MarketWatch

Why legal experts say the SEC has a strong case against Elon Musk

By Francine McKenna
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Tesla CEO's conduct was 'egregious,' says defense lawyer

HEIKO JUNGE/AFP/Getty Images
Elon Musk, CEO of Tesla Motors

Elon Musk's biggest fans may think the Tesla chairman and CEO's chronic casual indifference about legal and regulatory requirements is charming and even a sign of genius. But on Thursday the Securities and Exchange Commission warned Musk, and investors, that his "celebrity status or reputation as a technological innovator does not give license to take those responsibilities lightly."

The SEC made swift work of its investigation of Musk's series of allegedly false and misleading tweets starting on Aug. 7 about a potential transaction to take Tesla TSLA, +16.63% private, filing charges in federal court late Thursday less than two months later.

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David Chase, a former attorney with the SEC's division of enforcement, who now represents white-collar defendants at his own firm, told MarketWatch, "The SEC could move fast because it was a straight-up, simple case. Either he had factual support for the tweet or he didn't."

In its complaint, the SEC's lawyers methodically made a case for why Musk missed every step for a prudent go-private transaction when he made his go-private offer in a tweet on August 7.

"I was as surprised as anyone else when Musk tweeted the go-private proposal, that he chose that medium to communicate material information," Chase said in an interview with MarketWatch. "But given his position as chairman, CEO and largest shareholder, I also assumed there was some factual basis for it."

Beginning in January 2017, Musk had three or four in-person meetings with representatives of a Saudi Arabia sovereign investment fund. During these meetings, according to testimony Musk gave the SEC, the lead representative of the fund expressed a verbal desire to make a large investment in Tesla and establish a Tesla production facility in the Middle East.

Between July 31, 2018, when the SEC says Musk met again with representatives of the fund and the morning of Aug. 7 when he tweeted his go-private offer announcement, Musk did not have any further substantive communications with representatives of the fund or discuss a going-private transaction at a share price of $420 with any potential funding source, the SEC said.

He also did not contact any additional potential strategic investors to assess their interest in participating in a going-private transaction or retain any advisors to assist with a going-private transaction until after he made the tweet, according to the SEC.

The SEC says at the July 31 meeting with the fund, Musk did not discuss any dollar amount or specific ownership percentage for the fund's investment in a going-private transaction, any specific acquisition price premium to be offered to current Tesla shareholders or his own process for board approvals of the transaction. He also did not inquire about the fund's available liquid capital, whether the fund had any past experience participating in a going-private, and any potential restrictions on foreign ownership of a significant stake in Tesla or regulatory hurdles that would have to be overcome.

Musk, and Tesla, also did not notify Nasdaq, where the shares are listed, prior to publishing his Aug. 7 tweets. Nasdaq rules require that listed companies such as Tesla must notify Nasdaq at least ten minutes prior to publicly releasing material information about corporate events like a proposed going-private action.

Nasdaq halted trading in Tesla shares at 2:08 p.m. Eastern, about 1 hour and 20 minutes after Musk sent out the first tweet, in the middle of the day's official market trading. Immediately after this tweet, the trading volume and price of Tesla shares spiked. Nasdaq lifted the trading halt on Tesla shares about 90 minutes later. After trading resumed, Tesla's stock price continued to rise, closing at $379.57, up over 6% from the time Musk first tweeted about taking Tesla private earlier that day, according to the SEC's complaint.

Bennett Lasko, an attorney in private practice who represents companies and executives in securities litigation, told MarketWatch, "It's a pretty egregious case. Musk said he had funding secured and he didn't. He hadn't even discussed price with any funding source. Hundreds of millions of dollars changed hands within hours, and by the time the dust settled at the end of August, investors likely took more than a billion dollars in losses."

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Musk's calculation resulted in a price of $419, and Musk told the SEC that he rounded the price up to $420 because he had recently learned about the relationship between "420" in marijuana culture and thought his girlfriend "would find it funny, which admittedly is not a great reason to pick a price."

"Musk's description of the pricing approach may have seemed to the SEC to be flippant, bordering on an arrogant disregard for following securities laws," Chase told MarketWatch. "It was material information based on how dramatically the stock price moved, even if there was some lingering doubt because of the "420" reference that it might be a joke."

The SEC made a very specific point of describing the potential motivation for Musk's intentionally false and misleading statements. "Musk has complained that Tesla has been unfairly targeted by short sellers and predicted that short sellers would be 'burned,' the SEC's complaint says. On May 4, Musk tweeted, "Oh and uh short burn of the century comin' soon. Flamethrowers should arrive just in time." And on June 17, Musk tweeted that short sellers "have about three weeks before their short position explodes."

Lasko told MarketWatch, "Musk's running war of words with short-sellers provides an obvious motive for him to have misled the market intentionally. The allegations could support a criminal charge against him. But it is common that civil cases allege facts that could support a criminal charge and none are ever brought."

The Wall Street Journal reported late Thursday, citing unnamed sources, that Musk's lawyers called off a settlement with the SEC at the last minute.

CNBC reported that the SEC sought Musk giving up the chairman role for two years and the appointment of two independent directors.

The SEC is seeking to permanently restrain and enjoin Musk from repeating similar conduct by ordering that he "be prohibited from acting as an officer or director" because unless "restrained and enjoined" it says he will "continue to violate" the law since he did so this time with "scienter", or full intention, according to the complaint.

"The officer and director bar, or the length of it, may have been the obstacle to an immediate settlement," Chase told MarketWatch. "Musk may want to negotiate the bar away or at least reduce the length to less than forever."

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A Tesla spokeswoman told MarketWatch the company and board declined comment beyond this statement:

"Tesla and the board of directors are fully confident in Elon, his integrity, and his leadership of the company, which has resulted in the most successful US auto company in over a century. Our focus remains on the continued ramp of Model 3 production and delivering for our customers, shareholders and employees."

See also: The SEC vs. Elon Musk: What the lawsuit means right now for Tesla investors

Elon Musk's statement is unapologetic:

"This unjustified action by the SEC leaves me deeply saddened and disappointed. I have always taken action in the best interests of truth, transparency and investors. Integrity is the most important value in my life and the facts will show I never compromised this in any way."

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