Securities Regulation Daily

Wolters Kluwer

April 15, 2019

SEC Breakthrough Brings Déjà vu: *Lorenzo* Court Reclaims Expansive Scope of Federal Securities Laws

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Introduction

A decade after the Great Recession, the Supreme Court has made a clear statement in *Lorenzo*: financial crimes are indeed, crimes. The Supreme Court's decision in *Lorenzo*, which expanded the reach of Rule 10b-5, should not be read solely for its arguable erasure of *Janus*. To do so would be to visit Redwood National Park to examine just one sequoia tree. Instead, we should take a step back and examine the entirety of the forest. The analysis in *Lorenzo* harkens back to the foundational Supreme Court cases that expanded private remedies under federal securities laws. This is a judicial posture that has not been seen for decades and was seemingly gone for good. But with *Lorenzo*, the light might be peeking through the canopy once again.

Since its acceptance of New Deal legislation in the late nineteen-thirties, the Supreme Court has generally taken two approaches to reading the federal securities laws: flexibly and restrictively. From the passage of the New Deal to the mid-nineteen seventies, the Court waded briskly into the securities issues before them. The federal securities laws were intended to halt rampant fraud and scheming through disclosure. Therefore, the Court surmised, if there was fraud, then the securities laws must apply; if there was no obvious remedy, the Court would craft one lest some crooked behavior go unpunished.

This mindset changed in the mid-seventies, as the wave of American conservatism did not evade the high court. Legal methodology shifted from inquiries into Congress's general intent for remedies to whether Congress expressly authorized a specific remedy.[2] From *Blue Chip Stamps* to *Central Bank* to *Janus*, the Court restricted remedies and liability on the grounds that Congress did not explicitly create such actions. The Supreme Court's decision in *Lorenzo* once again represents a broad reading of the federal securities laws, which is a welcome reversion to the Court's mid-century approach to interpreting financial misconduct.

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1 **Mr. Ferrara** provided the inspiration and direction for this article, while **Ms. Jones** and **Mr. Rogoff** provided its intellectual content

2 *See Touche Ross & Co. v. Redington,* 442 U.S. 560, 568 (1979) (noting that the Court's role in proclaiming a private right of action is limited to "determining whether Congress intended to create the private right of action asserted" by the plaintiff).

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Lorenzo v. SEC

Francis Lorenzo was the director of investment banking at a registered broker-dealer. His only client at the time was Waste2Energy, a company whose $14 million valuation included a propriety "waste to energy" process that accounted for most of the company's value and likely provided the company's name. Lorenzo knew that this valuation was flawed, and later testified that the value of this intellectual property was essentially nil. Shortly after Waste2Energy hired Lorenzo's company to manage a public debt sale, Waste2Energy publicly disclosed that its intellectual property was worthless. Despite his personal knowledge, Lorenzo had forwarded emails to prospective investors containing false statements of Waste2Energy's assets. The SEC instituted proceedings against Lorenzo for brazen violations of various securities laws and found him liable.

Lorenzo appealed, arguing that he was not the *maker* of the false statements and lacked the intent required for Rule 10b-5(b), and therefore could not be held liable under Rule 10b-5's other subsections.[3] The Court of Appeals agreed that Lorenzo did not make the statement and was not liable under 10b-5(b), but decided that he could still be liable under 10b-5(a) and 10b-5(c)—so-called scheme liability. The Supreme Court (surprisingly) affirmed, holding that the subsections of Rule 10b-5 may overlap and that dissemination of false or misleading information with intent to defraud runs afoul of Rule 10b-5. Justice Breyer and the six-justice majority noted that if Lorenzo's reading of the securities laws were correct, "behavior that, though plainly fraudulent, might otherwise fall outside the scope of [Rule 10b-5]."[4] To avoid such an unintuitive outcome, the Court choose to use the Rule's expansive language.

An alternative view of the case comes from Justice Thomas' dissent. Typically silent during oral arguments, Thomas nonetheless attempted to sound the alarm throughout his dissent, noting the gravity of the Court's fundamental shift in its posture towards securities laws. Thomas argued that the majority's broad strokes brushed aside Supreme Court precedent "in a way that is likely to have far-reaching consequences."[5] These criticisms should not be disregarded as simply Thomas' preference for textual literalism. The Court had previously imposed limitations on Rule 10b–5, and the majority's decision "disregard[ed] these express limitations.[6]" Previously, the Court accepted the view that "the securities laws should not be viewed in isolation and stretched to their limits."[7] However, in Thomas' mind, the majority's "unduly capacious interpretation" led to interpretations of violations that are so broad "as to render superfluous the more stringent, on-point requirements of a narrower provision of the same offense."[8]

In his more specific critique of the majority's ruling as relates to *Janus*, Justice Thomas noted that the decision in *Janus* (also drafted by Justice Thomas) created a clear distinction between primary and secondary fraudulent-misstatement cases: a person may only be primarily liable if they are the *maker*

3 *See Janus Capital Grp., Inc. v. First Derivative Traders*, 564 U.S. 135 (2011).
4 *Lorenzo v. Sec. & Exch. Comm'n*, No. 17-1077, 2019 WL 1369839, at *6 (U.S. Mar. 27, 2019).
5 *Lorenzo*, *supra* note 4 at *9.
6 *Lorenzo*, *supra* note 4 at *11.
7 *Id.* (internal citations omitted).
8 *Id.* at *13.

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of the statement. That is, "the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."[9] The basis of the majority's holding appears to stem from a fear of unpunished fraud, which Thomas views as unlikely given the presence of secondary liability. In Justice Thomas' view, the majority contradicted precedent and theories of statutory interpretation in the name of hypothetical harm, all to the ends of rendering *Janus* "a dead letter," as well as its predecessors.[10]

In the grander scheme of things, *Lorenzo* may signal the Court's return to more foundational Supreme Court cases that relied on the intent of the securities laws to expand private remedies. Its rationale for stating plainly fraudulent behavior must fall within the scope of the securities laws echoes earlier decisions, including *W.J. Howey* and *Capital Gains*. Such a flexible approach is a revival of the intent of New Deal securities legislation, and may portend a return to a grander view of securities laws that had been thought to be only a relic of the past.

1933 – 1975: Creation and Judicial Expansion of Securities Laws

Before the Stock Market crash of 1929, most securities laws were enacted at the state level. As these "blue sky laws" did not halt the proliferation of fraudulent securities and schemes, President Roosevelt and Congress enacted four key pieces of legislation,[11] which we now know as the basis for federal securities law. Remember that these laws emerged from a country plagued by bank runs and breadlines. Congress was more concerned with protecting investors and ensuring the stability of the financial system than the means by which regulators enforced compliance. Phrased differently by the Supreme Court, these securities laws embodied "a flexible rather than a static principle, one that [was] capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[12]

Capital Gains furthered this idea by holding that scalping by a registered investment adviser qualified as a fraud or deficit within the meaning of the Investment Advisers Act ("'40 Act").[13] While the district court read the '40 Act more literally (and narrowly), the Supreme Court read the '40 Act's language in light of Congress' intent to "enact legislation to prevent fraudulent practices by investment advisers."[14] Justice Goldberg then linked the '40 Act to other securities legislation in its congressional origins: "Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation 'enacted for the purpose of avoiding frauds,' not technically and restrictively, but flexibly to effectuate its remedial purposes."[15]

9 *Janus, supra* note 3 at 142.
10 *Lorenzo, supra* note 4 at *12.
11 These seminal laws are the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940.
12 *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946).
13 *S.E.C. v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 182 (1963).
14 *Id.* at 284.
15 *Id.* at 195 (internal quotations omitted).

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The Court continued its broad reading of these laws by creating a second front on which to battle fraud and deceit: individual investors. In 1964, the Court held that parties had a private right of action for violations of § 14(a) of the Securities and Exchange Act ("'34 Act") because, while the '34 Act did not specifically mention this right, it was passed to protect investors.[16] The Court further noted that "it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose."[17] The Supreme Court expanded this rationale a few years later in *Bankers Life*, where it held that, while no express private right of action existed in Rule 10b–5 or § 10(b), "a private right of action [was] implied under § 10(b)."[18] However, this expansion of private rights and regulatory reach would be stumped by *Blue Chip Stamps* and its progeny.

Blue Chip Stamps

Blue Chip Stamps marked the end of an era of judicial expansion of private actions under the securities laws in favor of a focus on defining the limited availability of such actions. In *Blue Chip Stamps*, the Court narrowed—or at least refused to expand—the class of plaintiffs able to maintain private causes of action for money damages under Rule 10b-5. Specifically, *Blue Chip Stamps* accepted the *Birnbaum* Rule that "a person who is neither a purchaser nor a seller of securities may not bring an action under 10(b) or Rule 10b-5."[19]

In undertaking its analysis, the Court acknowledged that the language of Section 10(b) did not reveal the express intent of Congress as to the limits of private rights of action. Instead, the Court described "a judicial oak which [had] grown from little more than a legislative acorn."[20] Although such growth may have been consistent with congressional enactment and the role of the judiciary in interpreting it, the Court said, "it would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5."[21] Instead, the Court said that policy considerations play a large role in interpreting "portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance."[22]

Although we have seen such policy considerations hard at work in the Supreme Court's jurisprudence from 1933-75, they took another form in in *Blue Chip Stamps*. Many commentators had "taken the view that the *Birnbaum* limitation on the plaintiff class in a Rule 10b-5 action for damages [was] an arbitrary restriction which unreasonably prevent[ed] some deserving plaintiffs from recovering damages. . . caused by violations of Rule 10b-5."[23] Supreme Court precedent of the previous decades would have likely agreed with such criticism. Nevertheless, *Blue Chip Stamps* found

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16 *See J. I. Case Co. v. Borak*, 377 U.S. 426, 430–31 (1964).
17 *Id.* at 433.
18 *Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13, n. 9 (1971).
19 *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 723 (1975) (citing *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952)).
20 *Blue Chip Stamps*, *supra* note 15 at 737.
21 *Id.*
22 *Id.*
23 *Id.* at 738.

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the countervailing advantages of avoiding vexatious and speculative application of the securities laws to be more compelling.

"While much of the development of the law of deceit [had] been the elimination of artificial barriers to recovery on just claims," the *Blue Chip Stamps* Court expressed "concern that the inexorable broadening of the class of plaintiff who may sue in this area of the law [would] ultimately result in more harm than good."[24] Notably, the decision in *Lorenzo* harkens a return to eliminating "artificial barriers" to the recovery of just claims.[25] But, *Lorenzo* arguably does so at the cost of decades of precedent and clear line drawing.

Blue Chip Stamps noted that, were the Court to allow for a broader world of private securities lawsuits, it would leave the *Birnbaum* rule "open to endless case-by-case erosion depending on whether a particular group of plaintiffs was thought by the court in which the issue was being litigated to be sufficiently more discrete than the world of potential purchasers at large to justify an exception."[26] The Court did not believe that "such a shifting and highly fact-oriented disposition of the issue of who may bring a damages claim for violation of Rule 10b-5 [was] a satisfactory basis for a rule of liability imposed on the conduct of business transactions."[27]

However, a shifting and fact-oriented basis sounds a lot like what the majority uses in *Lorenzo*. According to Justice Thomas in his dissent, the Court unsuccessfully attempted "to cabin the implications of its holding by highlighting several facts that supposedly would distinguish this case from a case involving a secretary or other person tangentially involved in disseminating fraudulent misstatements."[28] In Justice Thomas' view, if Lorenzo's conduct qualifies for primary liability, "then virtually any person who assists with the making of a fraudulent misstatement [would] be primarily liable and thereby subject not only to SEC enforcement, but private lawsuits."[29]

Post-*Blue Chip Stamps*

The Court continued to corral private actions under the securities laws by drawing clear lines following *Blue Chip Stamps* up until *Lorenzo.* Consider, for example, the Supreme Court precedent directly precipitating *Lorenzo—Central Bank, Stoneridge,* and *Janus.*

In *Central Bank*, the Court held that Rule 10b–5's private right of action did not include suits against aiders and abettors.[30] The case involved an issuance of $26 million worth of bonds on which Central Bank served as a trustee. When the issuer of the bonds defaulted, the bondholders argued

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24 *Id.* at 747–48.

25 *See Lorenzo, supra* note 4 at *6.("Lorenzo's view. . . 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.")

26 *Blue Chip Stamps, supra* note 15 at 755.

27 *Id.*

28 *Lorenzo, supra* note 4 at *13 (Thomas, J. dissenting).

29 *Id.*

30 *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994).

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that Central Bank was liable for aiding and abetting violations of the securities laws. Looking to policy considerations, the Court concluded that although "extending the 10b–5 cause of action to aiders and abettors no doubt [would make] the civil remedy more far reaching . . . it [did] not follow that the objectives of the statute [were] better served [because] secondary liability for aiders and abettors [would exact] costs that may disserve the goals of fair dealing and efficiency in the securities markets."[31]

Stoneridge reinforced the holding of *Central Bank*.[32] Petitioner alleged that Charter Communications had fraudulently inflated the price of its stock through engaging in sham transactions with vendors, bringing 10(b) claims against both Charter and the vendors. The Court once again held that the § 10(b) private right of action did not extend to aiders and abettors—in this case the vendors—because Congress did not expand the § 10(b) private right of action when revisiting the law.

Janus is in many ways the inverse of *Lorenzo*: Thomas speaks for the majority while Breyer fumes that the court is stomping over its precedent. The majority in *Janus* held that to be liable under Rule 10b-5, the person or entity must "make" a statement in its own right and be in control of the content of that statement.[33] One who simply prepares or publishes a statement on behalf of another is not its maker, because without authority, it is not necessary or inevitable that any falsehood will be contained in the statement. The Court noted that it was obligated to give the implied private right of action a narrow scope and refused to expand the resulting "liability beyond the person or entity that ultimately has authority over a false statement."[34]

The majority in *Lorenzo* contends that *Janus* never spoke to Rule 10b-5's application to the dissemination of false or misleading information.[35] Further, the majority maintains that "*Janus* [will] 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."[36] Nevertheless, Justice Thomas, in dissent, said that this "supposed preservation of Janus is illusory," and lamented that *Janus* may be dead less than a decade after its publication.[37] Even if *Janus* remains good law, it will likely be of limited use to those brought before the SEC.

It should be noted that the Supreme Court's reigning in of the securities laws has not been limited to private rights of action under 10b-5. The Supreme Court has similarly restrained liability under Section 11 of the '33 Act for false statements of opinion[38] as well as time frames during which securities cases may be pursued.[39]

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31 *Id.* at 188.

32 *Stoneridge Inv. Partners, LLC v. Sci.-Atlanta*, 552 U.S. 148, 165 (2008).

33 *Janus, supra* note 3 at 142.

34 *Janus, supra* note 3 at 144 (citing Stoneridge, 552 U.S., at 167).

35 *Lorenzo, supra* note 4 at *6.

36 *Id.*

37 *Id.* at *12 (Thomas, J. dissenting).

38 *See Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318, 1332 (2015);

39 *See Kokesh v. S.E.C.*, 137 S. Ct. 1635, 1645 (2017) (Claims for disgorgement in an SEC enforcement action must be commenced within five years of the date the claim accrued.); *California Pub. Employees' Ret. Sys. v. ANZ Sec., Inc.*, 137 S. Ct. 2042, 2055 (2017) (Securities Act three-year time limit is a statute of repose not subject to equitable tolling).

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Conclusion – Where Might We Go From Here?

Lorenzo reflects a return to the Supreme Court's "greatest hits" on securities laws, eschewing literalist statutory interpretation for common sense and congressional intent. But the Court does walk through its more recent history of drafting distinctions for court-made remedies. *Central Bank* suggested that a "clean line" was needed to distinguish between a primary violation and a secondary violation of Rule 10b-5.[40] *Janus* attempted to divide primary violations under Rule 10b-5(b) from actors too far removed from the critical choice to disseminate false or misleading information. In this context, the majority in *Lorenzo* argues that it also draws a line: "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)."[41] However, it seems more likely that the dissent has the better sense of the holding's questionable claims of preserving *Janus*.

But conflict with *Janus* should not be a blemish on *Lorenzo*. Rather, the majority in *Lorenzo* returned to the purpose of securities laws after forty years of crafting esoteric distinctions. Lorenzo copied and pasted advice he knew was fraudulent and sent it to investors as if it were gospel. To avoid liability, Lorenzo argued that he did not craft the language, and argued that there could be no overlap in liability under Rule 10b-5. If that type of behavior is not prohibited by federal securities laws, we must judge whether we are prepared to live with that or if we must amend our laws. Perhaps the exceptionally brazen facts of *Lorenzo* pushed the majority towards its ruling instead of a more measured approach. But we think not. The securities laws, more than statutes and regulations, are a public declaration of intent by federal lawmakers: investors must be protected from fraud in all forms, and regulators must have the tools to battle these deceptions in schemes known and yet undiscovered. If the majority continues to see the securities laws as expansive rather than narrow delineations of particular offenses, *Lorenzo* may be a renewal of New Deal-era investor protections.

40 *See Lorenzo, supra* note 4 at *7 (citing Janus, 564 U. S., at 143, and n. 6.).
41 *Id*.

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