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High Court Extends Reach Of Securities Fraud Rule 10b-5

By **Jim Beha, Michael Birnbaum, Jina Choi and Mark Foster**
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On March 27, 2019, in Lorenzo v. U.S. Securities and Exchange Commission, the U.S. Supreme Court clarified that the types of conduct that violate the three subsections of SEC Rule 10b-5 are not mutually exclusive. The court held that while a defendant who is not the "maker" of misstatements may not be found liable under 10b-5(b), such defendant who disseminates false statements can still be found to violate the other subsections of Rule 10b-5 that prohibit fraudulent schemes and acts that operate as a fraud.

Michael Birnbaum

Before Lorenzo, in cases alleging primary liability for securities fraud based on misleading statements to investors, courts' threshold inquiry was whether a defendant "made" the statements at issue, as only the "makers" of such statements — those with ultimate authority over the statement, including its content and whether and how to communicate it — could be liable under Rule 10b-5(b), the federal anti-fraud provision that most directly addresses fraud based on false or misleading statements.[1]

Jina Choi

After Lorenzo, primary liability for securities fraud may also reach those who knowingly "disseminate" misleading statements made by others under those sections of Rule 10b-5 historically invoked to address fraudulent "schemes" or other practices that operate as a fraud or deceit on investors. The opinion's reasoning may open the door to other types of conduct giving rise to primary liability and, as a result, subject more individuals and entities to claims of securities fraud under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5.

Mark Foster

Background

The court's decision interpreted the reach of Rule 10b-5, the principal prohibition on securities fraud. Rule 10b-5 makes it unlawful, in connection with the purchase or sale of any security, to:

(a) employ any device, scheme, or artifice to defraud,

(b) make any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.[2]

Since 10b-5 was promulgated decades ago, many enforcement actions and private claims have been asserted under subpart (b) — the provision prohibiting misleading statements. In 2011, the Supreme Court narrowly construed the group of potential defendants who could be found liable for misstatements under Rule 10b-5(b), which gives rise to a claim for misstatements. In Janus Capital Group Inc. v. First Derivative Traders,[3] the court limited liability to those who "make" statements.

Under the Janus reasoning, the "maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."[4] Thus, the court held that an investment adviser who merely "participate[d] in the drafting of a false statement" could not be held liable for "making" a false statement under Rule 10b-5(b).[5] The bright-line rule articulated in Janus clarified what type of conduct and what type of defendants would normally be within Rule 10b-5(b)'s reach.

Less than two years after the Supreme Court issued its decision in Janus, the SEC brought an enforcement action against an investment banker, Francis Lorenzo, who was found to have sent emails at the request of his boss, who supplied the central content and approved the messages for distribution to investors and invited them to follow up with questions.[6] Importantly, there was no dispute that Lorenzo knew the email contained false statements. After a two-day administrative hearing, an administrative law judge found that Lorenzo had violated Rule 10b-5. The commission affirmed, finding violations of each of Rule 10b-5(a), (b) and (c).

On review, the U.S. Court of Appeals for the D.C. Circuit found, applying Janus, that Lorenzo could not be held liable for making a false statement under Rule 10b-5(b), because his boss, who had ultimate authority over the statement, was the "maker," not Lorenzo. But the court nonetheless sustained the SEC's finding that Lorenzo could be primarily liable under Rule 10b-5(a) and (c) for knowingly disseminating a false statement, even though Lorenzo did not "make" the statement.

Thus, the stage was set for the Supreme Court to decide whether, and under what circumstances, a misstatements claim not viable under Rule 10b-5(b) could be pursued under 10b-5(a) or (c).

Discussion

Where Janus narrowly construed the type of conduct that can give rise to liability under Rule 10b-5(b), Lorenzo concluded that the plain language of subparts (a) and (c) was "sufficiently broad to include within their scope the dissemination of false or misleading information with the intent to defraud."[7]

A comparison of Janus and Lorenzo reveals some doctrinal tension. Justice Stephen Breyer, who dissented in Janus, wrote the majority opinion in Lorenzo, holding that "someone who is not a 'maker' of a misstatement ... can nevertheless be found to have violated the other subsections of Rule 10b-5 ... when the only conduct involved concerns a misstatement."[8] While the court agreed that Lorenzo did not "make" the false statement, it held that his "dissemination" of the statement was a "scheme or artifice to defraud" under Rule 10b-5(a) and "an act or practice ... operat[ing]" as a fraud under Rule 10b-5(c). Seemingly, the majority felt that if it did not rule as it did, fraudulent behavior like Lorenzo's would fall outside the scope of Rule 10b-5.

The court reasoned that the language in 10b-5(a) and (c) “capture[s] a wide range of conduct,” observing that the dictionary definitions of the prohibited conduct — "device," "scheme," "artifice," "act" and "practice" — are “expansive,” reflecting congressional intent to “root out all manner of fraud in the securities industry.” The court concluded that the “provisions capture a wide range of conduct” and acknowledged that “[a]pplying them may present difficult problems of scope in borderline cases.” [9] What constitutes a borderline case may be a subject of contention in lower courts in the years to come.

In the face of perceived scope-creep endorsed by the majority, Justice Clarence Thomas (who wrote the majority opinion in Janus) dissented in Lorenzo. Justice Thomas, joined by Justice Neil Gorsuch, explained that Rule 10b-5(b)’s specific prohibition on false statements meant that the rule’s other “conduct-based provisions” “cannot be construed to encompass primary liability solely for false statements.”[10]

Justice Thomas noted that applying Rules 10b-5(a) and (c) to false statements like those disseminated by Lorenzo would “completely subsume[ ] [Rule 10b-5(b)] in cases involving fraudulent misstatements, even though [Rule 10b-5(b)] specifically govern[s] false statements.”[11] He also reasoned that “scheme” liability under Rule 10b-5(a) has traditionally been limited to a “scheme” involving “some form of planning, designing, devising, or strategizing,” such as a ‘“short selling scheme,’ a wash sale, a matched order, price rigging, or similar conduct.”[12] Justice Thomas opined that simply “disseminating” a false statement made by another is not such a “scheme.”

Finally, Justice Thomas pointed out that the majority’s position would effectively nullify the court’s decision in Janus because a party who had not “made” the false statement — and thus could not be liable under Rule 10b-5(b) — could still be liable for “facilitating” that same statement.

Key Takeaways

Lorenzo Will Not Have a Major Impact on Future SEC Cases

The SEC will gladly take a win after a difficult recent history before the Supreme Court, but the breadth of this victory will take some time to measure, and likely will not have a major impact on the kinds of cases the SEC pursues.

In Lorenzo, the Supreme Court confronted a defendant who admitted to knowingly disseminating false statements to potential investors. In light of those admitted facts, the Supreme Court decided that such conduct had to be covered by the primary anti-fraud statute at the SEC’s disposal. The court explained: “Our conviction is strengthened by the fact that we here confront behavior that, though plainly fraudulent, might otherwise fall outside the scope of the Rule.”[13]

But courts are rarely presented with cases where falsity and scienter are as clear as in Lorenzo. While Lorenzo may be seen as expanding the types of conduct within the reach of Rule 10b-5, it does not lighten the SEC’s burden in showing that an individual engaged in the conduct with an intent to deceive investors. As a result, Lorenzo perhaps provides the SEC with a little more bark, but not much (if any) more bite, as it pursues enforcement actions.

That is not to say the SEC is constrained. The SEC has many tools at its disposal with which to pursue fraud claims, including some that private plaintiffs do not have. Almost all “false statement” cases will still involve the maker of those statements and were never constrained by Janus. In many other cases,

schemes involve much more than the dissemination of others' statements. For those cases, Lorenzo at most confirms that the inclusion of false statements as part of a fraudulent scheme does not remove a case from the ambit of subsections (a) or (c). The SEC also has the ability to pursue claims for secondary liability against individuals who knowingly or recklessly provide substantial assistance to another individual who violates Rule 10b-5.

Lorenzo Does Not Make It Easier for Private Litigants to Assert 10b-5 Claims

Private litigants may try to seize upon Lorenzo to pursue claims against a wider range of potential defendants involved in the dissemination of statements to investors, and based on conduct beyond alleged misstatements. However, the Supreme Court has restricted the type of defendants and conduct giving rising to private litigation under Rule 10b-5.

For example, the Supreme Court has long held that private plaintiffs, unlike the SEC, may not bring claims against various secondary actors (e.g., accountants, underwriters, lawyers, lower-level employees) for aiding and abetting violations of Section 10(b) under the Supreme Court's decision in Central Bank of Denver v. First Interstate Bank of Denver.[14]

Private plaintiffs might try to seize upon Justice Thomas' statement that the Lorenzo majority opinion "eviscerates" the distinction between primary and secondary liability, and seek creative ways to repackage claims as supporting primary liability.[15] But the majority expressly rejected Justice Thomas' view,[16] and nothing in Lorenzo can be read to open the door to liability under Rule 10b-5 for these types of secondary actors, particularly individuals and entities (unlike Lorenzo) who have no awareness of an alleged fraud.

Nor should Lorenzo's expansive interpretation of the type of conduct reached by Rule 10b-5(a) and (c) give rise to securities class action litigation involving conduct aside from making or disseminating allegedly misleading statements.

That is because the Supreme Court, in Stoneridge Investment Partners v. Scientific-Atlanta,[17] held that a securities fraud plaintiff must establish each element of a securities fraud claim — in particular, reliance — in order to establish liability. While reliance on public statements made by or on behalf of public companies with efficiently traded stock is presumed in class actions, there is no similar presumption applicable to alleged "schemes" or other forms of deceptive conduct. That was fatal in Stoneridge and should remain so after Lorenzo. Eliminating any doubt about that, Lorenzo expressly reiterates Stoneridge's ruling that private plaintiffs cannot bring suit against defendants "based on undisclosed deceptions upon which the plaintiffs could not have relied." Accordingly, Lorenzo should not be construed as expanding the scope of class actions under Rule 10b-5.

Not only must private litigants overcome the reliance hurdle, they must also plead and prove (like the SEC) that each named defendant acted with scienter. That is not an easy task. Private litigants are required to plead particularized facts giving rise to a strong inference that a defendant acted with an intent to deceive. That requirement minimizes (but does not eliminate) baseless securities class actions based on alleged misstatements. It should function equally well, if not better, in curbing claims based on other forms of alleged deceptive conduct encompassed by Rule 10b-5(a) and (c).

The Lorenzo decision diminishes some of the certainty provided by Janus. But Lorenzo should not have a major impact on SEC enforcement behavior or spur new waves of private litigation. Nevertheless, given the Supreme Court's reading of Rule 10b-5 in Lorenzo, it is likely there will be skirmishes in the future as

the courts are asked to apply its reasoning to novel claims based on various forms of allegedly deceptive conduct.

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[1] Janus Capital Group, Inc. v. First Derivative Traders, 564 U.S. 135 (2011).

[2] 17 CFR § 240.10b-5.

[3] 564 U.S. 135 (2011).

[4] Id. at 142.

[5] Id. at 145.

[6] Slip Op. at 4.

[7] Slip Op. at 5-6.

[8] Slip Op. at 4.

[9] Slip Op. at 6.

[10] Dissent, Slip Op. at 5.

[11] Dissent, Slip Op. at 3.

[12] Dissent, Slip Op. at 3 (quoting United States v. Naftalin, 441 U.S. 768, 770, 778 (1979)).

[13] Slip Op. at 4.

[14] Stoneridge Investment Partners v. Scientific-Atlanta, 511 U.S. 164 (1994).

[15] Dissent, Slip Op. at 1.

[16] Slip Op. at 11.

[17] 552 U.S. 148 (2008).