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CYBERGOSSIP OR SECURITIES FRAUD? SOME FIRST AMENDMENT GUIDANCE IN DRAWING THE LINE

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Fifteen-year-old Jonathan Lebed, the youngest person ever pursued by the SEC in an enforcement action, made over $800,000 in six months by promoting stocks on Internet message boards. Using several fictitious screen names, Jonathan posted hundreds of messages on *Yahoo! Finance*, hyping selected over-the-counter stocks and then promptly selling his pre-purchased shares as soon as the stock prices rose. [1]

Publicly, the SEC painted a picture-perfect case of securities fraud. Yet, the SEC forced disgorgement of only $285,000 of Jonathan's profits, leaving many observers to wonder why the resolution of this supposedly clear-cut case left its teenaged perpetrator with over $500,000. The skepticism heightened when Michael Lewis, in an influential article in *The New York Times*, suggested that the SEC's pursuit of Lebed was partially motivated by a desire to keep a "little jerk" (to quote one SEC investigator) from outsmarting federal regulators. [2] The Lewis article further portrayed a regulatory agency fundamentally unable to adapt to the challenges of regulating fraud on the Internet.

Enforcement Leading to Uncertainty

The SEC's handling of cases like Lebed's threatens to chill not only fraudulent speech, but also more socially desirable speech traditionally protected by the First Amendment. By refusing to specify which of Lebed's trades were fraudulent and which were not, the SEC added to the current uncertainty about how far individuals can go while engaging in the new forms of "stock talk" that have arisen on the Internet without running afoul of federal securities laws.

In its press release, the SEC made much of the fact that Lebed used multiple screen names to recommend the purchase of particular stocks at, as Lebed put it, "DIRT CHEAP PRICES." [3] However, even the use of multiple screen names to post on financial message boards cannot, standing alone, constitute fraud, because the right to speak anonymously is constitutionally protected. [4] Likewise, if describing a stock in glowing terms on a message board is fraud, then *Yahoo! Finance, Silicon Investor, Raging Bull* and the other financial message boards would simply have to shut down: staid and objective analysis of stocks is the exception rather than the rule on Internet message boards.

A more problematic aspect of the Lebed case is the fact that Lebed hyped these stocks and at the same time allegedly failed to disclose his financial interest to his audience. [5] Or did he? Only the most credulous readers could have assumed he was disinterested, given the exclamation points, the obvious hyperbole in his posts, and his use of fictitious screen names rather than his actual identity. Although the SEC is charged with protecting the investing public, surely it cannot make Internet message boards safe for the most gullible investors without seriously threatening First Amendment values.

Finally, although the SEC stated that Lebed made materially false statements, it appears that most of his statements were, when read in context, constitutionally protected opinion.

The potential chilling effect of the SEC's approach to cases like Lebed's is compounded by the fact that the SEC's analysis of First Amendment issues usually begins and ends with the tired rhetoric that fraud is not constitutionally protected. [6] While true, this analysis ignores the role of the First Amendment in drawing the correct line between protected speech and securities fraud. This article offers a remedy to the SEC's approach by outlining the First Amendment principles necessary to distinguish securities fraud from mere "cybergossip."

The Proliferation of Internet Fraud

The SEC's concerns about securities fraud on the Internet are well-founded. Although many instances of Internet fraud are simply traditional scams transported to a new medium, the Internet magnifies the opportunities for fraud and creates unique difficulties in enforcing the securities laws. [7] For instance, the recent bubble market blinded people to the true risks of investing, allowing con artists to use the anonymity provided by Internet message boards and chat rooms to deceive naïve investors and rake in handsome profits.

It is not just the anonymity of most Internet communications that makes it more difficult for the SEC to detect fraud, however. The sheer volume of Internet communication and online trading has strained the SEC's limited enforcement resources.

Understandably, these developments have alarmed the SEC. To date, the SEC has brought over 200 Internet-related enforcement actions against over 750 named individuals and entities, [8] and it continues to respond to online fraud by devoting more resources to Internet regulation.

The Internet as a Public Forum for Economic Discussions

Yet, the SEC must not succumb to alarmist fears of the Internet in responding to these new circumstances. Any response to the problem of securities fraud must acknowledge the Internet's unique contribution to discourse about the markets. Simply stated, the Internet has revolutionized the once arcane world of "stock talk," primarily by empowering individual investors. No longer need they rely solely on intermediaries--analysts, brokers, financial journalists, or even the SEC itself--to gain access to market information.

The boards also provide an informal and idiosyncratic education about the behavior of particular corporations and the workings of the market. [9] More importantly, however, message boards have "democratized" financial discourse by creating forums that allow millions of ordinary citizens to participate in "uninhibited, robust and wide-open debate" (to use the famous phrase from *New York Times v. Sullivan*) about the corporations that shape our daily lives. [10] Any individual who wishes to discuss the management or future prospects of a company now has access to an audience of like-minded souls.

Discussions on the boards not only help to shape public opinion, but occasionally transform that opinion into action. Indeed, it is the worry that the boards will transform opinion into action that prompts many companies to monitor what is being said about them on the Internet. The boards thus act as a valuable back channel for shareholders to communicate their discontent, and thereby erode (albeit only slightly) the dominance of institutional investors.

Still, any argument that the message boards contribute to robust debate must concede that much of the conversation on the boards is uninformed and inane. The discourse resembles informal gossip more than rational debate and deliberation: idle speculation, unintelligible musing, baseless rumors, and "off-topic" trivia predominate, threatening to engulf serious financial discussions. Indeed, the culture of the boards fosters, in the words of commentator and former hedge fund manager Jim Cramer, "disinformation, rumors and garbage." [11]

Yet, to concede this point does not detract from the importance of the boards as a forum for public discussion of corporate behavior. An underlying premise of the First Amendment is that truth is best gathered "out of a multitude of tongues," [12] and a debate that includes not just educated elites but ordinary citizens as well will inevitably contain disinformation, rumors, and garbage. The problem for the SEC and for courts, therefore, is to attack securities fraud on the Internet while maintaining sufficient "breathing space" around this revolutionary new type of financial discourse.

Are Internet Posts Merely Commercial Speech?

Much of the speech on the financial message boards lies at the core rather than the periphery of the First Amendment's protection. It is worth amplifying this point because the Supreme Court expressly has declined to define the precise contours of First Amendment protection for speech about the securities markets. [13] Many courts and commentators, therefore, have assumed that *all* speech about securities should be subject to extensive government regulation as "commercial speech" or as an analogous category deserving only limited protection "because of the federal government's broad powers to regulate the securities industry." [14] While some types of speech that the SEC regulates, including speech that promotes the sale of securities or constitutes personal investment advice, may fall under this rubric, most of the speech on the message boards should not be treated as commercial speech.

Like Jonathan Lebed, most of those who post on Internet message boards do not give personalized investment advice to other investors. Instead, most Internet posters use the boards to discuss the management, stock price, and prospects of particular companies. Even though a poster may own stock in a company under discussion, it is not fair to say that his posts do "no more than propose a commercial transaction," which is one of the classic definitions of commercial speech. [15] Nor is it fair to characterize most message board posts as "expression related solely to the economic interests of the speaker and its audience." [16] Although the speaker has a financial interest, most Internet posters participate on message boards as an avocation rather than a vocation.

Concurrently, audiences turn to message boards for a variety of reasons: to glean information that may inform a trading decision, to learn more about a particular company, or, more often, merely to get the "buzz" about a particular company. In essence, the Internet has ended the domination of the dialogue on financial markets by educated elites and has given ordinary citizens a meaningful role in that dialogue. In deciding which Internet fraud cases to pursue, therefore, the SEC should presume that much of the speech on the boards is fully protected by the First Amendment.

The Opinion Privilege and the Message Boards

The SEC must insure that its Internet enforcement actions are not motivated by fear of the changes wrought by the democratization of financial discourse and a desire to return that discourse to the control of securities professionals. To this end, the SEC must be particularly sensitive to the context and culture of Internet message boards in drawing the line between material misstatements of fact and mere statements of opinion.

The distinction between statements that are materially false and statements that are merely opinion is critical as a matter of both securities and First Amendment law. The primary source of the SEC's regulatory authority in cases like Lebed's is Section 10b of the Securities Exchange Act of 1934, as interpreted by Rule 10b-5. [17] Among other things, Rule 10b-5 makes it unlawful "to make any untrue statement of a material fact" or, in some instances, to omit a material fact.

The distinction between false statements and statements of opinion appears to be constitutionally compelled. The Supreme Court noted in *SEC v. Lowe,* for example, that "the expression of an opinion about a marketable security" is just as deserving of protection as "the expression of an opinion about a commercial product"--an opinion that receives full First Amendment protection. [18]

Rule 10b-5 itself gives no guidance for distinguishing between factual and nonfactual statements on message boards, and the SEC's application of Rule 10b-5 shows little sensitivity to the difficulties of this inquiry. The SEC's approach is especially troubling in light of the speculative nature of stock tips generally and the unusual conventions of stock talk on the boards.

The constitutional privilege for statements of opinion bars the government from imposing liability for statements that do not imply an "assertion of objective fact." According to the Supreme Court, nonfactual statements must be protected in order "that public debate will not suffer for lack of 'imaginative expression.'" [19]

The Court identified two types of constitutionally protected statements in *Milkovich v. Lorain Journal Co.* [20] The first is a statement about a matter of public concern that is not provably false. For example, the statement that the CEO of a company is "asleep at the wheel" is incapable of being proved true or false. [21] A second type of constitutionally protected opinion is a statement that "cannot 'reasonably [be] interpreted as stating actual facts." [22] Hyperbole, satire, and parody all fall into this category because their tenor and context signal readers that they are not to be taken at face value. Although the Supreme Court did not make this point explicitly, its analysis indicates that context is a critical determinant of whether a statement is factual or nonfactual.

This analysis, in turn, has important implications for drawing the line between securities fraud and mere statements of opinion (including hyberbole, speculation, sarcasm, and the like). Specifically, in determining whether a statement posted on a message board is fraudulent, one must consider the context of the statement, including the speculative nature of stock talk generally and of stock talk on the boards in particular. Consider, again, the case of Jonathan Lebed. In hyping a "micro cap" company called Firetector, Lebed posted the following message under the title "THE MOST UNDERVALUED STOCK EVER":
I see little risk when purchasing FTEC at these DIRT-CHEAP PRICES. FTEC is making TREMENDOUS PROFITS and is trading UNDER BOOK VALUE!!!

This is the #1 INDUSTRY you can POSSIBLY be in RIGHT NOW….

These prices are GROUND-FLOOR! My prediction is that this will be the #1 performing stock on the NASDAQ in 2000. I am loading up with all the shares of FTEC I possibly can before it makes a run to $20.

Be sure to take the time to do your research on FTEC! You will probably never come across an opportunity this HUGE ever again in your entire life. [23]

The immediate context of Lebed's message signals the reader that it does not contain objective, buttoned-down analysis of Firetector's prospects. Not only do the punctuation and phrasing denote it as obvious speculation and hyperbole; the fact that it is posted under a fictitious name cautions the reader against interpreting it as stating objective facts.

More to the point, anyone who is familiar with the message boards knows emotional rants like Lebed's are the norm. The culture of the boards encourages posters to engage in "loose talk," relying on the collective wisdom of other posters to refute misstatements. Many posts are tongue in cheek, and the language used is often emotional, overheated, and caustic, particularly following a dramatic change in a company's stock price. Moreover, readers understand that Internet posters are, like themselves, not trained financial analysts and that their opinions should be taken for what they are--just opinions, and perhaps biased or uninformed ones. [24]

Even stock tips published by professionals are inherently speculative and subjective. Several courts have recognized that stock tips tend to contain opinion rather than fact. Indeed, one court concluded that investors "who blindly follow third party stock tips" should not be entitled to relief under Section 10(b) of the Securities Act because such reliance is unreasonable. [25] Another court, in extending the opinion privilege to an article in *Forbes* magazine's "Streetwalker" column, stopped short of creating a "doctrinal exemption" for stock tips, but nonetheless emphasized that such articles typically do not imply objective assertions of fact. [26]

This is not to say, of course, that all messages posted on Internet message boards should be interpreted as nonfactual. Some posters take great pains to convince their audience that they have inside knowledge or special expertise, and they should be held to this representation when their messages are fraudulent. Some messages, moreover, contain patently false data that is clearly of a factual nature. This analysis does suggest, however, that the decision whether a given message contains material misstatements of fact can be reached only after due consideration of the nature of stock talk on the Internet.

Conclusion

Compelling justifications argue for the SEC to keep the unique culture of Internet message boards in mind when deciding which enforcement actions to pursue. Given its limited resources for Internet enforcement, the SEC should be cautious in pursuing cases that fall into the gray area between securities fraud and protected speech. This cautious approach has the added benefit of protecting First Amendment values by guaranteeing sufficient breathing space for the revolutionary new types of financial discourse that are appearing online.

To further safeguard First Amendment values, the SEC must acknowledge that the line between securities fraud and mere cybergossip is partially a function of context and that, when read in context, most Internet posts cannot reasonably be interpreted as assertions of objective fact.

Finally, the SEC must provide a more cogent explanation of its decision-making process to avoid chilling speech traditionally protected by the First Amendment. Had the SEC explained why or how Lebed's use of the Internet constituted securities fraud, it could have avoided the potential chilling effect of the case, while simultaneously furthering its mission of educating investors.

Footnotes

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1 *See* Michael Lewis, *He Wanted to Get Rich. He Wanted to Tune out His School-kid Life. And Neither His Parents nor the SEC Was In a Position to Stop Him*, N.Y. TIMES, Feb. 25, 2001, at 26 (Sunday Magazine).

2 *See* SEC News Release, *SEC Brings Fraud Charges in Internet Manipulation Scheme* (visited Sept. 9, 2000) <www.sec.gov/news/press/2000-135.txt>.

3 *See id.*

4 *See* McIntyre v. Ohio Election Comm'n, 514 U.S. 334 (1994); *see also* ACLU v. Miller, 977 F. Supp. (N.D. Ga. 1997).

5 *See* MICHAEL LEWIS, NEXT: THE FUTURE JUST HAPPENED, 27-84 (2001). In at least one instance, it is clear that Jonathan disclosed his financial interest in the hyped company Firetector.

6 *See* Virginia Pharmacy Bd. v. Virginia Consumer Counsel, 425 U.S. 748, 771 (1975).

7 *See* Nancy Toross, *Double Click On This: Keeping Pace with Online Market Manipulation,* 32 LOY. L.A. L. REV. 1399, 1417-18 (1999).

8 Michael Schroeder, *Growth in Internet Securities Fraud will be Difficult to Combat, GAO Says*, WALL ST. J., Mar. 22, 1999, at C-15; Aaron Lucchetti & Larry Bauman, *Small Brokerage Firms Surge on Internet Fever*, WALL ST. J., Feb. 5, 1999, at C7; Claire Ann Koegler, *Here Come the Cyber Cops 3: Betting on the Net*, 22 NOVA L. REV. 545, 549 (1998); *see also* Press Release, *SEC Charges 23 Companies and Individuals in Cases Involving Broad Spectrum of Internet Securities Fraud* (visited Sept. 1, 2001) <www.sec.gov/news/press/2001-24.txt>.

9 *See* Toross, *supra* note 7, at 1402-03.

10 New York Times Co. v. Sullivan, 376 U.S. 254, 270 (1964).

11 *Reliable Sources: Are 24-Hour TV and the Internet Helping People Understand Wall Street, or Is There Too Much Bull in the Bull Market?* (CNN television broadcast, July 31, 1999), transcript available in LEXIS, Transcripts File.

12 United States v. Associated Press, 52 F. Supp. 362, 372 (S.D.N.Y. 1943) (opinion of the court by Judge Learned Hand), *aff'd*, 326 U.S. 1 (1945).

13 *See, e.g.,* SEC v. Lowe, 472 U.S. 181 (1985).

14 *See* SEC v. Wall Street Publ'g Inst., Inc., 851 F.2d 365 (D.C. Cir. 1988); *but see* Washington Legal Found. v. Friedman, 13 F. Supp. 2d 51 (D.D.C. 1998) (questioning the continuing validity of this approach).

15 *See* Lowe, 472 U.S. at 208; *see also* Posadas de Puerto Rico v. Tourism Co., 478 U.S. 328 (1986).

16 Central Hudson Gas & Elec. v. Pub. Serv. Comm'n, 447 U.S. 557, 556 (1980). *Central Hudson* describes a four-point test to determine whether or not commercial speech falls under the protection of the First Amendment.

17 Securities Exchange Act of 1934, §10(b) (1994), 15 U.S.C. §78j(b) (1994); 17 C.F.R. §240.10b-5 (1996).

18 *See* Lowe, 472 U.S. at 210.

19 Milkovich v. Lorain Journal Co., 497 U.S. 1, 20 (1990).

20 *Id.*

21 *Id.* at 21.

22 *Id.* (quoting Hustler Magazine Inc. v. Falwell, 485 U.S. 46, at 50 (1988)) (giving several historical examples of how political cartoons have contributed to debate and finding that a vicious parody of Jerry Falwell was protected by the First Amendment).

23 *See* Lewis, *supra* note 5, at 35-36.

24 For a more in depth view of financial message boards, including *Raging Bull, Silicon Investor*, and *Yahoo!Finance, see* Lyrissa Barnett Lidsky, *Silencing John Doe: Defamation and Discourse in Cyber Space*, 49 DUKE L.J. 855, 898 (2000); *see also* Matthew Heimer, *Herd on the Net*, BRILLS CONTENT < www.brillscontent.com/colums/moneypress_0599.html> (visited Sept. 3, 1999).

25 McCullough v. Shearson Lehman Bros., Inc., No. CIV.A.86-2752, 1988 WL 23008, at *5 (W.D. Pa. Feb. 18 1988); *see also* Jefferson County Sch. Dist. No. R-1 v. Moody's Investor's Servs., Inc., 175 F.3d 848, 850 (10th Cir. 1999) (holding an article giving investment advice to be opinion rather than fact).

26 Biospherics, Inc. v. Forbes, Inc., 151 F.3d 180, 184 (4th Cir. 1998).