Securities Regulation Daily Wrap Up, FRAUD AND MANIPULATION—NDIll: Court Addresses Application of *Janus* to Boiler Room Scheme, (Mar. 22, 2013)

Click to open document in a browser

By Rodney F. Tonkovic, J.D.

The SEC was able to successfully allege that defendants engaged in an international boiler room scheme were liable under Exchange Act Rule 10b-5(b). The Commission's claims under Rules 10b-5(a) or (c) failed, however. In a separate opinion, the court dismissed counts based on violations of Exchange Act Section 17(a) for lack of jurisdiction (*SEC v. Benger*, March 21, 2013, Cole, J.).

The SEC claimed that the defendants engaged in an international boiler room scheme that took in approximately $44 million from penny stock sales to foreign investors. The defendants, Illinois citizens operating out of Chicago (the "distribution defendants"), skimmed 60 percent of the proceeds as commissions for themselves and the foreign boiler room operators. The stock purchase agreements seen by the investors represented that there were no commissions and that there was only a nominal transaction fee. The distribution defendants allegedly concealed the extent of their involvement and claimed ignorance of the high-pressure sales tactics and misrepresentations used by the boiler room operators.

The movants in this action acted as escrow agents for several of the issuers and were charged with aiding and abetting the scheme. Once investors transferred their funds to the escrow in Illinois, the movants disbursed the funds in accordance with escrow and distribution agreements. They then caused the share certificates to be sent to the foreign investors accompanied by letters noting the number of shares purchased, but never the commissions paid. The escrow agents claimed that they were uninvolved in the scheme beyond the collection of the investors' money, but the Commission alleged that the agents provided knowing and substantial assistance to the boiler room scheme.

Rule 10b-5(b). The agents argued that the Commission failed to plead a primary violation of Rule 10b-5 (b) by failing to allege that the distribution defendants "made" the fraudulent statements in the share purchase agreements. Under *Janus Capital Group, Inc. v. First Derivative Traders,* the agents argued, the distribution defendants did not have the required "ultimate authority" over the statements. The court disagreed, determining that the complaint alleged not only that all the distribution defendants drafted the share purchase agreements, but that they also "approved, adopted, and collectively implemented" them. This allegation was barely sufficient, the court noted, but sufficed under *Janus* "for now."

Rule 10b-5(a) and (c). The Commission claimed two additional theories of liability under Rule 10b-5(a) and (c). At issue was whether the alleged conduct fell under subsections (a) and (c) or was limited to the already-addressed misrepresentations under subsection (b). The agents argued for "a delineation between claims under subsection (b) and claims under subsections (a) and (c)." The court stated that the issue has not been addressed by the 7th Circuit, but other courts have held that a market manipulation claim under Rule 10b-5(a) and (c) must encompass conduct beyond misrepresentations or omissions actionable under subsection (b).

The agents argued for dismissal of the Commission's claim under subsections (a) and (c) because it was premised on the purchase agreements' misrepresentation of the distribution and commission structure. The Commission countered that there were "boatloads" of "free-standing deceptive conduct" beyond the misrepresentations, including various efforts to conceal the scheme and its participants.

The court concluded that the conduct in this case was not equivalent to that in cases involving far more complex schemes in which conduct beyond misrepresentations was found. Activities designed to conceal the scheme are inherent in every illicit scheme, the court remarked, and without more, the SEC's case here was clearly a Rule 10b-5(b) case. The court accordingly found that the Commission adequately stated a 10b-5(b) claim against the agents but that the 10b-5(a) and (c) claims must be dismissed.

Exchange Act Section 17(a). A separate opinion in this action addressed a motion to dismiss two counts based on alleged violations of Exchange Act Section 17(a). The defendants argued that these counts should be dismissed for failure to state a claim under *Janus.* The court declined to apply *Janus* to Section 17(a) and denied the motion.

The court cited a recent decision from the Northern District of Illinois addressing the question. In that case, the court reasoned that *Janus* was based on the interpretation of the word "make," which is absent from Section 17(a). The court in this case noted further that the majority of cases addressing this question have reached the same conclusion.

Dismissal under *Morrison.* The defendants then argued that the SEC made no allegations that they offered any security in the United States. The court agreed and dismissed the counts under *Morrison v. National Australia Bank Ltd.*

Attorneys: Jonathan Stephen Polish for the SEC. Howard J. Stein for Stefan H. Benger and SHB Capital, Inc. Jason B. Meyers, pro se. Philip T. Powers, pro se. Peter B. Shaeffer for Frank I. Reinschreiber and Global Financial Management, LLC. James Arthur McGurk (Law Offices of James A. McGurk, P.C.) for CTA Worldwide Services, SA and Stephan von Hase. Linda M. Perry (Law Office of Linda M. Perry) for Pamela Benger.

Companies: CTA Worldwide Services, SA; Global Financial Management, LLC; SHB Capital, Inc.

The case is No. 09 C 676.

LitigationEnforcement: FraudManipulation IllinoisNews