



# SECURITIES REGULATION & LAW



## REPORT

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### INSIDER TRADING

## The War on Rumors at the SEC and CFTC

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**R**ecent price volatility, and actual distress, in certain sectors of the stock and commodities markets have reignited age-old concerns among politicians, regulators, and issuers about rumors as a means of manipulating the markets. Regulatory announcements have been abundant. On March 31, 2008, the Financial Industry Regulatory Authority (FINRA) issued a news release announcing that it together with the New York Stock Exchange (NYSE), and the Options Regulatory Surveillance Authority were “coordinating efforts to heighten the monitoring and investigation of trading activity in issuers that may be subject to credit market-related volatility.”<sup>1</sup>

On Sunday, July 13, the Securities and Exchange Commission (SEC) published a press release announcing that it, together with FINRA and the NYSE, would “immediately conduct examinations aimed at the pre-

vention of the intentional spread of false information intended to manipulate securities prices.”<sup>2</sup> In the same press release, the SEC underscored that it was already in the process of investigating the “alleged intentional manipulation of securities prices through rumor-mongering and abusive short selling.”<sup>3</sup> Nor is concern about rumors limited to federal securities authorities; on September 18, 2008, New York Attorney General Andrew Cuomo announced that his office had launched a “wide-ranging investigation into short selling in the financial market,” including short selling accompanied by the spreading of rumors.<sup>4</sup>

In December 2007, the U.S. Commodity Futures Trading Commission’s (CFTC) Division of Enforcement commenced an investigation into the trading of the nation’s crude oil supplies aimed at “ensuring that the markets are properly policed for manipulation and abusive practices.”<sup>5</sup> In May 2008, the press reported that “[a]nother area of concern for CFTC regulators is whether the owners of crude-oil storage tanks use their knowledge to make bets on oil-futures markets. In theory, the owner of a tank could issue misleading information about the tanks being full or empty, leaving the wrong impression about whether oil is in plentiful

<sup>1</sup> FINRA News Release (March 31, 2008).

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<sup>2</sup> SEC Press Release 2008-140 (July 13, 2008).

<sup>3</sup> *Id.*

<sup>4</sup> Joanna Chung, *US attorney-general to probe share deals*, Financial Times, September 19, 2008, at 2.

<sup>5</sup> CFTC Release 5503-08 (May 29, 2008).

supply. Then they could make trades to profit on that misunderstanding.”<sup>6</sup> A recent article reports that the CFTC’s crude oil investigation has progressed to taking testimony from market participants.<sup>7</sup>

Are the regulators onto something new? Hardly. As discussed below, concerns about rumors go back to the very inception of the federal securities and commodities laws. What is lacking is a well-developed body of case law to which either the regulators, or parties under investigation, can turn for guidance on the boundaries of “rumor” liability.

### Rumors Under the Securities Exchange Act

Rumors were among the culprits blamed for both the rise and the crash of the stock market in the late 1920s, and featured in the legislative debates that led to the adoption of the Securities Exchange Act of 1934 (Exchange Act).<sup>8</sup> The result was Section 9(a)(4) of the Exchange Act, which makes it illegal for:

a dealer or broker, or the person selling or offering for sale or purchasing or offering to purchase the security or a security-based swap agreement . . . to make . . . , for the purpose of inducing the purchase or sale of such security or such security-based swap agreement, any statement which was at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, and which he knew or had reasonable ground to believe was so false or misleading.

Seventy-four years later, the SEC had yet to bring one case that alleged manipulation by rumor. The silence was broken on April 24, 2008, when the SEC filed a settled case in the United States District Court for the Southern District of New York against Paul S. Berliner.<sup>9</sup> The Complaint alleged that on November 29, 2007 Berliner, a former proprietary trader at Schottenfeld Group, LLC, drafted and disseminated a rumor that caused the stock price of Alliance Data Systems Corp. (ADS), which was then the known target of an acquisition by The Blackstone Group (Blackstone), to plummet in violation of Section 17(a) of the Securities Act of 1933 (Securities Act) and Sections 9(a)(4) and 10(b) of the Exchange Act and Rule 10b-5 thereunder.<sup>10</sup>

According to the Complaint, on May 17, 2007, a public announcement was made that ADS and Blackstone entered into a definitive agreement pursuant to which Blackstone would acquire ADS at a price of \$81.75 per share.<sup>11</sup> On November 29, 2007, Berliner drafted the following message:

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.<sup>12</sup>

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The Complaint further alleges that Berliner then disseminated the message via instant messaging to 31 “individuals, including traders at brokerage firms and hedge funds.”<sup>13</sup> Within 30 minutes of the dissemination of the rumor, ADS’s stock price experienced a 17% decline from \$77 per share to an intraday low of \$63.65 per share.<sup>14</sup> Berliner’s rumor, which was further disseminated by the media and wire news services, instigated such heavy trading that it prompted the NYSE to temporarily halt trading in ADS’s stock.<sup>15</sup> During this period, Berliner invested in short positions of ADS stock and ultimately “made approximately \$25,000 in illicit trading profits before the price of ADS stock recovered later in the day” as a result of a press release issued by ADS that announced that the rumor was false.<sup>16</sup>

The SEC and Berliner settled the case the same day the Complaint was filed. As part of the settlement, Berliner was ordered to disgorge \$26,129 in illicit trading profits and prejudgment interest and to pay a third-tier civil penalty of \$130,000. Berliner also was barred from association with any broker or dealer. The comparatively small profits that Berliner earned from his manipulation did not deter the SEC from issuing a rhetorically rich press release in which Chairman Cox stated that “[t]he Commission will vigorously investigate and prosecute those who manipulate markets with this witch’s brew of damaging rumors and short sales.”<sup>17</sup>

<sup>12</sup> *Id.* at 4.

<sup>13</sup> *Id.* at 1.

<sup>14</sup> *Id.* at 2.

<sup>15</sup> According to the Complaint, 33,813,796 shares of ADS stock were traded on November 29 in comparison to just 1,561,923 shares traded the previous day. *Id.* at 5.

<sup>16</sup> *Id.*

<sup>17</sup> “SEC Charges Wall Street Short-Seller With Spreading False Rumors,” SEC Press Release 2008-64 (April 24, 2008). Somewhat ironically, the ADS/Blackstone deal eventually collapsed, and ADS brought suit against Blackstone for failing to use its best efforts to achieve regulatory approval of the proposed acquisition. Dana Cimilluca, *ADS: Blackstone’s Broken*

<sup>6</sup> Ian Talley, Ann Davis and Gregory Meyer, *Regulators Step Up Probes of Trading in Oil Markets*, Wall St. J., May 30, 2008, at A1.

<sup>7</sup> Ann Davis, *Oil-Supply Data Probed for Manipulation*, Wall St. J., September 4, 2008, at C1.

<sup>8</sup> See, e.g., H.R. Rep. No. 1383, 73d Cong., 2d Sess. 34 (“The pool sometimes depresses the price of the stock in advance through short selling or the dissemination of unfavorable rumors, and then accumulates substantial blocks at the reduced price.”); H.R. Rep. No. 1838, 73d Cong., 2d Sess. 55, 7560; 78 Cong. Rec. 10268, 73d Cong., 2d Sess. 10268 (remarks of Cong. Sabath).

<sup>9</sup> *SEC v. Paul S. Berliner*, Civ. A. No. 08-CV-3859 (JES) (S.D.N.Y.) (Hereinafter referred to as the “Complaint”). See also Exchange Act Rel. No. 57774, 200 SEC LEXIS 1019 (May 5, 2008).

<sup>10</sup> *Id.* at 1. Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 provide supplemental, and in some cases overlapping, statutory authority for enforcement cases that allege manipulation.

<sup>11</sup> *Id.*

Since April, there have been a number of SEC releases decrying rumors and some well-publicized investigative requests, but so far no more cases.<sup>18</sup> As a result, it is thoroughly unclear whether and how the agency will attempt to expand manipulation-by-rumor liability to cases in which, unlike *Berliner*, the defendant contests liability, or the defendant is someone other than the initiator of the rumor, or the rumor is not incontestably false.

### Rumors Under the Commodity Exchange Act

Because the commodities and commodities futures markets turn on the availability of, and demand for, physical commodities that must be grown or extracted and are subject to spoilage or loss, those markets might seem even more ripe for rumor-mongering than securities markets. In fact, in *Cargill, Inc. v. Hardin*, one of the more noteworthy trade-based commodity market manipulation cases, the court stated in dicta that “one of the most common manipulative devices” was “the floating of false rumors which affect futures prices.”<sup>19</sup> It is not surprising, then, that the legislative history of the commodities laws contains colorful concerns about such rumors. More surprising is the paucity of actual commodities cases that involve manipulation by rumor.

Since the early 1900s, Congress, the former Commodity Exchange Authority, and the CFTC have wrestled with how best to confront and prevent manipulation of the commodity futures markets.<sup>20</sup> For example, there is evidence that manipulation of market prices by the dissemination of false rumors was a concern as early as the 1920s. In an attempt to learn more about the trading conditions in the grain market, Congress heard testimony about “a scheme in which it was

claimed that ‘green bugs’ that ‘worked at night’ were infesting the wheat harvest. The party pulling this hoax mailed in samples of these bugs and went long the market. Later, after taking his profits and when it was disclosed that the bugs were harmless, they were actually lightning bugs, the manipulator went short the market as prices plunged.”<sup>21</sup>

To combat the dangers of market manipulation, in 1936, the Commodity Exchange Act (CEA) proscribed manipulative activity in Sections 6(c), 6(d), and 9(a). Manipulation through misinformation is specifically contemplated by Sections 9(a)(2) and (4), which make it a felony for:

(2) Any person to manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, or to corner or attempt to corner any such commodity or knowingly to deliver or cause to be delivered for transmission through the mails or interstate commerce by telegraph, telephone, wireless, or other means of communication false or misleading or knowingly inaccurate reports concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce, or knowingly to violate the provisions of section 4, section 4b, subsections (a) through (e) of subsection 4c, section 4h, section 4o(1), or section 19.

(4) Any person willfully to falsify, conceal, or cover up by any trick, scheme, or artifice a material fact, make any false, fictitious, or fraudulent statements or representations, or make or use any false writing or document knowing the same to contain any false, fictitious, or fraudulent statement or entry to a registered entity, board of trade, or futures association designated or registered under this chapter acting in furtherance of its official duties under this chapter.<sup>22</sup>

An early case alleging manipulation by misinformation brought under the CEA was *In re Reuben Earl McGuigan*.<sup>23</sup> In *McGuigan*, the respondent was charged with the manipulation of the price of commodities for future delivery on contract markets during 1945. The hearing officer found that McGuigan, who “advertised and represented himself to be in the business of selling market advice to traders in grain, cotton, and other commodities . . . for future delivery,” distributed a number of telegrams and letters to prospective clients and firms that included advice about the purchase and sale of certain commodity futures.<sup>24</sup> The respondent then “made transactions opposite to those he had advised, thus taking profits from the influenced price change.”<sup>25</sup> He also fraudulently used his wife’s name to set up his trading accounts and denied his trading activity when questioned by representatives from the U.S. Department of Agriculture. The opinion does not detail the contents of the letters and telegrams; thus, the case may be viewed more properly as an investment adviser “scalping” case, in which the defendant created demand by his advisees and then sold into that demand for his personal benefit, as opposed to one involving rumors.

*LBO Rerun*, Wall St. J., Jan. 30, 2008, at <http://blogs.wsj.com/deals/2008/01/30/ads-blackstones-broken-lbo-rerun/>.

<sup>18</sup> See, e.g., Kara Scannell, SEC Presses Hedge Funds, Wall St. J., September 25, 2008, at A3; Kara Scannell and Susanne Craig, *Agency Subpoenas Focus on 4 Rumors That Hit Lehman*, Wall St. J., July 28, 2008, at C1. See also Statement From SEC Chairman Christopher Cox, SEC Press Release 2008-210 (September 18, 2008) (noting that the SEC had “brought a landmark enforcement action against a trader who spread false rumors designed to drive down the price of stock” [emphasis added]).

<sup>19</sup> 452 F.2d 1154, 1163 (Dec. 7, 1971); see also *General Foods Corp. v. Brannan*, 170 F.2d 220, 224 (7th Cir. 1948) (“[T]he common criteria usual in manipulation or corner cases are deceit, trickery through the spreading of false rumors, concealment of position, the violation of express anti-manipulation controls, or other forms of fraud.”) Although this article is focused on enforcement action by the regulatory agencies, a handful of decisions in private lawsuits under the CEA have actually considered manipulation-by-rumor claims. See *In re Soybean Futures Litig.*, 892 F. Supp. 1025, 1045-47 (N.D. Ill. 1995) (denying summary judgment where plaintiff claimed manipulation through false reports regarding the cash market for soybeans); *United Egg Producers v. Bauer Intern. Corp.*, 311 F. Supp. 1375 (S.D.N.Y. 1970) (granting preliminary injunction in favor of egg producers who claimed that defendants had created false press reports of a large influx of eggs from Spain).

<sup>20</sup> Following the outbreak of World War I, a shortage of wheat and rising food prices prompted the Federal Trade Commission (FTC) to examine the grain trade. In connection with its study of the grain trade, the FTC conducted extensive hearings concerning the existence of manipulation in the commodity futures markets. FTC, Report on the Grain Trade (1921); FTC, Hearings On Market Manipulation Of Grain (1922).

<sup>21</sup> Jerry W. Markham, *Manipulation of Commodity Futures Prices – The Unprosecutable Crime*, 8 Yale J. on Reg. 281, 299 (1991). See also *id.* at 283, 285, 373 (noting wide variety of rumors, and calling on the CFTC to give greater scrutiny to false reports and rumors).

<sup>22</sup> See CEA 6, 7 U.S.C. § 13 (2006).

<sup>23</sup> 6 Agric. Dec. 250 (1946).

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

Although *McGuigan* may not have been a classic manipulation-by-rumor case, *In re Ralph W. Moore*<sup>26</sup> certainly was one. The facts of *Moore* require us to return to a time when means of communication (and, at least for some, our dietary habits) were rather different from the instant-messaging world of Paul Berliner.

As of October 1, 1947, Moore, through a number of nominees, controlled accounts that collectively held a long futures position of 1,800,000 pounds of lard. According to the hearing officer's decision, Moore believed that lard was underpriced by the market. On October 1, 1947, he composed a "Memorandum to the Press" stating that the United States Department of Agriculture intended in the coming months to make very large purchases of lard for overseas food programs. The memorandum ended by listing four "References," all of whom were unwitting Department of Agriculture employees. Moore's secretary typed the memorandum and made a number of copies. She then sent two or three copies to Moore's commodities broker at Merrill Lynch in Washington. The broker delivered them to the Washington representative of Merrill's commodities division, "who had it teletyped to the manager of the lard department of Merrill Lynch in Chicago, Illinois." Merrill took the precaution of checking with one of the "references" listed in the memorandum and, upon learning that he knew nothing about the memo, did not disseminate it further. Moore also left 50 to 100 copies of the memorandum on a table at the National Press Club where reporters picked up items of interest; persons unknown stuffed another 16 copies into boxes at the Department of Agriculture that were maintained for the press corps who covered the Department. Apparently none of the reporters who received the memorandum ran the story, and the decision does not suggest that the memorandum had any effect whatever on the price of lard.

Moore was charged with attempted manipulation, as well as position reporting violations. He contested the manipulation charges on the bases that the facts in the Memorandum to the Press were true (although it is unclear from the decision how he attempted to prove that), and that in any event no one was misled by it. The hearing officer barred Moore from access to any contract market for 90 days. Moore appealed that decision to the Court of Appeals for the District of Columbia Circuit, which affirmed, and petitioned for certiorari by the Supreme Court, which denied the petition.

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**It is not always clear that a rumor is false or that it was spread with the intent to manipulate or defraud the market.**

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The next two rumor by manipulation cases were decided in the summer of 1955. In *Landon V. Butler*,<sup>27</sup> the complaint charged that the respondents "attempted to manipulate the price of soybeans and soybean futures and disseminated false and misleading market information with respect to such commodities, in violation of

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<sup>26</sup> 9 Agric. Dec. 1299 (1950), *aff'd*, 191 F.2d 775 (D.C. Cir.), *cert. denied*, 342 U.S. 860 (1951).

<sup>27</sup> *In re Landon V. Butler*, 14 Agric. Dec. 429 (1955).

Sections 6(b) and 9 of the [CEA]."<sup>28</sup> The decision indicates that the respondents spread false rumors about the inability of certain operators of soybean storage elevators that contained large quantities of deliverable soybeans "to honor warehouse receipts issued by them covering soybeans . . ." <sup>29</sup> in order to drive up the price of their supply of soybeans. The decision further states that the respondents transmitted information that was "false, misleading, or knowingly inaccurate, and was transmitted . . . with knowledge of the fact that it would be widely circulated or disseminated, and for the purpose and with the intent of causing a price movement in the soybean market."<sup>30</sup>

In *Winn & Lovett Grocery Co.*,<sup>31</sup> the complaint charged that the respondents "attempted to manipulate the price of potatoes and potato futures, and delivered for transmission in interstate commerce false or misleading reports tending to affect the price of potatoes in violation of sections 6(b) and 9 of the [CEA]."<sup>32</sup> The respondents amassed substantial short positions in potatoes in an attempt to depress futures prices and then "made statements to their brokers and inquiries of the [U.S.] Department of Agriculture which indicated that they planned to deliver additional large quantities of potatoes against their short position," which were made for the purpose of depressing the futures prices further.<sup>33</sup> The respondents ultimately admitted the facts included in the complaint and consented to the entry of an order.

Much more recently, the CFTC has launched a number of enforcement actions aimed at participants in the natural gas markets who allegedly submitted reports of fictitious transactions to natural gas price indexes and other services for the purpose of manipulating the reported price of gas.<sup>34</sup> These cases, while akin to manipulation by rumor, prosecute alleged false statements about objective facts, and therefore provide little guidance about the contours of "rumor" liability.

Like *Berliner*, the commodities cases all involved the intentional dissemination of indisputably false information. Rumors, however, are typically defined as information the source or veracity of which is unverified. It is not always clear that a rumor is false or that it was spread with the intent to manipulate or defraud the market. Moreover, as noted in one recent newsletter, financial gossip is part and parcel of an efficient marketplace: "For those of us who work in finance, and in the hedge fund and private equity community in particular,

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<sup>28</sup> *Butler* (1955).

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> *In re Winn & Lovett Grocery Co., et al.*, 14 Agric. Dec. 561 (1955).

<sup>32</sup> *Winn & Lovett Grocery Co.* (1955).

<sup>33</sup> *Id.*

<sup>34</sup> See *CFTC v. Atha*, 420 F. Supp.2d 1373 (N.D. Ga. 2006) (denying defendants' motion to dismiss); *CFTC v. Bradley*, 408 F. Supp. 2d 1214 (N.D. Okla. 2005) (same); *In the Matter of Mirant Americas Energy Marketing, LP*, CFTC Docket No. 05-05, 2004 CFTC LEXIS 156 (December 6, 2004) (settled order in CFTC enforcement action); *In the Matter of Cinergy Marketing & Trading, LP*, CFTC Docket No. 05-03, 2004 CFTC LEXIS 154 (November 16, 2004) (same); *In the Matter of Coral Energy Resources, L.P.*, CFTC Docket No. 04-21, 2004 CFTC LEXIS 107 (July 28, 2004) (same); *In the Matter of Western Gas Resources, Inc.*, CFTC Docket No. 04-17 (July 1, 2004) (same);

we understand the importance of gossip. Keeping track of who's doing what, when they're doing it, at what price and with whom, are not only interesting to keep track of, but very relevant to understanding how money is being made (and lost)."<sup>35</sup>

The lack of manipulation by rumor case law suggests that such cases are not only difficult to identify, but also difficult to prosecute successfully. It is possible, of course, that advances in market surveillance and technological trading systems, as well as the ubiquity of e-mails and instant messages, will make the prosecution of rumor-mongers more commonplace. It is at least equally likely, however, that more black-and-white regulatory steps, such as the SEC's recent issuance of

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<sup>35</sup> Wall Street Oasis.com, *Research of the Week: Rumors* (July 18, 2008).

rules and emergency orders to limit naked short-selling and to prohibit the short selling of certain issuers,<sup>36</sup> or the downward adjustments of position limits that have been debated on the commodities side,<sup>37</sup> will turn out to be the means of choice to control the effects of rumors in the securities and commodities marketplaces.

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<sup>36</sup> See *SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets*, SEC Press Release No. 2008-211 (September 19, 2008); *SEC Issues New Rules to Protect Investors Against Naked Short Selling Abuses*, SEC Press Release 2008-204 (September 17, 2008); *SEC Enhances Investor Protections Against Naked Short Selling*, SEC Press Release No. 2008-143 (July 15, 2008).

<sup>37</sup> See *House Backs Oil Speculation Bill*, *The New York Times*, September 19, 2008, at C8 (noting, however, the possibility of a presidential veto of legislation).