



Schemes and False Statements: Supreme Court to Consider Scope of Anti-Fraud Liability Under Securities Laws

November 30, 2018

On December 3, 2018, the Supreme Court will hear oral arguments in *Lorenzo v. Securities and Exchange Commission*, a case involving the scope of anti-fraud liability under federal securities law that may have significant implications for private securities litigation and Securities and Exchange Commission (SEC) enforcement actions. In *Lorenzo*, the Court is considering whether individuals who knowingly or recklessly send false statements to prospective investors in connection with a securities transaction can be held liable for participating in a fraudulent “scheme” even if they do not possess ultimate authority over the content of the statements. The Court’s resolution of this question may affect the range of defendants that private plaintiffs and the SEC can sue for securities fraud.

This Sidebar discusses the *Lorenzo* case and its broader implications by first providing an overview of the principal anti-fraud provisions of federal securities law and the distinction between primary and secondary anti-fraud liability. The Sidebar then reviews the history of the *Lorenzo* litigation and the main arguments that the Supreme Court will consider in the case. Finally, the Sidebar discusses the implications of the Court’s decision for private securities litigation, SEC enforcement actions, and Congress.

Primary and Secondary Anti-Fraud Liability

After the 1929 stock market crash and ensuing economic depression, Congress enacted the [Securities Act of 1933](#) (the Securities Act) to ensure “full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof.” One year later, Congress passed the [Securities Exchange Act of 1934](#) (the Exchange Act) to “provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails,” and to “prevent inequitable and unfair practices on such exchanges and markets.”

Both the Securities Act and the Exchange Act contain prohibitions on fraud related to the sale of securities. [Section 10\(b\) of the Exchange Act](#) makes it unlawful to “use or employ, in connection with the

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LSB10224

purchase or sale of any security . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe.” SEC Rule 10b-5, which implements Section 10(b), in turn makes it unlawful “in connection with the purchase or sale of any security” to (1) “employ any device, scheme, or artifice to defraud,” (2) “make any untrue statement of a material fact,” or (3) “engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.” Similarly, while Section 17(a) of the Securities Act regulates the “offer or sale” of securities (as opposed to their “purchase or sale”), it contains anti-fraud provisions that courts have described as “substantially identical” to those in Rule 10b-5. Courts have generally referred to claims brought under the first and third subsections of Rule 10b-5 as “scheme liability” claims to distinguish them from “false statement” claims brought under the rule’s second subsection.

In interpreting Section 10(b) and Rule 10b-5, the Supreme Court has distinguished between (1) “primary” actors who make false statements or participate in a fraudulent scheme, and (2) “secondary” actors who assist primary actors in violating the law but do not themselves make false statements or participate in a fraudulent scheme. The Court first addressed this distinction between primary and secondary actors in its 1994 decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* In *Central Bank*, investors in public building authority’s bonds brought Section 10(b) claims against the building authority and its underwriters based on false statements concerning the appraisal of land securing the bonds. The investors also alleged that a bank that served as a trustee for the bonds was “secondarily” liable under Section 10(b). Specifically, the investors alleged that the bank aided and abetted the other defendants’ violations of Section 10(b) by delaying an independent review of the appraisal, even though the bank had not itself made any false statements or participated in a fraudulent scheme. However, the Court rejected the plaintiffs’ claims against the bank, holding by a 5-4 vote that based on the language of Section 10(b) and Rule 10b-5, private plaintiffs cannot sue actors who aid and abet violations of those provisions but do not themselves make false statements or participate in a fraudulent scheme.

The Court again addressed the distinction between primary and secondary actors in its 2011 decision in *Janus Capital Group, Inc. v. First Derivative Traders*. In *Janus*, investors brought Section 10(b) claims against an investment adviser that had assisted an associated mutual fund in preparing prospectuses containing false statements. Specifically, the plaintiffs in *Janus* alleged that the investment adviser had violated Rule 10b-5(b), the subsection of the rule that makes it unlawful to “make” material false statements in connection with the sale of securities (as opposed to the “scheme liability” subsections). The Court rejected the plaintiffs’ claims against the investment adviser by a 5-4 vote, reasoning that the investment adviser was not the “maker” of the relevant false statements within the meaning of Rule 10b-5(b) because it had only assisted in the preparation of the prospectuses. Relying in part on the distinction between primary and secondary actors established in *Central Bank*, the Court explained that the “maker” of a false statement under Rule 10b-5(b) is “the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.” By contrast, the Court explained that persons who merely assist in the making of the statement do not “make” the statement within the meaning of Rule 10b-5(b). According to the Court, a contrary rule under which persons who merely assist in the making of a false statement qualify as “makers” of the statement would “substantially undermine” the distinction between primary and secondary actors by making the latter “almost nonexistent.” Because only the mutual fund that had issued the prospectuses had “ultimate authority” over their content, the Court concluded that the investment adviser had not violated Rule 10b-5(b) because it was not the “maker” of the false statements in the prospectuses.

Lorenzo v. Securities and Exchange Commission

In *Lorenzo*, the Court is considering a question that is closely related to the issues explored in *Central Bank* and *Janus*: whether “scheme liability” claims can be brought against persons who (1) knowingly or recklessly send false statements to prospective investors in connection with a securities transaction, but

(2) do not themselves “make” the false statements within the meaning of Rule 10b-5’s “false statement” provision because they do not have “ultimate authority” over their content under *Janus*. In 2013, the SEC brought an [enforcement action](#) alleging that Francis Lorenzo (an investment banker) violated Section 10(b) of the Exchange Act, Rule 10b-5, and Section 17(a) of the Securities Act by sending emails misrepresenting a company’s assets to prospective investors. In defending himself against these charges, Lorenzo [argued](#) that he had not violated these provisions because he had sent the emails at the request of his boss, who had drafted them. However, an SEC administrative law judge (ALJ) rejected this argument, concluding that because Lorenzo had been at a minimum “reckless” in sending the emails, he had indeed violated the relevant “false statement” and “scheme liability” provisions. After Lorenzo petitioned the full SEC for review, the Commission [sustained](#) the ALJ’s decision on the grounds that Lorenzo “knew each of [the emails’ key statements] was false and/or misleading when he sent them.” Lorenzo then appealed the SEC’s decision to the U.S. Court of Appeals for the D.C. Circuit (D.C. Circuit), which [reversed](#) the decision in part. Specifically, a three-judge panel of the D.C. Circuit unanimously reversed the SEC’s determination that Lorenzo had violated Rule 10b-5’s “false statement” provision—that is, the provision at issue in *Janus*—but affirmed its conclusion that Lorenzo had violated the relevant “scheme liability” provisions by a 2-1 vote.

In reversing the SEC’s finding that Lorenzo had violated Rule 10b-5’s “false statement” provision, the D.C. Circuit concluded that because Lorenzo had sent the relevant false statements at the request of his boss, Lorenzo was not the “maker” of the statements under *Janus*. However, in affirming the SEC’s determination that Lorenzo had violated the relevant “scheme liability” provisions, the court explained that unlike Rule 10b-5’s false statement provision, the “scheme liability” provisions “do not speak in terms of an individual’s ‘making’ a false statement.” Rather, because the “scheme liability” provisions prohibit “device[s], scheme[s], or artifice[s] to defraud,” and Lorenzo’s conduct “fit[] comfortably within the ordinary understanding” of those terms, the D.C. Circuit affirmed the SEC’s conclusion that Lorenzo had violated those provisions. In affirming this aspect of the SEC’s decision, the D.C. Circuit agreed with the [Eleventh Circuit](#) and a [number of district courts](#) that securities-fraud allegations involving false statements can serve as the basis for “scheme liability” even if the alleged conduct does not amount to “making” a false statement under *Janus*. However, the court’s decision arguably stands in some tension with the proposition that “scheme liability” under Rule 10b-5 requires something more than involvement in the dissemination of false statements, which has been endorsed by the [Second](#), [Eighth](#), and [Ninth](#) Circuits.

The D.C. Circuit’s decision in *Lorenzo* drew a dissent from then-Judge Brett Kavanaugh, who argued (among other things) that the court’s interpretation of the “scheme liability” provisions would allow the SEC “to evade the important statutory distinction between primary and secondary . . . liability” that *Central Bank* and *Janus* established by implying that persons who merely assist in the communication of a false statement are themselves primary actors guilty of participating in a fraudulent scheme.

Lorenzo filed a [petition](#) for a writ of certiorari challenging the D.C. Circuit’s interpretation of the “scheme liability” provisions with the Supreme Court in January 2018, which the Court granted in June.

Implications of the Court’s Decision

The Court’s decision in *Lorenzo* may have significant implications for private securities litigation, SEC enforcement actions, and Congress. As discussed, under *Central Bank*, private plaintiffs cannot bring Section 10(b) claims against “secondary” actors who merely assist another actor in violating the securities laws. Accordingly, if the Court were to agree with the D.C. Circuit that persons who do not “make” false statements within the meaning of Rule 10b-5’s “false statement” provision (and accordingly cannot qualify as “primary” actors under that provision) can nevertheless qualify as “primary” actors guilty of participating in a fraudulent scheme, it would expand the range of defendants that private plaintiffs are able to sue for securities fraud.

A decision reversing the D.C. Circuit's interpretation of the "scheme liability" provisions may also prove significant for SEC enforcement actions. Congress responded to the Court's decision in *Central Bank* by enacting [Section 20\(e\) of the Exchange Act](#), which affirms the SEC's authority to bring enforcement actions against "secondary" actors who "substantially assist" others in violating Section 10(b) (without altering *Central Bank*'s holding concerning private plaintiffs). The SEC will accordingly retain the authority to bring enforcement actions against persons who aid and abet "false statement" violations irrespective of whether such persons can also qualify as "primary" violators of the "scheme liability" provisions. However, the SEC contends that *Lorenzo* may nevertheless have important implications for its enforcement authority. Specifically, the SEC [argues](#) that *Lorenzo*'s proposed reading of the "scheme liability" provisions would create a "loophole" in cases where the SEC is unable to prove that the "maker" of a false statement acted with the required mental state. In such cases, the SEC contends, it would be unable to bring enforcement actions against persons who knowingly or recklessly communicate the false statement if those persons did not "make" the statement. The SEC argues that it would be unable to bring enforcement actions in these circumstances under *Lorenzo*'s proposed interpretation because such persons would not qualify as (1) "primary" violators of the "scheme liability" provisions, or (2) "secondary" violators under Section 20(e) of the Exchange Act because there would be no "primary" violator for them to assist.

While the Supreme Court granted certiorari only with respect to the "scheme liability" issue, a decision affirming the D.C. Circuit's holding that *Lorenzo* did not "make" the relevant false statements under *Janus* would also have important implications. Specifically, the D.C. Circuit's determination that *Lorenzo* did not qualify as the "maker" of the false statements despite the fact that he signed the relevant emails arguably conflicts with at least one court's [conclusion](#) that securities underwriters can qualify as the "makers" of false statements when their names appear on the cover of a prospectus. Accordingly, if the Court were to address the issue, a decision affirming the D.C. Circuit's interpretation of Rule 10b-5's "false statement" provision would restrict the range of defendants that private plaintiffs and the SEC can pursue under that provision.

While *Lorenzo* accordingly has the potential to alter the scope of anti-fraud liability under the securities laws, it may also leave existing law undisturbed until the full nine-member Court can consider a similar case. Because of his participation in the D.C. Circuit's decision, Justice Kavanaugh has recused himself from the case, raising the possibility of a 4-4 split. Some [commentators](#) have [suggested](#) that such a split is the "most likely outcome" in *Lorenzo* in light of the close division among the Justices in *Central Bank* and *Janus*. Such a stalemate would result in an affirmation of the D.C. Circuit's decision, but would leave contrary decisions of other circuit courts unaffected.

Regardless of the outcome in *Lorenzo*, Congress could address the issues raised by the case. Specifically, Congress could clarify the scope of Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act by amending the underlying statutes, as it has done in response to *Central Bank* and [other securities law decisions](#).

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