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ANTIFRAUD

"We Intend to Resolve the Ambiguities": The SEC Issues Some Surprising Guidance on Fraud Liability in the Wake of *Janus*





By Matthew Martens, Michael Mugmon, Jaclyn Moyer, Timothy Perry, and Laura Goodall

The Securities and Exchange Commission recently issued what could be its most consequential adjudicatory opinion in years. In that opinion, the Commission purports to resolve many of the interpretive questions regarding the scope of antifraud liability that have arisen in the wake of the Supreme Court's decision in *Janus Capital Group v. First Derivative Traders*.[1]

Nearly four years ago, the Supreme Court issued its decision in *Janus*, narrowing the scope of liability under Rule 10b-5(b)[2]—a key antifraud provision under Section 10(b) of the Securities Exchange Act. Specifically, the Court held that a person is liable under Rule 10b-5(b) for "mak[ing]" a false or misleading statement only if he had "ultimate authority" for that statement.[3] More importantly, the *Janus* opinion signaled an interpretive shift away from the Court's much-quoted statement that the federal securities laws should not be construed "technically and restrictively, but flexibly to effectuate [those] remedial purposes."[4] From now on, the Court suggested, the securities laws will be interpreted as strictly as any other statute.

The Court's strict interpretation of Rule 10b-5(b) redirected the attention of both the SEC and the plaintiffs' bar to other antifraud provisions of the federal securities laws, and the ensuing litigation has generated much uncertainty regarding the manner in which those provisions should be interpreted. With its December 15, 2014 decision, *In the Matter of John P. Flannery & James D. Hopkins*,[5] the Commission has attempted to answer many of the difficult interpretive questions raised in the wake of *Janus*.[6]

[1] 131 S. Ct. 2296 (2011).

[2] 17 C.F.R. § 240.10b-5. The SEC promulgated Rule 10b-5 pursuant to authority granted under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b).

[3] *Janus*, 131 S. Ct. at 2302.

[4] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963).

[5] Opinion of the Commission, *In the Matter of John P. Flannery & James D. Hopkins*, No. 3-14081 (SEC Dec. 15, 2014) [hereinafter *Flannery*] at 12, *available at* http://www.sec.gov/litigation/opinions/2014/33-9689.pdf. Both Flannery and Hopkins have sought review of the Commission's decision by the U.S. Court of Appeals for the First Circuit. *See* Petition for Review, *James D. Hopkins v. SEC*, No. 15-1117 (1st Cir. Jan. 16, 2015); Petition for Review, *John P. Flannery v. SEC*, No. 15-1080 (1st Cir. Jan. 14, 2015).

[6] *Flannery* at 12 ("*Janus*'s narrowing of liability under Rule 10b-5(b) has shifted attention to Rule 10b-5(a) and (c), as well as Section 17(a) . . . . By setting out our interpretation of these provisions[,] . . . we intend to resolve the ambiguities in the

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The *Flannery* decision arose from an enforcement action brought in a Commission administrative proceeding in which the administrative law judge found the two respondents not liable on all claims after an 11-day trial.[7] The SEC's Division of Enforcement petitioned for review by the full Commission, which, in a 3-2 decision, found both respondents liable, albeit only on very narrow grounds.[8] The Commission found respondent Hopkins liable under Rule 10b-5(a), (b), and (c) and Section 17(a)(1) of the Securities Act on the ground that he ''made'' a false statement in a single slide of a PowerPoint presentation that he delivered orally to one investor.[9] The Commission found respondent Flannery liable under Section 17(a)(3) of the Securities Act as a result of supposed misstatements in two letters to investors that he was involved in drafting and/or approving.[10]

In addition to reaching these very narrow and fact-bound conclusions, the Commission took the opportunity in *Flannery* to offer a 15-page commentary on the proper interpretation of Section 10(b), Rule 10b-5, and Section 17(a) after *Janus*.[11] Most of the Commission's interpretations have no relation to the case at hand (indeed, many of the legal issues were never even briefed by the parties[12]), and instead serve as advisory opinions designed, it seems, to drive subsequent litigation of those questions in the courts. Indeed, the Commission appears to be making a bid for *Chevron* deference[13] from the courts for its interpretations of those provisions, first asserting that there is ''ambiguity in Section 10(b), Rule 10b-5, and Section 17(a),''[14] and then claiming that its interpretations are ''informed by [the agency's] experience and expertise in administering the securities laws.''[15]

In this article, we catalogue the most consequential ''holdings'' of *Flannery*.

1. Primary Liability Under Section 10(b) Requires That Defendant Personally Commit a Deceptive Act.

Counterintuitively, the Commission begins its legal discussion in *Flannery* by *limiting* one aspect of liability under Section 10(b). The Commission holds that Section 10(b) liability extends only to those individuals who themselves commit a manipulative or deceptive act.[16] Thus, a defendant who assists in a deception, but who does not personally commit any deceptive acts, is not primarily liable under Section 10(b).[17] Mere participation in, or assistance in the perpetration of, a fraud is insufficient to establish primary liability; there must be a showing of particular instances of deception by the defendant.[18]

The Commission's holding in this regard reflects a more narrow understanding of primary liability under Section 10(b) than that laid out in the Second Circuit's decision in *SEC v. First Jersey Securities, Inc.*,[19] which held that such liability extends ''not only [to] persons who made fraudulent misrepresentations but also [to] those who had knowledge of the fraud and assisted in its perpetration.''[20] Practically, then, the *Flannery* opinion draws a sharper line between primary and secondary violators of Section 10(b), consistent with Supreme Court precedent holding that Section 10(b) liability does not reach aiders and abettors.[21] This distinction is important, for while aiding and abetting liability has since been created by statute in SEC enforcement actions,[22] it still does not exist in private actions.

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meaning of Rule 10b-5 and Section 17(a) that have produced confusion in the courts and inconsistencies across jurisdictions.'').

[7] *Id.* at 3; *see also In the Matter of John P. Flannery & James D. Hopkins*, Initial Decision Release No. 438, No. 3-14081 (ALJ Oct. 28, 2011), at 1, *available at* http://www.sec.gov/alj/aljdec/2011/id438bpm.pdf.

[8] *Flannery* at 2, 58.

[9] *Id.* at 27-34.

[10] *Id.* at 39-48.

[11] *Id.* at 12-26.

[12] *See* Division of Enforcement's Brief in Support of its Petition for Review, *Flannery* (Apr. 30, 2012), *available at* http://www.sec.gov/litigation/apdocuments/3-14081-event-121.pdf; Respondent James D. Hopkins' Opposition to the Division's Brief in Support of its Petition for Review, *Flannery* (May 30, 2012), *available at* http://www.sec.gov/litigation/apdocuments/3-14081-event-124.pdf; Respondent John Patrick Flannery's Opposition to the Division of Enforcement's Brief in Support of its Petition for Review, *Flannery* (May 30, 2012), *available at* http://www.sec.gov/litigation/apdocuments/3-14081-event-125.pdf; Division of Enforcement's Reply Brief in Support of its Petition for Review, *Flannery* (June 13, 2012), *available at* http://www.sec.gov/litigation/apdocuments/3-14081-event-128.pdf.

That many of the issues addressed in dicta in the *Flannery* decision were not briefed by the parties will likely have a significant bearing on the Commission's bid for *Chevron* deference to those purported statements of the law in subsequent enforcement actions. Absent briefing on the issues, the Commission was precluded by law from consulting with the Enforcement Division to obtain its views. 17 C.F.R. § 201.120 (prohibiting *ex parte* communications in the course of administrative litigation). And, obviously, the Commission was acting without the benefit of any opposing arguments by defense counsel. We doubt that decision-making in the absence of this adversary process is the type of ''formal adjudication'' the *Chevron* Court intended would be afforded deference from the courts. *See, e.g.*, *United States v. Mead Corp.*, 533 U.S. 218, 230 (2001) (stating that *Chevron* deference is very often applied when reviewing ''formal adjudication[s]'' because such formal adjudications follow procedures that ''foster fairness and deliberation''); *Sierra Club v. EPA*, 118 F.3d 1324, 1326 (9th Cir. 1996) (explaining that a main characteristic of formal administrative adjudicatory proceedings is their adversarial nature).

[13] *Chevron, U.S.A., Inc. v. National Resources Defense Council , Inc.*, 467 U.S. 837, 843-44 (1984) (establishing that if a statute administered by a federal agency does not squarely address an issue, the agency's interpretation of the statute's ambiguity is entitled to deference by the courts so long as it is reasonable).

[14] *Flannery* at 12.

[15] *Id.*

[16] *Id.* at 16-17. The SEC defines a ''deceptive'' act to mean ''conduct that gives rise to a false appearance of fact.'' *Id.* at 17 n.52. The SEC limits ''manipulative'' to a ''term of art . . . referring to practices such as wash sales, matched order, or rigged prices that are intended to mislead investors by artificially affecting market activity.'' *Id.* (internal quotation marks omitted).

[17] *Id.* at 21 n.73.

[18] *Id.* at 40 n.142.

[19] 101 F.3d 1450 (2d Cir. 1996).

[20] *Id.* at 1471.

[21] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994).

[22] 15 U.S.C. § 78t(e).

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2. 'Scheme Liability' Under Section 10(b) Extends to Pure Misstatement Cases.

While narrowing the category of actors subject to primary liability under Section 10(b), the Commission simultaneously attempts to enlarge the scope of conduct that violates that provision. In *Flannery*, the Commission expansively interprets the scope of so-called ''scheme liability'' under Section 10(b) in a manner that purports to overrule the more narrow interpretation rendered by three courts of appeals.[23] In particular, the Commission holds that scheme liability under Rule 10b-5(a) and (c)—provisions that outlaw the use of deceptive ''device[s]'' and ''act[s],'' respectively—extends to cases where the only misconduct alleged is a misstatement.[24] This is significant because pure misstatement cases were thought to be the sole province of Rule 10b-5(b), which expressly covers such.

The Commission's interpretation of subsections (a) and (c) of Rule 10b-5 rejects the ''beyond-a-misstatement'' approach adopted by the Second, Eight, and Ninth Circuits.[25] Those circuits have held that any misstatement-related conduct is covered by subsections (a) or (c) of Rule 10b-5 only if some deceptive conduct beyond a misstatement is involved.[26]

In disagreeing with these appellate court interpretations, the Commission relied on its decision in *In the Matter of Cady, Roberts & Co.*[27] for the proposition that the three subsections of Rule 10b-5 must be read as ''mutually supporting rather than mutually exclusive.''[28] Conduct that comes within the scope of one subsection—*e.g.*, misstatements, within subsection (b)—may also fall within another.[29] And, so, according to the Commission, a misstatement actionable under subsection (b) may also be an actionable deceptive ''device'' (subsection (a)) or ''act'' (subsection (c)).[30]

Applying its broader interpretation of scheme liability to a hypothetical scenario, the Commission asserts that a defendant who drafts or devises, but does not ''make,'' a misstatement would be primarily liable under subsections (a) and (c) of Rule 10b-5 since such a misstatement is a deceptive ''device'' or ''act.'' [31] What the Commission does not explain is how a mere drafter of a misstatement has ''use[d] or employ[ed]'' the misstatement, as the language of Section 10(b) also requires in order to give rise to liability.[32] Perhaps the drafter of a misstatement could be found secondarily liable as an aider and abettor in an SEC enforcement action.[33] But the Commission's effort to extend *primary* liability under Section 10(b) to mere drafters of misstatements exposes those parties to private litigation as well.

3. Primary Liability Under Section 17(a) Does Not Require That Defendant Personally Commit a Deceptive Act.

In contrast to its narrowing of primary liability under Section 10(b) to those who personally commit deceptive acts, the Commission purports to expand, in a most surprising way, the scope of primary liability under Section 17(a) of the Securities Act. Specifically, the Commission contends that primary liability under Section 17(a) extends to those who do not themselves engage in deceptive or manipulative conduct.[34] It is enough, the Commission suggests, that a defendant's conduct ''contribute[s] to a fraud.''[35]

For example, if a company executes an entirely legitimate business transaction knowing that another entity will use the transaction to misstate its revenue, the company would (in the Commission's view) be liable under Section 17(a).[36] Yet, under Section 10(b), the company would only be liable for engaging in the transaction if it were a ''sham . . . designed to give the false appearance of business operations.''[37]

This distinction is perplexing. The language of Section 17(a) largely mirrors, and was indeed the model for, Rule 10b-5.[38] Nevertheless, the Commission treats the two provisions differently because Section 10(b)'s text ''requir[es] that the proscribed conduct be 'manipulative and deceptive,' '' while Section 17(a)'s text does not.[39] The Commission is careful to note that a Section 17(a) violation does require proof of actual or potential investor deception, but nevertheless contends that it need not show that it was the defendant's conduct that was deceptive.[40]

By its *Flannery* opinion, the Commission has served notice of its expansive reading of Section 17(a) that is potentially staggering in its implications. To take just the example offered by the Commission itself, if Section 17(a) creates liability for companies that participate in

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[23] *See Flannery* at 18.

[24] *Id.*

[25] *Id.* at 20 & n.69 (citing *Public Pension Fund Grp. v. KV Pharm. Co.*, 679 F.3d 972 (8th Cir. 2012); *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039 (9th Cir. 2011); *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005)).

[26] *Public Pension Fund*, 679 F.3d at 987; *WPP Luxembourg*, 655 F.3d at 1057-58; *Lentell*, 396 F.3d at 177-78.

[27] Exchange Act Release No. 6668, 1961 WL 60638, at *4 (Nov. 8, 1961).

[28] *Flannery* at 20 (internal quotation marks omitted).

[29] *Id.*

[30] *Id.* at 18.

[31] *Id.* The Commission's discussion in this regard is dicta because, with regard to the only respondent found liable for violating Section 10(b), the Commission concluded that he was a ''maker,'' not a mere drafter, of the misstatement. *Id.* at 33-34.

[32] In this regard, the language of Section 10(b) contrasts with that of the federal mail and wire fraud statutes, which extend liability to those who ''devise'' schemes to defraud. *See* 18 U.S.C. § § 1341, 1343.

[33] *See* 15 U.S.C. § 78t(e) (''[A]ny person that knowingly or recklessly provides substantial assistance to another person in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.'').

[34] *Flannery* at 22-23; *see also id.* at 26 (''Section 17(a)(3) does not require that the defendant have engaged in conduct that is itself deceptive (or manipulative).''). Elsewhere, however, the Commission seems to articulate the contrary position that liability under Section 17(a)(1) and (3), like Rule 10b-5(a) and (c), ''can be established only through a showing of particular instances of misconduct by the defendant.'' *Id.* at 40 n.142.

[35] *Id.* at 23 n.86.

[36] *Id.*

[37] *Id.* at 17.

[38] *Compare* 15 U.S.C. § 77q(a) *with* 17 C.F.R. § 240.10b–5. *See also United States v. Persky*, 520 F.2d 283, 287 (2d Cir. 1975) (''[Section 17(a)'s] language regarding fraudulent conduct is almost identical to, and indeed was the model for . . . Section 10(b) and Rule 10b-5 . . . .'').

[39] *Flannery* at 22.

[40] *Id.* at 23.

wholly legitimate transactions based merely on the deceptive purpose of a counterparty, must companies now conduct due diligence concerning their counterparty's intent? This concern is heightened by the fact that two subsections of Section 17(a) give rise to negligence-based liability even in the absence of fraudulent intent by the defendant. The Commission does not address—or even appear to consider—these potential ramifications.

4. A Section 17(a) Violation Exists Only if Investors Are Actually or Potentially Defrauded.

Section 17(a) outlaws various forms of fraud ''in the offer or sale of any securities.''[41] Consistent with this statutory language, the Commission holds that liability under Section 17(a) is limited to cases where investors were ''actually or potentially defrauded.''[42] As the Commission puts it, ''in any case brought under Section 17(a), there would need to be a showing that investors were or could have been defrauded.''[43]

One surprising—and perhaps unanticipated—implication of the Commission's holding in this regard is that it eliminates the possibility of misappropriation theory insider trading under Section 17(a). This is so because the misappropriation theory is premised not on actual or even potential deception of investors, but rather on deception of the source of information in breach of a duty of confidentiality owed to that source.[44] Thus, by requiring that investors were or could have been deceived in order to establish Section 17(a) liability, the Commission has precluded use of the misappropriation theory as a basis for insider trading liability under Section 17(a).

5. The *Janus* Standard Does Not Apply to Section 17(a)(2) Violations.

One of the earliest questions to arise in the wake of *Janus* was whether its limitation of Rule 10b-5(b) liability to ''makers'' of misstatements would likewise apply to Section 17(a)(2). This issue arose because the courts had previously held that the provisions of Rule 10b-5 and Section 17(a) were ''essentially the same.''[45] Defendants had therefore argued that the *Janus* ''make'' limitation should be read into Rule 10b-5(b)'s counterpart in Section 17(a)(2). For the most part, this simplistic argument has been unsuccessful in the courts.[46]

In *Flannery*, the Commission attempts to put the issue to rest, concluding that liability under Section 17(a)(2) is not limited to ''makers'' of misstatements.[47] As the Commission explains, Section 17(a)(2) does not contain the word ''make,'' the operative language that *Janus* analyzed in the context of Rule 10b-5(b).[48] Rather, Section 17(a)(2) imposes liability on those who ''obtain'' money or property ''by means of an untrue statement.''[49] Citing the First Circuit's decision in *SEC v. Tambone*,[50] the Commission construes Section 17(a)(2)'s phrase ''by means of'' an untrue statement to reach anyone who ''*uses*'' an untrue statement, regardless of whether the defendant himself made the misstatement.[51] So, under this reading of Section 17(a)(2), a defendant could be liable for redistributing a false statement that someone else made.[52] In effect, the Commission is attempting to extend nationwide the *Tambone* court's interpretation of Section 17(a)(2).

6. A Section 17(a)(2) Violation Requires That Defendant's Receipt of Money Be Causally Connected to Misstatements.

Next, the Commission stakes out a position with regard to the causal connection required under Section 17(a)(2) that is, surprisingly, much more limited than the position the Enforcement Division has typically advocated. The Commission holds that Section 17(a)(2)'s phrase to ''obtain money or property by means of any untrue statement'' requires a causal link between the misstatement and the defendant's receipt of money or property.[53] In other words, the misstatement ''must be at least relevant to, if not the cause of, the transfer of money or property from an investor to the defendant (or perhaps his employer).''[54] In requiring this causal link, the Commission analogizes to the federal bank fraud statute's language requiring that the defendant ''obtain'' money or property ''by means of false or fraudulent pretenses''[55]—language which the Supreme Court recently interpreted in *Loughrin v. United States*[56] and found satisfied only if the defendant's false statement was the mechanism ''naturally inducing'' a bank to part with money in its control.[57]

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[41] 15 U.S.C. § 77q(a).

[42] *Flannery* at 23.

[43] *Id.*

[44] *See*, *e.g.*, *United States v. O'Hagan*, 521 U.S. 642, 649-51 (1997).

[45] *First Jersey Secs.*, 101 F.3d at 1467 (''With respect to § 17(a)(1), essentially the same elements [as in a Rule 10b–5 claim] must be established in connection with the offer or sale of a security.''); *see also SEC v. Pentagon Capital Mgmt. PLC*, 725 F.3d 279, 285 (2d Cir. 2013) (''[T]he requirements for a violation of Section 17(a), as relevant here, are identical to the requirements for a violation of Section 10(b).'').

[46] *See*, *e.g.*, *SEC v. Monterosso*, 756 F.3d 1326, 1334 (11th Cir. 2014) (per curiam) (''*Janus* only discussed what it means to 'make' a statement for purposes of Rule 10b-5(b), and did not concern section 17(a)(1) . . . . The operative language of section 17(a) does not require a defendant to 'make' a statement in order to be liable''); *SEC v. Stoker*, 865 F. Supp. 2d 457, 465 (S.D.N.Y. 2012) (same, and collecting cases); *SEC v. Geswein*, 2 F. Supp. 3d 1074, 1080 (N.D. Ohio 2014) (''The Court will not presume to extend *Janus* to violations of the Securities Act Section 17(a).'').

[47] *Flannery* at 14-16.

[48] *Id.* at 15.

[49] *Id.* at 14.

[50] 550 F.3d 106, 127-28 (1st Cir. 2008), *opinion withdrawn*, 573 F.3d 54 (1st Cir. 2009), *reinstated in relevant part*, 597 F.3d 436 (1st Cir. 2010) (en banc).

[51] *Id.* at 15 & n.38.

[52] *Id.*

[53] *Flannery* at 34-35.

[54] *Id.* at 35.

[55] *Id.* at 35 n.132.

[56] 134 S. Ct. 2384 (2014).

[57] *Id.* at 2393-94. *See* Matthew T. Martens & Mark D. Cahn, *Unnoticed Supreme Court Decision Could Narrow Securities Fraud Law*, Securities Regulation & Law Report, Bloomberg BNA, Aug. 4, 2014, *available at* http://www.wilmerhale.com/uploadedFiles/Shared_Content/Editorial/Publications/Documents/unnoticed-supreme-court-decision-could-narrow-securities-fraud-law-bloombergbna-8Aug2014.pdf (predicting that the *Loughrin* Court's interpretation of the language of the bank fraud statute would apply with equal force to Section 17(a)(2)).

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In *Flannery*, the Commission elaborates on the causal link requirement by addressing the scenario in which the defendant's employer is the first recipient of the fraudulently obtained money or property and the defendant is the alleged second recipient.[58] According to the Commission, in such a situation, an investor's money received by the employer and then passed on to the employee will satisfy Section 17(a)(2)'s causation requirement, if at all, only where it can be traced back to the defendant-employee's misstatement to the investor.[59] In other words, merely showing that the defendant-employee received a salary or bonus from the employer is insufficient to make the causal showing required by Section 17(a)(2). The Commission must show that the employer originally received the investor's funds due to the defendant's misconduct and then ''passed on'' some portion thereof to the defendant.[60]

This interpretation of Section 17(a)(2) represents a narrowing of the position the Commission has previously taken in litigation. Indeed, in *SEC v. Wolfson*,[61] the Commission persuaded the Tenth Circuit that a defendant's receipt of money in return for drafting false statements subsequently used by a company in securities offerings was sufficient to satisfy the ''obtain money or property by means of any untrue statement'' element of Section 17(a)(2).[62] The direct tracing requirement adopted in *Flannery* is a more narrow position, and, as a result, the Commission has made it more difficult to bring successful cases under Section 17(a)(2). Presumably, the Enforcement Division will alter its position in ongoing cases accordingly.

7. Sections 17(a)(2) and (3) May Be Strict Liability Provisions, and a Showing of Negligence May Not be Required.

In *Aaron v. SEC*,[63] the Supreme Court held that, in contrast to the scienter requirement applicable to all three subsections of Rule 10b-5, liability may be imposed under the last two subsections of Section 17(a) based on a showing of mere negligence.[64] Since *Aaron*, courts of appeals have held that a showing of negligence is required to establish a violation of Section 17(a)(2) or (3).[65] In *Flannery*, however, the Commission suggests, in dicta, that a showing of negligence may be sufficient, but not *necessary*, to establish a violation of those provisions.[66] According to the Commission, *Aaron* ''suggests that, at least under Section 17(a)(3), the focus is only on the '*effect* of particular conduct on members of the investing public, rather than upon the culpability of the person responsible' for the conduct.''[67] These assertions suggest that the Commission is of the view that Section 17(a)(2) and (3) may in fact create strict liability.[68]

As an initial matter, any suggestion that Section 17(a) liability can be imposed based on something short of negligence seems to represent a shift from the position taken by SEC Chair White in a speech this past May.[69] While the Commission does not expressly state that Section 17(a)(2) and (3) are strict liability offenses—and any such statement would have been dicta in the context of this case—the fact that the Commission even raises this prospect is startling, to put it mildly. As noted above, the Commission is seemingly of the view that one can be liable under Section 17(a) for assisting another in a deception even without personally committing a deceptive act.[70] Now, the Commission suggests that such liability can be imposed without a showing of fault on the part of the individual or entity providing that assistance. Because these statements by the Commission were not necessary to the Commission's ultimate conclusions in this case as to these respondents,[71] they likely will not be challenged on appeal to the circuit court. Instead, the statements will linger until they are invoked by the Commission or those acting on its behalf against unwary professionals.

8. Extreme Recklessness May Suffice to Show a Violation of Section 10(b) and Section 17(a)(1).

The courts have long held that scienter—an ''intent to deceive, manipulate, or defraud''—is an element of a violation of both Rule 10b-5 and Section 17(a)(1). Although every federal court of appeals to consider the issue has held that the scienter requirement may be met by a showing that the defendant acted intentionally or recklessly, the circuits differ concerning the degree of recklessness required.[72] The Supreme Court has reserved judgment on the question whether reckless behavior of any type satisfies the scienter requirement.[73]

In *Flannery*, the Commission adopts the D.C. Circuit's approach, holding that extreme recklessness—defined as an '' 'extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it' ''—suffices to establish scienter.[74] Thus, in the absence of a Supreme Court decision on the issue, the Commission holds that scienter is satisfied by a showing stronger than that of simple recklessness but lower than that of specific intent.

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[58] *Flannery* at 35 n.133, 48 n.162.

[59] *Id.*

[60] *Id.* To be clear, the Commission reserves judgment on the question of whether receipt of funds by an employer that are passed on to an employee could satisfy the ''obtain'' money or property requirement of Section 17(a)(2). The Commission assumes as much for sake of argument, but then finds the requisite causal connection unproven here. *See id.*

[61] 539 F.3d 1249 (10th Cir. 2008).

[62] *Id.* at 1264.

[63] *Aaron v. SEC*, 446 U.S. 680 (1980).

[64] *Id.* at 697.

[65] *See SEC v. Ginder*, 752 F.3d 569, 574 (2d Cir. 2014); *SEC v. Shanahan*, 646 F.3d 536, 546 (8th Cir. 2011).

[66] *Flannery* at 14 n.30 (''But the [Supreme] Court has never addressed whether negligence is *necessary* to prove a violation of [Section 17(a)(2) or 17 (a)(3)].'').

[67] *See id.*

[68] *Id.*

[69] *See* Mary Jo White, SEC Chair, Three Key Pressure Points in the Current Enforcement Environment (May 19, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370541858285.

[70] *See supra* at Section 3.

[71] *Flannery* at 49 n.163.

[72] *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 n.3 (2007) (stating that ''[t]he question whether and when recklessness satisfies the scienter requirement is not presented in this case,'' while noting that the standards vary across circuits).

[73] *Id.*

[74] *Flannery* at 13 n.24 (quoting *Rockies Fund, Inc. v. SEC*, 428 F.3d 1088, 1093 (D.C. Cir. 2005)).

9. Scheme Liability Under Section 17(a)(1) Extends to Pure Misstatement Cases.

As with Rule 10b-5(a) and (c), the Commission asserts that scheme liability under Section 17(a)(1) extends to pure misstatement cases—that is, cases in which the only deceptive conduct is a misstatement.[75] The Commission reasons that Section 17(a)(1) encompasses misstatements and misstatement-related misconduct because a misstatement is a ''device'' or ''artifice'' to defraud.[76]

The Commission further states that a defendant who ''makes'' a material misstatement in the offer or sale of a security violates Section 17(a)(1), as does a defendant who merely drafts the misstatement.[77] Both actors, the Commission contends, ''employ'' a ''device'' or ''artifice to defraud.''[78] Again, however, the Commission fails to explain how a mere drafter of a misstatement has ''employ[ed]'' the misstatement, as the language of Section 17(a)(1) plainly requires.[79]

10. Scheme Liability Under Section 17(a)(3) Does Not Extend to Pure Misstatement Cases, at Least When Only a Single Misstatement Was Made.

While the Commission holds that even a single misstatement can violate Rule 10b-5(a) and (c) and Section 17(a)(1), the Commission holds that a different rule applies to Section 17(a)(3). This is so because Rule 10b-5(c) prohibits deceptive ''*acts*, practices, or courses of business,'' while Section 17(a)(3) prohibits deceptive ''*transactions*, practices, or courses of business.'' A single misstatement, the Commission explains, is not a ''transaction,'' nor can an isolated statement be considered a ''practice or course of business,'' and thus, Section 17(a)(3) does not cover the making or drafting of a single misstatement.[80]

The Commission states that Section 17(a)(3) would, however, cover a defendant who repeatedly makes or drafts misstatements because such behavior may well be a ''practice or course of business.''[81] Therefore, Section 17(a)(3) extends to misstatements only when the defendant has engaged in a series or pattern of misstatements.

[75] *Flannery* at 24.
[76] *Id.*
[77] *Id.* at 24-25.
[78] *Id.* at 25.
[79] 15 U.S.C. 77q(a)(1) (making it unlawful to ''employ any device, scheme, or artifice to defraud''). The Commission's discussion regarding the scope of Section 17(a)(1) liability for mere drafters is dicta because, with regard to the only respondent found liable for violating that provision, the Commission concluded that he was a ''maker,'' not a mere drafter, of the misstatement. *Flannery* at 33-34.
[80] *Flannery* at 25-26.
[81] *Id.* at 26.

11. The 'Willfully' Standard Requires Only Voluntary Conduct, Not Knowledge of Wrongdoing.

To impose certain sanctions against a respondent, the SEC must establish that a violation was committed ''willfully.''[82] In *Flannery*, the Commission asserts that the term ''willfully'' means merely that ''the person charged with the duty knows what he is doing.''[83] In other words, it is sufficient that the respondent ''intentionally'' or ''voluntarily'' committed the act that constitutes the violation; he need not also be aware that he is violating the law.[84]

True to this definition, the Commission finds that both *Flannery* respondents acted willfully because both acted volitionally, even though one of them was found liable only for a negligence-based offense.[85] In so holding, the Commission reads the term ''willfully'' to have a meaning different from the criminal context, where the Second Circuit has defined willfulness ''as a realization on the defendant's part that he was doing a wrongful act under the securities laws.''[86]

In conclusion, it is certainly understandable that the Commission would seek to resolve some of the interpretive uncertainty left in the wake of *Janus*. It remains to be seen whether the courts will accept the Commission's theories of liability as expressed in *Flannery*, but the Commission, as well as private plaintiffs, are sure to press these views in future actions.

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Matt Martens is a partner in WilmerHale's Washington, D.C. office and a member of the firm's Securities and Litigation/Controversy departments. He may be reached at (202) 663-6921 or matthew.martens@wilmerhale.com.

Michael Mugmon is a partner in WilmerHale's Palo Alto office and a member of the firm's Securities and Litigation/Controversy departments. He may be reached at (650) 858-6103 or michael.mugmon@wilmerhale.com.

Jaclyn Moyer is a counsel in WilmerHale's Washington, D.C. office and a member of the firm's Securities and Litigation/Controversy departments. She may be reached at (202) 663-6309 or jaclyn.moyer@wilmerhale.com.

Timothy Perry is a counsel in WilmerHale's Los Angeles office and a member of the firm's Securities and Litigation/Controversy departments. He may be reached at (213) 443-5306 or timothy.perry@wilmerhale.com.

Laura Goodall is an associate in WilmerHale's Palo Alto office and a member of the firm's Litigation/Controversy department. She may be reached at (650) 858-6109 or laura.goodall@wilmerhale.com.

[82] 15 U.S.C. § 80a-9(b).
[83] *Flannery* at 52.
[84] *Id.*
[85] *Id.*
[86] *United States v. Newman*, —- F.3d —-, Nos. 13-1837-cr (L), 13-1917-cr (con), 2014 BL 345948, at *7 (2d Cir. Dec. 10, 2014).

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