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How the Supreme Court Just Raised the Stakes in Muni Disclosure.

WASHINGTON — A U.S. Supreme Court decision handed down last week may have strengthened the Securities and Exchange Commission's enforcement powers in the municipal market and ramped up the pressure on market participants to be cautious in their disclosure undertakings, legal experts believe.

Bond lawyers said this week that the high court's 6-2 decision in Lorenzo v. SEC strengthens the SEC's hand in enforcement actions by broadening the scope of individuals it could charge as "primary" violators under the anti-fraud Rule 10b-5 of the Securities Exchange Act of 1934. The court's majority opinion held that Francis Lorenzo, a director of investment banking at an SEC-registered brokerage firm was violating subsections of Rule 10b-5 when at the direction of his supervisor he sent two emails containing fraudulent information to prospective investors.

The Supreme Court has previously held that only "makers" of false statements with authority over those claims have primary liability under Rule 10b-5(b), which prohibits making untrue statements of material fact and material omissions. While the case was not a muni case, lawyers said the opinion could allow the SEC to charge a broader group of participants with primary, rather than secondary violations.

"It's a win for the SEC," said Stacey Lewis, partner at Pacifica Law Group. "It strengthens the SEC's hand in enforcement proceedings and being able to bring primary violator actions against a broader group of folks. Even people who were not themselves the maker of the fraudulent statements are now held to be a primary violator of the Rule 10b fraud requirements and so that certainly adds something to the SEC's hand in enforcement proceedings."

In its 2011 decision in Janus Capital Grp., v. First Derivative Traders, the Court held that to be a "maker" of a statement under subsection (b) of the rule, "one must have ultimate authority over the statement, including its content and whether and how to communicate it."

But last week the court found that disseminating false statements can be violations of the other parts of Rule 10b-5, subsections (a) and (c), as well as related provisions of the securities laws. Rule 10b-5(a) makes it unlawful to "employ any device, scheme or artifice to defraud" and 10b-5(c) makes it unlawful to "engage in any act, practice or course of business" that "operates as a fraud or deceit."

"The Supreme Court did nothing to narrow the exposure of issuers and other municipal parties under the federal securities laws or limit the rights of investors," said Paul Maco, a partner at Bracewell in Washington, D.C.

The SEC has historically brought secondary violations against others involved in fraudulent conduct, so Lewis said she doesn't think the decision has behavioral implications among muni market participants who are already conscious of anti-fraud requirements. Rather than pursuing a particular individual on secondary fraud violations, the SEC now has a stronger card to play when going after somebody with a primary cause, Lewis said.

“It certainly kind of tilts the playing field slightly in that regard,” Lewis said. “If anything, it’s a win for the SEC and strengthens their hand.”

Emails forwarded from Lorenzo’s boss described a potential investment in a company with confirmed assets of $10 million. However, Lorenzo knew before sending the emails to investors that the company recently disclosed that its total assets were worth less than $400,000. Lower courts found that Lorenzo acted with knowledge of wrongdoing, and he did not appeal that scienter finding. That makes it harder for participants to know what the standard would be when it comes to passing down information, lawyers said. Lewis said she’d be interested to know what that standard would be.

“I do think it gives pause to folks who are really just following the fact pattern of forwarding on information that they have concern about,” Lewis said. “That’s probably the takeaway.”

Frederic Weber, of counsel at Norton Rose Fulbright, noted it was a case dealing with an intent to deceive and that it did not address a knowing standard.

“One might worry about whether if the person who passed on the information did not know it was false, but might have been reckless in not checking it,” Weber said. “Could they have the same liability even if they were not a maker of the statement?”

For example, Weber asked, if a broker hasn’t checked information for a file on EMMA, but sends it to a retail investor and the information turned out to be wrong, would the broker have liability under Rule 10b-5 for not having taken any steps to check it? He said that he believes it wouldn’t but that the decision didn’t address the question.

However, overall, the decision won’t have an impact on the course of disclosure in the municipal securities market, Weber said.

“The decision is limited to passing on information that’s known to be materially false or misleading,” Weber said.

Stakeholders like underwriters already have a duty to not only not pass on information they know to be false or misleading, but also have a duty to make a reasonable investigation to confirm that the key representations are not false or misleading, if they’re underwriting a primary offering, Weber said.

Lawyers and municipal advisors have a duty under Municipal Securities Rulemaking Board rules and ethical codes of conduct to speak up if they know of a material misstatement or misleading omission in an offering document.

“So I don’t think the decisions should be expected to have any real impact on the course of conduct in primary offerings,” Weber said. “It could in secondary market transactions.”

Under MSRB time of trade disclosure requirements, brokers are required to give customers known or readily accessible material facts that are supposed to be forwarded to customers, so there would be a violation of MSRB rules if that’s not done, Weber said.

“As a result of the decision, if brokers know that the information they are passing on to customers, for example an issuer’s EMMA filing, is materially incorrect or misleading, they now might be subject to an enforcement action for violating the anti-fraud provisions,” Weber said.

Another impact could be that issuers might view the decision as another case where the SEC is bringing an enforcement action against somebody for a document containing a material misstatement. As the SEC and MSRB are encouraging more frequent disclosure to the market by issuers, this could make them more reluctant, Weber said.

"It makes issuers even more reluctant to make voluntary interim disclosure without some form of comfort from the SEC that they won't be held liable if it turns out to have errors in it," Weber said.

By Sarah Wynn

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