THE SUPREME COURT ADOPTS A BRIGHT LINE ATTRIBUTION TEST FOR LIABILITY UNDER SECTION 10(b) OF THE SECURITIES EXCHANGE ACT

The Supreme Court this week issued a landmark decision that eliminates the potential uncertainty regarding who could be held liable under Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"). Previously, the circuits employed different tests concerning who is a primary actor and a secondary actor. The Supreme Court has now held that actions may go forward against only the actual maker (and not a creator) of the alleged false and misleading statements.

In 1994, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), the United States Supreme Court ruled that a party cannot be held liable as aider and abettor for violation of Section 10(b) of the 1934 Act.[1] The Supreme Court reaffirmed that holding in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), when it held that liability could not be imposed on a secondary actor on the ground that it participated in a scheme to defraud. The Court based its ruling on the ground that, absent an independent duty to disclose, there can be no reliance on the secondary actor's allegedly deceptive conduct. As explained in *In re Parmalat Securities Litigation*, 570 F. Supp. 2d 521, 526 (S.D.N.Y. 2008), "*Stoneridge* made plain that investors must show reliance upon a defendant's own deceptive conduct before that defendant, otherwise a secondary actor, may be found primarily liable." In other words, in order for an investor to assert a claim, the claim under Rule 10b-5 may be brought against only a primary actor.

After *Central Bank*, the courts developed a diversity of tests to determine whether a party could be liable as a primary actor. Until now, the test for who is a primary actor has devolved into two sharply divergent and conflicting tests. Under the test developed by the Second Circuit, several Circuits have applied the bright line attribution test – the statement must be attributed to the party in order for that party to be a primary actor. *See Pacific Management Co. v. Mayer Brown LLP*, 603 F.3d 144 (2d Cir. 2010). On the other extreme, the Ninth Circuit has applied a substantial participation test – the party had to substantially participate in the preparation of the statements. *See In re Software Toolworks Securities Litigation*, 50 F.3d 615 (9th Cir. 1994). Some Circuits have adopted a subjective attribution test that purports to be a blend of those two tests.

In its June 13, 2011 decision in *Janus Capital Group, Inc. v. First Derivative Traders*, No. 09-525, 564 U.S. ___ (June 13, 2011), the Supreme Court brought an end to that conflict and adopted the bright line test to determine who is a primary actor for the purposes of Rule 10b-5, expressly rejecting the middle ground test. The Court established the rule that only the maker of the false and misleading statement can

[1] Congress subsequently amended the 1934 Act to authorize only the SEC to bring enforcement actions for aiding and abetting a violation of Section 10(b).

be liable and that a party that participates in the creation of that statement, regardless of its level of involvement, cannot be held liable.

The Supreme Court reversed the decision of the Fourth Circuit that had applied the middle ground relationship test.[2] The Supreme Court started its analysis by observing: "One 'makes' a statement by stating it." Slip Op. at 6. Consequently, the Court held:

> For 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. Without control, a person or entity can merely suggest what to say, not "make" a statement in its own right. One who prepares or publishes a statement on behalf of another is not a maker. And in the ordinary case, 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. This rule might be best exemplified by the relationship between a speechwriter and a speaker. Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it. And it is the speaker who takes credit – or blame – for what is ultimately said.

Id. at 6-7.

The Court's opinion rejected the position advocated in Justice Breyer's dissent, which urged that the Fourth Circuit's subjective test be adopted. The Court, following the reasoning employed by the Second Circuit, observed that a bright line test is necessary in order to ensure that the Court's ruling in *Central Bank* regarding secondary liability is respected. It stated:

> But for *Central Bank* to have any meaning, there must be some distinction between those who are primarily liable (and thus may be pursued in private suits) and those who are secondarily liable (and thus may not be pursued in private suits). We draw a clean line between the two – the maker is the person or entity with ultimate authority over a statement and others are not. In contrast, the dissent's only limit on primary liability is not much of a limit at all. It would allow for primary liability whenever "[t]he specific relationships alleged . . . warrant [that] conclusion" – whatever that may mean.

Id. at 7 n.6 (citation omitted; ellipsis and brackets in original).

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[2] In *In re Mutual Funds Investment Litigation*, 566 F.3d 111 (4th Cir. 2009), shareholders of Janus Capital Group Inc. ("JCG") brought a claim under Rule 10b-5 against JCG and Janus Capital Management LLC ("JCM"), contending that they should be liable for the false and misleading statements regarding market timing trades in the prospectuses for various Janus mutual funds for which JCM was the investment adviser and administrator. The complaint alleged that JCG and JCM were liable for the misleading statements in the mutual funds' prospectuses because they had each participated in the writing and dissemination of the prospectuses. *Id.* at 121. The Fourth Circuit adopted a middle ground test that the public attribution requirement is satisfied if a plaintiff can prove that "interested investors (and therefore the market at large) would attribute the allegedly misleading statements to the defendant." *Id.* at 124. The Fourth Circuit held that investors would attribute the statements to JCM because of its role as the mutual funds' investment adviser, as JCM was responsible for the funds' day-to-day management. *Id.* at 125. Thus, the court reversed the dismissal of the complaint as against JCM because "interested investors would infer that JCM played a role in preparing or proving the content of the Janus Fund prospectuses, particularly the content pertaining to the funds' policies affecting the purchase or sale of shares." *Id.* at 127.

The Court rejected the argument made by the SEC that the word "make" should be construed to mean "create." The Court observed: "We see no reason to treat participating in the drafting of a false statement differently from engaging in deceptive transactions, when each is merely an undisclosed act preceding the decision of an independent entity to make a public statement." *Id.* at 9.

The Court also rejected the plaintiff's contention that the investment management company should be seen as the "maker" because of the close relationship between a mutual fund and its investment adviser. The Court "decline[d] this invitation to disregard the corporate form," as the Court noted "[i]t is undisputed that the corporate formalities were observed here." *Id.* at 9-10.

Finally, the Court rejected the plaintiff's assertion that JCM should be liable because it "was significantly involved in preparing the prospectuses," stating: "But this assistance, subject to ultimate control of [the Fund], does not mean that JCM 'made' any statements in the prospectuses. Although JCM, like a speechwriter, may have assisted [the Fund] with crafting what [the Fund] said in the prospectuses, JCM itself did not 'make' those statements for purposes of Rule 10b-5." *Id.* at 12.

In sum, in order for a party to be subject to a damages claim under Rule 10b-5, the plaintiff must satisfy the rule that "the maker of a statement is the entity with authority over the content of the statement and whether and how to communicate it." *Id.* at 8. In contrast to liability under the Securities Act of 1933, parties that participate in the preparation of a statement cannot be liable under Rule 10b-5, no matter what their level of participation or their relationship to the maker of the statement. This rule strengthens the defense that professionals, financial service firms and investment advisors have when sued under Rule 10b-5 for statements made by someone else, such as a public company or an investment fund.

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