

Securities Regulation Daily Wrap Up, FRAUD AND MANIPULATION— 11th Cir.: SEC shielded from liability for failure to stop Stanford Ponzi scheme, (Mar. 30, 2015)

Securities Regulation Daily Wrap Up

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By Matthew Garza, J.D.

A negligence claim filed against the SEC for its failure to take action to stop a massive Ponzi scheme was dismissed because exceptions to the general waiver of sovereign immunity under the Federal Tort Claims Act (FTCA) applied. The district court, therefore, had no jurisdiction to hear the claim ([Zelaya v. U.S.](#), March 30, 2015, Carnes, J.).

Stanford fraud. The case arose from the massive fraud committed by Allen Stanford in the 1990s and 2000s. Stanford created a network of entities that issued billions of dollars of high-interest certificates of deposits to tens of thousands of investors around the world. Stanford did not invest the deposits, but instead paid new investors with cash from earlier investors in the manner of a Ponzi scheme. One of the entities he created, Stanford Group, was a broker-dealer and investment adviser registered with the SEC. The court recounted that the SEC conducted four investigations of Stanford between 1997 and 2004, but took no action to stop the fraud until 2009.

The chief of the SEC's Fort Worth, Texas, office that first investigated Stanford was quoted as saying that he considered the purported returns on the CDs to be "absolutely ludicrous." Another investigator warned the Branch Chief that "someday it's going to blow up." The SEC's suspicions were confirmed again by investigators in 1998, 2002, and 2004, but the agency took no action. After "sitting on this information for five more years," said the court, the SEC finally moved against Stanford in 2009, when most of the investors' money was gone. The agency recovered only \$100 million of the \$7 billion invested.

Federal Tort Claims Act. The FTCA provides a general waiver to the government's sovereign immunity from tort actions based on the actions of its employees, but there are statutory exceptions to the general waiver. In the lower court the government argued that the "discretionary function exception" barred the Stanford investors' claims that the SEC: (1) failed to notify the Securities Investor Protection Corporation that Stanford was in financial trouble; and (2) failed to revoke the registration of Stanford Group. The lower court initially rejected the government's argument with regard to the notification claim, but later agreed that the "misrepresentation exception" to the waiver applied and dismissed the case. The lower court's [decision](#) was covered in *Securities Regulation Daily* on [August 13, 2013](#).

State court analogue. One obstacle to the suit that was "largely ignored" by the lower court proceedings, according to the Eleventh Circuit, was a statutory constraint that precludes liability of the federal government absent a showing by the plaintiff that a private individual who acted as the federal employee did, in like circumstances, would be liable for the particular tort under governing state law where the tort occurred. Here, the court said, the investors complained only of negligence, and did not identify which state's law of negligence applied in order to support the required analogous state tort cause of action.

The government argued that the tort claimed here would have to exist under the laws of Texas or the District of Columbia. Neither jurisdiction requires a person to act to prevent harm to others, absent some special relationship, the court said, which presented the investors here with "some uphill sledding." But because this was largely ignored in the lower court proceedings, the court wrote, so it was reluctant to decide the case on this ground.

Registration claim. The Eleventh Circuit agreed with the lower court that even though the SEC may have been required to disallow Stanford's registration based on its review of its initial registration, it did not have the same duty to revoke registration upon review of its subsequent registration amendments, which were at issue here. But even if the existence of "some undescribed duties" on the SEC to revoke a registration based on a review of the amendments to that registration could be established, the discretionary function exception to the general waiver of sovereign immunity under the FTCA would immunize the government for faulty performance of that duty, held the court.

Notification claim. Addressing the claim that the government was required to report Stanford Group's financial difficulties to SIPC, the court found itself in agreement with the lower court that the misrepresentation exception to the general liability waiver of the FTCA applied. The investors did not claim that the SEC miscommunicated regarding Stanford Group's insolvency, the court pointed out, but rather faulted the SEC for its non-communication of information regarding that issue. But this distinction did not matter, said the court. "Unfortunately for Plaintiffs, miscommunication and non-communication yield the same result for purposes of the misrepresentation exception, because the misrepresentation exception 'encompasses failure to communicate as well as miscommunication.'"

The court dismissed the case for lack of jurisdiction, but provided an alternative means for dismissal of the case. The court wrote that that should the FTCA waiver exceptions someday be interpreted as going to the merits of a plaintiffs claim, rather than the jurisdiction of the district court, then for the same reasons it affirmed the dismissal for lack of subject matter jurisdiction, it would also affirm for failure to state a claim.

Similar suits. Despite numerous attempts to pin liability on the agency for investigative failures, many emanating from Bernard Madoff's Ponzi scheme, the decision adds to a number that have let the SEC off the hook, despite investor cries of negligence and incompetence. The agency escaped liability for its failure to uncover the Madoff scheme in the Ninth Circuit case of [*Dichter-Mad Family Partners, LLP v. U.S.*](#), the Third Circuit case of [*Baer v. U.S.*](#), and the Second Circuit case of [*Molchatsky v. United States*](#).

The case is [No. 13-14780](#).

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