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Ruling may encourage SEC to pursue broader theories

By Nicolas Morgan, John Nowak and Thomas Zaccaro

After a string of high-profile Supreme Court defeats, the SEC finally won one. Recently, in *Lorenzo v. Sec. Exch. Comm'n*, 2019 DJDAR 2499 (March 27, 2019), the Supreme Court upheld a D.C. Circuit ruling that a director of a registered broker-dealer was liable for securities fraud when he cut-and-pasted false statements prepared by his boss and, at his boss's direction, emailed those statements to potential investors. Although the Supreme Court assumed the director was not liable for making false statements under the antifraud provisions of the federal securities laws, the Supreme Court did find Lorenzo liable of securities fraud because his conduct in disseminating his boss's statements was deceptive and part of a scheme.

Lorenzo interpreted the Supreme Court's landmark decision in *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135 (2011), which ruled that "the maker of a statement [for the purposes of Rule 10b-5] is the person or entity with ultimate authority over the statement .... [o]ne who prepares or publishes a statement on behalf of another is not its maker." *Id.* at 142. *Lorenzo* purports to clarify *Janus* by concluding that while only "makers" of a false statement have liability under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5(b) thereunder, others who only "disseminate" false statements may be liable for "deceptive conduct" or "scheme liability" under Rule 10b-5(a) or (c).

This decision is certain to encourage the SEC to pursue expansive theories as to what constitutes scheme-based conduct in an effort to cast a wider net for liability. Rather than simply relying on straightforward false statements claims (*i.e.*, ones that apply only to those who "make" the statement and have ultimate authority over the statement and its content), the SEC could pursue scheme liability claims against not only the makers of the alleged statement but also those who acted at the maker's direction or participated in the dissemination or distribution of the statement. As noted by the *Lorenzo* dissent, the SEC potentially could attempt to extend liability to anyone who merely undertakes the administrative task of sending an email or letter if the other elements of fraud liability are established.

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Background

The relevant fact pattern in *Lorenzo* was uncontested. The broker-dealer, Lorenzo's employer, was retained to sell $15 million of debentures offered by a renewable energy company, which purportedly had assets of $14 million, including intangible assets of $10 million. However, during the course of the debenture offering, the company publicly disclosed, and Lorenzo was told, that its assets were in fact valued at around $370,000 and that it had written off all of its worthless intangible assets. Shortly after the disclosure, Lorenzo sent two emails to potential investors that he knew falsely claimed that the debenture investment had multiple layers of protection, including $10 million in confirmed assets. The statements in the emails were not Lorenzo's statements; his boss had actually drafted the content of the statements, approved the language and directed Lorenzo to send the emails.

The sole issue before the Supreme Court on appeal was whether Lorenzo, who was not the "maker" of the statements under *Janus*, could be liable for securities fraud under subsections (a) and (c) of Rule 10b-5 of the Securities Exchange Act and Section 17(a)(1) of the Securities Act of 1933, when the only conduct that Lorenzo engaged in was the dissemination of his boss's false statements. The Supreme Court made clear that its review was also limited by the fact that Lorenzo was not challenging a finding that he acted with the intent to defraud — a critical element in any securities fraud claim and one that is often hotly contested.

The Supreme Court began its analysis by evaluating the language of subsection (a) and (c) of Rule 10b-5, which make it unlawful "[t]o employ any device, scheme, or artifice to defraud" and "[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. Section 240.10b-5. These provisions are often referred to as the "scheme liability" provisions of the rule. As the Supreme Court noted, Section 17(a) (1) contains similar scheme liability language. Rule 10b-5(b) was not at issue because, as noted, the Supreme Court assumed for the purpose of its decision that Lorenzo did not "make" any untrue or false statement.

The Supreme Court found that "scheme liability" provisions capture a wide range of conduct, and that it was "difficult to see how [Lorenzo's] actions could escape the reach of those provisions." That conclusion seemed especially swift where, as here, the Supreme Court was able to assume the fact that Lorenzo acted with the intent to defraud. Ultimately, the court held that those "who disseminate false or misleading statements to potential investors with the intent to defraud, can be found to have violated the other parts of Rule 10b-5, subsections (a) and (c), as well as related provisions of the securities laws," regardless of whether they "made" the statements as defined by its prior decision in *Janus*. The court noted, however, that borderline "scheme liability" cases might present challenges in the future, and that such cases could result in a narrowing of its interpretation. The court also made clear that the three subsections of Rule 10b-5 were not mutually exclusive, and that their application may overlap. Thus, while an individual may only be liable as a secondary actor under one subsection of the rule, she may be primarily liable under a separate section.

A strong dissent authored by Justice Clarence Thomas (who authored *Janus*) argued that the

Court's holding "eviscerates" *Janus* and turns into a "dead letter" the clear distinction between primary and secondary liability (*e.g.*, aiding and abetting claims) under the securities laws. But in *Lorenzo*, the Court rejected this argument, indicating that its holding was not an anomaly with respect to primary/ secondary determinations — in fact, it noted that unlawful conduct often creates primary exposure for some violations but only secondary liability for others. As to whether minor actors might be swept up as primary actors in a securities claim alleging scheme liability, the Court simply noted that "even a bit participant in the securities market" can be primarily liable if all of the requirements for liability are met — a statement that some might consider a warning.

Ramifications

Lorenzo will have a number of potential ramifications in SEC enforcement cases. First and foremost, it is likely to encourage the SEC to pursue broader theories of scheme liability in an effort to charge those whom the SEC subjectively believes are responsible for a violation. In the past, the SEC faced challenges when it attempted to assert scheme liability claims based on misrepresentations because courts found that those claims could be brought only under Rule 10b-5(b) and, after *Janus*, against only the "maker" of the misrepresentation. On the heels of *Lorenzo*, SEC Enforcement Division officials have already expressed their intent aggressively to bring misrepresentation claims under the scheme liability theories when the SEC cannot satisfy *Janus*.

Second, although "scheme liability" is not a new concept, the decision raises a number of questions: How will the term "disseminate" be defined? Will the definition include conduct where an individual simply forwards an email to another? If an email is forwarded, will all individuals on the email chain potentially face primary scheme liability? What other conduct, beyond dissemination, might be considered part of a scheme such that secondary actors will have primary exposure? These are among some of the critical questions to ask and consider — principally in light of the fact that the SEC will interpret this decision as sanctioning scheme-based claims against arguably bit participants.

Granted, the *Lorenzo* decision does not remove the SEC's burden to prove all elements of a violation, including scienter and deceitful conduct. However, *Lorenzo* does have the potential to erode the line between primary and secondary actors (e.g., aiders and abettors) and encourage more aggressive pursuit of claims against a larger pool of potential defendants, including those who played no part in the preparation of the statements at issue.

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