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Exchange Act Section 20(b):

The SEC Enforcement Division Dusts Off an Old Weapon

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The Securities and Exchange Commission (SEC) this summer made good on its promise to revive a rarely-used provision of the federal securities laws to expand its enforcement reach. In its 2011 ruling in *Janus Capital Group, Inc. v. First Derivative Traders*,[1] the Supreme Court limited fraud liability for a person not deemed to be the "maker" of a misrepresentation. The decision raised hurdles for the SEC in situations where the person responsible for the fraud is not the actual speaker—such as where a finance person cooks the books but does not sign the company's financial statements, or where a company disseminates misleading information through third-party newsletters. Beginning earlier this year, the SEC telegraphed its intention to surmount *Janus* by charging violations of Section 20(b) of the Securities Exchange Act of 1934—an obscure and infrequently-cited provision that prohibits persons from violating the securities laws "by means of another person."[2]

On August 4, the SEC brought its first post-*Janus* enforcement action charging violations of Section 20(b). Whether the SEC's interpretation of the statute holds up to judicial scrutiny, however, is an open question.

The *Janus* Paradox

The SEC, more so than private plaintiffs, has long enjoyed statutory authority to pursue securities fraud claims against a broad array of persons, both primarily and secondarily, under Section 10(b), the Exchange Act's general antifraud statute. That situation changed in 2011, when the Supreme Court's decision in *Janus* severely curtailed the application of Section 10(b).[3] Under *Janus*, only someone who actually "makes" a false statement—either the speaker or someone with "ultimate authority" over the statement—can be liable for fraud.

The application of *Janus* has had serious implications for the SEC. In the public company context, for example, only the CEO and CFO typically sign off on, or are quoted within, the company's public statements, and thus other employees and executives implicated in an accounting fraud might evade liability. Similarly, in the case of microcap fraud or a Ponzi scheme, the perpetrators of the fraud could route misrepresentations through third parties such as stock promoters or brokers, hoping to avoid liability by not making any statements directly to investors.[4]

To some extent, the impact of *Janus* is mitigated because the SEC, unlike private plaintiffs, has the authority to bring claims for aiding and abetting (or, in the case of administrative pro-

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ceedings, causing) the fraud. In many cases, a theory of secondary liability will allow the SEC to pursue an enforcement action against individuals and entities who do not themselves make statements to investors or the market.

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The problem for the SEC arises where there is no primary violator whose fraud has been aided and abetted. Consider a public company employee or executive who, facing pressure to make the quarterly numbers, uses improper means to create the appearance of significant sales—shipping products on terms that prevent revenue recognition or fabricating sales outright. If the CFO and CEO who sign the SEC filings and address shareholders have no knowledge of the improprieties, they lack the *scienter* for fraud liability under Section 10(b) (though they could be liable for certain lesser, non-fraud claims). And if the "makers" of the false statements have not committed fraud, then the employee or executive responsible for the improper sales could not have aided and abetted a fraud. *Janus* thus created a paradox of sorts, where the SEC may be unable to pursue charges against perpetrators of a fraud who speak only through non-culpable third parties.

The Revival of Section 20(b)

Presumably in response to this paradox, the SEC earlier this year began talking about plans to revive an arcane provision of the federal securities laws as a work-around.

Section 20(b) of the Exchange Act makes it "unlawful for any person, directly or indirectly," to violate the federal securities laws "through or by means of any other person."[5] In the 80 years since passage of the Act, the SEC has charged violations of this provision in only a handful of cases, primarily in decades-old settled actions with little or no analysis. *Janus* itself referenced Section 20(b) as a potential means for the SEC to deal with the Court's narrow reading of Section 10(b), but the Court sidestepped any interpretation of the law, stating in a footnote that "we do not address whether Congress created liability for entities that act through innocent intermediaries" under the statute.[6]

Three years after *Janus*, the agency appears to have belatedly seized on the Court's semi-invitation. In February, during a panel discussion at the annual SEC Speaks conference in Washington, D.C., Enforcement Division Chief Counsel Joseph Brenner noted that the Division was contemplating filing actions under Section 20(b). "It's a really powerful statute with a lot of potential applications to investigations we are doing now," explained Brenner.[7] Three months later, SEC Chair Mary Jo White herself gave a speech on Section 20(b). In a section entitled "What Is Old Is New," she identified Section 20(b) as one of a number of new tools being used by the agency as part of a more aggressive enforcement approach.[8] Needless to say, it is unusual for the Chair of the agency, amidst other loftier subjects, to dedicate part of a public address to a particular provision of the federal securities laws, much less one so obscure she had to define it for the audience.

It would be reasonable to assume that, when SEC senior officials and Commissioners begin talking publicly about a new enforcement initiative, an illustrative example will not be far behind. So it came as little surprise when, in August, the SEC filed an enforcement action featuring prominent charges under Section 20(b).

The SEC's *Houston American Energy* Case

Taken at face value, *In re Houston American Energy Corp.*[9] appears to be a relatively straightforward oil and gas fraud case. In the litigated administrative proceeding, the SEC alleges that Houston American and its President and CEO, John Terwilliger, misled investors regarding the company's rights in an oil and gas exploration and production area in Colombia. According to the SEC, the company dramatically overstated the volume and value of its purported energy reserves, causing the company's stock price to rise by some 500% over the period of the purported misrepresentations.

From a *Janus* perspective, the allegations appear to support an ordinary Section 10(b)/Rule 10b-5 claim. Terwilliger and Houston American are both alleged to have made the misrepresentations directly to investors. Houston American made the statements, for example, in a publicly-released investor presentation, attached to a company Form 8-K, and used by Terwilliger in the subsequent investor roadshow. A Section 10(b) claim that the Respondents "made" or had the requisite "authority" over the misrepresentations appears, at least on its face, supported by the allegations.

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However, the SEC's enforcement action challenges not just the respondents' direct misstatements to investors, but also misrepresentations allegedly disseminated by respondents through third parties. For example, the SEC's order alleges that Terwilliger and Houston American provided a stock promoter with false information that "[t]hey knew or were reckless in not knowing" the stock promoter would use in promoting Houston American stock to investors. The SEC further alleges that sales representatives at an unnamed investment bank, acting as placement agents for the public offering, sent emails to bank clients disseminating the false information provided by Terwilliger and Houston American. Finally, the SEC cites an unnamed independent research analyst's published report on Houston American, which incorporated and further disseminated the allegedly false information.

The SEC's order does not contend that any of these unidentified third parties were aware that the information received from the company and passed on to investors was false. Hence, any claims against Respondents based on these third-party representations seem to be both foreclosed by *Janus* (as not statements made by Respondents) and outside the reach of aiding and abetting liability. The case thus appears to present an ideal test case for the SEC's revival of Section 20(b).

Possible Limitations on Section 20(b)

Notwithstanding the SEC's enthusiasm about enlisting this provision, it is unclear whether Section 20(b) will actually solve the *Janus* paradox. As noted above, the SEC has rarely invoked this provision, and thus there is little guidance on its parameters. However, there have been a small number of private actions alleging Section 20(b) violations over the years, and some court rulings arising out of these cases may cast doubt on its utility for the agency.

In a 1974 decision in the U.S. Court of Appeals for the Sixth Circuit, *SEC v. Coffey*, the court read Section 20(b) as a counterpart to Section 20(a), which provides for control person liability, interpreting Section 20(b) as requiring a showing of "knowing use of a controlled person by a controlling person."[10] The consequence of finding otherwise, it reasoned, was that "every link in a chain of command would be personally criminally and civilly liable for the violations of inferior corporate agents. This was not the congressional intent in enacting section 20(b)."[11] Several subsequent cases have similarly held that Section 20(b) only applied where the defendant controlled the person whose actions constituted the securities law violation.[12]

Other cases have at least suggested that no such control requirement exists under Section 20(b). Last year, in *Union Central Life Insurance Co. v. Credit Suisse Securities (USA), LLC*, the U.S. District Court for the Southern District of New York ultimately dismissed a Section 20(b) charge, but only because it found no unlawful act, not because there was an absence of control.[13]

Introducing a control element to Section 20(b) would essentially defeat the SEC's purpose. If the defendant controls the actual speaker, then the SEC presumably could state a control-person claim under Section 20(a), or perhaps even establish that the defendant had ultimate authority over the statement such that he or she could be deemed the "maker" of the statement and directly liable under *Janus*. The SEC's need here is to establish liability specifically where the defendant does not control the speaker. Certainly *Houston American* includes no allegations that the company or its CEO controlled the unidentified third parties who disseminated the information to investors, and thus these claims would be unlikely to survive if a showing of control is required.

Notably, *Coffey* and other cases finding a control element within Section 20(b) predate *Janus*. It thus remains to be seen whether the courts, cognizant of the paradox created by *Janus*, will give a broader reading to Section 20(b) and find liability where the defendant neither aids a primary violator nor controls an innocent third party. Without the ability to fall back on other theories post-*Janus*, the SEC will be particularly incentivized to advocate for an interpretation of Section 20(b) that does not include any control requirement.

What Happens Next?

Given the limited case-law under Section 20(b), and the potential limitations on the statute's reach suggested by *Coffey*, it will be interesting to see how *Houston American* proceeds. In some ways, the *Houston American* case appears to be a particularly safe opening salvo for the SEC's Section 20(b) campaign. The indirect statements challenged by the SEC are only a subset of a much broader case alleging direct violations of Section 10(b). The Section 20(b) claims may thus evade close judicial scrutiny; should the SEC present a compelling fraud case based on the respondents' own statements, the indirect statements pursued under Section 20(b) may be given short shrift and receive a free ride under the Section 10(b) claims. A stand-alone Section 20(b) case, such as one challenging a finance executive's responsibility for a company's false statements, would have been more likely to generate careful scrutiny of the interplay between *Janus* and Section 20(b). This could very well have been by design, giving the SEC a useful precedent on a low-risk matter.

Moreover, the case also represents another recent SEC enforcement trend—namely, the increasing use of administrative proceedings rather than federal court actions.[14] As a relatively straightforward fraud action with no claims against regulated persons such as advisers or brokers, one would have expected *Houston American* to be filed in federal court. However, the SEC instead instituted administrative proceedings before an administrative law judge. Such matters typically involve only limited motion practice, and any appeal of the ultimate hearing in the case will be heard first by the SEC itself before finally making its way to a federal court of appeals. Even if *Houston American* were ripe for challenging the scope of a Section 20(b) claim, any decision interpreting the statute is far off on the horizon.

In any event, *Houston American* is only the first example of what is likely to be a growing trend—at least unless and until a court ruling finds fault with the SEC's reliance on this statutory provision. Pending such pushback, one can anticipate the SEC to seek other ways to enlist Section 20(b) to strengthen its enforcement program. For example, one could see the SEC using the statute to avoid a more onerous showing of aiding and abetting liability, escaping the need to establish that the primary actor—particularly one who is not a defendant in the litigation—committed fraud.

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Meanwhile, where the SEC goes, the plaintiff's bar generally follows, so Section 20(b) will likely be tested in the private context as well. And Section 20(b) may prove an even more meaningful tool to private plaintiffs, at least in the short term. Plaintiffs may increasingly seek to expand the list of class action defendants to include those whom *Janus* would otherwise exclude. There is, however, serious doubt as to whether Section 20(b) provides a private right of action, and private plaintiffs' pursuit of Section 20(b) claims might therefore be more tepid than the SEC's.

NOTES

[1] *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011).

[2] 15 U.S.C. § 78t(b) (titled "Unlawful activity through or by means of any other person").

[3] *Janus*, 131 S. Ct.

[4] One might argue that *Janus*, which arose out of a private lawsuit and expressly based its reasoning on the narrow scope given private rights of action, does not apply to the SEC. Indeed, one court of appeals recently held *Janus* inapplicable to federal criminal actions. *Prousalis v. Moore*, No. 13-6814 (4th Cir. May 7, 2014). However, the SEC has essentially acceded to *Janus* and declined to argue that it does not reach SEC Section 10(b) actions.

[5] 15 U.S.C. § 78t(b).

[6] *Janus*, 131 S. Ct. at 2304 n.10.

[7] Aruna Viswanatha, *U.S. SEC Enforcement Looks to Revive Use of 1930s Law*, Reuters (Feb. 21, 2014).

[8] SEC Speech, Mary Jo White, *Three Key Pressure Points in the Current Enforcement Environment* (May 19, 2014), *available at* www.sec.gov/News/Speech/Detail/Speech/1370541858285.

[9] *In the matter of Houston American Energy Corp., John F. Terwilliger, Jr., Undiscovered Equities Inc., and Kevin T. McKnight*, Admin. Proc. No. 3-16000 (August 4, 2014), available at www.sec.gov/litigation/admin/2014/33-9621.pdf.

[10] *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974).

[11] *Coffey* at 1318.

[12] *Moss v. Morgan Stanley Inc.*, 553 F. Supp. 1347, 1362 (S.D.N.Y. 1983) (applying *Coffey's* Section 20(b) analysis as requiring a showing of both "control" and "knowing use" of a controlled person), *aff'd on other grounds*, 719 F.2d 5 (2d Cir. 1983); *Cohen v. Citibank N.A.*, 954 F. Supp. 621, 629-30 (S.D.N.Y. 1996) (noting also that "few reported cases discuss the applicability of Section 20(b)," citing two, *Moss v. Morgan Stanley* and *SEC v. Coffey*).

[13] *Union Cent. Life Ins. Co. v. Credit Suisse Sec. (USA), LLC*, 11 Civ. 2327 GBD, 2013 WL 1342529 (S.D.N.Y. Mar. 29, 2013).

[14] For our analysis of this trend, *see* Gibson Dunn's 2014 Mid-Year Securities Enforcement Update, *available at* www.gibsondunn.com/publicatio ns/Pages/2014-Mid-Year-Securities-Enforcement-Update.aspx.

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