Bloomberg BNA

Securities Regulation & Law Report™

SEC ENFORCEMENT

Securities Fraud Enforcement (Without the Fraud): The Rise of Negligent Securities Fraud Under §§ 17(a)(2) and (3) of the 1933 Securities Act



BY ASHEESH GOEL, NICHOLAS M. BERG, AND TIMOTHY FARRELL

Section 10(b) of the Securities Exchange Act of 1934 and corresponding Rule 10b-5 are widely considered to be among the SEC's foremost tools in policing securities fraud. Yet in a number of recent high-profile enforcement actions, the SEC has declined to charge violations of Section 10(b), relying instead on the negligence standard of Sections 17(a)(2) and (3) of the Securities Act of 1933 to pursue securities ''fraud'' claims against financial institutions and professionals.

Asheesh Goel is a securities enforcement partner resident in the Chicago and Washington, D.C. offices of Ropes & Gray LLP. Asheesh focuses on securities enforcement matters, including internal investigations, government investigations and enforcement actions. Over his career, Asheesh has developed substantial depth advising clients on the U.S. Foreign Corrupt Practices Act, the U.K. Bribery Act, and related anti-corruption laws, financial statement and disclosure issues, insider trading, auditor issues, and industry matters. Nicholas Berg and Timothy Farrell are associates in the Chicago office of Ropes & Gray LLP. Both Nick and Tim focus on securities enforcement matters.

The most significant aspect of this developing trend is that under Sections 17(a)(2) and (3), the SEC may pursue securities enforcement actions based solely on negligence, whereas Section 10(b) requires the SEC to plead and prove scienter. And unlike Rule Section 10(b), misstatement claims under Section 17(a)(2) may be viable even where the defendant merely participated in preparing the statements. These hazards, along with the SEC's recent movement toward increasingly harsh penalties for violations of Sections 17(a)(2) and (3), present daunting problems for entities and professionals faced with SEC enforcement actions.

Negligent Securities Fraud

Congress enacted the Securities Act of 1933 to protect investors from fraud in the offer or sale of securities. Section 17(a)(2) establishes ''misstatement liability,'' making it unlawful to obtain money or property by means of any untrue statement or omission of a material fact. Section 17(a)(3) articulates a form of ''scheme liability'' by prohibiting transactions, practices, or a course of business that operate as a fraud or deceit upon the purchaser.[1]

As a preliminary matter, Section 17(a) is limited in two important respects. First, only the SEC can bring an action under Section 17(a), whereas Section 10(b) provides private litigants a right of action. Second, violations of Section 17(a) are chargeable only where there is fraud in the *offer* or *sale* of a security. Section 10(b), however, applies to fraudulent conduct in connection with *any* securities transaction, whether it is the offer, sale, or purchase of a security.[2] Consequently, 17(a) is chargeable where an entity or its employees commit wrongdoing in the issuance or promotion of securities through an IPO or other offering, for example, but is not in play where the misconduct alleged does not relate to an offer or sale.

On the other hand, where Section 17(a) *is* available, it provides the SEC an advantage not afforded by Section 10(b). While the language of Sections 17(a)(2) and (3) resembles provisions in Section 10(b) and Rule 10b-5, subtle textual differences led the Supreme Court to conclude that Congress imposed a scienter requirement upon Section 10(b) and Section 17(a)(1) but not on Sections 17(a)(2) and (3).[3]

In short, to bring securities fraud claims under Sections 17(a)(2) and (3), the SEC need only allege that a defendant was negligent, not that the defendants acted with scienter, *i.e.*, the defendant knew that his statement was misleading. This lower mental state means that the SEC can—*and does*—bring enforcement actions in the most difficult cases where the available facts are insufficient to allege scienter. Indeed, under Sections 17(a)(2) and (3), the SEC may aver that the defendant *should have known* that his statement was misleading or that a certain act operated as a deceit upon a purchaser.[4]

This ability to bring securities ''fraud'' charges based simply on allegations that a defendant should have known his acts would be deceptive represents a markedly lighter burden than the scienter requirement of Section 10(b) and Rule 10b-5, under which the SEC must produce evidence demonstrating ''a mental state embracing intent to deceive, manipulate, or defraud.''[5]

Trends in Enforcement of Negligent Securities Fraud

In traditional scienter-based enforcement actions, the SEC routinely charges violations of Section 10(b) and the entirety of section 17(a)—*i.e.*, 17(a)(1)-(3).[6] However, the SEC has recently filed a number of complaints charging only negligent securities fraud under Sections 17(a)(2) and (3).

For instance, in June the SEC settled Sections 17(a)(2) and (3) negligent disclosure claims against J.P. Morgan Securities, but is moving forward with identical claims against Edward Steffelin, the third-party investment advisor who assisted J.P. Morgan in preparing its offering materials. For its part, J.P. Morgan agreed to pay $153.6 million in disgorgement and penalties and to institute comprehensive remedial measures related to the issuance and delivery of its disclosures, including new audit, training, and legal procedures.[7] Meanwhile, the SEC continues to pursue its negligent securities fraud action against Steffelin, alleging that he ''knew or should have known'' that the offering materials he participated in drafting failed to disclose that the offered securities contained assets selected by a hedge fund with financial interests adverse to those assets.[8]

In a similar case filed in October in the Southern District of New York, the SEC is pursuing negligence-based securities fraud claims against Brian Stoker, a deal structurer employed by Citigroup Global Markets, Inc. (''Citi''). The SEC was nearing settlement of its related claims against Citi until the presiding federal judge, Jed S. Rakoff, rejected the settlement and set both actions for trial.[9] The SEC is currently appealing that decision. As the SEC alleged in its action against Steffelin, the SEC averred that Citi and Stoker ''knew or should have known'' that the offering materials failed to accurately disclose Citi's role in selecting the assets contained in the offered security as well as Citi's short position in those assets.[10]

The Broad Scope of Negligent Securities Fraud

Recent developments in the law suggest that Sections 17(a)(2) and (3) may also reach a broader class of defendants than Section 10(b). The Supreme Court recently held in *Janus Capital Group, Inc. v. First Derivative Traders* (''*Janus*'') that the ''maker'' of a statement for purposes of Section 10(b) must be the person ''with ultimate authority over the statement,'' and that ''[o]ne who prepares or publishes a statement on behalf of another is not its maker.''[11]

Individual defendants—including those mentioned above—are already arguing that *Janus* also applies to ''misstatement liability'' under Section 17(a)(2). At least one court agrees, reasoning that the elements of Section 10(b) and Section 17(a) are ''essentially the same,'' and that liability under Section 17(a)(2) is also limited to the person with ultimate authority over the statement.[12]

Such rulings are great news for defendants like Steffelin and Stoker who arguably had no ultimate author-

[1] 15 U.S.C. § 77q(a)(2)-(3).

[2] *SEC v. Tambone*, 550 F.3d 106, 127-28 (1st Cir. 2008), *relevant portion of opinion reinstated en banc by* 597 F.3d 436, 450 (1st Cir. 2010).

[3] *Aaron v. SEC*, 446 U.S. 680, 695-97 (1980) (noting that §§ 17(a)(2) and (3) focus ''upon the effect of particular conduct on members of the investing public, rather than upon the culpability of the person responsible'').

[4] *See, e.g.*, *SEC v. Steffelin*, No. 11-cv-04204, Doc. No. 1, Complaint at ¶¶ 63, 66, 74, 79, 81, 85 (June, 21, 2011).

[5] *Aaron v. Securities and Exchange Commission*, 446 U.S. at 686 n.5.

[6] *See, e.g.*, *SEC v. Hicks*, 11-cv-11888, Doc. No. 1, Complaint at 13-14 (D. Mass. Oct. 26, 2011).

[7] Litigation Release, Securities & Exchange Commission, No. 22008 (June 21, 2011).

[8] *SEC v. Steffelin*, No. 11-cv-04204, Doc. No. 1, Complaint at ¶¶ 3, 74, 79 (June, 21, 2011).

[9] *SEC v. Citigroup Global Markets, Inc.*, No. 11-cv-07387-JSR, Doc. No. 33, Opinion & Order at 1-3, 15 (Nov. 28, 2011).

[10] *SEC v. Citigroup Global Markets, Inc.*, No. 11-cv-07387-JSR, Doc. No. 1, Complaint at ¶ 1, 2, 40 (Oct. 19, 2011); *SEC v. Stoker*, No. 11-cv-07388, Doc. No. 1, Complaint at ¶ 1, 2, 60, 64 (Oct. 19, 2011).

[11] 131 S. Ct. 2296, 2297-2305 (2011).

[12] *SEC v. Kelly*, 2011 WL 4431161, at *1-5 (S.D.N.Y. Sept. 22, 2011).

   ISSN 0037-0665

ity over the disclosures that they helped prepare.[13] But many courts refuse to extend *Janus* to Section 17(a), stressing the fact that the critical element of Section 10(b) interpreted in *Janus*—the word ''make''—is not even present in Section 17(a). They note that liability is more narrowly construed under Section 10(b) than Section 17(a) because the former provides an implied private right of action whereas the latter does not.[14] Going even further, some courts have imposed liability on defendants under Section 17(a) who played no part *whatsoever* in generating the misstatement, but who merely *made use* of another's statement in a securities offering.[15]

Although uncertainty in the law persists, the prevailing view suggests that under Sections 17(a)(2) and (3), investment advisors, underwriters, and indeed anyone who participates in the preparation of a public statement—or who simply makes use of such a statement—face possible exposure to liability for negligent securities fraud.

SEC Remedies Under Sections 17(a)(2) and (a)(3) Are Substantial

While Sections 17(a)(2) and (a)(3) require the SEC to prove only negligence, the penalties for violations can still be substantial. Currently available remedies under Sections 17(a)(2) and (3) include injunctive relief, disgorgement, and civil monetary penalties.[16]

In one recent case, an executive paid $225,000 and forfeited partnership shares worth $1.1 million to settle charges under Sections 17(a)(2) and (3).[17] In the case mentioned above, J.P. Morgan paid $153.6 million in penalties and disgorgement. Citigroup paid a $75 million penalty in 2010 and was slated to shed another $285 million under the recently rejected consent judgment. Even more alarming for defendants, and as Judge Rakoff pointed out in rejecting the Citi settlement, equitable restitution is available in any government enforcement action. The implication is that restitution of investor losses—a potentially crippling measure of damages—may be an available remedy to the SEC even in negligence actions under Sections 17(a)(2) and (3).[18]

While these recent settlements of negligence claims under Section 17(a) have been significant, the enforcement landscape is likely to become only more punitive. Faced with criticism by Judge Rakoff and other commentators in the wake of the financial crisis that the SEC's penalties are too soft, SEC Chairman Mary Schapiro has requested statutory changes that will authorize the SEC to pursue significantly stiffer penalties. As part of her proposal, the Chairman requested that penalty measures such as ''ill-gotten gains'' be made available in administrative actions as well as actions in federal court.[19] This will allow the SEC to pursue higher dollar value enforcement actions on its own turf, where defendants' discovery rights are limited and the SEC's decisions enjoy even more deference from federal courts.[20]

Conclusion

As the SEC's recent enforcement actions make abundantly clear, firms and professionals can face full-fledged enforcement actions with harsh penalties based merely on the allegation that they acted negligently and ''should have known'' their actions violated the securities laws.

The threat of securities fraud-like charges—without the fraud—along with an uncertain legal terrain and an increasingly punitive enforcement environment, highlight the imperative that financial firms and professionals adopt best practices and maintain the highest standards of vigilance over securities transactions and disclosures in 2012 and beyond.

Because even when Section 10(b) is out of reach, the SEC is increasingly turning to Sections 17(a)(2) and (3) as a tool to meet the public's demand for a tough response to securities law violations, whether those violations are real or perceived.

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[13] *See, e.g.*, *SEC v. Steffelin*, No. 11-cv-04204, Doc. No. 22, Reply Brief at 18-19 (October, 12, 2011).

[14] *SEC v. Daifotis*, 2011 WL 3295139, at *5-6 (N.D. Cal. Aug. 1, 2011); *SEC v. Mercury Interactive, LLC*, Slip Copy, 2011 WL 5871020, *3 (N.D. Cal. Nov. 22, 2011); *Moldonado v. Dominguez*, 137 F.3d 1, 7 (1st Cir. 1998).

[15] *SEC v. Tambone*, 550 F.3d at 127-28.

[16] 15 U.S.C. § 77t.

[17] *SEC v. Kivisto*, 11-cv-641 (N.D. Okla. Oct. 18, 2011); Litigation Release, Securities & Exchange Commission, No. 22129 (Oct. 18, 2011).

[18] *SEC v. Citigroup Global Markets, Inc.*, No. 11-cv-07387-JSR, Doc. No. 33, Opinion & Order at 11-12, n.6 (Nov. 28, 2011).

[19] Letter from SEC Chairman Mary Schapiro to Sen. Jack Reed, Subcomm. on Sec., Ins. & Inv. (Nov. 28, 2011).

[20] Peter J. Henning, *S.E.C. Seeks More Power, but Does It Need It?*, N.Y. Times, Dec. 5, 2011, *available at* http://dealbook.nytimes.com/2011/12/05/s-e-c-seeks-more-power-but-does-it-need-it/.