Supreme Court Limits Scope of Rule 10b-5 "Maker" Liability

On June 13, 2011, in *Janus Capital Group, Inc, et al.* v. *First Derivative Traders*, No. 09-525, a divided Supreme Court held 5-4 that only the speaker to which a statement is specifically attributed can be liable for purposes of Securities and Exchange Commission (SEC) Rule 10b-5. The majority opinion by Justice Thomas announced a bright-line rule that "the maker of a statement" for purposes of Rule 10b-5 liability "is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."[1] A sharp dissent by Justice Breyer questioned the majority's interpretation and expressed concern that the majority opinion foreclosed claims against too broad a range of potential defendants under the securities laws.[2]

The *Janus* decision is important because it narrows the scope of liability under Rule 10b-5 for investment bankers, lawyers, accountants, and executives who assist in the preparation of securities filings. Rule 10b-5, which contains a prohibition against "making any untrue statement of a material fact . . .,"[3] is one of the primary provisions under which securities actions by private plaintiffs and enforcement actions by the SEC are brought. Accordingly, the questions of what it means to "make" a false or misleading statement and who can be liable for "making" a statement are of central importance to professionals and others who assist entities that make public securities filings. The federal appellate courts had been divided on whether "making" a statement should be narrowly construed to situations where it was publicly attributed to the defendant or more broadly interpreted to include those who had "substantially participated" in or had "intricate involvement" in preparing the statement. It is now clear that Rule 10b-5 is to be narrowly construed.

1 No. 09-525 (June 13, 2011), Majority Opinion (Op.) at 6.

2 For a more detailed examination of the parties' arguments before the Court, *see* Arnold & Porter LLP, "Advisory: Supreme Court to Consider Scope of "Service Provider" and "Non-Speaker" Liability in Securities Fraud Litigation," (December 2010) *available at*: http://www.arnoldporter.com/public_document.cfm?id=17091&key=2B3.

3 17 C.F.R. § 240.10b-5(b).

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Notably, the Court reached the decision over the objections of the government, which had urged the Court not to hear the *Janus* case and warned that Janus' interpretation of Rule 10b-5 was narrower than the SEC's interpretation and could make it more difficult to bring certain enforcement actions. The decision could have a significant impact on both private securities litigation and government enforcement proceedings by limiting the universe of potential defendants who may be subject to primary liability for securities fraud.

Background and Proceedings in Lower Courts

Janus Capital Group Inc. (JCG) is a publicly traded financial services company that manages the Janus family of mutual funds, organized in a business trust known as the Janus Investment Fund. The Janus Investment Fund retained Janus Capital Management LLC (JCM), a subsidiary of JCG, to be its investment advisor and administrator. Shares in Janus mutual funds were offered for sale by securities prospectuses issued in the name of the investment fund, not JCG or JCM. The prospectuses for the various funds stated that they were "not intended for market timing or excessive trading" and that Janus had measures in place to deter and stop market-timing trading, such as suspending trading privileges or revoking trade orders. In September 2003, however, an investigation by the New York Attorney General resulted in charges that a hedge fund had paid the Janus funds, among others, to allow it to engage in market timing, i.e., rapid trading in and out of the Janus funds, causing a significant drop in JCG's share price. Subsequently, shareholders sued alleging that JCG and JCM violated Section 10(b) by making fraudulent misrepresentations in the prospectuses regarding market-timing policies and that the public revelation of the fraud caused losses borne by JCG investors because JCG's stock price was related to the value of the Janus funds.

The primary issue in the *Janus* case was whether a "service provider"—here an investment adviser—who was involved in the preparation and dissemination of allegedly misleading securities prospectuses, but whose name is not publicly associated with the filing, can be considered to have "made" the false statements at issue. In particular, the *Janus* case posed the question whether, for purposes of assessing liability to shareholders under the securities laws, JCM "made" the false statements in the prospectuses that were issued by Janus Investment Fund.

Rule 10b-5(b), which is the most common legal basis for asserting fraud in private securities class actions, makes it unlawful, in connection with the purchase or sale of any security, "[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 light of the circumstances in which they were made, not misleading."[4] In prior decisions, most notably *Stoneridge Inv. Partners, LLC* v. *Scientific-Atlantic, Inc.*[5] and *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*,[6] the Supreme Court previously limited private action liability under Section 10(b) (under which Rule 10b-5 was promulgated) to "primary" actors, holding that there is no private right of action against parties for aiding-and-abetting securities fraud. To avoid this limitation, plaintiffs have asserted in many cases that outside professionals and executives who assisted in the preparation of securities filings should be considered "primary" actors, because they helped "make" the false and misleading statements in those filings.

In addressing this question, the district court dismissed the Section 10(b) claims against both JCG and JCM, concluding, among other things, that there were no allegations that JCG made or prepared the prospectuses and that there were no statements attributable to JCG. The Fourth Circuit reversed, holding that the allegation that JCM's participation in the writing and dissemination of the prospectuses was sufficient to satisfy the requirement that JCM made the misleading statements contained in the documents. The Fourth Circuit held that a case-by-case inquiry is required into whether interested investors would have known that a defendant was responsible for the statement at the time it was made "even if the statement on its face is not directly

4 17 C.F.R. § 240.10b-5(b).

5 552 U.S. 148 (2008).

6 511 U.S. 164 (1994)

attributed to the defendant."[7] In this case, the Fourth Circuit determined "interested investors would attribute to JCM a role in the preparation or approval of the allegedly misleading prospectuses" because, notwithstanding the fact that a mutual fund is its own company, an "investment advisor is well known to be intimately involved in the day-to-day operations of the mutual funds it manages."[8]

One Makes a Statement by Stating It

Stressing that it was important to give "narrow dimension" to an implied private right of action, Justice Thomas' majority opinion for the Court adopted a bright-line test to determine the "maker" of a statement that seeks to "draw a clean line" between primary violators and aiders and abettors. Relying on grammatical rules of construction, Justice Thomas interpreted the language of Rule 10b-5 "to make any . . . statement" as "the approximate equivalent of 'to state.'"[9] Simply put, "[o]ne 'makes' a statement by stating it."[10] Under the rule announced by the majority, "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."[11] Thus, "[o]ne who prepares or publishes a statement on behalf of another is not its maker."[12] "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."[13] Drawing on an analogy suggested by Justice Scalia during oral argument, the majority opinion analogized to a speechwriter and speaker—"[e]ven when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it."[14] Notably, the majority opinion expressly rejected the SEC's position that Rule 10b-5 should be interpreted as allowing primary liability for both directly or indirectly making a statement when a person, acting alone or with others, "creates" a misrepresentation.[15]

Justice Thomas's analysis stressed that the investment advisor is a distinct legal entity from the investment fund to which the statements in the prospectuses were attributed, noting that there were no statements attributed to the advisor and no allegations that corporate formalities had not been maintained. Analogizing to the Court's *Stoneridge* decision, the majority opinion saw "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."[16] Notwithstanding that investment advisors may exercise significant influence over their client funds, persons that do not have ultimate control over the content of a statement are, at best, aiders and abettors against whom there is no private right of action.

Justice Breyer's dissent criticized the bright-line rule articulated by the majority, arguing that "[p]ractical matters related to context, including control, participation, and relevant audience, help determine who 'makes' a statement and to whom that statement may be properly 'attributed.'"[17] Moreover, the dissent argues that the rule would foreclose liability in circumstances where prior cases have recognized it, and would limit potential SEC enforcement actions—most notably where "one actor exploits another as an innocent intermediary for its misstatements," such as when "guilty management writes a prospectus (for the board) containing materially false statements and fools both the board and public into believing they are true[.]"[18]

Significance of the Decision

The bright-line test announced in *Janus* is likely to significantly curtail the potential for Rule 10b-5 liability in private litigation against investment advisers, executives, professionals, and professional firms that provide advice

7 *In re Mutual Funds Investment Litigation*, 566 F.3d 111, 124 (4th Cir. 2009).
8 *Id.* at 127.
9 *Op.* at 6.
10 *Id.*
11 *Id.*
12 *Id.*
13 *Id.*
14 *Id.* at 6-7.
15 *Id.* at 8.
16 *Id.* at 9.
17 *Dissent* at 4.
18 *Id.* at 9-10.

or assist in the preparation of securities filings. *Janus* clarifies that claims for primary liability under Rule 10b-5 are only available against those with ultimate authority for the statement, which "in the ordinary case" means liability is limited to the person or entity to whom the statement is attributed. Accordingly, there can be no primary liability under Rule 10b-5 for assisting in the preparation of a statement, even if the assistance is substantial. Rather, absent legislative intervention, there will be narrower civil liability for those who provide advice or assist in the preparation of securities filings.

The impact of the decision on SEC enforcement activity is harder to predict. While the SEC's ability to bring an action for a primary violation of Rule 10b-5 is also likely to be curtailed, it will still be able to bring charges for aiding and abetting or causing a primary violation (assuming a primary violation is established in the first instance).

Notwithstanding the Court's drawing of a "clean line" between the person or entity with ultimate authority over a statement and those without it, questions are raised by the majority opinion with which lower courts are likely to wrestle for some time. These questions include:

- If "the ordinary case" for primarily liability is one in which the statement is attributed, can there nevertheless be cases for primary liability in which the statement is not attributed? If so, under what "surrounding circumstances"?
- To what extent can corporate formalities be used to insulate individuals from liability? The majority decision places some emphasis on corporate form, which may lead lower courts to scrutinize whether defendants are observing corporate formalities.
- What are the circumstances in which "indirect" statements may give rise to liability? Rule 10b-5 prohibits making misleading statements "directly or indirectly." The Court did not define what it means to communicate a statement that has been made indirectly, but noted that whatever else may be required, at a minimum, "attribution is necessary."[19]
- How, if at all, will courts analyze the "innocent intermediary" example proffered in Justice Breyer's dissent?

However these questions ultimately are answered, and whether *Janus* is best described as preventing an undue expansion of liability or narrowing current liability for "making" misstatements under Rule 10b-5, it will be welcomed by the securities industry and indicates that the Supreme Court remains unwilling to read the federal securities laws in an expansive fashion.

If you have any questions about any of the topics discussed in this Advisory, please contact your Arnold & Porter attorney or any of the following attorneys:

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19 *Op.* at 7 n.6.