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# The Currently Mandated Myopia of Rule 10b-5: Pay No Attention to That Manager Behind the Mutual Fund Curtain

Kelly S. Kibbie\*

## I. INTRODUCTION

This Article examines the current state of the Rule 10b-5<sup>1</sup> right of action following a constricting trilogy of Supreme Court cases that have rendered it a myopic remnant of the right previously endorsed by the United States Securities and Exchange Commission (the “SEC”) and hundreds of courts over a span of numerous decades.<sup>2</sup> The Roberts Court’s pronouncement in *Janus Capital Group, Inc. v. First Derivative Traders*<sup>3</sup> has generated an immense amount of criticism<sup>4</sup> and a slew of conflicting lower court decisions.<sup>5</sup> By effectively abolishing most private Rule 10b-5 claims against secondary actors,<sup>6</sup> including lawyers, accountants, credit rating agencies, underwriters and securities analysts, and by mistakenly including mutual fund investment managers in the class of ordinary secondary actors,<sup>7</sup> the Court has chosen a short-

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1. 17 C.F.R. § 240.10b-5 (2012).

2. *See infra* notes 68-69 and accompanying text.

3. 131 S. Ct. 2296 (2011).

4. *See infra* note 220 and accompanying text.

5. *See infra* Part V.

6. The phrase “secondary actors” is used herein to refer to persons or entities that provide services to or participate in transactions with corporate issuers. *See, e.g.*, U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-11-664, SECURITIES FRAUD LIABILITY OF SECONDARY ACTORS 1 n.1 (2011) [hereinafter GAO Study]. As discussed in Part III, the courts have struggled to determine the standards for the imposition of primary liability, versus those for secondary liability, with respect to secondary actors under the securities laws.

7. As discussed in detail below, with respect to a mutual fund investment adviser, the term “secondary actor” is a misnomer. *See, e.g.*, Brief for the United States of America as Amici Curiae Supporting Respondent at 17, *Janus*, 131 S. Ct. 2296 (No. 09-525), 2010 WL 4339892, at \*17 [hereinafter U.S. *Janus* Amicus Brief] (“Unlike a typical secondary actor such as ‘a lawyer, accountant, or bank,’ an investment adviser’s unique and close relationship with a mutual fund makes it essentially a corporate insider.” (internal citation omitted)); Brief of Law Professors William A. Birdthistle [Assistant Professor of Law, Chicago-Kent College of Law], Tamar Frankel [Michaels Faculty Research Scholar and Professor of Law, Boston University School

sighted, ill-reasoned standard that ignores the doctrinal foundations of the Securities Exchange Act of 1934 (the “1934 Act”),<sup>8</sup> as well as the practical realities and traditional bases of mutual fund law and practice.<sup>9</sup>

Specifically, despite the fact that a typical mutual fund<sup>10</sup> has no employees, no office space, no assets other than those it holds for its investors, no officers that are not also officers of its investment manager, and no involvement in its own day-to-day management (having delegated such management and investment decisions to its investment manager), the Roberts Court has mandated that aggrieved investors pursuing private Rule 10b-5 claims must ignore fraudulent managers and other “mutual fund malefactors,”<sup>11</sup> even

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of Law], Lyman P.Q. Johnson [Robert O. Bentley Professor of Law, Washington and Lee School of Law and LeJeune Distinguished Chair in Law, University of St. Thomas (Minneapolis) School of Law], Donald C. Langevoort [Thomas Aquinas Reynolds Professor of Law, Georgetown University Law Center] & Manning G. Warren III [H. Edward Harter Endowed Chair of Commercial Law, Louis D. Brandeis School of Law, University of Louisville] as Amici Curiae in Support of Respondent at 15, *Janus*, 131 S. Ct. 2296 (No. 09-525), 2010 WL 4380234, at \*15 [hereinafter Law Professors’ *Janus* Amici Brief] (“By labeling themselves taxonomically too remote to be held liable, petitioners circumvent the substantive fraud-on-the-market analysis set forth in *Stoneridge*.”); see also, e.g., *infra* Part IV. The terms “investment adviser,” “investment manager” and “manager” are used interchangeably herein. See, e.g., *infra* note 243.

8. 15 U.S.C. §§ 78a-78ee (2006).

9. As discussed later, the “lacunae of securities expertise” on the Supreme Court since Justice Powell’s retirement in 1987 has led to random decisions drawn not from the complex interplay of the securities laws, but from more general notions, such as narrow statutory interpretation. See A.C. Pritchard, *Securities Law in the Roberts Court: Agenda or Indifference?*, 37 J. CORP. L. 105, 106, 144 (2011); *infra* notes 56-65 and accompanying text. Further, as evidenced in *Janus*, the Roberts Court inexplicably disregards the reasoned and well-articulated views of those with the deepest understanding of the securities laws. See, e.g., U.S. *Janus* Amicus Brief, *supra* note 7, at \*13-14; Law Professors’ *Janus* Amici Brief, *supra* note 7, at \*1 (noting that the *Amici* were prompted to write due to the potential “significant consequences for all American shareholders and their investments” and because of their interest “in ensuring a uniform and coherent interpretation of the [1934 Act] and the regulations promulgated thereunder”); see also *infra* notes 64-65, 186-87 and accompanying text. Without doubt, said *Amici* represent some of the finest minds in the area of federal securities and investment fund regulation.

10. See *infra* Part IV.

11. Editorial, *So No One’s Responsible?*, N.Y. TIMES, June 15, 2011, at A26 [hereinafter *New York Times* Editorial], available at [http://www.nytimes.com/2011/06/15/opinion/15wed2.html?\\_r=0](http://www.nytimes.com/2011/06/15/opinion/15wed2.html?_r=0) (noting that Justice Thomas’ *Janus* opinion “has made it much harder for private lawsuits to succeed against mutual fund malefactors, even when they have admitted to lying and cheating[.]” as liability for misstatements attaches only to “the one whose name the statement is presented under. . . . [E]ven if the entity presenting the statement is a business trust – basically a dummy corporation – with no assets, while its owner has the cash.”).

where they have deceived their fund boards.<sup>12</sup> In sum, *Janus* does real harm: it potentially allows a deceitful manager to “coordinate all major aspects of a mutual fund”<sup>13</sup> for fraudulent purposes, while it reaps increased fees, hides its deceit and avoids private Rule 10b-5 liability. This “pay no attention to the manager behind the mutual fund curtain”<sup>14</sup> dictate is untenable and should be remedied by legislative action.

*Janus*'s absolution of all but those with “ultimate authority” in private Rule 10b-5(b) actions is particularly concerning in light of the high volume of financial frauds during the last decade involving complicit “gatekeepers,”<sup>15</sup> who prioritized their own economic interests over their ethical obligations: Enron, WorldCom, Tyco, and Global Crossing only begin the long list of complicit gatekeeper scandals.<sup>16</sup> *Janus* is especially perplexing in light of the numerous front-page stories of mutual fund adviser misconduct over the last decade, including scandals involving market timing, late trading, valuation misconduct and soft-dollar practices.<sup>17</sup> Concurrent with these high-profile frauds, recent years have also witnessed highly-publicized failures of the SEC, including its failure to discover Bernie Madoff's estimated \$13.2 billion to \$65 billion Ponzi scheme, despite “credible and specific allegations . . .

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12. See *infra* notes 217-19 and accompanying text.

13. Law Professors' *Janus* Amici Brief, *supra* note 7, at \*13; see *infra* note 172, (discussing the amount of mutual fund control that a manager must exert in order to perpetrate a market timing fraud).

14. With apologies to the Kansas balloonist's embarrassing moment in the 1939 film classic that catches him demanding Dorothy *et al.* to deny his obvious control of the levers and microphones appearing to enliven the projection of the “Great and Powerful Oz”. THE WIZARD OF OZ (Metro-Goldwyn-Mayer 1939). Post-*Janus*, investment advisers potentially have impunity in most private Rule 10b-5 suits to demand denial of their obvious control of mutual funds, requiring aggrieved investors to, in effect, sue the projection.

15. See generally Christopher C. Hines, *The Corporate Gatekeeper in Ethical Perspective*, 78 MO. L. REV. 77 (2013). Certain secondary actors are referred to as “gatekeepers”, as they occupy a vital position between issuers and investors that allows them to prevent wrongdoing in certain circumstances. See, e.g., GAO Study, *supra* note 6, at 1 n.1. For an excellent summary of the roles of various secondary actors in securities transactions, see *id.* at 11-16.

16. See, e.g., John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 305, 311-12 (2004); Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1615 (2010); Jeffrey N. Gordon, *Janus Capital Group v. First Derivative Traders: Only the Supreme Court Can “Make” a Tree*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REGULATION (June 29, 2011, 9:27 AM), <http://blogs.law.harvard.edu/corpgov/2011/06/29/janus-capital-group-v-first-derivative-traders-only-the-supreme-court-can-make-a-tree/>.

17. Law Professors' *Janus* Amici Brief, *supra* note 7, at \*23 (citing Josh Friedman, *FleetBoston, B of A to Pay \$675 Million*, L.A. TIMES, Mar. 16, 2004, at C1).

repeatedly brought to the attention of SEC staff. . . .<sup>18</sup> Without doubt, gatekeepers have also shouldered a significant amount of blame for the recent financial crisis.<sup>19</sup> The Supreme Court's constriction of the Rule 10b-5 right, despite this troubling confluence of events, will most surely disadvantage U.S. investors,<sup>20</sup> as further set forth herein, unless remedied by legislative and administrative action.

This Article discusses the potentially harmful consequences of the above-referenced trilogy of Supreme Court cases with respect to private investor suits and agency-driven actions, with a particular focus on the effect on aggrieved mutual fund investors. In light of drastically reduced regulatory budgets that compromise today's securities fraud enforcement efforts, this issue is particularly timely, given that over forty percent of American households own mutual fund shares, generally assuming such investments to be relatively safe retirement vehicles.<sup>21</sup>

Part II of this Article provides an overview of Section 10(b) of the 1934 Act<sup>22</sup> and describes Rule 10b-5<sup>23</sup> as promulgated under Section 10(b). Part III discusses the above-referenced trilogy of Supreme Court cases: *Central Bank of Denver v. First Interstate Bank of Denver, N.A.*,<sup>24</sup> *Stoneridge Invest-*

18. OFFICE OF INVESTIGATIONS, U.S. SEC. & EXCH. COMM'N, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME, CASE NO. OIG-509 1 (2009), <http://www.sec.gov/news/studies/2009/oig-509.pdf>; Christine Hurt, *Evil Has a New Name (and a New Narrative): Bernard Madoff*, 2009 MICH. ST. L. REV. 947, 952 (2009) (noting that the loss estimate depends on the calculation method utilized); *id.* at 954 n.44.

19. See, e.g., Donald C. Langevoort, *Chasing the Greased Pig Down Wall Street: A Gatekeeper's Guide to the Psychology, Culture and Ethics of Financial Risk-Taking*, 96 CORNELL L. REV. 1209 (2011) (discussing the challenges associated with being a gatekeeper for a financial institution).

20. One scholar hypothesizes that, "in the relatively safe and healthy environment of twenty-first century United States, perceived threats to financial welfare are more salient to most Americans than perceived threats to our physical welfare." Hurt, *supra* note 18, at 950-51. As a result, the criminal sentences of financial fraudsters are often greater than those of violent felons. *Id.* at 986. For example, Bernie Ebbers's twenty-five year sentence was "longer than the sentences routinely imposed by many states for violent crimes, including murder, or other serious crimes such as serial child molestation." *Id.* at 986 (quoting *United States v. Ebbers*, 458 F.3d 110, 129 (2d Cir. 2006)). Further, Bernie Madoff, a "seventy-one-year-old-man who had pled guilty quickly and saved the government the burden of a trial" in connection with his hedge fund Ponzi scheme was sentenced to 150 years in prison. *Id.* at 949. The court characterized his actions as an "extraordinary evil." *Id.*

21. INV. CO. INST., 2012 INVESTMENT COMPANY FACT BOOK 86 (52d ed. 2012); see *infra* notes 211-16 and accompanying text for further discussion of mutual funds.

22. 15 U.S.C. § 78j(b) (2006).

23. 17 C.F.R. § 240.10b-5 (2012).

24. 511 U.S. 164 (1994).

*ment Partners, LLC v. Scientific-Atlanta, Inc.*,<sup>25</sup> and *Janus*.<sup>26</sup> Part IV explores the unique relationship between an investment adviser and a mutual fund, with a focus on important doctrinal foundations of the Investment Company Act of 1940<sup>27</sup> (the “1940 Act”) ignored by the *Janus* Court. Part V examines the confusion among lower courts in adjudicating post-*Janus* cases and defines certain ambiguities and open questions in current Rule 10b-5 law. Part VI proposes legislative and regulatory fixes in line with the doctrinal underpinnings of the 1934 Act and the 1940 Act.

## II. STATUTORY LIABILITY FOR SECURITIES FRAUD AND THE ROBERTS COURT

This Part provides a brief overview of the securities laws involved in the subject trilogy of cases. Although § 10(b) and Rule 10b-5 liability is the focus of the Court’s analyses, an understanding of § 20 liability is also important to the discussion. Additionally, a brief summary of the Roberts Court’s approach to securities-related matters provides a necessary background to Part III’s trilogy analysis.

### A. Overview of § 10(b) and Rule 10b-5

To address widespread financial abuses after the 1929 stock market crash, the seventy-third Congress enacted the Securities Act of 1933 (the “1933 Act”),<sup>28</sup> governing initial securities distributions, and the Securities Exchange Act of 1934 (the “1934 Act”),<sup>29</sup> governing secondary market distributions.<sup>30</sup> The 1933 Act and the 1934 Act (collectively, the “Acts”) “embrace a fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*.”<sup>31</sup> To effectuate this purpose, the Acts establish an “extensive scheme of civil liability.”<sup>32</sup> The SEC and the De-

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25. 552 U.S. 148 (2008).

26. 131 S. Ct. 2296 (2011).

27. 15 U.S.C. §§ 80a-1 to -64.

28. Ch. 38, 48 Stat. 74 (1933) (codified at 15 U.S.C. §§ 77a-77aa).

29. Ch. 404, 48 Stat. 881 (1934) (codified at 15 U.S.C. §§ 78a-78ee).

30. *See, e.g.*, *Cent. Bank of Denver v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 170-71 (1994) (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752 (1975)).

31. *Id.* at 171 (quoting *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972) (internal quotation marks omitted)).

32. *Id.*; *see Herman & MacLean v. Huddleston*, 459 U.S. 375, 388-89 (1983) (“Indeed, an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct in the securities industry.”). Shortly after the promulgation of the Acts, Congress passed the Trust Indenture Act of 1939 (the “Trust Indenture

partment of Justice are authorized to institute proceedings and assert penalties against violators of various provisions.<sup>33</sup> Further, private litigants may sue violators of certain provisions that expressly provide for private rights of action.<sup>34</sup> Private litigants may also sue violators of certain statutes pursuant to judicially-created private rights of action found to be implied by such provisions.<sup>35</sup> The Supreme Court has historically stressed the importance of private antifraud securities actions in supplementing government criminal and civil enforcement proceedings.<sup>36</sup> Further, the Supreme Court has admonished

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Act”), the 1940 Act, and the Investment Advisers Act of 1940 (the “Advisers Act”), providing additional enforcement powers to the SEC.

33. See, e.g., *Central Bank*, 511 U.S. at 171; GAO Study, *supra* note 6, at 26. The SEC is authorized to bring civil actions in both administrative and court proceedings seeking injunctive relief, disgorgement orders, civil penalties and orders barring individuals from the securities industry, among other types of relief. GAO Study, *supra* note 6, at 26. The Department of Justice is authorized to impose criminal sanctions under the securities laws of up to \$5 million in penalties for individuals, \$25 million in penalties for corporations, and up to 20 years imprisonment. *Id.* at 27.

34. See *infra* note 88.

35. *Central Bank*, 511 U.S. at 171 (citing *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971); *J.I. Case Co. v. Borak*, 377 U.S. 426, 430-35 (1964)). For an excellent discussion of private express and implied rights under the 1933 Act and 1934 Act, see Elisse B. Walter, Comm’r, Sec. & Exch. Comm’n, Remarks Before the FINRA Institute at Wharton Certified Regulatory and Compliance Professional (CRCP) Program (Nov. 8, 2011), available at <http://www.sec.gov/news/speech/2011/spch110811ebw.htm>. Implied private rights of action under the 1934 Act have been recognized under § 10(b) and Rule 10b-5 thereunder (prohibiting fraudulent conduct and material misstatements and omissions); § 13(d) (listing reporting requirements with respect to the acquisition of five percent or more of any class of equity securities); § 14(a) and Rule 14a-9 thereunder (prohibiting misstatements or omissions in proxy materials); § 14(e) (prohibiting misstatements and omissions in connection with tender offers); and § 29(b) (prohibiting contracts made in violation of the 1934 Act or rules promulgated thereunder). Robert F. Serio & Aric H. Wu, *Basic Claims Under the Federal Securities Laws*, in *SECURITIES LITIGATION* § 2.2.2[A] (Practicing Law Institute, ed., 2011).

36. U.S. *Janus Amicus* Brief, *supra* note 7, at \*24 (emphasis added) (internal quotation marks omitted) (quoting *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007)) (citing H.R. Rep. No. 369 (1995)); see also, e.g., *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 174 n.10 (Stevens, J., dissenting). Then-Commissioner Elisse B. Walter of the SEC explained:

... I believe strongly that the public, Congress, courts, and even the securities bar *do not fully appreciate the interrelationship between public and private enforcement*. The impact of changes in the parameters or existence of private actions on the enforceability of the federal securities laws is simply not well understood. And yet, it is *critical to investors, our securi-*

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“that the statute should be construed not technically and restrictively, but flexibly to effectuate its remedial purposes.”<sup>37</sup>

Section 10(b)<sup>38</sup> embodies the “general antifraud provision of the 1934 Act.”<sup>39</sup> In 1942, pursuant to authority granted under § 10(b), the Securities

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*ties markets, and our economy overall that these laws remain fully enforceable. . . .*

. . . [T]he trend away from private rights of action under the securities laws has placed more and more pressure on the Commission and other regulators to be the sole guardians of the statutes. . . . If private rights are cut back further, or further constrained, that puts an increasing burden on already scarce governmental resources.

Walter, *supra* note 35 (emphasis added) (noting that there are also limitations on the SEC’s authority, including the fact that the SEC can’t seek damages and thus “cannot necessarily make the victims whole”).

37. SEC v. Zandford, 535 U.S. 813, 819 (2002) (internal quotation marks omitted); *see also, e.g.*, U.S. Janus Amicus Brief, *supra* note 7, at \*21. This flexibility is especially important with respect to unsophisticated, individual investors. *See, e.g.*, Jennifer O’Hare, *Retail Investor Remedies Under Rule 10b-5*, 76 U. CIN. L. REV. 521, 525 n.21 (2008) (noting that an overwhelming forty six percent of individual investors believed that any losses in their stock market investments were insured by the government or a quasi-governmental agency, and twenty two percent were not sure if they were insured or not) (citing APPLIED RESEARCH & CONSULTING LLC, NASD INVESTOR LITERACY RESEARCH: EXECUTIVE SUMMARY 9 (2003), *available at* [www.nasd.com/web/groups/inv\\_info/documents/investor\\_information/nasdw\\_011459.pdf](http://www.nasd.com/web/groups/inv_info/documents/investor_information/nasdw_011459.pdf)).

38. Section 10(b) provides in pertinent part:

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 . . . (b) *[t]o use or employ*, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . *any manipulative or deceptive device or contrivance* in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (2006) (emphasis added).

39. *Central Bank*, 511 U.S. at 171.



and Exchange Commission (“SEC”) promulgated Rule 10b-5,<sup>40</sup> which further delineates prohibited fraudulent activities.

The judicially-recognized Rule 10b-5 private right of action, “a judicial oak which has grown from little more than a legislative acorn,”<sup>41</sup> was established long ago and has been consistently recognized by the courts.<sup>42</sup> Because Congress has not provided any guidance regarding a Rule 10b-5 private right of action,<sup>43</sup> the courts “have had ‘to infer how the 1934 Congress would have addressed the issue[s] had the 10b-5 action been included as an express provision in the 1934 Act.’”<sup>44</sup> Without doubt, a private litigant may not sue under Rule 10b-5 for acts that are not prohibited by § 10(b).<sup>45</sup> As the Supreme Court explained, “our cases considering the scope of conduct prohibited by § 10(b) in private suits have emphasized adherence to the statutory

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40. *Id.* at 172. Rule 10b-5 provides:

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,

(a) *To employ any device, scheme, or artifice to defraud,*

(b) *To 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, or*

(c) *To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.*

17 C.F.R. § 240.10b-5 (2012) (emphasis added).

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

42. *See, e.g., Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011); *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 165 (2008); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971).

43. Although Congress has not specifically codified this judicially-created right of action, it has implicitly endorsed it on several occasions. *See, e.g., infra* note 110 and accompanying text.

44. *Central Bank*, 511 U.S. at 173 (quoting *Musick, Peeler & Garrett v. Emp’rs Ins. of Wausau*, 508 U.S. 286, 294 (1993)).

45. *Id.*

language, “[t]he starting point in every case involving construction of a statute.”<sup>46</sup>

To prevail on a Rule 10b-5 claim, a private plaintiff must prove the following elements: “(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.”<sup>47</sup> Significantly, in an enforcement action brought by the SEC, neither reliance nor loss need be demonstrated.<sup>48</sup>

### B. “Controlling Person” Liability under §20 of the 1934 Act

Congress also expressly provided for secondary liability of “control persons”<sup>49</sup> under § 20 of the 1934 Act.<sup>50</sup> It is important to note a few instances

46. *Id.* (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976)).

47. *Janus*, 131 S. Ct. at 2301 n.3 (citing *Stoneridge*, 552 U.S. at 157).

48. *See, e.g.*, Pritchard, *supra* note 9, at 133 (citing *Geman v. SEC*, 334 F.3d 1183, 1191 (10th Cir. 2003); *United States v. Haddy*, 134 F.3d 542, 549-51 (3d Cir. 1998)). In *Morrison v. National Australian Bank, Ltd.*, 130 S. Ct. 2869 (2010), the Court held that Rule 10b-5 was applicable only to U.S. securities transactions. *See, e.g.*, Ted Farris, *Limiting Primary Rule 10b-5 Liability for Offering Document Misstatements to the Person with Ultimate Authority over the Statement*, DORSEY.COM (July 21, 2011), [http://www.dorsey.com/eu\\_corp\\_janus\\_72011/](http://www.dorsey.com/eu_corp_janus_72011/). However, Congress responded after *Morrison* with § 929P of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of titles 12 & 15 of the U.S. Code), which confirmed the SEC’s authority to bring § 10(b) enforcement actions in matters involving non-U.S. transactions. *See, e.g.*, Walter, *supra* note 35. With respect to private rights, Congress enacted § 929Y requiring the SEC to conduct a study and solicit comment regarding the extension of 1934 Act antifraud remedies to non-U.S. transactions. *See, e.g. id.*

49. Although “control” is not defined in § 20, Rule 405 under the 1933 Act defines “control” as follows:

The term *control* (including the terms *controlling*, *controlled by* and *under common control with*) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

17 C.F.R. § 230.405 (2012) (emphasis added); *see* GAO Study, *supra* note 6, at 29-30 (noting that “the determination of whether control exists depends on the particular factual circumstance of each case”).

50. Section 20 provides in pertinent part:

(a) . . . Every person who, directly or indirectly, controls any person liable under any

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provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable (including to the Commission in any action brought under paragraph (1) or (3) of section 78u(d) of this title [providing for injunctive relief and civil penalties]), unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

(b) . . . It shall be unlawful for *any person, directly or indirectly, to do any act or thing which it would be unlawful* for such person to do under the provisions of this chapter or any rule or regulation thereunder *through or by means of any other person.*

.....  
(e) Prosecution of persons who aid and abet violations [ – ]For purposes of any action brought by the Commission under paragraph (1) or (3) of section 78u(d) of this title [providing for injunctive relief and civil penalties], *any person that knowingly or recklessly provides substantial assistance to another person* in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

15 U.S.C. § 78t (2006) (emphasis added). It should be noted that other securities laws also provide for control person liability. For example, § 15 of the 1933 Act provides:

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l, [ §§ 11 or 12 ] shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

in which § 20 would not provide an avenue of redress for an aggrieved investor. First, in order to establish liability of a “control person” under § 20(a), the liability of the “controlled person” must be established. As articulately discussed by the *Janus* dissent,<sup>51</sup> § 20(a) would be inapplicable in the case of an actor exploiting an innocent intermediary.<sup>52</sup> Second, it is currently uncertain whether entities acting through innocent intermediaries are liable under § 20(b).<sup>53</sup> Finally, § 20(e), added in 1995,<sup>54</sup> only applies with respect to actions brought by the SEC.<sup>55</sup>

### C. A Note on the Court

Since Justice Powell’s retirement in June 1987,<sup>56</sup> there has been no member of the Supreme Court with a background in securities law.<sup>57</sup> This twenty-six year void stands in contrast to the fifty years following the enactment of the Acts, when there was usually at least one Justice with expertise in the area.<sup>58</sup> This gap in the securities arena has led to random decisions drawn not from the complex interplay of the securities laws and the financial markets, but from more general notions, such as narrow statutory interpretation

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*Id.* § 77o; *see also, e.g.*, 15 U.S.C. §§ 80a-47 (§ 48 of the 1940 Act), 80b-3, 80b-8(d) (§§ 203 and 208(d) of the Advisers Act).

51. *See infra* notes 215-19 and accompanying text.

52. *Janus*, 131 S. Ct. at 2310 (Breyer, J., dissenting).

53. *See infra* Part V.E.

54. Private Securities Litigation Reform Act (PSLRA), Pub. L. No. 104-67, §104, 109 Stat. 737, 757 (1995) (codified at 15 U.S.C. §78t(e)). In 2010, Congress revised § 20(e) to increase the SEC’s authority to bring actions against those who merely act recklessly, in addition to those who act with knowledge. H.R. Rep. No. 111-517, § 9290 (2010); *see also, e.g.*, Pritchard, *supra* note 9, at 133 n. 193.

55. *See* 15 U.S.C. § 78t. After *Janus*, the SEC’s efforts to pursue aiders and abettors will be hindered if there is no primary violator. *See infra* notes 215-19 and accompanying text.

56. *See, e.g.*, Joan Biskupic & Fred Barbash, *Retired Justice Powell Dies at 90*, WASH. POST, Aug. 26, 1998, <http://www.washingtonpost.com/wp-srv/national/longterm/supcourt/stories/powell082698.htm>.

57. *See* Pritchard, *supra* note 9, at 106; *see also* A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841, 847 (2003) [hereinafter Pritchard, *Justice Lewis F. Powell*].

58. *See* Pritchard, *supra* note 9, at 106. Justice William O. Douglas, former chairman of the SEC, and Justice Powell, a practitioner before his time on the Court, were the only two securities lawyers to serve on the Court since the enactment of the 1933 Act and the 1934 Act. *See* Pritchard, *Justice Lewis F. Powell, supra* note 57, at 847. Justice Douglas served on the Court from 1939 to 1975. *See William O. Douglas*, OYEZ PROJECT AT IIT CHI.-KENT COLLEGE OF LAW, [http://www.oyez.org/justices/william\\_o\\_douglas/](http://www.oyez.org/justices/william_o_douglas/) (last visited Feb. 3, 2013). Justice Powell served from 1972 to 1987. *See Lewis F. Powell, Jr.*, OYEZ PROJECT AT IIT CHI.-KENT COLLEGE OF LAW, [http://www.oyez.org/justices/lewis\\_f\\_powell\\_jr](http://www.oyez.org/justices/lewis_f_powell_jr) (last visited Feb. 3, 2013).

and legislative history.<sup>59</sup> As discussed below in Part IV the Court's seeming lack of understanding of the complexities of the mutual fund/adviser relationship has caused "real damage."<sup>60</sup>

Paradoxically, a disproportionately large 2.6% of the cases heard by the Roberts Court during its first six years (2005-2011) were securities-related, in contrast to 0.7% heard by the New Deal Court (1936-1954), 0.5% heard by the Warren Court (1954-1969), 1.3% heard by the Burger Court (1969-1986), and 0.9% heard by the Rehnquist Court (1986-2005).<sup>61</sup> The Roberts Court has come to be known by many analysts as a "pro-business" Court, with dramatic increases from previous Courts in its percentage of rulings for business

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59. See Pritchard, *supra* note 9, at 108, 144 ("When one turns to the substance of the opinions written in these cases, one finds little effort to grapple with the relation between the financial markets and the securities laws."); see also *id.* at 138 ("*Janus* provides additional evidence of the Roberts Court's lack of engagement with the securities laws. Only Sections 20(b) is [sic] mentioned in the majority's opinion, and then only in a footnote. Neither the majority, nor the dissent, grapples with the complicated regulatory overlap of the securities laws to determine precisely what is given up by liming the Rule 10b-5 cause of action.").

60. Gordon, *supra* note 16 (detailing the degree of an adviser's control over a mutual fund and noting that the Court could have avoided the "collateral damage" created by *Janus* by basing its decision on loss causation grounds); see also, e.g., Stephen Juris, *Janus Capital Group Inc. v. First Derivative Traders and the Law of Unintended Consequences*, FORBES (Sept. 21, 2011, 11:51 AM), <http://www.forbes.com/sites/insider/2011/09/21/janus-capital-group-inc-v-first-derivative-traders-and-the-law-of-unintended-consequences/> (discussing the *Janus* aftermath, which has had a deleterious effect on numerous SEC actions in the lower courts, and lamenting the fact that "broadly worded decisions in the private securities litigation context can result in unintended – and likely unanticipated – problems for regulators"). As discussed herein, it remains to be seen how much damage the *Janus* decision will have on the fight against fraudulent activity in the U.S. capital markets.

61. See Pritchard, *supra* note 9, at 107 ("That increase suggests the Justices have taken a new interest in the field, despite the lack of a Justice with a background in securities law."). The Roberts Court has issued numerous decisions regarding the PSLRA, enacted in 1995, and the Securities Litigation Uniform Standards Act (the "SLUSA"), enacted in 1998. See *id.* at 108.

interests.<sup>62</sup> Its rulings carving away the private Rule 10b-5 right have most definitely been pro-business and anti-investor.<sup>63</sup>

Another defining characteristic of the Roberts Court has been its cavalier attitude towards the SEC's positions in numerous cases.<sup>64</sup> This attitude is in stark contrast to the New Deal Court's absolute respect for and deferral to the SEC. As noted by one Supreme Court scholar, "the expertise of the SEC was a bedrock belief among the New Deal alumni that Roosevelt appointed to the Supreme Court."<sup>65</sup> Such judicial deference resulted in frequent victories for the SEC during its first forty years.<sup>66</sup> The Court's brusque dismissal of the SEC's interpretations in the cases discussed below is illustrative of this shift in ideology.

### III. THE TURNABOUT TRILOGY

#### A. Central Bank

In 1994, the Supreme Court handed down its 5-4 decision in *Central Bank*, which abolished private aiding and abetting liability under §10(b) of the 1934 Act.<sup>67</sup> The decision was extremely controversial, because it overturned "hundreds of judicial and administrative proceedings in every [c]ircuit in the federal system."<sup>68</sup> Indeed, "all 11 Courts of Appeals to have consid-

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62. Adam Liptak, *Justices Offer Receptive Ear to Business Interests*, N.Y. TIMES, Dec. 18, 2010, <http://www.nytimes.com/2010/12/19/us/19roberts.html?pagewanted=all> (citing a study by scholars at Northwestern University and the University of Chicago analyzing 1,450 decisions since 1953, finding that the Roberts Court ruled in favor of business litigants in sixty one percent of cases, compared with Courts since 1953 that have made pro-business rulings in forty two percent of cases). The study also found that the percentage of cases involving business interests has grown during the Roberts years. *Id.* However, some legal scholars assert that "[i]f the court favors business . . . it is as part of a broader orientation toward free markets and a wariness of many kinds of lawsuits." *Id.*; see also, e.g., Pritchard, *supra* note 9, at 142-43.

63. See, e.g., Walter, *supra* note 35 ("Despite the broad sweep of the [PSLRA], to this day the Supreme Court continues to demonstrate what I would characterize as hostility toward private rights.").

64. See Pritchard, *supra* note 9, at 117; see also *infra* notes 187-88 and accompanying text.

65. See Pritchard, *supra* note 9, at 117 (footnotes omitted).

66. *Id.*

67. 511 U.S. 164, 191-92 (1994). The majority opinion was written by Justice Kennedy, with Justices Rehnquist, O'Connor, Scalia and Thomas joining. *Id.* at 166. Justice Stevens wrote for the dissent, with Justices Blackmun, Souter and Ginsberg joining. *Id.*

68. *Id.* at 192 (Stevens, J., dissenting). Notably, because the private aiding and abetting cause of action was so well-settled,

"[P]etitioner *assumed* the existence of a right of action against aiders and abettors, and

ered the question have recognized a private cause of action against aiders and abettors under § 10(b) and Rule 10b-5.<sup>69</sup>

### 1. *Central Bank* Background

Central Bank served as indenture trustee for bond issuances in 1986 and 1988 by the Colorado Springs-Stetson Hills Public Building Authority (the “Authority”).<sup>70</sup> The bond covenants required the bonds to be secured by landowner assessment liens on property with a value of at least 160% of the outstanding principal and interest of the bonds.<sup>71</sup> Pursuant to the bond covenants, AmWest Development (“AmWest”) was required to give Central Bank an annual report evidencing that the 160% test was satisfied.<sup>72</sup>

In early 1988, AmWest delivered to Central Bank an appraisal of the land securing the 1986 bonds and of the land that was proposed to secure the 1988 bonds.<sup>73</sup> However, the 1988 appraisal showed virtually no change in the values set forth in the 1986 appraisal.<sup>74</sup> The senior underwriter of the 1986 bonds thereafter sent a letter to Central Bank expressing concern that the 1988 appraisal was inaccurate, as local property values had declined, and that the 160% was not being satisfied.<sup>75</sup> Following an exchange of correspondence between Central Bank and AmWest, Central Bank agreed to postpone conducting an independent review of the appraisal until late 1988, six months after the closing on the June 1988 bond issue.<sup>76</sup> The Authority defaulted on the 1988 bonds before the independent review was completed.<sup>77</sup>

Respondents, purchasers of \$2.1 million of the 1988 bonds, sued several defendants alleging primary violations of §10(b) and also sued Central Bank,

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sought review only of the subsidiary questions whether an indenture trustee could be found liable as an aider and abettor absent a breach of an indenture agreement or other duty under state law, and whether it could be liable as an aider and abettor based only on a showing of recklessness.”

*Id.* at 194. However, “the Court *sua sponte* directed the parties to address a question on which even the petitioner justifiably thought the law was settled, and reach[e] out to overturn a most considerable body of precedent.” *Id.* at 194-95.

69. *Id.* at 192.

70. *Id.* at 167 (majority opinion).

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.* at 168.

77. *Id.*

alleging secondary liability under §10(b) for aiding and abetting the fraud.<sup>78</sup> The lower court granted Central Bank's motion for summary judgment, and the Court of Appeals for the Tenth Circuit reversed.<sup>79</sup>

## 2. The Decision

The issue before the Supreme Court in *Central Bank* was whether aiding and abetting liability could be imposed under §10(b).<sup>80</sup> Recognizing that the definition of conduct prohibited by §10(b) must be controlled by the statutory text, the majority prefaced its highly controversial opinion: "That bodes ill for respondents, for 'the language of Section 10(b) does not in terms mention aiding and abetting.'"<sup>81</sup>

Congress knew how to impose aiding and abetting liability when it chose to do so. If...Congress intended to impose aiding and abetting liability, we presume it would have used the words 'aid' and 'abet' in the statutory text. But it did not.<sup>82</sup>

The Court rejected the argument by respondents and the SEC that the phrase "directly or indirectly" in §10(b) covers aiding and abetting liability, explaining that "aiding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity; aiding and abetting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do."<sup>83</sup> Because §10(b) prohibits only conduct that is manipulative or deceptive, the majority opined that there can be no liability for acts merely involving the provision of aid to persons committing manipulative or deceptive acts.<sup>84</sup> "We cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute."<sup>85</sup>

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78. *Id.*

79. *Id.*

80. *Id.* at 166-67.

81. *Id.* at 175 (citing Brief for the Sec. & Exch. Comm'n as Amicus Curiae in Support of Respondents at 8, *Central Bank*, 511 U.S. 164 (No. 92-854), 1993 WL 13006275).

82. *Id.* at 176-77 (citations omitted).

83. *Id.* at 176. The majority cited numerous provisions in the 1934 Act using the phrase "directly or indirectly" that do not impose aiding and abetting liability. *Id.* (citing 15 U.S.C. § 78g(f)(2)(C) (direct or indirect stock ownership), § 78i(b)(2)-(3) (direct or indirect option, put, call, straddle or privilege interest), § 78m(d)(1) (direct or indirect beneficial ownership), § 78p(a) (direct or indirect beneficial ownership), § 78t (direct or indirect control of violator of the 1934 Act)).

84. *Id.* at 177. Importantly, respondents conceded that Central Bank had not committed a manipulative or deceptive act. *Id.* at 191.

85. *Id.* at 177-78.



Holding that the language of the statute resolved the case, the majority stated that it would have reached the same conclusion even if the language had not been determinative by analyzing how the 1934 Congress would have resolved the issue.<sup>86</sup> If Congress had enacted an express private right of action in § 10(b), the majority reasoned, that right would be similar to other express private rights of action in the Acts; thus, interpretive guidance with respect to §10(b) is obtainable by analyzing other express rights enumerated in the Acts.<sup>87</sup>

Because private aiding and abetting liability was not included in any of the express causes of actions under the Acts,<sup>88</sup> the majority concluded that

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86. *Id.* at 178.

87. *Id.*

88. *Id.* at 179 (citing Ch. 38, §§ 11, 12, 48 Stat. 74 (1933); Ch. 404, §§ 9, 16, 18, 20A, 48 Stat. 881 (1934)). Section 11(a) of the 1933 Act allows a private suit for registration statements containing untrue statements or omissions of a material fact against the following enumerated persons:

1. every person who signed the registration statement;
2. every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
3. every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;
4. every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;
5. every underwriter with respect to such security.

15 U.S.C. § 77k(a)(1)-(5) (2006)). Section 12(a) of the 1933 Act provides a private right of action against any person who “offers or sells a security in violation of section 5” of the 1933 Act (which sets forth “gun-jumping” violations and prospectus requirements) or who “offers or sells a security . . . by means of a prospectus or oral communication” that includes an untrue statement or omission of material fact. *Id.* § 77l(a). It should be noted that investors in offerings that are exempt from registration under Regulation S (certain non-U.S. offerings) or under § 4 of the 1933 Act (for example, § 4(2) private placements or Rule 144A qualified institutional buyer offer-

“Congress likely would not have attached aiding and abetting liability to §10(b) had it provided [an express] private §10(b) cause of action.”<sup>89</sup> The majority rested its analysis on its belief that permitting such a cause of action would allow petitioners to circumvent the required element of reliance.<sup>90</sup>

Respondents and some *amici* argued that, because liability for aiding and abetting was “well established in both civil and criminal actions by 1934,” Congress intended that such liability be incorporated into the 1934 Act.<sup>91</sup> The majority rejected this argument in light of Congress’ “statute-by-statute approach to civil aiding and abetting liability” and its enactment of §20 imposing secondary liability with respect to control persons.<sup>92</sup> [W]hen Congress wished to create such [secondary] liability, it had little trouble doing so.”<sup>93</sup> Similarly, the majority rejected arguments that Congress’ failure to revise §10(b) after courts began imposing aiding and abetting liability there-under illustrated congressional intent to impose such liability.<sup>94</sup> It concluded that mere inaction by Congress could not amend a formally enacted statute,<sup>95</sup>

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ings) may not sue under § 11 or § 12(a)(2) of the 1933 Act. *See, e.g.*, Farris, *supra* note 48.

Section 9(e) of the 1934 Act provides for a private right of action against persons engaging in manipulative acts, such as wash sales and matched orders. 15 U.S.C. § 78i(e); *Central Bank*, 511 U.S. at 179. Section 16(b) of the 1934 Act allows a private action by the issuer of a security against directors, officers, or beneficial owners of more than ten percent of any class of any registered equity security who engage in short-swing trading. 15 U.S.C. § 78p(b). Section 18(a) of the 1934 Act allows a private right of action against “[a]ny person who shall make or cause to be made any statement” that “was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact” in any document filed with the SEC. *Id.* § 78r(a). Finally, § 20A, which was enacted in 1988, provides for a private right of action against persons engaging in insider trading activities. 15 U.S.C. § 78t-1; *Central Bank*, 511 U.S. at 179.

Additionally, § 15 under the 1933 Act and § 20 of the 1934 Act provide for control person liability. *See supra* notes 49-55 and accompanying text. Control person liability under § 15 of the 1933 Act is limited to cases involving a primary violation of §§ 11 or 12 of the 1933 Act. *See, e.g.*, GAO Study, *supra* note 6, at 29.

89. *Central Bank*, 511 U.S. at 179-80.

90. *Id.* at 180.

91. *Id.* at 180-81 (internal quotation marks omitted) (citing Brief for the Sec. & Exch. Comm’n as Amicus Curiae in Support of Respondents, *supra* note 81, at 10).

92. *Id.* at 181-85.

93. *Id.* at 184 (alteration in original) (quoting *Pinter v. Dahl*, 486 U.S. 662, 650 (1988)) (internal quotation marks omitted).

94. *Id.* at 185-88.

95. *Id.* at 186 (citing *Helvering v. Hallock*, 309 U.S. 106, 121 (1940) (“[W]e walk on quicksand when we try to find in the absence of corrective legislation a controlling legal principle”).

reasoning that “several equally tenable inferences may be drawn from such inaction.”<sup>96</sup>

In a well-written dissent, Justice Stevens emphasized that “judges closer to the times and climate of the 73d Congress than we concluded that holding aiders and abettors liable was consonant with the Exchange Act’s purpose to strengthen the antifraud remedies of the common law.”<sup>97</sup> Explaining the Court’s change across time in its approach to implied causes of action, Justice Stevens explained:

Our approach to implied causes of action, as to other matters of statutory construction, has changed markedly since the . . . Exchange Act’s passage in 1934. At that time, and indeed until quite recently, courts regularly assumed, in accord with the traditional common-law presumption, that a statute enacted for the benefit of a particular class conferred on members of that class the right to sue violators of that statute.<sup>98</sup>

Noting that *none* of the cases relied upon by the majority with respect to its strict interpretation of §10(b) “even arguably involved a settled course of lower court decisions,” Justice Stevens asserted that a “settled construction of an important federal statute should not be disturbed unless and until Congress so decides.”<sup>99</sup> “[W]e should also be reluctant to lop off rights of action that have been recognized for decades, even if the judicial methodology that gave them birth is now out of favor.”<sup>100</sup>

Countering the majority’s refusal to confer meaning with respect to Congress’ inaction,<sup>101</sup> the dissent noted that, in its comprehensive amendments to the 1934 Act in 1975, “Congress left untouched the sizeable body of case law approving aiding and abetting liability in private actions under

96. *Id.* at 187. The majority also rejected policy arguments asserted by the SEC, stating that policy considerations cannot take precedence over the interpretation of the statutory text and structure, “except to the extent that they may help to show that adherence to the text and structure would lead to a result ‘so bizarre’ that Congress could not have intended it.” *Id.* at 188 (quoting *Demarest v. Manspeaker*, 498 U.S. 184, 191 (1991)).

97. *Id.* at 193 (Stevens, J., dissenting).

98. *Id.* at 195. The dissent further explained, “In light of the encompassing language of § 10(b), and its acknowledged purpose to strengthen the antifraud remedies of the common law, it was certainly no wild extrapolation for courts to conclude that aiders and abettors should be subject to the private action under § 10(b).” *Id.* at 198-99, 199 n.9 (noting that the Court had recognized a private right of action against secondary actors absent a provision specifically including them in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 394 (1982)).

99. *Id.* at 196, 196 n.6 (quoting *Reves v. Ernst & Young*, 494 U.S. 56, 74 (1990) (Stevens, J., dissenting)) (internal quotation marks omitted).

100. *Id.* at 201.

101. See *supra* notes 94-96 and accompanying text.

§10(b) and Rule 10b-5.”<sup>102</sup> Such amendments “emerged from the most searching reexamination of the competitive, statutory, and economic issues facing the securities markets, the securities industry, and, of course, public investors, since the 1930’s.”<sup>103</sup> Further, the SEC “has consistently understood §10(b) to impose aider and abettor liability since shortly after the rule’s promulgation.”<sup>104</sup>

The Court’s conclusion is particularly relevant with respect to the *Janus* analysis:

*The absence of §10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under rule 10b-5 are met. In any complex securities fraud, moreover, there are likely to be multiple violators; in this case, for example, respondents named four defendants as primary violators.*<sup>105</sup>

### 3. Legislative Response to *Central Bank*

As recognized by the *Central Bank* dissent, the opinion left little doubt that even the SEC could not pursue aiders and abettors under §10(b) and Rule 10b-5.<sup>106</sup> The opinion instigated petitions for Congress to enact a statutory cause of action for aiding and abetting liability, and the Senate held hearings on the issue within a month of *Central Bank*’s release.<sup>107</sup> The Chairman of the SEC at the time, Arthur Levitt, testified before the Senate Securities Subcommittee and recommended enacting a private right of action for aiding and abetting liability.<sup>108</sup> Members of the Senate Subcommittee on Securities also supported a private right of action.<sup>109</sup> Congress declined to do so,<sup>110</sup> but in-

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102. *Id.* at 197.

103. *Id.* at 197 n.8 (quoting *Herman & MacLean v. Huddleston*, 459 U.S. 375, 385 n.20 (1983)) (internal quotation marks omitted).

104. *Id.* at 198 (citing *Reves*, 494 U.S. at 75 (Stevens, J., concurring)).

105. *Id.* at 191 (majority opinion) (emphasis added); *see also id.* at 199 n.10 (Stevens, J., dissenting).

106. *Id.* at 200 (Stevens, J., dissenting).

107. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 158, 173 (citing S. Rep. No. 104-98 at 2 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679).

108. *Id.* at 158 (citing S. Hearing No. 103-759, at 13-14 (1994)).

109. *Id.* at 173-74, 174 n.9 (Stevens, J., dissenting) (citing views of Senators Dodd, Sarbanes, Boxer and Bryan).

stead enacted §20(e) of the 1934 Act, as part of the PSLRA,<sup>111</sup> enabling the SEC to pursue injunctive relief and civil penalties against aiders and abettors.<sup>112</sup> Section 20(e) was amended by the Dodd-Frank Act in 2010 to relax the previous “knowledge” state of mind requirement to recklessness.<sup>113</sup>

After the Enron scandal became public in late 2001, legislation was once again proposed, but not enacted, to restore private aiding and abetting liability.<sup>114</sup> Further, neither the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”)<sup>115</sup> nor the Dodd-Frank Act in 2010 did anything to restore pre-*Central Bank* private aiding and abetting liability.<sup>116</sup> The Dodd-Frank Act

110. It is interesting to note that the 1995 (pre-2008 financial meltdown, pre-Enron, pre-WorldCom . . .) Congress chose not to enact private Rule 10b-5 aiding and abetting liability, while all Circuits before *Central Bank* assumed that the 1934 (post-1929 Crash, mid-Great Depression) Congress intended such liability. *See supra* note 68.

111. The PSLRA was enacted to weed out frivolous securities lawsuits by requiring, among other things, heightened pleading requirements and an automatic discovery stay. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified with amendments throughout 15 U.S.C.); *see, e.g.*, Pritchard, *supra* note 9, at 109. For an excellent summary of the PSLRA, see the GAO Study, *supra* note 6, at 18-22. The Securities Litigation Uniform Standards Act of 1998 (SLUSA) preempts certain state law securities fraud class actions and was designed to prohibit plaintiffs from circumventing the requirements of the PSLRA. Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified with amendments throughout 15 U.S.C.); *see, e.g.*, GAO Study, *supra* note 6, at 22-23 (providing a summary of the SLUSA); Pritchard, *supra* note 9, at 109-10. Congress also enacted the Class Action Fairness Act (CAFA) in 2005, which provides federal court jurisdiction and minimum diversity requirements with respect to class actions with 100 or more petitioners. Pub. L. No. 109-2, 119 Stat. 4 (2005) (codified throughout 28 U.S.C.); *see also, e.g.*, GAO Study, *supra* note 6, at 23.

112. *See* 15 U.S.C. § 78t(e) (2006); *see supra* note 50 and accompanying text; *see also, e.g.*, *Stoneridge*, 552 U.S. at 158.

113. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929O, 124 Stat. 1376 (2010); *see, e.g.*, DAN L. GOLDWASSER, M. THOMAS ARNOLD & JOHN J. EICKEMEYER, ACCOUNTANT’S LIABILITY § 5.8.2, at 5-125 to -126 (2011).

114. *See, e.g.*, GOLDWASSER, ARNOLD & EICKEMEYER, *supra* note 113, at 5-125 to -126 (discussing the Accountability for Accountants Act of 2002, H.R. 3617, 107th Cong. § 3 (2002); Comprehensive Investor Protection Act, H.R. 3818, 107th Cong. § 14 (2002); the Shareholder and Employee Rights Restoration Act of 2002, H.R. 3829, 107th Cong. § 3 (2002); Investor Protection Act of 2002, S. 1933, 107th Cong. § 3). Bills were also introduced in 2009 by Senator Arlen Specter and in 2010 by Representative Maxine Waters that provided for secondary liability in securities fraud actions. *See* Liability for Aiding and Abetting Securities Violations Act of 2009, S. REP. NO. 1551 (2009); Liability for Aiding and Abetting Securities Violations Act of 2010, H.R. 5042, 111th Cong. (2010); *see also* Susan E. Hurd & Elizabeth P. Skola, *Stoneridge: Closing the Door on Expansive Section 10(b) Liability Theories*, in 27 SECURITIES LITIGATION: FORMS AND ANALYSIS § 1.3 (2012).

115. Pub. L. No. 107-204, 116 Stat. 745 (2002).

116. *See, e.g.*, GOLDWASSER, ARNOLD & EICKEMEYER, *supra*, note 113, at 5-126.

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did require the Comptroller of the United States to issue the GAO Study, which has had little, if no, effect on legislators to date.<sup>117</sup>

### B. Stoneridge

After *Central Bank's* ban on aiding and abetting liability, conflicting approaches to “scheme liability” evolved in the courts as plaintiffs asserted that secondary actors participating in fraudulent schemes were primarily liable under Rule 10b-5(a) and (c).<sup>118</sup> Fourteen years after *Central Bank*, the Roberts Court delivered its 5-3 decision in *Stoneridge*, which further restricted the Rule 10b-5 private right of action.<sup>119</sup>

#### 1. *Stoneridge* Background

Petitioner, representing a class of purchasers of stock (“Investors”) issued by Charter Communications, Inc. (“Charter”), a cable operator, filed suit alleging that Charter violated §10(b) and Rule 10b-5 by inflating its reported revenues by approximately \$17 million in order to hide an expected cash flow deficiency of \$15 to \$20 million.<sup>120</sup> According to Investors, Charter enlisted Scientific-Atlanta and Motorola (the “Suppliers”), its suppliers of digital cable converter boxes (also known as “set-top boxes”), to alter the terms of their contractual arrangements with Charter so that Charter’s financials would meet expectations.<sup>121</sup> Specifically, Charter and Suppliers agreed that Charter would overpay Suppliers by \$20 for each set-top box until year-end and that Suppliers would return such overpayment though their purchase of advertis-

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117. Dodd-Frank Act § 929Z; GAO Study, *supra* note 6; *see, e.g.*, GOLDWASSER, ARNOLD & EICKEMEYER, *supra* note 113, at 5-126.

118. *See, e.g.*, Kevin J. Lesinski, *Notable Cases and Recent Settlements in Securities Litigation*, in NEW DEVELOPMENTS IN SECURITIES LITIGATION: LEADING LAWYERS ON WORKING WITH FEDERAL AGENCIES, COMPLYING WITH NEW LEGISLATION, AND MONITORING COMPLIANCE 91, 98 (2011 ed.) (explaining that the Ninth Circuit’s view was that deceptive conduct part of a “scheme to defraud” was actionable under 10(b), while the Fifth and Eighth Circuits’ view was that conduct without a misstatement or omission was not actionable).

119. As in *Central Bank*, Justice Kennedy penned the majority opinion, with Justices Scalia and Thomas joining, and Justice Stevens wrote for the dissent, with Justices Souter and Ginsberg joining. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 150 (2008). Justices Roberts and Alito also joined the majority. *Id.* Justice Breyer did not participate. *Id.* Interestingly, while the SEC sided with Investors (Petitioners/Plaintiffs), the Solicitor General sided with Supplier (Respondents/Defendants). *See* Pritchard, *supra* note 9, at 132.

120. *Stoneridge*, 552 U.S. at 167 (Stevens, J., dissenting). Because the case reached the Court upon the lower court’s granting of Suppliers’ motion to dismiss, the facts alleged by Investors are assumed to be true. *See id.* at 153 (majority opinion).

121. *Id.* at 153-54 (majority opinion).

ing from Charter.<sup>122</sup> Because Charter would capitalize the purchase of the set-top boxes and record the advertising sales as revenue in violation of generally accepted accounting principles, Charter could deceive its auditor into approving false financial statements demonstrating that it had met its projected cash flow and revenue numbers.<sup>123</sup>

Suppliers, who played no part in the preparation or distribution of Charter's financial statements, recorded the above-described transactions as a "wash, under generally accepted accounting principles."<sup>124</sup> Investors alleged that Suppliers "knew or were in reckless disregard of Charter's intention to use the transactions to inflate its revenues and knew the resulting financial statements issued by Charter would be relied upon by research analysts and investors."<sup>125</sup> The Eighth Circuit Court of Appeals affirmed the lower court's ruling granting Suppliers' motion to dismiss its decision.<sup>126</sup>

## 2. The Decision

The majority prefaced its opinion by noting that the circuit courts were in disagreement regarding whether a plaintiff could recover under §10(b) against a party that did not make a public misrepresentation or violate a duty to disclose but did participate in a prohibited scheme under §10(b).<sup>127</sup> The Court determined that Suppliers' "course of conduct included both oral and written statements, such as the backdated contracts agreed to by Charter and respondents" and conceded that "[c]onduct itself can be deceptive."<sup>128</sup> However, the Court found that the lack of reliance was fatal to Investors' claim,

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122. *Id.* at 154. Suppliers drafted false documents in furtherance of the fraudulent scheme. *Id.* Specifically, Scientific-Atlanta sent documents to Charter that falsely stated that, in light of increased production costs, the price of the set-top boxes would be increased by twenty dollars per box. *Id.* Motorola, by written contract, obligated Charter to purchase a defined number of set-top boxes, with liquidated damages of twenty dollars due for each box that it did not take, knowing that Charter would pay the liquidated damages. *Id.* Further, Suppliers signed contracts with Charter agreeing to purchase advertising at an inflated rate and backdated the set-top box contracts so that the agreements would not appear to be connected. *Id.* at 154-55. These arrangements allowed Charter to inflate its reported revenue and operating cash flow numbers by approximately \$17 million. *Id.* at 155. Such inflated numbers were included in financial statements filed with the SEC and were publicly reported. *Id.*

123. *Id.* at 154.

124. *Id.* at 155.

125. *Id.*

126. *Id.*; see *In re Charter Commc'ns, Inc. Sec. Litig.*, 443 F.3d 987, 989 (8th Cir. 2006), *aff'd sub nom. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148 (2008).

127. *Stoneridge*, 552 U.S. at 156 (citations omitted).

128. *Id.* at 158.

noting that reliance provided the “requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury.”<sup>129</sup>

Investors argued that, under the theory of “scheme liability,” Suppliers were liable even without having made a public statement.<sup>130</sup> Rejecting this notion, the majority opined:

In effect [P]etitioner contends that in an efficient market investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect. Were this concept of reliance to be adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business; and there is no authority for this rule....<sup>131</sup>

The Court concluded that Suppliers’ deceptive acts were “too remote to satisfy the element of reliance,” noting that such acts were not publicly disclosed.<sup>132</sup> “It was Charter, not [Suppliers], that misled its auditor and filed fraudulent financial statements; nothing [Suppliers] did made it necessary or inevitable for Charter to record the transactions as it did.”<sup>133</sup> Because Investors could not demonstrate reliance on Suppliers’ alleged acts, except through

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129. *Id.* at 159 (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988)) (internal quotation marks omitted). The majority explained that there was a rebuttable presumption of reliance in two instances: (1) where there is an omission of a material fact by a person who has a duty to disclose, and (2) where there are public statements and the fraud-on-the-market doctrine is applicable. *Id.* The majority found neither of these instances were applicable in the case at bar. *Id.* The dissent noted that, because the Eighth Circuit’s decision was not based on a lack of reliance, the majority should have remanded for a determination of whether reliance had been properly alleged. *Id.* at 170 (Stevens, J., dissenting).

130. *Id.* at 159-60 (majority opinion).

131. *Id.*

132. *Id.*

133. *Id.* The majority stated that it was irrelevant whether the Investors had pled reliance under the standards of common law, as § 10(b) “does not incorporate common-law fraud into federal law.” *Id.* at 162. However, Pritchard notes:

It would seem more accurate to say that the incorporation is selective: the Court borrows the common law element of reliance, without really explaining why, but then disregards it when inconvenient. Kennedy’s rejection of common law standards in *Stoneridge* suggests that the Court is charting its own common law course. The Court’s interventions, however, are episodic; the Court takes an insufficient number of securities cases to develop this “common law” in any meaningful manner.

Pritchard, *supra* note 9, at 134-35.



a remote and indirect chain of events, the majority held that the motion to dismiss was properly granted.<sup>134</sup>

The dissent disagreed, asserting that the majority erroneously insisted on “a kind of super-causation”<sup>135</sup> to prove reliance. Specifically, the dissent reasoned that the fraud-on-the-market presumption (which protects investors who cannot demonstrate individual reliance) does not speak to how a corporation or individual *causes* the misleading information to reach the market.<sup>136</sup> As such, the dissent concludes that the majority “has it backwards when it first addresses the fraud-on-the-market presumption, rather than the causation required.”<sup>137</sup> Succinctly stated, “[t]he argument is not that the fraud-on-the-market presumption is enough standing alone, but that a correct view of causation coupled with the presumption would allow [P]etitioner to plead reliance.”<sup>138</sup> Therefore, in the dissent’s view, it was foreseeable that Suppliers’ actions caused Investors to undertake the securities transactions at issue.<sup>139</sup>

The Court also declined to extend the private right of action under §10(b) to “the realm of ordinary business operations[,]” which, it noted, is primarily governed by state law.<sup>140</sup> “Just as §10(b) is surely badly strained when construed to provide a cause of action . . . to the world at large, it should not be interpreted to provide a private cause of action against the entire marketplace in which the issuing company operates.”<sup>141</sup> The dissent convincingly countered that “liability only attaches when the company doing business with the issuing company has *itself* violated § 10(b).”<sup>142</sup>

134. *Stoneridge*, 552 U.S. at 159. Pritchard notes that the majority could have more naturally reached its conclusion by relying on the “in connection with the purchase or sale of any security” language in § 10(b), rather than the reliance analysis. Pritchard, *supra* note 9, at 132-33, 138. One reason for not doing so is that this approach could have restricted the SEC, which does not need to prove reliance in the matters it pursues. *Id.*

135. *Stoneridge*, 552 U.S. at 168 (Stevens, J., dissenting).

136. *Id.* at 171 (Stevens, J., dissenting) (internal citations omitted).

137. *Id.*

138. *Id.*

139. *Id.* at 172.

140. *Id.* at 161 (majority opinion). Because Suppliers’ activities “took place in the marketplace for goods and services, not in the investment sphere,” and because “Charter was free to do as it chose in preparing its books . . . and then issuing its financial statements[,]” Investors could not have relied on Suppliers’ alleged deceptive actions in deciding whether to purchase or sell securities. *Id.* at 166-67.

141. *Id.* at 162 (citations omitted) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 733 n.5 (1975)) (internal quotation marks omitted). “[T]he § 10(b) private right should not be extended beyond its present boundaries. . . . It is appropriate for us to assume that when . . . [the PSLRA] was enacted, Congress accepted the § 10(b) private cause of action as then defined but chose to extend it no further.” *Id.* at 165-66 (citing *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1102 (1991)).

142. *Id.* at 172 (Stevens, J., dissenting).

Particularly relevant to *Janus*, the majority noted, as it did in *Central Bank*, that in addition to the threat of criminal penalties and state actions, secondary actors may face private suit:

All secondary actors, furthermore, are not necessarily immune from private suit. The securities statutes provide an express private right of action against accountants and underwriters in certain circumstances and the implied right of action in § 10(b) continues to cover secondary actors who commit primary violations.<sup>143</sup>

The Court concluded that its opinion was “consistent with the narrow dimensions we must give to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.”<sup>144</sup>

In a strongly-written dissent, Justice Stevens prefaced his opinion by stating that the majority “seems to assume” that Suppliers could face aiding and abetting liability under § 20(e), but that they escape private liability because “they are, at most, guilty of aiding and abetting a violation of § 10(b), rather than an actual violation of the statute.”<sup>145</sup> Justice Stevens labeled the majority’s decision a “significant departure” from *Central Bank*.<sup>146</sup>

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143. *Id.* at 166 (majority opinion) (emphasis added) (internal citations omitted) (citing 15 U.S.C. § 77k (2006) (§ 11 of the 1934 Act, *see* Ch. 404, § 11, 48 Stat. 881 (1934)); *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994)). The majority also noted that the SEC’s “enforcement power is not toothless”, noting that since late 2002, the SEC, through enforcement actions, had collected more than \$10 billion in penalties and disgorgement, with much of that money inuring to the benefit of aggrieved investors. *Id.* at 166.

144. *Id.* at 167.

145. *Id.* at 167-68 (Stevens, J., dissenting).

146. *Id.* at 168.

What the Court fails to recognize is that this case is critically different from *Central Bank* because the bank in that case did not engage in any deceptive act and, therefore, did not *itself* violate § 10(b). . . .

. . . The facts of this case would parallel those of *Central Bank* if [Suppliers] had, for example, merely delayed sending invoices for set-top boxes to Charter. Conversely, the facts in *Central Bank* would mirror those in the case before us today if the bank had knowingly purchased real estate in wash transactions at above-market prices in order to facilitate the appraiser’s overvaluation of the security. *Central Bank*, thus, poses no obstacle to [P]etitioner’s argument that it has alleged a cause of action under § 10(b).

The dissent concluded with a detailed commentary on the importance and long history of implied private actions under the 1934 Act.<sup>147</sup> Noting that “[t]he Court’s current view of implied causes of action is that they are merely a ‘relic’ of our prior ‘heady days,’” Justice Stevens stated: “[t]hose ‘heady days’ persisted for two hundred years.”<sup>148</sup> Tracing the judicial development of the common law during the first two centuries of U.S. history, Justice Stevens explained that “[a] basic principle animating our jurisprudence was enshrined in state constitution provisions guaranteeing, in substance, that ‘every wrong shall have a remedy.’”<sup>149</sup> He emphasized how federal courts widely enforced private causes of action under the Acts until the Court’s decision in *Central Bank*.<sup>150</sup>

During the late 1940’s, the 1950’s, the 1960’s and the early 1970’s there was widespread, indeed almost general, recognition of implied causes of action for damages under many provisions of the ... [1934 Act], including not only the antifraud provisions, §§10 and 15(c)(1),... but many others. These included the provision, §6(a)(1), requiring securities exchanges to enforce compliance with the Act and any rule or regulation made thereunder,...and provisions governing the solicitation of proxies.... Writing in 1961, Professor Loss remarked with respect to violations of the antifraud provisions that with one exception ‘not a single judge has expressed himself to the contrary.’ ....When damage actions for violation of §10(b) and Rule 10b-5 reached the Supreme Court, the existence of an implied cause of action was not deemed worthy of extended discussion.<sup>151</sup>

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*Id.* at 169-70. Justice Stevens stated that he respectfully dissented “from the Court’s continuing campaign to render the private cause of action under § 10(b) toothless.” *Id.* at 175.

147. *Id.* at 175-79.

148. *Id.* at 175-76.

149. *Id.* at 176, 176 n.12 (noting that such a guarantee still appears in almost 75 percent of state constitutions). Federal courts adopted this principle with regard to statutes with open questions of remedy until 1975, when the Supreme Court handed down its decision in *Cort v. Ash*, 422 U.S. 66 (1975), requiring the application of a four-factor test to determine whether Congress envisioned a private right of action. See *Stoneridge*, 552 U.S. at 177-79 (listing implied causes of action recognized by the Court under various statutes). Thereafter, the Supreme Court clarified that an evaluation of Congressional intention as of a certain time “must take into account its contemporary legal context.” *Id.* at 178 (quoting *Cannon v. Univ. of Chi.*, 441 U.S. 677, 698-99 (1979)) (internal quotation marks omitted).

150. *Id.* at 178-79.

151. *Id.* at 179 (quoting *Leist v. Simplot*, 638 F.2d 283, 296-97 (2d Cir. 1989) (Friendly, J.)).

Concluding his dissenting opinion, Justice Stevens wrote that “Congress enacted §10(b) with the understanding that federal courts respected the principle that every wrong would have a remedy,” and that the majority’s decision cuts back further the remedy that Congress intended.<sup>152</sup>

### C. Janus

After *Central Bank*, the circuit courts were split regarding the method of distinguishing actionable primary liability for secondary actors from conduct for which no right of action existed.<sup>153</sup> The “bright-line attribution rule” required public attribution of a misstatement or omission to a defendant at the time of the dissemination to establish primary liability; this rule was followed by the Second, Fifth, Eighth and Eleventh Circuits.<sup>154</sup> The “substantial participation rule” required that a defendant’s involvement in a misstate-

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152. *Id.* at 180.

153. See, e.g., Liam O’Brien & Alexander Broche, *The Impact of the Janus Ruling on Secondary Liability in 10b-5 Claims*, 15 WALLSTREETLAWYER.COM: SEC. ELECTRONIC AGE 10 (2011), available at 15 No. 8 Wallstreetlawyer.com: Sec. Elec. Age 10.

154. See, e.g., *id.* (citing *In re Charter Commc’ns, Inc. Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006), *aff’d sub nom. Stoneridge Inv. Partners, LLC v. ScientificAtlanta*, 552 U.S. 148 (2008); *Regents of Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 386-90 (5th Cir. 2007); *Ziembra v. Cascade Int’l*, 256 F.3d 1194, 1205 (11th Cir. 2001); *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998)). Arguing against the bright-line attribution rule, the Law Professors’ *Janus Amici Brief* posited that “such a rule would automatically eliminate the possibility of review for a vast universe of fraud. . . .” Law Professors’ *Janus Amici Brief*, *supra* note 7, at \*7.

Consider the numerous cases in which a corporate executive intentionally misleads a journalist or financial analyst, who in turn publishes highly favorable reports without identifying the executive as a source. Even in the absence of direct attribution, the executive has nevertheless perpetrated a clear fraud on the market. Courts have reasonably responded to such cases by finding the executive liable, yet petitioners’ rule would overturn such decisions. The sensible approach, set forth by this Court in *Stoneridge*, is instead to inquire whether the executive engaged in a deceptive scheme and, if so, whether that deception was sufficiently proximate to the statements upon which investors relied. A strict attribution rule would senselessly abort the sound analysis of *Stoneridge*.

*Id.* at 8 (citations omitted).

ment's creation be sufficient enough to render attribution to such defendant reasonable; this rule was adopted by the Fourth and Ninth Circuits.<sup>155</sup> Further, the Tenth Circuit's rule imposed liability on actors who knew or should have known that their statements would reach potential investors who would rely on them.<sup>156</sup> The SEC's view, since 1998, has been that primary liability under Rule 10b-5 should be imposed where "a person, acting alone or with others, *creates* a misrepresentation – assuming, of course, that he or she acts with the requisite scienter."<sup>157</sup> According to the SEC, one "creates" a statement when "the statement is written or spoken by him, or if he provides the false or misleading information that another person then puts into the statement, or if he allows the statement to be attributed to him."<sup>158</sup> Three years

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155. See, e.g., O'Brien & Broche, *supra* note 153 (citing *In re Software Toolworks, Inc. Secs. Litig.*, 50 F.3d 615 (9th Cir. 1994); *In re Mut. Funds Inv. Litig.*, 566 F.3d 111, 124 (4th Cir. 2009), *rev'd sub nom.* *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011)). The Fourth Circuit *Janus* court reasoned:

We conclude . . . that given the publicly disclosed responsibilities of [Adviser] interested investors would infer that [Adviser] played a role in preparing or approving the content of the Janus fund prospectuses, particularly the content pertaining to the funds' policies affecting the purchase or sale of shares. It was publicly known that [Adviser] furnished advice and recommendations concerning the Janus funds' investment decisions and even made NAV determinations, which in part enabled market timing. In light of the publicly available material, interested investors would have inferred that if [Adviser] had not itself written the policies in the Janus fund prospectuses regarding market timing, it must at least have approved these statements. This circumstance is sufficient to support the adequacy of plaintiff's pleading of fraud-on-the-market reliance as to [Adviser].

*In re Mut. Funds Inv. Secs. Litig.*, 566 F.3d at 127 (distinguishing *Stoneridge* in which the fraud-on-the-market presumption was not applicable because the transactions at issue were not publicly disclosed). Note that some commentators believe that the Fourth Circuit's attribution rule was something other than "substantial participation" because of its requirement that a plaintiff must prove that investors would attribute the misstatements to the defendant, a determination made by the court on a case-by-case basis. See, e.g., Lesinski, *supra* note 118, at 100.

156. See, e.g., Lesinski, *supra* note 118, at 100 (citing *Anixter v. Home-Stake Prods. Co.*, 77 F.3d 1215, 1225 (10th Cir. 1996)).

157. U.S. *Janus* Amicus Brief, *supra* note 7, at \*13.

158. *Id.* (citing Brief of the Sec. & Exch. Comm'n, Amicus Curiae, in Support of the Position of Plaintiffs-Appellants on the Issue Addressed and in Support of Neither

after *Stoneridge*, in June 2011, in the midst of this confusion, the Roberts Court released its highly controversial 5-4 *Janus* decision.<sup>159</sup>

### 1. *Janus* Background

The relationship of the *Janus* entities at issue is typical of most mutual fund/adviser structures.<sup>160</sup> *Janus Capital Group, Inc.* (“Adviser Parent”), a publicly-traded company, created the “*Janus family*” of mutual funds, *Janus Investment Fund* (“Fund”), organized as a Massachusetts business trust.<sup>161</sup> Fund is entirely owned by mutual fund investors, and it has no assets except those owned by such investors.<sup>162</sup> Fund retained *Janus Capital Management LLC* (“Adviser”), a wholly-owned subsidiary of Adviser Parent, to serve as its investment adviser and administrator,<sup>163</sup> in such capacity, Adviser provides “the management and administrative services necessary for the operation” of Fund.<sup>164</sup> Adviser “manages the purchase, sale, redemption and distribution” of Fund’s investments; “prepares, modifies and implements . . . [Fund’s] long-term strategies[;]” and carries out Fund’s daily activities.<sup>165</sup> Notably, all of the officers of Fund were also officers of Adviser.<sup>166</sup> Further, one of Fund’s trustees was associated with Adviser.<sup>167</sup> As noted by the dissent, Adviser’s employees both drafted and reviewed Fund’s prospectuses, including the market timing language at issue in *Janus*.<sup>168</sup> Adviser also distributed the prospectuses through Adviser Parent’s website.<sup>169</sup> Critically, as noted by the dissent, Adviser “may well have kept the trustees in the dark about the true ‘market timing’ facts” at issue in this case.<sup>170</sup>

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Affirmance Nor Reversal at 7, *Pac. Inv. Mgmt. Co. LLC v. Mayer Brown LLP*, 603 F.3d 144 (2d Cir. 2010) (No. 09-16190cv), 2009 WL7768584).

159. *Janus*, 131 S. Ct. 2296. Notably, the same Justices who comprised the *Stoneridge* majority also made up the *Janus* majority: Justice Thomas authored this time, with Justices Roberts, Scalia, Kennedy and Alito joining. *Id.* at 2299. Justice Breyer wrote for the dissent and was joined by Justices Ginsburg, Sotomayor and Kagan. *Id.*

160. *See infra* Part IV.

161. *Janus*, 131 S. Ct. at 2299.

162. *Id.*

163. *Id.*

164. *Id.* (citations omitted) (internal quotation marks omitted).

165. *Id.* at 2306 (Breyer, J., dissenting).

166. *Id.* at 2299 (majority opinion).

167. *Id.* As noted by the Court, “[t]his is more independence than is required [under the 1940 Act.]” *Id.* Pursuant to the 1940 Act, up to sixty percent of a mutual fund’s board may be composed of “interested persons”, as defined in 15 U.S.C. § 80a-2(a)(19) (2006). 15 U.S.C. § 80a-10(a).

168. *Janus*, 131 S. Ct. at 2312 (Breyer, J., dissenting).

169. *Id.*

170. *Id.*; *see infra* notes 225, 230-31 and accompanying text.

The prospectuses issued to Fund investors stated that the funds at issue “were not suitable for market timing”<sup>171</sup> and could “be read to suggest that Adviser would implement policies to curb the practice.”<sup>172</sup> However, in late

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171. *Janus*, 131 S. Ct. at 2300 (majority opinion). For example, the Court cited the February 25, 2002 prospectus for the Janus Mercury Fund, which “stated that the fund was ‘not intended for market timing or excessive trading’ and represented that it ‘may reject any purchase request . . . if it believes that any combination of trading activity is attributable to market timing or is otherwise excessive or potentially disruptive to the Fund.’” *Id.*; see also *In re Mut. Funds Inv. Litig.*, 566 F.3d 111, 116-17 (4th Cir. 2009), *rev’d sub nom. Janus*, 131 S. Ct. 2296 (detailing other market timing statements from Fund prospectuses). “Clearly, . . . [such statements were] false, because at the same time . . . [they were] written, Janus’s managers were cutting market timing deals with large investors.” Nathan Hale, *Fund Investors Take a Hit from the Supreme Court*, CBS NEWS (June 20, 2011), [http://www.cbsnews.com/8301-505123\\_162-37640654/fund-investors-take-a-hit-from-the-supreme-court](http://www.cbsnews.com/8301-505123_162-37640654/fund-investors-take-a-hit-from-the-supreme-court).

172. *Janus*, 131 S. Ct. at 2300. Market timing is a practice that exploits the method in which mutual funds value their shares. *Id.* at 2300 n.1. Funds typically calculate the net asset value (“NAV”) of their shares at the close of the major markets in the United States, and investors buy or sell at a price based on the NAV calculation following their order. *Id.* Timing delays in valuation information can result in an NAV calculation that does not accurately reflect the true value of the fund. *Id.* For example, if a fund values its foreign securities as of the close of the applicable foreign market and if events post-closing increased the value of such securities, such increased value would not be reflected in the NAV calculation. *Id.* As such, a market timer could buy mutual fund shares at the artificially low price and sell the following day when the NAV calculation incorporated the increased valuation. *Id.* (citing Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, 68 Fed. Reg. 70,402-01 (Dec. 17, 2003)); see also, e.g., *In re Mut. Funds Inv. Litig.*, 566 F.3d at 116 (discussing “time zone arbitrage” in connection with market timing transactions). Market timing harms other investors in the fund “by diluting the value of shares, increasing transaction costs, reducing investment opportunities for the fund, and producing negative tax consequences.” *In re Mut. Funds Inv. Litig.*, 566 F.3d at 116. As articulately explained in the Law Professors’ *Janus* Amici Brief:

To choreograph a market-timing ruse, an investment manager needs – and arrogates for itself – control over all aspects of mutual fund operations: the manager advertises its funds to new purchasers through an affiliated distributor; the manager determines the policies that govern those funds and publicizes them in fund prospectuses that it writes; the manager monitors trading activity in the shares of its funds through an affiliated transfer agent or administrator; and the manager negotiates special arrangements for favored clients such as hedge funds who engage in market timing.

. . . .

2003, the Attorney General of the State of New York accused Adviser Parent and Adviser of entering into secret arrangements allowing market timing, to the detriment of investors who did not engage in such practices, in several funds in which Adviser served as investment adviser.<sup>173</sup> Fund investors subsequently withdrew “significant amounts” of money from Fund mutual funds.<sup>174</sup> Adviser Parent and Adviser settled in 2004, agreeing to reduce their fees by \$125 million, pay \$50 million in civil penalties, and disgorge \$50 million to mutual fund investors.<sup>175</sup>

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. . . In sum, to perpetrate a market-timing fraud, an investment manager must coordinate all major aspects of a mutual fund. The fund itself is little more than the manager’s weapon of choice.

Law Professors’ *Janus Amici* Brief, *supra* note 7, at \*11-13 (citing TAMAR FRANKEL & ANN TAYLOR SCHWING, *THE REGULATION OF MONEY MANAGERS* §§ 12, 21-22, 27, 32 (2d ed. 2001)).

173. *Janus*, 131 S. Ct. at 2300. Specifically, Adviser Parent allegedly knowingly allowed ten hedge funds to engage in market timing activities, which allowed them “guaranteed profits”, in return for the hedge funds’ agreements to invest heavily in other Janus funds, which increased Adviser’s advisory fees and Adviser Parent’s profits. *See, e.g.*, Hale, *supra* note 171. Of course, such “guaranteed profits” to the hedge funds came from the accounts of other mutual fund investors. *See id.*

174. *Janus*, 131 S. Ct. at 2300.

175. *Id.* at 2300 n.2; *In re Janus Capital Mgmt., LLC*, Investment Advisers Act Release No. 2277, Investment Company Act Release No. 26532, 83 SEC Docket 1766 (Aug. 18, 2004), 2004 WL 1845502, at \*4 (finding that Adviser had willfully violated (1) §§ 206(1) and 206(2) of the Investment Advisers Act of 1940, “in that, while acting as an investment adviser, it employed devices, schemes, or artifices to defraud clients or prospective clients, and engaged in transactions, practices, or courses of business which operated or would operate as a fraud or deceit upon clients or prospective clients;” (2) § 34(b) of the 1940 Act, “in that it made an untrue statement of material fact in a registration statement, application, report, account, record, or other document filed or transmitted pursuant to the Investment Company Act, or omitted to state therein any fact necessary in order to prevent the statements made therein, in the light of the circumstances under which they were made, from being materially misleading;” and (3) § 17(d) of the 1940 Act and Rule 17d-1 thereunder, “in that, while acting as a principal, it participated in and effected transactions in connection with joint arrangements in which the funds were participants without filing an application with the Commission and obtaining a Commission order approving the transactions.”), amended on other grounds by *In re Janus Capital Mgmt., LLC*, Investment Advisers Act Release No. 3065, Investment Company Act Release No. 29377, 2010 WL 3071930 (Aug. 5, 2010). In connection with the settlement, Adviser agreed to “use its best efforts to cause the Janus funds to operate in accordance with [certain enumerated] governance policies and practices[.]” *Id.* at \*5. This fact alone emphasizes the reality that, with respect to Fund, Adviser exerted a tremendous amount of control and was no ordinary secondary actor. *See, e.g.*, Hale, *supra* note 171.



Fund's decreased valuation as a result of the market timing scandal caused Adviser Parent's stock price to fall by approximately 25 percent.<sup>176</sup> First Derivative Traders ("First Derivative"), representing a class of plaintiffs who owned Adviser Parent stock, sued Adviser Parent and Adviser for violations of §10(b) and Rule10b-5, alleging that Adviser Parent and Adviser "caused mutual fund prospectuses to be issued for Janus mutual funds and made them available to the investing public, which created the misleading impression that [Adviser Parent and Adviser] would implement measures to curb market timing in the Janus [mutual funds]."<sup>177</sup> First Derivative claimed that plaintiffs relied "upon the integrity of the market price of [Adviser Parent] securities and market information relating to [Adviser Parent and Adviser]."<sup>178</sup> First Derivative also asserted a "controlling person" claim against Adviser Parent pursuant to §20(a) of the 1934 Act.<sup>179</sup>

The District Court of Maryland granted Adviser Parent's and Adviser's motion to dismiss for failure to state a claim.<sup>180</sup> On appeal, the Fourth Circuit Court of Appeals reversed, finding that the complaint adequately alleged that the defendants, "by participating in the writing and dissemination of the prospectuses, made the misleading statements contained in the documents."<sup>181</sup> The Fourth Circuit held that the element of reliance with respect to Adviser was adequately pled, as "investors would infer that Adviser 'played a role in preparing or approving the content of the [Fund's] prospectuses.'"<sup>182</sup> However, because investors would not make such an inference with respect to

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176. *Janus*, 131 S. Ct. at 2300. A "significant percentage of [Adviser Parent]'s income" was comprised of Adviser's management fees, which were based upon the total value of the mutual funds. *Id.* Thus, when the value of the mutual funds dropped, so did Adviser Parent's value. *Id.*

177. *Id.* (alteration in original) (citation omitted) (internal quotation marks omitted). Notably, First Derivative did not allege a § 20(a) control person claim against Adviser. *Id.* at 2301.

178. *Id.* at 2301 (alteration in original) (citation omitted) (internal quotation marks omitted). As noted by the dissent, the complaint set forth the elements of a typical "fraud on the market" claim." *Id.* at 2306 (Breyer, J., dissenting).

179. *Id.* at 2301 (majority opinion).

180. *In re Mut. Funds Inv. Litig.*, 487 F. Supp. 2d 618 (D. Md. 2007), *rev'd*, 566 F.3d 111 (4th Cir. 2009), *rev'd sub nom. Janus*, 131 S. Ct. 2296 (2011).

181. *Janus*, 131 S. Ct. at 2301 (quoting *In re Mut. Funds Inv. Litig.*, 566 F.3d 111, 121 (4th Cir. 2009), *rev'd sub nom. Janus*, 131 S. Ct. 2296 (2011)) (internal quotation marks omitted).

182. *Id.* (quoting *In re Mut. Funds Inv. Litig.*, 566 F.3d at 127). It has been noted that "the Fourth Circuit is not considered to be one of the more liberal circuits when interpreting the scope of the federal securities laws." ALAN R. BROMBERG, LEWIS D. LOWENFELS & MICHAEL J. SULLIVAN, *BROMBERG & LOWENFELS ON SECURITIES FRAUD* § 7:306.50 (2d ed. 2011).

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Adviser Parent, the Fourth Circuit held that Adviser Parent could only face control person liability under §20(a) of the 1934 Act.<sup>183</sup>

The Supreme Court granted certiorari to resolve the issue of whether Adviser could be held liable in a private Rule 10b-5 action for materially misleading statements included in Fund's prospectuses.<sup>184</sup> In a thinly-reasoned and tediously-written opinion, the Court held that it could not.<sup>185</sup>

## 2. The Decision

With no analysis whatsoever regarding §10(b),<sup>186</sup> the Roberts Court sophomorically based its opinion on selected definitions of the word "make" from the 1933 edition of the Oxford English Dictionary and the 1934 edition of the Webster's New International Dictionary:

One "makes" a statement by stating it. When "make" is paired with a noun expressing the action of a verb, the resulting phrase is "approximately equivalent in sense" to that verb. 6 Oxford English Dictionary 66 (def. 59) (1933) (hereinafter OED); accord, Webster's New International Dictionary 1485 (def. 43) (2d ed. 1934) ("Make" followed by a noun with the indefinite article is often nearly equivalent to the verb intransitive corresponding to that noun"). For instance, "to make a proclamation" is the approximate equivalent of "to proclaim," and "to make a promise" approximates "to promise." See 6 OED 66 (def. 59). The phrase at issue in Rule 10b-5, "[t]o make any ... statement," is thus the approximate equivalent of "to state."

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183. *Janus*, 131 S. Ct. at 2301 (citing *In re Mut. Funds Inv. Litig.*, 566 F.3d at 128-30).

184. *Id.*

185. *See id.*

186. The Court's failure to begin its analysis with a textual interpretation of § 10(b) and an analysis of how the 73d Congress would have dealt with the matter, as required pursuant to *Central Bank*, seems to underscore the policy-driven nature of its decision. *See Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994); *see also, e.g.*, James D. Redwood, *To Make or to Mar: The Supreme Court Turns Away Another Securities Law Plaintiff*, 14 U. PA. J. BUS. L. 463, 465-66 (2012) (noting that *Janus* "stands the traditional method of statutory analysis – by which one starts with the language of the statute and then proceeds to analyze, in descending order, the legislative history, the statutory scheme, and lastly, policy considerations – on its head."); Pritchard, *supra* note 9, at 136-37. Further, the Court's decision to disregard the views of the SEC, which promulgated Rule 10b-5 and is charged with its enforcement, is puzzling, to say the least. *See supra* note 64 and accompanying text; *infra* notes 192-93 and accompanying text.

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 its 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 best be exemplified by the relationship between a writer and a speaker. Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it.<sup>187</sup> And it is the speaker who takes credit – or blame – for what is ultimately said.<sup>188</sup>

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187. In its *Amicus* Brief, the SEC articulately demonstrated that the speechwriter/speaker analogy was flawed:

Whereas the phrase “make a speech” generally refers to oral delivery by a single person at a discrete point in time, the Funds’ prospectuses were written documents disseminated through a variety of methods. *The prospectuses, moreover, were issued in the names of artificial persons (the Janus Funds) who by definition can act only through (and at the direction of) others.* In the context of such a written document, those who actually drafted the statements contained in the document can naturally be described as their “maker.”

U.S. *Janus* Amicus Brief, *supra* note 7, at \*15.

188. *Janus*, 131 S. Ct. at 2302. This speechwriter/speaker analogy has spurred many counter-analogies. See, e.g., Law Professors’ *Janus* Amici Brief, *supra* note 7, at \*7 (principal/microphone and speakers); Redwood, *supra* note 186, at 496 (general contractor/subcontractor); Hale, *supra* note 171 (puppeteer/puppet); Brent Kendall, *Janus Found Not Liable for Funds’ Prospectuses*, WALL ST. J., June 14, 2011, <http://online.wsj.com/article/SB10001424052702303848104576383453742250090.html> (quoting Professor William Birdthistle of Chicago-Kent College of Law) (manipulator/marionette); see also *New York Times* Editorial, *supra* note 11 (stating that Adviser Parent used “legal ventriloquism to speak through the business trust and Janus funds”).

Given that the majority’s decision is premised upon a suspension of the realities of mutual fund law and practice, this Article suggests that the Oz analogy is appropriate. See *supra* note 14. The scene in L. Frank Baum’s 1899 story (which formed the basis for the 1939 movie) in which Dorothy’s group discovers “a little, old man, with a bald head and a wrinkled face” behind the screen, seems written for the occasion:

Rejecting the Government's contention that "make" should be interpreted as "create[.]"<sup>189</sup> the majority continued its abstruse analysis:

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"But, I don't understand," said Dorothy, in bewilderment. "How was it that you appeared to me as a great Head?"

"That was one of my tricks," answered Oz. "Step this way, please, and I will tell you all about it."

He led the way to a small chamber in the rear of the Throne Room, and they all followed him. He pointed to the corner, in which lay the Great Head, made out of many thicknesses of paper, and with a carefully painted face.

"This I hung from the ceiling by a wire," said Oz; "I stood behind the screen and pulled a thread, to make the eyes move and the mouth open."

"But how about the voice?" she enquired.

"Oh, I am a ventriloquist," said the little man, "I can throw the sound of my voice wherever I wish, so that you thought it was coming out of the Head."

L. FRANK BAUM, *THE WONDERFUL WIZARD OF OZ* 181-86 (100th Anniv. Ed., Harper Collins 2000).

189. *Janus*, 131 S. Ct. at 2303 (citing U.S. *Janus* Amicus Brief, *supra* note 7, at \*14-15). The SEC and DOJ asserted:

For purposes of the question presented here, the most salient feature of the Commission's interpretation is the conclusion that one can "make" a statement by "creat[ing]" or "writ[ing]" it, even if the statement's creator is not expressly identified. That conclusion is fully consistent with the ordinary meaning of the term "make." *See, e.g.*, 1 *Shorter Oxford English Dictionary* 1682 (6th ed. 2007) (def. I.1.c, transitive verb: "Compose, write as the author (a book, a poem, verses, etc.); draw up (a legal document, esp. one's will)"; def. I.2, transitive verb: "Cause the material or physical existence of; produce by action, bring about; create or take part in the creation of; produce by action, bring about; create or take part in the creation of (a sound recording, film, etc.)"); *Webster's New International Dictionary* 1485 (2d ed. 1958) (def. III. 17: "To cause to exist, appear, or occur"); *see also SEC v. Tambone*, 597 F.3d 436, 443 (1st Cir. 2010) (en banc) (referring to "several common and representative dictionary definitions of 'make,'

The Government contends that “make” should be defined as “create.” Brief for United States as Amicus Curiae 14-15 (citing Webster’s New International Dictionary 1485 (2d ed. 1958) (defining “make” as “[t]o cause to exist, appear, or occur”). This definition, although perhaps appropriate when “make” is directed at an object unassociated with a verb (e.g., “to make a chair”), fails to capture its meaning when directed at an object expressing the action of a verb.<sup>190</sup>

The majority’s curt dismissal of the SEC’s interpretation of its own rule<sup>191</sup> is mystifying and is in contradiction to the deference given the SEC by the New Deal Court.<sup>192</sup>

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which include ‘create [or] cause’; ‘compose’; and ‘cause (something) to exist’) (citations omitted).

U.S. *Janus* Amicus Brief, *supra* note 7, at \*14.

190. *Janus*, 131 S. Ct. at 2302. The majority also, in a footnote, dispensed with First Derivative’s assertion that “indirectly” in Rule 10b-5 broadens the definition of “make”, stating, “[w]e think the phrase merely clarifies that as long as a statement is made, it does not matter whether the statement was communicated directly or indirectly to the recipient.” *Id.* at 2305 n.11. The majority further muddied its muddy waters: “In this case, we need not define precisely what it means to communicate a ‘made’ statement indirectly because none of the statements in the prospectuses were attributed, explicitly or implicitly, to [Adviser]. . . . More may be required to find that a person or entity made a statement indirectly, but attribution is necessary.” *Id.* The dissent strongly noted that this attribution rule was unsupported by citation to any relevant legal authority. *Id.* at 2308 (Breyer, J., dissenting); *see also, e.g.*, Redwood, *supra* note 186, at 480 n.112 (noting the arguments of First Derivative and the United States as *amicus* that, with respect to § 10(b), “‘directly’ and ‘indirectly’ are adverbs that cannot grammatically modify prepositional phrases”); *id.* at 484 (“[N]either the actual language of Section 10(b) and Rule 10b-5 nor the grammatical structure of the statute and rule supports the Court’s limitation of the word ‘indirectly’ to the method of communication.”). As noted by the SEC, “[i]f an issuer can ‘indirectly make’ an untrue statement by using an analyst as a conduit, other persons can likewise indirectly make an untrue statement through an issuer.” U.S. *Janus* Amicus Brief, *supra* note 7, at \*16.

191. *Janus*, 131 S. Ct. at 2303 n.8 (majority opinion). As asserted by the SEC:

The Commission’s interpretation of the term “make” in Rule 10b-5 – having been adopted in the agency’s briefs and in a formal adjudication – is “controlling” as long as it is not “plainly erroneous or inconsistent with the regulation.” *Auer v. Robbins*, 519 U.S. 452, 461 (1997) (citations and internal quotation marks omitted); accord *Federal Express Corp. v. Holowecki*, 552 U.S. 389, 397 (2008) (deferring to the interpretation of an EEOC regula-

In his dissent, Justice Breyer countered:

But where can the majority find legal support for the rule that it enunciates? The English language does not impose upon the word “make” boundaries of the kind the majority finds determinative. Every day, hosts of corporate officials make statements with content that more senior officials or the board of directors have “ultimate authority” to control. So do cabinet officials make statements about matters that the Constitution places within the ultimate authority of the President. So do thousands, perhaps millions, of other employees make statements that, as to content, form, or timing, are subject to the control of another. Nothing in the English language prevents one from saying that several different individuals, separately or together, “make” a statement that each has a hand in producing.<sup>193</sup>

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tion advanced in an amicus brief); cf. *SEC v. Zandford*, 535 U.S. 813, 819-820 (2002) (according *Chevron* deference to an SEC interpretation of the “text of § 10(b)” adopted in a “formal adjudication”).

U.S. *Janus* Amicus Brief, *supra* note 7, at \*13-14.

192. See *supra* notes 66-67 and accompanying text; see also, e.g., Pritchard, *supra* note 9, at 117.

193. *Janus*, 131 S. Ct. at 2307 (Breyer, J., dissenting); see also *id.* at 2306 (“[B]oth language and case law indicate that, depending upon the circumstances, a management company, a board of trustees, individual company officers, or others, separately or together, might ‘make’ statements contained in a firm’s prospectus – even if a board of directors has ultimate content-related responsibility”) (emphasis added). Some commentators have expressed complete bewilderment at the majority’s selective use of the OXFORD ENGLISH DICTIONARY. See, e.g., Redwood, *supra* note 186, at 466 (“[E]ven if one focuses in solely on the Oxford English Dictionary, it is evident that a multitude of definitions of the verb ‘to make’ was available to the Court. Many of these definitions would have supported the plaintiffs in their efforts to hold [Adviser] liable as a ‘maker’ of the fund prospectus misstatements in question.”); *id.* at 495 (“Perhaps recognizing that its excursion into ‘definition 59,’ dead-ending as it did in the cul-de-sac of the transitive versus intransitive debate, did almost nothing to advance understanding of the term, and being perhaps too daunted to tackle any of the other ninety-five definitions propounded by the . . . [OXFORD ENGLISH DICTIONARY], the Court abruptly abandoned the definitional field entirely and substituted instead a ‘test’ for what is meant by the verb ‘to make.’”). Other commentators have noted that the *Janus* Court’s definition of “make” has created “an unusual carve-out for securities-related speech” that is inconsistent with other treatments of actionable speech. Edward Pekarek & Genavieve Shingle, *The Make Believe of Janus*, N.Y. ST. B. ASS’N SEC. LITIG. ARB. (Oct. 13, 2011, 5:20 PM), [http://nysbar.com/blogs/SecuritiesLitigation/2011/10/the\\_make\\_believe\\_of\\_janus.htm](http://nysbar.com/blogs/SecuritiesLitigation/2011/10/the_make_believe_of_janus.htm) 1 (discussing concepts of actionable speech under defamation law; the Lanham Act,

In a logical leap, the Court opined that *Central Bank's* ban on private aiding and abetting liability under Rule 10b-5 required its ruling adopting the "ultimate authority" test.<sup>194</sup> Drawing "a clean line" between those who are primarily liable and those who are secondarily liable, the Court held that "the maker is the person or entity with ultimate authority over a statement and others are not."<sup>195</sup> Thus, according to the majority's test, only those with "ultimate authority" can be held primarily liable under Rule 10b-5 as the "maker" of a statement.

The dissent, emphasizing *Central Bank's* secondary liability subject matter, countered that *Central Bank* "no more requires the majority's rule than free air travel for small children requires free air travel for adults."<sup>196</sup> Rather, the dissent viewed *Central Bank* as dealing with aiding and abetting liability with respect to those who did "not engage in the proscribed activities at all, but who gave a degree of aid" to those who did.<sup>197</sup> Further, it concluded that *Central Bank* supports the proposition that, under the right circumstances, numerous parties involved in the development of a prospectus might "make" materially false statements that would invoke primary liability.<sup>198</sup> The dissent highlighted the majority's cautionary language in *Central Bank* that it did

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15 U.S.C. § 1125(a)(1)(B) (2006); and the Communications Decency Act of 1996, 47 U.S.C. § 230, among other laws).

194. *Janus*, 131 S. Ct. at 2302 (majority opinion).

195. *Id.* at 2302 n.6. The dissent responded, "Where is the legal support for the majority's 'draw[ing] a clean line' that so seriously conflicts with *Central Bank*?" *Id.* at 2308 (Breyer, J., dissenting) (alteration in original) (citation omitted).

196. *Id.* at 2307 (Breyer, J., dissenting). In fact, the dissent argued that the majority's rule extended *Central Bank's* holding into areas "explicitly placed outside that holding." *Id.* at 2308.

197. *Id.* at 2307 (quoting *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 176 (1994)) (internal quotation marks omitted).

198. *Id.* at 2308. As articulately noted by one commentator:

Can it be said, for example, that a building has but one "maker"? Although a sign on a construction site might identify the architect or the general contractor, does that any the less make unidentified subcontractors *not* also the "makers" of the building? Certainly a person injured by faulty plumbing or electrical wiring in a building would expect that the subcontractor who designed, manufactured, constructed, or installed the defective plumbing or wiring would be held at least partly responsible for her injury, on the common understanding that the subcontractor was one of the "makers" of the building (assuming, of course, that the cause of the injury could be traced to the work of that subcontractor). And this would be so

...“not mean that secondary actors in the securities markets are always free from liability under the securities Acts. *Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met.*”<sup>199</sup>

The majority and dissenting opinions also diverged in their interpretations of *Stoneridge*. Emphasizing *Stoneridge*'s holding that “nothing [the defendants] did made it necessary or inevitable for [the company] to record the transactions as it did[,]”<sup>200</sup> the majority opined that, likewise, nothing that Adviser did “made it necessary or inevitable” for Fund to include the market timing misstatements in its prospectuses. The majority saw “no reason to treat participating in the drafting of a false statement differently from engaging in deceptive transactions [as in *Stoneridge*], when each is merely an undisclosed act preceding the decision of an independent entity to make a public statement.”<sup>201</sup> As discussed below, this is a misunderstanding of the facts alleged by First Derivative and the realities of mutual fund prospectus preparation.<sup>202</sup>

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regardless of whether the architect or the general contractor might also be liable.

Redwood, *supra* note 186, at 496 (emphasis added) (footnotes omitted).

199. *Janus*, 131 S. Ct. at 2308 (quoting *Central Bank*, 511 U.S. at 191).

200. *Id.* at 2303 (majority opinion) (quoting *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 161 (2008)) (internal quotation marks omitted).

201. *Id.* at 2304.

202. In fact, the following exchange during oral argument between Justice Ginsburg and counsel for Adviser and Adviser Parent elucidates this fact:

JUSTICE GINSBURG: Mr. Perry, you – you said that it was the fund’s lawyers who drafted the prospectus, *but, in fact, it was [Adviser]’s lawyers, the lawyers – they were in-house lawyers for [Adviser]. And they served – and they served the funds in doing this prospectus, but they were on the payroll of [Adviser], and they were [Adviser]’s legal department.*

MR. PERRY: Your Honor, like all lawyers, they wear multiple hats. I represent multiple clients. These lawyers represent multiple clients.

JUSTICE GINSBURG: I thought they were in-house lawyers?



The dissent countered that the *Stoneridge* Court “did not deny that the equipment suppliers *had made* the false statements contained in the letters, contracts, and conversations”, but rather ruled that there was not “‘the requisite *proximate relation* to the investors’ harm.”<sup>203</sup> Further, the dissent clarified that the *Stoneridge* decision was based on a lack of reliance on the false statements made by the suppliers, and that the suppliers’ fraudulent conduct “‘took place in the marketplace for goods and services, not in the investment sphere.’”<sup>204</sup> As such, the dissent’s bewilderment regarding the majority’s assertion that *Stoneridge* supported its ruling<sup>205</sup> was well-founded.

In response to the assertions by First Derivative and its *amici* that an investment adviser is generally understood to be the “maker” of statements by a mutual fund,<sup>206</sup> the majority opined in a terse, cavalier manner: “We decline this invitation to disregard the corporate form.”<sup>207</sup> The majority simply de-

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MR. PERRY: *They are in-house lawyers at [Adviser], but they also represent the funds, and the SEC has specifically recognized in the context of investment companies that where an adviser counsel is representing the funds, his client or her client, for those purposes, is the funds. And here, these lawyers are very careful to separate who their – their clients are for various purposes.*

Transcript of Oral Argument at 12-13, *Janus*, 131 S. Ct. 2296 (No. 09-525) (emphasis added); *see also* Redwood, *supra* note 186, at 498-99. In response to an interrogatory, Adviser also admitted that its in-house counsel drafted the prospectuses. *See* Law Professors’ *Janus Amici Brief*, *supra* note 7, at \*20.

203. *Janus*, 131 S. Ct. at 2309 (Breyer, J., dissenting) (quoting *Stoneridge*, 552 U.S. at 158-59).

204. *Id.* (quoting *Stoneridge*, 552 U.S. at 166).

205. *Id.*

206. First Derivative argued that as an actor delivers lines written by a playwright, so does a mutual fund via a prospectus deliver lines “made” by an investment adviser. *Id.* at 2304 (majority opinion).

207. *Id.* Contrary to the majority’s holding regarding corporate separateness, as explained in the Law Professors’ *Janus Amici Brief*, “the record amply demonstrates that petitioners effectively merged the existence of the funds into their own: regarding control of ‘business affairs,’ . . . officers . . . (all 17 officers of the funds were [Adviser’s] Vice Presidents), office space (provided by [Adviser]), . . . business address (shared by the funds, [Adviser], and [Adviser Parent]), . . . and signature . . . (the prospectuses were simply signed by ‘Janus.’” Law Professors’ *Janus Amici Brief*, *supra* note 7, at \*19. Several commentators have noted that the Court “ignored the practical operational control held by [Adviser] and seems to confusingly merge concepts of control with those involved in establishing an action for disregard of a corporate entity or ‘piercing the corporate veil.’” Farris, *supra* note 48, at n.7; *see also*, e.g., Redwood, *supra* note 181, at 467, 501-11 (discussing the inapplicability of separate entity protection in the case of fraud).

clined to participate in a more mature analysis of the complex issues presented, stating, “Any reapportionment of liability in the securities industry in light of the close relationship between investment advisers and mutual funds is properly the responsibility of Congress and not the courts.”<sup>208</sup>

In contrast, the dissent viewed other cases as supporting the consideration of the close relationship between advisors and mutual funds. Rejecting the majority’s “ultimate authority” test, the dissent listed a long line of cases holding that, under certain circumstances, corporate officials and others can be liable under Rule 10b-5 for having made a materially false statement that appears in a document or is made by a third person who is not legally controlled by such officials.<sup>209</sup> The dissent also cited a string of cases holding that corporate officials may be liable for making false statements where they use innocent parties as conduits to the public (even where such statements are not attributed to such corporate officials).<sup>210</sup> The dissent concluded:

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It should be noted that, with respect to private funds such as hedge funds and private equity funds, both U.S. and non-U.S. advisers may be more vulnerable to liability for prospectus misstatements, as the adviser or its principals usually serve as the managing member or general partner of the fund, and non-U.S. funds may not have an independent board. Farris, *supra*, note 48.

208. *Janus*, 131 S. Ct. at 2304.

209. *Id.* at 2311-12 (Breyer, J., dissenting) (citing *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994) (noting that a “lawyer, accountant, or bank, who . . . makes a material misstatement (or omission)” may be primarily liable under Rule 10b-5 if all elements are met); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386 n. 22 (1983) (explaining that corporate officers, lawyers and accountants who play a role in the preparation of a registration statement may be held primarily liable even though “they are not named as having prepared or certified” such registration statement); *SEC v. Wolfson*, 539 F.3d 1249, 1261 (10th Cir. 2008) (holding that an outside consultant could be primarily liable for making false statements where fraudulent annual and quarterly statements that were thereafter reviewed and certified by the firm’s counsel, officers and auditor); *McConville v. SEC*, 465 F.3d 780, 787 (7th Cir. 2006) (holding that a chief financial officer could be primarily liable for making misstatements that appeared in a Form 10-K prepared by her but not signed or filed by her); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1225-27 (10th Cir. 1996) (holding that an accountant could be primarily liable for making false statements where fraudulent opinions and certification letters issued by him were reproduced in prospectuses and other reports for which he did not have ultimate authority)).

210. *Id.* (citing *In re Navarre Corp. Sec. Litig.*, 299 F.3d 735, 743 (8th Cir. 2002) (holding that one may be liable for using an analyst as a conduit to communicate false statements); *In re Cabletron Sys., Inc.*, 311 F.3d 11, 38 (1st Cir. 2002) (refusing to adopt a test requiring legal control over a third party making a statement, as such a test would give “company officials too much leeway to commit fraud on the market by using analysts as their mouthpieces”); *Novak v. Kasaks*, 216 F.3d 300, 314-15 (2nd Cir. 2000); *Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1997); *Freeland v. Iridium World Commc’ns., Ltd.*, 545 F. Supp. 2d 59, 75-76 (D. D.C. 2008)).

In sum, I can find nothing in § 10(b) or in Rule 10b-5, its language, its history, or in precedent suggesting that Congress, in enacting the securities laws, intended a loophole of the kind that the majority's rule may well create.

....

. . . The relationship between . . . [Adviser] and . . . [Fund] could hardly have been closer. . . [Adviser's] involvement in preparing and writing the relevant statements could hardly have been greater. And there is a serious suggestion that the board itself knew little or nothing about the falsity of what was said. . . . Unless we adopt a formal rule (as the majority here has done) that would arbitrarily exclude from the scope of the word "make" those who manage a firm – even when those managers perpetrate a fraud through an unknowing intermediary – the management company at issue here falls within that scope. We should hold the allegations in the complaint in this respect legally sufficient.<sup>211</sup>

Finally, the majority considered First Derivative's arguments in light of §20(a) of the 1934 Act. It viewed the theory of liability proposed by First Derivative as resembling but "broader in application than" control person liability under §20(a) of the 1934 Act,<sup>212</sup> which, as discussed above, establishes liability for persons that directly or indirectly control violators of the securities laws.<sup>213</sup> The majority refused to expand on the liability expressly created by Congress in §20. The dissent disagreed, noting that the "possibility of an express remedy under the securities laws does not preclude a claim under § 10(b)."<sup>214</sup> Critically, the dissent emphasized that, if an actor exploited an innocent intermediary, §20(a), which requires primary liability by the controlled party, would not apply.<sup>215</sup> Further, the dissent emphasized that it was quite possible that *Fund's board of trustees knew nothing about the misstatements* in the prospectuses, in which case, § 20(a) would be inapplicable.<sup>216</sup>

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211. *Id.*

212. *Id.* at 2304 (majority opinion); see *supra* notes 50-52 and accompanying text.

213. See *supra* note 52 and accompanying text.

214. *Janus*, 131 S. Ct. at 2310 (Breyer, J., dissenting) (citing *Herman & MacLean*, 459 U.S. at 388).

215. *Id.* *Janus* has opened the door for a flood of litigation regarding the parameters of "control person" liability under § 20. See, e.g., Gordon, *supra* note 16.

216. *Janus*, 131 S. Ct. at 2310 (Breyer, J., dissenting) (citing *In re Lammert*, Release No. 348, 28, 93 SEC Docket 5676, 5700 (ALJ Apr. 28, 2008) (Adviser knew of market timing in Fund no later than 2002, but "[t]his knowledge was never shared with the Board")).

The possibility of guilty management and innocent board is the 13th stroke of the new rule's clock. What is to happen when guilty management writes a prospectus (for the board) containing materially false statements and fool both board and public into believing they are true? Apparently under the majority's rule, in such circumstances *no one could be found to have "ma[d]e" a materially false statement* – even though under the common law the managers would likely have been guilty or liable (in analogous circumstances) for doing so as principals (and not as aiders and abettors).<sup>217</sup>

In such circumstances, under the majority's rule, the dissent cautioned that even the SEC might be prohibited from asserting primary liability *or* aiding and abetting liability.<sup>218</sup> Paving the way for the next prominent case in securities fraud law, the Court reserved the issue of whether Congress had created liability for entities acting through innocent intermediaries in § 20(b).<sup>219</sup>

Although the *Janus* Court intended to create a workable, bright line test regarding Rule 10b-5 liability, the decision has confounded scholars, practitioners and judges since it was penned. Part IV explores why the decision is particularly impractical in the mutual fund context, and Part V summarizes the resulting confusion in the lower courts.

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217. *Id.* (emphasis added).

218. *Id.* As the majority did not specifically address this point, it is impossible to tell if this was an oversight by the majority or an anticipated effect of the ruling. *See Juris, supra* note 60 (suggesting that the decision's effect on the SEC was most likely an unintended and unanticipated result from a poorly worded opinion). This is in contrast to the Court's approach in *Stoneridge*, which was premised on a reliance analysis and would therefore not be applicable to the SEC. *See supra* note 129. It should be noted that the SEC may also, of course, pursue violators under other applicable laws, including pertinent sections of the 1933 Act, the 1934 Act, the Advisers Act, 1940 Act, and the Trust Indenture Act. *See Pritchard, supra* note 9, at 138; *see also, e.g., supra* note 175.

219. *Janus*, 131 S. Ct. at 2304 n.10 (majority opinion). In response, the dissent stated that, if § 20(b) provided a possible basis for liability, the majority should have remanded for possible amendment of the complaint. *Id.* at 2311 (Breyer, J., dissenting). The dissent further noted that "[t]here is a dearth of authority construing [§] 20(b)" because that section "has been thought largely superfluous in 10b-5 cases." *Id.* (quoting 5B ARNOLD S. JACOBS, DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAW § 11-8 (2011)) (internal quotation marks omitted). As such, First Derivative reasonably believed that it had referred to the proper law, and "is faultless for failing to mention § 20(b) as well." *Id.*

Section 20(b) provides that "[i]t shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this title or any rule or regulation thereunder through or by means of any other person." 15 U.S.C. § 78t (2006) (emphasis added).

#### IV. THE PRACTICAL REALITIES AND DOCTRINAL FOUNDATIONS OF THE MUTUAL FUND/ ADVISER RELATIONSHIP

As noted above, the *Janus* decision precipitated a barrage of criticism from scholars and practitioners.<sup>220</sup> A *New York Times* Editorial stated:

Justice Thomas's opinion is short and, from the mutual fund industry's perspective, very sweet: [Adviser Parent and Adviser] were heavily involved in preparing the prospectuses, but they didn't "make" the statements so they can't be held liable. Only the business trust set up to hold the funds can be held liable, though it has no assets of its own to compensate plaintiffs in the lawsuit. Which means that there is no one to sue for the misleading prospectuses.

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220. See, e.g., Law Professors' *Janus* Amici Brief, *supra* note 7, at \*2-3 (predicting that a victory by Adviser Parent and Adviser would "furnish a blueprint for widespread impunity from securities violations" and that "[a]ny corporation that publicly claims to police the quality of its products while surreptitiously soliciting douceurs to compromise that quality – as a investment manager does in a market-timing fraud – would receive a tutorial on how to evade legal liability."); Redwood, *supra* note 181, at 466 ("In this author's view, the Court's holding is based on raw policy and little else."); O'Brien & Broche, *supra* note 153 (noting that commentators have critiqued *Janus* as giving corporations "a license to lie" and as providing "a roadmap for fraud"); Hale, *supra* note 171 ("[T]he Supreme Court struck a blow against the rights of mutual fund investors, and in the process might have opened a Pandora's box, providing corporate America a road map that will allow them to avoid liability from investor suits."); *New York Times* Editorial, *supra* note 11 (noting that Justice Thomas' *Janus* opinion "has made it much harder for private lawsuits to succeed against mutual fund malefactors, even when they have admitted to lying and cheating"); Gordon, *supra* note 16 ("*Janus Capital Group* does real damage. . . . At a time when an increasingly large share of investment activity occurs through large pools of capital, the decision exacerbates the problem of 'agency capitalism' – the tendency of the managing agents to pursue their own objectives at the expense of the ultimate beneficiaries. Why strain to find ways to insulate wrong-doers from accountability systems?"); Pekarek & Shingle, *supra* note 193 ("It appears the *Janus* Court may have ushered in an era that may only make the capital markets increasingly risky for the investing public, and stock market charlatans can almost be heard saying, 'go ahead . . . make my day.'"); Walter, *supra* note 35 ("*Janus* represents [a decision] . . . that is shockingly out of line with the realities of the marketplace").

On the other hand, others praised the "much-needed certainty" provided by the decision's bright-line test. Kendall, *supra* note 188. Commentators have noted that shareholders of Fund could have most likely prevailed in a suit against Fund under §§ 11, 12 and 15 of the 1933 Act and under Rule 10b-5, assuming proof of damages. See, e.g., Farris, *supra* note 48. Although Adviser Parent shareholders were without remedy in *Janus*, it has been posted that perhaps they could have been successful in a suit against Adviser Parent based on omissions of material fact in Adviser Parent public filings. See, e.g., *id.*

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There is no doubt that [Adviser Parent] is responsible. It used legal ventriloquism to speak through the business trust and Janus funds. [Adviser] does everything for the funds, which have no employees. As Justice Stephen Breyer writes in dissent, “The relationship between [Adviser] and the Fund could hardly have been closer.”<sup>221</sup>

As set forth below, two fundamental untruths provide the pillars for Justice Thomas’ *Janus* decision: first, investment managers of mutual funds “are simply the minions of those funds,” and second, “the lifeless funds created and controlled by managers enjoy meaningful independent existence[.]”<sup>222</sup> In short, *Janus* is premised on the notion

that investment managers are merely subaltern “service providers” orbiting funds at a great distance, tethered only by the flimsiest thread of contract. Very much to the contrary, investment managers are prime movers who reign from the center of the mutual fund universe. In the beginning, managers create, incubate, and hold their funds as wholly owned subsidiaries. During this period of infancy, when the manager owns every share and every dollar in a fund, the manager and fund execute a contract . . . whose . . . signatories are each controlled by the manager.<sup>223</sup>

As noted above, in light of the numerous front page stories of mutual fund adviser misconduct over the last decade, including scandals involving market timing, late trading, valuation misconduct and soft-dollar practices,<sup>224</sup> *Janus*’ absolution of advisers under Rule 10b-5(b) is a wrong that should be legislatively remedied.

#### A. Background Regarding the Mutual Fund/ Adviser Relationship

The mutual fund industry has grown exponentially since the enactment of the 1940 Act.<sup>225</sup> Total net mutual fund assets have grown from \$0.45 billion in 1940 to \$13.05 trillion in 2012.<sup>226</sup> Further, the number of funds during that time frame has grown from 68 to 7596,<sup>227</sup> and the number of shareholder

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221. *New York Times* Editorial, *supra* note 11 (quoting *Janus*, 131 S. Ct. at 2313 (Breyer, J. dissenting)).

222. Law Professors’ *Janus* Amici Brief, *supra* note 7, at \*2.

223. *Id.* at \*4-5 (citations omitted).

224. *Id.* at \*23-24 (citing Josh Friedman, *FleetBoston, BofA to Pay \$675 Million*, L.A. TIMES, Mar. 16, 2004).

225. See *Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418, 1425 (2010).

226. INV. CO. INSTIT., 2013 INVESTMENT COMPANY FACT BOOK 142 (53d ed. 2013), [http://www.ici.org/pdf/2013\\_factbook.pdf](http://www.ici.org/pdf/2013_factbook.pdf).

227. *Id.*

accounts has grown from 296,000 to 264,131,000.<sup>228</sup> Investors generally expect mutual funds to be relatively safe, well-regulated investments; over 44 percent of households in the United States own shares of mutual funds.<sup>229</sup> Further, ninety-three percent of mutual fund investors are saving for retirement.<sup>230</sup> Given these numbers, Justice Thomas' *Janus* opinion creates the potential for real harm.

The 1940 Act was enacted because of Congress' "concern with the potential for abuse inherent in the structure of investment companies"<sup>231</sup> and its realization "that the relationship between a fund and its investment adviser was fraught with potential conflicts of interest[.]"<sup>232</sup>

Before the enactment of the 1940 Act, there were widespread abuses by investment companies and their sponsors, resulting in disastrous consequences to investors.<sup>233</sup> According to SEC estimates, investors lost forty percent of their investment company investments from 1929 to 1936, and numerous funds failed.<sup>234</sup> As a result, Congress commissioned a comprehensive study of the investment company industry in 1935, referred to as the "Investment Trust Study," which confirmed alarming abuses endemic in the industry.<sup>235</sup> Investors, who were generally unsophisticated, were frequently misled and "often did not understand their rights, the sales charges they were obligated to pay, or how the investment company's manager was managing the company's assets."<sup>236</sup> In short, "investment companies were being organized and operated to benefit the interests of their affiliates rather than the interests of their shareholders."<sup>237</sup> Funds were structured so that "unscrupu-

228. *Id.*

229. *See, e.g., id.* at 90; Press Release, Sec. & Exch. Comm'n, SEC Seeks Public Comment on Use of Derivatives by Mutual Funds and Other Investment Companies (Aug. 31, 2011) [hereinafter SEC Fact Sheet], available at <http://www.sec.gov/news/press/2011/2011-175.htm>; *see also* COMM. ON FED. REGULATION OF SECS., ABA SECTION OF BUS. L., REPORT OF THE TASK FORCE ON INVESTMENT COMPANY USE OF DERIVATIVES AND LEVERAGE 3 (2010).

230. 2013 INVESTMENT COMPANY FACT BOOK, *supra* note 226, at 91.

231. *Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418, 1422 (2010) (quoting *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984)) (internal quotation marks omitted).

232. *Id.* (quoting *Daily Income Fund*, 464 U.S. at 536-38) (internal quotation marks omitted).

233. *See, e.g.,* Paul F. Roye, Dir., Div. of Inv. Mgmt., Sec. & Exch. Comm'n, Remarks at the American Law Institute/American Bar Association Investment Company Regulation and Compliance Conference: The Exciting World of Investment Company Regulation (June 14, 2001) [hereinafter Roye Speech], available at <http://www.sec.gov/news/speech/spch500.htm>.

234. *Id.*

235. *Id.*

236. *Id.*

237. *Id.*

lous” sponsors remained in control, and conflicts of interest were rampant.<sup>238</sup> The investment company industry was so corrupt that some suggested that it was a “parasite upon the stream of industrial earnings, levying a toll upon the yield of blue chip companies, resulting in unnecessary administrative costs and taxes that were not economically justified.”<sup>239</sup>

In light of these problems, Congress, the SEC and the industry worked diligently together to come up with the 1940 Act, which was “truly a negotiated statute.”<sup>240</sup> The 1940 Act is an extremely complicated, creative statute that borrowed concepts from the 1933 Act, the 1934 Act, the banking laws, the Public Utility Holding Company Act of 1935, the Chandler Act (which regulated bankruptcies), and even the Civil Aeronautics Act; however, the 1940 Act contains many wholly original provisions unique to the investment company industry.<sup>241</sup> It is unfortunate that its doctrinal underpinnings and practical realities were disregarded by the *Janus* Court.

### B. Mutual Fund Structure and Adviser Control

It is well accepted, even by the Supreme Court, that mutual funds are significantly different than typical operating companies.<sup>242</sup> The “extraordinary degree of control” exerted by investment managers over their funds has been recognized by each of the three branches of the United States government.<sup>243</sup> In its unanimous 2010 opinion, *Jones v. Harris Associates L.P.*,<sup>244</sup>

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238. *Id.* Specifically, sponsors often viewed the funds’ assets as their own “source of private capital,” and embezzlements were common. *Id.* Further, improper transaction between the funds and affiliates of the sponsors were often detrimental to investors. *Id.* For example, underwriters often dumped unmarketable securities into their affiliated funds. *Id.*

239. *Id.*

240. *Id.*

241. *Id.* It should be noted that neither the 1940 Act nor the Investment Adviser’s Act of 1940 contain an express private right of action for fraudulent activity, and although some courts have implied private rights under the 1940 Act, “the strong trend is against recognizing implied private rights under the federal securities laws.” Clifford J. Alexander & Arthur C. Delibert, *Private Rights of Action*, in MONEY MANAGER’S COMPLIANCE GUIDE ¶ 1070 (2010). Further, “although each of the major federal securities statutes contains a provision providing that contracts made in violation of the statute are void . . . [t]he Supreme Court has held that such provisions provide an implied private right of action only for rescission of the contract.” *Id.* (citing *Transamerica Mortg. Advisors Inc. v. Lewis*, 444 U.S. 11 (1979)).

242. See, e.g., U.S. *Janus* Amicus Brief, *supra* note 7, at \*18-19 (citing *Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418, 1422 (2010)).

243. Law Professors’ *Janus* Amici Brief, *supra* note 7, at \*3. The SEC has also noted that “the term investment adviser is to some extent a misnomer because [t]he so-called adviser is no mere consultant. He is the fund’s manager. Hence the investment adviser almost always controls the fund.” *Id.* at \*9 (quoting *In re Steadman Sec. Corp.*, 46 S.E.C. 896, 920 n.81 (1977)) (internal quotation marks omitted). Fur-



the Supreme Court acknowledged the unique relationship between an adviser and a mutual fund:

A separate entity called an investment adviser creates the mutual fund, which may have *no employees of its own*. The adviser selects the fund's directors, manages the fund's investments, and provides other services. Because of the relationship between a mutual fund and its investment adviser, *the fund often cannot, as a practical matter sever its relationship with the adviser*. Therefore, the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.<sup>245</sup>

Investment advisers are “essentially responsible for writing the prospectus.”<sup>246</sup> Although mutual fund boards sign off on the prospectus language, they turn to the adviser to “vouch for the statements made therein.”<sup>247</sup> The Law Professors' *Janus Amici* Brief articulately explained:

Were one to conclude that the manager does not make the statements, misleading or otherwise, in a fund prospectus, one would be left to wonder *who does*. To answer that the fund makes such statements would be to admit circuitously that the manager does so, inasmuch as the fund has no employees and its only officers are

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ther, “even the managers' own trade association has reported the extensive degree to which managers run their funds, prepare fund prospectuses, and incur consequent liability.” *Id.* at \*14 (citing Brief for the Investment Company Institute as Amicus Curiae Supporting Respondent at 18, *Jones*, 130 S. Ct. 1418 (No. 08-586), 2009 WL 2896317 (stating that “[m]utual fund advisers . . . prepare prospectuses, shareholder reports and other disclosures for which they have liability under the securities laws”).

244. *Jones*, 130 S. Ct. 1418 (defining the parameters of an investment adviser's fiduciary duty with respect to fees it charges a mutual fund). Justice Alito penned the unanimous decision, and Justice Thomas filed a concurring opinion. *Id.* at 1421.

245. *Id.* (alterations in original) (emphasis added) (citations omitted) (internal quotation marks omitted); see also, e.g., Hale, *supra* note 171 (detailing the “entrenched” relationship between a mutual fund and its management company, and recalling only one instance in which a mutual fund board fired its management company, which was “hailed as a ‘watershed event for the fund industry’”).

246. Hale, *supra* note 171; see also, e.g., Law Professors' *Janus Amici* Brief, *supra* note 7, at \*19 (“The [*Janus*] complaint alleges, and industry practice supports the contention, that the fund manager ‘wrote and represented [its] policy against market timers . . .’”); Farris, *supra* note 48.

247. Hale, *supra* note 171 (“If the fund's board cannot rely on the information they are receiving from the management company, I wonder where the Court supposes they should turn?”); see also, e.g., Farris, *supra* note 48 (noting that “the prospectus and most significant SEC filings would generally be approved by the fund's board of directors”).

employees of the manager, who pays their salaries. To answer that the board of trustees makes such statements would be to misunderstand fundamentally the process by which hundreds of pages of mandatory disclosure are created for each fund every year, a production from which trustees are almost entirely absent. In fact, *the detailed and extensive content of fund disclosure is furnished almost exclusively by the one entity who knows that information: the investment manager actually operating the fund.*<sup>248</sup>

In comparing a mutual fund to “a microphone and speakers: necessary instrumentalities that insentiently broadcast the principal’s message,” the Law Professors’ *Janus Amici* Brief stated:

The investment manager, of course, *is always the principal*, writing and broadcasting the communications of its funds. And courts have long since ceased to find inanimate objects guilty for the wrongdoings of those who wield them.<sup>249</sup>

The SEC articulately rebuffed the notion of the investment adviser as a secondary actor in its *Janus Amicus* Brief:

Although [Adviser] [like the corporate officers who would more typically manage a company’s operations] was subject to oversight by the Funds’ trustees, [Adviser] *is alleged to have performed the “insider” functions that corporate officers and employees would ordinarily perform, not the advisory role typically associated with outside service providers.* If [Adviser] created statements for the Funds’ prospectuses that misled investors about how the Funds combated market timing, it can be held liable for its own “direct[]

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248. Law Professors’ *Janus Amici* Brief, *supra* note 7, at \*6-7 (emphasis added). An interesting question arises as to the liability of individual directors:

The mutual funds’ directors signed the registration statements of the mutual funds on whose boards they sit. Yet *Janus* suggests that individual directors, alone, cannot be considered to have “made” the statements because they alone do not have “authority over the content of the statement and whether and how to communicate it”; only the board as a whole does.

Jay G. Baris, Jordan Eth, & Mark David McPherson, *U.S. Supreme Court Limits Reach of Primary Liability in Securities Fraud Cases*, BUS. L. TODAY, July 2011, at 2.

249. Law Professors’ *Janus Amici* Brief, *supra*, note 7, at \*7 (emphasis added) (citing *Calero-Toledo v. Pearson Yacht Leasing Co.*, 416 U.S. 663, 682 (1974) for the proposition that “[d]eodands did not become part of the common-law tradition of this country”).

or indirect[]” statements to the market. As courts have recognized in the context of conduits and publicly unidentified corporate employees, such cases involve primary liability, not aiding-and-abetting liability, because the defendant is being held liable for its own conduct – not for merely assisting someone else.<sup>250</sup>

The *Janus* Court’s requirement that aggrieved fund investors must sue the fund, which holds no assets other than those of such investors,<sup>251</sup> rather than a fraudulent adviser, is troublesome because such an adviser would be highly motivated to hide its own deceit. For example, in *Janus*, the Adviser “was the only entity which [sic] had a motivation to hide the market timing investments . . . [as it] received additional management fees based on these investments.”<sup>252</sup> In sum, *Janus* does real harm: it allows a deceitful manager to “coordinate all major aspects of a mutual fund”<sup>253</sup> for fraudulent purposes, while it reaps increased fees, hides its deceit and avoids Rule 10b-5 liability. Such an outcome must be rectified.

### C. The Mutual Fund Board

Practically speaking, in performing their oversight function, mutual fund boards rely heavily on the investment adviser.<sup>254</sup> A critical feature of the 1940 Act, as amended in 1970, is the requirement that no more than 60 percent of the directors of a fund are “interested persons”, meaning that they have no affiliation with or interest in the investment adviser.<sup>255</sup> Such “disinterested directors” are intended to serve as “independent watchdogs of the relationship between a mutual fund and its adviser.”<sup>256</sup> However, as noted in the United States *Janus Amicus* Brief, the 1940 Act provisions providing for disinterested directors “simply ensure that a fund’s board of directors can ‘supply an independent check on [the investment adviser’s] management.’”

250. U.S. *Janus Amicus* Brief, *supra* note 7, at \*23 (emphasis added).

251. See Law Professors’ *Janus Amici* Brief, *supra* note 7, at \*2; Farris, *supra* note 48. Notably, with respect to securitizations, aggrieved holders of securities may have no other recourse than to sue the special purpose vehicle that issued the securities. See *id.*

252. Farris, *supra* note 48.

253. Law Professors’ *Janus Amici* Brief, *supra* note 7, at \*13; see *supra* note 172 for a discussion of the amount of mutual fund control that a manager must exert in order to perpetrate a market timing fraud.

254. See, e.g., Hale, *supra* note 171 (“And where does the board get the information they [sic] need in order to provide their [sic] oversight? Well, from the management company, of course.”).

255. 15 U.S.C. §§ 80a-2(a)(19), 80a-10(a) (2006); see also, e.g., *Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418, 1422-23 (2010).

256. *Jones*, 130 S. Ct. at 1427 (internal quotation marks omitted) (citing *Burks v. Lasker*, 441 U.S. 471, 484 (1979)).

*The board's oversight role does not change the fact that the adviser continues to provide the management.*"<sup>257</sup>

The Supreme Court in *Jones* recognized that a mutual fund board's oversight role may be compromised in certain situations because of its heavy dependence on the adviser; in such circumstances, greater scrutiny of board actions is warranted.<sup>258</sup> Specifically, the *Jones* Court noted that, with respect to adviser compensation, although "a measure of deference to a board's judgment may be appropriate in some instances . . . the appropriate measure of deference varies depending on the circumstances."<sup>259</sup>

[W]here the board's process was deficient or the adviser withheld important information, *the court must take a more rigorous look at the outcome.* When an investment adviser fails to disclose material information to the board, *greater scrutiny is justified because the withheld information might have hampered the board's ability to function as 'an independent check upon the management.'* But an adviser's compliance or noncompliance with its disclosure obligations is a factor that must be considered in calibrating the degree of deference that is due a board's decision to approve an adviser's fees. . . . '[P]otential conflicts [of interest] may justify some restraints upon the unfettered discretion of even disinterested mutual fund directors, particularly in their transactions with the investment adviser'....<sup>260</sup>

In this light, Justice Thomas' reliance on the "corporate separateness" of Adviser and Fund in the *Janus* opinion seems grossly misplaced. By disregarding the important practical realities and doctrinal foundations of mutual fund law and practice highlighted above, *Janus* potentially disadvantages all mutual fund investors. Using *Central Bank's* ominous opener, "[t]hat bodes ill for" the ninety-three percent of mutual fund investors who are counting on their mutual fund investments for safe and comfortable retirements.<sup>261</sup>

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257. U.S. *Janus* Amicus Brief, *supra* note 7, at \*18 (emphasis added) (citations omitted).

258. *Jones*, 130 S. Ct. at 1429-30.

259. *Id.* at 1421.

260. *Id.* at 1430 (emphasis added) (citations omitted).

261. 2013 INVESTMENT COMPANY FACT BOOK, *supra* note 226, at 90-91.

V. POST-*JANUS* CONFUSION

The *Janus* opinion has spawned many contradictory lower court decisions over a variety of issues created by Justice Thomas' opinion.<sup>262</sup> This Part summarizes the confusing aftermath created by *Janus*.

A. *Questions Regarding Janus' Impact on Public Suits Under Rule 10b-5, § 17(a) of the 1933 Act, and Other Laws*

Historically, the SEC has typically charged corporate executives with violations of §10(b) of the 1934 Act and §17(a) of the 1933 Act in enforcement actions.<sup>263</sup> Section 17(a), which does not provide a private right of action,<sup>264</sup> provides:

(a) It shall be unlawful for any person in the *offer or sale* of any securities (including security-based swaps) or any security-based swap agreement (as defined in section 78c(a)(78) [§ 3(a)(78)] of [the Securities Exchange Act]) by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly

(1) *to employ any device, scheme, or artifice to defraud, or*

(2) *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; or*

(3) *to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.*<sup>265</sup>

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262. See, e.g., Jonathan K. Youngwood, Bruce D. Angiolillo & Jason B. Gumer, *Lower Courts Seek to Answer Janus's Open Questions*, 8 SECURITIES LITIGATION REPORT 1 (2011).

263. See, e.g., ROBERT P. HOWARD, JR., LAW360, IN PURSUIT OF FINANCIAL FRAUDSTERS (2011), <http://www.mmlawus.com/Data/Files/Articles/InPursuitOfFinancialFraudsters.pdf>. As referenced throughout this article, the SEC also pursues violators under other applicable laws, including pertinent sections of the 1933 Act, the 1934 Act, the Advisers Act, 1940 Act, and the Trust Indenture Act.

264. See, e.g., Farris, *supra* note 48.

265. 15 U.S.C. § 77q(a) (2006) (emphasis added). Sections 17(a)(1) and (3) are associated with "scheme liability." See, e.g., HOWARD, *supra* note 263, at 4; see also *supra* notes 119-52 and accompanying text (discussing Rule 10b-5 scheme liability).

It should be noted that, although §17(a) uses parallel language to Rule 10b-5, it does not use the word “make” in connection with material misstatements or omissions, but rather prohibits “obtain[ing] money or property” in connection therewith.<sup>266</sup>

Although *Janus* specifically dealt with the private Rule 10b-5 right of action, the impact on the public right of action was immediately manifested; within a month of the decision, the SEC withdrew several primary Rule 10b-5 claims against corporate executives and substituted aiding and abetting claims instead.<sup>267</sup> The SEC noted in its withdrawal papers that, due to the *Janus* Court’s focus on the definition of “make” in Rule 10b-5(b), the decision in no way affected the analysis under Rule 10b-5(a) or (c).<sup>268</sup>

In *SEC v. Kelly*,<sup>269</sup> *Janus*’ threat to government enforcement efforts became realized.<sup>270</sup> In *Kelly*, the SEC asserted scheme liability claims under Rule 10b-5 and §17(a) of the 1933 Act against America Online Inc. executives who, the SEC claimed, “engineered, oversaw, and executed a scheme to artificially and materially inflate the Company’s reported online advertising revenue.”<sup>271</sup> The district court dismissed the SEC’s Rule 10b-5 claims, holding that Rule 10b-5 scheme liability is inapplicable where the alleged scheme’s “primary purpose and effect . . . is to make a public misrepresentation or omission[.]”<sup>272</sup> The court also dismissed the § 17(a) claims, opining that § 17(a) was “essentially the same” as Rule 10b-5, despite the difference in language.<sup>273</sup>

266. 15 U.S.C. § 77q(a)(2).

267. HOWARD, *supra* note 263, at 2 (citing *SEC v. Big Apple Consulting USA, Inc.*, 6:09-cv-01963, 2011 WL 3759916 (M.D. Fla. Aug. 25, 2011); Docket entry no. 83 (July 28, 2011) in that same matter)).

268. *See id.* (citing *Big Apple Consulting*, 2011 WL 3759916, Mot. for Leave to File a First Am. Compl. by S.E.C.).

269. 817 F. Supp. 2d 340 (S.D.N.Y. 2011).

270. *See, e.g.*, Gregory S. Bruch & James C. Dugan, *District Court, Applying Janus Broadly, Rules Against the SEC in Securities Fraud Case*, 4 FIN. FRAUD L. REP. 156, 156 (2012).

271. Complaint at ¶¶ 1-3, *Kelly*, 817 F. Supp. 2d 340 (No. 08-cv-04612); *see* HOWARD, *supra* note 263, at 2.

272. *Kelly*, 817 F. Supp. 2d at 343; *see also* HOWARD, *supra* note 263, at 3.

273. *Kelly*, 817 F. Supp. 2d at 345; *see also* HOWARD, *supra* note 263 (noting that, two weeks after the *Kelly* decision, the SEC filed suit in *SEC v. Sells*, No. 11-cv-04941, 2012 U.S. Dist. LEXIS 112450 (N.D. Cal. Aug. 10, 2012), asserting scheme liability (with no allegations of misstatements or omissions) under Rule 10b-5 and § 17(a) against two sales executives); Complaint, *Sells*, 2012 WL 3242551). *Sells* held that the SEC had alleged violations “beyond the making of material misstatements or omissions” and that *Janus* did not prohibit scheme liability claims under Rule 10b-5(a) and (c). *Sells*, 2012 U.S. Dist. LEXIS 112450, at \*20-21 (citing *SEC v. Lucent Technologies, Inc.*, 610 F. Supp. 2d 342, 359-60 (D.N.J. 2009)). *Sells* further held that *Janus* was inapplicable to claims under § 17(a). *Id.* at \*22.

Shortly after *Kelly*, the SEC's Chief Administrative Law Judge followed the *Kelly* court's analysis, opining that *Janus* prohibits scheme liability involving misstatements under Rule 10b-5 and § 17(a) where the defendant was not the maker of the misstatement.<sup>274</sup> The judge also held that despite the difference in language, the standard for primary liability under §17(a) and Rule 10b-5 was the same.<sup>275</sup> Thereafter, the Central District of California in *SEC v. Perry*<sup>276</sup> agreed that *Janus* is applicable to SEC claims under both § 17(a) and Rule 10b-5.<sup>277</sup>

Other courts have refused to extend *Janus* to SEC enforcement actions. For example, in *SEC v. Daifotis*,<sup>278</sup> the United States District Court for the Northern District of California held that *Janus* was inapplicable to suits under § 17(a) and also under § 34(b) of the 1940 Act, but applied *Janus* to the SEC's Rule 10b-5(b) claims.<sup>279</sup> The court stressed that “*Janus* was not a touchstone to change myriad laws that happen to use the word ‘make’ – it

274. *In re Flannery*, Release No. 438, 42-43, 42 n.69 (ALJ Oct. 28, 2011); see, e.g., HOWARD, *supra* note 263, at 3-4; Bruch & Dugan, *supra* note 270, at 159.

275. *In re Flannery*, Release No. 438, at 42 n.70; see HOWARD, *supra* note 263, at 4; see also, e.g., Ethan Brown, ‘*Janus Capital*’ Will Likely Provide Powerful Defense Against SEC, WEINGARTEN BROWN LLP (Nov. 8, 2011), <http://www.wbllp.com/blog/archives/2011/11> (“This decision is significant because it suggests that there is increasing momentum for an expansive view of *Janus Capital*, applying it broadly against the SEC and to Section 17(a) in addition to 10(b). . . . As a result, *Janus Capital* appears increasingly to provide defendants with a powerful defense against the SEC.”).

276. *SEC v. Perry*, 2012 U.S. Dist. LEXIS 76018, at \*21-22 (C.D. Cal. May 31, 2012), *partial summary judgment granted by* 2012 U.S. Dist. LEXIS 136596 (C.D. Cal. Sept. 24, 2012) (dismissing remaining claim under § 17(a)(2)).

277. Other courts have applied *Janus* to Rule 10b-5 claims by the SEC. See, e.g., *SEC v. Carter*, No. 10 C 6145, 2011 U.S. Dist. LEXIS 136599 (N.D. Ill. Nov. 28, 2011); *SEC v. Das*, No. 8:10CV102, 2011 WL 4375787 (D. Neb. Sept. 20, 2011). Further, after the *Janus* opinion was issued, the SEC on its own accord withdrew certain claims under § 10(b) and Rule 10b-5 and substituted aiding and abetting claims. See *supra* note 267 and accompanying text.

278. No. C 11-00137 WHA, 2011 WL 3295139 (N.D. Cal. Aug. 1, 2011); see also HOWARD, *supra* note 263.

279. *Daifotis*, 2011 WL 3295139, at \*6. Section 34(b) of the 1940 Act provides:

It shall be unlawful for any person to *make* any untrue statement of a material fact in any registration statement, application, report, account, record, or other document filed or transmitted.

15 U.S.C. § 80a-33(b) (2006) (emphasis added). The court also noted that *Janus*' “stringent reading of the word ‘make’ followed from the Court's prior decisions limiting the scope of implied private rights of action under Rule 10b-5, and the same rationale does not apply in the context of Section 34(b) because there is already no private right of action under Section 34(b) claims.” *Daifotis*, 2011 WL 3295139, at \*6; see also Youngwood, Angiolillo, & Gumer, *supra* note 262.

was a decision interpreting primary liability under Rule 10b-5.”<sup>280</sup> The Northern District of Ohio, in *SEC v. Geswein*, also ruled that claims under § 17(a), along with Rule 10b-5 scheme liability claims, remain unaffected by *Janus*.<sup>281</sup> Numerous courts have followed this line of reasoning.<sup>282</sup>

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280. *Daifotis*, 2011 WL 3295139, at \*6; *see also* Youngwood, Angiolillo, & Gumer, *supra* note 262; Bruch & Dugan, *supra* note 286, at 159.

281. No. 5:10CV1235, 2011 WL 4565861, at \*2 (N.D. Ohio Sept. 29, 2011) (noting that the SEC had conceded that it could not maintain a claim under Rule 10b-5(b) in light of *Janus*); *see also* Youngwood, Angiolillo, & Gumer, *supra* note 262.

282. *See, e.g.*, *SEC v. Big Apple Consulting USA*, No. 6:09-cv-1963-Orl-28GJK, 2012 U.S. Dist. LEXIS 111923 (M.D. Fla. Aug. 9, 2012) (noting that the SEC had withdrawn its claims under §10(b) and Rule 10b-5 after the issuance of the *Janus* opinion, but holding that *Janus* was not applicable to claims under §17(a)); *SEC v. Sentinel Mgmt. Grp., Inc.*, No. 07 C 4684, 2012 WL 1079961 (N.D. Ill. Mar. 30, 2012); *SEC v. Radius Capital Corp.*, No. 2:11-cv-116-FtM-29DNF, 2012 U.S. Dist. LEXIS 26648 (M.D. Fla. Mar. 1, 2012) (applying *Janus* to the SEC’s Rule 10b-5(b) claim, but not to its §17(a) claim); *Sells*, 2012 U.S. Dist. LEXIS 112450; *SEC v. Pentagon Capital Mgmt. PLC*, 844 F. Supp. 2d 377 (S.D.N.Y. 2012), *aff’d in part, vacated in part, and remanded*, 2013 U.S. App. LEXIS 16402 (2d Cir. Aug. 8, 2013); *SEC v. Stoker*, 865 F. Supp. 2d 457 (S.D.N.Y. 2012) (finding that *Janus* was inapplicable to the SEC’s §17(a)(2) and (3) claims); *SEC v. Mercury Interactive, LLC*, No. 5:07-cv-02822-WHA, 2011 U.S. Dist. LEXIS 134580 (N.D. Cal. Nov. 22, 2011) (holding that *Janus* did not bar the SEC’s claims under Rule 10b-5(a) and (c), § 17(a) or § 14(a) (which prohibits proxy solicitation “by means of” misleading or false statements)).

Interestingly, the *Pentagon* district court decision, which held that *Janus* did not bar the SEC’s claims under Rule 10b-5 (a) and (c) or § 17(a), created a split in the Southern District of New York regarding *Janus*’ applicability to SEC enforcement actions, as it contradicted *Kelly*. *See, e.g., New Decision Creates Split in Southern District of New York over Janus Decision*, VINCENT & ELKINS (Feb. 24, 2012), [http://www.welaw.com/resources/pub\\_detail\\_print.aspx?id=20661](http://www.welaw.com/resources/pub_detail_print.aspx?id=20661); *see also Stoker*, 865 F. Supp. 2d at 465-66; *SEC v. Garber*, 2013 U.S. Dist. LEXIS 57643, at \*16 n.50 (S.D.N.Y., Apr. 22, 2013) (noting the split in the district and stating that *Janus* textually does not extend to scheme liability claims under Rule 10b-5(a), (c) or § 17(a)(1)). The *Pentagon* district court noted that, even though *Janus* did not extend to SEC enforcement actions or to scheme liability claims, the *Pentagon* defendants, an investment adviser and its chief executive officer, indisputably had ‘authority over the content of . . . and whether and how to communicate’ . . . the late trades” at issue. *Pentagon*, 844 F. Supp. at 422-23 (citing *Janus*, 131 S. Ct. at 2303). Thus, the district court concluded that “[d]efendants’ ultimate authority over both the content of and the decision to make late trades as if they had been placed before 4 p.m. is undoubtedly sufficient under even the more stringent standard articulated in *Janus*.” *Id.* at 423. Without directly addressing the issue of whether *Janus* applies to SEC enforcement actions and scheme liability claims, the Second Circuit recently agreed with the district court and rejected the *Pentagon* defendants’ claims that they could not be held liable under *Janus* “because they did not communicate directly with the mutual funds,” but rather executed trades through their brokers. *Pentagon*, 2013 U.S. App. LEXIS 16402, at \*19. The Second Circuit stated that “[t]o the extent that late trading



The confusion caused by *Janus* is most surely affecting the SEC's securities fraud enforcement efforts. For example, in February 2012, the SEC settled a high-profile case against two former Bear Stearns executives who allegedly deceived investors regarding hedge funds that were heavily invested in subprime mortgage-backed securities.<sup>283</sup> This settlement followed the executives' claim that, pursuant to *Janus*, they could not, as a matter of law, be liable for misstatements in monthly reports to investors for which they did not have "ultimate authority" because they merely assisted in the preparation of such reports.<sup>284</sup> The defendants also argued that scheme liability was inapplicable.<sup>285</sup> Although many factors likely influenced the SEC's decision to settle, it is telling that the federal district judge presiding over the case noted that the case was being "settled for, relatively speaking, chump change."<sup>286</sup> If this lowball settlement was due in any respect to *Janus*' flawed opinion, and if it is a harbinger of *Janus*-influenced lowball settlements to come, legislators and regulators should act to restore effective enforcement efforts.

*B. Statements by Executives and Other Employees – Who has “Ultimate Authority”?*

*Janus* left many questions unanswered regarding who has "ultimate authority" within a corporate entity;<sup>287</sup> the expected flood of litigation has

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requires a 'statement' in the form of a transmission to a clearing broker, we find that in this case, . . . [the defendants] were as much 'makers' of the statements as were the brokers . . . . The brokers may have been responsible for the act of communication, but . . . [defendants] retained ultimate control over both the content of the communication and the decision to late trade." *Id.* at 20 (finding that defendants' conduct "violated all three subsections of Rule 10b-5, not just subsection (b), which was the only subsection at issue in *Janus*").

283. Peter Lattman, *Bear Stearns Ex-Managers to Pay \$1 Million to Settle Fraud Case*, N.Y. TIMES DEALB%K (Feb. 13, 2012, 9:51 a.m.), <http://dealbook.nytimes.com/2012/02/13/bear-stearns-ex-managers-to-pay-1-million-to-settle-s-e-c-case/>.

284. See, e.g., *Ex-Bear Stearns Execs Ask Judge to Narrow SEC*, CRAIN'S N.Y. BUS. (Dec. 21, 2011), <http://www.crainsnewyork.com/article/20111221/FINANCE/111229968>.

285. *Id.*

286. Lattman, *supra* note 283. Pursuant to the settlement, one executive will disgorge \$700,000 in unlawful gains, pay a penalty of \$100,000, and be banned for the securities industry for three years; the other will disgorge \$200,000 in unlawful gains, pay a penalty of \$50,000, and be banned for two years. *Id.*; *Court Approves SEC Settlements with Two Former Bear Stearns Hedge Fund Portfolio Managers; SEC Bars Managers from Regulated Industries*, SEC Litigation Release No. 22398 (June 24, 2012), <http://www.sec.gov/litigation/litreleases/2012/lr22398.htm> (noting that the executives did not admit or deny the SEC's allegations).

287. See, e.g., *U.S. Supreme Court Decision May Limit Scope of Persons who Can Be Primarily Liable for Securities Fraud Under Rule 10b-5*, KING & SPALDING (June 16, 2011) [hereinafter King & Spalding Client Alert] <http://www.kslaw.com>

already begun, with varying results. As set forth below, some courts have held that *Janus* applies only to secondary actors and does not apply to corporate insiders at all. Other courts have held that *Janus* is applicable to corporate insiders, but the decisions vary widely in their analyses.

### 1. Courts Holding that *Janus*' "Ultimate Authority" Test Does Not Apply to Corporate Insiders

With respect to courts holding that *Janus* does not apply to corporate insiders, some have taken a "group pleading"<sup>288</sup> approach in determining who makes a statement for purposes of Rule 10b-5. For example, the United States District Court for the District of Colorado explained in *Touchstone Group, LLC v. Rink*<sup>289</sup> that "*Janus* involved a statement drafted by one organization on behalf of another such that the latter had ultimate authority over the statement" and that "[s]uch hierarchy does not apply in the case of a group-published statement published collectively by a corporation's directors and officers."<sup>290</sup>

Other courts that have rejected the group pleading doctrine<sup>291</sup> have nonetheless found *Janus*' ultimate authority test to be inapplicable to corpo-

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/imageserver/KSPublic/library/publication/ca061611b.pdf; 2012 Year-End Securities Litigation Update, GIBSON DUNN (Jan. 2013), <http://www.gibsondunn.com/publications/pages/2012-Year-End-Securities-Litigation-Update.aspx>.

288. The group pleading doctrine allows a presumption that group-published statements, such as those contained in press releases and annual reports, are attributable to those officers and directors within a corporate entity that have daily control or involvement with respect to ordinary company operations. See, e.g., *In re Merck Co. Sec. Derivative & "ERISA" Litig.*, MDL No. 1658, 2011 U.S. Dist. LEXIS 87578, at \*19 (D. N.J. Aug. 8, 2011). Many courts have held that the group pleading doctrine did not survive the heightened pleading requirements instituted by the PSLRA. See *infra* note 291 and accompanying text.

289. 913 F. Supp. 2d 1063 (D. Colo. 2012).

290. *Id.* at 1079. The court also noted that, using the *Janus* analysis, the plaintiff had adequately alleged that two of the defendants had ultimate authority over the statements at issue, as they were the company's chief legal counsel and chief financial officer, and "it appear[ed] likely that they possessed ultimate authority over any statement that they prepared or for which they were otherwise responsible." *Id.*

291. A decision from the U.S. District Court for the Southern District of New York noted that "each circuit court to have squarely addressed the issue" prior to *Janus* held that the group pleading doctrine did not survive the PSLRA. *In re UBS AG Secs. Litig.*, No. 07 Civ. 11225, 2012 U.S. Dist. LEXIS 141449 (S.D.N.Y. Sept. 28, 2012) (citing decisions from the Third, Fifth and Seventh Circuits rejecting the doctrine, but noting that the Tenth Circuit applied the doctrine without discussing whether it survived the PSLRA). The *UBS* court noted that, although the majority of district courts in the Southern District of New York held before *Janus* that the doctrine survived the PSLRA, numerous decisions have since found that the doctrine did not survive *Janus*. *Id.* at \*30-31.

rate officers and have allowed liability where misstatements can be attributed to such officers.<sup>292</sup> For example, the *Merck* court explained that the defendant officer made the statements attributed to him “pursuant to his responsibility and authority to act as an agent of Merck, not as in *Janus*, on behalf of some separate and independent entity.”<sup>293</sup> The court explained that *Janus* “certainly cannot be read to restrict liability for Rule 10b-5 claims against corporate officers to instances in which a plaintiff can plead, and ultimately prove, that those officers—as opposed to the corporation itself—had ‘ultimate authority over the statement.’”<sup>294</sup> Such a reading, “[t]aken to its logical conclusion, . . . would absolve corporate officers of primary liability for all Rule 10b-5 claims, because ultimately, the statements are within the control of the corporation which [sic] employs them.”<sup>295</sup>

Likewise, in *Sawant v. Ramsey*,<sup>296</sup> the United States District Court for the District of Connecticut upheld a jury instruction that stated that one is a “maker” of a statement if he is “involved with the production or dissemination of the statement, such as through drafting, producing, reviewing, or assisting with the preparation of the statement.”<sup>297</sup> Quoting *Merck*, the *Sawant* court explained that *Janus* “did not alter the well-established rule that a corporation can act only through its employees and agents.”<sup>298</sup>

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292. See *infra* Part V(D) (discussing how the lower courts have addressed the issue of attribution).

293. *In re Merck*, 2011 WL 34444199 at \*25.

294. *Id.*

295. *Id.*

296. No. 3:07-cv-980, 2012 U.S. Dist. LEXIS 112151 (D. Conn. Aug. 9, 2012).

297. *Id.* at \*41; see also *In re Fannie May 2008 Sec. Litig.*, 891 F. Supp. 2d 458 (S.D.N.Y. 2012) (stating that “[i]n the post-*Janus* world, an executive may be held accountable where the executive had ultimate authority over the company’s statement; signed the company’s statement; ratified and approved the company’s statement; or where the statement is attributed to the executive” (emphasis supplied)).

298. *Id.* at \*42-43 (quoting *Merck*, 2011 U.S. Dist. LEXIS at \*25) (internal quotation marks and citation omitted). Because of the obvious fact of a corporation’s dependence on its employees, an issue arises as to what constitutes scienter on behalf of a corporation; courts are split regarding the applicability of the “collective scienter doctrine,” which imputes the scienter of employees to issuers. See, e.g., King & Spaulding Client Alert, *supra* note 287; *In re Merck*, 2011 WL 3444199, at \*29 (finding that the complaint adequately alleged that the scienter of two officers could be imputed to the corporation). For a thorough discussion of this issue, see Browning Jeffries, *The Implications of Janus on Issuer Liability in Jurisdictions Rejecting Collective Scienter*, 43 SETON HALL L. REV. 491, 523-29 (2013) (noting three lines of cases with respect to the collective scienter doctrine: a “strong” version, in which the combined knowledge of all corporate employees may be imputed to a corporation without identifying the scienter of a specific individual; a “limited” version, in which the scienter of an identified managerial employee may be imputed even though such employee did not “make” the alleged misstatement; and a rejection of the doctrine

Courts holding that *Janus*' ultimate authority test does not apply to corporate insiders seem to be in the clear minority.<sup>299</sup> However, until the issue is uniformly resolved through the appellate process, ambiguity remains for investors, corporate insiders and issuers.

## 2. Courts Holding that *Janus*' "Ultimate Authority" Test Applies to Corporate Insiders

A majority of courts addressing the issue have held that *Janus*' ultimate authority standard applies to corporate insiders, but such courts have been inconsistent in their application of this standard.<sup>300</sup> As such, ambiguity remains in these jurisdictions as well.

An early and often-cited case applying the ultimate authority standard to corporate insiders, *Hawaii Ironworkers Annuity Trust Fund v. Cole*,<sup>301</sup> explained that *Janus*' "interpretation of the verb 'to make' is an interpretation of the statutory language in question in this case, and therefore cannot be ignored simply because the defendants are corporate insiders."<sup>302</sup> Applying that rationale, the *Hawaii Ironworkers* court held that the plaintiff had failed to state a Rule 10b-5 claim against the defendants, who allegedly manipulated accounting figures "in response to a mandatory directive" to increase profit margins and to "ensure their continued employment," because such defendants did not have ultimate authority over such statements.<sup>303</sup>

Likewise, in *Red River v. Mariner Systems, Inc.*,<sup>304</sup> a chief financial officer allegedly used unsubstantiated numbers in financial statements because he was concerned he would be fired if he did not do so; the United States District Court for the District of Arizona held that plaintiff's allegations were insufficient to demonstrate that the officer had ultimate authority over the statements.<sup>305</sup> However, the *Red River* court held that plaintiffs had adequately pled that another officer made statements where he allegedly "calculated and adjusted key numbers for the financial statements" and "had direct involvement in the preparation of false and misleading revenue projections and a business plan."<sup>306</sup>

In a slightly different scenario, the United States District Court for the Northern District of California held that "an executive who undisputably ex-

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altogether, allowing scienter to be imputed only where the individual who made the misstatement also possessed the required scienter).

299. See, e.g., Jeffries, *supra* note 298, at 510-11.

300. See, e.g., *id.* at 510-20.

301. No. 3:10CV371, 2011 U.S. Dist. LEXIS 98760 (N.D. Ohio Sept. 1, 2011).

302. *Id.* at \*10.

303. *Id.* at \*14-15.

304. No. CV 11-02589-PHX-FJM, 2012 U.S. Dist. LEXIS 90959 (D. Ariz. June 29, 2012).

305. *Id.* at \*17.

306. *Id.* at \*17-18 (internal quotations omitted).

exercised authority over his own [internal] non-casual statements with the intent and reasonable expectation that such statement would be relayed to the investing public should be deemed to be the person who ‘made’ the statements to the investing public (so long as it is proven that the statement was made to the investing public).<sup>307</sup> The *Daifotis* defendant made statements on an internal conference call with employees, who were financial consultants, but prefaced his remarks with a statement that the purpose of the call was to provide information that the consultants could pass on to their clients.<sup>308</sup> But in *Curry v. Hansen Medical, Inc.*,<sup>309</sup> allegations that a senior vice president who took actions to alter the company’s recognition of revenue were insufficient to demonstrate Rule 10b-5(b) liability where the court found that plaintiffs did not allege that the officer “made” any statements.<sup>310</sup> The United States District Court for the Northern District of California held that plaintiffs’ allegations that, “as a result of the decisions ... [the officer] took to manipulate ... [the company’s] financial results, he made it necessary and inevitable that false and misleading statements” would be communicated to investors were insufficient to state a claim.<sup>311</sup> Plaintiffs’ arguments that, because the officer was a disclosure committee member, he was responsible for accurate press releases and filings were also unavailing.<sup>312</sup>

Numerous other courts have applied *Janus*’ ultimate authority standard to corporate insiders, with varying results.<sup>313</sup> As discussed more fully in Part V(D), the issue of attribution is closely tied with the analysis of who has “ultimate authority” over a statement within a corporation, and there are numerous opinions regarding corporate insiders’ liability for signing or not signing

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307. SEC v. Daifotis, 874 F. Supp. 2d 870, 881 (N.D. Cal. 2012).

308. *Id.* at 880-81.

309. No. C 09-5094 CW, 2012 U.S. Dist. LEXIS 112449 (N.D. Cal. Aug. 10, 2012).

310. *Id.* at \*12-14.

311. *Id.* at \*12-13.

312. *Id.* at \*13.

313. See, e.g., Fezzani v. Bear, Stearns & Co., 716 F.3d 18 (2d Cir. N.Y. 2013); SEC v. Pentagon Capital Mgmt. PLC, 2013 U.S. App. LEXIS 16402 (2d Cir. N.Y. 2013); SEC v. Garber, 2013 U.S. Dist. LEXIS 57643 (S.D.N.Y. Apr. 22, 2013); *In re Longtop Fin. Tech. Ltd. Sec. Litig.*, 2012 U.S. Dist. LEXIS 91004 (S.D.N.Y. June 29, 2012); SEC v. Greenstone Holdings, Inc., 2012 U.S. Dist. LEXIS 44192 (S.D.N.Y. Mar. 28, 2012); *In re Smith Barney Transfer Agent Litig.*, 884 F. Supp. 2d 152 (S.D.N.Y. 2012); SEC v. Cartner, No. 10 C 6145, 2011 U.S. Dist. LEXIS 136599 (N.D. Ill. Nov. 28, 2011); *City of Roseville Emps. Ret. Sys. v. Energysolutions, Inc.*, 814 F. Supp. 2d 395 (S.D.N.Y. 2011); Youngwood, Angiolillo, & Gumer, *supra* note 262; Joseph B. Crace & Matthew M. Curley, *District Courts Grapple with U.S. Supreme Court’s Janus Decision*, THOMPSON REUTERS, Oct. 21, 2011, available at [http://newsandinsight.thomsonreuters.com/Securities/Insight/2011/10/\\_October/District\\_courts\\_grapple\\_with\\_U\\_S\\_Supreme\\_Court’s\\_Janus\\_decision/](http://newsandinsight.thomsonreuters.com/Securities/Insight/2011/10/_October/District_courts_grapple_with_U_S_Supreme_Court’s_Janus_decision/); Jeffries, *supra* note 298, at 510-20.

public documents.<sup>314</sup> Not surprisingly, the courts have been inconsistent in their approaches to this issue as well. Given the subtle variations in the fact patterns of each case, and the ambiguities inherent in the *Janus* standard, it is difficult to draw the “bright line” that Justice Thomas had hoped would be so evident.

### C. Statements by Wholly-Owned Subsidiaries

Conflicting decisions have also arisen regarding whether a parent corporation can be liable for the misstatements of its wholly-owned subsidiary.<sup>315</sup> In *City of Roseville Employees' Retirement System v. Energy Solutions, Inc.*, the United States District Court for the Southern District of New York held that a parent could face Rule 10b-5 liability for the statements of its wholly-owned subsidiary because the parent had “control over the content of the message, the underlying subject matter of the message, and the ultimate decision of whether to communicate the message.”<sup>316</sup> The court rejected the parent entity’s claim that it could not be liable under *Janus* because it was a legally distinct entity and because the allegedly misleading registration statements were attributed to its subsidiary, not to it.<sup>317</sup> Distinguishing *Janus*, the court held that, unlike the Manager in *Janus*, the parent, which was the selling shareholder in both of the offerings at issue, was the sole owner of shares in the subsidiary at the time of the initial public offering and planned to retain a controlling interest thereafter.<sup>318</sup> Further, the registration statements referenced the subsidiary’s agreement to indemnify the parent for material misstatements or omissions contained therein.<sup>319</sup> As such, the parent had “ultimate authority” over the alleged misstatements.<sup>320</sup>

However, in a subsequent decision, a different judge from the United States District Court for the Southern District of New York held that “it follows from *Janus* that Rule 10b-5 liability for a one-hundred percent shareholder of an entity ‘making’ a misleading statement is inappropriate; rather,

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314. See *infra* Part V(D).

315. See Youngwood, Angiolillo & Gumer, *supra* note 262; Farris, *supra* note 48, n.2 (noting that typically, the parent company is the listed company and would be responsible for statements in its prospectuses regarding its subsidiaries and that, if the subsidiary were the publicly traded issuer, then that issuer would presumably be responsible under *Janus* for statements in its prospectuses regarding its parent and its subsidiaries).

316. 814 F. Supp. 2d at 417-18; see also, e.g., Youngwood, Angiolillo & Gumer, *supra* note 262; Crace & Curley, *supra* note 313. See generally Farris, *supra* note 48.

317. *City of Roseville*, 814 F. Supp. 2d at 417-18.

318. *Id.*

319. *Id.*

320. *Id.*

section 20(a) is the appropriate source of liability.”<sup>321</sup> The *Optimal* court explained that the “[p]laintiffs’ attempt to avoid *Janus* by conflating shareholder control with ‘ultimate authority’” was unavailing, since the board of the subsidiary had the ultimate authority to issue the misleading documents in question, and not the parent.<sup>322</sup> The fact that the parent had the authority to select the subsidiary’s board did not change the court’s analysis.<sup>323</sup>

As with the analysis regarding corporate insiders discussed above in Part V(B), a post-*Janus* bright line seems elusive in the parent/ subsidiary context as well. Further, as with the corporate insider analysis, the issue of attribution is closely tied with the determination of parent liability. Ambiguities regarding the attribution analysis are discussed in Part V(D) below.

#### D. Determining Express and Implied Attribution

Lower courts applying *Janus* have varied widely in their interpretation of *Janus*’ statement that “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.”<sup>324</sup>

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321. *In re Optimal* U.S. Litig., No. 10 CIV 4095 SAS, 2011 U.S. Dist. LEXIS 119141, at \*21 (S.D.N.Y. Oct. 14, 2011); see Youngwood, Angiolillo & Gumer, *supra* note 262.

322. *In re Optimal*, 2011 U.S. Dist. LEXIS 119141 at \*16-17.

323. *Id.* Likewise, in *Reese v. BP Exploration (Alaska) Inc.*, 643 F.3d 681 (9th Cir. 2011), the court noted in dicta that even though trust documents provided that the defendant entity was responsible for the filings of the trust, such provision did “not demonstrate . . . [that the defendant] had ‘ultimate authority over the statement, including its content and whether and how to communicate it.’” *Id.* at 693 n.8 (quoting *Janus Capital Grp. v. First Derivative Trader*, 131 S. Ct. 2296, 2302 (2011) (emphasis omitted)).

324. *Janus*, 131 S. Ct. at 2302. *Janus*’ holding that statements in mutual fund prospectuses cannot be attributed to investment managers is particularly problematic. As articulately posited in the Law Professors’ *Amici* Brief:

Investment managers themselves strive consciously to form a public connection between themselves and their funds. When forming a new fund, the manager typically selects a name that blazons the manager’s brand upon the new fund by incorporating the manager’s name into the fund’s name. Hence, at each of the putatively autonomous funds at issue here features “Janus” in its name. Investment managers take direct and voluntary measures to persuade the marketplace to attribute the performance of their funds to the operations of their managers. The marketplace, in turn, reasonably does so. . . . As an empirical matter, the marketplace demonstrated its widespread attribution of

Further confusing courts is *Janus*' statement that "[m]ore may be required to find that a person or entity made a statement indirectly, but attribution is necessary."<sup>325</sup> This section surveys some of the caselaw developing regarding the attribution issue.

A substantial body of case law has developed regarding whether signatories of documents containing allegedly misleading statements are the "makers" of such statements under *Janus*. A clear majority of courts examining this issue under various factual scenarios have held that such signatories can be held liable under Rule 10b-5(b).<sup>326</sup> However, in certain limited circum-

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fund statements to investment managers: upon the public allegation of market timing in mutual funds, stock prices of the accused managers fell rapidly.

Law Professors' *Janus* Amici Brief, *supra* note 7, at \*8-9 (citing Riva D. Atlas, *Janus Capital Meets the Enemy and It Is Janus*, N.Y. TIMES, Nov. 13, 2003, at C1 (commenting that Janus Capital lost "more than 20 percent of market value of its shares in recent weeks")); *see also, e.g.*, U.S. *Janus* Amicus Brief, *supra* note 7, at \*29-32. It should be noted that, as a practical matter, it is commonplace in the market for issuers to use a legend on prospectuses and offering materials in which they expressly acknowledge their responsibility for most statements contained therein. *See, e.g.*, Farris, *supra* note 48, n.12 (noting also that "[u]nderwriters typically provide in underwriting agreements that the only statements attributable to them concern their name and address and the amount of the concession or reallowance in a public equity offering"). Further, market professionals are typically careful to prohibit reliance on any statement not contained in the prospectus. *See, e.g., id.* In light of the *Janus* decision, issuers may attempt to "reallocate attribution of some such statements to bankers, accountants, lawyers, industry research firms or other market participants . . ." *Id.* It is difficult to predict whether issuers will be successful in overcoming the inertia of past practice.

325. *Janus*, 131 S. Ct. at 2305 n.11; *see supra* note 190. One commentator has noted that the Court "mistakenly appeared to believe that absent attribution, a statement is not even *made*." Redwood, *supra* note 181, at 486 (emphasis added) ("If the Court wishes to hold, after *Stoneridge*, that a misstatement which never comes to the attention of the plaintiff is not one on which the plaintiff can be said to have relied, and then to deny recovery on that basis, that is one thing. But that does *not* mean that a misstatement was not actually *made* by the defendant, and the Court should not conflate what are in fact two separate elements of the Rule 10b-5 cause of action.").

326. *See, e.g., In re Smith Barney Transfer Agent Litig.*, 884 F. Supp. 2d 152 (S.D.N.Y. 2012) (citing *In re Stillwater Capital Partners Inc. Litig.*, 858 F. Supp. 2d 277 (S.D.N.Y. 2012)); *SEC v. Merkin*, 2012 U.S. Dist. LEXIS 155679 (S.D. Fla. Oct. 2, 2012); *In re Longtop Fin. Tech. Ltd. Sec. Litig.*, 2012 U.S. Dist. LEXIS 91004 (S.D.N.Y. June 29, 2012); *In re Pfizer Inc. Sec. Litig.*, Nos. 04 Civ. 9866 (LTS)(HBP), 05 MD 1688 (LTS), 2012 U.S. Dist. LEXIS 39454 (S.D.N.Y. Mar. 22, 2012); *SEC v. Brown*, 878 F. Supp. 2d 109 (D.D.C. 2012); *City of Roseville Emps. Ret. Sys. v. Energysolutions, Inc.*, 814 F. Supp. 2d 395 (S.D.N.Y. 2011); *SEC v. Carter*, No. 10 C 6145, 2011 U.S. Dist. LEXIS 136599 (N.D. Ill. Nov. 28, 2011); *SEC v. Das*, No. 8:10CV102, 2011 WL 4375787 (D. Neb. Sept. 20, 2011); *In re Merck Co. Sec. Derivative & "ERISA" Litig.*, MDL No. 1658, 2011 U.S. Dist. LEXIS 87578, at



stances, courts have found that signatory status is not enough to confer liability.<sup>327</sup>

Further, courts have differed on whether an entity's inclusion on an offering document cover page is sufficient to allege Rule 10b-5(b) liability. For example, the *Optimal* court held that a defendant's inclusion on the cover page of fund explanatory memoranda "alongside several other support professionals—including auditors, lawyers and custodians" was insufficient to establish liability under *Janus*.<sup>328</sup> However, *Scott v. ZST Digital Networks, Inc.* held that plaintiff had sufficiently alleged Rule 10b-5 liability against an underwriter whose name was "featured prominently on the offering documents" and who was alleged to be "the architect of the fraud."<sup>329</sup>

Other courts have found express attribution in the context of advertisements and press releases. For example, in *SEC v. Daifotis*, the United States District Court for the Northern District of California denied a defendant officer's motion for summary judgment with respect to fund advertising that included his picture and a quote attributed to him.<sup>330</sup> The court held that, even though the officer claimed that "he did not give" the quote and "did not recall" seeing the advertisement, the express attribution in the advertisement was sufficient to present the matter to a jury.<sup>331</sup> Further, *SEC v. Carter* held that attribution was appropriately alleged where a press release quoted the

\*19 (D. N.J. Aug. 8, 2011); Jeffries, *supra* note 298, at 518-20 (discussing whether Sarbanes-Oxley Section 302 certification constitutes express attribution).

327. See *Ho v. Duoyuan Global Water, Inc.*, 887 F. Supp. 2d 547, 576-77 (S.D.N.Y. 2012) (holding that plaintiffs had failed to sufficiently allege that audit documents signed by "Grant Thornton" could be attributed to Grant Thornton International, Ltd., "an umbrella organization comprised of independent registered public accounting firms world-wide," rather than its member firm, GT-Hong Kong, and stating that "[t]he fact that two parties share a similar name is not indicative that both may be held liable for the alleged misstatements, even if GTIL and GT-HK share close business ties"); see also *Merck*, 2011 WL 3444199, at \*28 (holding that allegations that an officer made actionable misrepresentations by signing certain SEC filings that were "knowingly or recklessly misleading based on their access to information that contradicted Merck's public statements" were insufficient under the PSLRA to plead scienter). Further, some argue that Sarbanes-Oxley § 302 certifications are not always indicative of ultimate authority. Jeffries, *supra* note 298, at 518-20.

328. *In re Optimal*, 2011 U.S. Dist. LEXIS 119141, at \*23-24.

329. 896 F. Supp. 2d 877, 889-90 (C.D. Cal. 2012) (citing *In re Allstate Life Ins. Co. Litig.*, Nos. CV-09-8162-PCT-GMS, CV-09-8174-PCT-GMS, 2012 WL 176497 (D. Ariz. Jan. 23, 2012) (holding that a claim under *Janus* had been stated against underwriters whose names were prominent and in bold type on the first page)); *In re Nat'l Century Fin. Enterprises, Inc.*, 846 F. Supp. 2d 828 (S.D. Ohio 2012) (stating that private placement memoranda with defendant's name prominently displayed on the front pages could be a "shared product").

330. 874 F. Supp. 2d 870, 877-78 (N.D. Cal. 2012).

331. *Id.*

defendant, listed him as the contact person and was attached to a Form 8-K signed by him.<sup>332</sup>

More complex scenarios arise in connection with claims of “implicit” attribution. For example, in *City of Roseville*, the United States District Court for the Southern District of New York held that even though allegedly misleading registration statements were expressly attributed to a subsidiary, such statements could also be implicitly attributed to the parent corporation as well.<sup>333</sup> The court reasoned that “[a] reasonable jury could find that, on the basis of the facts alleged..., [the parent’s] role went well beyond that of ‘a speechwriter draft[ing] a speech....’<sup>334</sup> Likewise, in *SEC v. Garber*, an attorney advisory opinion stating that certain debts could be converted to unrestricted stock certificates was attributable to defendants because they “solicited the advisory opinion and had ‘ultimate authority...over whether and how to communicate it,’ at least in the context of the alleged scheme.”<sup>335</sup> Further, *SEC v. Carter* held that the SEC had properly alleged attribution to defendant of a press release that was drafted by others in reliance on allegedly misleading information supplied by him; the fact that defendant allegedly reviewed and approved the releases before they were issued and was listed as a contact person was sufficient to allege that he was a “speaker.”<sup>336</sup> Other courts have found implicit attribution under a variety of factual scenarios.<sup>337</sup>

In sum, once again, it is hard to find the bright line with respect to the post-*Janus* caselaw. Legislators and regulators should remedy the ambiguities caused by *Janus*’ abstruse attribution language. In the interim, more confusing and conflicting lower court decisions can be expected.

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332. 2011 U.S. Dist. LEXIS 136599.

333. *City of Roseville Emps. Ret. Sys. v. Energysolutions, Inc.*, 814 F. Supp. 2d 395, 418 (S.D.N.Y. 2011).

334. *Id.* (citing *Janus*, 131 S. Ct. at 2302).

335. 2013 U.S. Dist. LEXIS 57643, at \*18 (S.D.N.Y. Apr. 22, 2013).

336. 2011 U.S. Dist. LEXIS 136599, at \*3-4, 6-7.

337. *See, e.g.*, *Red River v. Mariner Sys., Inc.*, No. CV 11-02589-PHX-FJM, 2012 U.S. Dist. LEXIS 90959, at \*17-18 (D. Ariz. June 29, 2012); *In re Pfizer, Inc. Sec. Litig.*, Nos. 04 Civ. 9866(LTS)(HBP), 05 MD 1688(LTS), 2012 WL 983548, at \*4 (S.D.N.Y. Mar. 22, 2012); *SEC v. Landberg*, 836 F. Supp. 2d 148, 155 (S.D.N.Y. 2011); *Jeffries*, *supra* note 298, at 515-16. However, implicit attribution was rejected in *Reese*, where the court noted in dicta that a trust’s SEC filings were not attributable to the defendant entity, even though the trust documents provided that the defendant entity was responsible for the filings of the trust. *Reese v. BP Exploration (Alaska) Inc.*, 643 F.3d 681, 693 n.8 (9th Cir. 2011). Likewise, *In re DVI Inc. Securities Litigation* rejected the implicit attribution of statements in a client’s Form 10-Q to a law firm. No. 03-5336, 2013 WL 56083 (E.D. Pa. Jan. 4, 2013).

*E. Liability Under §20(b)*

As intimated by the *Janus* dissent, liability under §20(a), which is dependent on a primary violation, will be greatly curtailed with the reality of fewer possible “makers” capable of making such a primary violation.<sup>338</sup> Thus, because the *Janus* Court reserved the issue of liability under §20(b), it is expected that this issue will soon be working its way through the lower courts.<sup>339</sup> Although plaintiffs have begun asserting §20(b) claims, only a couple of reported decisions have referenced such claims.

For example, in *City of Pontiac General Employees’ Retirement System v. Lockheed Martin Corp.*, the United States District Court for the Southern District of New York dismissed the plaintiff’s §20(b) claims because the complaint did “not allege any plausible alternative theory where defendants are not primary violators and yet can still be held liable on a secondary violation theory through controlling” the corporate defendant.<sup>340</sup> As such, the court did “not address the defendants’ argument that Section 20(b) does not create a private right of action that plaintiff can assert.”<sup>341</sup> Additionally, *Jackson v. Fischer* held that, because there were no “viable allegation[s] of primary liability,” plaintiff’s §20(b) must be dismissed.<sup>342</sup>

As noted by the *Janus* dissent, §20(b) “has been thought largely superfluous in 10b-5 cases,” and, as such, “[t]here is a dearth of authority construing §20(b).”<sup>343</sup> Congress should act to bring clarity to the area.

## VI. PROPOSED LEGISLATIVE AND REGULATORY FIXES

A legislative and regulatory response is necessary to correct the damage caused by the trilogy of decisions discussed herein and to provide investors with the level of redress envisioned by the seventy-third Congress, which faced the widespread financial abuses endemic in the economic disaster of the Great Depression. As noted by then-Commissioner Walter, “it is critical to investors, our securities markets, and our economy overall that these laws remain fully enforceable.”<sup>344</sup>

Simply stated, it should not be the law in the United States in 2013 that a deceitful manager can potentially coordinate every essential aspect of a

338. See, e.g., King & Spaulding Client Alert, *supra* note 287.

339. *Janus*, 131 S. Ct. at 2304 n.10 (citing Transcript of Oral Argument, *supra* note 202, at 6, 61).

340. 875 F. Supp. 2d 359, 375 (S.D.N.Y. 2012).

341. *Id.*

342. No. C 11-2753 PJH, 2013 U.S. Dist. LEXIS 36327, at \*25-26 (N.D. Cal. Mar. 15, 2013).

343. *Janus*, 131 S. Ct. at 2311 (Breyer, J., dissenting) (quoting 5B JACOBS, *supra* note 219, §§ 11-8, 11-72) (internal quotation marks omitted).

344. Walter, *supra* note 35 (emphasis added); see also *supra* note 36 and accompanying text.

mutual fund for fraudulent purposes, while it reaps increased fees, hides its deceit and avoids private Rule 10b-5(b) liability. Given the high percentage of the population relying on mutual funds for retirement support, the uncertain state of Social Security reserves, and the historic level of government deficits, action should be taken.

Policy arguments on both sides of the issue of whether to restore pre-*Central Bank* Rule 10b-5 liability center primarily around concerns with respect to securities class actions in general, including whether such suits effectively deter securities fraud, whether injured investors are adequately compensated, and how such suits affect the capital markets.<sup>345</sup>

As has been noted above, in this era of slashed regulatory budgets, it is important that the private right of action be firmly established in order to effectively combat securities fraud.<sup>346</sup> Although it is true that private plaintiffs may pursue certain expressly-enumerated causes of action against violators of the securities laws,<sup>347</sup> said provisions do not offer the breadth of the pre-*Central Bank* private Rule 10b-5 right. Further, state law avenues have been greatly curtailed by the SLUSA.<sup>348</sup> Finally, although the Fair Funds provision of Sarbanes-Oxley<sup>349</sup> allows the SEC to distribute monetary penalties to aggrieved investors in the small number of cases that it has the resources to prosecute, such amounts “cannot necessarily make the victims [of such frauds] whole.”<sup>350</sup> In this light, this Article suggests the following legislative and regulatory solutions.

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345. GAO Study, *supra* note 6, at 38. For an excellent analysis of arguments on both sides of the issue, *see id.* at 37-45.

346. *See, e.g., id.* at 6.

347. *See supra* note 88 and accompanying text. For an excellent discussion of current secondary liability provisions applicable to attorneys, investment banks, accountants, credit rating agencies, and securities analysts, *see* GAO Study, *supra* note 6, at 30-37; *see also, e.g.,* Stephen M. Sinalko & Maten Koch, “Janus Capital” and *Underwriter Liability Under Section 10(b) and Rule 10b-5*, *NEW YORK LAW JOURNAL*, July 12, 2011.

348. *See supra* note 111; *see, e.g.,* GAO Study, *supra* note 6, at 26, 30. SLUSA generally limits state causes of action for secondary liability to individual plaintiffs or classes of fifty or fewer. GAO Study, *supra* note 6, at 30 (citing 15 U.S.C. § 78bb(f)(5)(B)(ii) (2006)).

349. *See, e.g.,* GAO Study, *supra* note 6, at 27. Sarbanes-Oxley was enacted in 2002 to protect investors following several highly publicized accounting scandals. *See supra* notes 115-17 and accompanying text.

350. Walter, *supra* note 35. Prior to enactment of the Dodd-Frank Act, monies were only distributed to aggrieved investors if there was a disgorgement order; however, the Dodd-Frank Act added a provision to allow the SEC to distribute monetary penalties to investors where there is no disgorgement order. *See* 15 U.S.C. § 7246(a) (Supp. V 2011); GAO Study, *supra* note 6, at 28.

### A. Congress Could Amend §10 and §20

With respect to private aiding and abetting liability, Congress could simply revise §20 of the 1934 Act to expressly provide for a private cause of action, as has been proposed on previous occasions.<sup>351</sup> Nothing in the GAO Study commissioned by the Dodd-Frank Act would prevent Congress from revising §20 in this manner.

Further, with respect to the harm caused by *Janus*' strained interpretation of the word "make" in Rule 10b-5, Congress could revise §10(b) of the 1934 Act to expressly provide for a private cause of action for violations of §10(b), with a clear definition of "make" based on enumerated factors that parallel the "substantial participation test"<sup>352</sup> or the SEC's "creation" test,<sup>353</sup> rather than *Janus*' "ultimate authority" test.<sup>354</sup>

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351. See *supra* notes 107-18 and accompanying text.

352. See *supra* note 155 and accompanying text.

353. See *supra* notes 157-58 and accompanying text. For example, with respect to the determination of who "makes" a statement, one commentator has proposed a "benefits test" based on the Supreme Court's decisions in *Dirks v. SEC*, 463 U.S. 646 (1983), and *Pinter v. Dahl*, 486 U.S. 622 (1988). Redwood, *supra* note 181, at 508-10. In *Dirks*, the Court held that a tippee of inside information is not liable unless the insider providing such information has breached a duty by disclosing such information and the tippee knew or should have known of such breach; in determining whether such a breach existed, the Court looks to "whether the insider personally will benefit, directly or indirectly, from his disclosure." *Dirks*, 463 U.S. at 662; see also Redwood, *supra* note 181, at 508-09. Similarly, in *Pinter*, in determining who is a "seller" or "solicitor," the Supreme Court held that "liability extends only to the person who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner." *Pinter*, 486 U.S. at 647; see also Redwood, *supra* note 181, at 510. Thus, the proposed "benefits test" with respect to the "maker" of a statement would provide: "A 'maker' would include not merely the actual person who issues the false statement . . . but also any other related party who, *motivated at least in part by a desire to serve his own financial interests*, was in a position to promote or influence the creation and distribution of the misleading statements." Redwood, *supra* note 181, at 510 (emphasis added).

354. See *supra* notes 194-95 and accompanying text. Interestingly, the Dodd-Frank Act amended § 9 of the 1934 Act, 15 U.S.C. § 78i, captioned "Manipulation of Security Prices" to add two provisions that call into question the *Janus* Court's definition of "make" in Rule 10b-5. Pub. L. No. 111-203, § 762(d), 124 Stat. 1376 (2010) (codified at 15 U.S.C. § 78i(a)(4), (f)); see also Pekarek & Shingle, *supra* note 193; Harriet B. Alexson, *Intermediaries in Securities Transactions: Changes Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*, HARRIET B. ALEXSON L. (Nov. 15, 2011), <http://www.alexsonlaw.com/blog/intermediaries-in-securities-transactions-changes-under-the-dodd-frank-wall-street-reform-and-consumer-protection-act/>. Specifically, § 9(a)(4) provides that a dealer or broker may not "make . . . any statement" that is materially misleading for the purpose of inducing the purchase or sale of a security, and § 9(f) provides for a private right of action against anyone who "willfully participates" in any act in violation of § 9(a), (b) or (c). 15

As noted in the GAO Study, various commentators have proposed legislation for secondary actors that would incorporate liability limits with respect to such actors.<sup>355</sup> For example, one commentator has proposed a liability ceiling for secondary actors, which would deter fraudulent conduct, while keeping liability insurance premiums at a reasonable level and obviating the need for *in terrorem* settlements.<sup>356</sup> This expert proposed a ceiling of \$2 million for individuals and \$50 million for public corporations.<sup>357</sup>

Another proposal is to limit fraud-on-the-market damages to further the goal of deterrence, rather than compensation; such proposal would require defendants to disgorge their gains or expected gains and would not impose responsibility for all losses caused by the fraudulent activity.<sup>358</sup> Finally, some have proposed that aiding and abetting liability be limited to proportionate liability for those secondary actors with actual knowledge or intent to defraud.<sup>359</sup>

As previously discussed throughout this Article, Congress should act to protect investors left potentially vulnerable in the trilogy's aftermath.

### B. The SEC Could Amend Rule 10b-5

An alternative to congressional amendment of §10(b) would be administrative amendment of Rule 10b-5. Because the *Janus* Court referred only to Rule 10b-5 in its analysis, and not §10(b), it is possible that the SEC could amend the language of Rule 10b-5 to include persons who “create”, or “substantially participate in the making of” a material misstatement or omission, rather than merely those who “make” a material misstatement or omission. However, because the *Janus* Court purported to anchor its decision on *Central Bank* and *Stoneridge*, which had nothing to do with the definition of the

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U.S.C. § 78i(a)(4),(f) (emphasis added). The act of “willfully participat[ing]” in “mak[ing]” a misstatement seems to include more actors than the “maker” with ultimate authority, leaving quite a conundrum for lower courts presented with this provision. See, e.g., Alexson, *supra* (noting that “‘willingly participates’ is not defined[]” and that there is “no requirement in Section 9(f) that the willing participant have knowledge of the false statement, an intent to misrepresent a material fact, or even a careless disregard of the facts given to offerees”); Pekarek & Shingle, *supra* note 193.

355. GAO Study, *supra* note 6, at 37-45.

356. *Id.* at 44 (citing *Evaluating S.1551: The Liability for Aiding and Abetting Securities Violations Act of 2009: Hearing Before the Subcomm. on Crime and Drugs of the S. Comm. on the Judiciary*, 111th Cong. (2009) [hereinafter *Liability Hearing*] (statement of John C. Coffee, Jr.)).

357. *Id.* (citing *Liability Hearing*, *supra* note 356 (statement of John C. Coffee)).

358. See *id.* at 45 (citing *Liability Hearing*, *supra* note 356 (statement of Adam C. Pritchard)).

359. See *id.*

word “make” in Rule 10b-5(b), it is unlikely that the SEC would attempt this course.<sup>360</sup>

### *C. The SEC or Congress Could Require Advisors to Sign Fund Filings*

If the SEC or Congress were to act to require investment advisers to sign all fund filings, such advisers would become “makers” of statements contained therein under *Janus*, and thus subject to Rule 10b-5 liability.<sup>361</sup> However, extending this requirement broadly to other secondary actors would be problematic, as the extent of their individual involvement in the preparation of such filings may not warrant exposure to primary liability.

### *D. Rethinking of the Congenial Fund Board/ Adviser Relationship*

It has been suggested that mutual fund board members should be cautious after *Janus* to not rely so heavily on their investment adviser for information critical to their oversight function.<sup>362</sup> As has been thoroughly discussed herein, the mutual fund board’s reliance on its investment adviser is a firmly entrenched matter of practice and doctrine under the 1940 Act, with the one contemporary instance in which a board fired its adviser being “hailed as a ‘watershed event for the fund industry.’”<sup>363</sup> However, *Janus* has upset the proverbial applecart, placing board members in a particularly precarious position.

If *Janus* is not legislatively and administratively remedied, mutual fund board members must undertake a critical reanalysis of their relationship with their investment advisors, with a clear focus on their duties to their shareholders. Such a reanalysis would, without question, dynamically change the mutual fund industry as a whole.

## VII. CONCLUSION

As set forth herein, the Supreme Court’s trilogy of decisions constricting the Rule 10b-5 right of action has already begun to manifest harmful consequences with respect to private investor suits and agency-driven actions. In light of the high percentage of the U.S. population relying upon the perceived

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360. See Pritchard, *supra* note 9, at 137. Additionally, the Court’s statement that Rule 10b-5 could not be read to create “a theory of liability similar to – but broader in application than – what Congress has already created expressly” in § 20(a) would be prohibitive. See *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2304 (2011) (internal citations omitted); Pritchard, *supra* note 9, at 137.

361. See, e.g., Gordon, *supra* note 16.

362. See, e.g., Hale, *supra* note 171 (“Perhaps fund directors will . . . decide that their relationship with their fund’s management company deserves to be much less chummy and more adversarial.”).

363. See *id.*

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relative safety of mutual fund investments and the unfortunate reality of slashed regulatory budgets hindering securities fraud enforcement efforts, remedial action is necessary. As the nation's gatekeepers repeatedly demonstrate their fallibility with respect to vulnerable investors, our response cannot be "*caveat emptor*" where Rule 10b-5 actions are concerned. For the protection of investors and the capital markets, the Roberts Court's "pay no attention to the manager behind the mutual fund curtain" dictate should be replaced with meaningful reforms.