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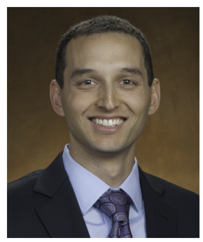
Section 17(a) of the Securities Act of 1933: Unanswered Questions



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In recent years, the Securities and Exchange Commission has increasingly relied on Section 17(a) of the 1933 Securities Act. Indeed, many of the cases the SEC has brought in the wake of the recent financial crisis have been charged solely under Section 17(a). While Section 17(a) shares the same basic structure as the more familiar Rule 10b-5, it is different in important ways. However, because courts often analyze Section 17(a) and Rule 10b-5 together, the unique provisions of Section 17(a) have received less attention over the years. There are thus a number of important questions regarding the application of Section 17(a) that have not yet been resolved. Below, we provide a brief overview of Section 17(a) and discuss the key differences between Section 17(a) and Rule 10b-5, then discuss several significant unanswered questions regarding Section 17(a).

Overview of Section 17(a) and Its Relationship to Rule 10b-5

Congress passed the 1933 Securities Act in the wake of the market crash of 1929, to "provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of hon-

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esty and fair dealing.''[1] As the key enforcement provision of the 1933 Act, Section 17(a) prohibits fraud and misrepresentations in the offer or sale of securities. It provides:

> It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (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; 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.

Although some courts have treated the three subsections as all covering the same types of misconduct[2], most courts have interpreted the three subsections as proscribing different types of misconduct, with subsections (a)(1) and (a)(3) covering so-called ''scheme'' liability and subsection (a)(2) covering misrepresentation and omission liability.[3]

Section 17(a) is similar in many respects to Rule 10b-5, promulgated pursuant to Section 10(b) of the 1934 Securities Exchange Act, and the two provisions follow roughly the same structure. However, Section 17(a) and Rule 10b-5 are different in two respects. Section 17 is broader than Section 10(b) and Rule 10b-5 because claims under Section 17(a)(2) and (a)(3) may be based on negligent conduct, while all Rule 10b-5 claims require proof of scienter.[4] On the other hand, Section 17 is narrower than Rule 10b-5 because it does not allow for private rights of action.[5]

Unanswered Questions About Section 17(a)(2)

Janus and the Scope of Section 17(a)(2). One of the most hotly contested questions in Section 17(a) litigation is what level of responsibility a defendant must have for a misstatement to be liable under Section 17(a)(2). In *Janus Capital Group, Inc. v. First Derivative Traders*[6], the U.S. Supreme Court held that the only party that may be held liable for a false or misleading statement under Rule 10b-5(b) is ''the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.'' The question with respect to Section 17(a) is whether *Janus*'s ''ultimate authority'' standard applies to misstatement liability under Section 17(a)(2) as well.

Until recently, courts generally held that Section 17(a)(2) and Rule 10b-5(b) are coextensive. Although Rule 10b-5(b) is framed in terms of ''making'' a misstatement, while Section 17(a)(2) is framed in terms of ''obtaining money or property by means of'' a misstatement, courts required that the same elements be proved for claims brought under the two provisions.[7] Thus, pre-*Janus*, courts held that the same standard was required to show that a defendant had ''made'' a statement under Rule 10b-5(b) as was required to show misstatement liability under Section 17(a)(2).[8]

Based on this precedent, defendants have argued that, while *Janus* did not explicitly address Section 17(a)(2), applying the *Janus* ''ultimate authority'' standard for misstatement responsibility in Rule 10b-5(b) cases but not in Section 17(a)(2) cases would be inconsistent.

To date, however, only one court has endorsed this argument. In *SEC v. Kelly*, the court reasoned that, ''[a]lthough the language of subsection (2) of Section 17(a) is not identical to that of subsection (b) of Rule 10b-5, both provisions have the same functional meaning,'' in that ''[t]o succeed on a misstatement claim under either Rule 10b-5(b) or Section 17(a)(2), the SEC must prove that the defendant *made* materially false statements or omissions.''[9]

Thus, it held that ''[b]ecause subsection (2) of Section 17(a) and subsection (b) of Rule 10b–5 are treated similarly, it would be inconsistent for *Janus* to require that a defendant have made the misleading statement to be liable under subsection (b) of Rule10b–5, but not under subsection (2) of Section 17(a).''[10]

Meanwhile, the majority position has been that *Janus* does not apply to Section 17(a)(2) claims. Courts have reasoned that the Supreme Court's decision in *Janus* was based specifically on an interpretation of the word ''make,'' which does not appear in Section 17(a)(2), and on the need to limit implied private rights of action, a policy concern that is not implicated by Section 17(a).[11]

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[1] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976).

[2] *See, e.g.*, *SEC v. Merchant Capital, LLC*, 483 F.3d 747, 766 (11th Cir. 2007).

[3] *See, e.g.*, *SEC v. Kelly*, 817 F. Supp. 2d 340, 343-45 (S.D.N.Y. 2011).

[4] *Aaron v. SEC*, 446 U.S. 680, 696-97 (1980); *SEC v. Monarch Funding Corp.*, 192 F.3d 295, 308 (2d Cir. 1999); *Pagel Inc. v. SEC*, 803 F.2d 942, 946 (8th Cir. 1986).

[5] *Touche Ross & Co. v. Redington*, 442 U.S. 560, 568-71 (1979); *Finkel v. Stratton Corp.*, 962 F.2d 169, 174-75 (2d Cir. 1992); *e.g.*, *Finkel*, 962 F.2d at 174 (explaining that Section 17 also only applies to ''the offer or sale of securities,'' whereas Section 10(b) and Rule 10b-5 reach the ''purchase'' of securities as well); *see SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 859 (2d Cir. 1968) (noting that Section 10(b) was intended as a ''catch-all'' enforcement provision directed at both buyers and sellers of securities and was purposefully written in broad language to effect this purpose). *See generally* Larry Bumgardner, *A Brief History of the 1930s Securities Laws in the United States—and the Potential Lesson for Today*, 4 J. Global Bus. Mgmt. 39 (2008) (stating that the Roosevelt administration originally drafted legislation that would have combined regulation of the sale and issuance of new securities with regulation of securities exchanges but ultimately decided to separate the two issues into separate statutes).

[6] 131 S. Ct. 2296, 2302 (2011).

[7] *Monarch*, 192 F.3d at 308; *accord, e.g.*, *SEC v. Gottleib*, 88 F. App'x 476, 477 (2d Cir. 2004).

[8] *See SEC v. McGinn, Smith & Co., Inc.*, 752 F. Supp. 2d 194, 212 (N.D.N.Y. 2010), *vacated in part on unrelated grounds by SEC v. Wojeski*, 752 F. Supp. 2d 220 (N.D.N.Y. 2010); *SEC v. KPMG LLP*, 412 F. Supp. 2d 349, 376 (S.D.N.Y. 2006); *SEC v. PIMCO Advisors Fund Mgmt. LLC*, 341 F. Supp. 2d 454, 466-67 (S.D.N.Y. 2004) *SEC v. Global Telecom Servs., LLC*, 325 F. Supp. 2d 94, 111 (D. Conn. 2004).

[9] 817 F. Supp. 2d at 345 (emphasis in original).

[10] *Id.*

[11] *SEC v. Daifotis*, No. C11-137, 2011 BL 199412, at *5-6 (N.D. Cal. Aug. 1, 2011); *accord SEC v. Sells*, —- F. Supp. 2d ——, 2012 BL 204698, at *7 (N.D. Cal. Aug. 10, 2012); *SEC v. Big Apple Consulting USA, Inc.*, —- F. Supp. 2d ——, 2012 BL 203486, at *3 (M.D. Fla. Aug. 9, 2012); *SEC v. Sentinel Mgmt. Group, Inc.*, —- F. Supp. 2d ——, 2012 BL 85573, at *15-16

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This issue has not yet been addressed on the circuit court level.

A few courts have gone a step further, to hold that even pre-*Janus* standards for misstatement responsibility do not apply to Section 17(a)(2). These decisions have been based on a pre-*Janus* First Circuit opinion, *SEC v. Tambone*.[12] *Tambone* held that, notwithstanding the precedent that Section 17(a)(2) and Rule 10b-5(b) were generally treated as coextensive, claims of primary liability under Section 17(a)(2) could be established by showing "use" of the alleged misstatement, even if the defendant had no responsibility for creating the alleged misstatement.[13] To date, *Tambone*'s "use" standard for Section 17(a)(2) misstatement responsibility has been applied in two district court opinions.[14]

The cases holding that use of a misstatement is sufficient to establish liability under Section 17(a)(2) potentially blur the line between primary and secondary liability. Before *Tambone*, Section 17(a)(2) claims premised on statements for which someone else was entirely responsible were brought as *secondary* liability claims.[15] Such secondary liability claims require proof that the defendant acted "knowingly or recklessly."[16] But no such requirement exists for Section 17(a)(2) primary liability claims.[17]

Thus, *Tambone* and the cases endorsing it would appear to permit the SEC to circumvent the actual knowledge requirement by recasting claims based on alleged misstatements for which the defendant had no responsibility as primary violations.

The 'Money or Property' Requirement in Section 17(a)(2). Section 17(a)(2) imposes liability on anyone who directly or indirectly obtains money or property by means of a misrepresentation or omission, including those who profit legally, i.e. through bonuses or pay raises.[18] Another question regarding Section 17(a) that is unresolved is whether a defendant must personally obtain money or property for Section 17(a)(2) to apply.

Some courts have required that the SEC allege and prove that the defendant personally obtained money or property as a result of the defendant's conduct or role in the alleged fraud. For example, in *SEC v. Syron*, the court applied the ordinary meaning of "obtain" to Section 17(a)(2) to conclude that "to obtain an object is to gain possession of it."[19] The court then found that "the final step, whereby the defendant personally gains money or property from the fraud, is essential," and—noting that the SEC failed to allege such conduct—dismissed the claim.[20]

Other courts have held that, where an employer profits from a misrepresentation or omission, a defendant can held liable if subsequent incentive compensation earned by the defendant employee is derived from the employer's wrongful profit.[21]

Yet, other courts have not required that the defendant personally obtain any benefit at all and have held that it is sufficient under Section 17(a)(2) that the defendant obtained money for his employer.[22] This third approach was followed most recently in *SEC v. Stoker*.[23] The court acknowledged that "[t]he case law addressing these points is surprisingly sparse and inconclusive," but ultimately concluded that it is sufficient under Section 17(a)(2) for the defendant to obtain money or property for his employer while acting as its agent.[24] The court also suggested that it might be sufficient to show that the victim of the alleged fraud lost money, regardless of whether the defendant or his employer obtained any profit.[25]

The Difference Between Section 17(a)(2) 'Misstatement Liability" and Section 17(a)(3) 'Scheme Liability.' A third question that comes up in litigation involving Section 17(a) is what distinguishes a misstatement claim under Section 17(a)(2) from a claim for scheme liability under Section 17(a)(3). Courts have generally adopted the rule from the Rule 10b-5 context that, to state a claim under Section 17(a)(3), the SEC must allege a deceptive scheme or course of conduct that goes beyond any misrepresentations alleged under Section 17(a)(2).[26] Indeed, in the context of private litigation, it is well established that "[c]laims for engaging in a fraudulent scheme and for making a fraudulent statement or omission are . . . distinct claims, with distinct elements,"[27]

(N.D. Ill. Mar. 30, 2012); *SEC v. Pentagon Capital Management PLC*, 844 F. Supp. 2d 377, 422 (S.D.N.Y. 2012); *SEC v. Mercury Interactive, LLC*, No. 5:07-cv-2822, 2011 BL 301076, at *3 (N.D. Cal. Nov. 22, 2011).

[12] 550 F.3d 106, 127 (1st Cir. 2008), *reh'g en banc granted and opinion withdrawn*, 573 F.3d 54 (2009), *and opinion reinstated in relevant part*, 597 F.3d 436 (2010) (en banc).

[13] *Id.* at 127.

[14] *SEC v. Stoker*, 865 F. Supp. 2d 457, 465 (S.D.N.Y. 2012); *SEC v. Radius Capital Corp.*, —- F. Supp. 2d ——, 2012 BL 52382, at *7 (M.D. Fla. Mar. 1, 2012).

[15] *See, e.g., SEC v. Coven*, 581 F.2d 1020, 1030 (2d Cir. 1978).

[16] 15 U.S.C. § 78t(e); *see also Coven*, 581 F.2d at 1030; *SEC v. Pasternak*, 561 F. Supp. 2d 459, 478 (D. N.J. 2008).

[17] *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1467 (2d Cir. 1996); *see also Coven*, 581 F.2d at 1030.

[18] *See SEC v. Norton*, 21 F. Supp. 2d 361, 365 (S.D.N.Y. 1998).

[19] No. 11 Civ. 9201 (RJS), Dkt. No. 91, at 28 (S.D.NY. March 28, 2013).

[20] *Id.*; *see also SEC v. Daifotis*, No. C 11-00137 (WHA), 2011 BL 149557, at *10 (N.D. Cal. June 6, 2011) (dismissing Section 17(a)(2) claim for its failure to allege defendant's receipt of money from the alleged fraud); *SEC v. Burns*, No. 84-0454, 1986 WL 36318, at *3-4 (S.D. Cal. Feb. 19, 1986) ("[T]he literal language of the statute requires a finding that the Defendant 'obtain money or property,' "); *cf. SEC v. Wolfson*, 539 F.3d 1249, 1264 (10th Cir. 2008) (holding that defendant's receipt of a fee for preparing reports that included misrepresentations would meet the "obtain" standard).

[21] *Compare SEC v. Hopper*, 2006 BL 131098, at *13 (S.D. Tex. Mar 24, 2006) ("It is reasonable to infer that those inflated trading volumes and revenues factored into the calculation of [defendant's] bonuses."), *with SEC v. Mudd*, 885 F. Supp. 2d 654, 670 (S.D.N.Y. 2012) (citing allegation that the defendants "received a bonus that was tied to both FNMA's performance and their own personal performance in attaining individual year-end goals"), *and SEC v. Forman*, 2010 BL 129645, at *8-9 (D. Mass., June 9, 2010) (granting summary judgment where the evidence showed that the defendant received a set, predetermined bonus not tied to the company's performance).

[22] *See, e.g., SEC v. Delphi Corp.*, No. 06-14891, 2008 BL 231467 (E.D. Mich. Oct. 8, 2008).

[23] 865 F. Supp. 2d at 462-63.

[24] *Id.*

[25] *See id.* at 463 n.7. *But see Syron*, No. 11 Civ. 9201 (RJS), Dkt. No. 91, at 27-28.

[26] *See, e.g., Kelly*, 817 F. Supp. 2d at 346; *Daifotis*, 2011 BL 149557, at *9-10; *SEC v. Lucent Techs., Inc.*, 610 F. Supp. 2d 342, 360 (D. N.J. 2009).

[27] *In re Global Crossing Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 336 (S.D.N.Y. 2004).

and that the same set of facts may give rise to liability under both subsections only where the defendants allegedly both made misrepresentations and ''undertook a deceptive scheme or course of conduct that went beyond the misrepresentations.''[28]

What is less clear is what this rule means in practice. Some courts have taken their cues from private securities litigation to find that the conduct at issue under Section 17(a)(3) must involve ''sham'' or ''inherently deceptive'' practices such that the alleged conduct would still have been wrongful absent a misleading statement.[29] For example, in *In re Parmalat Sec. Litig.*[30], relied upon by *Lucent*, the court dismissed one scheme claim but allowed another scheme claim to survive.

In the former instance, the defendants issued loans that were later mischaracterized as equity investments on its financial statements; the court dismissed the scheme claim based on these allegations because ''[a]ny deceptiveness resulted from the manner in which [the debtor] or its auditors described the transactions on [its] balance sheets.''[31]

However, in the second instance, the defendants securitized worthless invoices; the court found that, unlike the case of mischaracterized loans, the securitizations depended on a fiction that the underlying invoices had value, and were therefore inherently deceptive.[32]

In *Alstom*, also relied upon by the *Lucent* court, the conduct at issue was the defendant's intentional underbidding of a contract and later nondisclosure of overrun costs associated with the same contract.[33] The court dismissed the scheme liability claim because neither the underbidding nor the costs were inherently deceptive, and the plaintiffs did not allege that the defendant underbid the contract so that it could underreport costs years later.[34]

Other courts have instead focused on whether the same set of facts that support misstatement liability under Section 17(a)(2) may also support allegations of a deceptive scheme, without distinguishing ''sham'' or ''inherently deceptive'' practices.[35] In *Stoker*, the SEC alleged that the defendant failed to disclose to investors that his company had both influenced the selection of certain poorly-performing securities for inclusion in a collateralized debt obligation and also held a short position on the same deal.

The court first concluded that ''a defendant may be liable under both Section 17(a)(2) and Section 17(a)(3) based on allegations stemming from the same set of facts as long as the SEC alleges that the defendants undertook a deceptive scheme or course of conduct that went beyond the misrepresentations.''[36] However, the court found that the alleged misrepresentations only constituted ''part of the conduct, but they were not the entirety of it.''[37] In particular, the court relied upon allegations that the defendant's company sought to profit from a downturn in the housing market by deliberately seeking poor-performing securities for a short position on its own account. The court concluded that these alleged actions, ''especially when combined with the misstatements and/or omissions . . . are sufficient to state a claim under Section 17(a)(3).''[38]

In another recent SEC enforcement case, *SEC v. Familant,*[39] the court found that the SEC properly stated a claim for scheme liability under Rule 10b-5(a) and (c) over the defendant's objection that the alleged misconduct was not a scheme. The SEC alleged that the defendant accepted and recorded fake grants of credit as reductions to expenses, thus inflating his company's performance. First, as in *Stoker*, the *Familant* court found that the alleged misconduct went beyond misrepresentations that could otherwise be covered by Rule 10b-5(b). The court then broadly defined the word ''scheme'' as ''a plan or program of something to be done; an enterprise; a project; as, a business scheme, or a crafty, unethical project,'' and—relying by analogy upon the ''expansive reach'' of Section 17(a)—found that the alleged conduct fit within the similarly broad scope of Section 10(b) even if the ''primary purpose and effect'' of the defendant's alleged scheme was only to make misrepresentations.[40] While not a Section 17(a) case, *Familant* provides a roadmap to how a court might draw favorable comparisons between Section 17(a)(3), Section 10(b), and Rule 10b-5(c) to find that the same misconduct may form the basis for both a scheme and a misrepresentation.

As these cases show, no precise line has been drawn between liability under Section 17(a)(2) and (a)(3).

The Standard for Negligence in Section 17(a) Claims. A fourth open question is: what constitutes negligent conduct under Section 17(a)? As discussed above, claims under Section 17(a)(2) and (a)(3) may be based on negligence, unlike analogous claims under Section 10(b) and Rule 10b-5, which require proof of scienter.[41] However, because Section 17(a) has been used less frequently and when it has courts have often analyzed it concurrently with Rule 10b-5, the unique negligence element of Section 17(a) has received little attention. For example, no major jury instruction treatise offers a model instruction on the definition of negligence specifically in the context of Section 17(a)(2) or (a)(3) claims.

One aspect of this question that is likely to receive increased attention is whether evidence of industry practice, custom, and standards can be considered in determining whether the conduct of a Section 17(a)(2) or (a)(3) defendant rose to the level of negligence. Section 17(a) claims will often be brought based on complex financial transaction, involving numerous professionals beyond the defendant. Can the jury consider the actions

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[28] *In re Alstom SA*, 406 F. Supp. 2d 433, 475 (S.D.N.Y. 2005); *see also Kelly*, 817 F. Supp. 2d at 343-44.
[29] *Daifotis*, 2011 BL 149557, at *9-10; *see also Lucent Techs.*, 610 F. Supp. 2d at 359-60.
[30] 376 F. Supp.2d 472 (S.D.N.Y. 2005).
[31] *Id.* at 505.
[32] *See id.* at 504.
[33] 406 F. Supp.2d at 476–77.
[34] *Id.*
[35] *See, e.g.*, *Stoker*, 865 F. Supp. 2d at 467.
[36] *Id.* (quoting *Alstom*, 406 F. Supp. 2d at 475).
[37] *Id.*
[38] *Id.* at 468; *see also SEC v. Alternative Green Technologies, Inc.*, 11-Civ-9056 (SAS), 2012 WL 4763094, at *5 (S.D.N.Y. Sept. 24, 2012) (finding that the defendant may be liable under subsections (a) and (c) [of Rule 10b-5] ''for conduct in one period that gives rise to a misstatement in a later period'').
[39] F. Supp. 2d—-, 2012 BL 331047, at *8-13 (D.D.C. Dec. 19, 2012)
[40] *Id.*
[41] *Aaron*, 446 U.S. at 696-97; *Monarch*, 192 F.3d at 308; *Pagel*, 803 F.2d at 946.

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of these other professionals, or how such transactions were generally done at the time, in assessing the reasonableness of the defendant's actions, or is this all irrelevant? Put another way, is reasonableness assessed based on the particular context and specialized duties of the defendant?

The trend appears to be towards expanding the scope of evidence that can be considered in determining whether conduct was negligent. In the *Stoker* case, the court instructed the jury that, in deciding whether the defendant's conduct met the negligence standard, the jury could ''consider any evidence of industry practice, custom, or standards, as they pertained to a reasonably prudent person in [the defendant's] position at the time.''[42] In *SEC v. Shanahan*, the Eighth Circuit held that the negligence standard for Section 17(a)(2) and (a)(3) claims required consideration of the defendant's ''duties as a member of [the company's] Board of Directors and as a member of the Compensation Committee.''[43] And in *SEC v. O'Meally*, the district court held that claims involving ''specialized and technical aspects of [the defendant's] job'' required consideration of ''the pricing of mutual funds, the applicable legal and regulatory requirements and the computing requirements for executing a large volume of trades quickly.''[44]

IV. Conclusion

As the SEC continues to rely on Section 17—and in particular its negligence-based provisions—we anticipate that the statute's unique provisions will receive more and more attention.

[42] Instructions of Law to the Jury at 13, *SEC v. Stoker*, No. 1:11-cv-7388 (S.D.N.Y. July 31, 2012), ECF No. 89.

[43] 646 F.3d 536, 546 (8th Cir. 2011),

[44] No. 06-Civ-6483 (LTS)(RLE), 2012 WL 1969300 at *3-4 (S.D.N.Y. May 30, 2012).