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Report from Washington

Supreme Court Considers Applicability of Rule 10b-5(a) and (c) to an Individual Who Was Not the "Maker" of a Fraudulent Statement

December 4, 2018

"This is a kind of belt-and-suspenders statute, where it's like we're going to find every possible way to say this thing in order to make sure that fraudulent acts are covered."

— Justice Kagan

Introduction

The Supreme Court heard oral arguments in *Lorenzo v. Securities and Exchange Commission*, No. 17-1077, on Monday, December 3, 2018, to decide whether an individual who merely distributed a material misstatement or omission, and is thereby not the "maker" of the statement under the test set forth in *Janus Capital Group, Inc. v. First Derivative Traders*,[1] can nonetheless be held liable under the "fraudulent scheme" provisions of Rule 10b-5(a) and (c). The circuit courts are split on this issue: The Second, Eighth, and Ninth Circuits have held that a misstatement cannot be the sole basis for a fraudulent scheme claim, while the D.C. Circuit and Eleventh Circuit have held that a misstatement standing alone can be the basis for such a claim.

The decision in this case has the potential to impact civil enforcement by the Securities and Exchange Commission, as well as the claims that can be brought by private litigants.

Background

SEC Rule 10b-5 enables the SEC—or private plaintiffs—to investigate and bring civil actions to enforce three types of securities fraud violations: those committed (1) by employing any "device, scheme or artifice to defraud;" (2) by making a false statement or omitting information that would be misleading to an investor; or (3) by engaging in fraudulent or deceitful conduct.

Francis Lorenzo, a registered representative of a broker-dealer, sent two emails to potential investors allegedly omitting material information. The emails indicated they were sent "at the request" of Lorenzo's boss, and Lorenzo testified that he copied and pasted content that

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

was supplied by his boss. The SEC initiated an administrative enforcement action against Lorenzo, charging violations of, inter alia, all three Rule 10b-5 provisions.

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, issuing a lifetime bar on Lorenzo working in the securities industry, as well as imposing a $15,000 monetary penalty.

"[T]he argument is if you read [10b-5] (a) and (c) the way you do, Janus *is a dead letter, right?"*

— Chief Justice Roberts

A divided panel of the D.C. Circuit reversed the Commission in part, finding that Lorenzo's tenuous connection to the statements was insufficient to find that Lorenzo was the "maker" of the statements under *Janus*, as required to impose fraudulent misstatement liability under Rule 10b-5(b). In reaching this conclusion, the D.C. Circuit emphasized that under *Janus*, Lorenzo's boss was the one with control and the "ultimate authority" over when and how to communicate the information.

However, the D.C. Circuit affirmed the SEC's decision to impose fraudulent scheme liability on Lorenzo under Rule 10b-5(a) and (c) due to his role in disseminating the misstatements to potential investors. The Court reasoned that although Lorenzo was not the "maker" of the misstatement, he "conveyed materially false information to prospective investors about a pending securities offering backed by the weight of his office as director of investment banking," thereby using the statements to defraud investors. The Court took an expansive view of the securities laws and found that other provisions could be employed to find liability for false statements even where the conduct would otherwise be outside the scope of Rule 10b-5(b). In a vehement dissent, then-Judge Kavanaugh—who is not participating in the decision at the Supreme Court—argued that "scheme liability must be based on conduct that goes beyond a defendant's role in preparing mere misstatements or omissions made by others."

Lorenzo petitioned the Supreme Court for a writ of certiorari, which was granted on June 18, 2018.

Oral Argument Highlights

The oral argument focused heavily on whether permitting liability under Rule 10b-5(a) and (c) would allow for an end run around the Court's ruling in *Janus*. In addressing this issue, the Court also explored whether the provisions of Rule 10b-5 were intended to be mutually exclusive, or whether the provisions were in fact intended to operate together to broadly prohibit fraudulent conduct in the securities industry.

Lorenzo's counsel argued that imposing fraudulent scheme liability in this case, where an individual only distributed someone else's false statement, would essentially reduce *Janus* to a case of incorrect pleading. After receiving some pushback from Justice Kagan on the idea that Rule 10b-5(a) and (c) are meant to operate separately from Rule 10b-5(b), Lorenzo's counsel did admit that there could be a situation where additional deceptive conduct could take the misstatement into fraudulent scheme territory; however, Lorenzo's counsel reiterated that the act of sending an email, as was the case here, would be insufficient to do so because such an act is not "inherently deceptive."

"And the only act seems to be this statement issued to potential investors, and we have a finding from the D.C. Circuit that it wasn't made, that act wasn't made, that statement wasn't made by this defendant."

— Justice Gorsuch

Justice Gorsuch seemed to be convinced by Lorenzo's arguments, as he challenged the government's insistence that sending the email itself was an act of fraud. Instead, Justice Gorsuch appeared to be of the opinion that the misstatement was the sole act of fraud, and Lorenzo could not be held liable as he did not "make" the statement. The government continued to rely on the fact that *Janus* was decided exclusively within the context of fraudulent misstatement allegations under Rule 10b-5(b) and argued that the "maker" standard was not relevant to an interpretation of Rule 10b-5(a) or (c).

This case is further complicated by the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,[2] which drew a distinction between primary and secondary liability. Lorenzo's counsel argued that if the Court were to affirm the D.C. Circuit's decision, essentially holding Lorenzo liable for conduct amounting to aiding-and-abetting his boss's misstatement, such a holding would blur the lines between primary and secondary liability, opening a new avenue of lawsuits to private plaintiffs. Lorenzo's counsel acknowledged that Section 17(a)(2), which makes it unlawful to obtain money or property by means of any untrue statement of material fact, would have been a better mechanism through which the SEC could have sought liability for Lorenzo's conduct that would not jeopardize the distinction made in *Central Bank*, as enforcement under Section 17(a)(2) is only available to the government.

Implications

The justices appear split on the issues of this case, with Justices Ginsburg, Breyer, Sotomayor and Kagan (the original dissenters in *Janus*) appearing sympathetic to the government and Chief Justice Roberts and Justices Thomas, Alito and Gorsuch seemingly skeptical of expanding SEC enforcement abilities. With Justice Kavanaugh recused, this could leave open the possibility of a split decision, which, while affirming the D.C. Circuit's decision below as

[2] 511 U.S. 165 (1994).

"[D]on't we make statements all the time through conduct? I think it's a well-rounded principle that conduct does include statements."

— Justice Breyer

to Lorenzo, would fail to resolve the circuit split, potentially encouraging forum shopping by private plaintiffs.

If the Court does reach a majority in favor of the government's position, however, this case stands to have broad implications for private securities litigants. If Rule 10b-5(a) and (c) can be used to circumvent the "maker" requirement of Rule 10b-5(b) under *Janus*, private plaintiffs could potentially bring securities fraud actions against individuals who are otherwise only minimally connected to the misstatement.

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