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US Statute Does Not 'Rule The World' – Second Circuit Limits Reach Of The Foreign Corrupt Practices Act

by Michael J. Engle and Kristen M. Gibbons Feden

During its October 2018 term, the U.S. Supreme Court will hear *Lorenzo v. Securities and Exchange Commission*, which should settle a circuit split on liability for three simple acts – cut, paste and send – done at another person's direction. After this decision, broker-dealers and others in the industry will better understand the scope of Rule 10b-5. Shareholders also should pay close attention, as the ability to privately sue certain actors for fraudulent statements and related acts could be affected.

Background – Cut, Paste and Send

It all began when Francis Lorenzo cut some text, pasted it into an email and clicked "send." Lorenzo was the director of investment banking at Charles Vista, LLC, an SEC-registered broker-dealer. In that capacity, Lorenzo's duties involved conducting due diligence on his clients, including reviewing their financial statements and public filings. In September 2009, Charles Vista served as the exclusive placement agent for a startup company's $15 million convertible debenture offering. The following month, the company issued two public filings indicating that (1) its technological asset, a gasification technology, was valueless; (2) there was a total impairment of its intangible assets; and (3) the company's total assets were valued at approximately $370,000. These public filings were a reflection of the failed gasification technology.

There is no dispute that Lorenzo had access to the public filings that revealed a significant decline in the company's financial health. There is also no dispute that prior to the release of the public filings, Lorenzo cautioned his boss about offering a $15 million convertible debenture for a company that had no assets to liquidate to protect its investors in the event of default. Nevertheless, sometime thereafter Lorenzo emailed two investors stating that (1) the company had more than $10 million in confirmed assets; (2) the purchase orders and letters of interest totaled over $43 million and (3) Charles Vista would raise additional monies to repay debenture holders, if necessary. All these statements were false. Moreover, these emails were actually typed by Lorenzo's boss and sent to Lorenzo with the directive to send them to the two investors which he did. Both emails noted that they were being sent at the request of Lorenzo's boss. The primary question, then, is whether Lorenzo's "cut, paste and send" can make him liable for **making** untrue statements in violation of Rule 10b-5(b). If he cannot be found liable for **making** untrue statements, can he be found liable for employing a scheme to defraud or for engaging in an act that operates to defraud?

The Legal Issue – Rule 10b-5 and *Janus*

Four years later, the SEC charged Lorenzo, his boss and Charles Vista with violating antifraud provisions of the federal securities laws. Lorenzo's boss and Charles Vista settled with the SEC – but Lorenzo did not. Among the SEC's charges against Lorenzo were claims for violating all three subsections of Rule 10b-5, which accused Lorenzo of making a fraudulent statement

and engaging in a fraudulent scheme. Specifically, Rule 10b-5 provides that

> [i]t shall be unlawful for any person directly or indirectly … (a) [t]o employ any device, scheme or artifice to defraud, (b) [t]o **make** any untrue statement of a material fact … or (c) [t]o engage in any act … which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. 240.10b-5 (emphasis added). The SEC did not charge Lorenzo with aiding or abetting a fraudulent act.

The SEC prevailed against Lorenzo in administrative proceedings where the judge found Lorenzo violated all three subsections of Rule 10b-5. The judge imposed stiff penalties, including banning Lorenzo from the industry for life. He appealed to the full commission, but it sustained the administrative judge's decision, finding that Lorenzo knew the statements in the emails were false and misleading when he sent them. Lorenzo took an appeal to the Court of Appeals for the District of Columbia Circuit, but he lost once again, in a 2-1 decision (http://www.scotusblog.com/wp-content/uploads/2018/02/17-1077-opinion-below.pdf).

Relying on guidance in *Janus Capital Group Inc. v. First Derivative Traders* (https://www.bloomberglaw.com/public/desktop/document/Janus_Capital_Group_Inc_v_First_Derivative_Traders_131_S_Ct_2296_?1537299605), a 2011 Supreme Court decision, the court decided Lorenzo did not "make" a statement under subsection (b) of Rule 10b-5, because he had no authority and control over the statement. "One 'makes' a statement by stating it … For purposes of Rule 10b–5, … **One who prepares or publishes a statement on behalf of another is not its maker.**" *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135, 142-143 (2011) (emphasis added). The court found, however, Lorenzo's conduct of transmitting misinformation directly to the investors, making his involvement transparent, violative of Rule 10b-5 subsections (a) and (c). This made him liable as a fraudulent schemer under an aiding and abetting or substantial assistance theory, a holding the majority cited as supported under *Janus*. See *Janus*, 564 U.S. at 143 ("Rule 10b-5's private right of action does not include suits against aiders and abettors. **Such suits** – against entities that contribute 'substantial assistance' to the making of a statement but do not actually make it – **may be brought by the SEC**, see 15 U.S.C.A. § 78t(e), but not by private parties.") (emphasis added).

In dissent, Judge Brett Kavanaugh (who is now an Associate Justice of the U.S. Supreme Court) opined that Lorenzo could not be deemed a schemer, because the statements were made by his boss – not him. In other words, the SEC should have been required to show more than a misstatement in proving that Lorenzo violated Rule 10b-5(a) and (c). According to Judge Kavanaugh, holding otherwise equates to "legal jujitsu" and eliminates the distinction between primary liability (direct violation) and secondary liability (aiding and abetting). Judge Kavanaugh harshly criticized the SEC, claiming it is attempting to "unilaterally rewrite the law" and "expand the scope of primary liability under securities law." Judge Kavanaugh's position has commanded majorities of panels in the Second, Eighth and Ninth Circuits.[1]

According to Lorenzo's brief to the U.S. Supreme Court, his "ministerial acts" of cutting, pasting and sending an email cannot form the basis for imposing scheme liability, and the District Court erred when it concluded that a misstatement claim that failed to meet the "maker" element set forth in *Janus* could be successfully "repackaged and pursued" as a fraudulent scheme claim. In support, the Securities Law Professors submitted a brief of amici curiae (https://static.reuters.com/resources/media/editorial/20180830/lorenzovsec--profsamicus.pdf), noting that while Lorenzo may have given substantial assistance to the commission of his boss's fraud, "he lacked the ultimate control and independence over the deception necessary to create primary fraud liability." Likewise, the Securities Industry and Financial Markets Association and the Chamber of Commerce of the United States of America submitted a brief of amici curiae (https://www.chamberlitigation.com/sites/default/files/cases/files/18181818/U.S.%20Chamber%20and%20SIFMA%20Amicus%20Brief%20--%20Lorenzo%20v.%20SEC%20%28U.S.%20Supreme%20Court%29.pdf), asserting that the court's "myopic reliance on the language of *the regulation*" was at the "exclusion of any meaningful analysis of whether Lorenzo's conduct violated *the statute*."

While Lorenzo is simply looking for removal of the penalty imposed on him, the industry will be watching for how the court might clarify the scope of *Janus* and the distinctions between primary and secondary liability under Rule 10b-5, particularly as it applies to actions instituted by the SEC. Either way, it will be interesting to watch as the Supreme Court reviews the three simple acts of cutting, pasting and sending an email, and delivers an opinion that could ignite a significant change in the securities and white-collar landscape as a whole. Stay tuned.

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[1] *See, e.g., Public Pension Fund Group v. KV Pharmaceutical Co.*, 679 F.3d 972, 987 (8th Cir. 2012); *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1057 (9th Cir. 2011); *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 177 (2d Cir. 2005).

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