Case No. 21-4126

In the

United States Court of Appeals

for the

Tenth Circuit

IN RE: OVERSTOCK SECURITIES LITIGATION:

THE MANGROVE PARTNERS MASTER FUND, LTD.,
Plaintiff-Appellant,

v.

OVERSTOCK.COM, INC., GREGORY J. IVERSON,
PATRICK M. BYRNE and DAVID J. NIELSEN,
Defendants-Appellees.

Appeal from a Decision of the United States District Court for the District of Utah - Salt Lake City
Case No. 2:19-CV-00709-DAK · Honorable Dale A. Kimball, Senior U.S. District Judge

AMICI CURIAE BRIEF OF JOSHUA MITTS, ROBERT J. JACKSON JR., DONALD C. LANGEVOORT, EDWARD F. GREENE, JOHN C. COFFEE, JESSE M. FRIED, JOEL SELIGMAN, DAVID H. WEBBER, JAMES D. COX, RANDALL S. THOMAS, DANIEL J. TAYLOR, FRANK PARTNOY, MINOR MYERS, AND MARC I. STEINBERG IN SUPPORT OF APPELLANT THE MANGROVE PARTNERS MASTER FUND, LTD. FOR REVERSAL

JEREMY A. LIEBERMAN
EMMA GILMORE
POMERANTZ LLP
600 3rd Avenue, 20th Floor
New York, New York 10016
Telephone: (212) 661-1100
Facsimile: (212) 661-8665
jalieberman@pomlaw.com
egilmore@pomlaw.com

Attorneys for Amici Curiae Joshua Mitts, Robert J. Jackson Jr., Donald C. Langevoort, Edward F. Greene, John C. Coffee, Jesse M. Fried, Joel Seligman, David H. Webber, James D. Cox, Randall S. Thomas, Daniel J. Taylor, Frank Partnoy, Minor Myers, and Marc I. Steinberg

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IDENTITY AND INTEREST OF AMICI CURIAE

Joshua Mitts is an Associate Professor of Law and Milton Handler Fellow at Columbia Law School. He uses advanced data science for his research on corporate and securities law. His primary focus is on information disclosure in capital markets, consumer financial protection, and related topics in law and finance. Mitts employs empirical methods, including statistical analysis and machine learning, for his research on short-selling, informed trading on cybersecurity breaches, information leakage and hedge-fund activism, insider trading on corporate disclosure, and information transmission in financial markets. Mitts frequently speaks at conferences, symposiums, and workshops. Mitts is also a member of the Center for Financial and Business Analytics at Columbia University's Data Science Institute. He has a Ph.D. in Finance & Economics from Columbia Business School, a J.D. from Yale Law School, and a B.A. in Liberal Studies from Georgetown University.

Robert J. Jackson Jr. served as Commissioner of the SEC from 2018-2020 after being appointed by President Donald J. Trump. He is now the Pierrepont Family Professor of Law and Co-Director of the Institute for Corporate Governance and Finance at the New York University School of Law. Previously, he served as a senior policy advisor in the U.S. Treasury Department.

Donald C. Langevoort is the Thomas Aquinas Reynolds Professor of Law at Georgetown Law School. His research covers corporate and securities law. The

courses Professor Langevoort teaches are Contracts, Securities Regulation, seminars on corporate and securities issues, and Corporations. Professor Langevoort practiced law at Wilmer, Cutler & Pickering in Washington, D.C. and served as Special Counsel in the Office of the General Counsel of the United States Securities Commission. Professor Langevoort received a B.A. degree from the University of Virginia and a law degree from Harvard Law School.

Edward F. Greene is a Lecturer-in-Law & Senior Research Scholar at Columbia Law School, where he teaches International Securities Regulation as well as Issues on Global Regulatory Reform. He is also Senior Counsel at Cleary Gottlieb Steen & Hamilton, where his practice focuses on capital markets and corporate governance. Mr. Greene served as General Counsel of the Securities and Exchange Commission from 1981 to 1982 and Director of the Division of Corporation Finance from 1979 to 1981. Mr. Greene has a B.A from Amherst College and an LL.B from Harvard Law School.

John C. Coffee is the Adolf A. Berle Professor of Law at Columbia Law School. A prolific scholar, sought-after speaker, and frequent news commentator, Professor Coffee is active in several fields and is a recognized leading authority on securities law, corporate governance, white collar crime, complex litigation, and class actions. He also is a co-author or co-editor of widely used casebooks including *Securities Regulation: Cases and Materials*, 13th edition (2015), *Cases and*

Materials on Corporations, 8th edition (2013), and *Business Organizations and Finance*, 11th edition (2010). He has been ranked the most cited legal scholar in corporate and business law. Professor Coffee received a B.A. from Amherst College, an LL.B from Yale University Law School, and an LL.M. from New York University Law School.

Jesse M. Fried is the Dane Professor of Law at Harvard Law School, where he teaches courses on the federal and state regulation of businesses, including securities regulation. Professor Fried's areas of scholarly interest include corporate law and securities regulation. He holds an A.B. and A.M. in Economics from Harvard University, and a J.D. from Harvard Law School.

Joel Seligman is President Emeritus and University Professor at the University of Rochester where he served as President from 2005 to 2018 and is also Dean Emeritus and Professor of Law at the Washington University where he served as Dean and Ethan A.H. Shepley University Professor from 1999 to 2005. His scholarship has largely been in the field of securities regulation. He has co-authored the 11 volume treatise Securities Regulation and is the author of two histories of financial regulation, The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance (3d ed. 2003) and Misalignment: The New Financial Order and the Failure of Financial Regulation (Wolters Kluwer 2020). He also is the author of 20 books and over 40 articles on

securities regulation and corporate law. He served on the Financial Industry Regulatory Authority from 2007 to 2015 and co-chaired the Finger Lakes Regional Economic Development Council from 2011 to 2016. Professor Seligman received an A.B. from the University of California at Los Angeles and a J.D. from Harvard Law School.

David H. Webber is a Professor of Law and Paul M. Siskind Scholar at Boston University School of Law. His areas of scholarly interest include: Civil Procedure, Corporate, Business & Transactional Law, Mergers & Acquisitions, Securities, Shareholder Activism & Litigation. Professor Webber's research covers corporate and securities law. Professor Webber is a graduate of Columbia and NYU Law School.

James D. Cox is the Brainerd Currie Professor of Law at Duke University School of Law. Professor Cox specializes in the areas of corporate and securities law. In addition to his texts, *Financial Information, Accounting and the Law*; *Corporations and Other Business Organizations*; *Cases and Materials* (with Eisenberg) and *Securities Regulations Cases and Materials* (with Hillman & Langevoort) and his multi-volume treatise *Cox and Hazen on Corporations*, he has published extensively in the areas of market regulation and corporate governance, and has testified before the U.S. House and Senate on insider trading, class actions, and market reform issues. Professor Cox earned his B.S. from Arizona State

University and law degrees at the University of California, Hastings College of the Law (J.D.) and Harvard Law School (LL.M.).

Randall S. Thomas is the John S. Beasley II Professor of Law and Business at Vanderbilt Law School. Professor Thomas is a scholar of corporate and securities law. His research interests include shareholder activism, corporate and securities litigation, executive compensation, corporate voting, and corporate governance. He holds a B.A. from Haverford College and a Ph.D. in Economics and a J.D. from the University of Michigan.

Daniel J. Taylor is an Associate Professor of Accounting at the Wharton School of the University of Pennsylvania. Dr. Taylor is an award-winning researcher and teacher with extensive expertise on issues related to corporate transparency, accounting fraud, insider trading, and corporate governance. A world-renown scholar, Professor Taylor leads the Wharton Forensic Analytics Lab; has written more than 20 articles published in leading academic journals in accounting, finance, and management; led seminars at dozens of top business schools across the globe; and won numerous academic and industry awards. His research frequently appears in the business media; has been cited in rules and regulations promulgated by the Securities and Exchange Commission; and has been instrumental in multiple investigations by the SEC, FBI, Treasury, and Department of Justice. Professor Taylor received his bachelor's degree from University of Delaware, his master's

from Duke University, and his PhD from Stanford University.

Frank Partnoy is the Adrian A. Kragen Professor of Law at The University of California, Berkeley, School of Law. Professor Partnoy has written several dozen scholarly publications on topics in business law and financial markets, including in peer-reviewed journals. He also has testified as an expert in a range of civil and criminal litigation, including on behalf of the Department of Justice, the Securities and Exchange Commission, and the Commodity Futures Trading Commission. Before becoming a professor, Professor Partnoy worked as a lawyer at Covington & Burling and as a fixed income derivatives specialist at Morgan Stanley and CS First Boston. He received a B.A./B.S. from the University of Kansas and a J.D. from Yale Law School.

Minor Myers is a Professor of Law at the University of Connecticut School of Law. In his research, he specializes in corporate law, mergers and acquisitions, and corporate finance. Outside of the academy, he works with entities involved in corporate litigation and also offers expert advice on corporate governance matters. He earlier practiced law in the corporate and litigation departments of Debevoise & Plimpton. Professor Myers received a B.A. from Connecticut College and a J.D. from Yale Law School.

Marc I. Steinberg is the Radford Professor of Law at Southern Methodist University Dedman School of Law. His areas of expertise include Business

Enterprise Law, Securities Law, and Legal Ethics. Professor Steinberg was an enforcement attorney at the U.S. Securities and Exchange Commission, and thereafter became special projects counsel. In that position, he directly assisted the SEC's General Counsel in a wide variety of projects and cases and served as the General Counsel's confidential legal adviser. Professor Steinberg received his undergraduate degree at the University of Michigan and his law degrees at the University of California, Los Angeles (J.D.) and Yale University (LL.M.).

Amici are a group of professors and scholars who are experts in federal securities law and have advised plaintiffs, defendants, regulators, and enforcement authorities on issues related to securities fraud and market manipulation.

No party or counsel for a party authored this motion or the brief in whole or in part. No party, counsel for a party, or person other than the prospective amici or their counsel made any monetary contribution intended to fund the preparation or submission of this motion or the brief.

ARGUMENT

MARKET MANIPULATION DISTORTS THE ALLOCATION OF CAPITAL IN THE ECONOMY AND IMPAIRS LIQUIDITY AND CAPITAL FORMATION

It is widely recognized that "preventing manipulation was a primary motivation for enacting the U.S. securities laws" and that "the problem of

manipulation is of a similar scale to insider trading."[1] Preventing market manipulation furthers a number of critical public-policy goals, including promoting the efficient allocation of capital to investment projects, promoting the efficient use of the economy's productive capacity and ensuring that markets operate fairly and perceived as such by the investing public.[2]

Manipulation interferes with these important goals by distorting two central characteristics of markets: price accuracy and liquidity. Because share prices are widely observed and drive decisions by investors, creditors, customers and other parties, accurate prices make it more likely that investment capital and productive capacity are allocated to those issuers whose projects are most promising.[3] Accurate share prices also promote a sense of fairness because investors experience fewer

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[1] Merritt B. Fox, Lawrence R. Glosten & Gabriel V. Rauterberg, *Stock Market Manipulation and Its Regulation*, 35 YALE J. ON REG. 67, 69 n.4 (2018) (citing William A. Roach, Jr., *Hedge Fund Regulation: "What Side of the Hedges Are You on?"*, 40 U. MEM. L. REV. 165, 178 (2009) ("The shocking results of the [congressional] investigation uncovered high levels of market manipulation and led Congress to pass the first federal securities laws, the Securities Act of 1933."))).

[2] Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 730 (2006).

[3] *See, e.g.*, Goshen & Parchomovsky, *supra at* 726 (2006) ("[T]rading against a party with superior information or based on fraudulent information will result in a loss."); Tom C.W. Lin, *The New Market Manipulation*, 66 EMORY L.J. 1253, 1280-81 (2017).

sharp declines in the value of their investments.[4]

Similarly, market manipulation makes it more risky and costly to provide liquidity. Liquidity providers hold themselves out as willing to sell to or purchase from investors seeking to buy or sell shares of stock. The less liquid a market is, the more investors must pay to purchase a given security and the less investors receive when selling that security. Illiquidity thus functions like a "tax" on transactions. Indeed, to the extent that manipulation makes markets less liquid, this "tax" in effect reallocates capital from ordinary investors to manipulators, as liquidity providers pass along to ordinary investors the cost of transacting against manipulators.

Illiquidity reduces the expected returns to investing, making it less likely that capital and productive capacity will be allocated to the most promising investment projects. Moreover, illiquid, manipulated markets are likely to be perceived as fundamentally unfair by ordinary investors who find themselves suffering unexpected losses at the hands of manipulators. Indeed, the actual and perceived integrity of the financial markets are crucial to the ability of issuers to attract capital. If investors see the markets as unfair, many may refrain from participating, while those who do participate may end up heavily discounting promising projects.

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[4] *See, e.g.*, Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1051 (1982).

THE DIGITAL DIVIDEND WOULD DISTORT THE SUPPLY AND DEMAND FOR OVERSTOCK'S STOCK, SENDING A MANIPULATIVE AND DECEPTIVE FALSE PRICING SIGNAL

The District Court held that plaintiffs failed to state a claim for market manipulation because Overstock publicly disclosed its plans to offer a digital dividend, eliminating any deception. JA8_1828-30. The District Court errs for several reasons. First, the District Court's insistence on an affirmative misrepresentation erroneously conflates misstatement fraud with market manipulation through facially legitimate transactions. Second, manipulation misleads investors by "artificially affecting market activity" and thus is inherently deceptive. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977). Finally, defendants' statements disclosing plans to offer a digital dividend were incomplete and, more fundamentally, irrelevant, because they were made after the manipulative scheme was set in motion.

A. Facially Legitimate Transactions Can Constitute Market Manipulation Even Without an Affirmative Misrepresentation

As the Supreme Court recently held, the securities laws were intended "to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Lorenzo v. Sec. & Exch. Comm'n*, 139 S. Ct. 1094, 1103 (2019) (quoting *SEC v. W. J. Howey Co.*, 328 U.S. 293, 299 (1946)). Section 10(b) of the Securities Exchange Act of 1934 (the "*Exchange Act*"), which prohibits fraud and manipulation in the securities markets, should be

interpreted "not technically and restrictively, but flexibly to effectuate its remedial purposes." *SEC v. Zandford*, 535 U.S. 813, 819 (2002).

The "gravamen" of manipulation is the "deception of investors into believing that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators." *Gurary v. Winehouse*, 190 F.3d 37, 45 (2d Cir. 1999). Courts ask whether activity "sends a false pricing signal to the market" so that "competing judgments of buyers and sellers as to the fair price of the security" no longer "brings about a situation where the market price reflects as nearly as possible a just price." *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 100-101 (2d Cir. 2007) (quoting *SEC v. First Jersey Sec., Inc.,* 101 F.3d 1450, 1466 (2d Cir. 1996) (quoting H.R.Rep. No. 73–1383, at 11 (1934))).

It is well understood that facially legitimate, open-market transactions can manipulate the market even without an affirmative misrepresentation.[5] Two cases cited by the District Court— *SEC v. Martino* and *SEC v. Masri*—held just that. In *Martino*, 255 F. Supp. 2d 268, 286–87 (S.D.N.Y. 2003), the court cited *SEC v. Resch–Cassin & Co.*, 362 F.Supp. 964, 975-76 (S.D.N.Y.1973) for the proposition that "[S]ufficient proof of manipulation [exists] if the manipulator caused either actual or apparent activity or caused a rise in the market price." 255 F. Supp. 2d 268,

[5] *See, e.g.*, Gina-Gail S. Fletcher, *Legitimate Yet Manipulative: The Conundrum of Open-Market Manipulation*, 68 DUKE L.J. 479 (2018).

286 (S.D.N.Y. 2003). *Resch-Cassin* identified four factors indicating manipulation: "(1) price leadership by the manipulator; (2) the exercise of 'dominion and control of the market for the security'; (3) the manipulator's attempt to reduce the 'floating supply of the security'; and (4) collapse of the market for the security after the manipulator's activities cease." *Id.* at 287.

None of the *Resch-Cassin* factors refers to affirmative misrepresentations, and all may be satisfied by facially legitimate, open-market transactions. In *Martino*, the defendants worked together to control the supply of stock of the issuer, Titanic, by selling shares to overseas customers and by protecting a market maker against the downside risk of purchasing stock, "thus affording him the freedom to purchase large blocks of Titanic stock at ever-increasing prices." 255 F. Supp. 2d at 288. Moreover, the defendants paid "brokers to influence their clients to purchase Titanic stock (thus increasing demand)." *Id.* at 287. All of these consisted of ordinary purchases and sales in the open market. What made these transactions manipulative was that they furthered a scheme to "gain[] control of both the supply and demand of Titanic stock sufficient to drive up Titanic's stock price artificially." *Id.*

Similarly, in *SEC v. Masri*, also cited by the District Court, the court held that "if an investor conducts an open-market transaction with the intent of artificially affecting the price of the security, and not for any legitimate economic reason, it can constitute market manipulation." 523 F. Supp. 2d 361, 372 (S.D.N.Y. 2007). In

Masri, the defendant allegedly purchased shares to drive the price up before the close to ensure that a put options position would expire worthless. Again, these open-market purchases were facially legitimate transactions.

One type of market manipulation which distorts the supply and demand for a security through facially legitimate transactions is a *short squeeze*, where traders drive up the price to inflict losses on short sellers, as occurred here. For example, in *Minpeco, S.A. v. Conticommodity Services, Inc.,* defendants' conspiracy to drive up the price of silver futures to inflict losses on short sellers constituted illegal manipulation because the price increases "would not represent genuine demand; that is, it would not reflect increased desire of buyers for the product-to the contrary, it would result from the alleged . . . manipulation of the market." 552 F. Supp. 332, 335 (S.D.N.Y. 1982).

More recently, in *Set Capital,* Credit Suisse argued that its hedging trades could not be manipulative under Section 10(b) because they were "done openly" for the legitimate purpose of "manag[ing] risk," not deceiving investors. The Second Circuit found that Credit Suisse's hedging trades, while potentially legitimate, violated Section 10(b) if they were done with the intent to manipulate the market and create an artificial price: "Open-market transactions that are not inherently manipulative may constitute manipulative activity when accompanied by manipulative intent." *Set Cap. LLC v. Credit Suisse Grp. AG*, 996 F.3d 64, 76–78

(2d Cir. 2021); *see also Koch v. S.E.C.,* 793 F.3d 147, 153–54 (D.C. Cir. 2015), *cert. denied*, 577 U.S. 1235 (2016) (a "burst of trading" on the open market, combined with manipulative intent, violates the Exchange Act).

B. Market Manipulation Is Inherently Deceptive

The District Court cites *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985) to suggest that plaintiffs must independently establish deceptive statements in addition to manipulative conduct. JA4_851. But *Schreiber* was not a market manipulation case. It did not even involve Section 10(b) of the Exchange Act. Rather, in *Schreiber*, the Court declined to "oversee the substantive fairness of **tender offers**" by allowing plaintiffs to challenge the "quality of an offer" by mischaracterizing it as "manipulative" under Section 14(e) of Exchange Act:

> To adopt the reading of the term "manipulative" urged by petitioner would not only be unwarranted in light of the legislative purpose but would be at odds with it. **Inviting judges to read the term "manipulative" with their own sense of what constitutes "unfair" or "artificial" conduct would inject uncertainty into the tender offer process.** An essential piece of information—whether the court would deem the fully disclosed actions of one side or the other to be "manipulative"—would not be available until after the tender offer had closed. This uncertainty would directly contradict the expressed congressional desire to give investors full information.

Schreiber, 472 U.S. at 12 (emphasis added). Nowhere in *Schreiber* did the Court indicate that a deceptive statement is "an element of a market manipulation case," as the District Court incorrectly suggested. JA4_851.

Indeed, when evaluating whether allegedly manipulative conduct violates Section 10(b), the Court has held that "'[m]anipulation' is 'virtually a term of art when used in connection with securities markets.' The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors **by artificially affecting market activity.**" *Santa Fe Indus.,* 430 U.S. at 476 (emphasis added) (quoting *Ernst & Ernst*, 425 U.S. 185, 199 (1976)). None of these—wash sales, matched orders or rigged prices—entail deceptive statements apart from the manipulative acts themselves.

The Court in *Sante Fe* gave additional examples of manipulation under Section 10(b) that also lacked separate deceptive statements, like then-Rule 10b-6, which sought "to prevent stimulative trading by an issuer in its own securities in order to create an unnatural and unwarranted appearance of market activity." *Id.* In short, *Sante Fe* does not stand for the proposition that Section 10(b) immunizes market manipulation but rather that Congress did not employ this "term of art" to encompass "instances of corporate mismanagement" where "the essence of the complaint is that shareholders were treated unfairly by a fiduciary." *Id.* at 477.

Under plaintiffs' market manipulation theory, the question is not whether Overstock made a false statement but whether the planned digital dividend would "artificially affect[] market activity," *Santa Fe*, 430 U.S. at 476 (emphasis added), and "send[] a false pricing signal to the market" so that "competing judgments of

buyers and sellers as to the fair price of the security" no longer "brings about a situation where the market price reflects as nearly as possible a just price." *ATSI*, 493 F.3d at 100-01.

Here, inducing a short squeeze by issuing a non-tradable digital dividend would "artificially affect[] market activity" and "send a false pricing signal to the market" by distorting the supply and demand for Overstock's shares. *Id.* The pricing signal would be false because purchases by short sellers would drive up Overstock's share price—not because of "competing judgments of buyers and sellers as to the fair price of the security" but simply because short sellers had no choice but to buy shares of stock they otherwise would not have purchased. *Id*.

The District Court's conclusion that "Defendants could not 'manipulate' a market via truthful statements," JA4_850, is beside the point. Statements, on their own, do not change stock prices. Rather, prices go up when investors buy shares and down when investors sell shares.[6] A false statement can induce artificial buying—driving up the share price—but so can forcing short sellers to buy shares by issuing a non-tradable digital dividend. In both cases, the conduct at issue "artificially affects market activity," *Santa Fe*, 430 U.S. at 476, and is thus the product of a "manipulative or deceptive device or contrivance." 15 U.S.C. § 78j(b).

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[6] *See, e.g.*, Lawrence R. Glosten & Paul R. Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. FIN. ECON. 71 (1985).

C. **Defendants Did Not Disclose the Likelihood of a Digital Dividend and Resulting Short Squeeze Before Setting it in Motion**

When finding that plaintiffs failed to plead intent to deceive short sellers, the District Court pointed to defendants' disclosure: "Defendants readily disclosed the short squeeze. Defendants disclosed the nature of the dividend and the market immediately understood the dividend's impact on short sellers." JA4_854. For one, plaintiffs alleged that defendants failed to disclose the purpose and effect of the digital dividend in inducing a short squeeze and inflating the price so that insiders could profitably sell shares. JA4_744-45. But more fundamentally, disclosure is a defense to market manipulation claim only if it occurs *before* setting in motion the alleged manipulative scheme. Here, defendants' disclosure occurred *after* the manipulative short squeeze was announced; it was thus insufficient to alert short sellers of the risk of a digital dividend and resulting short squeeze *ex ante*.

The requirement that exculpatory disclosure must occur before an allegedly manipulative scheme is set in motion is obvious on its face. Otherwise, defendants could publicly declare that they had already initiated a scheme to manipulate the market and enjoy immunity from liability under Section 10(b) on the grounds that there was supposedly no deception. Schemes like *Martino*—where defendants induced a market maker to purchase large blocks of shares at ever-increasing prices—or *Masri*—where defendants drove up the share price minutes before the close—are no less manipulative if announced after the fact.

The rationale for allowing disclosure to immunize otherwise manipulative conduct is that it puts investors on notice of the risk that a defendant may engage in that conduct, allowing investors to choose whether to accept that risk (by opening or maintaining a position in the shares) or not (by closing a position in the shares). For example, in *Wilson v. Merrill Lynch & Co.*, defendants alleged that disclosure of certain bidding practices in auction rate securities rendered those practices non-manipulative. The court specifically considered whether these disclosures were made *before* setting in motion the alleged manipulative scheme:

> Our discussion of the timing of [plaintiff's] purchase focuses on its relevance to the "manipulative acts" element of his market manipulation claim, or, in other words, **whether [plaintiff] has alleged that [defendant's] bidding activity sent a false signal to the [] market at times relevant to his purchase.** As noted, the determination of whether certain market activities are "manipulative" within the meaning of the securities laws requires us to consider whether these activities were fully disclosed to the market. This assessment of the adequacy of disclosure, in turn, must look to **what was known by the market as of the time of the alleged manipulative acts.**

671 F.3d 120, 134 n.7 (2d Cir. 2011) (emphasis added).

In *Wilson*, the defendant disclosed the alleged manipulative acts—its bidding activity in certain auction rate securities—*one year before* the plaintiff's purchase of those securities. The court's analysis turned explicitly on whether such disclosure put plaintiffs on sufficient notice of the alleged conduct: "[w]e conclude only that [defendant's] particular disclosures sufficiently alerted investors [] of the likelihood that the interest rates and apparent liquidity [] reflected [defendant's] own

interventions in these auctions rather than the 'natural interplay of supply and demand.'" *Id.* at 139 (quoting *Gurary*, 190 F.3d at 45).

Similarly, in *Onel v. Top Ships*, plaintiffs alleged that defendants orchestrated a "*death spiral*" financing scheme through dilutive reverse stock splits. Relying on *Wilson*, the court pointed specifically to advance disclosure of the risk of dilution in the defendants' public registration statements:

> Here, Plaintiffs do not — and cannot — argue that any of the individual transactions comprising the alleged scheme were not fully disclosed. The full terms of each purchase agreement were disclosed via Top Ships' public registration statements. Similarly, each of the complained-of reverse stock splits was disclosed to the public and approved by shareholder vote. **A Top Ships investor would thus have been fully on notice that significant numbers of Top Ships shares would be issued to Kalani . . . leading to dilution**; **indeed, Top Ships specifically disclosed the risk of dilution as one of the risks to investors associated with the purchase agreements**.

Onel v. Top Ships, Inc., 806 F. App'x 64, 67 (2d Cir. 2020).

Here, by contrast, there is no allegation that Overstock "*alerted investors*" to the likelihood of a non-tradable digital dividend and resulting short squeeze before setting in motion the manipulative scheme. Unlike *Wilson*, plaintiffs here did not open or maintain a short position in Overstock's shares with as much as a hint that the company might issue a non-tradable digital dividend on the tZERO platform and thereby force short sellers to buy shares. Had such disclosure been made, short sellers could have managed risk by limiting or reducing their short positions up front.

The principle is straightforward: advance warning of risks yields immunity in securities law only if given *before* those risks are certain to occur. By analogy, consider the "bespeaks caution" doctrine, by which cautionary language "may protect an issuer from liability for alleged misrepresentations in a stock offering," *Wilson*, 671 F.3d at 130. But under this doctrine, "[c]autionary words about future risk cannot insulate from liability the failure to disclose that the risk has transpired." *Rombach v. Chang,* 355 F.3d 164, 173 (2d Cir. 2004). As the D.C. Circuit has explained, there is a "critical distinction between disclosing the risk a future event might occur and disclosing actual knowledge the event *will* occur." *Dolphin & Bradbury, Inc. v. SEC,* 512 F.3d 634, 640 (D.C. Cir. 2008). Or in the colorful words of *In re Prudential Sec. Inc. Ltd. P'ships Litig*: "The doctrine of bespeaks caution provides no protection to someone who warns his hiking companion to walk slowly because there might be a ditch ahead when he knows with near certainty that the Grand Canyon lies one foot away." 930 F.Supp. 68, 72 (S.D.N.Y.1996). For short sellers in Overstock's shares, the digital dividend was the Grand Canyon—and Overstock said nothing about a ditch before plunging them headfirst into the canyon.

Granted, the distinction between giving investors advance notice of a risk and announcing an impending distortion to supply and demand for a company's shares will not always be clear-cut. There are cases—like *Santa Fe* and *Schreiber*—where an issuer truthfully discloses a corporate action that affects the share price (such as

a tender offer or merger), and investors have no recourse under the securities laws so long as the terms of the transaction were truthfully disclosed.

This is not such a case. Like *Wilson*, there is no question that defendants took actions which altered the "natural interplay of supply and demand" for Overstock's shares. But unlike *Wilson*, defendants' prior disclosures failed to "sufficiently alert[] investors" of the risk of such manipulation before setting that scheme in motion. Far from an exculpatory disclosure, the announcement on July 30, 2019 amounted to little more than a declaration that a short squeeze was imminent, as the market correctly surmised by bidding up the share price. Announcing that a security is about to be manipulated hardly constitutes "*full and fair disclosure*" under Section 10(b).

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/s/Jeremy A. Lieberman

JEREMY A. LIEBERMAN ESQ.
EMMA GILMORE ESQ.
POMERANTZ LLP
600 Third Avenue, 20th Floor
New York, NY 10016
Telephone: (212) 661-1100
Facsimile: (212) 661-8665
jalieberman@pomlaw.com
egilmore@pomlaw.com

Counsel for Amici Curiae

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1. This brief complies with the type-volume limitations of Fed. R. App. P. 29(a)(5) and Fed. R. App. P. 32(a)(7)(B)(i) because, excluding the parts of the document exempted by Fed. R. App. P. 32(f), this document contains 4,960 words.

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Dated: February 2, 2022

/s/Jeremy A. Lieberman

JEREMY A. LIEBERMAN ESQ.
POMERANTZ LLP
600 Third Avenue, 20th Floor
New York, NY 10016
Telephone: (212) 661-1100
Facsimile: (212) 661-8665
Email: jalieberman@pomlaw.com

Counsel for Amici Curiae

CERTIFICATE OF DIGITAL SUBMISSION

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Dated: February 2, 2022

/s/Jeremy A. Lieberman

JEREMY A. LIEBERMAN ESQ.
POMERANTZ LLP
600 Third Avenue, 20th Floor
New York, NY 10016
Telephone: (212) 661-1100
Facsimile: (212) 661-8665
Email: jalieberman@pomlaw.com

Counsel for Amici Curiae

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I hereby certify, on the 2nd day of February 2022, the foregoing brief was filed electronically with the Clerk of Court for the United States Court of Appeals for the Tenth Circuit using the CM/ECF system. Notice of this filing and its viewing and downloading are thereby provided to all counsel of record by cooperation of the CM/ECF system.

/s/Jeremy A. Lieberman

JEREMY A. LIEBERMAN ESQ.
POMERANTZ LLP
600 Third Avenue, 20th Floor
New York, NY 10016
Telephone: (212) 661-1100
Facsimile: (212) 661-8665
Email: jalieberman@pomlaw.com

Counsel for Amici Curiae