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Practice Update

A Rule Divided? Rule 10b-5's Subsections Do Not Require Separate Conduct to Support Securities Liability

March 29, 2019

The Supreme Court Limits *Janus* and Upholds Securities Liability

On March 27, 2019, the United States Supreme Court issued a significant decision in the securities liability space. Justice Stephen Breyer's opinion in *Lorenzo v. Securities and Exchange Commission* — joined by five of the justices, with two dissenting and Justice Kavanaugh abstaining — held that an investment banker can be held liable for securities fraud for sending a client an email drafted by the banker's supervisor, even though the banker did not have ultimate authority over the content of the misstatements.

In the underlying action, the U.S. Securities and Exchange Commission (SEC) found the investment banker, Francis Lorenzo, liable for violating Rule 10b-5, §10(b) of the Exchange Act, and §17(a)(1) of the Securities Act. Lorenzo sought an appeal before the D.C. Circuit Court of Appeals, relying primarily on *Janus Capital Group, Inc. v. First Derivative Traders*, in which the Supreme Court held that Rule 10b-5(b)'s prohibition against making any untrue statement of material fact applies to the maker of the statement, specifically, "the person or entity with ultimate authority over the statement, including its content

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and whether and how to communicate it." 564 U.S. 135, 142 (2011). Lorenzo argued that he could not be liable under Rule 10b-5(b) because he was not the "maker" of the statement. The D.C. Circuit agreed, yet found Lorenzo liable under Rule 10b-5(a) and (c), which proscribe "employ[ing] any device, scheme, or artifice to defraud," and "engag[ing] in any act, practice, or course of business which operates . . . as a fraud or deceit."

The issue before the Supreme Court was:

> . . . whether someone who was not a "maker" of a misstatement under *Janus* can nevertheless be found to have violated the other subsections of Rule 10b-5 and related provisions of securities laws, when the only conduct involved concerns a misstatement.

The question was answered in the affirmative.

The Court considered the fact that Lorenzo did not challenge the Court of Appeal's scienter finding: Lorenzo knew that the emails he sent contained "material untruths." Even so, Lorenzo argued that because he was not liable under Rule 10b-5(b), given that he was not the "maker" of the false statement, that same conduct could not subject him to liability under Sections (a) and (c) because different and mutually exclusive spheres of conduct were required for each of Rule 10b-5's subsections.

The Court rejected Lorenzo's theory:

> Lorenzo's view that subsection (b), the making-false-statements provision, *exclusively* regulates conduct involving false or misleading statements would mean those who disseminate false statements with the intent to cheat investors might escape liability under the Rule altogether. But using false representations to induce the purchase of securities would seem a paradigmatic example of securities fraud. We do not know

> why Congress or the Commission would have wanted to disarm enforcement in this way.

In so ruling, the Court confirmed that *Janus'* holding is still preserved:

> We can assume that *Janus* would remain relevant (and preclude liability) where an individual neither *makes* nor *disseminates* false information — provided, of course, that the individual is not involved in some other form of fraud.

Finally, the majority believes that its ruling maintains a clear line between primary and secondary violations of Rule 10b-5, confirming that those who disseminate false information are primarily liable, without inappropriately expanding secondary liability:

> Those who disseminate false statements with intent to defraud are primarily liable under Rules 10b-5(a) and (c), §10(b) and §17(a)(1), even if they are secondarily liable under Rule 10b-5(b). . . . In instances where a "maker" of a false statement does *not* violate subsection (b) of the Rule (perhaps because he lacked the necessary intent), a disseminator of those statements, even one knowingly engaged in an egregious fraud, could not be held to have violated the "aiding and abetting" statute. That is because the statute insists that there be a primary violator to whom the secondary violator provided "substantial assistance."

It is not yet clear whether *Lorenzo* signals a broader interpretation of securities liability by the Supreme Court. The result in this case is not surprising, given the fact that Lorenzo disseminated information, known by him to be false, in order to induce investors to make bad investments; a fact that dominated oral argument, and was subsequently featured in the decision.