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Report from Washington

Supreme Court Upholds Liability Under Rule 10b-5(a) and (c) for an Individual Who Disseminated but Was Not the "Maker" of a Fraudulent Statement

April 2, 2019

Introduction

"It would seem obvious that the words in these provisions are, as ordinarily used, sufficiently broad to include within their scope the dissemination of false or misleading information with the intent to defraud."

– Justice Breyer

On March 27, 2019, the Supreme Court in *Lorenzo v. Securities and Exchange Commission*, No. 17-1077, held that an individual who disseminates false or misleading statements with an intent to defraud can be found to have violated the "fraudulent scheme" provisions of Rule 10b-5(a) and (c) even if such an individual did not "make" the statements and is therefore outside the scope of subsection (b) of Rule 10b-5. A 6-2 justice majority affirmed the D.C. Circuit's conclusion that petitioner is liable for knowingly conveying his boss's false statements to potential investors. Justice Kavanaugh was recused from the case, as he dissented from the D.C. Circuit's ruling.

Background

SEC Rule 10b-5 proscribes three types of securities fraud: subsection (a) makes it unlawful to employ any "device, scheme or artifice to defraud"; subsection (b) prohibits making a false statement or omitting information that would be misleading to an investor; and subsection (c) prohibits engaging in fraudulent or deceitful conduct.

In 2013, the SEC initiated an administrative enforcement action against Francis Lorenzo, a registered representative of a broker-dealer, alleging that he intended to defraud potential investors when he sent two emails to potential investors, "at the request" of his boss, omitting material information. An SEC Administrative Law Judge found that Lorenzo's conduct amounted to offenses under all three provisions of Rule 10b-5. The Commission affirmed this ruling in 2015, issuing a lifetime bar on Lorenzo working in the securities industry, and imposing a $15,000 monetary penalty.

Lorenzo appealed to the D.C. Circuit, and in 2017 the court reversed the Commission in part, finding that although Lorenzo had the requisite intent to defraud, Lorenzo was not the "maker" of the statements under the test set forth in *Janus Capital Group, Inc. v. First*

Derivative Traders,[1] because the content of the emails came from Lorenzo's boss, and therefore Lorenzo could not be liable under Rule 10b-5(b). However, the D.C. Circuit affirmed the SEC's application of fraudulent scheme liability under Rule 10b-5(a) and (c) due to Lorenzo's role in disseminating the misstatements to potential investors.

Lorenzo petitioned the Supreme Court for a writ of certiorari. Lorenzo did not challenge the finding that he had the requisite "mental state embracing intent to deceive, manipulate, or defraud."[2] Instead, he asked the Court to consider whether individuals who do not "make" statements, but who disseminate false or misleading statements to potential investors with the intent to defraud, can be found to have violated subsections (a) and (c) of Rule 10b-5, which were not addressed by the Court's decision in *Janus*. The Supreme Court granted review to resolve a circuit split on this issue.[3] Oral arguments were held on December 3, 2018.

"[U]sing false representations to induce the purchase of securities would seem a paradigmatic example of securities fraud. We do not know why Congress or the Commission would have wanted to disarm enforcement in this way."

– Justice Breyer

Summary of the Court's Opinion

In an opinion delivered by Justice Breyer, the Court concluded that the language of subsections (a) and (c) of Rule 10b-5 is "sufficiently broad to include within their scope the dissemination of false or misleading information with the intent to defraud." The Court emphasized that Lorenzo knew the emails he sent to potential investors contained materially false information, he sent them in his capacity as vice president of an investment banking company, and he invited follow up questions. While acknowledging that borderline cases could involve difficult questions concerning the scope of these provisions, which should be read narrowly to avoid liability for tangential actors (for example, a mailroom clerk), the Court determined that there was "nothing borderline" about Lorenzo's actions in this case.

The Court further addressed three primary arguments advanced by Lorenzo and articulated in a dissenting opinion penned by Justice Thomas and joined by Justice Gorsuch. First, both Lorenzo and the dissent insisted that subsections (a) and (c) of Rule 10b-5 address only "scheme liability claims," not liability for false statements, and that to hold otherwise would render subsection (b) "superfluous." Citing dictionary definitions and historical precedent, the dissent reasoned that subsection (a) cannot impose liability for a mere misstatement that does not involve "some form of planning, designing, devising, or strategizing." The dissent further argued that while subsection (c) appears to proscribe broader conduct, it must not be

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[1] 564 U.S. 135 (2011).

[2] *See Aaron v. SEC*, 446 U.S. 680, 686, n. 5 (1980).

[3] Compare *Lorenzo v. SEC*, 872 F.3d 578 (D.C. Cir. 2017), with *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1057-1058 (9th Cir. 2011).

construed to encompass primary liability solely for misstatements because that conduct is specifically covered by the language in subsection (b) of Rule 10b-5.

The majority, however, held that the subsections of Rule 10b-5 are not mutually exclusive; to the contrary, the Court and the SEC have always understood that these subsections, as well as related provisions of the securities laws, overlap and may prohibit the same conduct in certain circumstances.

"Congress intended to root out all manner of fraud in the securities industry. And it gave the Commission the tools to accomplish that job."

– Justice Breyer

Second, Lorenzo and the dissent both raised a concern that the Court's decision in *Janus* would be a "dead letter" if the Court were to apply subsections (a) and (c) to fraudulent misstatements. The majority dismissed this concern, noting that *Janus* did not address the application of Rule 10b-5 to *dissemination* of false or misleading information, and further noted that *Janus* would still have force and preclude liability where an individual neither makes nor disseminates with fraudulent intent the false or misleading information.

Finally, the majority addressed the dissent's concern that imposing liability in this case would improperly result in an individual who disseminates but does not "make" a misstatement being held both primarily liable under subsections (a) and (c), as well as secondarily liable under subsection (b) of Rule 10b-5. The Court noted, "it is hardly unusual for the same conduct to be a primary violation with respect to one offense and aiding and abetting with respect to another." Further, the Court explained that a construction of Rule 10b-5 that would impose only secondary liability on an individual who fraudulently disseminates false statements would risk allowing such an individual to "escape liability" altogether (for example, where the "maker" of the statement is found not to have held the requisite intent, and there is therefore no primary violation for the disseminator to have aided and abetted). The Court held: "That is not what Congress intended. Rather Congress intended to root out all manner of fraud in the securities industry. And it gave to the Commission the tools to accomplish that job."

Implications

After a string of difficult losses before the Supreme Court, the victory will certainly come as a welcome relief to the SEC's Enforcement Division. Most significantly, the decision removes an oft-pursued argument by defense counsel that the presence of a "false statement" statement in an investigation under Rule 10b-5(b) effectively forecloses the ability of the Staff to pursue alternative theories such as scheme liability. The decision also provides the Staff with modest additional charging flexibility in multi-defendant cases in which the conduct at issue is a blend of traditional disclosure-based theories and other forms of deceptive conduct unrelated to the making of the false statement at issue.

Beyond that, we do not expect the decision to have a major impact on the SEC's enforcement program, as the decision leaves intact the most important element of any SEC fraud claim—the need to plead and prove fraudulent intent either in the aiding and abetting or primary liability context.

In the private litigation context, plaintiffs will likely invoke *Lorenzo* to assert primary liability claims against a broader range of persons on the grounds that even those who did not "make" challenged statements are at risk. However, nothing in the decision suggests that those "only tangentially involved" in the alleged fraud should face potential liability; to the contrary, the Court focused on the particular facts and circumstance of this case, including the unchallenged finding of Lorenzo's fraudulent intent. Following this decision, we expect litigants and courts will continue to place great emphasis on the scienter inquiry in each case.

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