Hogan Lovells

SEC Update

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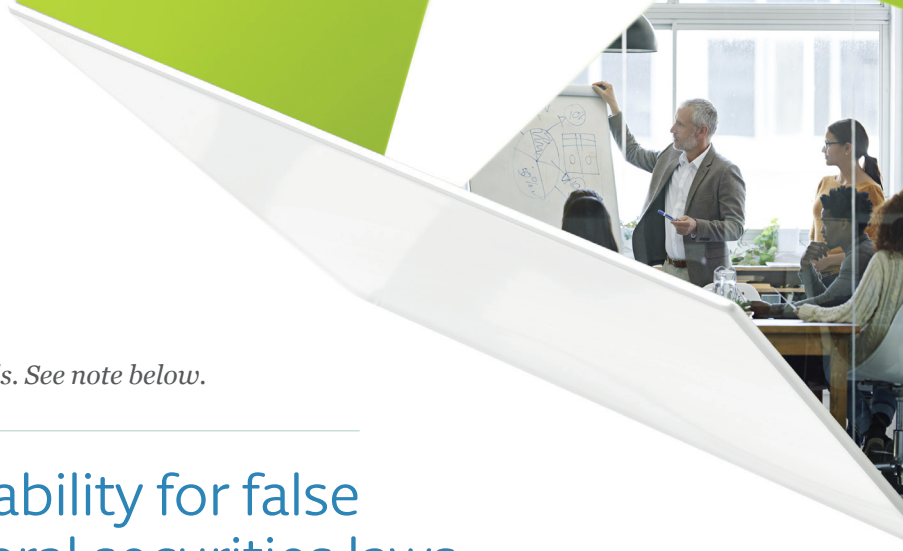

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Supreme Court expands liability for false statements under the federal securities laws

On March 27, the Supreme Court issued its much-anticipated decision addressing whether someone who is not the "maker" of a misstatement can nonetheless be primarily liable for fraud under the federal securities laws, when the misstatement is the only deceptive conduct at issue. *Lorenzo v. SEC*, 2019 WL 1369839 (U.S. Mar. 27, 2019).

The Court held that liability for misstatements is not limited to "makers," instead ruling that those who "disseminate" false or misleading statements can also be primarily liable under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, as well as under Section 17(a)(1) of the Securities Act, the primary antifraud provisions under the federal securities laws. By holding that liability exists for those who "disseminate" false statements, the Supreme Court potentially expanded the reach of the antifraud provisions well beyond the narrow confines of "maker" liability, which the Court had delineated in *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135 (2011).

Background

In 2013, the SEC found that Francis Lorenzo had violated Rule 10b-5, Section 10(b), and Section 17(a)(1) based on e-mails he had sent to potential investors in his capacity as the director of investment banking at an SEC-registered brokerage firm. Specifically, at his boss's direction, Lorenzo e-mailed potential investors to solicit their participation in a debt offering being managed by his firm. Lorenzo's boss composed the content of the e-mails, which Lorenzo "copied-and-pasted" into the messages he sent. The SEC found that Lorenzo's e-mails not only falsely reported that the issuer had "confirmed assets" of over US$10 million, but also that Lorenzo knew at the time he sent the e-mails that the issuer's assets totaled less than US$400,000.

Lorenzo appealed the SEC's decision, both on the basis that he lacked "scienter" (which the Supreme Court has held embraces an intent to deceive, manipulate, or defraud) and that he was not the "maker" of the e-mail statements —since he was acting at his boss's direction—and thus could not be held liable under the federal securities laws consistent with the Supreme Court's *Janus* ruling. On appeal, the U.S. Court of Appeals for the D.C. Circuit rejected Lorenzo's scienter argument but agreed with Lorenzo that he was not the "maker" of the statements as defined in *Janus*. The Circuit Court nonetheless sustained the SEC's action and found that Lorenzo had violated subsections (a) and (c) of Rule 10b-5 and Section 17(a)(1), which largely parallels the language of Rule 10b-5(a).

Supreme Court's decision

Lorenzo appealed the Circuit Court's holding that he could be liable under the foregoing antifraud provisions when the only challenged conduct concerned misstatements. Critically, Lorenzo did not appeal the Circuit Court's ruling on scienter. Thus, in issuing its decision, the Supreme Court could "take for granted that he sent the e-mails with 'intent to deceive, manipulate, or defraud' the recipients." 2019 WL 1369839, at *4.

With scienter thus assumed, the majority had no trouble concluding that Lorenzo could be liable under subsections (a) and (c) of Rule 10b-5, as well as the relevant statutory texts, for the "dissemination of false or misleading statements." *Id.* at *4. The Court reached its conclusion based primarily on its common sense reading of the words used in the rule and the statutes. As the Court observed, it was "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." For example, the Court concluded that the e-mails were a "device," "artifice," and

"scheme" to defraud (prohibited under Rule 10b-5(a)) and that Lorenzo had engaged in an "act," "practice," and "course of business" that operated as a fraud or deceit (prohibited under Rule 10b-5(c)).

The Court rejected Lorenzo's statutory interpretation argument, in which he contended that that each subsection of Rule 10b-5 should be read as mutually exclusive, governing only a non-overlapping sphere of conduct. Thus, in his view, because Rule 10b-5(b) outlaws the "making" of an untrue statement, it was the exclusive means to prosecute frauds premised on false or misleading statements and such frauds could not be addressed under subsections (a) and (c). The majority dismissed this exclusivity argument as inconsistent with the language of the subsections, which the Court found to clearly overlap with each other; with precedent, which recognized the overlapping nature of the provisions; and with the purpose of the securities laws, in which Congress adopted a belt-and-suspenders approach to stamping out fraud, providing that each succeeding provision of the securities laws was "'meant to cover additional kinds of illegalities—not to narrow the reach of the prior sections.'" *Id.* at *5.

The Court had an only slightly more difficult time reconciling its ruling that "disseminators" could be liable under subsections (a) and (c) of Rule 10b-5 with its *Janus* decision, which limited liability under Rule 10b-5(b) to the "makers" of a false or misleading misstatement, whom it defined as the persons "with ultimate authority over the statement, including its content and whether and how to communicate it." *Janus*, 564 U.S. at 142.

Based on *Janus*, Lorenzo made two arguments. First, he contended that a finding of liability for his conduct would render *Janus* a dead letter. But the Court found otherwise, noting that *Janus* addressed only whether liability under Rule 10b-5(b) extended to persons who *drafted* a misstatement as opposed to those who made them; *Janus* said nothing about the liability of those who "disseminate" false information. Thus, the Court found that *Janus* "would remain relevant to (and preclude liability) where an individual neither *makes* nor *disseminates* false information." *Lorenzo*, 2019 WL 1369839, at *6 (emphasis added). The Court failed to explain, however, how anyone subject to liability under Rule 10b-5(b) would not also be liable under subsections (a) and (c), in which event not only would lawsuits under Rule 10b-5(b) be unnecessary, but the limits imposed by Rule 10b-5(b), as found by the Court in *Janus*, would not constrain suits under Section 10(b).

Lorenzo's second argument was that the Court's narrow construction of Rule 10b-5(b) in *Janus* was driven, in part, by its desire to draw a clean line between primary and secondary ("aiding and abetting") liability under Section 10(b), permitting primary liability and prohibiting secondary liability. According to Lorenzo, that line would be blurred beyond recognition if conduct that only qualified as secondary liability under subsection (b) of the rule could be found to constitute primary liability under subsections (a) and (c).

Once again, the Court dismissed Lorenzo's argument, explaining that there is nothing unusual about a person being primarily liable for an offense under one statute and secondarily liable for an offense under another. The Court noted, by way of example, that A might sell an unregistered firearm to B to help him rob a bank, making A primarily liable for the gun sale and secondarily liable for the bank robbery. *Id.* at *7. The Court's analogy, however, goes only so far. As the dissent pointed out, unlike prosecutions under separate statutes, the three subsections of Rule 10b-5 implement only the single provision of Section 10(b). Accordingly, under the Court's reasoning, the same conduct can support either primary or secondary liability under Section 10(b), even though there is a private right of action only for the former and not the latter. *Id.* at *13.

Analysis

What is clear from the Court's *Lorenzo* decision is that the reach of Rule 10b-5 for false or misleading statements extends beyond simply those persons who "make" such statements. What remains uncertain is how broadly Rule 10b-5's net will be cast now that those persons who "disseminate" false or misleading information may also be held liable.

The Court's decision does offer some insights. For example, the Court noted that liability for "actors tangentially involved in dissemination"—such as a "mailroom clerk"—would "typically be inappropriate." *Id.* at *5. But, as the dissent observed, the Court's opinion offers "no legal principle" to distinguish between actors who are too tangentially involved in the dissemination of information and those who are not. *Id.* at *13.

Similarly, the Court's opinion raises questions concerning the possible liability of so-called "speechwriters" and other persons who knowingly supply false information for incorporation into a public statement. Under *Janus*, those persons fall outside the narrow scope of "makers" and thus are not subject to liability under Rule 10b-5(b). Now, however, their potential immunity under Section 10(b) is not so clear.

The Court did note, in distinguishing its holding in *Lorenzo* from its prior Section 10(b) decisions, that "Lorenzo's conduct involved the direct transmission of false statements to prospective investors intended to induce reliance." *Id*. at *7. The Court's reference to reliance harkens back to some of its precedents, in which the Court found that a distinguishing feature of primary liability under Rule 10b-5(b) should be whether investors knew the identity of—and thus could rely upon—the speaker. *Janus*, 564 U.S. at 144. Nonetheless, the Court did not make investors' reliance a criterion for the application of its *Lorenzo* holding.

As is often true with Supreme Court decisions that break new ground, it remains to be seen how the expansion of liability under Section 10(b) to persons who "disseminate" false and misleading information will evolve in the courts. We predict, however, that the plaintiffs' bar will actively press the boundaries of "dissemination" liability to assert claims against corporate insiders and advisors who previously had enjoyed a litigation reprieve under *Janus*. As a consequence, the already high cost of securities litigation will continue apace.

This SEC Update is a summary for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. If you have any questions or would like any additional information regarding this matter, please contact your relationship partner at Hogan Lovells or any of the lawyers listed on the following page of this update.

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