

10th Circ.'s Securities Fraud Reading May Be Too Broad

By **Peter Morrison, Virginia Milstead and Raza Rasheed** (August 28, 2019, 1:45 PM EDT)

On Aug. 13, in the first case by a circuit court to apply the U.S. Supreme Court's recent decision in *Lorenzo v. U.S. Securities and Exchange Commission*,^[1] the U.S. Court of Appeals for the Tenth Circuit **held** in *Malouf v. SEC* that the defendant could be liable under SEC Rules 10b-5(a) and (c) for knowingly failing to correct another party's material misstatements in connection with a securities transaction.^[2]

Dennis Malouf was an executive at two unrelated firms: a securities brokerage that was a subsidiary of Raymond James Financial Services Inc., and investment adviser UASNM Inc. Malouf sold his interest in the brokerage in a transaction that compensated him in installments based on the commissions the brokerage earned on securities sales.

Afterward, Malouf steered UASNM clients to the brokerage without disclosing to the clients or UASNM his financial interest in the brokerage, and despite knowing that UASNM had represented that Malouf did not have any financial conflicts. After learning of Malouf's conflict of interests, the SEC brought enforcement proceedings, and an administrative law judge found that Malouf had violated, among other provisions, Rules 10b-5(a) and (c), which prohibit fraudulent schemes and artifices.

The Tenth Circuit affirmed. Applying *Lorenzo* — which **held** that a defendant can be liable under Rules 10b-5(a) and (c) for knowingly disseminating material misstatements made by others — the Tenth Circuit reasoned that Malouf's knowledge that a conflict existed and "that UASNM was telling its clients that he was independent," combined with his failure "to correct UASNM's statements" or "disclose his own conflict," constituted an unlawful fraudulent scheme.

The court rejected Malouf's argument that the SEC had improperly collapsed the distinction between provisions prohibiting false or misleading statements in connection with securities transactions, which apply to the persons or entities who themselves make the unlawful statements, and provisions prohibiting fraudulent schemes, which purportedly have no such limitations.



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The Malouf court cited Lorenzo in its decision. However, Lorenzo arguably does not support Malouf's holding. The Supreme Court in Lorenzo held the defendant liable for the affirmative act of disseminating material misstatements. The Malouf court held the defendant liable for his knowing inaction — failing to correct statements made and disseminated by UASNM. It is not clear, however, that the Supreme Court intended Lorenzo to be applied beyond the specific context of disseminating false or misleading statements.

In Lorenzo, the court observed that "where an individual neither makes nor disseminates false information," that person will not be held liable under Rules 10b-5(a) and (c), "provided, of course, that the individual is not involved in some other form of fraud." Nothing in Lorenzo suggests that the court counted knowing failure to correct a misstatement — and not some affirmative misconduct — as "some other form of fraud" that would subject a defendant to liability under Rules 10b-5(a) and (c), and the Malouf court did not address this limitation in Lorenzo's holding.

Given the limitation in Lorenzo, it remains to be seen whether other courts will follow Malouf. In any event, Malouf should be limited to situations where the defendant created and exploited the very situation that caused the third party to make the misstatements at issue.

In addition, Malouf was decided in the context of an SEC enforcement action. Therefore, Malouf does not address whether a defendant could be liable to a private plaintiff under Rules 10b-5(a) and (c) for failing to correct another person's material misstatements. Unlike the SEC, a private plaintiff is required to plead and prove reliance on the deceptive conduct, and in *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc.*,^[3] the Supreme Court held that a private plaintiff could not bring a suit based on undisclosed conduct on which the plaintiff could not have relied.

Ultimately, while Malouf is the first post-Lorenzo circuit court case to address whether a knowing failure to correct another's material misstatements can trigger liability under Rule 10b-5, it may be difficult for a plaintiff to argue that Malouf broadened the universe of conduct giving rise to potential Rule 10b-5 exposure.

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[1] 139 S. Ct. 1094 (2019).

[2] No. 16-9546, 2019 WL 3788225 (10th Cir. Aug. 13, 2019).

[3] 552 U.S. 148 (2008).