



Lies and Schemes: Supreme Court Expands Securities Fraud Liability

April 24, 2019

The Supreme Court recently held in *Lorenzo v. Securities and Exchange Commission* that persons who knowingly disseminate false statements to investors violate the “scheme liability” provisions of federal securities law even if they do not have ultimate authority over the content of those statements. In reading the scheme liability provisions to reach this conduct, the Court expanded the scope of “primary” securities fraud liability and, by extension, the range of defendants that private plaintiffs can sue for fraud. The Court’s decision—which bucks a trend of [recent opinions narrowing](#) the anti-fraud provisions of the securities laws—highlights a [longstanding debate](#) over the proper scope of private causes of action under those provisions. This Sidebar discusses the Court’s decision in *Lorenzo* and its implications for Congress.

“Primary” and “Secondary” Securities Fraud Liability

The federal securities laws contain a variety of anti-fraud provisions. [Section 10\(b\) of the Securities Exchange Act of 1934 \(the Exchange Act\)](#) makes it unlawful to “use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe.” [SEC Rule 10b-5](#), which implements Section 10(b), in turn makes it unlawful to “in connection with the purchase or sale of any security”:

1. employ any device, scheme, or artifice to defraud;
2. make any untrue statement of a material fact; or
3. engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

Courts have generally referred to claims brought under the first and third subsections of Rule 10b-5 as “[scheme liability](#)” claims to distinguish them from “false statement” claims brought under the Rule’s second subsection. Similarly, while [Section 17\(a\) of the Securities Act of 1933](#) regulates the “offer or sale” of securities (as opposed to their “purchase or sale”), it contains anti-fraud provisions that [courts](#) have [described](#) as “substantially identical” to those in Rule 10b-5.

Congressional Research Service

<https://crsreports.congress.gov>

LSB10293

In interpreting Rule 10b-5, the Supreme Court has [distinguished](#) between (1) “primary” actors who make false statements or participate in a fraudulent scheme, and (2) “secondary” actors who assist primary actors in violating the law but do not themselves make false statements or participate in a fraudulent scheme. Specifically, the Court has held that because Rule 10b-5 by its terms does not prohibit *aiding and abetting* the making of a false statement or the execution of a fraudulent scheme, the Rule does not apply to secondary actors who merely assist others in violating the law. As a result of this distinction, the SEC must rely on a separate statutory provision—[Section 20\(e\) of the Exchange Act](#)—to pursue enforcement actions against secondary actors, while private plaintiffs lack a cause of action against secondary actors altogether. This limitation on private causes of action makes the precise boundaries of primary fraud liability [highly significant](#).

The Court has drawn these boundaries narrowly in interpreting Rule 10b-5(b)—the subsection of the Rule concerning false statements (as opposed to fraudulent schemes). In its 2011 decision in *Janus Capital Group, Inc. v. First Derivative Traders*, the Court held that based on the text of Rule 10b-5(b), primary liability under that subsection is limited to persons who “make” a false statement. Specifically, the *Janus* Court held that a person “makes” a false statement and can accordingly be held primarily liable under Rule 10b-5(b) only if he has “ultimate authority over the statement, including its content and whether and how to communicate it.” As a result of this limitation, private plaintiffs do not have a cause of action under Rule 10b-5(b) against persons who help prepare or disseminate false statements when those persons do not have “ultimate authority” over the statements.

While *Janus* clarified that primary liability *under Rule 10b-5(b)* extends only to persons who “make” a false statement, it did not address whether persons who help prepare or disseminate false statements can be primarily liable under the Rule’s scheme liability provisions. Courts have traditionally [read](#) these provisions to prohibit various forms of inherently manipulative conduct, including “wash sales,” “matched orders,” and other trading conduct that distorts a security’s price. However, before *Lorenzo*, a [number](#) of lower federal [courts](#) had interpreted Rule 10b-5’s scheme liability provisions to also encompass the preparation or dissemination of false statements, even though such conduct does not amount to “making” a false statement under *Janus*’s reading of Rule 10b-5(b). By contrast, [other courts](#) had [concluded](#) that the scheme liability provisions do not prohibit conduct related *only* to false statements, and that Rule 10b-5(b) accordingly provides the sole avenue for claims related to such conduct.

Lorenzo v. Securities and Exchange Commission

In *Lorenzo*, the Supreme Court resolved this circuit split, holding that persons who knowingly disseminate false statements to investors violate the relevant scheme liability provisions even if they do not “make” the statements under Rule 10b-5(b). The *Lorenzo* litigation involved an SEC enforcement action against an investment banker who knowingly sent fraudulent emails to prospective investors at the request of his boss. While the U.S. Court of Appeals for the D.C. Circuit [held](#) that the investment banker had not violated Rule 10b-5(b) because he was not the “maker” of the false statements under *Janus*, it affirmed the SEC’s conclusion that the banker had violated the scheme liability provisions by knowingly disseminating the statements to investors.

The Supreme Court affirmed the D.C. Circuit’s decision by a 6-2 vote (Justice Kavanaugh was recused from the case because of his participation in the D.C. Circuit’s decision), [concluding](#) that the investment banker had “employ[ed]” a “device,” “scheme,” and “artifice to defraud,” and “engage[d] in a[n] act, practice, or course of business” that “operate[d] . . . as a fraud or deceit” In holding that the “natural meaning” of this statutory language encompasses the knowing dissemination of false statements, the Court [rejected](#) the argument that the scheme liability provisions apply “only when conduct other than misstatements is involved.” Specifically, the Court declined to interpret each subsection of Rule 10b-5 as prohibiting separate, mutually exclusive categories of conduct. The Court rejected this reading of the Rule

on the grounds that its previous decisions had explicitly recognized that different securities law provisions prohibit some of the same behavior. Moreover, the Court noted that Rule 10b-5's scheme liability provisions—which prohibit “device[s],” “scheme[s],” and “artifice[s] to defraud,” and “engag[ing] in a[n] act . . . which operates . . . as a fraud,” respectively—themselves reflect considerable overlap. The Court further explained that its reading of Rule 10b-5 was “strengthened” by the fact that a contrary interpretation would permit the “plainly fraudulent” act of “using false representations to induce the purchase of securities.” According to the Court, such a result would be difficult to reconcile with the “basic purpose” of the securities laws “to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*.”

Finally, the Court rejected the argument that its interpretation of the scheme liability provisions would “erase” the distinction between primary and secondary fraud liability. The Court rejected this argument—which Justice Thomas offered in a dissenting opinion—on the grounds that it is “hardly unusual for the same conduct to be a primary violation with respect to one offense and aiding and abetting with respect to another” (*e.g.*, when a defendant sells an unregistered firearm in order to assist a bank robbery, making him primarily liable for the gun sale and secondarily liable for the robbery). As a result, the Court explained, there is nothing anomalous about the conclusion that certain conduct can amount to a primary violation of the scheme liability provisions and a secondary violation of Rule 10b-5's false statement provision.

Lorenzo's Implications

While *Lorenzo* involved an SEC enforcement action, the Court's decision is most significant for the plaintiffs' bar. Under [Section 20\(e\) of the Exchange Act](#), the SEC retains the authority to pursue enforcement actions against secondary actors who “substantially assist” others in committing fraud irrespective of the outcome in *Lorenzo*. However, by holding that persons who are not primarily liable under Rule 10b-5(b) can nevertheless violate the relevant scheme liability provisions, the Court extended the range of defendants that *private* plaintiffs can pursue in securities fraud actions. Specifically, commentators have [noted](#) that *Lorenzo* “may open a new front” in private litigation against securities underwriters, as the Court's decision makes clear that persons who knowingly disseminate false statements can be primarily liable for fraud even if they do not have “ultimate authority” over the statements.

The extent to which primary liability for participation in a fraudulent scheme extends beyond the dissemination of false statements remains unclear. In its decision, the Court [explained](#) that imposing primary liability on actors who are “tangentially involved” in disseminating a false statement (*e.g.*, a mailroom clerk) would “typically be inappropriate.” However, the Court did not elaborate on *why* such actors would not be primarily liable under the scheme liability provisions when they knowingly contribute to the dissemination of a false statement. While attorneys in the SEC's Enforcement Division have acknowledged this limiting principle in the Court's opinion, they have also [indicated](#) that they read the decision as extending to “other kinds of deceptive conduct” involving false statements beyond their dissemination. Lower courts are accordingly likely to confront closer cases where a defendant's involvement in a fraudulent scheme falls somewhere between disseminating a false statement and performing more “tangential[]” administrative functions.

To the extent there is legislative interest, Congress could amend the securities laws to maintain its desired balance between deterring fraud and preventing excessive litigation. Legislation [introduced](#) in 2009 and 2010 would have amended the Exchange Act to create a private right of action against secondary actors who knowingly or recklessly assist primary violations of the Act. The bills' supporters argued that such a cause of action would enhance the deterrent and compensatory functions of the securities laws. By contrast, the bills' opponents contended that an expansion of secondary liability would harm economic

growth by increasing the costs of doing business with publicly traded companies. It remains to be seen whether the Court's decision in *Lorenzo*—which expands the Rule 10b-5 private cause of action—will prompt renewed congressional interest in the appropriate scope of the securities laws.

Author Information

Jay B. Sykes
Legislative Attorney

Disclaimer

This document was prepared by the Congressional Research Service (CRS). CRS serves as nonpartisan shared staff to congressional committees and Members of Congress. It operates solely at the behest of and under the direction of Congress. Information in a CRS Report should not be relied upon for purposes other than public understanding of information that has been provided by CRS to Members of Congress in connection with CRS's institutional role. CRS Reports, as a work of the United States Government, are not subject to copyright protection in the United States. Any CRS Report may be reproduced and distributed in its entirety without permission from CRS. However, as a CRS Report may include copyrighted images or material from a third party, you may need to obtain the permission of the copyright holder if you wish to copy or otherwise use copyrighted material.