

SEC Sues Hedge Fund Adviser For Alleged Short-and-Distort Scheme

September 25, 2018

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On September 12, 2018, the U.S. Securities and Exchange Commission (“SEC”) filed a civil action against Gregory Lemelson and his investment advisory firm Lemelson Capital Management, LLC (“LCM”),¹ alleging that Lemelson engaged in an illegal “short and distort” scheme in which Lemelson took short positions in Ligand Pharmaceuticals Inc. (“Ligand”) stock through his hedge fund, The Amvona Fund, LP (“Amvona”), while manipulating the price of the stock by disseminating a series of false negative statements about Ligand. The alleged market manipulation scheme purportedly generated more than \$1.3 million in ill-gotten gains for Lemelson and his fund. Although the actions alleged in the *Lemelson* case are egregious, the SEC’s determination to bring a relatively rare case involving short sellers should still serve as a clear reminder of the priority the SEC places on market manipulation cases that impact retail investors.

Background. The SEC Complaint alleges that beginning in May 2014, Lemelson, through Amvona, a hedge fund that LCM advised and Lemelson partially owned, took short positions in Ligand. According to the SEC Complaint, Lemelson made fraudulent statements regarding Ligand during the following months, including that Ligand was on the brink of bankruptcy, that its flagship drug Promacta (the main source of its licensing revenue) was going to become obsolete and immediately was “going away,” and that one of its licensing relationships with another pharmaceutical company, Viking Therapeutics, Inc. (“Viking”), was a sham based on false statements about Viking’s finances and operations. The SEC asserts that Lemelson stated on more than one occasion that “the intrinsic value of Ligand shares must be reaffirmed as \$0 with downside risk justifiably calculated at 100%” and also stated that “common shareholders could be wiped out almost entirely without notice.” Lemelson allegedly made these false statements in interviews, press releases and five “research reports” that were distributed to media outlets, including *PR Newswire*, *Seeking Alpha*, *Benzinga*, *Street Insider* and *USA Today*, and on blogs and other social media accounts between June and October 2014.

The SEC asserts that Lemelson did not have factual bases for the statements he made about Ligand and that the two articles Lemelson cited as sources did not actually discuss

¹ *SEC v. Lemelson*, No. 1:18-cv-11926 (D. Mass. filed Sept. 12, 2018).

Promacta and could not be construed to suggest that the drug was headed toward obsolescence. In addition, the SEC alleges that Lemelson also purported to have knowledge about Promacta's supposed obsolescence from two medical experts, but he did not disclose that one of these doctors was his hedge fund's largest investor and that he had never actually spoken directly to the other doctor. Lemelson also asserted that he learned about the company's belief in Promacta's obsolescence from a Ligand investor relations representative, but the SEC claims that Lemelson did not publicly disclose that the Ligand representative reached out to him after hearing a radio interview given by Lemelson to deny having made such a statement. Furthermore, Lemelson's statements about Ligand's licensing transaction with Viking were allegedly directly contradicted by the same public filing that he had supposedly relied on for his claims about Viking. The SEC also asserts that Lemelson used misstatements regarding Ligand's debt load, including a falsely presented debt-to-equity ratio, to support his claim about Ligand's debt and near-bankruptcy. Additionally, the SEC Complaint charges that Lemelson did not disclose in interviews or online posts his short position in Ligand or his lack of expertise in the pharmaceutical industry. Finally, Lemelson allegedly had comments critical of him removed from *Seeking Alpha*.

As a result of Lemelson's allegedly false statements, the SEC claims that Ligand's stock price dropped approximately 16 percent in the days following Lemelson's first report in June 2014 and approximately 34 percent overall between June and October 2014. Furthermore, the SEC asserts that Lemelson's false statements regarding Ligand were intended to bring in additional investors to The Amvona Fund. The SEC alleges that Lemelson himself asserted in a solicitation to a prospective Amvona investor that "[s]hares of Ligand dropped ~2% during [his first radio] interview." Lemelson and his firm are alleged to have largely covered their short positions, according to the SEC.

The SEC has charged Lemelson and LCM for violations of Exchange Act Section 10(b) and Advisers Act Section 206(4) and Rule 206(4)-8. The complaint seeks injunctive relief, disgorgement of Lemelson's ill-gotten profits and other penalties.

Analysis. The *Lemelson* case highlights the SEC's interest in addressing market manipulation schemes that affect retail investors and involve the use of electronic and social media outlets to spread false or misleading information about public companies.² The SEC recently created a special task force that is collaborating with the FBI in an

² See *Testimony Before the Fin. Servs. and Gen. Gov't Subcomm. of the S. Comm. on Appropriations*, 115th Cong. (June 5, 2018) (statement of Jay Clayton, Chairman, SEC), <https://www.sec.gov/news/testimony/testimony-financial-services-and-general-government-subcommittee-senate-committee>; *SEC Division of Enforcement Annual Report: A Look Back at Fiscal Year 2017* 1-2, 4 (Nov. 15, 2017) [hereinafter SEC Enforcement Annual Report 2017], <https://www.sec.gov/files/enforcement-annual-report-2017.pdf>.

attempt to investigate and combat market manipulation.³ Last year, the SEC brought 41 standalone market manipulation cases—a notable increase from the 30 enforcement actions it filed in 2016.⁴ These cases have primarily involved pump-and-dump schemes⁵ and, more recently, schemes involving microcap companies.⁶ SEC enforcement actions alleging short-and-distort tactics, however, have been rarer.⁷ This may be due to a general reluctance by companies to bring concerns about short sellers to the SEC's attention for fear that any investigation would necessarily require the SEC to probe the company itself and draw attention to previously undetected compliance issues.

The litigation against Lemelson should also serve as notice to activist and other investors who comment publicly on their investments that the SEC is tuned into how market participants are using social media and other electronic sources to disseminate information about public companies. Both companies and investors should be vigilant in ensuring that all public statements, including tweets and blog posts, are carefully vetted for accuracy and supported by documentation. Fund managers and others who may be in a position to make public statements should be regularly reminded about their firms' policies and procedures governing the making of public statements and, more broadly, the use of social media for fund-related purposes.

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Please do not hesitate to contact us with any questions.

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³ See Marius-Gabriel Ciobanu, *The U.S. Senate Hearing On Cryptocurrencies Had Both Positive and Negative Voices*, CryptoStreet (Feb. 7, 2018), <https://cryptostreet.co/cryptocurrency-news/the-us-senate-hearing-cryptocurrencies-had-positive-negative-voices>.

⁴ SEC Enforcement Annual Report 2017, *supra* note 2, at 15.

⁵ In a pump-and-dump scheme, a manipulator takes a long position in a target company's stock, spreads false or misleading information that encourages investors to buy the stock and drive up its price, and then sells his or her own shares at a profit. See, e.g., *SEC v. Burns*, No. 1:18-cv-06257 (S.D.N.Y. filed July 11, 2018); *SEC v. Murray*, No. 1:17-cv-03788 (S.D.N.Y. filed May 19, 2017); *SEC v. Aly*, No. 16 Civ. 3853 (PGG) (S.D.N.Y. filed May 24, 2016); *SEC v. PTG Capital Partners LTD*, No. 15-CV-04290 (S.D.N.Y. filed June 4, 2015).

⁶ See *SEC v. Honig*, No. 1:18-cv-08175 (S.D.N.Y. filed Sept. 7, 2018); *SEC v. Appel*, No. 2:18-cv-03200-PD (E.D. Pa. filed July 27, 2018); *SEC v. Beaufort Sec. Ltd.*, No. 2:18-cv-01317 (E.D.N.Y. filed Mar. 2, 2018); *SEC v. Mancino*, No. 2:18-cv-01316 (E.D.N.Y. filed Mar. 2, 2018).

⁷ See, e.g., *SEC v. Craig*, No. 3:15-cv-05076 (N.D. Cal. filed Nov. 5, 2015) (charging a Scottish trader for making false statements on Twitter to depress the stock prices of two companies and trigger a trading halt in one of them); *In re Barry J. Minkow*, Investment Advisers Act of 1940 Release No. 3320 (Nov. 22, 2011), <https://www.sec.gov/litigation/admin/2011/ia-3320.pdf> (individual barred after pleading guilty to conspiracy to commit securities fraud for his involvement in a short-and-distort scheme).

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