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Supreme Court Expands Scope of Liability for Securities Fraud

On March 27, 2019, the U.S. Supreme Court issued a 6-2 decision in *Lorenzo v. SEC* holding that an individual who is not a “maker” of a misstatement under *Janus v. First Derivative Traders*, 564 U.S. 135 (2011) can nonetheless be held primarily liable under Section 10(b) of the Exchange Act and Rules 10b-5(a) and (c) thereunder for knowingly “disseminating” a misstatement made by another person. As we previewed in our [Alert following oral argument in *Lorenzo*](#), the Court’s decision potentially expands the ability of private plaintiffs to bring Section 10(b) claims against those who knowingly or recklessly transmit false and misleading statements that were made by someone else, and could meaningfully erode the limits on primary liability under Section 10(b) established by the Court in *Janus* and *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

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Background

SEC Rule 10(b) implements Section 10(b) of the Securities Exchange Act of 1934, and contains three subsections prohibiting fraudulent conduct in connection with the purchase or sale of securities. Rule 10b-5(a) makes it unlawful to “employ any device, scheme, or artifice to defraud”; Rule 10b-5(b) makes it unlawful to “make any untrue statement of a material fact”; and Rule 10b-5(c) prohibits engaging in “any act, practice, or course of business” that “operates . . . as a fraud or deceit.” Claims asserted under Rule 10b-5(b) are often referred to as addressing “misstatement liability,” while claims asserted under Rules 10b-5(a) and (c) are referenced as addressing “scheme liability.”

In *Janus*, the Court considered the scope of Rule 10b-5(b), and ruled in a 5-4 decision that “misstatement liability” under Rule 10b-5(b) only extends to the “maker of a statement,” which the Court held is “the person or entity with ultimate authority over the statement.”¹

In *Lorenzo*, the SEC charged Francis Lorenzo, the director of investment banking at a brokerage firm, with violating Rule 10b-5 by sending two false and misleading emails to potential investors.² However, Lorenzo argued (and the Court accepted as true for purposes of the appeal) that he had merely copied and pasted the false and misleading statements from an email that his supervisor sent him. Nevertheless, an ALJ concluded that Lorenzo acted with fraudulent intent and that his conduct violated Rules 10b-5(a), (b) and (c) of the Exchange Act.³ In a split decision, the D.C. Circuit affirmed the ALJ’s ruling on a “scheme liability” theory, finding that even though Lorenzo did not “make” the misstatements under *Janus* and thus could not be held liable under Rule 10b-5(b), he still violated Rules 10b-5(a) and (c) for his intentionally fraudulent “use” of the misstatements.⁴

On March 27, 2019, the Supreme Court affirmed in a 6-2 decision, ruling that “dissemination of false or misleading statements with intent to defraud” constitutes a violation of subsections (a) and (c) of Rule 10b-5, “even if the disseminator did not ‘make’ the statements.”⁵ The Court reasoned that subsections (a) and (c) “capture a wide range of conduct,” and that it was “obvious” that the language is “sufficiently broad” to “prohibit the dissemination of false and misleading information,” which would include Lorenzo’s emails. As such, the Court concluded that both subsections can cover actors who disseminate misstatements that, under *Janus*, are “made” by someone else.

In so ruling, the Court rejected Lorenzo’s argument that each of the subsections of Rule 10b-5 “should be read as governing different, mutually exclusive spheres of conduct,” and that one can only be liable for a misstatement under provisions that

¹ 564 U.S. at 142.

² See Case No. 17-1077, 2019 WL 1369839 (U.S. Mar. 27, 2019).

³ *Francis V. Lorenzo*, SEC Release No. 9762, 111 SEC Docket 1761, 2015 WL 1927763 (Apr. 29, 2015).

⁴ *Lorenzo v. SEC*, 872 F.3d 578, 586 (D.C. Cir. 2017).

⁵ *Lorenzo*, 2019 WL 1369839, at *4.

“refer specifically to false statements.” Rather, the Court reasoned that there is “considerable overlap among the subsections,” and that Rule 10b-5 is best read as “includ[ing] both a general proscription against fraudulent . . . practices and, out of an abundance of caution, a specific proscription against nondisclosure.” Because Lorenzo, who did not challenge the appeals court’s finding of intent, knew that his emails contained material misstatements and sent them with the “intent to deceive, manipulate, or defraud” investors, the Court concluded that there was “nothing borderline about this case.”⁶

Implications

While the Court’s decision appeared to view Lorenzo’s conduct as an example of the core, intentionally fraudulent conduct that Congress and the Commission sought to prohibit in the securities laws and regulations, the decision offered little guidance on the scope and limitations of liability for “disseminating” false and misleading statements. On one end, the Court acknowledged that Rule 10b-5 liability would “typically be inappropriate” for actors “tangentially involved in disseminating” a false statement, such as “a mailroom clerk.” On the other, Lorenzo, who did not challenge the appeals court’s finding of fraudulent intent, and who “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,” was a “paradigmatic example” of an individual who should be held liable for securities fraud. According to the majority, going forward, “purpose, precedent, and circumstance” will clarify the scope of liability between those two extreme scenarios.⁷

Lorenzo also raises the question of what remains of the Court’s holding in *Janus* that liability for a misstatement under Rule 10b-5(b) extends only to the “maker” of a statement, *i.e.*, “the person or entity with ultimate authority over the statement.”⁸ In response to the dissent’s claim that the *Lorenzo* decision renders *Janus* a “dead letter,” the majority insisted that *Janus* will still preclude liability where a defendant “neither makes nor disseminates false information”—for instance, where the defendant merely helps draft misstatements “issued by a different entity that controlled the statements’ content.”⁹

Finally, *Lorenzo* potentially blurs the line between primary liability and secondary (*i.e.* aiding and abetting) liability under Section 10(b). While Section 20(e) of the Exchange Act authorizes the Commission to assert claims for aiding and abetting against those who “knowingly or recklessly provid[e] substantial assistance to another person” in violation of Rule 10b-5, the Supreme Court’s prior decision in *Central Bank* held that private actions under Rule 10b-5 cannot be premised on conceptions of secondary liability.¹⁰ It remains to be seen what, if any, distinction exists between intentional dissemination of a false and misleading statement made by someone else, which the *Lorenzo* decision held can be subject to primary liability under Section 10(b), and knowingly providing “substantial assistance” to the maker of a false and misleading statement, which only triggers secondary liability under Section 20(e). To the extent the two overlap, the *Lorenzo* decision could significantly expand the scope of potential Section 10(b) defendants in private litigation to include those who are better characterized as aiders and abettors.

While this decision expands upon the holding in *Janus*, we do not believe it is surprising that the Supreme Court believes that the SEC is able to bring a case against an individual that knowingly disseminates a fraudulent statement in connection with a securities transaction. In *Janus*, the Court found that an investment adviser that did not control the final content of statements in prospectuses distributed by a third party-client was not the “maker” of the statements, and therefore was not liable under 10b-5(b). In our view, these two cases represent the guardrails, and the battleground over the next few years will be defining just how far *Lorenzo* expands Rule 10b-5 liability. What amount of control over a fraudulent statement is enough, and what level of involvement in distribution is required—these are the questions that the courts will need to address. The SEC will undoubtedly continue to believe that anyone who comes close on either front should be subject to close scrutiny, but courts in civil class actions have generally shown more willingness to draw the lines that will be relevant going forward.

⁶ *Id.* at *4–6.

⁷ *Id.*

⁸ 564 U.S. at 142.

⁹ 2019 WL 1369839, at *6.

¹⁰ *See* 511 U.S. 164, 177 (1994).