

Supreme Court Expansively Interprets Reach of Antifraud Provisions of the Federal Securities Laws

March 29, 2019

On March 27, in *Lorenzo v. SEC*, the U.S. Supreme Court issued a much anticipated opinion concerning the reach of Securities and Exchange Commission (SEC) Rule 10b-5 and other antifraud provisions of the federal securities laws. While the core claim — misstatements concerning a company's financial characteristics — was similar to claims the Commission and private litigants routinely make, the defendant, Lorenzo, was not responsible for the misstatements but merely sent emails that had been drafted by another. The case grew into a fundamental dispute about the reach of the antifraud provisions of the federal securities laws, perhaps the most serious since the Supreme Court's 2011 decision in *Janus Capital Grp., Inc. v. First Derivative Traders* limited the reach of certain securities fraud claims to the actual "maker" of those statements, and was seen as an opportunity for the SEC and private plaintiffs to bolster their ability to bring actions against a range of individuals for securities fraud.¹

The SEC's Enforcement Action Against Lorenzo

The case arose from an enforcement action the Commission filed in an administrative proceeding against Lorenzo, the director of investment banking at a small broker-dealer, for alleged misstatements contained in emails Lorenzo sent at the request of his supervisor to potential investors regarding the financial strength of a company that had hired Lorenzo's firm in connection with a debt offering. An SEC administrative law judge found that Lorenzo had violated Section 17(a)(1) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and each of the three subparts of Rule 10b-5, and the Commission, on direct review, agreed. On further appeal, however, the U.S. Court of Appeals for the District of Columbia, applying the test articulated by the Supreme Court in *Janus*, held that Lorenzo was not the "maker" of the statements in the emails he sent "because Lorenzo's boss, and not Lorenzo himself, retained 'ultimate authority' over the statements."² But over a dissent from then-Circuit Judge Brett Kavanaugh, the court held that even though Lorenzo did not violate Rule 10b-5(b), the Commission had established that Lorenzo acted with scienter (i.e., an intent to deceive, manipulate or defraud) and violated Section 17(a)(1), Section 10(b) and Rules 10b-5(a) and (c) by sending the two emails.

Before the Supreme Court, Lorenzo focused on the fact that he did not "make" the fraudulent statements. He principally argued that holding him liable — even if he acted with scienter — would inappropriately permit "the SEC and private plaintiffs to sidestep *Janus*'s carefully drawn elements of

fraudulent statement claims merely by relabeling the claims — with nothing more — as fraudulently scheme claims.”³ He also argued that Rule 10b-5(b) would effectively be rendered superfluous if claims related to misstatements could also be brought under Rule 10b-5(a) or (c).

The Supreme Court’s Opinion

The Supreme Court, in a 6-2 decision with Justice Kavanaugh recused, rejected Lorenzo’s argument. Describing Lorenzo’s conduct as “plainly fraudulent,” 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” Section 17(a)(1), Section 10(b) and Rules 10b-5(a) and (c).⁴ The Court’s holding largely rested on the expansive terms used in those provisions, such as “device,” “scheme,” “act” and “practice.” According to the Court, “[i]t 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.”⁵ Focusing on Lorenzo’s conduct — where Lorenzo “sent false statements directly to investors, invited them to follow up with questions, and did so in his capacity as vice president of an investment banking company”⁶ — and emphasizing that Lorenzo did not challenge that he had acted with scienter, the Court explained that “it is difficult to see how his actions could escape the reach of those provisions.”⁷

The Court also rejected Lorenzo’s argument that the subsections of Rule 10b-5 “should be read as governing different, mutually exclusive, spheres of conduct.”⁸ That argument, the Court explained, was inconsistent with the Court’s own precedent regarding the expansive and overlapping reach of the antifraud provisions of the federal securities laws and was also inconsistent with the Commission’s long-held view that the provisions are not mutually exclusive. And the Court did not see *Janus*, which only interpreted Rule 10b-5(b), as compelling a different result. Adopting Lorenzo’s argument, the Court observed, “would mean those who disseminate false statements with the intent to cheat investors might escape liability under the Rule altogether.”⁹ The Court did caution, however, that there may be some “borderline cases” that could make application of Section 17(a)(1), Section 10(b) and Rules 10b-5(a) and (c) “difficult” and that “[p]urpose, precedent, and circumstance could lead to narrowing their reach in other contexts.”¹⁰ But in the Court’s view, there was “nothing borderline about this case.”¹¹ In the end, the Court held that the antifraud provisions of the federal securities laws should be interpreted to reach what “would seem a paradigmatic example of securities fraud.”¹²

Implications of the Supreme Court’s Ruling

The Court’s decision, while largely fact-bound and heavily influenced by Lorenzo’s decision not to challenge the conclusion that he had acted with fraudulent intent, could be seen as a substantial victory for private plaintiffs and the Commission. Both may read the Court’s decision as abrogating some decisions by the lower courts that had arguably taken a narrower view on the type of conduct reached by Rules 10b-5(a) and (c). Moreover, a ruling in Lorenzo’s favor could have substantially narrowed the conduct that could give rise to primary liability under the antifraud provisions of the federal securities laws. That concern was particularly acute for private plaintiffs who, unlike the Commission, cannot bring causes of actions for secondary liability but might now be emboldened to bring claims against individuals who arguably disseminated misstatements made by others such as executives, underwriters, analysts and financial professionals who circulate corporate information.

For the Commission, even though it already had the power to assert claims for secondary liability, the

Court's decision may be viewed as preserving the enforcement authority it always thought it had. One particular concern for the Commission, and the Court, was that accepting Lorenzo's argument might have prevented the Commission from bringing any enforcement action (even an action alleging secondary liability) where a person, with intent to defraud, sent out incorrect information that was prepared by others. That possibility could arise because a secondary violation requires proof of a primary violation, and establishing a primary violation of Rule 10b-5(b) requires proving both the existence of a material misstatement or omission and that the "maker" acted with scienter. Had the Court adopted it, Lorenzo's theory could have created anomalous complications for the SEC to bring enforcement actions against secondary actors with fraudulent intent where the primary actor or "maker" acted only negligently and where the facts did not fit the negligence-based provisions of Section 17(a)(2) and (3) of the Securities Act: The absence of a primary violation by such a "maker" in those circumstances might well have left the SEC without a viable theory against the secondary actor, despite the latter's level of scienter.

Although *Lorenzo* will likely be viewed as a victory for the securities plaintiffs' bar and the Commission, it is too soon to see how the decision will affect actions that do not involve "plainly fraudulent" conduct that the Supreme Court considers "a paradigmatic example of securities fraud." Parties confronted with different facts should be mindful that there may be some contexts where, as the Court itself observed, it would be appropriate to narrow the reach of Section 17(a)(1), Section 10(b) and Rules 10b-5(a) and (c). What those contexts are, however, remains to be seen.

¹ 564 U.S. 135 (2011).

² *Lorenzo v. SEC*, 872 F.3d 578, 580 (D.C. Cir. 2017).

³ Brief for Petitioner at 6, *Lorenzo v. SEC*, 587 U.S. ---- (Mar. 27, 2019) (No. 17-1077).

⁴ *Lorenzo v. SEC*, 587 U.S. ---- (Mar. 27, 2019), slip op. at 2.

⁵ *Id.* at 6.

⁶ *Id.* at 7.

⁷ *Id.* at 6.

⁸ *Id.* at 7.

⁹ *Id.* at 9.

¹⁰ *Id.* at 6-7.

¹¹ *Id.* at 7.

¹² *Id.* at 9.

CONTACTS

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, or

Stephen L. Cohen, Partner

+1 202 736 8682, scohen@sidley.com

Hille R. Sheppard, Partner

+1 312 853 7850, hsheppard@sidley.com

Andrew W. Stern, Partner

+1 212 839 5397, astern@sidley.com

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