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Supreme Court Affirms *Lorenzo v. SEC*, Expanding the Scope of Primary Liability for Securities Fraud

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On March 27, 2019, the U.S. Supreme Court issued its decision in *Lorenzo v. SEC*,[1] affirming the expansive view of the U.S. Securities and Exchange Commission ("SEC" or "Commission") that, under the right circumstances, sending out false or misleading statements alone can create liability not just for fraudulent misrepresentations under Rule 10b-5(b) of the Securities Exchange Act of 1934 ("Exchange Act") but a fraudulent scheme under Rule 10b-5(a) and (c) as well. *Lorenzo*'s holding may well result in:

- An emboldened SEC more inclined to push the boundaries of liability for fraudulent schemes under the federal securities laws;
- Greater sanctions being available to the SEC in enforcement proceedings (including increased civil penalties, broader application of securities industry and officer-and-director bars, and potentially fewer waivers from automatic disqualifications); and
- Private plaintiffs feeling encouraged to bring claims that test the line between primary and secondary liability.

THE LAW BEFORE LORENZO

The *Lorenzo* Court's decision focused on two separate subsections of Exchange Act Rule 10b-5, and how those subsections interact and at times overlap with each other. Rule 10b-5 is the primary antifraud tool utilized by the SEC and provides that in connection with the purchase or sale of a security, it is unlawful to:

- 10b-5(a): employ any device, scheme, or artifice to defraud,

- 10b-5(b): make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- 10b-5(c): engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

Subsection (b) of rule 10b-5 is commonly referred to as creating liability for "false statements," whereas subsections (a) and (c) are commonly referred to in terms of "scheme liability."[2]

The Supreme Court indelibly shaped the contours of 10b-5(b) liability in its 2011 *Janus Capital Group, Inc. v. First Derivative Traders* decision.[3] The *Janus* Court held that under 10b-5(b), only the "maker" of a false statement – defined as the "person or entity with ultimate authority over the statement, including its content and whether and how to communicate it" – can be subject to primary liability.[4]

The *Janus* decision curtailed the SEC and private securities bar's use of Rule 10b-5(b) in circumstances where a false statement was distributed by someone other than the maker. But, the text of *Janus* itself was not completely clear in the extent of its application to false statements by non-makers under provisions of the federal securities laws other than Rule 10b-5(b). As the post-*Janus* case law evolved, the majority of federal courts restricted the *Janus* "maker" requirement to only subsection 10b-5(b), and not to Section 17(a) of the Securities Act of 1933 ("Securities Act")[5] or subsections (a) or (c) of Rule 10b-5.[6] With respect to Rule 10b-5(a) and (c), however, much of the case law responded to *Janus* by further differentiating these scheme liability provisions from the false statements provisions and imposing a requirement that for scheme liability to exist, there must be some additional deceptive conduct that went beyond just misrepresentations or omissions.[7] In contrast, the D.C. Circuit held in its decision in *Lorenzo* that knowingly distributing another's false statements, without more, could form the basis for a fraudulent scheme.[8]

The Supreme Court resolved this split last week in *Lorenzo*, when it held that the "dissemination of false or misleading statements with an intent to defraud can fall within the scope of subsections (a) and (c) of Rule 10b-5 … even if the disseminator did not 'make' the statements" and is therefore not liable under Rule 10b-5(b).[9] But how the Supreme Court arrived at this conclusion may well be a result of "bad facts" (in this case egregious underlying conduct) resulting in an expansive view of the law. As the Court itself stated, Lorenzo's conduct was "plainly fraudulent."[10]

THE BACKGROUND

The history of the *Lorenzo* decision is fairly straightforward, but ends with a political plot twist that led many to expect a rare 4-4 tie at the Supreme Court.

The Commission's case addressed conduct by Francis "Frank" V. Lorenzo in 2009, when Lorenzo worked as the director of investment banking at a New York broker-dealer.[11] Lorenzo himself described his firm as a "small boiler room" where brokers used "high pressure sales" tactics and were known by some to "stretch[] the truth" with customers.[12] Lorenzo's only client at the time was a start-up energy entity, Waste2Energy Holdings, Inc. ("W2E") that purported to be developing technology to generate electricity from solid waste.[13] In order to finance its operations, W2E was offering up to $15 million in convertible debentures, which are general, unsecured debt obligations of the issuer.[14]

Lorenzo conceded to the SEC during its investigation that he knew W2E's purported technology "didn't really work."[15] Lorenzo further acknowledged that by early October, he knew that W2E's "intellectual property was worthless" and that it had total assets worth less than $400,000.[16] Despite this knowledge, Lorenzo continued to seek investors for the debentures – for which he would receive commissions of between 7 to 9 percent.[17]

On October 14, 2009, Lorenzo sent two emails describing the debenture offering to prospective investors he was soliciting.[18] Lorenzo's argument, which the Supreme Court accepted for review, was that these two emails were "sent at

the direction of [Lorenzo's] boss, who supplied the content and 'approved' the messages."[19] The emails falsely represented to prospective investors that the W2E investment had "'3 layers of protection,' including $10 million in 'confirmed assets.'"[20] Despite conceding that he knew the information regarding $10 million in assets was false, Lorenzo sent the emails under his own name, listed his title as "Vice President—Investment Banking," and "invited recipients to 'call with any questions.'"[21]

In 2013 the Commission instituted proceedings against Lorenzo not in federal court, but before the agency's in-house administrative tribunal.[22] The Commission charged Lorenzo with violations of Section 10(b) and Rule 10b-5 of the Exchange Act, along with Section 17(a)(1) of the Securities Act.[23] In her December 2013 order, the administrative law judge found that Lorenzo had violated the antifraud provisions as charged, holding that he "knew the truth about W2E's parlous financial condition" when he sent the two emails, which the administrative law judge found to be "staggering" in their "falsity."[24] The administrative law judge ordered Lorenzo to cease and desist from future violations, imposed a $15,000 civil penalty, and permanently barred Lorenzo from working in the securities industry.[25]

Lorenzo first appealed the administrative law judge's order to the full Commission, which in April of 2015 sustained the administrative law judge's order in its entirety.[26] Lorenzo thereafter appealed the Commission's order against him to the D.C. Circuit Court of Appeals, arguing that that he could not be liable for violating Rule 10b-5(b) because he was not, under *Janus*, the "maker" of the false statements.[27] The D.C. Circuit agreed with Lorenzo, holding that Lorenzo's boss – who "asked Lorenzo to send the emails, supplied the central content, and approved the messages for distribution" – was the individual with "ultimate authority" over the false statements.[28] Hence, Lorenzo was not the "maker" under *Janus*, and the D.C. Circuit reversed the Commission.[29]

Lorenzo also argued to the D.C. Circuit that because he was not the "maker" of the false statements at issue, his mere re-broadcast, or cutting-and-pasting, of his boss's statements, could not, per *Janus*, make him liable under Rule 10b-5 subsections (a) or (c) either. The D.C. Circuit held that even though Lorenzo "was not the 'maker' of the false statements," he still "'engaged' in a fraudulent 'act' and 'employed' a fraudulent 'device' when, with knowledge of the statements' falsity and an intent to deceive, he sent the statements to potential investors carrying his stamp of approval as investment banking director."[30]

The D.C. Circuit's holding on this point though was not unanimous. The dissenting judge lambasted the SEC's decision as a "debacle" that utilized "alternative facts," and that required a "wafer-thin semantic distinction" to be supportable.[31] As for the dissenter's colleagues in the majority who affirmed the SEC's decision, he equated their holding with "legal jujitsu."[32] The dissenter also sided with the majority of the courts of appeal on record in concluding that "scheme liability must be based on conduct that goes beyond a defendant's role in preparing mere misstatements … made by others."[33]

The dissenting judge thought was not long for the D.C. Circuit. By the time the case made its way to the U.S. Supreme Court, the former dissenting judge had become Justice Brett Kavanaugh. His role in the D.C. Circuit decision, however, meant that he would not be participating in the Supreme Court's review of the *Lorenzo* appeal, leading many to question whether the circuit split would remain a circuit split following a rare 4-4 tie at the Supreme Court.[34]

THE ISSUE

Lorenzo sought review only as to "whether a misstatement claim that does not meet the elements set forth in *Janus* can be repackaged and pursued as a fraudulent scheme claim."[35] In contrast to Lorenzo's casting of the case as one of repackaging a failed *Janus* false statements claim as a scheme liability claim, the SEC framed the case as whether one "who knowingly disseminates false or misleading statements" can be found to have violated the scheme liability provisions of the securities laws.[36]

THE HOLDING

Despite many predictions of a 4-4 tie, a 6-2 majority of the Supreme Court affirmed the D.C. Circuit, relying in part on what it viewed as the common meaning of "device," "scheme, "and artifice to defraud" and in part on what it viewed as egregious, "plainly fraudulent" conduct.[37] The Supreme Court held that by "sending emails he understood to contain material untruths," Lorenzo violated the scheme liability provisions of Rule 10b-5 subsections (a) and (c).[38]

Given the Supreme Court's starting point – which Lorenzo did not contest on appeal – that he had acted with "'an intent to deceive, manipulate, or defraud,'" it seems far from surprising that the Court adopted the SEC's view of the law.[39] The majority in *Lorenzo* was not shy in voicing its disdain for Lorenzo's actions, finding "nothing borderline about this case, where [Lorenzo] disseminat[ed] false and misleading information to prospective investors with the intent to defraud."[40]

The majority's decision also announced a shift from the narrow, limiting approach of *Janus* and a return to the SEC's broad view that the subsections of Rule 10b-5 are not mutually exclusive, and instead have "considerable overlap" and at times "prohibit some of the same conduct."[41] The majority dismissed any concerns about the role of aiding-and-abetting versus primary liability, reasoning that it is far from unusual for conduct to be charged both as a primary violation of one rule or statute and as aiding-and-abetting another.[42]

THE DISSENT

The dissent, authored by Justice Thomas and joined by Justice Gorsuch, conceptualized both the facts and the law quite differently. As opposed to the majority's description of Lorenzo as a "knowing disseminator," the dissent viewed Lorenzo as one whose conduct was of an "essentially administrative nature," having "cut and pasted" email content belonging to his boss.[43]

Legally, the dissent found the majority's expansive interpretation of Rule 10b-5(a) and (c) would render the specific language of Rule 10b-5(b) "entirely superfluous" – essentially asking that if disseminating a misstatement is a fraudulent scheme under 10b-5(a) and (c), why would there need to be a separate provision for false statements liability in Rule 10b-5(b) at all?[44] Moreover, if Rule 10b-5(b) is not distinct in its purpose, then in the dissenters' view the Court's holding in *Janus* would become a "dead letter."[45] The dissent also found the majority's holding unnecessary in light of the availability to the SEC of aiding-and-abetting liability.[46]

The Take-Aways

AN EMBOLDENED SEC ENFORCEMENT PROGRAM

Beyond being a significant victory in its own right, *Lorenzo* was something of a return to form for an agency that had suffered numerous Supreme Court losses of late. Recent key Supreme Court decisions had called into question the viability of the SEC's administrative forum,[47] imposed previously unapplied statutes of limitations on both civil penalties[48] and disgorgement,[49] and significantly restricted the agency's definition of a "whistleblower."[50]

The *Janus* decision, though, and its narrowing of the scope of the SEC's primary antifraud rule may have had the most significant impact on the SEC's enforcement program – restricting the universe of potential defendants and leading the SEC to more reflexively bring aiding-and-abetting charges. But *Lorenzo*'s broad, almost prudential reading of the securities laws and its allusion to *Capital Gains*' concern with "achiev[ing] a high standard of business ethics in the securities industry" may well lead to an SEC that is far more willing to aggressively push the margins of the securities laws through its enforcement program.[51] *Lorenzo* is unlikely to result in the wholesale filing of what would previously have been unsupported SEC enforcement actions, but it is likely to lead to the SEC bringing new counts charging primary liability, especially under Rules 10b-5(a) and (c), which have rarely been used on a stand-alone basis in the past.

These additional primary antifraud violations could result in the SEC obtaining even more significant sanctions against future defendants.

MORE PENALTIES, MORE BARS, FEWER WAIVERS

The SEC's sanctions toolbox typically consists of injunctions (for federal court actions) and cease-and-desist orders (for administrative proceedings), penalties, disgorgement, and conduct-based sanctions barring individuals from the securities industry (as with Lorenzo) or from serving as officers or directors of public companies.[52]

The SEC's statutory authority to impose civil penalties contains a dizzying number of provisions that are far from consistently implemented, with penalty amounts varying based on the degree of intent, investor losses, and the gross number of violations committed.[53] Primary antifraud violations under Rule 10b-5 quite often result in penalties being imposed at the highest level, while aiding-and-abetting violations relating to the identical misconduct may lead to a lesser penalty. To the extent that the SEC now may charge conduct as a primary violation of 10b-5(a) and (c), rather than as aiding-and-abetting a 10b-5(b) violation, the new primary charge may well result in higher penalties even though the underlying fraudulent conduct is the same.

Furthermore, in determining whether to impose securities industry or officer-and-director bars, courts frequently reference a list of judge-made factors.[54] Though the factors for the differing bars are not identical, they overlap with respect to the egregiousness of the underlying conduct, the scienter involved, and the likelihood of similar misconduct in the future.[55] As the Supreme Court's holding in *Lorenzo* makes it more likely that a defendant will be charged with primary liability, the needle will move with respect to evaluating egregiousness, scienter, and the number of violations involved. Hence, the burden upon the SEC to justify the imposition of a securities industry or officer-and-director bar will correspondingly move in its favor following *Lorenzo*.

Beyond the sanctions that the SEC affirmatively seeks in enforcement actions, there are a host of automatic disqualifications that can result from a person or entity having been found to have violated the antifraud provisions of the federal securities laws. These disqualifications typically relate to the ability to use streamlined securities offerings procedures, to employ safe harbors for forward looking statements, or to act as an investment adviser or investment company.[56] Although the distinction between primary and aiding-and-abetting violations may not be as relevant to the triggering of these disqualifications, the process to seek a waiver from the impact of these disqualifications often turns on an evaluation of the egregiousness of the underlying misconduct. As with civil penalties and bars, an increase in the total number of violations, or a primary violation being charged as opposed to just an aiding-and-abetting violation, can only make it more difficult to obtain waivers from disqualification in these sorts of circumstances in the future.

PRIVATE SECURITIES CLASS ACTIONS

The *Lorenzo* decision could also impact private securities class actions by encouraging shareholders to bring claims against a broader range of actors who did not "make" false statements, but allegedly disseminated those statements. The Court previously has held that private securities litigants cannot bring Rule 10b-5 claims against secondary actors who aid and abet a primary actor[57] or against secondary actors upon whom investors do not primarily rely under a scheme liability theory.[58] As then-Judge Kavanaugh observed in his *Lorenzo* dissent, there is a "distinction between primary and secondary liability matters, particularly for private securities lawsuits," and the Court previously "pushed back hard against" attempts to erase that distinction.[59]

Although *Lorenzo* may encourage plaintiffs to bring claims that test the line between primary and secondary liability, and to pursue claims against individual defendants not previously named in securities class actions, the implications of the case should be limited by its facts. Lorenzo intentionally sent emails to prospective investors despite knowing that the information contained in them was false.[60] The Court's observation that this was not a "borderline" case of securities

fraud stands in stark contrast to most private securities class actions, where the issues of falsity and scienter are frequently unclear and challenged at the motion to dismiss stage.[61] The Court also noted that "one can readily imagine other actors tangentially involved in dissemination — say, a mailroom clerk — for whom liability would typically be inappropriate."[62] As a result, there are grounds for arguing that *Lorenzo* does not reach actors who, unlike Lorenzo, are further removed from the fraudulent conduct or did not act with the requisite scienter. And *Lorenzo* does not affect the various hurdles the Private Securities Litigation Reform Act imposes on private Section 10(b) class action claims, including the requirements that plaintiffs plead a strong inference of scienter and state their falsity claims with particularity.

FINAL THOUGHTS

An emboldened SEC with greater sanctions potentially at its disposal and an opportunity for private plaintiffs to more aggressively pursue their claims directly impacts the risk to financial services firms and public market issuers. *Lorenzo* only serves to increase the need for experienced, measured, and thoughtful responses to SEC investigative demands and private securities class actions.

[1] *Lorenzo v. SEC*, 587 U.S. ___, 2019 WL 1369839 (Mar. 27, 2019).
[2] *See, e.g., SEC v. Kelly*, 817 F.Supp.2d 340, 343-44 (S.D.N.Y. 2011).
[3] 564 U.S. 135 (2011).
[4] *Id.*, at 142.
[5] 15 U.S.C. § 77q (Securities Act Section 17(a) makes it unlawful, in the offer or sale of a security: "(1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission 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 (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser").
[6] *See, e.g., SEC v. Strebinger*, 114 F.Supp.3d 1321, 1330-31 (N.D. Ga. 2015) (explaining that *Janus* only applies to Rule 10b-5(b) and that "*Janus* did not alter the potential for liability under Rule 10b-5(a) and (c)" (internal citations omitted); *SEC v. Benger*, 931

F.Supp.2d 904, 906 (N.D. Ill. 2013) ("[T]he vast majority of courts dealing with the question of whether Janus also applies to claims under Section 17 have answered that question with a resounding 'no.'").
[7] *See*, *e.g.*, *SEC v. Familant*, 910 F.Supp.2d 83, 93 (D.D.C. 2012) ("At least three circuit courts have held that 'scheme liability' is viable only if Rule 10b–5(b) cannot fully cover the deceptive acts – that is, the 'scheme' must include deceptions beyond misrepresentations and omissions.").
[8] *Lorenzo v. SEC*, 872 F.3d 578, 595 (D.C. Cir. 2017).
[9] *Lorenzo*, 2019 WL 1369839 at *4.
[10] *Id.*, at *6.
[11] *Id.*, at *3; Brief for Petitioner, *Lorenzo v. SEC*, No. 17-1077 (U.S. Aug. 20, 2018), p. 8.
[12] Joint Appendix, *Lorenzo v. SEC*, 17-1077 (U.S. Aug. 20, 2018), pp. 301, 352.
[13] *Lorenzo*, 872 F.3d at 581.
[14] *Id.*; *Lorenzo*, 2019 WL 1369839 at *3.
[15] *Joint Appendix*, at pp. 192, 197-98.
[16] *Lorenzo*, 2019 WL 1369839 at *3.
[17] *Joint Appendix*, at p. 277.
[18] *Lorenzo*, 2019 WL 1369839 at *3.
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] *Id.* Lorenzo did not raise on appeal any of the issues addressed by the Supreme Court in its *Lucia v. SEC*, 138 S.Ct. 2044 (2018) decision concerning the constitutionality of the SEC's administrative law judges.
[23] *In the matter of Gregg C. Lorenzo, et al.*, SEC Release No. 9385, Order Instituting Proceedings (Feb. 15, 2013).
[24] *In the matter of Gregg C. Lorenzo, et al.*, SEC AP File No. 3-15211, Initial Decision, J. Foleak (Dec. 31, 2013), pp. 6, 9.
[25] *Id.*, at 12.
[26] *In the matter of Francis V. Lorenzo*, SEC Release No. 9762, Comm. Op. (Apr. 29, 2015).
[27] *Lorenzo*, 2019 WL 1369839 at *3–4.
[28] *Id.*
[29] *Id.*
[30] *Lorenzo*, 872 F.3d at 595.
[31] *Id.*, at 598, 599, 600 n.2.
[32] *Id.*, at 598, 599, 601.
[33] *Id.*, at 600 ("The majority opinion creates a circuit split by holding that mere misstatements, standing alone, may constitute the basis for so-called scheme liability under the securities laws – that is, willful participation in a scheme to defraud – even if the defendant did not make the misstatements. No other court of appeals has adopted the approach that the majority opinion adopts here. Other courts have instead concluded that scheme liability must be based on conduct that goes beyond a defendant's role in preparing mere misstatements or omissions made by others.").
[34] *See*, *e.g.*, Yahoo! Finance, *Kavanaugh's Recusal in Securities Fraud Case Could be Good News for the SEC* (Dec. 4, 2018) (available at finance.yahoo.com/news/kavanaughs-recusal-securities-fraud-case-good-news-sec-155737417.html) ("If the case ties, as [Professor John Coffee] suspects it will, then a lower court ruling that was largely in favor of the SEC will stand — bucking a current trend in the Supreme Court of cutting back on securities litigation.").
[35] Petition for Writ of Certiorari, *Lorenzo v. SEC*, (U.S. Jan. 26, 2018), p. i.
[36] Brief for the Respondent in Opposition, *Lorenzo v. SEC*, (U.S. May 2, 2018), p. I.
[37] *Lorenzo*, 2019 WL 1369839 at *4, *6.
[38] *Id.*, at *4.
[39] *Lorenzo*, 2019 WL 1369839 at *4 (*quoting Aaron v. SEC*, 446 U.S. 680, 686 n.5 (1980)).
[40] *Lorenzo*, 2019 WL 1369839 at *5.
[41] *Id.*, at *5 (*quoting Herman & MacLean v. Huddleston*, 459 U.S. 375, 383 (1983)).

[42] *Id.*, at *7.
[43] *Id.*, at *7, *9, and *10.
[44] *Id.*, at *11.
[45] *Id.*, at *12.
[46] *Id.*
[47] *Lucia, et al. v. SEC*, 138 S.Ct. 2044 (2018).
[48] *Gabelli v. SEC*, 568 U.S. 442 (2013).
[49] *Kokesh v. SEC*, 137 S.Ct. 1635 (2017)
[50] *Digital Realty Trust, Inc. v. Somers*, 138 S.Ct. 767 (2018).
[51] *Lorenzo*, 2019 WL 1369839 at*9 (*quoting SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)).
[52] *See*, *e.g.*, Steven Peikin, *Remedies and Relief in SEC Enforcement Actions*, Speech before the Practicing Law Institute (Oct. 3, 2018) (available online at: www.sec.gov/news/speech/speech-peikin-100318).
[53] *See* 15 U.S. Code § 77t (Securities Act Section 20, providing for civil penalties and identifying different tiers of penalties based on underlying conduct); 15 U.S.C. § 78u (Exchange Act Section 21, providing for civil penalties and identifying different tiers of penalties based on underlying conduct).
[54] *See*, *e.g.*, *Lowry v. SEC*, 340 F.3d 501, 504-05 (8th Cir. 2003) (listing factors to evaluate securities industry bars); *SEC v. Patel*, 61 F.3d 137, 140-42 (2d Cir. 1995) (listing factors to evaluate officer-and-director bars).
[55] *Id.*
[56] *See*, *e.g.*, 15 U.S.C. § 77z–2 (Private Securities Litigation Reform Act, defining eligibility for safe harbor for forward looking statements); 15 U.S.C. § 80a-9 (Section 9(a) of the Investment Company Act of 1940, defining ineligible statuses); 17 C.F.R. § 230.405 (Securities Act Rule 405, defining well-known seasoned issuer); 17 C.F.R. § 230.506 (Securities Act Rule 506(d), defining "Bad Actor" disqualification); and 17 C.F.R. § 230.602 (Securities Act Rule 602, defining ineligible issuers).
[57] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).
[58] *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).
[59] *Lorenzo*, 872 F.3d at 601 (Kavanaugh, J., dissenting) (*citing Central Bank* and *Stoneridge*).
[60] *Lorenzo*, 2019 WL 1369839 at *3–4.
[61] *Id.*, at *5.
[62] *Id.*