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Musk Case Signals New Era Of SEC Internet Enforcement

By **John Reed Stark** (October 1, 2018, 1:47 PM EDT)

The U.S. Securities and Exchange Commission's complaint against Elon Musk and the settlement that followed seems like an obvious, routine and easy win for the government. But there is a lot more to the Tesla tweet debacle than meets the eye. The SEC complaint against Musk signals a new and aggressive era of SEC enforcement and the internet.

John Reed Stark

The Musk and Tesla SEC Lawsuits

The facts of the SEC lawsuit against Elon Musk, filed Sept. 27, 2018, are fairly straightforward. On Aug. 7, 2018, Musk tweeted a nine-word message that he was "taking Tesla private at $420" and noted cryptically and confidently, "funding secured."

From the time of Musk's first tweet that day until the close of trading, Tesla's stock price increased by more than 6 percent on significantly increased volume and closed up 10.98 percent from the previous day — and also caused considerable market disruption.

The SEC quickly investigated, and concluded that Musk either knew, or was reckless in not knowing, that his tweet was false and misleading. The SEC then filed an SEC civil enforcement action, which is similarly straightforward in its allegations.

A few days after its filling, on Sept. 29, 2018, Musk, without admitting or denying wrongdoing, settled the SEC charges, while the agency simultaneously filed a new complaint, this time against Tesla, which Tesla also settled without admitting or denying wrongdoing. The SEC's complaint against Tesla alleges that (1) Tesla had no disclosure controls or procedures in place to determine whether Musk's tweets contained information required to be disclosed in an SEC filing; and 2) Tesla did not have sufficient processes in place to ensure that Musk's tweets were accurate or complete.

Among other relief, the Musk and Tesla settlements require that:

- Musk will step down as Tesla's chairman and be replaced by an independent chairman;
- Musk will be ineligible to be re-elected chairman for three years;

- Musk will be ineligible to be re-elected chairman for three years;
- Tesla will appoint a total of two new independent directors to its board;
- Tesla will establish a new committee of independent directors and put in place additional controls and procedures to oversee Musk's communications; and
- Musk and Tesla will each pay a separate $20 million penalty. The $40 million in penalties will be distributed to harmed investors under a court-approved process.

But here's the rub. The SEC does not typically file enforcement actions like the one against Musk. Indeed, a close reading of the SEC's complaint against the celebrated billionaire finds a litany of glaring absences within the SEC's allegations, including:

- No alleged profits or other ill-gotten gain earned by Musk;
- No alleged scheme conducted by Musk;
- No alleged market manipulation orchestrated by Musk;
- No alleged pump-and-dump ploy executed by Musk;
- No alleged conspiracy between Musk and anyone else;
- No alleged evidence of scienter or intent by Musk;
- No alleged false filing or other false or inaccurate Tesla report to the SEC by Musk;
- No alleged violation of any sort of required SEC "quiet period" by Musk; and
- No concrete evidence of any alleged motive attested to Musk (Though not required in SEC enforcement actions, motive is typically pled or implied in some way, shape or form).

No doubt, Musk's tweet was impetuous, impulsive, ill-advised, stupid, silly, unprofessional, childish, petty, and the list goes on. Musk's tweet also clearly had a material impact on Tesla securities and disrupted U.S. and even global financial markets.

But was this really a scheme by Musk to defraud investors? Or was it instead a juvenile missive from an exhausted entrepreneur whose ego and id had spun out of control, or perhaps a hapless attempt at transparency to inform his shareholders what, at that very moment, he was contemplating for their future. Perhaps the explanation is even simpler: Musk failed to think before he tweeted — and hit "post" during a momentary lapse in judgment between caffeine jolts and marijuana tokes on a bumpy car ride to the airport.

None of these possibilities seem to matter to the SEC, and we will never know if any are true. Because whatever the truth or the facts, someone at Tesla decided that a $40 million SEC settlement might pale in comparison to any Tesla stock market cap recovery after the settlement's announcement. (Note: Tesla stock opened almost 15 percent higher on the Monday morning after the weekend the SEC announced the settlement.)

But putting all the machinations and drama of the "funding secured" fiasco aside, there is a much broader and emphatic SEC edict that now rings clear: Whenever a corporate executive makes a material false statement online — boom — it's securities fraud. Period. End of story.

The SEC Anti-Fraud Provisions

Section 10(b) (codified in 15 U.S.C. § 78j) is the SEC's primary anti-fraud statutory provision. The SEC principally enforces this anti-fraud provision under Rule 10b-5, which specifically states:

> **§ 240.10b-5 Employment of manipulative and deceptive devices.**
>
> 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,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact

necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The SEC's anti-fraud provisions are broad and sweeping — and are meant to be flexible to bend and adapt to new or evolving forms of investment fraud and chicanery. No matter the medium, the SEC's anti-fraud statutory weaponry applies.

The SEC's fraud charge against Musk relies solely on the paragraph of Section 10b-5 regarding false statements, which is not the typical centerpiece of an SEC fraud action. Specifically, the SEC complaint charges:

CLAIM FOR RELIEF

Violations of Section 10(b) of the Exchange Act and Rule 10b-5 Thereunder

78. Paragraphs 1 through 77 are hereby re-alleged and are incorporated herein by reference.

79. Defendant, with scienter, in connection with the purchase or sale of securities as set forth above, directly or indirectly made untrue statements of material fact and omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading by the use of the means or instrumentalities of interstate commerce, and of the mails, and the facilities of a national securities exchange.

The SEC's above "claim for relief" may appear typical but it is far from the norm. An SEC fraud charge typically alleges evidence of more than merely a false statement — and adds conversations, testimony, emails, profit calculations and a broad range of other facts demonstrating a nefarious scheme.

Some Eerily Relevant SEC History

When considering the SEC Musk prosecution, two cases from almost 20 years ago are uncannily relevant: (1) the 1999 SEC case (and parallel U.S. Department of Justice criminal prosecution) against Gary Hoke; and (2) the 2000 SEC case (and parallel DOJ criminal prosecution) against Fred Moldofsky.

PairGain and Gary Hoke

The PairGain online hoax was perpetrated by 25-year old Californian Gary Hoke. The Hoke prosecutions were followed by a string of similar online market manipulation impersonation hoaxes, many of which were successfully prosecuted by the SEC as well as, in some cases, the DOJ, which seemed to stifle the new age fraud's growth in its tracks.

Hoke worked for a company called PairGain, a California based telecommunications equipment manufacturer whose stock traded on Nasdaq at the time. Hoke posted a message on an internet message board falsely reporting that an Israeli company planned to acquire PairGain. The message board posting contained a link to a website designed by Hoke to mimic a Bloomberg online news report announcing the impending acquisition.

A snapshot of Hoke's actual phony Bloomberg webpage is as follows:

Bloomberg.com : Top Financial News - Netscape

Top Financial News
Wed, 07 Apr 1999, 8:55am EDT

ECI Telecom to Acquire PairGain Technologies, Inc., a Leading Provider of DSL Technology

PETAH TIKVA, Israel, and TUSTIN, Calif., April 7 (Bloomberg) -- ECI Telecom Ltd. and PairGain Technologies, Inc. today jointly announced that they have entered into a definitive agreement under which ECI Telecom Ltd. will acquire PairGain Technologies, Inc. in a cash transaction. PairGain is a world leader in the design, manufacture and marketing of DSL (Digital Subscriber Line) networking systems.

The acquisition of PairGain Technologies, together with the Tadiran Telecommunications Ltd. merger completed earlier this month, provides ECI Telecom with best-of-breed communication technologies for both carrier and enterprise markets. It also reaffirms its commitment to expand its presence in the U.S.

The transaction has an implied value of $1.35 billion, which includes the equity purchase price as well as a technology development incentive plan. The incentive plan will leverage PairGain Technologies outstanding DSL microelectronics know-how to develop new products broadening ECI Telecom's networking solutions for the carrier market.

Hoke constructed the phony Bloomberg article website by using a fake name and an internet service that offered users free websites. Hoke then linked to the fake website from messages about PairGain that he posted on internet message boards (the early precursor to today's social media platforms).

Hoke's hoax (no pun intended) quickly inflated PairGain's stock by more than 30 percent, from $8.50 per share to as high as $11.25. Trading that day totaled 13.7 million shares, about seven times PairGain stock's average trading volume. The price of PairGain stock fell back to $9.38 when the company issued a statement denying that such a deal was in the works.

Hoke's scheme was the first SEC and criminal prosecution that truly demonstrated how, in cyberspace, a single individual using just a single phony website and a few message board postings could trick a large number of investors to trade. Hoke, apparently spooked by the publicity surrounding his scheme (which, given its ingenuity and novelty, made immediate headlines), opted not to add fuel to the fire and sell any of the 1,000 shares of PairGain stock he owned — despite opportunity for a quick and easy profit.

The SEC and the DOJ identified Hoke as the bogus website's creator by tracing certain website message board postings to his internet service provider, and Hoke was charged both by the SEC in a civil enforcement action and by the U.S. Attorney's Office for the Central District of California in a criminal action. Bloomberg LP, the parent company of the Bloomberg news service, also filed a related lawsuit against Hoke in federal court in New York City, seeking unspecified damages for the scheme.

In the SEC enforcement action, just like Musk, Hoke was charged with violating the SEC's anti-fraud provisions alleging:

> Hoke knew or was reckless in not knowing that his statements ... were materially false and misleading and, in addition, that posting those statements on a counterfeit Bloomberg page would materially mislead investors as to the reliability of that information ... and would result in an increase in both the price and the volume of trading in PairGain securities.

Hoke eventually settled with the SEC, and agreed, without admitting or denying wrongdoing, to an order barring him from future violations of federal anti-fraud laws.

In the criminal case, Hoke was charged with five counts of securities fraud and faced a maximum sentence of 10 years in prison and up to $1 million in fines per count, but he later pled guilty to two counts of securities fraud. At sentencing, U.S. District Judge Terry Hatter dismissed the prosecutors' recommendation of 12 to 13 months in prison, saying he was convinced Hoke's decision to post the fraudulent story was an aberration in an otherwise honorable life. Judge Hatter sentenced Hoke to five months of home detention, five years' probation and ordered Hoke to pay $93,000 to about 30 investors who purchased PairGain stock and sold it at a loss after PairGain denied Hoke's bogus report.

Interestingly, Judge Hatter also questioned whether the lack of internet safeguards to prevent posting of false messages was partly to blame for the scam. Judge Hatter also criticized professional investors who failed to verify the fake report before buying PairGain stock, and said he was impressed by a letter in which Hoke's mother said her son was "a victim" of the internet.

"It doesn't seem right that we proceed with this matter criminally when we don't have protections out there," Judge Hatter said.

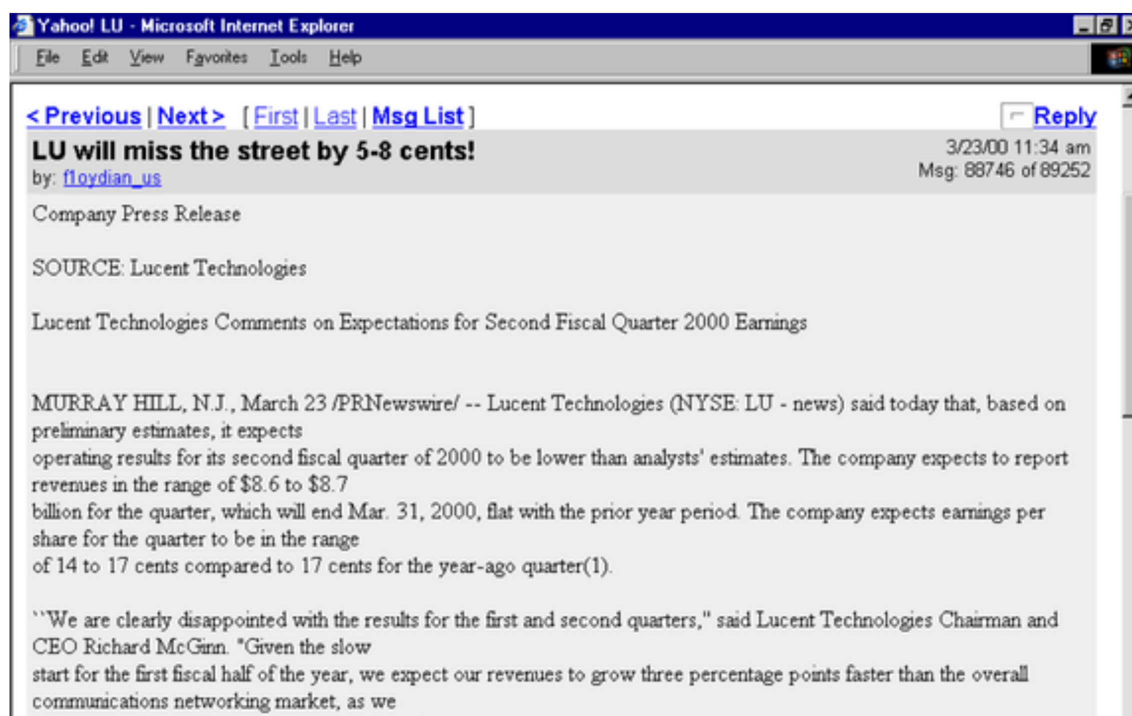
Hoke told Judge Hatter that he posted the story to counter chat room messages that disparaged PairGain and the value of its stock. Hoke said he believed the messages were posted by traders who hoped to profit by driving down the price of the company's shares. Hoke told reporters outside the courtroom, "As a PairGain stockholder, it just made me unhappy. I felt I could influence the negative remarks people were making in a positive way. It was stupid."

Sound familiar? Tesla short sellers have tortured Musk for years. Musk and Hoke clearly felt the same pain.

Lucent and Fred Moldofsky

On the afternoon of March 22, 2000, Fred Moldofsky, a 46 year-old Canadian citizen living in Houston, posted on a message board rumors that Lucent would not meet its quarterly earnings estimates. Later, during that same evening, Moldofsky posted a fake PR Newswire announcement and several dozen other messages repeatedly stating that Lucent's earnings were going to be poor. The postings were made March 22 and 23, 2000, under aliases such as "hot-like-wasabe" and "ya-gotta- believe-in-me." Moldofsky apparently lifted language from an old Lucent press release to enhance his fake press release's authenticity.

A snapshot of Moldofsky's actual fake press release is as follows:



Yahoo! LU - Microsoft Internet Explorer

File Edit View Favorites Tools Help

< Previous | Next > [First | Last | Msg List] Reply

LU will miss the street by 5-8 cents!
by: f1oydian_us

3/23/00 11:34 am
Msg: 88746 of 89252

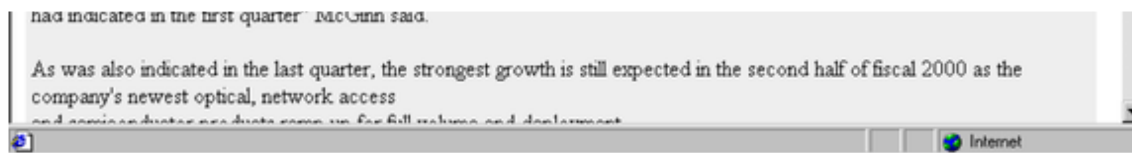
Company Press Release

SOURCE: Lucent Technologies

Lucent Technologies Comments on Expectations for Second Fiscal Quarter 2000 Earnings

MURRAY HILL, N.J., March 23 /PRNewswire/ -- Lucent Technologies (NYSE: LU - news) said today that, based on preliminary estimates, it expects
operating results for its second fiscal quarter of 2000 to be lower than analysts' estimates. The company expects to report revenues in the range of $8.6 to $8.7
billion for the quarter, which will end Mar. 31, 2000, flat with the prior year period. The company expects earnings per share for the quarter to be in the range
of 14 to 17 cents compared to 17 cents for the year-ago quarter(1).

``We are clearly disappointed with the results for the first and second quarters," said Lucent Technologies Chairman and CEO Richard McGinn. "Given the slow
start for the first fiscal half of the year, we expect our revenues to grow three percentage points faster than the overall communications networking market, as we



had indicated in the first quarter" McGinn said.

As was also indicated in the last quarter, the strongest growth is still expected in the second half of fiscal 2000 as the company's newest optical, network access

Internet

On March 22, 2000, Lucent's stock closed at $62.63 a share, down $2.63. The next day, March 23, the stock opened at $62.13 and traded as low as $60.38. Market commentators attributed Lucent's stock price decline to the press release that Moldofsky had disseminated. Lucent disavowed the information in the fake press release during the morning of March 23.

Moldofsky was caught within days of his false postings and charged by both the SEC and by the U.S. Attorney's Office for the Southern District of New York.

In the SEC action, without admitting or denying wrongdoing, Moldofsky agreed to a final SEC judgment permanently enjoining him from future securities violations. According to the SEC, Moldofsky did not have to pay a penalty based on his sworn inability to do so.

In the criminal action, Moldofsky was convicted by a jury of one count of securities fraud and was sentenced to the two months in prison he had already served. At the time of his sentencing, Moldofsky held a $30,000-a-year job at a Texas refinery, and could have received a six-year prison sentence. SDNY prosecutors argued that the fake press release, posted in March 2000, sent Lucent's shares tumbling by 3.6 percent and harmed investors.

In handing down the sentence, U.S. District Judge Robert P. Patterson noted Moldofsky's otherwise clean criminal record and the fact that he did not profit from the bogus release. The judge imposed a $4,000 fine and also ordered Moldofsky to be confined to his home for six months (when not working), though also admonishing Moldofsky at sentencing, stating: "You can't have people posting messages on the Internet willy-nilly."

At sentencing, Moldofsky told the judge he did not realize he was breaking any law when he posted the fake release on Yahoo's message board: "I deeply regret what happened. There was never any intent to defraud investors."

Sound familiar? Like Moldofsky, whatever Musk intended, he does not believe he was engaged in a scheme to defraud Tesla investors. And like the judge in Moldofsky, the SEC is essentially telling corporate executives that the SEC will not permit them to post on Twitter "willy-nilly."

Investors, Social Media, Disintermediation and Transparency

Hoke and Moldofsky were, of course, outsiders, and not corporate insiders like Musk. But there is a big difference between the conduct of small-time stock perps, like Hoke and Moldofsky, and entrepreneurial visionary CEOs like Musk, though the charging statute used against Musk, Hoke and Moldofsky, Section 10b and Rule 10b-5, is exactly the same.

Some may argue that Twitter and other social media are not suitable for important corporate disclosures. I get that — corporate disclosures must be fulsome and robust, and can carry onerous and critical duties to update and correct.

Others, like Judge Hatter in the Hoke case, may argue that the investors who bought Tesla stock after reading Musk's "funding secured" tweet bear some of the blame for Musk's predicament. Rather than basing their investment decisions on sound and thoughtful research, on consultations with professionals they trust, and on the wealth of data and analysis available online, certain Tesla investors made a dangerous snap judgment with the same imprudent impulsiveness as Musk did. I get that, too — investors should make investment decisions slowly, wisely, cautiously and carefully, not at the lightning speed of a tweet that has 280 characters or less.

But albeit well-intentioned, the SEC has sent a clear message to any corporate executive who wants to use social media to reach shareholders, analysts, media or anyone else — don't do it. After all, how could any corporate communication ever be worth the risk of an SEC enforcement action or investigation — no matter how beneficial, insightful or important. This is a shame.

Social media could be a revolutionary tool for investors and should be embraced. Social media disintermediates communication lines between shareholders and executives, empowering corporate leaders to reach shareholders in ways never even imagined only a few years ago. Social media could democratize investing and enhance the vibrancy and efficiency of global capital markets. But there is little chance of any of this kind of progress after the Musk tweet SEC enforcement action.

Sadly, we may now revert back to relying on routine SEC filings, such as 10-Ks and 10-Qs, which have become so replete with boilerplate risk disclosures, maddening legalese, lengthy excess verbiage and confusing gobbledygook that they have been rendered almost meaningless for everyday investors. Ironically, the greatest value of EDGAR (the SEC's online warehouse that stores corporate filings) is probably for plaintiffs lawyers, who scour the prehistoric database in search of potentially misleading, actionable and class-action-worthy corporate statements.

Looking Ahead

There is not a securities lawyer on the face of the Earth that would have given Musk the go-ahead to post his now infamous Aug. 7 tweet. Moreover, the phrase "funding secured" will undoubtedly take on a life of its own in securities regulation lure, much like the notorious "your bunny has a good nose," whispered by Martin Siegel, confirming inside information to a co-conspirator in one of the many SEC/Rudy Giuliani-led insider trading prosecutions of the 1980s.

But that does not change the fact that in the SEC's complaint against Musk, there are no allegations of any scheme, plot or plan by Musk. There are no allegations of any illicit profit, reprehensible chicanery or clandestine treachery by Musk. Musk is not even charged with any of the usual lesser SEC charges or more picayune securities violations.

To me, Musk's story seems more about a petulant, careless, rash, exhausted and out-of-control founder with delusions of grandeur. A train wreck? Yes, indeed. A subject of criticism and discipline by the Tesla board? Absolutely. A defendant in a lawsuit by disgruntled shareholders? Maybe. But a scheming fraud artist charged with the same securities violation as Hoke, Moldofsky and so many other criminal miscreants? No.

Musk's tweet was abominable and inexcusable, but having said that, by charging Musk with fraud, the SEC may end up doing more harm than good. Thanks to Elon Musk and the SEC, we may have now entered a new era of SEC internet enforcement, where corporate executives may never risk tweeting or otherwise posting any meaningful data or information on social media.

The SEC threw the book at Musk, including forcing Musk to pay a $20 million penalty, a penalty that is exponentially greater than the penalties levied against Hoke ($93,000), Moldofsky ($4,000) and countless other more egregious SEC fraudsters (consider Elizabeth Holmes, the alleged billionaire perpetrator of the recent massive and notorious Theranos fraud, who settled with the SEC for a mere $500,000 penalty).

And while the SEC succeeded in sending an important message about the need for truth, candor and accuracy of corporate communications uttered via every medium, the charges were not just overkill but were also perhaps a pyrrhic victory for investors. Indeed, when the dust settles, the SEC may not have scored a win for its precious investor constituency but instead, scored a win for its own self-preservation of the sacred remnants of Stone Age-based securities regulation.

John Reed Stark is the president of John Reed Stark Consulting LLC, a data breach response and digital compliance firm. Formerly, Stark served for almost 20 years in the Enforcement Division of the U.S. Securities and Exchange Commission, including 11 years as the chief of its Office of Internet Enforcement. He is the author of "The Cybersecurity Due Diligence Handbook."

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