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Unnoticed Supreme Court Decision Could Narrow Securities Fraud Law

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On June 23, 2014, all eyes in the securities bar were fixed on the Supreme Court's opinion in *Halliburton* as practitioners and commentators evaluated the impact of that decision on the future of private securities class action litigation. Unnoticed that day was a bank fraud decision by the Supreme Court that could have a far greater impact on SEC enforcement actions. In *Loughrin v. United States*,[1] the Supreme Court narrowed the scope of the bank fraud statute, which makes it unlawful to ''obtain money or property . . . by means of'' false statements or omissions. The reasoning of *Loughrin*, if applied to the nearly identical language of Section 17(a)(2) of the Securities Act of 1933,[2] would likewise constrict the reach of that provision.

In 2011, the Supreme Court issued a decision in *Janus Capital Group, Inc. v. First Derivative Traders*[3] that dramatically narrowed the scope of liability under Section 10(b) of the Securities Exchange Act of 1934.[4] Rule 10b-5(b), issued by the SEC under the authority of Section 10(b), makes it unlawful to ''make'' a false statement or omission in connection with the purchase or sale of securities.[5] In *Janus*, the Supreme Court held that primary liability for those who ''make'' false statements under Rule 10b-5(b) extends only to the person or entity with ''ultimate authority'' over the statement.[6] Using the analogy of a speechwriter, the Court held that primary liability under Rule 10b-5(b) reaches only to the person who delivers the speech, not to the speechwriter.[7]

Prior to *Janus*, courts had held that the elements of claims under the three subsections of Rule 10b-5 were ''essentially the same'' as the elements of claims under the three subsections of Section 17(a).[8] Accordingly, since the decision in *Janus*, defendants in SEC enforc-

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[1] 134 S.Ct. 2384 (2014).

[2] 15 U.S.C. § 77q(a)(2).

[3] 131 S.Ct. 2296 (2011).

[4] 15 U.S.C. § 78j(b).

[5] 17 C.F.R. § 240.10b-5(b).

[6] 131 S.Ct. at 2302.

[7] *Id.*

ment actions have attempted to use this line of cases – mostly without success – to extend the holding of *Janus* to claims brought under Section 17(a)(2).[9] Defendants' lack of success in this regard is largely attributable to the differing language of that provision, namely its failure to impose liability only on those who ''make'' false statements. Instead, Section 17(a)(2) applies to those who, in the offer or sale of securities, ''obtain money or property by means of'' a materially false statement or omission.[10]

At the same time, however, little case law has developed interpreting the scope of Section 17(a)(2) liability. This dearth of case law is likely due to the fact that Section 17(a) is not subject to a private right of action, few SEC cases proceed through trial to the appellate level, and most criminal securities fraud cases are brought under Rule 10b-5 rather than Section 17(a).

The leading appellate cases interpreting the scope of Section 17(a)(2) liability are *SEC v. Tambone*[11] and *SEC v. Wolfson*.[12] In *Tambone*, the First Circuit held that one ''obtains money or property by means of'' a false statement in the sale of a security if the false statement was ''used'' to obtain the money or property.[13] In other words, according to the *Tambone* court, one can violate Section 17(a)(2) by using a false statement made by another in order to obtain money in the sale of securities.[14] In *Wolfson*, the Tenth Circuit held that, for purposes of Section 17(a)(2), money is obtained by means of a false statement in the sale of securities if one is paid a fee to prepare the misstatement that is later used by another in the sale of securities.[15] Read together, then, *Tambone* and *Wolfson* hold that a defendant violates Section 17(a)(2) if he obtains money, whether from the victim or a third party, as a result of (a) preparing a false statement that will be used by another in the sale of securities or (b) using, in the sale of securities, a false statement prepared by another.

The Supreme Court's recent decision in *Loughrin* casts substantial doubt on the *Tambone* and *Wolfson* courts' broad reading of Section 17(a)(2) liability. At issue in *Loughrin* was the meaning of the federal bank fraud statute, which makes it unlawful to ''obtain money or property'' from a bank ''by means of'' a false statement.[16] The Supreme Court held that one obtains money or property from a bank ''by means of'' a false statement only if the false statement ''is the mechanism naturally inducing a bank . . . to part with money in its control.''[17] The Court further explained that this test cannot be satisfied ''where no false statement will ever go to a financial institution.''[18]

Section 17(a)(2), in language analogous to the bank fraud statute, makes it unlawful to ''obtain money or property'' in the offer or sale of securities ''by means of'' a materially false statement.[19] Both Section 17(a)(2) and the bank fraud statute require proof that the defendant obtained money or property ''by means of'' a false statement. Under the bank fraud statute, that money or property must be obtained from a bank,[20] while under Section 17(a)(2) the money or property must be obtained in the offer or sale of securities.[21]

Given the similarity of these two provisions, it would seem that the *Loughrin* Court's interpretation of the language of the bank fraud statute would apply with equal force to Section 17(a)(2). In particular, the causal connection required by the ''by means of'' language should be the same in both instances. Just as the government must prove in a bank fraud prosecution that the defendant's fraud was ''the mechanism naturally inducing a bank . . . to part with money in its control,'' so also should the SEC be required, in an action under Section 17(a)(2), to prove that the defendant's fraud was ''the mechanism naturally inducing'' the buyer of securities ''to part with money in its control.'' Following the reasoning of *Loughrin*, this cannot be proven ''where no false statement will ever go to'' a buyer of securities. In other words, the *Loughrin* Court's interpretation of the relevant language would require, for purposes of Section 17(a)(2), that a false statement reach the buyer of securities, that the false statement be ''the mechanism naturally inducing'' the buyer of securities ''to part with money,'' and that the money with which the buyer parted then reach, at least indirectly, the fraudster.[22]

So what, you might ask, would be the practical import of such a reading of Section 17(a)(2)? Answering that question requires an understanding of the broader securities law landscape. After *Janus*, an effective strategy for attacking a securities fraud case brought by the SEC is to chip away at the claims on a subsection-by-subsection basis. *Janus* provided a means to attack a Rule 10b-5(b) claim on the ground that the defendant did not ''make'' (*i.e.*, have ultimate authority over) a statement. At least three federal courts of appeals have held that so-called ''scheme liability'' claims under Rule 10b-5(a) and (c) and Section 17(a)(1) and (3) only cover those frauds that involve some deceptive conduct be-

[8] *See*, *e.g.*, *SEC v. Monarch Funding Corp.*, 192 F.3d 295, 308 (2d Cir. 1999).

[9] *See*, *e.g.*, *SEC v. Monterosso*, Nos. 13-10341, 13-10342, 13-10464, 2014 BL 180766, at *6 (11th Cir. June 30, 2014) (rejecting application of *Janus* to claims brought under Section 17(a)). *But see SEC v. Kelly*, 817 F. Supp. 2d 340, 345 (S.D.N.Y. 2011). The SEC's chief administrative law judge has also held that *Janus* applies to Section 17(a)(2) claims. *See In the Matter of Flannery and Hopkins*, Initial Decision, Admin. Proc. File No. 3-14081 (filed Oct. 28, 2011). The SEC's Enforcement Division appealed that ruling to the full Commission, which recently heard oral argument on that issue.

[10] 15 U.S.C. § 77q(a)(2).

[11] 550 F.3d 106 (1st Cir. 2008).

[12] 539 F.3d 1249 (10th Cir. 2008).

[13] 550 F.3d at 127-28.

[14] *Id.*

[15] 539 F.3d at 1264.

[16] 18 U.S.C. § 1344(2).

[17] 134 S.Ct. 2384, 2394.

[18] *Id.*

[19] 15 U.S.C. § 77q(a)(2).

[20] 18 U.S.C. § 1344(2).

[21] 15 U.S.C. § 77q(a)(2).

[22] This reading of Section 17(a)(2) is reinforced by the Supreme Court's recent decision in *Chadbourne & Parke LLP v. Troice*, 134 S.Ct. 1058 (2014), where the Court held that a fraudulent misrepresentation or omission is made ''in connection with'' the purchase or sale of securities only if ''it is material to a decision by one or more individuals . . . to buy or sell'' securities. *Id.* at 1066. The Supreme Court long ago suggested that Section 17(a)'s prohibition against fraud ''in'' the sale of securities is equal in reach to Rule 10b-5's prohibition against frauds ''in connection with'' the sale of securities. *See United States v. Naftalin*, 441 U.S. 768, 773 n.4 (1979).

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yond a false statement.[23] Thus, in some cases, that leaves only Section 17(a)(2) as a potential source of liability for a defendant.

But, applying the *Loughrin* reasoning to the language of Section 17(a)(2), it too would not cover many types of fraud. For example, frauds with regard to secondary trading in securities (*e.g.*, most accounting frauds) would not be covered by Section 17(a)(2) because, in those situations, neither the company making the false statement nor any corporate officer obtains any money (even indirectly) from the buyer of securities.[24] Similarly, it is hard to see how an auditing firm could ever be liable under Section 17(a)(2) so interpreted. The *Loughrin* interpretation of Section 17(a)(2) would also seem to preclude bringing misappropriation theory insider trading cases under that subsection because, in those cases, the false statement is directed to someone other than the buyer of the securities. Still further, the factual scenario presented in *Wolfson* – in which a defendant was simply paid a fee to draft a false statement that was later distributed to securities purchasers – likely would not be covered by Section 17(a)(2) under *Loughrin*. As these few examples demonstrate, the decision in *Loughrin* could prove to be an effective weapon in a defendant's arsenal for combatting an overly aggressive securities fraud case brought by the SEC.

[23] *Public Pension Fund Group v. KV Pharm. 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).

[24] Prior to *Loughrin* the SEC has succeeded in arguing that a corporate officer who obtained a bonus connected to the performance of his company that is reported in financial statements that impact secondary market trading in the company's stock can be liable under Section 17(a)(2). *See SEC v. Mudd*, 885 F. Supp. 2d 654, 670 (S.D.N.Y. 2012).