false and/or misleading statements or omissions, a number of additional factors should be weighed in deciding whether to impose liability. The additional factors that must be assessed are best understood when broken down into two sub-groups: (1) factors relating to the source of the misinformation and (2) factors relating to the company being misrepresented.²⁸⁰ No single factor is in and of itself dispositive. Although traditional analysis would address these factors in making a materiality determination such as that discussed above in Step One, the instant analysis addresses these factors separate and apart from a fact specific materiality inquiry of the alleged fraudulent or misleading statement. Therefore, these additional factors are used as a supplemental analysis to determine liability for false and misleading statements made in connection with a securities manipulation scheme.²⁸¹

1. FACTORS RELATING TO THE SOURCE OF THE MISINFORMATION

In analyzing the factors relating to the source of information, one must consider the age, investing experience and track record of the speaker.²⁸² While cases where the inexperience of the speaker can be attributed to youth weigh in favor of not imposing liability, cases such as *Colt* and *Lebed* where the speaker made misrepresentations regarding these facts cut the opposite way and lean towards a finding of liability.²⁸³ When a speaker makes

²⁸⁰ See *supra* Part III.C.1 and 2 and accompanying notes (discussing factors relating to the source of the misinformation and factors relating to the company being misrepresented that should be considered in determining whether liability should be imposed for making false and misleading statements about a public company).

²⁸¹ In other words, some material statements made in violation of §10(b) and Rule 10b-5 thereunder should not impose liability upon their speaker when considered in the light of these alternative factors.

²⁸² *But cf.* *US. v. Bollin*, 264 F.3d 391 (4th Cir. 2001), where the defendant misrepresented that he knew about debentures trading programs, knew their track record, and had experience investing in them. It is important to note, however, that the ease in verifying or disproving the represented information must also be considered. For example, while it is fairly easy to verify that an analyst has spent the past ten years working at a high profile brokerage firm and has a history of picking successful stocks, it is nearly impossible to verify such representations when they appear on the internet anywhere other than the on a high profile brokerage firm's web page or in an email.

²⁸³ Compare *Jonathon Lebed* who was fifteen years old at the time he allegedly violated §10(b) of the Exchange Act and Rule 10b-5 with *Shannon Terry* who was twenty-eight when he allegedly violated the same law. It would be nearly impossible to find a trier of fact who would disagree with the proposition that a reasonable person should have no expectation of reliance upon investment advice obtained from a minor.

misrepresentations about their age, employer, or track record, further analysis of their liability for making false and misleading statements must proceed as if these misrepresentations were, in fact, true. Similar considerations must also be given to both the medium used to communicate the misleading information to the investing public and the reputation of that medium.²⁸⁴ For example, an analyst report coming from a venerable investment firm such as Fidelity or Robertson Stephens should carry substantially more credibility than a market newsletter such as the *Whisper Newsletter*, which is generated by unknown analysts who operate out of their house. Likewise, the use of a medium such as an analyst report that is sent by a reputable investment firm or made available on its website is a more reliable source of information than the use of an email or message board posting issued by someone who was most likely hiding their true identity.²⁸⁵

2. FACTORS RELATING TO THE COMPANY BEING MISREPRESENTED

Turning next to the company being targeted by those engaged in a scheme to disseminate materially false or misleading information with the intent to induce others to either buy or sell securities in that company, a number of similar factors must also be analyzed. The age, primary business purpose and prior stock performance of the targeted company are critical factors in deciding whether to impose liability for securities fraud.²⁸⁶ Newer

²⁸⁴ Compare statements made by Jeffrey Vinik in the Fidelity Magellan Fund Semiannual Report with statements made by Douglass Colt in emails he sent from the Fast-Trades website. While the investing public should be able to completely rely on any statement contained within an official publication from a mutual fund company like Fidelity that is responsible for managing billions of dollars in assets, the same cannot be said of an email sent from a website that has little to no verifiable history of offering successful and/or impartial investment guidance.

²⁸⁵ Compare <http://ml.com/media/15072> (section discussing Patterson-UTI Energy, Inc.) with <http://finance.yahoo.com/q/mb?s=PTEN> (last visited March 27, 2005). Note that while the Merrill Lynch website identifies the authors of its article on Patterson-UTI Energy, Inc. by name and provides their contact information, the postings that appear on finance.yahoo.com about the same company are simply listed by individuals with anonymous onscreen names that rarely, if ever, have accurate contact information.

²⁸⁶ Compare Coca-Cola Co. which "is the largest manufacturer, distributor and marketer of nonalcoholic beverage concentrates and syrups in the world. Finished beverage products bearing [Coke's] trademarks, sold in the United States since 1886, are now sold in more than 200 countries and include the leading soft drink products in most of these countries (at http://www2.coca-cola.com/investors/pdfs/form_10K_2004.pdf) and has a market capitalization in excess of \$99 billion (at <http://finance.yahoo.com/q/ks?s=KO>) and has 10 stock splits since 1927 (at <http://ir.thecocacola.com/phoenix.zhtml?c=94566&p=irol-dividends>) with Argonaut Technologies, Inc. which "develops innovative products designed to help pharmaceutical and other chemists engaged in the discovery and development of new chemical entities increase their productivity and reduce their operating costs without compromising the scientific integrity of their research." (at

companies with small market capitalization that operate in a volatile business sector such as technology are more suited to investors who are willing to take the high degree of risk that is inherent in these types of securities.

Although one may argue that a willingness to accept extreme volatility does not include a willingness to have the market in a given security manipulated by fraud, reality dictates otherwise. A large number of the high-tech start-up companies during the past decade have traded at astronomical levels (particularly during the first few months following their initial public offering), yet the price of these stocks are hundreds (and in some cases over one-thousand) times the companies earnings.²⁸⁷ In these cases, there is absolutely no justification whatsoever for the lofty share price of these companies. There is no substantial difference between the market running up the price of one of these high-tech companies on the (often false) belief that it will prove highly successful and the victims of a pump and dump scheme doing the same. In both cases, the investors are buying volatile stocks with the sole intent to receive a substantial return on their investment in a relatively short period of time.

Other factors that must be explored about the companies targeted by those seeking to manipulate the share price of that company through false and misleading information include the share price (before, during and after the manipulation), the trading volume (before, during and after the manipulation) and the availability of information about the targeted company.²⁸⁸ The share price and trading volume of the targeted company are particularly important in assessing whether liability should apply.²⁸⁹ If a company is thinly traded, as the majority of the stocks in classic “pump and dump” schemes are, it does not take a substantial level of market interest (or lack thereof) to move the share price one way or the other.²⁹⁰ For example, suppose that a little-known company is trading at \$1 per share before a manipulation scheme is initiated. At the height of the manipulation, the shares of that company rise by \$4 to trade at \$5 per share, or an increase of

<http://biz.yahoo.com/e/041112/agt10-q.html>) which has a market capitalization in excess of \$18 million (at <http://finance.yahoo.com/q/ks?s=AGNT>) and has only been publicly traded since 2000. (all websites last visited March 27, 2005).

²⁸⁷ For example, Amazon.com (AMZN) went public in May, 1997. Amazon.com, *Investor Relations*, at <http://phx.corporate-ir.net/phoenix.zhtml?c=97664&p=irol-faq> (last visited April 26, 2004). As of April 5, 2003, Amazon.com closed at \$46.09 which represents a price to earnings ratio of 631.37. Yahoo! Finance, at <http://finance.yahoo.com/q?s=AMZN> (last visited April 5, 2004).

²⁸⁸ See *supra* notes 174, 183, 186, 192, 194, 197, 202, 204, 204, 209, 211, 236, 240, 242, and 244-45 and accompanying text.

²⁸⁹ See *supra* notes 174, 183, 186, 192, 194, 197, 202, 204, 204, 209, 211, 236, 240, 242, and 244-45 and accompanying text.

²⁹⁰ See *supra* notes 187 and 234 and accompanying text.

four hundred percent. Compare that result to a well-known company trading at \$50 per share prior to the initiation of a manipulation scheme. While the share price also rises by \$4 per share to \$54, the increase is just eight percent. Therefore, because the return potential for manipulating small company stocks is substantially greater than larger company stocks, those investing in smaller company stocks should be on guard and undertake a higher degree of due diligence before investing.²⁹¹

Finally, the doctrine of *caveat emptor* should be considered before imposing liability on those who perpetrate fraudulent schemes to manipulate the market by supplying it with materially false or misleading information. In today's information age, data about any given security is readily available around the clock. Anyone can log onto the internet and review SEC filings at www.sec.gov or (most likely) the issuer's website. There are also numerous websites, such as finance.yahoo.com and cbs.marketwatch.com, which are devoted to supplying the public with current (nearly real time) market information at a minimal or no charge.²⁹² In addition, there are several television stations such as CNBC, MSNBC, Bloomberg TV and CNN that are dedicated almost exclusively to covering the securities market.²⁹³ Finally, analysts' reports (written by known and reputable analysts) are easily obtainable with just a phone call or a mouse click.²⁹⁴

Considering these additional factors in relation to the five cases discussed above in this article, the following conclusions about whether to impose liability upon someone who makes materially false or misleading statements about a security should be drawn. Defendant Paul Johnson should be found liable for securities fraud. Johnson was an analyst with Robertson Stephens, a highly regarded securities firm. The public should have a high level of confidence in the advice that such analysts render to the public and should be able to rely on such reports as being unbiased or, at the

²⁹¹ Compare a small company with a low average daily trading volume like Man Sang Holdings, Inc. with a closing price of \$1.125 share on January 5, 2000 and based on false news increased by over 416% to \$4.6875 with a large company with a high average daily trading volume like Lucent Technologies, Inc. On March 22, 2000 Lucent closed at \$62.625, down \$2.625 from the opening price that day. On March 23, Lucent opened at \$62.125 and traded as low as \$60.375 which accounted for a maximum drop of \$2.25 or 3.6% drop before the fraudulent press release was disavowed. See *infra* notes 204-42 and accompanying text and <http://www.sec.gov/litigation/litreleases/lr16493.htm> (last viewed April 2, 2005).

²⁹² See e.g. <http://finance.yahoo.com>, and <http://cbs.marketwatch.com> (all sites last viewed April 2, 2005).

²⁹³ See e.g. <http://moneycentral.msn.com/cnbc/tv/default.asp>, <http://www.msnbc.msn.com>, <http://www.bloomberg.com/media/tv/index.html>, and <http://money.cnn.com> (all sites last visited April 2, 2005).

²⁹⁴ See e.g. http://ml.com/index.asp?id=7695_8137, <http://www.smithbarney.com/research> and <http://www.goldmansachs.com/insight/research> (all sites last viewed April 2, 2005).

very least, free of the taint of attempting to recognize personal gain by market manipulation. Johnson clearly had a conflict of interest in Corvis stock because although he thought it was a poor investment, he held a sizeable position and wanted to sell it at a profit. In this case, Johnson should be rightfully punished for his actions, if for no other reason than to send a message to other analysts of his alleged caliber that such improprieties will not be tolerated. Were Johnson allowed to retain any of his ill-gotten gains, the investing public would have a substantially diminished reason to put their confidence in the advice provided by analysts and the markets would not be as efficient.²⁹⁵

The defendants in *SEC v. Huttoe* should not be found liable for securities fraud. Although these individuals charged subscriber fees for their newsletter for worthless and misleading advice, a number of “additional factors” preclude their liability. First, these defendants neither had (nor apparently represented) any history nor skills as stock analysts.²⁹⁶ In fact, they were so unknown that they were operating out of their house. Second, the companies that they targeted were all thinly traded and lesser known “high risk aggressive growth” companies.²⁹⁷ The share prices of the targeted investments rose substantially in light of the fact that there was no other source of public information able to substantiate the sudden increase or the information being given in the newsletter.²⁹⁸ Had subscribers of the Whisper Newsletter taken the time to investigate the credibility of the analysts they were blindly trusting and then examined the quality of the companies that were being recommended, they should have been able to see the newsletter for what it was—a conduit for a fraudulent scheme. At the very least, it should have become clear that this newsletter was an unreliable source of market information. In such cases, the SEC should not expend its limited resources on chasing after individuals who manipulate thinly traded securities, especially when doing so may be at the expense of more pressing matters. While some may argue that permitting such a fraud only

²⁹⁵ Eugene F. Fama, *Random Walks in Stock Market Prices*, 51 FIN. ANALYSTS JOURNAL 75, (Jan./Feb. 1995). (“An ‘efficient’ market is defined as a market where there are large numbers of rational, profit-maximizers actively competing, with each trying to predict future market values of individual securities, and where important current information is almost freely available to all participants. In an efficient market, competition among the many intelligent participants leads to a situation where, at any point in time, actual prices of individual securities already reflect the effects of information based both on events that have already occurred and on events which, as of now, the market expects to take place in the future. In other words, in an efficient market at any point in time the actual price of a security will be a good estimate of its intrinsic value.”).

²⁹⁶ *SEC v. Huttoe*, 1998 U.S. Dist. LEXIS 23211, *6 (D. DC 1998) also available at <http://johnreedstark.com/ClassMaterials/Opinions/huttoe.htm> (last viewed April 2, 2005).

²⁹⁷ *Id.* at *6-*7 and n.5; see also *supra* note 82 and accompanying text.

²⁹⁸ *Huttoe*, 1998 U.S. Dist. LEXIS 23211 at *11.

encourages other would-be perpetrators to follow suit, in reality, it serves to discourage such schemes by forcing the investing public to be more vigilant with their investments and more diligent with respect to their investment decisions.

Defendant Jeffrey Vinik in *Fidelity/Micron* should not be found liable for securities fraud. In many ways, this is a hybrid case because although the fund manager for the world's largest mutual fund clearly made positive comments about Micron, when in fact, he sold the fund's position shortly thereafter, he was not really directly advising anyone.²⁹⁹ Although Vinik worked for Fidelity, the world's most renowned mutual fund company, and was responsible for managing in excess of \$50 billion, analysis of this case boils down to duty. Vinik owed a fiduciary duty exclusively to Magellan (and its investors) and not the market in general. Unlike Paul Johnson, Vinik was neither acting as an analyst nor purporting to be one. The fact that the market may have construed his positive statements about Micron, a sizeable component of Magellan, as an indication to buy its stock is merely incidental to his job as the fund's manager. During the period in question, 1995, Micron traded between roughly \$18 and \$55 per share.³⁰⁰ While the stock was highly volatile, it was neither thinly traded nor thinly covered by other analysts.³⁰¹ The market did not have to react to Vinik's praise of Micron in light of the fact that a substantial amount of public information about the company was readily available. Failing to find Vinik liable for securities fraud would serve to apprise the market that it should not be looking to mutual fund managers to play a dual role as analysts. This is especially true considering that most mutual fund companies have employees who exclusively serve as analysts.

Defendants Douglas Colt and Jonathan Lebed should not be found liable for securities fraud. In fact, of any of the five cases discussed in this article, Colt and Lebed are the two defendants who present the strongest case for being found not liable. While Colt made up a false track record to lend credibility to his website, Fast-Trades.com, and the stocks that it targeted, Lebed, it is believed, never made any such representations in the messages that he posted.³⁰² Nonetheless, both Colt and Lebed targeted thinly traded microcap stocks that were little known. The commonalities between their targeted stocks demonstrates that had they disseminated the same type of false information about a heavily traded stock, it would have

²⁹⁹ See *supra* notes 159-163 and accompanying text.

³⁰⁰ See <http://www.micron.com/ir/sec.html> (last viewed July 20, 2005).

³⁰¹ See <http://www.marketwatch.com/tools/quotes/snapshot.asp?symb=MU&vc=0&siteid=mktw&dist=dropmenu> and <http://micron.com/ir/profile.html> (last viewed April 3, 2005).

³⁰² Although Lebed did tout stock with no basis for his recommendation, he did not provide disclaimers or purport to be an expert.

had little or no effect on the market price because the relatively small number of victims who received and then traded on Colt and Lebed's advice pales in comparison to the number of people who invest in heavily traded stocks or rely on analysts' reports. Furthermore, those stocks that are heavily traded or covered by a number of analysts are less likely to be affected by such misleading or false information. This is due to the fact that the market quickly corrects itself due to the large number of investors and the vast amount of coverage such stocks receive.³⁰³

Another similarity between the Fast-Trades and Lebed schemes is that the victims went looking—of all places—on the internet for investment advice. While Colt placed ads on various bulletin boards advertising Fast-Trades, Lebed just directly posted his false and misleading messages in these electronic forums.³⁰⁴ Any reasonable person using the internet should have a healthy level of skepticism about the quality and utility of the information they obtain online. It is simply far too easy for those who post on bulletin boards to adopt a false username, misrepresent their credentials, or generally provide information that cannot be verified.

IV. CONCLUSION

An old adage dictates that “you can't get something for nothing.” Yet, investors scour the market daily looking for a free nugget of information in the hopes of getting ahead of everyone else. Despite the nearly improbable odds of cashing in on an investment and making a mammoth profit, many people keep trying to find that “sure thing” or the next “big winner.” When a “hot” stock tip is dropped onto the market by the perpetrator of a fraudulent securities scheme, any investor can almost instantaneously check to verify the credibility of the information. However, few of these victims ever do. Whether it is laziness, lack of skepticism, or fear that their due diligence efforts will result in the investment taking off without them is unknown. But what is known is that the SEC simply does not have the resources to be the investor's advocate for everyone all of the time despite former Chairman Douglass' now infamous words.³⁰⁵ Therefore, should an overly naive and/or greedy investor choose to blindly accept the advice of a stranger, he must be willing to accept the inevitable financial consequences that are soon to follow. Like lambs to the slaughter, some people simply cannot resist the temptation to chase a fast buck in the securities markets.

³⁰³ This is the basis of the “Truth on the Market” theory as a defense. See *supra* text accompanying note 64 (discussing the “Truth on the Market” theory in detail).

³⁰⁴ See *supra* notes 181 and 227 and accompanying text.

³⁰⁵ See *supra* text accompanying note 249.

In such cases, the weak investor deserves the harsh dose of reality that will soon set in while the fraudsters laugh all the way to the bank.

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