Securities Regulation Daily Wrap Up, ENFORCEMENT—1st Cir.: Court affirms SEC win in priestly short-and-distort scheme, (Jan. 5, 2023)

Securities Regulation Daily Wrap Up

Click to open document in a browser

By Anne Sherry, J.D.

The First Amendment did not shield the defendant from liability for false statements that were in the nature of fact, not opinion.

The First Circuit affirmed a victory for the SEC against a hedge fund adviser charged with conducting a short-and-distort scheme. After a jury found the defendant liable for three false statements, he appealed on the basis that the First Amendment sheltered some of the statements and that the verdict had insufficient evidentiary support. But the statements were of fact, not opinion, and the verdict had a sufficient basis, the court reasoned (*SEC v. Lemelson*, January 3, 2023, Lynch, S.).

The Commission charged hedge fund adviser Gregory Lemelson and his investment advisory firm, Lemelson Capital Management, with scheming to drive down the price of a pharmaceutical company's stock. In May 2014, Lemelson took a short position in Ligand Pharmaceuticals Inc. on behalf of a hedge fund he advised and partly owned. According to the SEC, after establishing his short position, Lemelson made a series of false statements intended to shake investor confidence in Ligand, lower its stock price, and increase the value of his position. By October 2014, Lemelson had covered his short position and generated approximately $1.3 million in illegal profits.

The SEC won partial summary judgment and secured a guilty verdict in the ensuing jury trial. The Massachusetts district court judge ordered a civil penalty and five-year injunction. Lemelson appealed, arguing that his statements were protected by the First Amendment and that the SEC failed to introduce sufficient evidence to support the jury's determination that the statements were of fact rather than opinion, were material, and were made with scienter.

Facts, not opinion. The first false statement at issue was Lemelson's claim that Ligand's investor relations representative had told him that its largest royalty-generating drug was "going away." In another report concerning Ligand, Lemelson made two additional challenged statements: that a Ligand licensee (Viking) did not intend to conduct any preclinical studies or trials and that Viking's financial statements were unaudited. The First Circuit disagreed that the statements concerning Viking were opinions that could enjoy First Amendment protection. Neither was prefaced by words signaling uncertainty, such as "I think" or "I believe." Both were factually contradicted by Viking's S-1, and Lemelson testified that he had been mistaken about the unaudited financials.

Materiality. The court also concluded that the SEC introduced sufficient evidence for a rational jury to find the three statements material. The Commission demonstrated the importance of the "going away" drug and the Viking license to Ligand's bottom line and produced evidence showing that investors were alarmed and concerned about the statements and communicated these concerns to Ligand. The jury also considered evidence that Lemelson himself took credit for the decline in Ligand's stock value.

Scienter. The court disagreed with Lemelson as to the sufficiency of the jury's basis for finding scienter. The jury could have credited the IR representative's testimony that he did not say the critical drug was "going away" and find that Lemelson intentionally or recklessly chose to misconstrue the conversation. A reasonable jury could also infer that Lemelson understood from the Viking S-1 that Viking's financials were audited and that the company intended to manage preclinical studies and trials, but intentionally or recklessly made statements to the contrary. Lemelson testified that he studies the S-1 carefully and that he knew a Form S-1 cannot be filed without

audited data. Furthermore, Lemelson's portfolio had a substantial short position that, while not by itself proving scienter necessarily, could be the basis for an inference that Lemelson would have carefully researched Viking and thus been aware that his statements were misleading.

Injunction. Finally, the district court did not abuse its discretion in imposing an injunction. The district properly weighed the three relevant factors for imposing an injunction by examining the egregious nature of the violation, noting that Lemelson would be in a position to violate Section 10(b) and Rule 10b-5 again due to his occupation as an investment adviser and hedge fund manager, and determining that Lemelson had failed to recognize the wrongfulness of his conduct. Lemelson leaked confidential information about the lawsuit to the press and said in post-verdict argument that he would "never regret the things [he] did." The district court also contrasted Lemelson's case with other cases involving egregious conduct, finding that his violation lay somewhere in the middle of the spectrum of egregiousness, and issued only a five-year injunction accordingly.

The case is No. 22-1630.

Attorneys: Paul Gerard Alvarez for the SEC. Douglas Scott Brooks (Libby Hoopes Brooks, P.C.) for Gregory M. Lemelson, a/k/a Father Emmanuel Lemelson, Lemelson Capital Management, LLC and The Amvona Fund, LP.

Companies: Lemelson Capital Management, LLC; The Amvona Fund, LP

LitigationEnforcement: Enforcement FraudManipulation GCNNews HedgeFundsNews InvestmentAdvisers MaineNews MassachusettsNews NewHampshireNews PuertoRicoNews RhodeIslandNews