

Can the SEC Eradicate The Distinction Between Primary and Secondary Liability?

“The distinction between primary and secondary liability matters . . . For decades . . . the SEC has tried to erase that distinction. . .” *Lorenzo v. SEC*, 872 F. 3d 578, 601 (D.C. Cir. 2017) (Kavanaugh, Circuit Judge, dissenting).

The Supreme Court will hear a case which may have a significant impact on SEC enforcement and liability in securities class actions. Specifically, the Court will consider the question of whether the agency can circumvent *Janus Capital Group, Inc. v. First Derivate Traders*, 564 U.S. 135 (2011) regarding the requirements for pleading and establishing a claim for false statements and/or material omissions under Section 10(b) and rule 10b-5 thereunder by recasting its claim as one for “scheme” liability. *Lorenzo v. SEC*, No. 17-1077 (*certiorari* granted June 18, 2018). Perhaps more importantly, the case has the potential to blur if not eradicate the distinction between primary and secondary liability, easing the SEC’s burden of proof in some cases. Since the case turns largely on an interpretation of Exchange Act section 10(b) and rule 10b-5 – the predicate for class action liability – it may also impact securities class actions.

Factual background

Frank Lorenzo became a director of investment banking firm Charles Vista, LLC in February 2009. The firm’s largest investment banking client was start-up W2Energy Holdings, Inc. The firm’s business depended largely on the success of certain technology. The technology failed. In September 2009 W2E sought to raise about \$15 million through the sale of convertible debentures to escape financial ruin. Charles Vista was the exclusive placement agency.

Mr. Lorenzo emailed two potential investors “several key point” about W2E’s pending debenture offering. The emails failed to mention the recent devaluation of the firm’s assets. To the contrary, investors were told that there were “3 layers of protection.” One of the messages stated it had been sent at the request of Gregg Lorenzo, the owner of

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the firm (no relation to Respondent).

The Commission issued an Order charging Mr. Lorenzo, Gregg Lorenzo and Charles Vista with fraud in violation of Securities Act Section 17(a)(1) and Exchange Act Section 10(b). The firm and its owner settled.

Respondent Lorenzo proceeding to hearing before an ALJ. The only witness at the hearing was Frank Lorenzo. He testified to sending emails at the behest of his boss by cutting and pasting – he did not write them. The Division did not call the owner of the firm to testify. No other testimony was presented.

The Initial Decision found that that Mr. Lorenzo did not read the text of the emails. It also found that Mr. Lorenzo had sent the emails “without thinking.” Nevertheless, the ALJ concluded that Mr. Lorenzo had acted willfully with the intent to deceive, manipulate, or defraud in violation of each statute. A cease and desist order was entered along with a \$15,000 penalty and a life time bar from the securities business.

The Commission affirmed. In its opinion the agency concluded that Mr. Lorenzo was responsible for the emails and their content. A footnote stated that the agency need not accept the findings of the ALJ.

On a Petition for Review, the D.C. Circuit largely affirmed in a 2-1 decision, although the case was remanded for reconsideration of the sanctions. The majority opinion, written by Circuit Judge Srinivasan and joined by Judge Griffith, began with an extensive review of the statements in the emails. The court concluded that the Commission’s findings that each e-mail was false and misleading, and that Mr. Lorenzo acted with scienter, were supported by substantial evidence.

Nevertheless, the majority concluded that the Commission’s determination had to be remanded because Mr. Lorenzo had not violated Rule 10b-5(b) as charged in view of the Supreme Court’s determination in *Janus Capital Corp., Inc. v. First Derivative Traders*, 564 U.S. 135 (2011). There the Court held that only the “maker” of the statement could be held primarily liable under rule 10b-5(b). In this case “Lorenzo did not ‘make’ the false statements at issue for purposes of rule 10b-5(b) because Lorenzo’s boss, and not Lorenzo himself, retained ‘ultimate authority’ over the statements,” the Court concluded.

Despite this determination the majority went on to hold that Mr. Lorenzo’s conduct violated Section 10(b) and rule 10b-5 because the false statements contravened the other subsections of the rule based on a theory of scheme liability. In reaching this conclusion the Court rejected Respondent’s claim that such a holding would undermined the distinction between primary and secondary liability on which *Janus* is based. Since the penalty determination could have been impacted by the Commission’s incorrect determination on liability however, the sanctions were vacated and the action was remanded to the SEC for further consideration.

Judge Kavanaugh dissented. While the Judge agreed with the determination by the majority on *Janus*, he dissented writing: “The good news is that the majority opinion

vacates the lifetime suspension. The bad news is that the majority opinion – invoking a standard of deference that, as applied here, seems akin to a standard of ‘hold your nose to avoid the stink’—upholds much of the SEC’s decision on liability. I would vacate the SEC’s conclusions as to both sanctions and liability.”

Judge Kavanaugh’s conclusion is based on three key points. First, although the factual findings by the ALJ were very favorable to Mr. Lorenzo, the “legal conclusion [of the ALJ] do not square up.” If Mr. Lorenzo did not draft the emails, did not think about their contents and only sent them at the behest of his boss, he did not act willfully. That means men’s rea is missing. Accordingly, the “administrative law judge’s decision in this case contravenes basic due process” by making findings of violation and imposing sanctions.

Second, the Commission’s decision reflects the error of the ALJ. Noting that the agency recognized this issue, the SEC then did a “Houdini-like move . . . [and] rewrote the administrative law judge’s factual findings to make those factual findings correspond to the legal conclusion that Lorenzo was guilty and deserving of a lifetime suspension.” Thus “the Commission – without hearing any testimony – simply manufactured a new assessment of Lorenzo’s credibility and rewrote the judge’s factual findings. So much for a fair trial,” the dissent concluded.

Finally, in accepting the “alternative facts” of the SEC, the court ignored the key principle that “When the case turns on eyewitness testimony . . . the initial decision should be given considerable weight. Perhaps more importantly, the majority created a circuit split “by holding that mere misstatements, standing alone, may constitute the basis for so-called scheme liability under the securities laws . . . No other court of appeals has adopted the approach” taken here. This is because “the Supreme Court has pushed back hard against the SEC’s attempts to unilaterally rewrite” the law in this manner.

In the end the administrative adjudication “of individual disputes is usually accompanied by deferential review from the Article III Judiciary. That agency-centric process is in some tension with Article III of the Constitution, the Due Process Clause of the Fifth Amendment, and the Seventh Amendment right to a jury trial in civil cases . . . That tension is exacerbated when, as here, the agency political appointees – without hearing from witnesses – disregard an administrative law judge’s factual findings. . . I respectfully dissent.”

The briefs before the Supreme Court

Petitioner presented the question for review as follows: “In *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135 (2011), this Court considered the elements of a fraudulent statement claim and held that only the ‘maker’ of a fraudulent statement may be held liable for that misstatement under Section 10(b) . . . The question presented is whether a misstatement claim that does not meet the elements set forth in *Janus* can be repackaged and pursued as a fraudulent scheme claim.” The answer, according to Petitioner, is no.

Petitioner relied primarily on the fact that the circuit court decision is contrary to *Janus* and on a split among the circuits in urging High Court review. First, Petitioner claimed that Mr. Lorenzo was not a “maker” as defined by *Janus*. This is because under that decision liability for a false statement can only be imposed on “the person or entity with ultimate authority on whether and how to communicate the statements . . .” Stated differently, without control over the publication of the statement, liability does not attach.

Second, the majority of the circuits have held that a claim for making a false statement cannot be repackaged into a scheme and result in Section 10(b) liability. For example, in *Lentell v. Merrill Lynch & Co.*, 396 F. 3d 161, 177 (2nd Cir. 2005) “the Second Circuit held that misstatements alone could not form the basis of fraudulent scheme claims.” The eighth and ninth circuits have reached similar conclusion. See, e.g., *Public Pension Fund Group v. KV Pharmaceutical Co.*, 679 F. 3d 972 (8th Cir. 2012); *Desai v. Deutsche Bank Sec., Ltd.*, 573 F. 3d 931, 939 (9th Cir. 2009).

Finally, while the D.C. Circuit, in accord with the Eleventh Circuit, has reached an opposite conclusion, those decisions are contrary to *Janus*. See, e.g. *SEC v Monterosso*, 756 F. 3d 1326 (11th Cir. 2014). To the contrary, the majority decision by the court below ignores the bright line test for primary liability established by the Court in *Janus*, according to Petitioner.

The Commission opposed granting the writ. First, the agency claimed that the conduct involved here falls “comfortably within” the ordinary understanding of the statutory language for Section 17(a) (1) and Section 10(b). Petitioner, in this regard, fails to present any argument to the contrary.

Second, while the court below found that Mr. Lorenzo was not the “maker” of the statement and did not have “ultimate authority” over its publication, that does not mean he cannot be liable. To the contrary “as the court of appeals explained, a non-maker of a statement can be liable under Section 17(a) (1) and Section 10(b), and subsections (a) and (c) of rule 10b-5 if he carries out a device, scheme, artifice, or act to defraud.”

Third, there is no real circuit split. This is because “none of the decisions petitioner identifies as forming a ‘majority’ position . . . involved the kind of conduct at issue here – knowing dissemination of a false statement directly to investors with intent to induce a financial transaction. And all the cases that petitioner cites were initiated by private plaintiffs rather than by the Commission. That distinction is significant because different statutory and other standards govern private securities-fraud actions” such as the PSLRA. Under that statute allegations of false statements must meet heightened pleading standards. In contrast, some courts have held that those standards do not apply to subsections (a) and (c) of rule 10b-5. Thus the “decisions cited by petitioner . . . rest on a concern that is wholly absent here, because the PSLRA does not apply to cases initiated by the Commission.”

Comment

Lorenzo is significant. It is clear that *Janus* created a bright line for establishing primary

liability under Section 10(b) regarding false statements and material omissions. Equally clear is the fact that to plead a claim for engaging in a fraudulent scheme more than a false statement or omission must be established. Thus, since at least the ruling in *Janus*, courts have typically required that the Commission plead specific facts in addition to those necessary to demonstrate a false statement or a material omission to establish scheme liability. See, e.g., *SEC v. Pentagon Capital Management PLC*, 725 F. 3d 279 (2nd Cir. 2013) (more than false statement about late trading required to prove scheme).

If the same facts were sufficient to support a claim of false statement and material omission under rule 10b-5b as those required for a scheme claim under subsections (a) and (c), the distinction between making a false statement and engaging in a fraudulent scheme would vanish as would any real line between the subsections of rule 10b-5. Such a ruling could expand the scope of primary liability under the statute and rule by, for example, easing the proof burden in false statement cases, while chipping away at the Court's ruling in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) (rejecting a claim that there is liability for aiding and abetting under Section 10(b)). That would move the Commission toward what Judge Kavanaugh called its decades long goal – eliminating the distinction between primary and secondary liability. *Lorenzo* may well represent the end of the SEC's decade's long quest. It may also have a similar impact in securities class actions which the Commission has long viewed as a necessary adjunct to its enforcement actions.