Securities Regulation Daily Wrap Up, TOP STORY—D.C. Cir.: Broker did not 'make' false email statements, but still incurs 10b-5 scheme liability, (Sept. 29, 2017)

Securities Regulation Daily Wrap Up

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By John M. Jascob, J.D., LL.M.

A broker who sent an email containing false statements drafted by his boss did not "make" those misstatements under *Janus*, but the SEC still prevailed in imposing liability on him for fraud under the federal securities laws. A divided D.C. Circuit panel upheld the Commission's findings that the broker violated Exchange Act Rules 10b-5(a) and (c) and Securities Act Section 17(a)(1) by sending the misleading emails to clients with scienter. As the SEC's decision to impose a lifetime ban on the broker turned partly on its misimpression that the broker "made" the misstatements in violation of Rule 10b-5(b), however, the appellate court set aside the sanctions and remanded the matter to the SEC to determine the appropriate penalties (*Lorenzo v. SEC*, September 29, 2017, Srinivasan, S.).

Layers of protection. The appellant, Frank Lorenzo, headed the Investment Banking division at Charles Vista, LLC, a registered broker-dealer. On October 14, 2009, Lorenzo separately sent emails to two potential investors at the request of his boss, Gregg Lorenzo (no relation). The emails described a debenture offering by Waste2Energy Holdings, Inc. (W2E), a start-up energy company that was Charles Vista's biggest client. Although W2E was facing financial ruin at the time, the emails contained language drafted by Gregg Lorenzo stating that the offering had "3 layers of protection."

In 2013, the SEC commenced proceedings against Lorenzo, Gregg Lorenzo, and Charles Vista, alleging that the statements concerning the offering's promised protections were false. Gregg Lorenzo and Charles Vista settled the charges against them, but the claims against Frank Lorenzo proceeded to resolution before the SEC. An administrative law judge deemed "[t]he falsity of the representations in the emails . . . staggering" and found that Lorenzo willfully violated the antifraud provisions of the Securities and Exchange Act. The full Commission then sustained upon review the ALJ's decision, including her imposition of an industry-wide bar, a cease-and-desist order, and a $15,000 civil penalty.

Falsity and scienter. On review before the D.C. Circuit, the panel first concluded that the SEC's findings as to falsity and scienter were supported by substantial evidence regarding the pertinent statements in Lorenzo's emails. Although Lorenzo contended that he had a good-faith belief in the statement that W2E had over $10 million in confirmed assets, the evidence supported the SEC's conclusion that Lorenzo knew that the company's intangibles were valueless by at least October 5, 2009. The record also revealed grave doubts on Lorenzo's part that claimed orders of $43 million for W2E's technology would occur. Finally, substantial evidence supported the Commission's finding that Lorenzo acted with scienter regarding an assurance to investors that Charles Vista had agreed to raise additional funds to repay the holders of the debentures, if necessary.

Rule 10b-5(b). Next, the panel turned to Lorenzo's argument that under the Supreme Court's decision in *Janus Capital Group, Inc. v. First Derivative Traders* (U.S. 2011), he did not "make" thestatements at issue for purposes of Rule 10b-5(b). Although agreeing with Lorenzo that his conduct did not fall within the scope of that subsection, the court concluded that his status as a non-"maker" of the statements under Rule 10b-5(b) did not vitiate the SEC's conclusion that his actions violated the other subsections of Rule 10b-5, as well as Securities Act Section 17(a)(1).

The court determined that under the test set forth in *Janus*, Gregg Lorenzo, and not Lorenzo, was "the maker" of the false statements in the emails because he had ultimate authority over their substance and distribution.

The court noted that "voluminous testimony" established that Lorenzo had cut and pasted and then transmitted statements devised by Gregg Lorenzo at Gregg Lorenzo’s direction. Although the SEC assigned great weight to a remark by Lorenzo that he "authored" the emails, the statement was consistent with Lorenzo’s repeated account that he had populated the messages with content sent by Gregg Lorenzo. Moreover, Lorenzo’s statement that the messages were "approved" by Gregg Lorenzo before he sent them reinforced Gregg Lorenzo’s ultimate authority over the emails’ substance and distribution. Accordingly, the court overturned the SEC’s finding of liability under Rule 10b-5(b) and vacated the sanctions, remanding the matter to enable the Commission to reconsider the appropriate penalties.

Liability under other antifraud provisions. The panel rejected, however, Lorenzo’s argument that his conduct necessarily also fell outside the other antifraud provisions with which he was charged by the SEC. Unlike Rule 10b-5(b), the court noted, Rules 10b-5(a) and (c) and Section 17(a)(1) do not speak in terms of an individual’s "making" a false statement. Lorenzo's conduct in producing and sending the emails thus constituted employing a deceptive "device," "act," or "artifice to defraud" for purposes of liability under those provisions.

The court dismissed Lorenzo’s assertion that, if he could be found to have violated the provisions, the decision in *Janus* would effectively be rendered meaningless by eliminating any distinction between primary and secondary liability. Unlike the conduct in Janus, Lorenzo’s role was not "undisclosed" to investors, but instead the recipients were fully alerted to his involvement because Lorenzo himself communicated with investors, directly emailing them misstatements about the debenture offering. Unlike in *Janus*, therefore, the recipients of Lorenzo’s emails were not exposed to the false information only through the intervening act of "another person." Lorenzo’s actions thus formed the basis of violations of Rules 10b-5(a) and (c) and Section 17(a)(1).

Dissent. In a sharply worded dissent, Judge Kavanaugh agreed with the majority’s conclusion that Lorenzo did not "make" the statements in the emails for purposes of Rule 10b-5(b) liability, while also praising the majority’s decision to vacate Lorenzo's lifetime suspension. The dissent took the majority to task, however, for "invoking a standard of deference [to the SEC] that, as applied here, seems akin to a standard of 'hold your nose to avoid the stink.'"

Judge Kavanaugh questioned how Lorenzo could be deemed to have willfully engaged in a scheme to defraud when the administrative law judge concluded, after hearing Lorenzo’s testimony, that Lorenzo did not draft the emails, did not think about the contents of the emails, and sent the emails only at the behest of his boss. In Judge Kavanaugh’s view, these factual conclusions demonstrated that Lorenzo lacked the necessary mens rea of willfulness for liability.

Judge Kavanaugh also accused the majority of creating a circuit split by holding that mere misstatements, standing alone, may constitute the basis for scheme liability under the federal securities laws. Contrary to the majority’s holding, he observed, all the other federal appellate courts have concluded that scheme liability must be based on conduct that goes beyond a defendant’s role in preparing mere misstatements or omissions made by others. Otherwise, the SEC would be able to evade the important statutory distinction between primary liability and secondary liability. In his view, the SEC has tried hard for decades to erase that distinction, undeterred by Supreme Court precedent. Accordingly, he disagreed with the majority opinion that Lorenzo’s role in forwarding the alleged misstatements could be the basis for scheme liability.

The case is No. 15-1202.

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Companies: Waste2Energy Holdings, Inc.; Charles Vista, LLC

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