Prosecuting Securities Fraud Under Section 17(a)(2)

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Introduction

Traditionally, securities fraud has been civilly enforced and criminally prosecuted under Section 10(b) of the Securities Exchange Act[1] and Rule 10b-5 promulgated thereunder.[2] Because there is a private right of action for violating the Exchange Act's securities fraud prohibition,[3] a rich body of case law interprets most of the elements of Rule 10b-5. Indeed, the Supreme Court has been quite active in defining the contours of Rule 10b-5 in the private litigation context.[4]

Recently, however, the Securities and Exchange Commission (SEC)

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1. 15 U.S.C. § 78j(b) (2012).
2. 17 C.F.R. § 240.10b-5 (2018).
3. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976) ("Although § 10(b) does not by its terms create an express civil remedy for its violation, and there is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated such a remedy, the existence of a private cause of action for violations of the statute and the Rule is now well established." (footnotes omitted)).
4. *See, e.g.*, Janus Capital Grp., Inc. v. First Derivative Traders, 564 U.S. 135 (2011) (scope of primary liability); Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27 (2011) (materiality and scienter); Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247 (2010) (extraterritorial applicability); Basic Inc. v. Levinson, 485 U.S. 224 (1988) (materiality); *Ernst & Ernst*, 425 U.S. 185 (scienter).

has increasingly asserted claims under Section 17(a)(2) of the Securities Act for conduct that sounds in securities fraud,[5] including in its civil enforcement action against Fabrice Tourre.[6] Moreover, because Securities Act violations are criminalized, securities fraud prosecutions could follow this trend. Indeed, the Department of Justice has recently prosecuted several high-profile defendants under Section 17(a) instead of, or in addition to, Rule 10b-5.[7]

Yet, many of the elements of a Section 17(a)(2) violation remain unsettled. Because there is not a private right of action under Section 17(a)(2),[8] and because the SEC has increasingly elected to pursue violators in administrative proceedings rather than civil enforcement actions,[9] courts have not had the opportunity to interpret Section 17(a)(2) in nearly as much depth as Rule 10b-5. The uncertainty surrounding the elements of Section 17(a)(2) is exacerbated when it is criminally prosecuted.

Against this backdrop, this Essay seeks to define the elements of the crime of violating Section 17(a)(2); compares and contrasts those elements to the crime of violating Rule 10b-5; and considers the policy implications of prosecuting securities fraud under Section 17(a)(2) rather than Rule 10b-5.

I. STATUTES CRIMINALIZING VIOLATIONS OF SECTION 17(A)(2) AND RULE 10B-5

Section 17(a)(2) of the Securities Act contains the following

5. Jean Eaglesham, *At SEC, Strategy Changes Course*, WALL ST. J., Sept. 30, 2011, at C1 ("In a major shift from the agency's traditional enforcement strategy, the SEC could file more civil cases in which defendants are accused of negligence only [under Section 17(a)(2) or 17(a)(3)], rather than harder-to-prove charges of intentional wrongdoing or recklessness, according to SEC officials.").

6. Amended Complaint, SEC v. Tourre, 4 F. Supp. 3d 579 (S.D.N.Y. 2014) (No. 10-CV-3229 (BSJ)(MHD)), 2010 WL 5863739.

7. *See, e.g.*, Indictment, United States v. Wilson, No. 1:13-cr-0190-001, 2017 WL 370247 (S.D. Ind. Jan. 5, 2017) (1:13-cr-0190 SEB-TAB), 2013 WL 11037121 (charging executives of Imperial Petroleum, Inc., a public company, with violations of Section 17(a) and Rule 10b-5); Superseding Indictment, United States v. Ayers, 759 F. Supp. 2d 495 (S.D. Ohio 2010) (No. 2:06-CR-129), 2007 WL 2065217 (charging senior executives of National Century Financial Enterprises with violations of Section 17(a)).

8. Maldonado v. Dominguez, 137 F.3d 1, 7 (1st Cir. 1998) ("In recent years, every circuit to have addressed the issue has refused to recognize a private right of action under section 17(a), including four circuits which originally had held otherwise. We now come to the same conclusion." (citations omitted)).

9. Stephen J. Choi & A.C. Pritchard, *The SEC's Shift to Administrative Proceedings: An Empirical Assessment*, 34 YALE J. ON REG. 1, 4 (2017) ("Our empirical results show a decline in the number of court actions and an increase in the number of administrative proceedings post-Dodd-Frank.").

prohibition:

> It shall be unlawful for any person in the offer or sale of any securities . . . by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly . . . 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.[10]

Section 24 of the Securities Act, which criminalizes the violation of Section 17(a)(2), states as follows:

> Any person who willfully violates any of the provisions of this subchapter, or the rules and regulations promulgated by the Commission under authority thereof, or any person who willfully, in a registration statement filed under this subchapter, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than $10,000 or imprisoned not more than five years, or both.[11]

Rule 10b-5(b), promulgated under Section 10(b) of the Exchange Act,[12] contains the following prohibition:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, . . . [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of any security.[13]

Section 32(a) of the Exchange Act, which criminalizes the violation of Rule 10b-5(b), provides as follows:

> Any person who willfully violates any provision of this chapter . . . , or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter, or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement . . . which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than $5,000,000, or imprisoned not more than 20 years, or both, except that when such person is a person other than a natural person, a fine not exceeding

10. 15 U.S.C. § 77q(a)(2) (2012).
11. 15 U.S.C. § 77x (2012).
12. 15 U.S.C. § 78j(b) (2012).
13. 17 C.F.R. § 240.10b-5(b) (2018).

> $25,000,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.[14]

At first glance, the elements of Section 17(a)(2) and Rule 10b-5(b) appear coextensive.[15] Each requires an untrue statement or omission of a material fact. Indeed, the drafters of Rule 10b-5 used Section 17(a) as a model.[16]

Yet, the Supreme Court has clarified that, at least in one respect, Section 17(a)(2) and Rule 10b-5(b) differ substantially. A violation of Section 17(a)(2) does not require scienter and thus can be established if the defendant acted negligently.[17] By contrast, a violation of Rule 10b-5 requires scienter, and thus the defendant must have acted at least recklessly.[18] Because Rule 10b-5 was promulgated pursuant to Section 10(b), which prohibits only "manipulative or deceptive devices," the Court interpreted Rule 10b-5 as requiring scienter, lest the rule exceed its statutory authorization.[19]

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14. 15 U.S.C. § 78ff(a) (2012).

15. SEC v. Farmer, No. 4:14-CV-2345, 2015 WL 5838867, at *12 (S.D. Tex. Oct. 7, 2015) ("Because 'the basic precepts of Sections 17(a) . . . and Rule 10b-5 are the same,' claims arising under the two provisions are often 'analyzed as one.'" (alteration in original) (quoting SEC v. Helms, No. A-13-CV-01036 ML, 2015 WL 5010298, at *1 (W.D. Tex. Aug. 21, 2015))).

16. SEC v. Tambone, 550 F.3d 106, 122 n.20 (1st Cir. 2008) ("According to Milton Freeman, one of the rule's co-drafters, Rule 10b–5 was hastily drafted and approved in response to a report that the president of a company was buying up his company's stock based on false statements regarding its financial outlook. In an attempt to address this specific situation, Freeman claims to have combined sections 10(b) and 17." (citing Milton V. Freeman, *Conference on Codification of the Federal Securities Laws: Administrative Procedures*, 22 BUS. LAW. 891, 922 (1967))), *reh'g en banc granted, opinion withdrawn*, 573 F.3d 54 (1st Cir. 2009), *reinstated in part on reh'g*, 597 F.3d 436 (1st Cir. 2010).

17. Aaron v. SEC, 446 U.S. 680, 702 (1980) ("We further hold that the Commission need not establish scienter as an element of an action to enjoin violations of § 17(a)(2) and § 17(a)(3) of the 1933 Act.").

18. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 n.3 (2007) ("We have previously reserved the question whether reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5. Every Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required." (citation omitted)); *Aaron*, 446 U.S. at 701–02 ("[W]e hold that the Commission is required to establish scienter as an element of a civil enforcement action to enjoin violations of § 17(a)(1) of the 1933 Act, § 10(b) of the 1934 Act, and Rule 10b-5 promulgated under that section of the 1934 Act.").

19. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976) ("The argument simply ignores the use of the words 'manipulative,' 'device,' and 'contrivance'—terms that make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence. Use of the word 'manipulative' is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." (footnote omitted)); *id.* at 214 ("Thus, despite the broad view of the Rule advanced by the Commission in this case, its scope

In addition, upon closer examination, the phrasing of Section 17(a)(2) and Rule 10b-5(b) differs in several potentially meaningful ways. First, Section 17(a)(2) applies "in the offer or sale of any securities," while Rule 10b-5(b) applies "in connection with the purchase or sale of any security." Second, Section 17(a)(2) includes the element "to obtain money or property," while Rule 10b-5(b) does not. Third, Section 17(a)(2) requires the defendant to have acted "by means of" any misrepresentation or omission, while Rule 10b-5(b) requires the defendant to "make" the misrepresentation or "omit" the omission.

Finally, while Section 24 and Section 32 both criminalize violations (albeit with significantly different maximum penalties), Section 24 requires the defendant to have acted only "willfully," while Section 32 requires the defendant to have acted "willfully and knowingly" if the misrepresentation or omission is contained in a mandatory SEC filing or registration statement.

Below I analyze the potential implications of these textual differences on the prosecution of securities fraud.

II. "IN THE OFFER OR SALE OF ANY SECURITIES" VERSUS "IN CONNECTION WITH THE PURCHASE OR SALE OF ANY SECURITY"

Section 17(a)(2) applies to misrepresentations and omissions "in the offer or sale of any securities,"[20] while Section 10(b) and Rule 10b-5 apply "in connection with the purchase or sale of any security."[21]

The Supreme Court has broadly interpreted the "in connection with" element of Section 10(b) and Rule 10b-5. In short, a fraudulent misrepresentation or omission is "in connection with the purchase or sale" of any security if "it is material to a decision by one or more individuals (other than the fraudster) to buy or to sell" a security.[22] Therefore, Rule 10b-5 applies, not only to statements made during the selling process, but also to other statements made to the secondary market, such as statements contained in periodic reports filed with the SEC, analyst calls, and press releases.[23]

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cannot exceed the power granted the Commission by Congress under § 10(b).").

20. 15 U.S.C. § 77q(a)(2) (2012).

21. 15 U.S.C. § 78j(b) (2012); 17 C.F.R. § 240.10b-5 (2018).

22. Chadbourne & Parke LLP v. Troice, 571 U.S. 377, 386–87 (2014) (analyzing the meaning of this phrase in the Securities Litigation Uniform Standards Act by relying on precedent analyzing this phrase in Section 10(b) and Rule 10b-5).

23. *E.g.*, SEC v. Rana Research, Inc., 8 F.3d 1358, 1362 (9th Cir. 1993) ("Where the fraud alleged involves public dissemination in a document such as a press release, annual report, investment prospectus or other such document on which an investor would presumably rely, the 'in connection with' requirement is generally met by proof of the means of dissemination and the materiality of the misrepresentation or omission.").

The issue is whether Section 17(a)(2) likewise applies beyond the offering/selling process.[24] The phraseology "in" is arguably narrower than "in connection with,"[25] thus supporting a narrower interpretation of Section 17(a)(2). In *United States v. Naftalin*, however, the Supreme Court, in dicta, cast doubt on that textual interpretation:

> Respondent contends that the requirement that the fraud be "in" the offer or sale connotes a narrower range of activities than does the phrase "in connection with," which is found in § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b). First, we are not necessarily persuaded that "in" is narrower than "in connection with." Both Congress and this Court have on occasion used the terms interchangeably. But even if "in" were meant to connote a narrower group of transactions than "in connection with," there is nothing to indicate that "in" is narrower in the sense insisted upon by Naftalin.[26]

The *Naftalin* Court did not resolve the issue because, even if Section 17(a)(2) were more limited in scope than Section 10(b) and Rule 10b-5, the terms "offer" and "sale" are "expansive enough to encompass the entire selling process, including the seller/agent transaction."[27] According to the Court, Naftalin, who had falsely represented to his broker that he already owned the stock that he was selling, was acting within the scope of the "entire selling process."[28] A few years later, in *Rubin v. United States*, the Supreme Court again rejected a party's argument that his conduct fell outside the scope of Section 17(a), without reaching the question of whether Section 17(a) applies outside the offering/selling process.[29] In that case, Rubin was convicted of violating Section 17(a) for making misrepresentations about the stocks that he was pledging to a bank as collateral for a loan.[30] The Court rejected Rubin's

24. Of note, in one way, Section 10(b) and Rule 10b-5 are more limited in scope than Section 17(a). If an offer does not result in a securities transaction (i.e., a purchase or a sale), then alleged misrepresentations associated therewith are within the scope of Section 17(a) but not within the scope of Section 10(b) and Rule 10b-5. SEC v. Spence & Green Chem. Co., 612 F.2d 896, 903 (5th Cir. 1980) ("While section 17(a) pertains to offers as well as sales, section 10(b) and rule 10b-5 apply only to acts occurring 'in connection with the purchase or sale' of securities. Absent this nexus with a sale or purchase, no section 10(b) or rule 10b-5 violation can be found.").

25. *See* Maracich v. Spears, 570 U.S. 48, 59 (2013) (analyzing the phrase "in connection with" in the Driver's Privacy Protection Act of 1994) ("The phrase 'in connection with' is essentially 'indeterminat[e]' because connections, like relations, 'stop nowhere.'" (alteration in original) (quoting N.Y. State Conference of Blue Cross & Blue Shield Plans v. Travelers Ins. Co., 514 U.S. 645, 655 (1995))).

26. United States v. Naftalin, 441 U.S. 768, 773 n.4 (1979) (citations omitted) (citing H.R. REP. NO. 73-85, at 6 (1933); Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 10 (1971)).

27. *Id.* at 773.

28. *Id.*

29. Rubin v. United States, 449 U.S. 424 (1981).

30. *Id.* at 424–28.

argument that pledging stock as collateral was outside the scope of the offering/selling process: "It is not essential under the terms of the Act that full title pass to a transferee for the transaction to be an 'offer' or a 'sale.'"[31]

Relying on the dicta in *Naftalin*, most lower courts to have addressed the issue have held that Section 17(a)(2), like Section 10(b) and Rule 10b-5, applies broadly to statements made to the secondary market, as long as the securities at issue are publicly traded.[32] For example, Judge Paul A. Crotty in the Southern District of New York denied the defendants' motion to dismiss a Section 17(a)(2) claim premised on alleged misrepresentations in 10-K and 10-Q SEC filings:

> The complaint here alleges that FNMA's common stock was traded on the New York Stock Exchange ("NYSE") during the Relevant Period. Accordingly, the Court can take "judicial notice of the fact that a common stock listed on the NYSE is intended, for the most part, to be sold and exchanged." This is sufficient to find that the SEC has adequately stated a claim against [the defendants] under Section 17(a)(2).[33]

As another example, Magistrate Judge Judith G. Dein in the District of Massachusetts denied a defendant's motion for judgment as a matter of law on a Section 17(a) claim premised on alleged misrepresentations in a press release and in 10-Q and 8-K SEC filings:

> In light of the Supreme Court's discussion in *Naftalin*, and its direction to interpret Section 17(a) broadly, this court concludes that where a defendant has made false or misleading statements in materials typically relied upon by investors engaged in the ordinary market trading of securities, the requirement that fraud occur "in the offer or sale" is satisfied. There is no question in the instant case that Applix's stock was continuously traded throughout the relevant period. Therefore, this court finds that the SEC's claims under Section 17(a) were properly predicated upon misstatements and omissions contained in Applix's press release and in its Forms 10-Q and 8-K filed with the SEC.[34]

A few other courts, however, have suggested that Section 17(a)(2) is

31. *Id.* at 430.

32. SEC v. RPM Int'l, Inc., 282 F. Supp. 3d 1, 29 (D.D.C. 2017) ("Many courts have concluded that an allegation that the company's stock was publicly traded is sufficient to plead this element under Section 17(a)(2)."); SEC v. Forman, No. 07-11151-RWZ, 2010 WL 2367372, at *7 (D. Mass. June 9, 2010) ("Courts draw no distinction between 'in the offer or sale' and the 'in connection with the purchase or sale' language of Rule 10b-5.").

33. SEC v. Mudd, 885 F. Supp. 2d 654, 670 (S.D.N.Y. 2012) (citations omitted).

34. SEC v. Goldsworthy, No. 06-10012-JGD, 2008 WL 8901272, at *12 (D. Mass. June 11, 2008).

more limited in reach than Rule 10b-5.[35] For example, the Ninth Circuit, when rejecting the argument that Rule 10b-5 requires the defendant to have actually traded in the subject securities, contrasted Rule 10b-5 with Section 17(a), stating that Section 17(a) imposes "liability only where the fraud is part of a securities transaction."[36]

I contend that the dicta in *Naftalin* should not be interpreted as expanding Section 17(a)(2) to all statements made to the secondary market. In 1979, when the Supreme Court issued its *Naftalin* opinion, the ultimate breadth of Section 10(b) and Rule 10b-5's "in connection with" element was itself unclear, casting doubt on whether the Court anticipated that Section 17(a) would be applied so broadly. At that time, the only Supreme Court precedent on the meaning of Rule 10b-5's "in connection with" requirement was *Superintendent of Insurance of New York v. Bankers Life & Casualty Co*.[37] In that case, Manhattan Casualty Co. was allegedly "injured as an investor though a deceptive device which deprived it of any compensation for the sale of its valuable block of securities."[38] The Court held that the alleged deception was "in connection with the purchase or sale" of any security, even though the securities transaction was "not conducted through a securities exchange or an organized over-the-counter market."[39] Manhattan Casualty Co. was allegedly injured by "deceptive practices touching its sale of securities as

35. *See, e.g.*, SEC v. Tambone, 550 F.3d 106, 122 (1st Cir. 2008) ("First, whereas section 17(a) applies only to brokers and dealers *selling* or *offering to sell* securities, Rule 10b-5 explicitly covers 'any person' who commits a fraudulent act 'in connection with the *purchase* or *sale* of any security.'"), *reh'g en banc granted, opinion withdrawn*, 573 F.3d 54 (1st Cir. 2009), *reinstated in part on reh'g*, 597 F.3d 436 (1st Cir. 2010); SEC v. JB Oxford Holdings, Inc., No. CV 04-07084 PA (VBKx), 2004 WL 6234910, at *4 (C.D. Cal. Nov. 9, 2004) ("Defendants are not alleged to have solicited purchases in particular funds or to have benefitted financially from their clients' investment decisions except as a fixed percentage of assets under management. Accordingly, Defendants are not 'sellers' within the meaning of Section 17(a). Because Section 17(a) 'applies only to sellers', and Defendants are not 'sellers,' the Court dismisses the FAC's first claim for relief for violations of Section 17(a)." (citations omitted)); Buford White Lumber Co. Profit Sharing & Saving Plan & Tr. v. Octagon Props., Ltd., 740 F. Supp. 1553, 1568–69 (W.D. Okla. 1989) ("Section 17(a), as Defendant notes, applies to those who offer or sell securities. 'Offer' and 'sell' have the same definitions for purposes of Section 17(a) as they do for Section 12. Accordingly, the Supreme Court's explication of the application of these definitions in *Pinter v. Dahl* is equally pertinent when violations of Section 17(a) are alleged. Plaintiffs have failed to allege facts showing that Defendant was an offeror or seller for purposes of Section 17(a)." (citations omitted)).

36. McGann v. Ernst & Young, 102 F.3d 390, 394–95 (9th Cir. 1996) ("In the words of *Texas Gulf*, these laws demonstrate that 'when Congress intended that there be a participation in a securities transaction as a prerequisite of a violation, it knew how to make that intention clear.' Thus, it would ignore the structure of the federal securities laws to read an implied trading requirement into the text of § 10(b)." (citation omitted) (quoting SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 860 (2d Cir. 1968) (en banc))).

37. Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971).

38. *Id.* at 10.

39. *Id.*

an investor," and thus the alleged deception was cognizable under Section 10(b) and Rule 10b-5.[40] Notably, the alleged misrepresentations at issue in *Bankers Life* were made in the context of a securities transaction by a party arranging the transaction, so the holding in *Bankers Life* did not forecast the Court's eventual expansive interpretation of "in connection with" to apply to statements to the secondary market.

In addition, the legislative history about the role of Section 17(a) within the Securities Act supports its application to the offering/selling process, not to the overall securities markets. The purpose of the Securities Act of 1933 was "to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof."[41] The Act accomplished this via its central provision, Section 5, which makes it unlawful to offer or sell a security, either in an initial offering or a resale, unless it is either registered or exempt from registration.[42] Section 17(a), alongside the private civil liability provisions contained in Sections 11 and 12,[43] was intended to ensure that the disclosures mandated by the Securities Act during the offering/selling process were accurate and complete.[44] Huston Thompson, the Federal Trade Commission Chairman who drafted a precursor of the bill that Congress ultimately enacted as the Securities Act, urged the committee "to keep in mind when you go into the bill that always in the background there is this fraud section."[45] Similarly, in testimony before the House Interstate and Foreign Commerce Committee, Ollie M. Butler with the Department of Commerce's Foreign Service Division explained that the precursor to Section 17(a) was "auxiliary to [the] main body of the bill" and "was added to control those who managed to evade the main provision of the

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40. *Id.* at 12–13.

41. H.R. REP. NO. 73-152, at 24 (1933) (Conf. Rep.) (to accompany H.R. 5480, 73d Cong. (1933)).

42. 15 U.S.C. § 77e (2012).

43. 15 U.S.C. §§ 77k, 77l (2012); William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 173 (1933) ("The civil liabilities imposed by the Act are not only compensatory in nature but also *in terrorem*. They have been set high to guarantee that the risk of their invocation will be effective in assuring that the 'truth about securities' will be told." (footnotes omitted)).

44. *See* Douglas & Bates, *supra* note 43, at 182 ("It is clear, however, that a willful violation of Section 17 would give rise to the criminal penalties of Section 24. Furthermore Section 20 gives the Commission power to investigate any violation of the Act and to obtain injunctive relief against such violations. . . . Wisely used this injunctive power and the criminal penalties can go further in real protection of the investor than mere piling up of civil penalties.").

45. *Hearing on H.R. 4314 Before the H. Comm. on Interstate and Foreign Commerce*, 73d Cong. 13 (1933). Note that, in this version of the bill, the antifraud provision was contained in Section 10, not Section 17 as ultimately enacted.

law."[46] By contrast, Section 10(b) of the Securities Exchange Act of 1934 was intended to serve as a "catch-all" provision, thus supporting its applicability beyond the selling process.[47]

Further, Congress explicitly tied the scope of Section 17(a) to the defined terms of "offer" and "sale," thus supporting a more limited application of Section 17(a) to the offering/selling process. When Congress enacted the Securities Act in 1933, Section 17(a) applied only "in the sale of any securities,"[48] but the term "sale" was defined to include the "attempt or offer to dispose of" any security.[49] In 1954, Congress amended the Securities Act by disaggregating the definitions of "sale" and "offer."[50] Under the new definitions, "sale" included the "disposition of a security," while "offer" included "every attempt or offer to dispose of" a security.[51] In order to "preserve existing law,"[52] Congress also amended Section 17(a) to insert "offer or" before "sale."[53] As subsequently interpreted by the Supreme Court in the context of Section 12(a)(2), a person "offers" or "sells" a security by transferring title or by "engag[ing] in solicitation, an activity not inherently confined to the actual owner."[54]

In sum, contrary to the weight of authority, I contend that Rule 17(a)(2)'s "in the offer or sale of any securities" element should be interpreted as applying only to statements used during the offering/selling process (such as by an issuer, a reseller, or other parties or agents involved in the offering/selling process), not to all statements disseminated to the secondary market. Under my interpretation, statements used outside the offering/selling process, such as statements in SEC filings that are not incorporated into registration statements, would be within the scope of

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46. *Id.* at 116 (statement of Ollie M. Butler, Foreign Serv. Div., Dep't of Commerce).

47. *Hearing on H.R. 7852 and H.R. 8720 Before the H. Comm. on Interstate and Foreign Commerce*, 73d Cong. 115 (1934) ("Of course subsection (c) is a catch-all clause to prevent manipulative devices I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices.").

48. Securities Act of 1933, Pub. L. No. 73-22, § 17(a), 48 Stat. 74, 84–85.

49. *Id.* § 2(3).

50. *See* H.R. REP. NO. 83-1542, at 2993 (1954) ("Section 1 amends section 2(3) of the Securities Act of 1933 to redefine the term 'sale' so as to distinguish between 'offers' and 'sales.'").

51. Act of Aug. 10, 1954, Pub. L. No. 83-577, § 1, 68 Stat. 683, 683.

52. H.R. REP. NO. 83-1542, at 2993 (1954) (to accompany S. 2846, 83d Cong. (1954)).

53. Act of Aug. 10, 1954, Pub. L. No. 83-577, § 10, 68 Stat. 683, 686.

54. Pinter v. Dahl, 486 U.S. 622, 643 (1988). Note that the *Pinter* Court's interpretation of "purchasing such security from him," which limits the offering/selling defendants who are liable under Section 12(a), would not apply to Section 17(a), which does not include any such limiting language. *See id.* at 643 ("Determining that the activity in question falls within the definition of 'offer' or 'sell' in § 2(3), however, is only half of the analysis. The second clause of § 12(1), which provides that only a defendant 'from' whom the plaintiff 'purchased' securities may be liable, narrows the field of potential sellers.").

Section 10(b) and Rule 10b-5, but not Section 17(a)(2).

III. "TO OBTAIN MONEY OR PROPERTY" ELEMENT

Section 17(a)(2) includes an element not included in Rule 10b-5: the defendant must have acted "to obtain money or property."[55] Lower courts have interpreted this element in two ways.

Under one line of authority, the defendant must have personally received funds by virtue of participation in the wrongful conduct, such as a transfer of funds from the alleged victim or additional compensation (such as a bonus or a commission) tied to the wrongful conduct.[56] These courts interpret "to obtain" as meaning "to gain possession of"[57] and thus conclude that it is essential that "the defendant personally gain[] money or property from the fraud."[58] For example, Judge P. Kevin Castel in the Southern District of New York granted a defendant's motion to dismiss a Section 17(a)(2) claim on this basis:

> The essence of the Section 17(a)(2) claim is that the person, in the offer or sale of securities, obtained money or property by means of an untrue statement of material fact. It is not sufficient that a materially untrue statement was made and the person also made money, such as the incidental payment of a scheduled salary and bonus. It must be plausibly alleged that the money was obtained "by means of" the false statement. Thus, regardless of the manner of compensation, if the person would have earned the same fees or compensation regardless of whether the statement was false, a Section 17(a)(2) claim does not lie.[59]

A second line of authority, with two complementary strains, rejects the requirement of a so-called "fraud bonus."[60] Under the first strain, courts

55. 15 U.S.C. § 77q(a)(2) (2012).

56. *E.g.*, SEC v. RPM Int'l, Inc., 282 F. Supp. 3d 1, 29 (D.D.C. 2017) ("An allegation that ties a company officer's received bonus to the company's performance has been found to be sufficient to state a claim under Section 17(a)(2)."); SEC v. DiMaria, 207 F. Supp. 3d 343, 358 (S.D.N.Y. 2016) ("Here, the SEC does not allege any chain of events, however attenuated, that concludes with Gamsey receiving money or property as a result of the alleged scheme. There are no allegations that Gamsey's compensation was increased in any way, or that he owned (or sold) Bankrate stock that increased in value as a result of the alleged misconduct. Because the amended complaint does not allege that Gamsey obtained money or property by means of the alleged misstatements, the § 17(a)(2) claim against him is dismissed without prejudice."); SEC v. Forman, No. 07-11151-RWZ, 2010 WL 2367372, at *8 (D. Mass. June 9, 2010) (granting the defendant's motion for summary judgment where there was "no evidence that the employee bonus was tied to company performance or that Forman was an executive within the meaning of the bonus plan").

57. SEC v. Syron, 934 F. Supp. 2d 609, 638 (S.D.N.Y. 2013).

58. *Id.* at 640.

59. SEC v. Wey, 246 F. Supp. 3d 894, 915 (S.D.N.Y. 2017) (citations omitted).

60. *See* SEC v. Sayid, No. 17 Civ. 2630 (JFK), 2018 WL 357320, at *6 (S.D.N.Y. Jan. 10, 2018) ("The majority of courts have held that there is no requirement that the SEC allege a 'fraud bonus'—i.e. that the defendant received additional compensation for participating in fraudulent conduct.").

have held that the "to obtain money or property" element can be satisfied via the defendant's receipt of ordinary compensation.[61] For example, Judge Katherine B. Forrest in the Southern District of New York denied a defendant's motion for judgment as a matter of law, reasoning as follows:

> Section 17(a)(2) does not require the SEC to show that a banker like Tourre received some sort of additional "fraud bonus" on top of his base salary in order to establish liability; as the statute clearly states, the SEC must prove that Tourre obtained money or property by means of a material misstatement or omission. Tourre ignores the fact that the evidence adduced at trial showed that he was paid by Goldman Sachs for his work during the time period covering the ACI transaction, and that Tourre's work on the ACI transaction was within his job responsibilities.[62]

Under the second strain, courts have held that the "to obtain money or property" element can be satisfied if the defendant's employer received money or property by virtue of the defendant's participation in the wrongful conduct.[63] For example, Judge Jed S. Rakoff in the Southern District of New York reasoned as follows:

> The Court concludes that it is sufficient under Section 17(a)(2) for the SEC to allege that Stoker obtained money or property for his employer while acting as its agent . . . .
>
> To begin with, the statute, on its face, does not state that a defendant must obtain the funds personally or directly. On the contrary, all three prongs of liability under Section 17(a) are preceded by the common modifier "directly or indirectly." It would be contrary to this language, and to the very purpose of Section 17(a), to allow a corporate employee who facilitated a fraud that netted his company millions of dollars to escape liability for the fraud by reading into the statute a narrowing requirement not found in the statutory language itself.[64]

I agree with the second line of authority, whereby it is sufficient to satisfy the "to obtain money or property" element if the defendant acted to benefit his employer or principal and received ordinary compensation for those efforts. In addition to the arguments advanced by those courts, I argue that the "to obtain money or property" element should be victim-focused, not defendant-focused. In the offering context, the focus should be on whether the victim would have been deprived of money or property, and in the sale context, the focus should be on whether the

61. *See* SEC v. Cole, No. 12-cv-8167 (RJS), 2015 WL 5737275, at *2, 6, 7 (S.D.N.Y. Sept. 19, 2015) (denying the defendant's motion for summary judgment where the defendant, a partner at a public accounting firm, "received approximately $28,000 for his work on EGMI matters").

62. SEC v. Tourre, No. 10 Civ. 3229(KBF), 2014 WL 61864, at *4 (S.D.N.Y. Jan. 7, 2014).

63. *See* SEC v. Stoker, 865 F. Supp. 2d 457, 462 (S.D.N.Y. 2012).

64. *Id.* at 463.

victim was deprived of money or property. A defendant's wrongful involvement in the offering or selling process—designed to accomplish that deprivation—should be sufficient to satisfy the "to obtain money or property" element, regardless of whether the defendant received a "fraud bonus" or merely benefitted his employer or principal and received ordinary compensation for those efforts.

This interpretation recognizes that Section 17(a)(2) was not enacted in a vacuum.[65] As Robert A. Prentice explained, "[t]he purpose of section 17(a) was to 'extend[] to all securities transactions in interstate commerce the protection formerly afforded only where the mails were employed.'"[66] In 1909, Congress amended the mail fraud statute to include the following clause, which is strikingly similar to the text of Section 17(a)(2): "or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises."[67]

The Supreme Court, when analyzing the "for obtaining money or property" element of the mail and wire fraud statutes,[68] has focused on whether the victim was deprived of money or property, not on whether the defendant received money or property. In *Carpenter v. United States*, a reporter for the *Wall Street Journal* tipped his coconspirators about the contents of forthcoming columns, enabling them to trade on the basis thereof, and profits were shared among the conspirators.[69] The Court held that this scheme violated the mail and wire fraud statutes because it deprived the *Journal* of intangible property—namely, its confidential business information.[70] As recognized by the Third Circuit,

> [a]lthough the defendants in *Carpenter* clearly "obtained" the Journal's confidential business information, this was not the conduct, according to the Court, that constituted the mail fraud violation. Rather, the conduct on which the Court focused was the act of fraudulently depriving the Journal of the exclusive use of its information.[71]

In *Cleveland v. United States*, several individuals were convicted of mail fraud for making false statements to the Louisiana State Police in

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65. *See id.* at 463 n.7 ("It is also worth noting that Section 17(a) is modeled on the federal mail fraud statute. Applying language in that statute similar to Section 17(a), the Second Circuit has held that the statute does not require that 'the defendant must receive the same money or property that the deceived party lost, but only that the party deceived must lose money or property.'" (citations omitted)).

66. Robert A. Prentice, *Scheme Liability: Does It Have a Future After* Stoneridge*?*, 2009 WIS. L. REV. 351, 365 n.77 (second alteration in original) (quoting *Legislation: The Securities Act of 1933*, 33 COLUM. L. REV. 1220, 1243 (1933)).

67. Act of Mar. 4, 1909, Pub. L. No. 60-350, § 215, 35 Stat. 1088, 1130.

68. 18 U.S.C. §§ 1341, 1343 (2012).

69. Carpenter v. United States, 484 U.S. 19, 23 (1987).

70. *Id.* at 25.

71. United States v. Hedaithy, 392 F.3d 580, 601 (3d Cir. 2004).

order to obtain licenses to operate video poker machines.[72] The Court reversed the conviction because the statute "requires the object of the fraud to be 'property' in the victim's hands" and "a Louisiana video poker license in the State's hands is not 'property.'"[73] Again, the focus of the Court's analysis was whether the victim was deprived of money or property, not whether the defendant received money or property.[74] This victim-oriented approach, if applied to Section 17(a)(2), suggests that the "to obtain money or property" element is satisfied even if the wrongfully obtained money or property would inure to the benefit of the defendant's employer or principal rather than the defendant himself or herself.[75]

In addition, as discussed above, Section 17(a)(2) applies, not only in the "sale" context, but also in the "offer" context.[76] Congress explicitly amended Section 17(a) in 1954 in order to ensure that it continued to apply even if the transaction did not close.[77] To require the defendant to receive a "fraud bonus" would, in effect, write the "offer" context out of Section 17(a)(2) because it is unlikely that, if the offer did not result in a sale, the defendant would have received anything other than ordinary compensation for his or her efforts to deprive the victim of money or property.

In sum, although I contend that Section 17(a)(2) should be limited to the offering/selling process,[78] I argue that the "to obtain money or property" element should focus on the victim's deprivation of money or property (either potential, in the "offer" context, or actual, in the "sale" context), not the defendant's receipt of money or property by virtue of his wrongful conduct. Therefore, even if the defendant did not receive a "fraud bonus," the "to obtain money or property" element should be satisfied if the defendant acted to benefit his or her employer or principal and received ordinary compensation for those efforts.

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72. Cleveland v. United States, 531 U.S. 12, 15 (2000).

73. *Id.* at 26–27.

74. *See* United States v. Finazzo, 850 F.3d 94, 107 n.14 (2d Cir. 2017) ("Requiring that the object of the fraud be property of the victim is separate from requiring that it be obtainable by the defendant.").

75. *See* Porcelli v. United States, 404 F.3d 157, 162 (2d Cir. 2005) ("We have held that the essential elements of a mail fraud violation include: (1) use of the mails to further (2) a scheme to defraud with (3) money or property as the object of the scheme. Under this Court's analysis, the defendant does not need to literally 'obtain' money or property to violate the statute." (citations omitted)).

76. *See supra* text accompanying notes 49–54.

77. *Supra* text accompanying notes 49–54. *See also* SEC v. Tambone, 550 F.3d 106, 122 (1st Cir. 2008) ("[B]ecause section 17(a) applies to both sales and offers to sell securities, the SEC need not base its claim of liability on any completed transaction at all."), *reh'g en banc granted, opinion withdrawn*, 573 F.3d 54 (1st Cir. 2009), *reinstated in part on reh'g*, 597 F.3d 436 (1st Cir. 2010).

78. *See supra* Part II.

IV. "BY MEANS OF" VERSUS "MAKE"

Rule 17(a)(2) makes it unlawful to act "by means of" a materially misleading misstatement or omission, while Rule 10b-5(b) makes it unlawful to "make" a materially misleading misstatement or omission. In *Janus Capital Group, Inc. v. First Derivative Traders*, the Supreme Court restrictively interpreted "maker" liability under Rule 10b-5(b).[79] Thus, the question is whether *Janus*'s restrictive interpretation likewise applies to liability under Section 17(a)(2).

In *Janus*, the Court held that, "[f]or purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."[80] The Court examined dictionary definitions of the word "make" and concluded that it is "thus the approximate equivalent of 'to state.'"[81] The Court also reasoned that this restrictive interpretation of maker liability "follows from" the Court's holding in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, in which the Court held that "Rule 10b-5's private right of action does not include suits against aiders and abettors . . . . If persons or entities without control over the content of a statement could be considered primary violators who 'made' the statement, then aiders and abettors would be almost nonexistent."[82]

Most courts have rejected the argument that *Janus*'s restrictive interpretation of "maker" liability applies to Section 17(a)(2).[83] First, the *Janus* Court's reasoning was based on the meaning of the word "make," and Section 17(a)(2) does not include the word "make."[84] Second, the *Janus* Court's policy concern about undercutting the distinction between primary violators, who are subject to private civil liability, and mere aiders and abettors, who are not, is not implicated by Section 17(a)(2) because there is not a private right of action for violating Section 17(a)(2).[85] Therefore, these courts hold that Section 17(a)(2) applies, not

79. Janus Capital Grp., Inc. v. First Derivative Traders, 564 U.S. 135, 142 (2011).

80. *Id.*

81. *Id.*

82. *Id.* at 136, 143 (citing Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N. A., 511 U.S. 164 (1994)).

83. *See* SEC v. Husain, No. 2:16-cv-03250-ODW (E), 2017 WL 810269, at *8 (C.D. Cal. Mar. 1, 2017) ("The vast majority of courts to consider this argument since *Janus* have declined to extend its holding to Rule 17(a)(2).").

84. *E.g.*, SEC v. Stoker, 865 F. Supp. 2d 457, 465 (S.D.N.Y. 2012) ("Although 'to make a statement' is the equivalent of 'to state,' to obtain money 'by means of' a statement plainly covers a broader range of activity. Thus, the emphasis of the *Janus* Court on the word 'make' serves, if anything, to highlight the importance of the difference in language between the two provisions.").

85. *E.g.*, *id.* ("[T]here is no need to read Section 17(a) narrowly in light of concerns about the implied private cause of action, because there is no private right of action—implied or explicit—under Section 17(a).").

only to makers, but also to those who use materially misleading misstatements or omissions.[86]

A few courts, which have been characterized as "outliers,"[87] have nonetheless applied *Janus* to Section 17(a)(2). These courts, without analyzing the reasoning in *Janus*, reach this conclusion via the shorthand assumption that Section 17(a)(2) and Rule 10b-5(b) should be interpreted similarly.[88]

Because the reasoning in *Janus* does not apply to Section 17(a)(2), I agree with the vast majority of courts that *Janus*'s restrictions do not apply to Section 17(a)(2). Therefore, a person can violate Section 17(a)(2) by using a materially misleading misstatement or omission in the offer or sale of securities, even if he or she did not have ultimate authority over its content. As additional support for this conclusion, the Supreme Court recently held in *Lorenzo v. SEC* that *Janus*'s restrictive interpretation of "maker" liability is inapplicable to claims under Section 17(a)(1), Rule 10b-5(a), and Rule 10b-5(c), which do not include the word "make."[89] The Court held that a mere "disseminator" of misleading statements could be liable under these provisions.[90]

V. "Willfully" versus "Willfully and Knowingly"

The crimes of violating Section 17(a)(2) and Rule 10b-5 require a multilayered analysis of the defendant's requisite mental state with respect to the falsity of an alleged misrepresentation. First, each substantive provision contains an embedded mental state element. Section 17(a)(2) requires that the defendant have been at least negligent about truth or falsity,[91] while Rule 10b-5 requires the defendant to have been at least reckless about truth or falsity.[92] Second, Section 24 of the Securities Act and Section 32(a) of the Exchange Act contain their own

86. *E.g.*, *id.* ("Stoker may be held liable under 17(a)(2), though not under 10b-5, if, he obtains money or property *by use* of a false statement, whether prepared by himself or by another.").

87. *Husain*, 2017 WL 810269, at *8.

88. *See* SEC v. Perry, No. CV-11-1309 R, 2012 WL 1959566, at *8 (C.D. Cal. May 31, 2012) ("This [*Janus*] requirement applies to claims under both Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, and Section 17(a) of the Securities Act of 1933."); SEC v. Kelly, 817 F. Supp. 2d 340, 345 (S.D.N.Y. 2011) ("Because 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).").

89. Lorenzo v. SEC, 139 S. Ct. 1094, 1104 (2019) ("Those who disseminate false statements with intent to defraud are primarily liable under Rules 10b-5(a) and (c), § 10(b), and § 17(a)(1), even if they are secondarily liable under Rule 10b-5(b).").

90. *Id.*

91. Aaron v. SEC, 446 U.S. 680, 702 (1980).

92. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 n.3 (2007).

mental state elements. Section 24, which criminalizes the violation of Section 17(a)(2) (and other provisions of the Securities Act), requires the defendant to have acted "willfully."[93] Section 32(a), which criminalizes the violation of Rule 10b-5 (and other provisions of the Exchange Act), requires the defendant to have acted "willfully and knowingly" with respect to statements in mandatory SEC filings and registration statements filed with the SEC, and it requires the defendant to have acted only "willfully" with respect to other violations of the Exchange Act.[94]

Thus, layering these statutory provisions together, there are three applicable mental states for criminal prosecutions under Section 17(a)(2) and Rule 10b-5: (1) negligence plus willfulness (for violations of Section 17(a)(2), as criminalized by Section 24); (2) recklessness plus willfulness (for violations of Rule 10b-5 premised on statements not contained in SEC filings, as criminalized by Section 32(a)); and (3) knowledge plus willfulness (for violations of Rule 10b-5 premised on statements contained in SEC filings, as criminalized by Section 32(a)).

Courts have struggled to interpret these provisions, leading to significant doctrinal incoherence. As characterized by Samuel W. Buell, "The lower federal courts have issued dozens of opinions making a mess of the matter."[95] This Essay attempts to interpret these intersecting statutory provisions coherently, while acknowledging that those interpretations lead to some anomalous results.

First, "willfulness" is a common thread among all three crimes. Section 32(a)'s structure provides guidance on the term's meaning by, in effect, defining it in the negative. First, "willfulness" does not require knowledge of illegality, lest the final sentence of Section 32(a), which states that "no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation," be rendered meaningless.[96] Second, "willfulness" does not require knowledge of falsity, lest the inclusion of "knowingly" in the second sentence of Section 32(a), which applies only to false statements in SEC filings, be mere surplusage.[97]

93. 15 U.S.C. § 77x (2012).

94. 15 U.S.C. § 78ff(a) (2012).

95. Samuel W. Buell, *What Is Securities Fraud?*, 61 DUKE L.J. 511, 556 (2011) ("The Supreme Court has never identified the scienter required for a criminal conviction for securities fraud. The lower federal courts have issued dozens of opinions making a mess of the matter.").

96. United States v. Peltz, 433 F.2d 48, 54–55 (2d Cir. 1970) ("The language makes one point entirely clear. A person can willfully violate an SEC rule even if he does not know of its existence. . . . It follows also from the proviso whereby lack of knowledge of a rule or regulation prevents imprisonment but not a fine.").

97. United States v. Dixon, 536 F.2d 1388, 1396 (2d Cir. 1976) ("The difference seems to have been deliberate since the second clause covers violations of the Act that involve misrepresentations;

Against that backdrop, the Second Circuit has defined "willfulness" for purposes of Section 32(a) as requiring "a realization on the defendant's part that he was doing a wrongful act" and that the act "be 'wrongful under the securities laws and that the knowingly wrongful act involve a significant risk of effecting the violation that has occurred.'"[98] This interpretation is consistent with the one offered by William B. Herlands in an article published shortly after the Exchange Act was enacted.[99] The Second Circuit has likewise applied the same definition of "willfulness" in cases under Section 24 of the Securities Act, which is structurally similar to Section 32(a) and was enacted only one year prior to Section 32(a).[100] The question remains how "willfulness," so understood, intersects with the elements of knowledge, recklessness, and negligence.

Under Section 32(a) of the Exchange Act, if the misrepresentation is contained in a required SEC filing or registration statement, the defendant must have acted both "willfully" and "knowingly." Therefore, not only must the defendant have acted in a knowingly wrongful manner that involved a significant risk of a misrepresentation, he or she must also have acted with knowledge of falsity.[101]

Under Section 32(a) of the Exchange Act, if the misrepresentation is not contained in a mandatory SEC filing, however, the defendant must have "willfully" violated Rule 10b-5, which itself requires the defendant to have acted at least recklessly.[102] Thus, the defendant must have acted in a knowingly wrongful manner that involved a significant risk of a

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hence the inclusion of the term 'knowingly,' a concept typically associated with prosecution for acts grounded in fraudulent intent. . . ." (citations omitted)).

98. *Id.* at 1395 (citations omitted); *see* United States v. Tarallo, 380 F.3d 1174, 1188 (9th Cir. 2004) ("Under our jurisprudence, then, 'willfully' as it is used in § 78ff(a) means intentionally undertaking an act that one knows to be wrongful . . . ."), *amended by* 413 F.3d 928 (9th Cir. 2005).

99. William B. Herlands, *Criminal Law Aspects of the Securities Exchange Act of 1934*, 21 VA. L. REV. 139, 147–48 (1934) ("The word 'willfully' in the ordinary sense in which it is used in penal statutes means 'not merely "voluntarily" but with a bad purpose.' And such was the definition which the Congressional Committees intended the word to have in the present legislation." (footnote omitted)).

100. Metromedia Co. v. Fugazy, 983 F.2d 350, 364 (2d Cir. 1992).

101. Herlands, *supra* note 99, at 148–49 ("The requirement of 'willfulness' in the general provision quoted above is to be contrasted with the requirement of 'willfulness *and knowledge*' which appears in the specific provision. . . . Under the specific provision the prosecution must show that the defendant had actual knowledge of the false or misleading character of the statement made by him."); Arthur F. Mathews, *Criminal Prosecutions Under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases*, 39 GEO. WASH. L. REV. 901, 956 (1971) ("Thus, mere proof of 'reckless disregard' probably will not support a false filing conviction under section 32(a), unless actual knowledge of the alleged fraudulent statement, omission or scheme can be inferred.").

102. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 n.3 (2007).

reckless misrepresentation.[103] This is a slightly lower standard than knowledge of falsity.[104]

It is somewhat anomalous to apply different *mens rea* standards to false statements contained in mandatory SEC filings and other false statements, such as oral statements or press releases, as observed by Judge Herlands:

> In the case of *written* statements contained in applications, reports, or documents *required* to be filed, there can be criminal liability only if the defendant makes the false or misleading statements "willfully and knowingly." . . . On the other hand, an oral misstatement made willfully, not knowingly, . . . may furnish grounds for a prosecution.[105]

Indeed, one would expect a higher degree of care when drafting SEC filings as opposed to speaking in a less formal setting.[106]

However, this anomaly is not a mere drafting error. The legislative history of the Exchange Act reflects significant debate about the applicable *mens rea* standard, which ultimately led to Section 32(a)'s differential structure. Early bills required only that the defendant have acted "willfully."[107] In a hearing on one of the early bills before the House Interstate and Foreign Commerce Committee, Representative George Huddleston expressed concern about imposing liability for mere "willful" violations: "Willfully is more applicable to a civil liability than to a criminal liability. I submit that 'willfully' does not necessarily mean knowingly."[108] In impassioned testimony before the Senate Banking and

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103. *See Tarallo*, 380 F.3d at 1189 n.5 (holding that "a defendant could 'willfully' violate [Section 32] by willfully acting with reckless indifference to the truth of statements made in the course of the fraud").

104. *Id.* at 1186–87 ("The conduct for which Defendant was indicted, tried, and convicted did not involve the filing of an application, report, or document required by the securities laws. Instead, his conduct was covered by 17 C.F.R. § 240.10b-5. That conduct clearly falls under the first provision of [Section 32(a)], which requires only that the act be done 'willfully,' but does *not* require that the act be done 'knowingly.'").

105. Herlands, *supra* note 99, at 186.

106. Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 135 S. Ct. 1318, 1330 (2015) ("Registration statements as a class are formal documents, filed with the SEC as a legal prerequisite for selling securities to the public. Investors do not, and are right not to, expect opinions contained in those statements to reflect baseless, off-the-cuff judgments, of the kind that an individual might communicate in daily life.").

107. S. 2642, 73d Cong. § 9 (as introduced by Mr. King and referred to the S. Comm. on Banking and Currency, Feb. 9, 1934); S. 2693, 73d Cong. § 24 (as introduced by Mr. Fletcher and referred to the S. Comm. on Banking and Currency, Feb. 9, 1934); H.R. 7852, 73d Cong. § 24 (as introduced by Mr. Rayburn referred to the H. Comm. on Interstate and Foreign Commerce, Feb. 10, 1934); H.R. 7855, 73d Cong. § 24 (as introduced by Mr. Sabath and referred to the H. Comm. on Interstate and Foreign Commerce, Feb. 10, 1934); H.R. 7924, 73d Cong. § 11 (as introduced by Mr. Sabath and Referred to the H. Comm. on Interstate and Foreign Commerce, Feb. 13, 1934).

108. *Stock Exchange Regulation: Hearing on H.R. 7852 and 8720 Before the H. Comm. on Interstate and Foreign Commerce*, 73d Cong. 113 (1934).

Currency Committee, Howard Butcher, Jr., the Vice President of the Philadelphia Stock Exchange argued that the "willfully" requirement was cold comfort: "Don't you yourself think that if you were a director in a corporation you would resign if this bill were enacted into law?"[109] It was not until March 19, 1934 that a revised bill added the "and knowingly" requirement.[110] This differential structure was retained in the bills that ultimately passed both houses of Congress.[111]

Finally, under Section 24 of the Securities Act, the defendant must have "willfully" violated Section 17(a)(2), which itself requires the defendant to have acted at least negligently. Here, the willfulness element is inconsistent with mere negligence because a willful act cannot be "the result of innocent mistake, negligence or inadvertence."[112] Therefore, the willfulness requirement should operate to elevate the requisite mental state with respect to falsity to at least recklessness, akin to the standard that applies under Section 32(a) to misrepresentations outside the context of mandatory SEC filings. In other words, a criminal prosecution under Section 17(a)(2) should require the defendant to have acted in a knowingly wrongful manner that involved a significant risk of a reckless misrepresentation. This interpretation has two somewhat anomalous consequences.

First, as recognized by one commentator, a false statement in a registration statement could be prosecuted under Section 24 with a lower *mens rea* than it could be prosecuted under Section 32(a):

> Furthermore, the express false filing provision in section 24 of the 1933 Act relates only to a "registration statement," and a violation constitutes a crime only if done "willfully." The similar provision in section 32(a) of the 1934 Act encompasses "any application, report or document required to be filed" as well as "any undertaking contained in a registration statement" pursuant to section 15(d) of the 1934 Act, and constitutes a crime if done "willfully and knowingly."[113]

As a consequence, prosecutions for false statements in registration statements could be channeled to Section 24 rather than Section 32(a).[114]

109. *Stock Exchange Practices: Hearings on S. Res. 56, 84 and 97 Before the S. Comm. on Banking and Currency*, 72d & 73d Cong. 6967 (1934).

110. H.R. 8720, 73d Cong. § 25 (as introduced by Mr. Rayburn and referred to the H. Comm. on Interstate and Foreign Commerce, March 19, 1934).

111. H.R. 9323, 73d Cong. § 32 (as passed by the House, May 7, 1934); H.R. 9323, 73d Cong. § 30 (as passed by the Senate, May 14, 1934).

112. *See* United States v. Dixon, 536 F.2d 1388, 1397 (2d Cir. 1976).

113. Mathews, *supra* note 101, at 906 (footnotes omitted); *id.* at 956 ("[P]roof of knowledge would not have been necessary if the count had been framed under the false filing provision of section 24.").

114. *Id.* at 906–07 ("As a result of these distinctions, prosecutions of particularly blatant and egregious violations which could come within the purview of either statute . . . will usually be

One way of rationalizing that disparate *mens rea* under current law is that Section 24 violations have a statutory maximum sentence of only five years,[115] while Section 32(a) violations have a statutory maximum sentence of twenty years.[116] At the time of enactment, however, Section 24's statutory maximum sentence was five years,[117] while Section 32(a)'s was only two years.[118] Thus, although this rationalization might make sense now, it does not explain Congress's intent at the time of enacting these provisions.

Second, there is a differential treatment of false statements in registration statements (which can be prosecuted under Section 24) and false statements in other mandatory SEC filings (which can only be prosecuted under Section 32(a)'s "willfully and knowingly" standard).[119] One conceivable explanation for this difference is that policing the accuracy of statements in registration statements is of heightened importance because, at the time of offer or sale, the information asymmetry is greater, the incentive to make misrepresentations is more pronounced,[120] and the impact on allocation of capital is more direct.[121]

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brought under the 1933 Act.").

115. 15 U.S.C. § 77x (2012).

116. 15 U.S.C. § 78ff(a) (2012).

117. Securities Act of 1933, Pub. L. No. 73-22, § 24, 48 Stat. 74, 87.

118. Securities Exchange Act of 1934, Pub. L. No. 73-291, § 32, 48 Stat. 881, 904.

119. This assumes that courts agree with my interpretation that Section 17(a)(2) applies only to statements made in the offering/selling process. *See supra* Part II.

120. Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 620 (1984) ("Suppose, for example, that an issuer contemplates going to the capital market only once, and thereafter intends to finance its growth internally. In that case, an investment in reputation may be not a bond but bait, willingly lost in order to catch a more valuable fish. The gains from opportunism may well exceed the costs of lost reputation."); Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 1028–29 (1992) ("[T]he compensation a manager receives may be tied to the stock price, either because she owns stock or stock options in her company or because she expects to be rewarded with a larger salary raise if the company's stock price increases. Further, a low stock price may make it more likely that the manager will be fired by the company's board of directors, that her company will be taken over, or that a challenger will institute a proxy contest." (footnotes omitted)).

121. James Dow & Gary Gorton, *Stock Market Efficiency and Economic Efficiency: Is There a Connection?*, 52 J. FIN. 1087, 1087 (1997) ("[S]econdary stock market prices . . . have no direct role in the allocation of equity capital since managers have discretion in determining the level of investment."); Kahan, *supra* note 120, at 1006 ("Inaccurate stock prices, however, can lead to an inefficient allocation of capital. When companies raise capital at inaccurate prices, existing shareholders derive gains to the extent that new investors overpay for their shares, and suffer losses to the extent that new investors underpay. If the gains to existing shareholders from issuing overpriced shares exceed a project's losses, a company may raise capital for such an unprofitable project; and it may refrain from raising the capital for a lucrative project if the losses from selling new shares at a bargain price exceed the project's profits." (footnote omitted)); Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 694 (1988) ("A second flaw in the capital-allocation theory is its failure to recognize that the trading markets are discrete from the corporate issues market.").

Despite these troubling anomalies, the absence of a "knowing" requirement in Section 24 does not appear to be a drafting error.[122] Early versions of the bill included the following knowledge requirement for participant liability:

> Any person who shall willfully violate any of the provisions of this Act, or the rules and regulations promulgated by the Commission pursuant thereto, shall upon conviction be fined not more than $5,000, or imprisoned not more than five years, or both, and any officer, director, or agent or any corporation who knowingly participates in such violation shall be punished by a like fine or imprisonment, or both.[123]

In a hearing before the House Interstate and Foreign Commerce Committee, Representative George Huddleston expressed the view that "'[k]nowingly' affords an ample loophole for the ignorant and the innocent."[124] In a hearing before the Senate Banking and Currency Committee, Alexander Holtzoff, Special Assistant to the Attorney General, commented: "Criminal responsibility is limited to a director or officer who knowingly participates."[125] The Senate Report on an early version of the bill likewise highlighted the knowledge requirement: "Where an officer or director knowingly participates in violation of the terms of the bill, either by failure to file the information, or by filing false information, or advertises falsely, he subjects himself also to fine or imprisonment, or both."[126] The House eventually introduced and passed a bill containing the text of Section 24 as ultimately enacted,[127] while the Senate passed a bill that retained the knowledge requirement for participant liability.[128] The Conference Committee resolved this discrepancy without explanation in the Conference Committee Report,

122. Herlands, *supra* note 99, at 148 n.26 ("It should be observed that the language in the specific provision of this statute [the Exchange Act] differs from that in the Securities Act of 1933. In the latter Act the requirement for criminal liability is that the defendant make the false statement or omission 'willfully.' There is no express requirement of 'knowingly' making the misstatement or omission. This raises the vexatious question whether the prosecution must prove that the defendant *knew* of the falsity of the misstatement or omission under the 1933 Act. There does not appear to be such a sharp difference in policy between the two statutes as to warrant such a variation in language, especially in view of the troublesome question of interpretation it now presents. This is more than a mere matter of inartistic draftsmanship.").

123. S. 875, 73d Cong. § 16 (as reported in the Senate, Apr. 27, 1933). *See also* H.R. 4314, 73d Cong. § 17 (as introduced by Mr. Rayburn and referred to the H. Interstate and Foreign Commerce Comm., Mar. 29, 1933); S. 875, 73d Cong. § 17 (as introduced by Mr. Robinson and referred to the S. Judiciary Comm. & S. Banking & Currency Comm., Mar. 30, 1933).

124. *Federal Securities Act: Hearing on H.R. 4314 Before the H. Comm. on Interstate and Foreign Commerce*, 73d Cong. 17 (1933).

125. *Securities Act: Hearings on S. 875 Before the Comm. on Banking & Currency*, 73d Cong. 207 (1933).

126. S. REP. NO. 73-47, at 5 (1933) (Conf. Rep.).

127. H.R. 5480, 73d Cong. § 23 (as passed by the House, May 4, 1933).

128. H.R. 5480, 73d Cong. § 16 (as passed by the Senate with amendments, May 10, 1933).

with the House's version prevailing.[129]

These anomalous results lend additional support for other scholars' calls for revision and clarification of the *mens rea* standards for criminal prosecution of securities violations.[130] This call for reform is especially pressing because there is a risk that, as the SEC has increasingly turned to Section 17(a)(2) in the realm of civil enforcement,[131] the DOJ may follow suit in the realm of criminal prosecution.

VI. IMPLICATIONS OF PROSECUTING SECURITIES FRAUD UNDER SECTION 17(A)(2)

In order to exemplify the implications of this Essay's interpretation of the elements of the crime of violating Section 17(a)(2), I consider six factual scenarios. Under each scenario, I demonstrate how the crime of violating Section 17(a)(2) intersects with, and diverges from, the crime of violating Rule 10b-5.

Scenario One: Person makes or uses materially a misleading statement or omission during the offering/selling process in a registration statement, and a sale is consummated.

This person could potentially be prosecuted under Section 24 for violating Section 17(a)(2). The statement or omission occurred during the offering/selling process and thus "in the offer or sale of any securities." The person either made or used the statement or omission and thus acted "by means of" it. The "to obtain money or property" element would be met if the person acted to benefit his or her employer and received ordinary compensation for those efforts. The mental state element would be satisfied if the person acted in a knowingly wrongful manner that

129. *See* H.R. REP. NO. 73-152 (1933) (Conf. Rep.) (to accompany H.R. 5480); *see* James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 45 (1959) (explaining that, in the Conference Committee, the House bill was used as "the basic draft" rather than the Senate bill).

130. *E.g.*, Buell, *supra* note 95, at 565 ("I argue that the status quo potentially imposes serious costs in the form of a disconnect between the legal regime and its basic regulatory purposes, doctrine that risks criminally sanctioning undeserving actors, and loss of message clarity in the public sanctioning of fraud in financial markets."); Ann M. Olazábal & Patricia S. Abril, *Recklessness as a State of Mind in 10(b) Cases: The Civil-Criminal Dialectic*, 18 N.Y.U. J. LEGIS. & PUB. POL'Y 305, 307 (2015) ("By comparing the civil and criminal standards, and laying bare their inconsistencies, we contend that these contradictory standards—over-inclusive on the criminal side and under-inclusive on the civil side—have created an unjust and unsustainable incongruity in the law."); Michael L. Seigel, *Bringing Coherence to Mens Rea Analysis for Securities-Related Offenses*, 2006 WIS. L. REV. 1563, 1569 ("As shocking as it may seem to criminal-law aficionados, this Article represents the very first effort to bring coherence to mens rea analysis for securities-related offenses.").

131. *See supra* note 6.

involved a significant risk of a reckless misrepresentation.

This person could also potentially be prosecuted under Section 32(a) for violating Rule 10b-5. If the person "made" the statement or omission, he or she could be liable for violating Rule 10b-5(b). If he or she did not make the statement or omission but "disseminated" it, he or she could be liable for violating Rule 10b-5(a) or (c).[132] Under either scenario, because the statement or omission was contained in a registration statement, the person would be criminally liable under Section 32(a) only if he or she acted in a knowingly wrongful manner that involved a significant risk of a misrepresentation and with knowledge of falsity.

<u>Scenario Two</u>: *Person makes or uses a materially misleading statement or omission during the offering/selling process, but not in a registration statement, and a sale is consummated.*

This person could potentially be prosecuted under Section 24 for violating Section 17(a)(2). The statement or omission occurred during the offering/selling process and thus "in the offer or sale of any securities." The person either made or used the statement and thus acted "by means of" it. The "to obtain money or property" element would be met if the person acted to benefit his or her employer and received ordinary compensation for those efforts. The mental state element would be met if the person acted in a knowingly wrongful manner that involved a significant risk of a reckless misrepresentation.

This person could also potentially be prosecuted under Section 32(a) for violating Rule 10b-5. If the person "made" the statement or omission, he or she would be liable for violating Rule 10b-5(b). If the person "disseminated" the statement or omission, he or she would be liable for violating Rule 10b-5(a) or (c). Because this statement or omission was not contained in a registration statement, the mental state element would be satisfied if the person acted in a knowingly wrongful manner that involved a significant risk of a reckless misrepresentation.

<u>Scenario Three</u>: *Person makes or uses a materially misleading statement or omission in the offering/selling process, either in a registration statement or not, but no sale is consummated.*

This person could potentially be prosecuted under Section 24 for violating Section 17(a)(2). The statement or omission occurred during the offering/selling process (even though no sale was consummated) and thus "in the offer or sale of any securities." The person either made or used the statement or omission and thus acted "by means of" it. The "to obtain money or property" element would be met if the person acted to benefit

132. Lorenzo v. SEC, 139 S. Ct. 1094, 1102–03 (2019).

his or her employer and received ordinary compensation for those efforts. The *mens rea* element would be met if the person acted in a knowingly wrongful manner that involved a significant risk of a reckless misrepresentation.

This person could not be prosecuted under Section 32(a) for violating Rule 10b-5 because, absent a consummated sale, the misleading statement or omission was not "in connection with the purchase or sale of any security."

<u>Scenario Four</u>: *Person makes or uses a materially misleading statement or omission outside the offering/selling process in a mandatory SEC filing, and a purchase or sale is consummated.*

This person could not be prosecuted under Section 24 for violating Section 17(a)(2). The statement or omission occurred outside the offering/selling process and thus the "in the offer or sale of any securities" element would not be met.

This person could be prosecuted under Section 32(a) for violating Rule 10b-5. If the person "made" the statement or omission, he or she would be liable for violating Rule 10b-5(b). If the person "disseminated" the statement or omission, he or she would be liable for violating Rule 10b-5(a) or (c). Because the statement or omission was contained in a mandatory SEC filing, the person would be criminally liable under Section 32(a) only if he or she acted in a knowingly wrongful manner that involved a significant risk of a misrepresentation and with knowledge of falsity.

<u>Scenario Five</u>: *Person makes or uses a materially misleading statement or omission outside the offering/selling process, but not in a mandatory SEC filing, and a purchase or sale is consummated.*

This person could not be prosecuted under Section 24 for violating Section 17(a)(2). The statement or omission occurred outside the offering/selling process, and thus the "in the offer or sale of any securities" element would not be met.

This person could be prosecuted under Section 32(a) for violating Rule 10b-5. If the person "made" the statement or omission, he or she would be liable for violating Rule 10b-5(b). If the person "disseminated" the statement or omission, he or she would be liable for violating Rule 10b-5(a) or (c). If the misleading statement or omission was material to a decision by one or more individuals (other than the fraudster) to buy or to sell a security, then it was made "in connection with the purchase or sale of any security." Because this statement or omission was not contained in a mandatory SEC filing, the mental state element would be satisfied if the person acted in a knowingly wrongful manner that involved a significant risk of a reckless misrepresentation.

Scenario Six: Person makes or uses a materially misleading statement or omission outside the offering/selling process, but not in a mandatory SEC filing, and no purchase or sale is consummated.

This person could not be prosecuted under Section 24 for violating Section 17(a)(2). The statements or omissions occurred outside the offering/selling process, and thus the "in the offer or sale of any securities" element would not be met.

Neither could this person could be prosecuted under Section 32(a) for violating Rule 10b-5 because, absent a consummated purchase or sale, the misleading statement or omission was not "in connection with the purchase or sale of any security."

CONCLUSION

In this Essay, I have sought to interpret the elements of the crime of violating Section 17(a)(2) of the Securities Act and to compare and contrast those elements to the crime of violating Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. As exemplified by the above six scenarios, these partially overlapping crimes, when analyzed side-by-side, potentially lead to anomalous results. Hopefully, this Essay will spark an ongoing conversation about potential reform, especially in light of the SEC's increased reliance on Section 17(a)(2) in civil enforcement and the potential that the DOJ may follow suit in criminal prosecutions.