Rumor Has It:
A discussion of SEC v. Berliner

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Background

- Under Rule 10b-5 of the Securities Exchange Act, which prohibits the use of manipulative or deceptive devices, it is unlawful "to make any untrue statement of fact" in connection with the purchase or sale of any security.
- Under Section 10(b) of the Act, disseminating incorrect information about a company, even if it has an impact on the company's stock price, is not illegal unless accompanied by scienter, or a manipulative intent.
- Conduct that merely affects the price of a security is not sufficient to demonstrate manipulation.

Background, ctd

- Market actors may circulate rumors without any such intent, as speculating about companies lies at the heart of what traders and other financial players do.
- In the words of former SEC Chairman Arthur Levitt, "[t]alking about differing ideas and opinions [about companies] . . . is 'the food of the market.'
- Where market actors such as analysts are paid to make positive statements about a company, the securities laws lay the burden of disclosure on the analysts and not the issuer of the stock. Diomed

Background, ctd.

- Unless the subject of the rumor is also the source, there's no duty to correct a false rumor in the marketplace. Silence, absent a duty to disclose, is not misleading under Rule 10b-5.
- "No comment" statements are generally the functional equivalent of silence

SEC. v. Berliner

- In April 2008, the SEC charged an individual trader at Schottenfeld Group LLP with securities fraud and market manipulation for intentionally spreading a false rumor concerning the Blackstone Group's acquisition of Alliance Data Systems Corp ("ADS") while selling ADS short.

The Rumor

- The SEC complaint alleges that on November 29, 2007 from 1:10-1:15 pm, the trader, Paul S. Berliner, sent the following messages to 31 securities professionals:

> ADS getting pounded – hearing the board is now meeting on a revised proposal from Blackstone to acquire the company at $70/share, down from $81.50. Blackstone is negotiating a lower price due to weakness in World Financial Network – part of ADS' Credit Services Unit, as evidence [sic] by awful master trust data this month from the World Financial Network Holdings off-balance sheet credit vehicle.

Market Impact

- Within 30 minutes, the price of ADS stock declined 17%, from $ 77 to $63.65
- Berliner sold short 10,000 shares from 1:11-1:17 pm. At 1:19pm, he began covering the entire short position, allegedly making a profit of $ 25,509.
- The New York Stock Exchange temporarily halted trading in the company and ADS issued a press release rejecting the rumor, leading the ADS stock price to close the day at near its pre-rumor price.
- More than 33,000,000 shares of ADS were traded that day – more than 20x the previous day's trading volume.

Outcome

- The complaint alleges that Berliner violated Section 17(a) of the Securities Act of 1933, Sections 9(a)(4) and 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder.
- "The message of this case is simple and direct. The Commission will vigorously investigate and prosecute those who manipulate markets with this witch's brew of damaging rumors and short sales," said former SEC Chairman Christopher Cox
- Without admitting or denying the allegations in the SEC's complaint, Berliner agreed to settle the charges against him by consenting to the entry of a final judgment enjoining him from future violations of the antifraud and anti-manipulation provisions of the federal securities laws, and requiring him to disgorge $26,129 in profits and interest, pay a maximum third-tier penalty of $130,000, and consent to the entry of a Commission Order barring him from association with any broker or dealer.

Financial Crises / Actions taken by SEC

- Negative rumors during the Spring/Summer of 2008
  - Bear Stearns
  - PIMCO
- July 2008: SEC issued an emergency order prohibiting naked short-selling of certain stocks and launching of broad investigation into potential manipulation of financial institution stocks through the spreading of baseless, negative rumors. In September 19, 2008, SEC expanded the investigation to include obtaining statements under oath from market participants.
- October 2008: SEC formed a nationwide Rumors and Market Manipulation Working Group
- Financial Industry Regulatory Authority (FINRA) and New York Stock Exchange (NYSE)

THE END

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