

Client Alert

Latham & Watkins Litigation Department

District Court Ruling Paves the Way for More “Negligent Securities Fraud” Enforcement Actions Under Sections 17(a)(2) and (3) of the Securities Act

Last year, the *Wall Street Journal* predicted that the SEC “could file more civil cases in which defendants are accused of negligence only, rather than harder-to-prove charges of intentional wrongdoing or recklessness.”¹ That forecast was reiterated by SEC Director of Enforcement Robert Khuzami, who stated at a securities law conference that the SEC will bring more cases based on negligence “in the appropriate cases if there is a deviation from the appropriate standard of care and the result is that investors lost money.”²

Consistent with these predictions, the SEC has recently filed at least two litigated enforcement actions charging individuals with violations of Sections 17(a)(2) and (3) of the Securities Act of 1933 – under which the SEC claims the authority to bring negligence-based actions – without also including scienter-based charges under Section 10(b) of the Securities Exchange Act of 1934 and related Rule 10b-5 that have traditionally been the bread and butter of litigated enforcement actions.³ A June 6, 2012 opinion issued by Judge Jed S. Rakoff of the United States District Court for the Southern District of New York in one of those cases, *SEC v. Stoker*, approved of a fairly expansive reading of Sections 17(a)(2) and (3), and may provide further motivation for the SEC to shift its enforcement focus away from Section 10(b) towards Sections 17(a)(2) and (3).⁴

Among other things, in his opinion in *Stoker*, Judge Rakoff expressly rejected the argument that the central holding of the Supreme Court’s ruling last summer in *Janus Capital Group, Inc. v. First Derivative Traders, Inc.* – that, for purposes of civil liability under Section 10(b) and Rule 10b-5(b), the only party that may be held liable for making a false statement is “the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it”⁵ – should be extended to apply to Section 17(a)(2). Judge Rakoff also permitted the SEC to proceed with a “scheme liability” claim under Section 17(a)(3) based on some of the same allegations as its Section 17(a)(2) claim.

This Client Alert examines Judge Rakoff’s ruling in *SEC v. Stoker* in the context of the SEC’s apparent efforts to circumvent the strictures imposed by *Janus* via the pursuit of negligence charges.

“*SEC v. Stoker* . . . may provide further motivation for the SEC to shift its enforcement focus away from Section 10(b) towards Sections 17(a)(2) and (3).”

“Negligent Securities Fraud” Under Sections 17(a)(2) and (3)

Congress enacted the Securities Act of 1933 to protect investors from fraud in the offer or sale of securities. To that end, Section 17(a)(2) establishes “misstatement liability,” making it unlawful to obtain money or property by means of any untrue statement or omission of a material fact.⁶ Sections 17(a)(1) and (3) each articulate forms of “scheme liability” by prohibiting, respectively, “any device, scheme, or artifice to defraud” and “any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.”⁷ Rule 10b-5,⁸ adopted by the SEC pursuant to Section 10(b) of the Exchange Act,⁹ makes similar prohibitions as those contained in Section 17(a) applicable to “purchasers” of securities as well; Rule 10b-5(b), like Section 17(a)(2), establishes “misstatement liability” and Rules 10b-5(a) and (c), like Sections 17(a)(1) and (3), establish “scheme liability.”

Over three decades ago, the Supreme Court established that Section 10(b), Rule 10b-5, and Section 17(a)(1) require the SEC to prove that the defendant acted with an intent to “deceive, manipulate or defraud.”¹⁰ No such specific intent is required to establish a claim under Sections 17(a)(2) or (3). Rather, Sections 17(a)(2) and (3) only require proof of negligence and, in that regard, focus “upon the effect of particular conduct on members of the investing public, rather than upon the culpability of the person responsible.”¹¹

The SEC began to use Section 17(a)(2) in a litigated context prior to *Janus*.¹² In 2008, the First Circuit ruled in *SEC v. Tambone* that primary liability under Section 17(a)(2) is broader than under Rule 10b-5 and attaches to anyone who “uses” a false or misleading statement, even if that person did not “make” the statement.¹³ Post-*Janus*, however, the import of *Tambone* is unclear, and more broadly, lower courts have not developed a consensus on whether the Supreme Court’s “ultimate authority” limitation should extend beyond Rule 10b-5(b) in the SEC enforcement context. A handful of courts have ruled that *Janus* is equally applicable to misstatement liability claims under Section 17(a)(2) and scheme liability claims under Rules 10b-5(a) and (c) as well as Section 17(a)(3), on the theory that the elements of claims under Rule 10b-5 and Section 17(a) are functionally the same.¹⁴ But more have refused to apply *Janus* to Rule 10b-5(a) or (c) scheme liability or to Section 17(a) at all, primarily on the theory that the pivotal language of Rule 10b-5(b) interpreted in *Janus* – the word “make” – is entirely absent from those provisions.¹⁵ Judge Rakoff’s opinion in *SEC v. Stoker* is in the latter camp.

Judge Rakoff’s Analysis of Sections 17(a)(2) and (3) in *SEC v. Stoker*

Brian Stoker, the defendant in *SEC v. Stoker*, was a director from March 2005 to August 2008 in a division of Citigroup Global Markets, Inc. that structured and marketed collateralized debt obligations (CDOs).¹⁶ The SEC’s complaint against Stoker alleged that he violated Sections 17(a)(2) and (3) in connection with his role as lead structurer for a “CDO squared,” or a CDO collateralized by other CDOs, known as Class V III (the Fund). Specifically, the SEC alleged that Stoker was responsible for ensuring the accuracy and completeness of the Fund’s primary marketing documents, which allegedly failed to disclose to investors that Citigroup had taken substantial short positions related to some of the reference securities included in the Fund’s portfolio, among other things. In early 2007, nine months after the Fund transaction closed, it experienced an event of default; its poor performance ultimately resulted in losses by investors of several hundred million dollars.¹⁷

Section 17(a)(2) Claim: Stoker advanced two arguments for dismissal of the SEC's Section 17(a)(2) claim, both of which were rejected by the Court.

First, Stoker argued that the SEC had not alleged that Stoker "obtain[ed] money or property" by means of the alleged fraud, reasoning that money made by Citibank from the Fund could not be imputed to him personally and that the SEC had not established a direct connection between the fraud and his own compensation (which doubled from the prior year).¹⁸ After acknowledging the "surprisingly sparse[] and inconclusive case law" in this area, Judge Rakoff found Stoker's argument to be contradicted by the statute – which only requires that the defendant obtain money or property "directly or indirectly"¹⁹ – and in conflict with plausible inferences that could be drawn from the allegations in the complaint regarding, among other things, the temporal proximity of the consummation of the Fund transaction and Stoker's raise.²⁰ Judge Rakoff concluded "that it is sufficient under Section 17(a)(2) for the SEC to allege that Stoker obtained money or property for his employer while acting as its agent, or, alternatively, for the SEC to allege that Stoker personally obtained money indirectly from the fraud."²¹

Second, Stoker argued that the SEC had not alleged facts to show that Stoker should be held responsible for the alleged misstatements underlying the Section 17(a)(2) charge; as Judge Rakoff characterized it, "the assertion [in defendant's papers] is . . . that the Complaint fails to adequately allege that Stoker was the person who 'made' or was responsible for the alleged false statements."²² Stoker staked this position principally on *Janus*. Judge Rakoff refused to extend *Janus* to Section 17(a), stressing the fact that the Supreme Court had focused on the word "make" in Rule 10b-5(b). In Judge Rakoff's view, Section 17(a)(2)'s prohibition on obtaining money "by means of" a misstatement "plainly covers a broader range of activity" than Rule 10b-5(b).²³ Further, Judge Rakoff found that the Supreme Court's narrow reading in *Janus* was driven in part by the existence of an implied private right of action under Section 10(b) and noted that, "[b]y contrast, there is no need to read Section 17(a) narrowly in light of concerns about the implied private right of action because there is no private right of action – implied or explicit – under Section 17(a)."²⁴ Accordingly, Judge Rakoff adopted the First Circuit's view articulated in *SEC v. Tambone* that liability attaches under Section 17(a)(2) "so long as the statement is used 'to obtain money or property,' regardless of its source."²⁵

Section 17(a)(3) Claim: Stoker sought dismissal of the SEC's Section 17(a)(3) claim on the grounds that it was duplicative of the Section 17(a)(2) claim. Judge Rakoff held that a defendant could be liable under both subsections based on allegations stemming from the same set of facts so long as the SEC alleged a deceptive scheme or course of conduct that went beyond the misrepresentations and omission, and found that the SEC had carried that burden by plausibly alleging that Citigroup had engaged in a fraudulent scheme in connection with the formation and marketing of the Fund and that Stoker was a part of that scheme.²⁶ Although Judge Rakoff did not expressly decline to extend *Janus* to Section 17(a)(3), his stated reasoning for finding *Janus* inapplicable to Section 17(a)(2) (the statute does not prohibit "making" of misstatements and there is no implied private right of action to justify a narrow reading) applies with equal force to Section 17(a)(3).

Conclusion

Judge Rakoff's ruling in *SEC v. Stoker* highlights several key considerations that might lead the SEC to increase its use of stand-alone Sections 17(a)(2) and (3) claims in civil enforcement proceedings. As an initial matter, under Sections 17(a)(2) and (3), the SEC need only plead and prove that a defendant acted negligently, rather than with a deceptive intent. Further, the *Stoker* case makes clear that these

provisions can be potent weapons against individuals in light of Judge Rakoff's holding that the SEC can establish a misstatement liability claim under Section 17(a)(2) by alleging merely that an individual "obtained money" from a misstatement on behalf of his employer, or indirectly through incentive compensation. Lastly, and perhaps most significantly, according to Judge Rakoff's interpretation of Section 17(a)(2), the SEC need only plead and prove that a defendant *used* a false statement, rather than that he or she *made* the statement within the meaning of *Janus*; in the same vein, Judge Rakoff strongly implied that *Janus* will not foreclose a defendant's liability under Section 17(a)(3) for a corporate scheme in which he participated, but for which he may not have been ultimately responsible.

As noted above, *SEC v. Stoker* is not the first opinion to address whether or how *Janus* applies to SEC enforcement actions under Sections 17(a)(2) and (3), and it remains to be seen how other courts – including the Second Circuit – will ultimately rule on the matter. In the interim, however, the decision will likely further whet the SEC's appetite for charging individuals with negligence.

Pressure for the Commission to bring aggressive enforcement actions has never been greater. For an individual, such an action can be career-threatening. While the Director of the Division has suggested that the SEC will avoid prosecuting "honest mistakes,"²⁷ that statement may provide cold comfort as a skeptical SEC staff considers, after the fact, whether an individual's conduct was reasonable. Viewed in this light, the decision creates some risk of a chilling effect on employees who assist with and profit — even indirectly — from public offerings, as they may become increasingly reluctant to work in a capacity that renders them personally liable for alleged negligence.

Endnotes

- ¹ Jean Eaglesham, "At SEC, Strategy Changes Course," WALL ST. J, September 30, 2011, at C1.
- ² Joshua Gallu, "Khuzami Says Seeking Admissions of Guilt Would Slow Probes," Bloomberg News, November 11, 2011, *available at* <http://www.bloomberg.com/news/2011-11-11/sec-s-khuzami-says-forcing-guilty-pleas-may-divert-resources.html> (last visited June 18, 2012).
- ³ See *SEC v. Steffelin*, No. 11 Civ. 4204(MGC) (S.D.N.Y. June 21, 2011), SEC Litigation Release No. 22008 (June 21, 2011); and *SEC v. Stoker*, No. 11 Civ. 7388(JSR) (S.D.N.Y. Oct. 22, 2011), SEC Litigation Release No. 22134 (October 19, 2011).
- ⁴ -- F.Supp.2d ---, No. 11 Civ. 7388(JSR), 2012 WL 2017736 (S.D.N.Y. June 6, 2012).
- ⁵ 131 S. Ct. 2296, 2302 (2011).
- ⁶ 15 U.S.C. § 77q(a)(2) ("It shall be unlawful for any person in the offer or sale of any securities... or any security-based swap agreement . . . directly or indirectly . . . (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.").
- ⁷ 15 U.S.C. § 77q(a)(1), (3) ("It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement . . . directly or indirectly . . . (1) to employ any device, scheme or artifice to defraud, or . . .(3) to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.").
- ⁸ 17 C.F.R. § 240.10b-5(b).
- ⁹ 15 U.S.C. § 78j.
- ¹⁰ *Aaron v. SEC*, 446 U.S. 680, 686, 695-97 (1980).
- ¹¹ *Id.* at 696-97.
- ¹² See, e.g., *SEC v. Softpoint, Inc.*, 958 F. Supp. 846 (S.D.N.Y. 1997) (Sotomayor, J.).

- ¹³ 550 F.3d 106, 127-28 (1st Cir. 2008), *reh'g en banc granted, opinion withdrawn*, 537 F.3d 54 (1st Cir. 2009) and *opinion reinstated in relevant part on reh'g*, 597 F. 3d 436 (1st Cir. 2010) (en banc).
- ¹⁴ *SEC v. Kelly*, 817 F.Supp.2d 340, 345-46 (S.D.N.Y. 2011) (McMahon, J.); *In the Matter of John P. Flannery & James D. Hopkins*, Initial Decision Release No. 438, Administrative Proceeding, File No. 3-14081 (SEC Administrative Decision, Oct. 28, 2011).
- ¹⁵ *SEC v. Pentagon Capital Mgmt. PLC*, -- F.Supp.2d ---, No. 08 Civ. 3324(RWS), 2012 WL 479576, at *42 (S.D.N.Y. Feb. 14, 2012) (Sweet, J.) (*Janus* inapplicable to Rule 10b-5(a) or (c) or Section 17(a)); *SEC v. Mercury Interactive LLC*, No. 07 Civ. 2822(WHA), 2011 U.S. Dist. LEXIS 134580 (N.D. Cal. Nov. 22, 2011) (Fogel, J.) (same); *SEC v. Daifotis*, No. 11 Civ. 137(WHA), 2011 U.S. Dist. LEXIS 83872, at *14 (N.D. Cal. Aug 1, 2011) (Alsup, J.) (*Janus* inapplicable to Section 17(a)).
- ¹⁶ *SEC v. Stoker*, 2012 WL 2017736, at *1.
- ¹⁷ No. 11 Civ. 7388(JSR), Dkt. No. 1, Complaint at ¶¶ 4, 7, 71, 76-78.
- ¹⁸ *Id.* at ¶¶ 79-80.
- ¹⁹ 15 U.S.C. § 77q(a)(2) (emphasis added).
- ²⁰ *SEC v. Stoker*, 2012 WL 2017736, at *5-*6.
- ²¹ *Id.* at *5.
- ²² *Id.* at *7.
- ²³ *Id.* at *8.
- ²⁴ *Id.* (citing *Finkel v. Stratton Corp.*, 962 F.2d 169, 174 (2d Cir. 1992)).
- ²⁵ 550 F.3d at 127.
- ²⁶ *SEC v. Stoker*, 2012 WL 2017736, at *11. Note, however, that S.D.N.Y. Judge Miriam Cedarbaum reached the opposite conclusion in *SEC v. Steffelin*, an enforcement action charging an individual with negligence under Sections 17(a)(2) and (3) on allegations closely paralleling those made in *SEC v. Stoker*. In *Steffelin*, Judge Cedarbaum ruled from the bench to deny the defendant's motion to dismiss the Section 17(a)(2) claim while granting the motion as to the Section 17(a)(3) claim on the grounds that "[t]his conduct doesn't bear more than one violation of 17(a) . . . you can't take the same conduct and just describe it differently." *SEC v. Steffelin*, No. 11-cv-4204(MGC), Dkt. No. 25, Oct. 25, 2011 Tr. at 38. Judge Cedarbaum's ruling in *Steffelin* did not mention *Janus* at all.
- ²⁷ *Supra* note 2.

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