June 15, 2011

U.S. Supreme Court Limits Securities Fraud Liability to Parties with "Ultimate Authority" over Misstatements

Rule 10b-5 of the Securities and Exchange Commission declares it unlawful for "any person, directly or indirectly, . . . to make any untrue statement of a material fact" in connection with the purchase or sale of securities. In *Janus Capital Group, Inc.* v. *First Derivative Traders*,[1] the Supreme Court ruled that for purposes of a private action under Rule 10b-5, a person "make[s]" a statement only if that person "is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." Slip op. at 6.

Janus significantly limits the universe of persons who can be primarily liable in a private action under Rule 10b-5 based on false statements. Private plaintiffs often attempt to bring claims against secondary actors—such as investment bankers, law firms, and auditors—who allegedly participated in the creation of false statements that were attributed to another. Under different doctrinal approaches, the Court's prior decisions in *Central Bank*[2] and *Stoneridge*[3] had already substantially reduced the ability of private plaintiffs to bring claims under Rule 10b-5 against such secondary actors.

More specifically, *Central Bank* held that a private plaintiff may not sue a defendant for aiding and abetting a violation of Rule 10b-5. *Stoneridge* held that in an action under Rule 10b-5, members of the plaintiff class could not establish the element of reliance against certain non-issuer defendants for two reasons. First, although deceptive acts by the *Stoneridge* defendants allegedly contributed to the preparation of false financial statements by an issuer of securities, those defendants were merely business suppliers to the issuer, and the defendants' own allegedly deceptive acts were not disclosed to the investing public. Second, the defendants' relationship to the issuer's financial statements, which were publicly disclosed, was too remote.

Private plaintiffs frequently sought to circumvent *Central Bank* and *Stoneridge* through an expansive interpretation of who "make[s]" a statement under Rule 10b-5. An expansive interpretation of "make[s]" had the potential to evade *Central Bank*, because *Central Bank* did not directly address the scope of primary liability under Rule 10b-5; the decision concerned liability for aiding and abetting. An expansive interpretation of "make[s]" also had the potential to evade *Stoneridge*. If a secondary actor is viewed as having "made" a false statement attributed to another, a private plaintiff could attempt to argue that the plaintiff's reliance on the

1 No. 09-525 (June 13, 2011).

2 *Cent. Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

3 *Stoneridge Inv. Partners, LLC* v. *Sci.-Atlanta, Inc.*, 552 U.S. 148 (2008).

false statement itself was sufficient to establish reliance for purposes of a claim against the secondary actor.

Janus, however, rejected efforts by private plaintiffs to use a broad understanding of "make[s]" in order to overcome the doctrinal boundaries drawn by *Central Bank* and *Stoneridge*. Both *Janus* and *Stoneridge* were decided by the same five-Justice majority. *Janus* appears to reflect the Court's conviction that *Central Bank* and *Stoneridge* were not merely technical decisions; they instead arose in part from the Court's fundamental conviction that the judicially created private action under Rule 10b-5 must be given a "narrow scope." Slip op. at 8.

The "ultimate authority" test under *Janus* for identifying the maker of a statement is new. That test is considerably narrower than the test proposed by the SEC and does not appear to correspond with any of the tests previously prevailing in the courts of appeals. The lower federal courts will now need to begin, largely without guidance from prior case law other than *Janus* itself, to determine just how sharply the "ultimate authority" test restricts primary liability under Rule 10b-5. The potential implications of *Janus*, some of which we sketch below after we summarize the decision, are far-reaching.

1. The *Janus* Decision

Janus involved private claims for securities fraud under Rule 10b-5 against Janus Capital Group, Inc. ("JCG"), a publicly traded company, and its wholly owned subsidiary, Janus Capital Management LLC (the "Janus Investment Adviser"). JCG created the Janus family of mutual funds. The Janus mutual funds were organized in a Massachusetts business trust, the Janus Investment Fund (the "Fund"), which was a separate legal entity owned by the investors in Janus mutual funds. The Janus Investment Adviser was the investment adviser to the Janus mutual funds.

Janus involved alleged "market timing" by some investors in several Janus mutual funds. Market timing, as relevant to *Janus*, is an investment strategy that involves short-term trading by an investor in a mutual fund. Market timing seeks to exploit pricing anomalies created by the time at which a mutual fund calculates its net asset value. Market timing is not unlawful, but it allegedly harmed other investors in the Janus mutual funds.

The prospectuses for the Janus mutual funds arguably suggested that the Janus Investment Adviser would implement policies to prevent market timing. According to the *Janus* plaintiffs, JCG nonetheless entered into secret arrangements to permit market timing in several Janus mutual funds. The Attorney General of the State of New York filed a complaint against JCG and the Janus Investment Adviser based on these alleged secret agreements. When the Attorney General's allegations became public, the price of JCG stock declined. Shareholders in JCG then sued the Janus Investment Adviser, among other defendants. According to the plaintiff shareholders, they had relied on false and misleading statements in the prospectuses for the funds suggesting that market timing would not be allowed.

Under Rule 10b-5, it is unlawful "[t]o *make* any untrue statement of a material fact" in connection with a securities transaction. 17 C.F.R. § 240.10b-5(b) (emphasis added). *Janus* concerned whether the Janus Investment Adviser had "made" statements contained in the prospectuses for the funds. In upholding the complaint, the Fourth Circuit emphasized the

close relationship between the Janus Investment Adviser and the funds. Given that relationship, the Fourth Circuit accepted as sufficient plaintiffs' allegation that the Janus Investment Adviser had "'participat[ed] in the writing and dissemination of the prospectuses.'" Slip op. at 4 (quoting *In re Mutual Funds Inv. Litig.*, 566 F.3d 111, 121 (4th Cir. 2009)).

In an opinion delivered by Justice Thomas and joined by four other Justices, the Supreme Court reversed. The Court held that the Janus Investment Adviser could not be primarily liable based on the statements in the prospectuses because the Janus Investment Adviser did not "make" the statements contained in them. The Court announced that under 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." *Id.* at 6. "[I]n the ordinary case," the Court wrote, "attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by—and only by—the party to whom it is attributed." *Id*.

Applying this definition, the Court found that Janus Investment Fund, not the Janus Investment Adviser, made the statements in the prospectuses. The Court noted the following factors: (1) the Fund had the sole statutory obligation to file the prospectuses; (2) according to the SEC's records, the Fund filed the prospectuses; (3) there was no allegation that in fact the Janus Investment Adviser filed the prospectuses and falsely attributed them to the Fund; and (4) nothing on the face of the prospectuses indicated they contained statements that should be attributed to the Janus Investment Adviser instead of the Fund. *See id.* at 11.

The Court rejected more expansive definitions advocated by plaintiffs and the SEC in part out of concern that they would undermine the Court's decisions in *Central Bank* and *Stoneridge*, both of which limit the ability of private plaintiffs to recover against secondary actors. The Court in *Janus* stated that limiting liability to persons or entities with "ultimate authority" for false statements was consistent with these decisions, and with the Court's general admonition in *Stoneridge* against judicial expansion of the private right of action under Rule 10b-5.

Justice Breyer, joined by three other Justices, dissented.

2. Questions and Issues Raised by *Janus*

(a) "Narrow" construction of Rule 10b-5. The Court's holding in *Janus* was influenced by the "'narrow dimensions'" and "narrow scope" that the Court gives to the implied right of action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Slip op. at 6 (quoting *Stoneridge*, 552 U.S. at 167), 8. The Court originally recognized an implied right of action under Section 10(b) and Rule 10b-5 using an analytic framework that the Court has since abandoned. According to *Stoneridge,* Congress "ratified the implied right of action" in the Private Securities Litigation Reform Act of 1995 (the "PSLRA"). 522 U.S. at 165. In the view of the *Stoneridge* Court, "Congress accepted the § 10(b) private cause of action as . . . defined [when the PSLRA was enacted] but chose to extend it no further." *Id.* at 166.

Stoneridge concerned reliance as an element of a private right of action. Reliance is not an element in a civil enforcement action by the SEC or a criminal prosecution under the Rule. *Janus*, however, concerns the meaning of Rule 10b-5 itself. The Court seems

unlikely to give the phrase "to make any untrue statement" a different meaning in the context of an action by the SEC or the Government than in the context of a private right of action. If that is so, *Janus* arguably suggests that Rule 10b-5 itself, at least in some respects, should be construed narrowly.

(b) Claims against secondary actors. Under the standards previously prevailing in some circuits, plaintiffs could arguably allege that a secondary actor "made" a false statement if the secondary actor had a sufficiently high level of involvement in the creation, approval, and/or dissemination of the statement. The Supreme Court's decision in *Janus*, however, wipes the slate clean. Where a statement is published by and attributed to an issuer of securities, the "ultimate authority" test seems to leave little room for the imposition of liability on secondary actors to whom the statement is not explicitly attributed, such as investment bankers, law firms, and auditors. Such a secondary actor is unlikely to have "ultimate authority" concerning a statement attributed to the issuer that retained the secondary actor. That is particularly so given the Court's further observation that ordinarily, the person to whom a statement is attributed is its maker.

The Court did appear to indicate that in some circumstances, a statement made by and attributed to a non-issuer, and then communicated by the issuer to the investment markets, could be the basis for primary liability under Rule 10b-5 against the non-issuer. *See* slip op. at 11 n.11. The Court cited as an example a signed auditor's report included in a prospectus. *Id*. There, a plaintiff would presumably contend that an audit firm is ordinarily the "maker" of an audit report signed on behalf of and expressly attributed to the audit firm. A plaintiff might then seek to impose liability on the audit firm for an allegedly false audit report, based on the indirect communication of the audit report to the investment markets through the vehicle of an issuer's prospectus.

In this circumstance, the Court held that attribution to the original maker of an indirectly communicated statement is necessary for a plaintiff to hold the original maker primarily liable under Rule 10b-5. But the Court also stated in strong terms that attribution may not be enough: "More may be required to find that a person or entity made a statement indirectly, but attribution is necessary." *Id.* For example, it may be that the original maker must intend the indirect communication to occur, or at least must have some other level of awareness respecting it. Other additional elements may be required as well. *Janus* expressly leaves these significant issues unresolved in the Supreme Court.

(c) Claims against corporate officers, directors, and employees. Private plaintiffs frequently sue corporate officers, directors, or employees for statements made on behalf of a corporate issuer. In some such actions, the individual defendant is overtly identified in the corporate statement—for example, a corporate officer who signs a certification under Section 302 of the Sarbanes-Oxley Act of 2002 respecting a corporation's annual report on Form 10-K, or who makes oral statements on behalf of the corporation at a news conference. In other instances, a corporate statement may not identify any individual who is responsible for its content, or may not identify the individuals within the corporation who had ultimate authority for approving the statement.

At least in contexts where a statement attributed to an issuer does not also attribute the statement to an individual corporate insider, and where no attribution to any such insider

is "implicit from surrounding circumstances," defendants are likely to argue that the issuer is the only "maker" of the statement and thus the only potential defendant with primary liability under Rule 10b-5. Slip op. at 6. It may be that the issuer is the only "maker" in additional circumstances. After all, even an individual corporate insider named in a corporate statement may not have had "ultimate authority over the statement." *Id*. And as the *Janus* Court stated, "[o]ne who prepares or publishes a statement on behalf of another is not its maker." *Id.*

Janus concerned whether a corporation external to Janus Investment Fund could be considered a "maker" of statements attributed to the Fund. The lower federal courts will need to assess the meaning of *Janus* in the context of individuals who hold positions within a corporate "maker" of statements.[4]

(d) Control-person liability. The more restrictive test for primary liability announced in *Janus* may give greater prominence to Section 20(a) of the Exchange Act. Section 20(a) subjects certain persons who "control" a violator of the Exchange Act to joint and several liability for the underlying violation. Private plaintiffs may now attempt to assert control-person claims against some persons who might previously have been sued as primary violators.

(e) Deference to the SEC. The *Janus* Court declined to defer to the SEC's proposed interpretation of "make" in Rule 10b-5, on the ground that the term, in the context of the Rule, is not ambiguous. Slip op. at 9 n.8. The Court "note[d] . . . that [it had] previously expressed skepticism over the degree to which the SEC should receive deference regarding the private right of action." *Janus* also pointedly cited four prior decisions in which the Court "ha[d] disagreed with the SEC's broad view of § 10(b) or Rule 10b-5," one of which, like *Janus*, concerned the scope of the Rule rather than solely the scope of a private claim under the Rule.[5]

Courts generally defer to agencies because they "presume that the power authoritatively to interpret [the agency's] own regulations is a component of the agency's delegated lawmaking powers."[6] The *Janus* Court's comments, however, suggest that the Court's views concerning the SEC, and perhaps the Court's view of its own historical role in the development of securities law, may influence the extent of the deference it will afford to the SEC's views. The "judicial oak"[7] of private actions under Rule 10b-5 remains intact, but this Court clearly expects any substantial further growth to occur only at the will of Congress.

---

4 *Cf. Pac. Inv. Mgmt. Co. LLC* v. *Mayer Brown LLP*, 603 F.3d 144, 158 n.6 (2d Cir. 2010).

5 *Id.* (citing, *inter alia*, *Dirks* v. *SEC*, 463 U.S. 646, 666 n.27 (1983)).

6 *Martin* v. *OSHRC*, 499 U.S. 144, 151 (1991).

7 *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 737 (1975).

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Charles E. Davidow
202-223-7380
cdavidow@paulweiss.com

Brad S. Karp
212-373-3316
bkarp@paulweiss.com

Daniel J. Kramer
212-373-3020
dkramer@paulweiss.com

Walter G. Ricciardi
212-373-3350
wricciardi@paulweiss.com

Walter Rieman
212-373-3260
wrieman@paulweiss.com

Richard A. Rosen
212-373-3305
rrosen@paulweiss.com

Audra J. Soloway
212-373-3289
asoloway@paulweiss.com

NEW YORK
1285 Avenue of the Americas
New York, NY 10019-6064
+1-212-373-3000

BEIJING
Unit 3601, Fortune Plaza Office
Tower A
No. 7 Dong Sanhuan Zhonglu
Chao Yang District, Beijing 100020
People's Republic of China
+86-10-5828-6300

HONG KONG
12th Fl., Hong Kong Club Building
3A Chater Road
Central Hong Kong
+852-2846-0300

LONDON
Alder Castle, 10 Noble Street
London EC2V 7JU
United Kingdom
+44-20-7367-1600

TOKYO
Fukoku Seimei Building, 2nd Floor
2-2, Uchisaiwaicho 2-chome
Chiyoda-ku, Tokyo 100-0011
Japan
+81-3-3597-8101

TORONTO
One Yonge Street, Suite 1801
Toronto, ON M5E 1W7
Canada
+1-416-504-0520

WASHINGTON, D.C.
2001 K Street NW
Washington, DC 20006-1047
+1-202-223-7300

WILMINGTON
500 Delaware Avenue, Suite 200
Post Office Box 32
Wilmington, DE 19899-0032
+1-302-655-4410

Contributing authors include John H. Longwell and Andrew W. Amend.