When Your Government Thinks You've Been Unreasonable:
The SEC's New War on Negligence

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The SEC's Enforcement Division has recently made clear that it intends to bring more enforcement actions based on allegations that a defendant has been negligent, even if there is no evidence of any intent to defraud anyone. (*See*, *e.g.*, "At SEC, Strategy Changes Course," WSJ, 9/30/11.)

Charging negligent conduct is nothing new for the SEC. Section 17(a)(2) of the Securities Act of 1933 has long been understood to prohibit negligent misstatements in the offer or sale of securities. *See, e.g.*, *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968). For many years, however, the SEC's practice has been to charge negligence in two types of cases: where the SEC also charges fraud and negligence is, in essence, a lesser included offense, and where the SEC believes the evidence would support a fraud charge but accepts negligence in a negotiated settlement. The SEC's newfound interest in negligence dramatically expands the scope of conduct that may be subject to government enforcement and raises significant questions about the SEC's interpretation of Section 17(a)(2) and the standards it will use to assess whether conduct has been negligent.

Understanding the SEC's interest in negligence starts with changes in the interpretation of a different rule, Rule 10b-5, the SEC's primary vehicle for charging defendants with fraud. Rule 10b-5 makes it illegal "to make any untrue statement of a material fact" in connection with the purchase or sale of securities. 17 C.F.R. § 240.10b-5(b). Last year, after many years of uncertainty in the lower courts over what it means "to make" a statement, the Supreme Court finally clarified the standard for primary liability under Rule 10b-5. *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011). Prior to *Janus,* federal courts had developed

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two tests for determining what it means to "make" a statement under Rule 10b-5. Under the "bright-line" test, a defendant must have actually made a statement that was publicly attributed to him. *Wright v. Ernst & Young*, 152 F.3d 169, 174-75 (2d Cir. 1998). Under the broader "substantial participation" test, the "substantial participation or intricate involvement in the preparation" of a statement is all that is required to establish that a defendant made a statement. *Howard v. Everex Systems, Inc.*, 228 F.3d 1057, 1061-62, n.5 (9th Cir. 2000).

In *Janus*, the Court adopted a formulation of Rule 10b-5 that is very close to the "bright-line" test. The Court held that the "maker" of a statement is the person "with ultimate authority over the statement, including its content and whether and how to communicate it." *Janus*, 131 S. Ct. at 2302. Without control, a person can participate in the drafting process, review the statement, and suggest what to say, but does not "make" the statement. The Court further held that the fact that a statement is attributed to a person is strong evidence that that person is the "maker" of the statement, and the "maker" is the *only* person who can be held personally liable for a material misstatement.

The *Janus* decision has had profound implications for the SEC's enforcement program. For example, even senior company employees who participate in the drafting of a misstatement, but do not make it, can no longer be held primarily liable under Rule 10b-5. Similarly, participants in a transaction that results in a material misstatement of earnings (such as a side letter or sham transaction), but who do not sign the relevant financial statement, can no longer be held primarily liable.

The SEC Staff's position, stated many times on panels and in public and private meetings, is that *Janus* has impacted *what* defendants are charged with but not *who* is charged. In particular, the Staff often notes that the SEC has authority to charge culpable persons with aiding and abetting a Rule 10b-5 violation. But aiding and abetting charges do not entirely fill the void created by *Janus*. This is because aiding and abetting requires that the SEC prove a primary violation by someone else. There are instances in which the culpable person is not the "maker" of the

statement, but the SEC cannot state a primary violation against the actual "maker" of the statement because that person did not intend to defraud. Without a viable claim against the "maker," there can be no claim for aiding and abetting, even if the secondary actor acted with a bad intent.

It is in the context of dealing with the *Janus* decision that the Staff has also explored negligence-based charges. The language of Section 17(a)(2), the basis for negligence charges, does not raise the same "maker" problem posed by Rule 10b-5. Section 17(a)(2) makes it illegal "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." 15 U.S.C. § 77q(a)(2). For many years, the SEC took the position, citing *U.S. v. Naftalin*, 441 U.S. 768 (1979), that the elements of a Section 17(a)(2) claim against sellers of securities were essentially the same as a claim under Rule 10b-5, except for the lesser state of mind requirement.

The SEC began to expand its view of liability under Section 17(a)(2) in the several years prior to the Supreme Court's decision in *Janus*, during a period in which some lower courts began to narrow the scope of primary liability under Rule 10b-5. An example of the SEC's then-expanding view is found in the *Tambone* market timing case, filed in 2004. In *Tambone*, cognizant that the court might apply the restrictive "bright-line" test under Rule 10b-5, the SEC argued that under Section 17(a)(2), primary liability attaches to anyone who "uses" a false or misleading statement, even if that person did not "make" the statement.

The First Circuit agreed with the SEC's argument. In *SEC v. Tambone*, 550 F.3d 106 (1st Cir. 2008), *rev'd en banc in part on other grounds*, 597 F.3d 436 (2010), the court held that the scope of liability under Section 17(a)(2) is more broad than under Rule 10b-5 because the plain language of Section 17(a)(2) expressly proscribes the *use* of a false statement rather than merely the *making* of a false statement. Because dissemination of the allegedly false prospectuses to investors was a use, the court held that the SEC stated a claim under Section 17(a)(2).

Since *Janus*, the SEC has adopted the reasoning of *Tambone*, and other decisions like it, to use Section 17(a)(2) as an end run around the limitations imposed on Rule 10b-5 liability. The *Steffelin* case, filed one week after *Janus* was decided, is the highest profile example of the SEC's new approach of charging negligence. *SEC v. Steffelin*, Civ. A. No. 11-04204-MGC (S.D.N.Y.). The crux of the SEC's allegation is that Edward Steffelin, a portfolio manager of a synthethic collateralized debt obligation pool, was negligent in failing to disclose to prospective investors that another investor, who the SEC alleges was shorting the assets in the pool, had participated in the process of selecting portfolio investments.

The defendant did not draft or disseminate the allegedly misleading disclosure, but allegedly "reviewed and edited" them. Thus, under *Janus*, he could not be held primarily liable under Rule 10b-5 because he did not make any statements to investors. To avoid the *Janus* limitation, the SEC charged the defendant with violations of Section 17(a)(2) and contends that the "substantial participation" test still applies to Section 17(a)(2) claims. Indeed, the SEC has argued in response to Steffelin's motion to dismiss that Section 17(a)(2) imposes primary liability "on persons . . . who had knowledge of the fraud and assisted in its perpetration." *See* SEC's Opposition to Motion to Dismiss.

The SEC's argument in *Steffelin* appears simply to graft its pre-*Janus* interpretation of Rule 10b-5 onto Section 17(a)(2). This position, however, is at odds with the *Janus* decision's clear instruction that the plain language of the securities laws is meaningful. Indeed, as the First Circuit noted in *Tambone*, Section 17(a)(2) is particular about the conduct that it is proscribing: it prohibits "obtain[ing] money or property" "by means of" a misleading statement. Yet, nowhere does the SEC allege that Steffelin used a misleading statement to obtain money or property.

Perhaps more troubling, the SEC has not articulated the standard that it will use to assess whether a person has been negligent. One senior staffer was quoted in the Wall Street Journal as stating that negligence charges could be based on a "[f]ailure to check properly that investors are being provided with fair and accurate

information." But a "failure to check" standard raises more questions than it answers: who possesses a duty to check? where does the duty arise from? what conduct satisfies the duty?

In several ongoing investigations, the Staff appears to be contemplating negligence charges in situations where it previously would have considered charging fraud based on a failure to respond appropriately to "red flags," but where there is no statement to investors and no evidence of any intent to defraud on which to base fraud charges. Assessing whether a person's response to purported "red flags" was negligent can be a very subjective exercise and neither the *Steffelin* case nor other statements by Staff provides much guidance as to how the SEC will make that assessment. In the absence of clear guidance from the SEC or a court, practitioners are left to explore traditional indicia of reasonableness: did the person act openly, visibly, transparently or in secret? were persons with appropriate expertise involved in the decisionmaking process? were inside or outside counsel consulted? were compliance personnel consulted? was there a pattern or practice of inappropriate decisionmaking? did the individuals involved deviate from past practices or procedures? The right questions to ask in any case, however, are necessarily determined by the facts and circumstances of that case.

Finally, in assessing whether to use its enforcement power to charge negligence, the SEC should consider the often draconian collateral consequences of being charged by the SEC. Such consequences occur by operation of law, such as statutory disqualifications for the securities industry, disclosure obligations, and the elimination of safe harbor and offering exemptions. Other, often harsher, consequences occur in practice, such as the termination of employment, unemployability, loss of livelihood, and reputational harm.

After reading the *Steffelin* complaint, one is left to wonder whether it's good policy for the securities industry for a person's livelihood to rest on the SEC's assessment of whether he or she acted reasonably in situations where no one suggests any intent to defraud.