

THE JANUS-FACED SUPREME COURT:
THE DECISION IN *JANUS CAPITAL GROUP* AND
IMPLICATIONS OF THE COURT'S THIRD LOOK AT
SECONDARY LIABILITY FOR SECURITIES FRAUD

*Lisa P. Goldstein**

INTRODUCTION

Imagine you are a wealthy, sophisticated investor interested in investing in a hedge fund you have heard a lot about—let us call it Minerva Fund, Ltd., a Cayman Islands exempt company. Apparently, the fund has posted incredible returns, even as other funds have faltered because of the financial crisis of 2008 and the resulting poor economic environment. You call the fund's investment manager, Minerva Investment Management, LLC, and request an offering memorandum. It confirms what you have heard through the grapevine: the fund reports average returns of 17 percent over the last five years. You sign an agreement, thereby purchasing fund shares for one million dollars.

Within a month, the Securities and Exchange Commission ("SEC") begins investigating the fund. The SEC uncovers evidence that the fund overstated its returns in the offering memorandum. You and the other investors are victims of fraud, and you want to sue.

There are a number of sections of the federal securities laws pursuant to which you can bring your private right of action, but by far the most commonly used is the judicially created private right under Section 10(b) of the Securities and Exchange Act of 1934¹ ("Exchange Act") and Rule 10b-5 thereunder.² These provisions have been called the "general antifraud" provisions³ and a "catchall" for fraud,⁴ and together make unlawful any fraud or deceit "in connection with the purchase or sale of any security."⁵ Specifically, Rule 10b-5(b) makes it

* George Mason University School of Law, J.D. Candidate, May 2013; Associate Editor, *GEORGE MASON LAW REVIEW*, 2012-2013; University of Vermont, B.A., Economics, May 2008.

¹ Securities and Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (2006).

² 17 C.F.R. § 240.10b-5 (2012); see Lewis D. Lowenfels & Alan R. Bromberg, *SEC Rule 10b-5 and Its New Statute of Limitations: The Circuits Defy the Supreme Court*, 51 *BUS. LAW.* 309, 310 (1996) (calling private actions under the Exchange Act and Rule 10b-5 "the most common actions for relief by defrauded investors in our system").

³ *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 171 (1994).

⁴ *Id.* at 174 (quoting *Chiarella v. United States*, 445 U.S. 222, 234-35 (1980)).

⁵ 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5.

unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange . . . [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of any security.⁶

Considering your experience, it seems like you have an excellent case.⁷ Note, though, that you do not want to sue the fund. The hedge fund has no assets except for what you and other investors have put into it. It has no employees, and its board of directors consists of two lawyers from the firm in the Cayman Islands that took care of the incorporation. So, if you sued the fund you would, in essence, be suing yourself. The actual perpetrator of the fraud is the investment manager, Minerva Investment Management, whose employees supplied the false information contained in the offering memorandum. In fact, pursuant to its contract with the fund, Minerva Investment Management collected a 20 percent performance fee on the false profits.

Can you sue Minerva Investment Management for violating Rule 10b-5(b)? According to some commentators, and at least one lower court, who have interpreted a recent Supreme Court decision, probably not.⁸

⁶ 17 C.F.R. § 240.10b-5. The full rule reads as follows:

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.

Id.

⁷ Generally, private litigants have to “prove (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” to prevail in a § 10(b) suit. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 157 (2008).

⁸ *Cf. Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2299 (2011) (“This case requires us to determine whether . . . a mutual fund investment adviser[] can be held liable in a private action under . . . Rule 10b-5 for false statements included in its client mutual funds’ prospectuses. . . . We conclude that [the investment adviser] cannot be held liable because it did not make the statements in the prospectuses.” (citation omitted)); *see also In re Optimal U.S. Litig.*, No. 10 Civ. 4095(SAS), 2011 WL 4908745, at *5-6 (S.D.N.Y. Oct. 14, 2011) (holding that the statements in a hedge fund’s “EM” (the equivalent of a confidential offering memorandum) were made by the fund itself and not by the adviser and refusing to allow the case against the adviser to proceed pursuant to Rule 10b-5 based on the decision in *Janus*); Patrick Wagner, *Janus Capital: What It Means to “Make” a Statement Under Rule 10b-5*, THE RACE TO THE BOTTOM (July 29, 2011, 6:00 AM), <http://www.theracetothetbottom.org/securities-issues/janus-capital-what-it-means-to-make-a-statement-under-rule-1.html> (“Ja-

In June 2011, the Supreme Court announced its ruling in *Janus Capital Group, Inc. v. First Derivative Traders*.⁹ The Court, in a decision split five to four along ideological lines, dismissed a private Section 10(b) action brought against a mutual fund's investment adviser based on allegedly false statements made in the fund's prospectus.¹⁰ The Court declared that only the fund itself could "make" the statements in the prospectus, even though the investment adviser prepared and disseminated the prospectus on behalf of the fund, because the fund had "ultimate authority" over the contents of the prospectus.¹¹ This decision is the most recent in a line of cases examining what is necessary to allege primary versus secondary liability under the securities laws.¹² Here, the investment adviser could not be liable as a primary violator of Section 10(b) because it did not engage in the conduct specified by the statute; it did not "make" any statements.¹³ Instead, the suit would have to be brought pursuant to some form of secondary liability.¹⁴

Let us return to your case. Some have read the *Janus* opinion to demand the following analysis: Minerva Investment Management is a separate entity, connected to the fund only through an investment advisory contract.¹⁵ The fund is the entity to which the offering memorandum is attributed and which had "ultimate authority" over its contents, so it is the entity that "made" the false statement on which you relied.¹⁶ If Minerva Investment Management is liable for securities fraud, it is merely as an "aider and abettor," and there is no private right of action for aiding and abetting a violation of Section 10(b); aiding and abetting violations can only be prosecuted by the SEC.¹⁷ You cannot sue the adviser for your injury.

Using this analysis, even the SEC would probably be unable to bring a suit against Minerva Investment Management for aiding and abetting a Sec-

Janus Capital Grp. v. First Derivative Traders . . . allows advisors to circulate prospectuses for investment funds even when they know the document contains false statements." (citations omitted)).

⁹ 131 S. Ct. 2296 (2011).

¹⁰ *Id.* at 2299, 2301.

¹¹ *Id.* at 2302.

¹² See Matthew Ingber, *Litigation: The Janus Capital Decision*, INSIDECOUNSEL (June 16, 2011), <http://www.insidecounsel.com/2011/06/16/litigation-the-janus-capital-decision> (discussing the *Janus* decision's impact on secondary liability).

¹³ *Janus*, 131 S. Ct. at 2304 ("Under this rule, [the adviser] did not 'make' any of the statements in the [fund] prospectuses; [the fund] did.").

¹⁴ *Id.* ("To adopt [plaintiff's] theory would read into Rule 10b-5 a theory of liability similar to—but broader in application than—what Congress has already created expressly [in secondary liability sections of the Exchange Act]. We decline to do so." (footnote and citation omitted)).

¹⁵ *Cf. id.* at 2299 ("[The mutual fund] is a separate legal entity owned entirely by mutual fund investors. [The fund] has no assets apart from those owned by the investors. [The investment adviser] provides [the fund] with investment advisory services.").

¹⁶ *Cf. id.* at 2305 ("[Nothing] on the face of the prospectuses indicate that any statements therein came from [the investment adviser] rather than [the fund].").

¹⁷ *Cf. id.* at 2302 ("[S]uits . . . against entities [without ultimate authority over a statement] may be brought by the SEC but not by private parties." (citation omitted)).

tion 10(b) violation.¹⁸ In order to bring an aiding and abetting suit, there must be a primary violation,¹⁹ and a primary violation requires scienter.²⁰ Therefore, unless the board of directors of the fund was complicit in the fraud, there is no primary violation by the fund on which to base an aiding and abetting suit against the adviser.²¹ Another form of secondary liability, “control person” liability under Section 20(a) of the Exchange Act, would also fail on the same grounds; the adviser cannot be liable as a control person unless the fund committed a primary violation.²²

To some, such an application of *Janus* results in an unacceptable avoidance of liability, and the decision has been heavily criticized on that ground.²³ However, as this Note will argue, the *Janus* opinion does not demand this analysis.

This Note posits that, in one way, the Supreme Court’s recent decision in *Janus* is not the watershed case that it has been portrayed as; the out-

¹⁸ See *id.* at 2310 (Breyer, J., dissenting) (“Indeed, under the majority’s rule it seems unlikely that the SEC itself in such circumstances could exercise the authority Congress has granted it to pursue primary violators who ‘make’ false statements or the authority that Congress has specifically provided to prosecute aiders and abettors to securities violations.”). The SEC may or may not have other actions available post-*Janus*. See *infra* Part III.C.3.

¹⁹ See *Janus*, 131 S. Ct. at 2310 (Breyer, J., dissenting).

²⁰ See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313-14 (2007) (noting that Congress enacted legislation demanding “exacting” pleading standards for the scienter associated with securities litigation and that, in order to successfully plead scienter, plaintiffs must demonstrate that an “inference of scienter [is] more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent”); see also *supra* text accompanying note 7.

²¹ See *Janus*, 131 S. Ct. at 2310 (Breyer, J., dissenting).

²² See *id.* (“[A] person who is liable under § 20(a) controls another ‘person’ who is ‘liable’ for a securities violation. . . . [T]here is at least one significant category of cases that § 10(b) may address that derivative forms of liability, such as under [section] 20(a), cannot, namely, cases in which one actor exploits another as an innocent intermediary for its misstatements.” (emphasis omitted)); see also *In re Optimal U.S. Litig.*, No. 10 Civ. 4095(SAS), 2011 WL 4908745, at *4 (S.D.N.Y. Oct. 14, 2011) (“There is no liability under section 20(a) without a primary violation by the controlled person.”).

²³ See, e.g., Jeffrey N. Gordon, *Janus Capital Group v. First Derivative Traders: Only the Supreme Court Can “Make” a Tree*, THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL 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> (“The Supreme Court decision in *Janus Capital Group v. First Derivative Traders* is one of those cases that takes your breath away. The case astonishingly holds that an investment advisor is not liable for fraud in the prospectus of a sponsored mutual fund”); Jennifer S. Taub, *Facing the Unintended Consequences of Janus v. First Derivative Traders*, THE RACE TO THE BOTTOM (June 13, 2011, 2:02 PM), <http://www.the.racetothetobottom.org/securities-issues/facing-the-unintended-consequences-of-janus-v-first-derivati.html> (“It is possible that a corporation outside of the fund industry might rely on this opinion to shield itself from securities fraud liability under 10b-5.”); Steve Randy Waldman, *A License to Lie, Backdated*, RITHOLTZ.COM (June 21, 2011, 8:00 AM), <http://www.ritholtz.com/blog/2011/06/a-license-to-lie-backdated> (“Plausible deniability is the order of the day. Managers can be as nasty as they wanna be. As long as their misbehavior is obscure enough that fund directors can plead ignorance, nobody gets in trouble.”).

come—no liability for the defendants—was dependent on a narrow, fact-specific scenario inapplicable to almost any other set of circumstances. In other words, *Janus* does not provide a roadmap for avoiding securities fraud liability.²⁴ On the other hand, *Janus* is an extremely important decision because it finally coherently addressed a question that the Court had previously answered in a confusing and politicized manner: where does primary liability for securities fraud end and secondary liability begin? Unfortunately, lower courts' overbroad interpretations of *Janus* have led to results that some find untenable, and that have left the SEC worrying that its authority has been compromised.²⁵ This leaves the decision ripe for congressional review, which could lead to the Legislature overruling the important rule of law set forth in the decision.

The Note proceeds as follows: Part I examines the history of private actions under Section 10(b), and demonstrates that the cases leading up to *Janus* were purposefully designed to limit the use of Rule 10b-5 in private securities litigation but not in SEC actions. Part I also examines the circuit split that arose as lower courts struggled to apply the reasoning of *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*²⁶ and *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,²⁷ the cases leading up to *Janus*. Part II first introduces the *Janus* opinion, and then compares and analyzes the test for primary liability from the *Janus* Court to that of the Court in *Stoneridge*. Part II concludes that the test articulated in *Stoneridge* was faulty because it incorrectly focused on the reliance element of a Section 10(b) suit instead of the conduct element. Part II posits that the rule announced in *Janus* is the better and easier test for distinguishing between primary and secondary liability because it finally defined the requisite conduct. Part III concludes the Note by revealing how courts have already read the *Janus* opinion in an overly broad manner and predicts potential issues in future litigation associated with such a reading. This Note

²⁴ *Contra* Taub, *supra* note 23 (describing the ways in which corporations can use the *Janus* opinion to shield themselves from liability under 10b-5).

²⁵ See Elisse B. Walter, Comm'r, SEC, Remarks Before the FINRA Institute at Wharton Certified Regulatory & Compliance Professional (CRCP) Program (Nov. 8, 2011), available at <http://www.sec.gov/news/speech/2011/spch110811ebw.htm>.

In its recent *Janus* decision, the Supreme Court focused simply on the language of Section 10(b) and Rule 10b-5, which of course apply to Commission actions as well as private actions. This change may have the unfortunate and ironic result of throwing the proverbial baby out with the bathwater. What I mean is that by limiting implied private rights through strict statutory interpretation, the Court has also potentially limited the express public rights of action contained in the statute.

Id.

²⁶ 511 U.S. 164 (1994).

²⁷ 552 U.S. 148 (2008).

speculates that the fallout from such a broad reading will be severe enough that Congress will address the decision.

I. THE SUPREME COURT AND SECTION 10(B)

This Part presents the background precedential cases leading up to *Janus*. Section A briefly examines the early history of secondary liability under Section 10(b) and introduces the changing methods by which the Supreme Court has interpreted the federal securities statutes. Section B sets forth the Court decision in *Central Bank*, which declared that Section 10(b) did not support aiding and abetting liability, and Section C examines the circuit split and legislative action that resulted. Section D analyzes the Court's decision in *Stoneridge*, which examined the scope of secondary liability for securities fraud and prompted the need for a reexamination in *Janus*.

A. *The Availability of a Private Action for Secondary Violations of Section 10(b)*

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder are the primary anti-fraud provisions of the federal securities laws and together make unlawful any fraud or deceit in connection with the purchase or sale of any security.²⁸ Section 21 of the Exchange Act gives the SEC the authority to enforce the Exchange Act and the rules and regulations promulgated under it, including Section 10(b).²⁹ Though nothing in language of the statute or rule would suggest a complementary private right of action for violations of Section 10(b), federal courts quickly and consistently held that such a right was implied.³⁰ Additionally, lower courts, starting in 1966 with *Brennan v. Midwestern United Life Insurance Co.*,³¹ permitted private suits even when the plaintiffs alleged only that the defendant had “aided and abetted” a Section 10(b) violation, importing principles from criminal and

²⁸ Securities and Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (2006); 17 C.F.R. § 240.10b-5 (2012).

²⁹ Exchange Act § 21, 15 U.S.C. § 78u.

³⁰ See *Kardon v. Nat'l Gypsum Co.*, 69 F. Supp. 512, 513-514 (E.D. Pa. 1946) (holding that a private right of action is implied under Section 10(b) and Rule 10b-5 for the first time in federal court, four years after Rule 10b-5's enactment); see also *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971) (acknowledging that “[i]t is now established that a private right of action is implied under [S]ection 10(b)”).

³¹ 259 F. Supp. 673 (N.D. Ind. 1966), *abrogated by* *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

tort law into the securities laws to further the laws' purposes of protecting investors and ensuring a safe and transparent securities market.³²

However, beginning in the 1970s, Supreme Court opinions interpreting the federal securities laws refused to expand the scope of conduct prohibited past the text of the relevant statutes.³³ This strict textualism was in contrast to the approach taken in decisions like *Brennan*, which had interpreted the "broad language" of Section 10(b) "'not technically and restrictively, but flexibly to effectuate its remedial purposes.'"³⁴ The change was justified by policy considerations³⁵ and an appreciation that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."³⁶ Some commentators and courts speculated that the Court's shift from a broad, remedial reading of the securities laws to a more textual approach did not bode well for the continued existence of liability for aiding and abetting a securities fraud,³⁷ even though the cause of action had been widely accepted by the

³² See, e.g., *id.* at 680 ("[G]eneral principles of law should continue to guide the development of federal common law remedies under Section 10(b) and Rule 10b-5."); see also Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CALIF. L. REV. 80, 84 (1981).

³³ *Cent. Bank*, 511 U.S. at 173; see also *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473-74 (1977) (rejecting a Section 10(b) suit based on a breach of fiduciary duty because without a misrepresentation the conduct was not "manipulative or deceptive"); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (refusing to allow negligence-based Section 10(b) suits because the use of the words "manipulative or deceptive" indicated Congress intended to prohibit knowing or intentional misconduct). This "textualist" reading of Section 10(b) began in 1975. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731-49 (1975) (upholding precedent limiting plaintiffs who can use Rule 10b-5 to actual purchasers and sellers of a security based on the text of the statute, and after examining policy considerations with respect to the consequences of the judicial expansion of Section 10(b) liability).

³⁴ *Cent. Bank*, 511 U.S. at 198 (Stevens, J., dissenting) (quoting *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972)); see also *Bankers Life & Cas. Co.*, 404 U.S. at 12 (using same language); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963) (same).

³⁵ See *Blue Chip Stamps*, 421 U.S. at 737-39. Chief Justice Rehnquist argued:

When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn. . . . [I]t would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5. It is therefore proper that we consider, in addition to the factors already discussed, what may be described as policy considerations [W]e are of the opinion that there are countervailing advantages to [not expanding beyond the text of the statute], purely as a matter of policy

Id.

³⁶ *Id.* at 739.

³⁷ *Cent. Bank*, 511 U.S. at 170; see also Fischel, *supra* note 32, at 82 ("[T]he theory of secondary liability is no longer viable in light of recent Supreme Court decisions strictly interpreting the federal securities laws."). The *Central Bank* Court seems to have been heavily influenced by Professor Fischel's argument. Donald C. Langevoort, *Reading Stoneridge Carefully: A Duty-Based Approach to Reliance and Third-Party Liability Under Rule 10b-5*, 158 U. PA. L. REV. 2125, 2130 n.17 (2010).

lower courts.³⁸ Unfortunately, by the time the Supreme Court addressed the issue, suits for primary and secondary liability had largely become conflated, and the line between the two causes of action was virtually nonexistent.³⁹

B. *The Supreme Court Addresses Aiding and Abetting Liability*—Central Bank of Denver

In 1992, after nearly thirty years of jurisprudence holding that there was a private right of action for aiding and abetting a Section 10(b) violation,⁴⁰ the Supreme Court granted certiorari in *Central Bank*.⁴¹ The plaintiffs in *Central Bank* purchased bonds that were secured by landowner assessment liens.⁴² The liens were required to be on land worth at least 160 percent of the amount outstanding on the bonds.⁴³ The defendant was the indenture trustee for the bond issuance.⁴⁴ In order to ensure the coverage requirement was being met, the bond covenants required the developer of the land securing the bonds to provide the indenture trustee with an appraisal of the land.⁴⁵ An appraisal was provided prior to the issuance of the bonds, but the indenture trustee had reason to know the value ascribed to the land was

³⁸ *Cent. Bank*, 511 U.S. at 169 (“Like the Court of Appeals in this case, other federal courts have allowed private aiding and abetting actions under § 10(b).”). In fact, eleven circuits had affirmed the existence of a private right of action for aiding and abetting a Section 10(b) violation. *See* Farlow v. Peat, Marwick, Mitchell & Co., 956 F.2d 982, 986 (10th Cir. 1992); Levine v. Diamantheset, Inc., 950 F.2d 1478, 1483 (9th Cir. 1991); K & S P’ship v. Cont’l Bank, N.A., 952 F.2d 971, 977 (8th Cir. 1991); Schatz v. Rosenberg, 943 F.2d 485, 496-97 (4th Cir. 1991); Fine v. Am. Solar King Corp., 919 F.2d 290, 300 (5th Cir. 1990); Schlifke v. Seafirst Corp., 866 F.2d 935, 947 (7th Cir. 1989); Schneberger v. Wheeler, 859 F.2d 1477, 1480 (11th Cir. 1988); Moore v. Fenex, Inc., 809 F.2d 297, 303 (6th Cir. 1987); Cleary v. Perfectune, Inc., 700 F.2d 774, 777 (1st Cir. 1983), *abrogated by Cent. Bank*, 511 U.S. 164 (1994); IIT v. Cornfeld, 619 F.2d 909, 922 (2d Cir. 1980), *abrogated by Morrison v. Nat’l Austl. Bank Ltd.*, 130 S. Ct. 2869 (2010); Monsen v. Consol. Dressed Beef Co., 579 F.2d 793, 799-800 (3d Cir. 1978). In *Dirks v. SEC*, 681 F.2d 824, 844 (D.C. Cir. 1982), *rev’d on other grounds*, 463 U.S. 646 (1983), the D.C. Circuit dismissed an aiding and abetting suit brought by the SEC, but it had previously recognized that such a claim might be available to private litigants. *See* Zoelsch v. Arthur Andersen & Co., 824 F.2d 27, 35-36 (D.C. Cir. 1987), *abrogated by Morrison*, 130 S. Ct. 2869 (2010).

³⁹ *See* Robert A. Prentice, *Locating That “Indistinct” and “Virtually Nonexistent” Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N.C. L. REV. 691, 705 (1997) (“[M]ost courts just did not bother to delineate between primary and secondary liability.”).

⁴⁰ *See supra* note 38 (listing the cases in which eleven circuit courts of appeals accepted the existence of a private right of action for aiding and abetting a Section 10(b) violation).

⁴¹ *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 508 U.S. 959, 959 (1993) (mem.).

⁴² *Cent. Bank*, 511 U.S. at 167-68.

⁴³ *Id.* at 167.

⁴⁴ *Id.*

⁴⁵ *Id.*

too high and that the bond offering was proceeding on fake information.⁴⁶ However, following a discussion with the developer, the indenture trustee agreed to postpone performing an independent appraisal until six months after the issuance.⁴⁷

The issuer defaulted on the bonds and, following the default, the purchasers sued.⁴⁸ They alleged that the indenture trustee aided and abetted violations of Section 10(b) committed by, among others, the bonds' issuer and underwriter, when it failed to perform a new appraisal and verify the value of the collateral.⁴⁹ In order to prevail, the plaintiffs had to prove: (1) the existence of a primary violation of the securities laws by another; (2) recklessness by the aider and abettor as to the existence of the primary violation; and (3) substantial assistance by the alleged aider-and-abettor in achieving the primary violation.⁵⁰

The district court granted defendant's motion for summary judgment, holding that "silence and inaction are not bases to establish substantial assistance absent an additional fiduciary duty to disclose."⁵¹ The Tenth Circuit Court of Appeals reversed the grant of summary judgment because there was a genuine issue of material fact regarding the indenture trustee's recklessness, and because a trier of fact could conclude that delaying the appraisal was an action, not an omission, and so constituted substantial assistance.⁵²

Though petitioners had appealed the lower court's decision on other grounds (namely, whether recklessness was sufficient scienter for an aiding and abetting charge and whether an omission could constitute substantial assistance),⁵³ the Supreme Court directed the parties to brief and argue "[w]hether there is an implied private right of action for aiding and abetting violations of § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5."⁵⁴

⁴⁶ *Id.* at 167-68.

⁴⁷ *Id.* at 168.

⁴⁸ *Cent. Bank*, 511 U.S. at 168.

⁴⁹ *Id.*

⁵⁰ *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 898 (10th Cir. 1992), *rev'd sub nom* *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* 511 U.S. 164 (1994). The district court held that an aiding and abetting charge required scienter, and found that recklessness did not satisfy the knowledge requirement. *Id.* at 900. The Tenth Circuit concluded that the required level of scienter for aiding and abetting Section 10(b) violations was recklessness. *Id.* at 903.

⁵¹ *Id.* at 899 (quoting the district court's opinion).

⁵² *Id.* at 904.

⁵³ Therese H. Maynard, Foreword, *The Fourth Annual Fritz B. Burns Lecture: Central Bank: The Methodology, The Message, and the Future*, 29 LOY. L.A. L. REV. 1, 8 & n.37 (1995) (discussing the "narrow grounds" upon which Central Bank petitioned for review).

⁵⁴ *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 508 U.S. 959, 959 (1993) (mem.). The Court had reserved the issue on two previous occasions. *See Herman & MacLean v. Huddleston*, 459 U.S. 375, 379 n.5 (1983); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 191 n.7 (1976).

Justice Anthony Kennedy authored the majority opinion, and was joined by the four other conservative Justices on the Court.⁵⁵ The majority agreed with those commentators who had predicted the demise of aiding and abetting liability, saying:

We reach the uncontroversial conclusion, accepted even by those courts recognizing a § 10(b) aiding and abetting cause of action, that the text of the [Exchange] Act does not itself reach those who aid and abet a § 10(b) violation. Unlike those courts, however, we think that conclusion resolves the case. It is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text. To be sure, aiding and abetting a wrongdoer ought to be actionable in certain instances. The issue, however, is not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting is covered by the statute.⁵⁶

Though the majority's holding seemingly applied to all Section 10(b) actions, including those brought by the SEC,⁵⁷ language in the opinion indicated that the majority's concern was with expanding *private* liability.⁵⁸ First, the majority reasoned that its holding was supported because the plaintiff's "argument would impose 10b-5 aiding and abetting liability when at least one element critical for recovery under 10b-5 is absent: reliance. . . . Allowing plaintiffs to circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by our earlier cases."⁵⁹ In contrast, reliance is not a required element of SEC enforcement actions using Rule 10b-5.⁶⁰ Second, though the majority insisted that it need not look at policy considerations because of the clarity of the text,⁶¹ the

⁵⁵ *Cent. Bank*, 511 U.S. at 166.

⁵⁶ *Id.* at 177 (citation omitted).

⁵⁷ *See id.* at 199-200 (Stevens, J., dissenting); *see also* Joel Seligman, *The Implications of Central Bank*, 49 BUS. LAW. 1429, 1435 (1994). *But see* Simon M. Lorne, *Central Bank of Denver v. SEC*, 49 BUS. LAW. 1467, 1467-68 (1994) (in which an attorney in the SEC's Office of General Counsel drafts a fictional "opinion" of the Supreme Court declining to apply *Central Bank* to SEC aiding and abetting actions).

⁵⁸ *Cent. Bank*, 511 U.S. at 173.

In § 10(b), Congress prohibited manipulative or deceptive acts in connection with the purchase or sale of securities. It envisioned that the SEC would enforce the statutory prohibition through administrative and injunctive actions. Of course, a private plaintiff now may bring suit against violators of § 10(b). But the *private* plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b).

Id. (emphasis added).

⁵⁹ *Id.* at 180.

⁶⁰ *See Langevoort*, *supra* note 37, at 2127-28 ("The Court's choice of reliance as the crucial element indicates the Court's comfort with having different liability outcomes in Rule 10b-5 cases depending on whether the action is an SEC enforcement or criminal prosecution (where reliance is not required) or private litigation (where it is).").

⁶¹ *Cent. Bank*, 511 U.S. at 188 ("Policy considerations cannot override our interpretation of the text and structure of the [Exchange] Act, except to the extent that they may help to show that adherence

opinion proceeded to weigh in on the debate, positing that secondary liability leads to ad hoc, shifting, and fact-based decisions, which in turn forces businesses to address the resulting uncertainty, the high costs of which are passed on to investors.⁶²

The four-Justice dissent, written by Justice John Paul Stevens, criticized the majority's opinion on numerous grounds.⁶³ First and foremost, the dissent was concerned with overruling a well-settled judicial construction, affirmed in eleven circuit courts of appeal.⁶⁴ Second, the dissent noted that in 1934, when the Exchange Act was passed, the Supreme Court had just recently "instructed that such 'remedial' legislation should receive 'a broader and more liberal interpretation than that to be drawn from mere dictionary definitions of the words employed by Congress.'"⁶⁵ Finally, the dissent recognized that the majority's holding, text-based as it was, did away with not just private litigants' ability to bring aiding and abetting suits, but also the SEC's.⁶⁶

C. *Fallout from Central Bank—Legislative Action and Lower Court Confusion*

Commentators were also quick to criticize the Court's opinion in *Central Bank*.⁶⁷ The two most important criticisms to this Note are that (1) the holding significantly interfered with the SEC's ability to bring actions against persons engaging in securities fraud,⁶⁸ and (2) the opinion lacked

to the text and structure would lead to a result 'so bizarre' that Congress could not have intended it." (quoting *Demarest v. Manspeaker*, 498 U.S. 184, 191 (1991)).

⁶² *Id.* at 189.

⁶³ *Id.* at 192 (Stevens, J., dissenting).

⁶⁴ *Id.* at 196 ("I . . . disagree with the majority for the simple reason that a 'settled construction of an important federal statute should not be disturbed unless and until Congress so decides.'" (quoting *Reves v. Ernst & Young*, 494 U.S. 56, 74 (1990) (Stevens, J., concurring))). Additionally, the dissent notes that none of the other cases in which the Court strictly construed Section 10(b) "even arguably involved a settled course of lower court decisions." *Id.* at 196 n.6.

⁶⁵ *Id.* at 195 (quoting *Piedmont & N. Ry. Co. v. ICC*, 286 U.S. 299, 311 (1932)). Justice Stevens continues that "[t]here is a risk of anachronistic error in applying our current approach to implied causes of action to a statute enacted when courts commonly read statutes of this kind broadly to accord with their remedial purposes and regularly approved rights to sue despite statutory silence." *Id.* at 195-96 (citation omitted). Additionally, plaintiffs contended, and the dissent agreed, that Congress's intent in 1934 can be gleaned from prevailing common laws of tort at the time, which widely recognized aiding and abetting liability for misrepresentations in the marketing of securities. *Id.* at 193 n.2.

⁶⁶ *Id.* at 200. Justice Stevens practically directs Congress to examine the decision. *Id.* at 196 n.7 ("Of course, when a decision of this Court upsets settled law, Congress may step in to reinstate the old law.").

⁶⁷ See Prentice, *supra* note 39, at 710-11 (listing criticisms of *Central Bank*).

⁶⁸ *Abandonment of the Private Right of Action for Aiding and Abetting Securities Fraud/Staff Report on Private Securities Litigation: Hearing Before the Subcomm. on Sec. of the S. Comm. on*

guidance on what constituted a primary violation as opposed to a secondary one.⁶⁹

Legislative action quickly addressed the first criticism. In 1995, as part of a huge effort to curb frivolous litigation and ensure that plaintiffs, not plaintiffs' lawyers, benefitted from securities fraud actions, Congress enacted the Private Securities Litigation Reform Act ("PSLRA").⁷⁰ Part of PSLRA amended the Exchange Act and specifically granted the SEC the authority to bring aiding and abetting suits.⁷¹ Notably, though, Congress rejected efforts to completely overturn *Central Bank* and restore private liability for aiding and abetting a violation of the securities laws.⁷²

The second criticism resulted from the majority opinion in *Central Bank* expressly leaving open the possibility of holding secondary actors responsible as primary violators, so long as plaintiffs could prove all of the elements of a private Section 10(b) action.⁷³ The language the Justices used in this portion of the opinion paralleled and referenced an article by Professor Daniel Fischel.⁷⁴

Banking, Hous., and Urban Affairs, 103d Cong. 17 (1994) (statement of Arthur Levitt, Chairman, SEC) ("[G]oing forward, we just would be handicapped. You'd be taking away a very important tool from us.").

⁶⁹ See Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293, 1294 (1999) (noting the failure of the *Central Bank* Court to provide guidance in determining what constitutes primary liability).

⁷⁰ Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

⁷¹ Section 104, 15 U.S.C. § 78t(e) ("For purposes of any action brought by the [SEC] . . . any person that knowingly provides substantial assistance to another person in violation of a provision of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided."). In the recently enacted Dodd-Frank Act, Congress amended the section to make reckless behavior satisfy the scienter requirement. Dodd-Frank Wall Street Reform and Consumer Protection Act § 929O, Pub. L. No. 111-203, 124 Stat. 1376, 1862 (2010) (codified at 15 U.S.C. § 78t(e)) ("Section 20(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78t(e)) is amended by inserting 'or recklessly' after 'knowingly'.").

⁷² See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 158 (2008). Additionally, Congress did nothing to clarify one of the elements of aiding and abetting liability that had been debated in courts pre-*Central Bank*: what degree of conduct was required. See David S. Ruder, *The Future of Aiding and Abetting and Rule 10b-5 After Central Bank of Denver*, 49 BUS. LAW. 1479, 1484 (1994) (discussing confusion in pre-*Central Bank* cases over what conduct would merit aiding and abetting liability). Thus, uncertainty remained for secondary actors as to what conduct left them open to SEC action. *Id.* Professor Ruder suggested that Congress codify aiding and abetting liability, answering the debate by stating that "inaction should not be a basis for an aiding and abetting violation unless a separate duty to disclose exists." *Id.* at 1484-85. Otherwise, he said, "some of the *dicta* in *Central Bank of Denver* will become important." *Id.* at 1485. This contention was certainly true, as seen in the "attribution" approach of some circuits and the Court's opinion in *Stoneridge*, which relied heavily on the *Central Bank* Court's *dicta* about reliance. See *infra* Part I.D.

⁷³ *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994) ("Any person or entity, including a lawyer, accountant, or bank . . . may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under 10b-5 are met.").

⁷⁴ Compare *id.* (citing Fischel, *supra* note 32, at 107-08), with Fischel, *supra* note 32, at 107-08.

According to Professor Fischel, the following classes of defendants do not engage in “deceptive conduct” within the meaning of Section 10(b): “lawyers or accountants who fail to ‘blow the whistle,’ employers who do no more than employ wrongdoers, and banks which knowingly finance a wrongdoer.”⁷⁵ However, with respect to Rule 10b-5(b) and secondary actors, Professor Fischel said that “[u]nlike the other forms of conduct [listed above], the making of misrepresentations which distort the transmission of accurate information is the core conduct which Section 10(b) and Rule 10b-5 are meant to deter. That such misrepresentations are made by accountants or lawyers should not provide a shield from liability.”⁷⁶

Given the Court’s heavy reliance on Professor Fischel’s article and theory, it seems likely that the Justices agreed that secondary actors would often be held liable as primary violators, including in some cases where liability had previously been based on aiding and abetting.⁷⁷ However, neither this information nor any other guidance was transmitted to the lower courts, which prompted confusion over the scope of primary liability for secondary actors.⁷⁸

The lower courts focused on the *Central Bank* Court’s reference to reliance to distinguish between primary and secondary violations.⁷⁹ Three circuits “famously split” over when the reliance element could be satisfied with respect to the conduct of secondary actors.⁸⁰ The Ninth Circuit was the first to weigh in, and held that reliance was satisfied whenever plaintiffs relied on false statements that the defendant “substantially participated” in making.⁸¹ Other circuits, however, thought such a test would essentially reverse *Central Bank*—“substantially participate” seemingly too close to

⁷⁵ Fischel, *supra* note 32, at 111. This theory alone was very disconcerting to the *Central Bank* dissent. See *Central Bank*, 511 U.S. at 200 n.12 (Stevens, J., dissenting).

⁷⁶ Fischel, *supra* note 32, at 108.

⁷⁷ See *id.* at 107-08.

⁷⁸ Langevoort, *supra* note 37, at 2131.

⁷⁹ Compare *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 972-73 (C.D. Cal. 1994) (reliance satisfied even when there is no public attribution of statements), with *Ziemba v. Cascade Int’l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) (requiring public attribution to satisfy reliance) and *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2nd Cir. 1998) (same).

⁸⁰ Langevoort, *supra* note 37, at 2131 & n.22.

⁸¹ See *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 623-24 (9th Cir. 1994) (finding that an auditor and underwriter who participated in drafting and reviewing misleading letters to the SEC could be held liable as a primary violator); see also *In re ZZZZ Best*, 864 F. Supp. at 972-73 (holding that an auditor could be held liable for material misstatements in a corporation’s public statements so long as plaintiffs showed that the defendant’s participation was extensive enough to *objectively* attribute the statements to the defendant). The *ZZZZ Best* court stated that the auditor would be liable if “the statements should reasonably be attributed to [it]” and that the reliance element was satisfied despite the statement not being attributed to the auditor, because “the securities market still relied on those public statements.” 864 F. Supp. at 970, 973.

“substantial assistance” for comfort.⁸² The Second Circuit, most notably, along with the Eleventh Circuit, held that unless a misstatement was attributed to the defendant, the plaintiff did not rely on the defendant’s statement or conduct.⁸³ This test effectively shielded secondary actors from primary liability, no matter how egregious their conduct, because the statements would be attributed to the issuer in the end.⁸⁴

D. *What Constitutes a Primary Violation?*—Stoneridge Investment Partners

Noting lower courts’ conservatism in misstatement cases, as demonstrated through the bright-line attribution test, plaintiffs moved towards using subsections (a) and (c) of Rule 10b-5, which prohibit deceptive conduct—also called “scheme liability.”⁸⁵ The Ninth Circuit indicated it would be amenable to considering “deceptive conduct in furtherance of a ‘scheme to defraud’” a primary violation of Section 10(b),⁸⁶ as did the district court judge in the litigation resulting from the Enron scandal.⁸⁷

⁸² See *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 n.10 (10th Cir. 1996) (“To the extent [the ‘substantial assistance’] cases allow liability to attach without requiring a representation to be made by defendant, and reformulate the ‘substantial assistance’ element of aiding and abetting liability into primary liability, they do not comport with *Central Bank of Denver*.”).

⁸³ See, e.g., *Ziemba*, 256 F.3d at 1205 (“[T]he alleged misstatement or omission . . . must have been publicly attributable to the defendant at the time that the plaintiff’s investment decision was made.”); *Wright*, 152 F.3d at 175 (“[A] secondary actor cannot incur primary liability under the [Exchange] Act for a statement not attributed to that actor at the time of its dissemination.”). The Second Circuit relaxed the test in later cases. See, e.g., *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 333 (S.D.N.Y. 2004) (rejecting the necessity of public attribution for reliance to be satisfied: “[a]bsolving an auditor who prepares, edits, and drafts a fraudulent financial statement knowing it will be publicly disseminated simply because [it was signed by another, affiliated auditor] would stretch *Central Bank*’s holding too far.” (alterations in original) (quoting *In re Lernout & Hauspie Sec. Litig.*, 230 F. Supp. 2d 152, 168 (D. Mass. 2002))). Following *Stoneridge Inv. Partners, LLC v. ScientificAtlanta, Inc.*, 552 U.S. 148 (2008), the Second Circuit attempted to clarify its case law, and re-established the bright-line test of attribution in *Pacific Investment Management Co. v. Mayer Brown LLP*, 603 F.3d 144, 159 (2d Cir. 2010), *cert. denied*, 131 S. Ct. 3021 (2011). Judge Parker, in a concurring opinion, practically begged the Supreme Court for clarification—a request supposedly granted in *Janus*. See *id.* at 162 (Parker, J., concurring).

⁸⁴ See Prentice, *supra* note 39, at 731 n.178.

⁸⁵ 17 C.F.R. § 240.10b-5 (2012) (“It shall be unlawful for any person . . . (a) [t]o employ any device, scheme, or artifice to defraud, [or] . . . (c) [t]o 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.”); see also *In re DVI, Inc. Sec. Litig.*, 639 F.3d 623, 642-43 (3d Cir. 2011) (describing claims under subsections (a) and (c) of Rule 10b-5 as scheme liability claims).

⁸⁶ *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1043 (9th Cir. 2006), *vacated sub nom. Simpson v. Homestore.com.*, 519 F.3d 1041 (9th Cir. 2008).

⁸⁷ *In re Enron Corp. Sec. Derivative & “ERISA” Litig.*, 529 F. Supp. 2d 644, 706-07 (S.D. Tex. 2006).

Backlash quickly followed. The Eighth Circuit, in *In re Charter Communications, Inc., Securities Litigation*⁸⁸ (the case that would eventually become *Stoneridge*) adopted a strict test; it narrowly defined “deceptive act” to include only “misstatements, omissions by one who has a duty to disclose, and manipulative trading practices (where ‘manipulative’ is a term of art).”⁸⁹ Borrowing heavily from the Eighth Circuit’s reasoning, the Fifth Circuit later overturned the district court’s opinion in the Enron litigation.⁹⁰ The Supreme Court addressed the split in *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*⁹¹

The defendants in *Stoneridge* produced cable boxes, and had contracted to supply the boxes to Charter Communications (“Charter”), a cable provider.⁹² Charter was in financial hot water, and had already engaged in numerous fraudulent acts in order to meet the market’s earnings expectations.⁹³ However, the company’s profits remained lower than analysts’ estimates.⁹⁴ To help make up the shortfall, executives from Charter and the defendant companies agreed to alter their existing arrangements; the defendants artificially raised the price of each cable box and amended the contract price with the understanding that they would purchase advertising from Charter with the additional money they received.⁹⁵ These “round-trip transactions” had no economic substance, as they were part of the same transaction; however, the parties structured the deals so that they appeared to be separate.⁹⁶ Charter was thus able to report the advertising time it sold as revenue, while improperly capitalizing the purchase of the cable boxes.⁹⁷ Plaintiffs purchased shares in Charter based on financials that included the improperly recorded revenues, and brought a 10b-5 suit once the deception was uncovered.⁹⁸

The conservative majority of the Court held that defendants’ conduct was not a primary violation of Section 10(b).⁹⁹ Four other Justices joined the majority opinion of Justice Kennedy, which first noted that the Court disagreed with the Eighth Circuit’s definition of “deceptive act”—Section

⁸⁸ 443 F.3d 987 (8th Cir. 2006).

⁸⁹ *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 158 (2008).

⁹⁰ *Regents of the Univ. of Cal. v. Credit Suisse First Bos. (USA), Inc.*, 482 F.3d 372, 389-90 (5th Cir. 2007).

⁹¹ *Stoneridge*, 552 U.S. at 156.

⁹² *Id.* at 154.

⁹³ *Id.* at 153.

⁹⁴ *Id.*

⁹⁵ *Id.* at 153-55.

⁹⁶ *Id.* at 154-55; *see also* *Teacher’s Ret. Sys. v. Hunter*, 477 F.3d 162, 169 (4th Cir. 2007) (describing round-trip transactions as transactions that lack economic substance).

⁹⁷ *Stoneridge*, 552 U.S. at 154-55.

⁹⁸ *Id.* at 155.

⁹⁹ *Id.* at 152-53.

10(b) is not limited to misstatements.¹⁰⁰ Instead, the majority held that the actions and statements of the defendants were “not actionable because [they] did not have the requisite proximate relation to the investors’ harm.”¹⁰¹ In other words, plaintiffs “cannot show reliance upon any of [defendants’] actions except in an indirect chain that we find too remote for liability.”¹⁰² The test articulated was that a defendant’s conduct is too remote to satisfy the reliance element of a private Section 10(b) suit unless the defendant’s conduct made the misstatement “necessary or inevitable.”¹⁰³

Plaintiffs argued that they should prevail because the defendants’ conduct was intended to deceive Charter’s investors and that investors did rely on the resulting misrepresentation.¹⁰⁴ The majority countered this analysis with a policy argument, asking: where is the limit?¹⁰⁵ The Justices of the majority contended that the rule proffered by the plaintiffs would render *Central Bank* moot: “[plaintiffs’] view of primary liability makes any aider and abettor liable under § 10(b) if he or she committed a deceptive act in the process of providing assistance.”¹⁰⁶ The majority thus declined to expand the private right under Section 10(b) past what Congress had implicitly approved through its adoption of the PSLRA.¹⁰⁷

The dissent, authored again by Justice Stevens, was joined by Justice Ruth Bader Ginsburg and Justice David Souter.¹⁰⁸ The dissent disagreed with two of the majority’s basic contentions. First, the dissent distinguished the instant case from *Central Bank* on the grounds that the defendant in *Central Bank* had not engaged in any action, merely inaction.¹⁰⁹ In contrast, the defendant here had engaged in sham transactions, which should fall squarely within the “deceptive conduct” language of Section 10(b).¹¹⁰

Second, the dissent criticized the “super-causation” test for reliance proffered by the majority: plaintiffs are “required to allege that [defendants] made it ‘necessary or inevitable for Charter to record the transactions as it did.’”¹¹¹ The dissent countered that “[t]his Court has not held that investors must be aware of the specific deceptive act which violates § 10b to demon-

¹⁰⁰ *Id.* at 158.

¹⁰¹ *Id.* at 158-59.

¹⁰² *Id.* at 159.

¹⁰³ *Stoneridge*, 552 U.S. at 160-61.

¹⁰⁴ *Id.* at 160.

¹⁰⁵ *See id.* (contending that if the “concept of [indirect] reliance [was] adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business”).

¹⁰⁶ *Id.* at 162-63.

¹⁰⁷ *Id.* at 165-66.

¹⁰⁸ *Id.* at 167 (Stevens, J., dissenting). Justice Breyer did not participate in the consideration of the case.

¹⁰⁹ *Stoneridge*, 552 U.S. at 169 (Stevens, J., dissenting).

¹¹⁰ *Id.* at 168-70.

¹¹¹ *Id.* at 170.

strate reliance.”¹¹² Justice Stevens contended that plaintiffs successfully pleaded reliance by: (1) showing that “but-for” the defendants’ actions, the misstatement would not have been issued; and (2) once the misstatement was publicly distributed, showing that the transaction would not have taken place “but-for” defendants’ conduct using the fraud-on-the-market theory of reliance, which assumes the market price of the security was affected by the misstatement once it was made public.¹¹³

Additionally, if proximate causation were required, the dissent believed that the plaintiffs had successfully pleaded it by alleging the defendants *knew* Charter would inflate its revenues based on the sham transactions; plaintiffs’ purchase of Charter shares at an artificially high price was therefore a foreseeable circumstance of defendants’ conduct.¹¹⁴ The dissent concluded with a brief defense of the policy justifications for private right of action under Section 10(b), attempting to counter the majority’s resistance to what it called an “expansion” of that right.¹¹⁵

II. FROM CAUSATION TO CONDUCT

This Part contends that the Court correctly moved from a reliance-based test for primary liability in *Stoneridge* to a conduct-based test in *Janus*. It posits that the use of reliance in *Stoneridge* was a policy-driven attempt by the conservative majority of the Court to limit private securities litigation without infringing the SEC’s enforcement authority. Section A sets forth the *Janus* opinion, and Section B delves further into the *Stoneridge* Court’s reasoning for analyzing how and why its rule of law was misguided. Section C questions how a conduct-based analysis of *Stoneridge* would have proceeded and further examines the rule of law articulated in *Janus*.

A. Janus Capital Group

The Court had the opportunity to reexamine its secondary liability precedent only a few years after *Stoneridge*, in *Janus Capital Group v. First Derivative Traders*. The facts in *Janus* involve three entities: a mutual fund, Janus Investment Fund (“JIF” or the “fund”); its investment adviser, Janus Capital Management (“JCM” or the “adviser”); and the adviser’s parent company, Janus Capital Group (“JCG”).¹¹⁶

¹¹² *Id.* at 171.

¹¹³ *Id.* at 171-72.

¹¹⁴ *Id.*

¹¹⁵ *Stoneridge*, 552 U.S. at 172-73 (Stevens, J., dissenting).

¹¹⁶ *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2299 (2011).

JCG, a publicly owned corporation, is in the business of sponsoring and managing mutual funds.¹¹⁷ It formed JIF, a Massachusetts business trust.¹¹⁸ JIF, like most mutual funds, is a pool of investor assets to be invested pursuant to a certain strategy.¹¹⁹ Investors can redeem their shares in the fund at any time for a pro rata share of the fund's net asset value ("NAV").¹²⁰ The fund has a board of trustees, of which at least 40 percent are required to be "uninterested" or "independent" (the "board").¹²¹

The board signed an investment advisory contract with JCM on behalf of the fund.¹²² Pursuant to the contract, JCM manages the day-to-day operations of the fund in exchange for an advisory fee equal to a percentage of the fund's NAV.¹²³ JCG, which is the sole owner of JCM, makes almost all of its revenue when this fee passes through to it.¹²⁴

JIF had statements in its prospectus that could be read to say it had in place policies to prevent market-timing transactions, and would cancel such redemptions.¹²⁵ Market-timing is a perfectly legal type of transaction.¹²⁶ However, since most mutual funds revalue their portfolios only once per day, sophisticated investors can take advantage of stale prices to buy shares in a mutual fund when it is undervalued, and sell it again once the discount has been corrected, or vice versa.¹²⁷ This short-term buying and selling hurts the other investors in the mutual fund, who usually are buy-and-hold retail investors.¹²⁸ Because of this, mutual funds that allow market timers to invest in the fund are not desirable investments.¹²⁹

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ SEC, *Invest Wisely: An Introduction to Mutual Funds*, SEC.GOV, <http://www.sec.gov/investor/pubs/inwsmf.htm> (last modified July 2, 2008) ("A mutual fund is a company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments.").

¹²⁰ *Id.*

¹²¹ *Janus*, 131 S. Ct. at 2299.

¹²² *Id.*

¹²³ *Id.* at 2299-300.

¹²⁴ *Id.*

¹²⁵ *Id.* at 2300.

¹²⁶ *Id.*

¹²⁷ *Janus*, 131 S. Ct. at 2300 n.1.

¹²⁸ *See id.* at 2300 (discussing how market timing hurts other investors); *see also infra* note 129 and accompanying text.

¹²⁹ The Fourth Circuit includes an excellent description of market timing in its opinion:

Market timing . . . refers to the practice of rapidly trading in and out of a mutual fund to take advantage of inefficiencies in the way the fund values its shares. Some funds, including the Janus funds, use stale prices to calculate the value of the securities held in the fund's portfolio (net asset values (NAVs)), which may not reflect the fair value of the securities as of the time the NAV is calculated. The use of stale prices to calculate the NAV makes a fund vulnerable to time zone arbitrage and other similar strategies; repeated use of such strategies is referred to as "timing" the fund. Time zone arbitrage can occur when a fund is invested in foreign securities. . . . "[T]ime zone differences allow market timers to purchase shares of

Despite the statements in the fund's prospectus, employees of the investment adviser were secretly allowing select hedge funds to engage in market-timing.¹³⁰ The New York Attorney General's office discovered the misconduct and charged the parties involved.¹³¹

Shareholders in JIF redeemed their shares en masse.¹³² The fund's NAV fell dramatically, which meant that JCM's advisory fee decreased, and, along with it, JCG's revenues.¹³³ JCG's stock price tumbled.¹³⁴ Its shareholders sued JCM and JCG for violating Section 10(b), specifically Rule 10b-5(b), when they falsely indicated in the fund's prospectus that the fund was not used for market-timing.¹³⁵

The federal district court dismissed the plaintiffs' suit against JCM and JCG for failure to state a claim.¹³⁶ The Court of Appeals for the Fourth Circuit reversed in part.¹³⁷ First, the Fourth Circuit held that plaintiffs adequately plead that both JCG and JCM "made" the statements "by participating in the writing and dissemination of the prospectuses."¹³⁸ On the issue of reliance, the court held that, once past the pleading stage, plaintiffs would have to "prove that interested investors (and therefore the market at large)

[mutual] funds [that invest in foreign securities] based on events occurring after foreign market closing prices are established, but before the fund's NAV calculation." . . . Market timing has the potential to harm other fund investors 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 111, 116 (4th Cir. 2009) ((third, fourth, and fifth alterations in original) (citation omitted) (quoting *In re Mut. Funds Inv. Litig.*, 529 F.3d 207, 211 (4th Cir. 2008)), *rev'd sub nom.* *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011).

¹³⁰ *Janus*, 131 S. Ct. at 2300.

¹³¹ *Id.*

¹³² *Id.*

¹³³ *Id.*

¹³⁴ *Id.* JCG's stock price fell nearly 25 percent in under one month. *Id.*

¹³⁵ *Id.*

¹³⁶ *In re Mut. Funds Inv. Litig.*, 487 F. Supp. 2d 618, 622 (D. Md. 2007), *rev'd*, 566 F.3d 111 (4th Cir. 2009), *rev'd sub nom.* *Janus Capital Grp., Inc., v. First Derivative Traders*, 131 S. Ct. 2296 (2011). The district court held that JCG had not "made" the actionable statements; the same judge had allowed a Rule 10b-5 suit by the mutual fund shareholders themselves to proceed against JCG on the basis of scheme liability. *Id.* The judge stated that scheme liability was not available for plaintiffs in this action because "[t]he gravamen of the alleged scheme underlying all of this . . . litigation is that mutual fund shareholders were the intended victims of the fraudulent scheme, not the shareholders of the corporate parent of fund advisers." *Id.* The district court assumed the statements were made by the investment adviser, JCM, but refused to allow the claim to proceed against JCM because the misstatements were not in connection with the sale of JCG stock. *Id.* at 623-24 ("[T]here is no nexus between plaintiffs, as JCG shareholders, and JCM, the funds' investment adviser. . . . [A] mutual fund investment adviser that allegedly made misrepresentations to mutual fund shareholders cannot be liable under [S]ection 10(b) to its parent's shareholders who purchased no mutual fund shares.").

¹³⁷ *In re Mut. Funds Inv. Litig.*, 566 F.3d 111, 131 (4th Cir. 2009), *rev'd sub nom.* *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011).

¹³⁸ *Id.* at 121.

would attribute the allegedly misleading statement to the defendant.”¹³⁹ The Fourth Circuit concluded that the complaint sufficiently alleged that it was plausible that the market would presume that JCM had “made” the statements, but not JCG.¹⁴⁰

Essentially, the Fourth Circuit addressed both conduct and reliance: it adopted the Ninth Circuit’s “substantial participation” test to determine who *actually* made the statements *and* used the Ninth Circuit’s objective test for reliance to ask whether the market relied on that entity enough to establish the “super-causation” the *Stoneridge* opinion made necessary.¹⁴¹

Once again, the Supreme Court split five to four and, once again, the split was along ideological grounds.¹⁴² However, unlike in *Stoneridge*, the Court did not couch its analysis in reliance, and instead focused on conduct. The majority held that “[f]or purposes of [R]ule 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.”¹⁴³ In doing so, the Court rejected the Government and SEC’s contention that one makes a statement by “creating” it.¹⁴⁴ The opinion proffered four major justifications for this finding: (1) it is the plain meaning of the word “make”;¹⁴⁵ (2) it is consistent with *Central Bank*;¹⁴⁶ (3) it is consistent with the test for reliance proffered in *Stoneridge*;¹⁴⁷ and (4) it observes legal formalities and the corporate form.¹⁴⁸

First, the majority used a dictionary definition from 1934 to show that to “make” cannot mean “create” because it is paired with “a statement.”¹⁴⁹ Therefore, “[o]ne ‘makes’ a statement by stating it.”¹⁵⁰ Interestingly, another dictionary cited by the court for support also defines “make” to mean “to

¹³⁹ *Id.* at 124.

¹⁴⁰ *Id.* at 127-28.

¹⁴¹ *Cf. In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 970-73 (C.D. Cal. 1994) (holding that an auditor could be held liable for material misstatements in a corporation’s public statements so long as plaintiffs showed that the defendant’s participation was extensive enough to objectively attribute the statements to the defendant, and that the reliance element was satisfied despite the statement not being attributed to the auditor because “the securities market still relied on those public statements”); *see also supra* text accompanying note 81 (describing the Ninth Circuit’s test for reliance).

¹⁴² *See Janus Capital Group v. First Derivative Traders*, THE OYEZ PROJECT AT IIT CHICAGO-KENT COLLEGE OF LAW, http://www.oyez.org/cases/2010-2019/2010/2010_09_525 (last visited Oct. 02, 2012).

¹⁴³ *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011).

¹⁴⁴ *Id.* at 2303.

¹⁴⁵ *Id.* at 2302.

¹⁴⁶ *Id.*

¹⁴⁷ *Id.* at 2303.

¹⁴⁸ *Id.* at 2304.

¹⁴⁹ *Janus*, 131 S. Ct. at 2302 (“When ‘make’ is paired with a noun expressing the action of a verb, the resulting phrase is ‘approximately equivalent in sense’ to that verb.” (quoting 6 OXFORD ENGLISH DICTIONARY 66 def.59 (1933))).

¹⁵⁰ *Id.*

cause to exist, appear, or occur.”¹⁵¹ Additionally, though the Court has previously held that the opinion of an agency such as the SEC is entitled to deference when it interprets ambiguous language in its own implementing rules and regulations,¹⁵² the majority found that “make” is not ambiguous, so it need not consider the SEC’s interpretation.¹⁵³

The dissent countered that the majority limited the meaning of the word “make” in a way that “[n]either common English nor this Court’s earlier cases” requires.¹⁵⁴ Instead, the dissent contended that numerous people can and do make one statement—“[a]nd the circumstances here are such that a court could find that [the investment adviser] made the statements in question.”¹⁵⁵ The dissent, then, wished to look at who, objectively, caused the statements to come into existence and to be false, not who approved their dissemination.¹⁵⁶

Second, the majority said that its test follows from the holding in *Central Bank* because private litigants cannot bring actions for substantially assisting the making of a statement.¹⁵⁷ The dissent contended that the majority’s test need not follow from *Central Bank*, which did not profess to define primary liability, but merely said that the text of Section 10(b) did not support secondary liability.¹⁵⁸ Furthermore, *Central Bank* expressly left open the line between primary and secondary liability.¹⁵⁹

Third, the majority claimed that the “ultimate authority” test is consistent with the “necessary or inevitable” test articulated in *Stoneridge* because “without [ultimate] authority [over a statement], it is not ‘necessary or inevitable’ that any falsehood will be contained in the statement.”¹⁶⁰ The dissent pointed out that *Stoneridge* purported to create a test defining reliance, not conduct.¹⁶¹ Furthermore, in the case of *Janus*, the adviser’s actions

¹⁵¹ Compare *id.* (“‘Make followed by a noun with the indefinite article is often nearly equivalent to the verb intransitive corresponding to that noun.’” (quoting WEBSTER’S NEW INTERNATIONAL DICTIONARY 1485 def.43 (2d ed. 1934))), with Brief for Respondent at 15, *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011) (No. 09-525), 2010 WL 4253501, at *15 (“[M]ake’ means ‘[t]o cause to exist, appear, or occur’” (alterations in original) (quoting same))).

¹⁵² *Auer v. Robbins*, 519 U.S. 452, 462-63 (1997).

¹⁵³ *Janus*, 131 S. Ct. at 2303 n.8 (“Because we do not find the meaning of ‘make’ in Rule 10b-5 to be ambiguous, we need not consider the Government’s assertion that we should defer to the SEC’s interpretation of the word elsewhere.”). The Court continued by noting that “we have previously expressed skepticism over the degree to which the SEC should receive deference regarding the *private* right of action,” lending some support to the premise that the SEC’s definition can continue to be used in its own cases. *Id.* (emphasis added).

¹⁵⁴ *Id.* at 2306 (Breyer, J., dissenting).

¹⁵⁵ *Id.*

¹⁵⁶ *Id.*

¹⁵⁷ *Id.* at 2302 (majority opinion).

¹⁵⁸ *Id.* at 2307-08 (Breyer, J., dissenting).

¹⁵⁹ See *supra* Part I.C.

¹⁶⁰ *Janus*, 131 S. Ct. at 2303.

¹⁶¹ *Id.* at 2309-10 (Breyer, J., dissenting).

did, in fact, make it necessary or inevitable that the false statements be issued to the public because the board of directors, who had ultimate authority over the statement, was also deceived.¹⁶²

Fourth, the majority refused to declare that JCM made the statements in JIF's prospectus because JCM exerts "significant influence" over its client mutual fund: "We decline this invitation to disregard the corporate form. . . . JCM and [JIF] remain legally separate entities, and [JIF's] board of trustees was more independent than the [Investment Company Act of 1940] requires."¹⁶³ The dissent would, using its broader definition of "make" and recognizing the degree of control JCM has over its client, allow the suit to proceed, especially because, in this circumstance, the board of trustees was innocent and unknowing.¹⁶⁴

B. *Reliance in Central Bank and Stoneridge*

The Supreme Court's use of reliance as a rationale for eliminating aiding and abetting liability, the continued focus on it by lower courts who adopted the "attribution" rule, and the Supreme Court's affirmation of that use in *Stoneridge* were all rather puzzling considering previous precedent on the element of reliance.¹⁶⁵ Reliance in securities litigation is also known as "transaction causation" and is likened to a "but-for causation" standard, where without the false statement or deceptive conduct, the plaintiff would not have purchased the security at that price.¹⁶⁶

Additionally, the fraud-on-the-market theory of reliance, which courts have allowed in securities fraud cases for many years, presumes reliance when a statement is made public.¹⁶⁷ This theory recognizes that shareholders are actually relying on the integrity and efficiency of capital markets generally—shareholders assume that the share price accurately reflects the value of the company given the information available.¹⁶⁸ This principle conflicts with the idea that investors and the market generally are ever relying on a specific entity as the maker of a statement—they merely rely on the truth of that statement.¹⁶⁹

¹⁶² *Id.* at 2310.

¹⁶³ *Id.* at 2304 (majority opinion).

¹⁶⁴ *Id.* at 2312 (Breyer, J., dissenting).

¹⁶⁵ See *Langevoort*, *supra* note 37, at 2131.

¹⁶⁶ See *id.*

¹⁶⁷ See *Basic Inc. v. Levinson*, 485 U.S. 224, 247 (1988) ("An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.").

¹⁶⁸ *Id.* at 246-47.

¹⁶⁹ See *Langevoort*, *supra* note 37, at 2133 ("I am not inclined to linger over the Court's choice in *Stoneridge* to make reliance the determinative issue in assessing scheme liability, even though, like the

Given these premises, the Ninth Circuit's "substantial participation" test, as opposed to the Second and Eleventh Circuits' bright-line attribution rule, correctly focused on the type of conduct necessary to distinguish between primary and secondary liability, though it still professed to ground its opinions in the reliance element.¹⁷⁰ The majority's reasoning in *Stoneridge*, however, seemed to affirm the strict focus on reliance used by the public attribution test in the Second and Eleventh, though the "remoteness" test announced was actually less restrictive.¹⁷¹

However, using reliance as a hook on which to hang holdings makes perfect sense when considered in tandem with the policy judgment that informed the courts' analyses: "[private] litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."¹⁷² The SEC does not need to prove reliance; by placing the dividing line between primary and secondary violations within the reliance element, the Court only hampered private litigants and specifically addressed the policy goal of decreasing "vexatiousness" in private litigation.¹⁷³

dissenters, I find it strange. The standard fraud-on-the-market theory presumes that investors rely on price integrity, not directly on the misinformation itself."); see also Larry Ribstein, *The Stoneridge Opinion*, IDEOBLOG (Jan. 15, 2008, 3:42 PM), <http://busmovie.typepad.com/ideoblog/2008/01/the-stoneridge.html> ("[I]nstead of focusing on the type of conduct that should get a defendant into trouble under the securities laws, the Court [in *Stoneridge*] focused on reliance. This is a weak theory once you accept, as the Court does, that 10b-5 liability can be based on conduct rather than misstatements. Given the fraud-on-the-market presumption of reliance, it's far from clear why reliance was missing here, as the dissent pointed out.").

¹⁷⁰ See *supra* note 81 and accompanying text.

¹⁷¹ Compare *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 160-61 (2008) (a defendant's conduct is too remote to satisfy the reliance element of a private Section 10(b) suit unless the defendant's conduct made the misstatement "necessary or inevitable"), with *Pac. Inv. Mgmt. Co. v. Mayer Brown LLP*, 603 F.3d 144, 148 (2d Cir. 2010) (holding that "a secondary actor can be held liable in a private damages action brought pursuant to Rule 10b-5(b) only for false statements attributed to the secondary-actor defendant at the time of dissemination. Absent attribution, plaintiffs cannot show that they relied on defendants' own false statements, and participation in the creation of those statements amounts, at most, to aiding and abetting securities fraud." (footnote omitted)), *cert. denied*, 131 S. Ct. 3021 (2011); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) ("Following the Second Circuit, we conclude that, in light of *Central Bank*, in order for the defendant to be primarily liable under § 10(b) and Rule 10b[-]5, the alleged misstatement or omission upon which a plaintiff relied must have been publicly attributable to the defendant at the time that the plaintiff's investment decision was made.").

¹⁷² *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 189 (1994) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975)).

¹⁷³ See *Langevoort*, *supra* note 37, at 2133 (explaining that the Court limited private securities litigation by situating its restrictive approach in the reliance element); cf. Ribstein, *supra* note 169 (arguing that the Court's focus on reliance for determining 10b-5 liability is a weak theory and one that has significant consequences as it determines who may seek a judicial remedy).

C. *The Case for Conduct*

The Supreme Court in *Stoneridge* should have instead focused on whether the defendant's *conduct* constituted a primary violation of the securities laws or if the defendant merely aided and abetted the scheme to defraud. The case against the defendants in *Stoneridge* may still have been weak had the Court examined defendants' conduct instead of plaintiffs' reliance. A "round trip transaction" need not be inherently deceptive. For instance, the defendants would not have been engaging in a deceptive act if they believed Charter was attempting to *legally* recognize accounting gains without realizing them for tax purposes.¹⁷⁴ Plaintiffs alleged, however, that defendants knew that Charter intended to *improperly* record the revenue, as evidenced by the defendants' agreement to provide false letters and back-date documents.¹⁷⁵ A transaction with no economic substance combined with knowledge of fraud should fall squarely within the conduct covered by the "scheme to defraud" language of Section 10(b).¹⁷⁶

The dissent in *Stoneridge* pointed towards this: Justice Stevens's first argument was that the majority used an "overly broad" reading of *Central Bank*, where the defendant's conduct was mere inaction.¹⁷⁷ This contention could be easily dismissed: the debate in lower courts pre-*Central Bank* was about whether omissions absent a duty to disclose even constituted *aiding and abetting*, not whether an action was a primary or secondary violation.¹⁷⁸ However, to dismiss this argument would be to ignore the fact that because of the widespread acceptance of a private action for aiding and abetting a Section 10(b) violation, many cases before *Central Bank* conflated the two causes of action, and may have, in fact, pleaded both without distinguishing the conduct.¹⁷⁹ In fact, many commentators believed that *Central Bank* would have little impact, since lower courts would reclassify conduct that fell within the text of Section 10(b) as primary violations.¹⁸⁰ Furthermore,

¹⁷⁴ Cf., e.g., *Cottage Sav. Ass'n v. Commissioner*, 499 U.S. 554, 556 (1991) (holding that a savings and loan association could recognize tax losses on a transaction even when the swap it engaged in was for a package of loans of substantially the same economic value).

¹⁷⁵ *Stoneridge*, 552 U.S. at 154-55.

¹⁷⁶ *Id.* at 168-69 (Stevens, J., dissenting) ("The allegations in this case—that respondents produced documents falsely claiming costs had risen and signed contracts they knew to be backdated in order to disguise the connection between the increase in costs and the purchase of advertising—plainly describe 'deceptive devices' under any standard reading of the phrase.").

¹⁷⁷ *Id.* at 168.

¹⁷⁸ *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 899 (10th Cir. 1992), *rev'd sub nom.* *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

¹⁷⁹ See Prentice, *supra* note 39, at 705.

¹⁸⁰ See, e.g., *id.* at 722 (showing two approaches of how the courts have dealt with conduct that falls within 10b-5 as primary liability); Seligman, *supra* note 57, at 1435 (stating that following the Central Bank approach would not result in significant losses for going after 10b-5 conduct).

this may have been exactly what the majority in *Central Bank* intended and anticipated, to some extent.¹⁸¹

Plaintiffs, courts, and commentators were puzzled by the holding of *Stoneridge*.¹⁸² As one court later put it: “after *Stoneridge*, it is somewhat unclear how the deceptive conduct of a secondary actor could be communicated to the public and yet remain ‘deceptive.’”¹⁸³ The ruling effectively closed off the use of scheme liability by private plaintiffs against secondary actors who did not directly issue statements to the public.¹⁸⁴ This meant that an entire class of actors engaged in deceptive conduct was subject to suit only by the SEC. However, those same secondary actors had no guidance about whether a court would classify the conduct of the defendants in *Stoneridge* as a primary or secondary violation for the purposes of SEC action.

The Supreme Court’s opinion in *Janus* rightly focused on the requisite conduct, rather than reliance, for a primary violation of Rule 10b-5.¹⁸⁵ It defined the “maker” of a statement to be the person or entity with “ultimate authority” over the statement.¹⁸⁶ Though the majority said that attribution may be good evidence of who the maker of a statement is, it did not indicate, like the Second Circuit previously had, that it is necessary.¹⁸⁷ In that manner, it was less stringent than the previous bright-line rule, and should be flexible enough to encompass most cases of obvious fraud by examining what person or entity was actually responsible for the statements. Unfortunately, however, the test has not been read flexibly and has been misapplied.¹⁸⁸

III. UNDER *JANUS*, WHO IS LIABLE AND FOR WHAT?

The previous parts of this Note have praised the *Janus* opinion for clarifying and focusing an important area of securities law. However, the decision has many critics, and has been derided as another policy-driven

¹⁸¹ See Prentice, *supra* note 39, at 714-16 (explaining that the majority opinion in *Central Bank* admitted Rule 10b-5 permitted finding primary liability for collateral defendants under a broad reading of the rule to serve the legislative goal of preventing and punishing fraud).

¹⁸² See, e.g., *Pac. Inv. Mgmt. Co. v. Mayer Brown LLP*, 603 F.3d 144, 159 (2d Cir. 2010), *cert. denied*, 131 S. Ct. 3021 (2011); Langevoort, *supra* note 37, at 2131; Ribstein, *supra* note 169.

¹⁸³ *Pacific Inv. Mgmt. Co.*, 603 F.3d at 159.

¹⁸⁴ *Contra* Charles J. Wilkes, *Secondary-Actor Liability in a Post-Stoneridge World: Yes, a Successful Suit Against Secondary Actors Is Still Possible*, 40 SETON HALL L. REV. 1811, 1839 (2010) (proposing a test for “imputing” liability to secondary actors that would seem to be foreclosed by *Janus*).

¹⁸⁵ *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2301 (2011).

¹⁸⁶ *Id.* at 2302.

¹⁸⁷ *Id.* (“[I]n 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.” (emphasis added)).

¹⁸⁸ See *infra* Part III.C.

exercise by the conservative Justices of the Supreme Court to limit private plaintiffs in securities litigation.¹⁸⁹ This Part posits that this criticism is merely an overreaction, and that not only is the outcome in *Janus* completely acceptable, but also that the reasoning limits the outcome to cases involving mutual funds. Section A outlines the potential problems with the “ultimate authority” test articulated in *Janus* that critics have identified. Section B states that these are unfounded concerns that ignore the procedural posture of *Janus*; in truth, wronged fund shareholders will still be able to collect in private litigation, and the SEC can still proceed against offending actors as well. Section C demonstrates that, unfortunately, lower courts have read the opinion in the overly broad manner critics worried about, and predicts that a continuance of such a reading will lead to Congressional action.

A. *Potentially, No One is Liable*

As alluded to in the dissenting opinion, the problem with *Janus*, for some, is that the formalistic reading of Rule 10b-5 and “ultimate authority” test may allow for a result that Congress could not possibly have intended: the potential for no liability in either an SEC or private suit when an obvious fraud has occurred.¹⁹⁰

With respect to private actions, these commentators believe that the majority, in its effort to create certainty through a bright-line test, has refused to acknowledge that there may be a middle ground where primary liability should attach between the “substantial assistance” necessary to aid and abet the making of a material misstatement and the actual legal issuance of such a statement.¹⁹¹

¹⁸⁹ E.g., J. Robert Brown Jr., *Janus Capital, the US Supreme Court and Political Decision Making: Reversing the Private Right of Action Under Rule 10b-5 (Part 1)*, THE RACE TO THE BOTTOM (June 22, 2011, 6:00 AM), <http://www.theracetothetbottom.org/securities-issues/janus-capital-the-us-supreme-court-and-political-decision-ma.html> (“Make no mistake about it. The opinion of the five-Justice conservative majority in *Janus Capital v. First Derivative* is a piece of political decision making, more in line with a legislature than a court.”); see also Wagner, *supra* note 8 (discussing the Court’s *Janus* opinion and showing how the Court’s analysis of the word “made” potentially limits private plaintiffs because a plaintiff must show that the defendant “made” the statement).

¹⁹⁰ Cf. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 188 (1994) (“Policy considerations cannot override our interpretation of the text and structure of the [Exchange] Act, 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.” (quoting *Demarest v. Manspeaker*, 498 U.S. 184, 191 (1991))).

¹⁹¹ *Janus*, 131 S. Ct. at 2307 (Breyer, J., dissenting) (“Practical matters related to context, including control, participation, and relevant audience, help determine who ‘makes’ a statement and to whom that statement may properly be ‘attributed’ . . .”). In the majority’s defense, counsel for respondent couldn’t articulate a principled test for distinguishing primary and secondary conduct during oral argument either. See Transcript of Oral Argument at 56, *Janus*, 131 S. Ct. 2296 (No. 09-535), available at

Additionally, with respect to SEC enforcement, it remains to be seen whether lower courts will allow the SEC to successfully sue parties such as JCM as an aider and abetter to a Section 10(b) violation in a case with the same facts.¹⁹² So long as the board of trustees was innocent, JIF lacked the scienter necessary to be liable under Rule 10b-5(b).¹⁹³ If there is no primary violation, JCM could not have aided and abetted it, nor could it be liable as a control person.¹⁹⁴

B. *Should Someone Be Liable?*

Critics of the *Janus* opinion read the case in an overly broad manner. Contrary to the worries of many, not only would the SEC be able to sue the adviser under a number of other provisions of the federal securities laws,¹⁹⁵ it almost certainly could still sue the adviser under Section 10(b) for making false statements to the *fund* itself and its board. This is because the adviser failed to disclose to the fund's board that, despite its stated policy, it had entered into agreements to allow market timing in the fund. Such an omission of material facts constitutes a breach of the adviser's fiduciary duty and is actionable under Sections 206(1) or (2) the Investment Advisers Act

http://www.supremecourt.gov/oral_arguments/argument_transcripts/09-525.pdf. When Justice Sotomayor asked counsel to “[d]efine what a primary violator is, what a secondary violator is who aids and abets, and who a control person is” in three sentences, he answered that a “primary violator must be somebody who has actually committed all the elements of a 10b-5 cause of action.” *Id.* at 49-50. His best attempt at a distinction came earlier, when he answered who the maker of a statement is depended on “[w]ho has substantive control over the content of the message.” *Id.* at 44-45. It seems as though respondent may have believed most of the fight in the Supreme Court would be on whether or not the element of reliance was present, as it was in *Stoneridge*. This may not have been a bad assumption considering the Government and the SEC's support for the “creator” standard for “make” and precedent indicating the SEC's interpretation was entitled to deference. See Brief for the United States as Amicus Curiae Supporting Respondent at 8, *Janus*, 131 S. Ct. 2296 (No. 09-535), 2010 WL 4339892 (“The [SEC] has construed the term ‘make’ as providing for primary liability when a person ‘creates’ a misrepresentation either by writing or speaking it, providing false or misleading information for another to put into it, or allowing it to be attributed to him. Under *Auer v. Robbins*, 519 U.S. 452, 461 (1997), the [SEC's] construction of its own rule is entitled to controlling weight.”).

¹⁹² *Janus*, 131 S. Ct. at 2310 (Breyer, J., dissenting).

¹⁹³ *Id.*

¹⁹⁴ *Id.*; see also Securities and Exchange Act of 1934 § 20(a), 15 U.S.C. § 78t(a) (2006) (requiring a primary violation by the controlled person or entity in order to have control person liability). The petitioners in *Janus* contended that section 20(b), which makes it illegal to do anything indirectly that one could not do directly, should take care of when there is an innocent intermediary. *Janus*, 131 S. Ct. at 2304 & n.10 (majority opinion). The majority does suggest but does not proffer an opinion on the matter. *Id.* at 2305 n.12. This contention may be true, but there is a “dearth of authority” on the section. *Id.* at 2311 (Breyer, J., dissenting).

¹⁹⁵ *E.g.*, Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (2006); Investment Advisers Act of 1940 § 206(1)-(2), 15 U.S.C. § 80b-6(1)-(2) (2006). But see *infra* Section III.C.3. (discussing section 17(a) of the Securities Act.)

of 1940 (the anti-fraud statute for investment advisers that only the SEC can enforce), as well as Section 10(b) and Rule 10b-5.¹⁹⁶

Additionally, private shareholders in the *mutual fund* still have a remedy, using the same theory.¹⁹⁷ The opinion's critics and some lower courts have completely ignored the procedural posture of *Janus*: the suit was not brought by shareholders in the mutual fund, it was brought by shareholders in the mutual fund's *sponsor*, a publicly owned corporation that derived most of its revenues from pass-through profits from the investment adviser, its wholly owned subsidiary.¹⁹⁸

Even after *Janus*, the shareholders of the mutual fund itself could certainly still bring a derivative suit against the investment adviser, since the adviser had a duty to the fund to disclose that the fund was being run contrary to stated policy, and the failure to do so constitutes an "omissions" suit under Rule 10b-5.¹⁹⁹ In fact, the defendants in *Janus* recognized that the fund shareholders retained a viable 10b-5 suit in oral argument.²⁰⁰

Investors in the mutual fund at issue did in fact recover.²⁰¹ In this case, the SEC negotiated a settlement with the adviser and the sponsor.²⁰² Then, in conjunction with the board of trustees of the fund, the agency set up a fund to distribute to harmed investors the disgorgement it received in the settlement.²⁰³ However, if the board of trustees had not been acting to recompense the investors, individual shareholders could have brought a private

¹⁹⁶ See Investment Advisers Act of 1940 § 206(1)-(2), 15 U.S.C. § 80b-6(1)-(2) (anti-fraud statute for investment advisers). A "client" for purposes of the Advisers Act is the fund itself, not its shareholders. *Goldstein v. SEC*, 451 F.3d 873, 881 (D.C. Cir. 2006); see also Oral Argument, *supra* note 191, at 9-10 (counsel for the defendants stating that the mutual fund shareholders had a legitimate Section 10(b) claim: "[The mutual fund shareholders] can sue JCM . . . for an omission, because there's a duty that runs from JCM to the funds. That was the theory advanced in that separate lawsuit accepted by the district court, which has since been resolved.").

¹⁹⁷ See Donald C. Langevoort, *Lies Without Liars? Janus Capital and Conservative Securities Jurisprudence* 3-4 (Georgetown Pub. Law and Legal Theory Research Paper No. 12-019, 2012), available at <http://ssrn.com/abstract=2010745>.

¹⁹⁸ *In re Mut. Funds Inv. Litig.*, 556 F.3d 111, 115 (4th Cir. 2009), *rev'd sub nom.* *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011).

¹⁹⁹ See *In re Mutual Funds Inv. Litig.*, 384 F. Supp. 2d 845, 853 (D. Md. 2005) ("[Plaintiffs] plead an omissions case against the [investment adviser] defendants under Rule 10b-5(b) . . ."); Oral Argument, *supra* note 191, at 9-10, 64-65.

²⁰⁰ See Oral Argument, *supra* note 191, at 64-65 (arguing that the mutual fund shareholders had a legitimate Section 10(b) claim).

²⁰¹ See *In re Janus Capital Mgmt., LLC*, Investment Advisers Act Release No. 2277, Investment Company Act Release No. 26532, 83 SEC Docket 1766, 2004 WL 1845502, at *4 (Aug. 18, 2004) (ordering disgorgement of profits and civil penalties), *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). The SEC settled with the adviser using statutes under which there is no private right of action, namely Section 206 of the Investment Advisers Act of 1940 and Sections 34(b) and 17(d) of the Investment Company Act of 1940 and Rule 17d-1 thereunder. *Id.*

²⁰² *Id.* at *1

²⁰³ *Id.* at *11

derivative suit, stepping into the shoes of the fund and bringing any action against the adviser that the fund could.²⁰⁴

The real question, therefore, is whether the SEC or private litigants should *ever* be able to sue and collect based upon the losses suffered by the adviser's parent corporation, as was the case in *Janus*. The answer to this question is no. As some *amici* contended, such a precedent would weaken the interests of mutual fund shareholders, since their advisers would now have two sets of shareholder interests to take into account.²⁰⁵ Additionally, the adviser owes no duty to the shareholders in its parent corporation that is equivalent to the duty it owes the fund.²⁰⁶

In the example provided in the introduction to this Note, then, both the SEC and private investors could still bring a suit against the adviser for losses suffered by shareholders of the fund. What should not be allowed under the *Janus* test is a suit by investors in the parent corporation of Minerva Asset Management for losses sustained when the fund lost money.

This is an acceptable result. Not all wrongdoing by public companies can or should result in a securities fraud charge. For instance, the massive BP oil spill in the Gulf of Mexico led to a huge drop in the company's stock price. However, the shareholders in BP cannot sue under Section 10(b) for the decrease in their shares' value merely based on negligence by company officials—they must show a material misstatement about BP's activities in the Gulf made in connection with a sale of its stock (e.g., show that the company lied about its safety record in public SEC filings).²⁰⁷ The claim in *Janus* is roughly the same: company officials were engaged in some sort of

²⁰⁴ See FED. R. CIV. P. 23.1; see also *In re Mutual Funds Inv. Litig.*, 384 F. Supp. 2d at 851-52 (allowing a derivative suit to be brought by an individual shareholder).

²⁰⁵ See Brief of Amici Curiae G. Eric Brunstad, Jr., et al. in Support of Petitioners at 6, *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011) (No. 09-525), 2010 WL 3559536.

When mutual funds prepare their prospectuses, they and their advisers properly focus on the interests of the investors in the funds. Emphatically, they do not properly focus on the interests of the advisers' shareholders (let alone the shareholders of an adviser's corporate parent). First Derivative proposes a novel liability rule that would fundamentally change this mandate by expanding dramatically the parties who may sue on the basis of a mutual fund prospectus. Unavoidably, such an expanded liability rule would misdirect the attention of mutual fund boards and their advisers in a manner at odds with the interests of the funds and their shareholders.

Id.

²⁰⁶ See *supra* note 196 and accompanying text.

²⁰⁷ See *In re BP P.L.C. Sec. Litig.*, 852 F. Supp. 2d 767, 774 (S.D. Tex. 2012) ("Plaintiffs claim that they purchased their shares in reliance on BP's representations that it had implemented appropriate safety mechanisms to reduce the risk of catastrophic incidents in the Company's deepwater drilling operations. Plaintiffs suffered the loss of a substantial portion of their investment when the true state of BP's operations was revealed, tragically, through the Deepwater Horizon catastrophe and subsequent oil spill." (citation omitted)). Interestingly, the complaint in this case was dismissed in part due to *Janus*. *Id.* at 819. Some of the misrepresentations at issue were contained in a document filed by BP with the SEC, but attributed to a subsidiary of BP, foreclosing part of the plaintiffs' claim. *Id.*

wrongdoing, but there was no misrepresentation made in connection with a sale of JCG's stock.²⁰⁸ Therefore, no liability should attach.

Additionally, the facts of *Janus* are not easily replicated. The result in this case is almost entirely due to the unique mutual fund structure. The Investment Company Act of 1940, which governs mutual funds, does not mandate the internalization of the management function, and the SEC, instead of changing the law, has instead focused on the fund's board to ensure shareholders are adequately represented.²⁰⁹ In the case of the Janus fund, the board of trustees reviewed every policy in the prospectus prior to issuance.²¹⁰ It did have ultimate authority over the statements therein, and the Court focused in on this in its opinion and especially during oral argument.²¹¹

Mutual funds are not the only investment vehicles that use an externalized management structure. Hedge funds are similarly structured, but are often limited partnerships with no board, or have boards of directors who are not as engaged as those in mutual funds.²¹² Similarly, many of the cases arising out of the 2008 financial crisis involved asset-backed securities.²¹³ Investors in a collateralized debt security, for example, invest in a special purpose vehicle ("SPV") formed by an arranger (usually an investment bank).²¹⁴ However, in cases such as this, it should not be difficult to prove that the hedge fund adviser or SPV arranger did indeed have ultimate authority over the statement, since there exists no equivalent to the independent and highly regulated board of a mutual fund.²¹⁵

C. *Unintended Consequences of the Court's Decision*

Lower courts and commentators have not limited *Janus* in the way that this Note contends it should be and as described in Part III.B. Instead, *Janus* has been read to limit the liability of external managers to the companies or funds they advise and control, to limit the liability of individuals, and extended to cover other portions of the securities laws.

²⁰⁸ *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2300 (2011).

²⁰⁹ See Brief of Amici Curiae, *supra* note 205, at 11-13.

²¹⁰ See Oral Argument, *supra* note 191, at 12.

²¹¹ See generally *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2305 (2011); Oral Argument, *supra* note 191.

²¹² *Goldstein v. SEC*, 451 F.3d 873, 876 (D.C. Cir. 2006).

²¹³ See Waldman, *supra* note 23 (discussing the "high stakes fraud" that has been concentrated in the securitization business).

²¹⁴ *Id.*

²¹⁵ The Justices focused on this a great extent during oral argument in *Janus*. See generally Oral Argument, *supra* note 191.

1. Misapplication of *Janus* Test to Relieve Advisers of Liability to Fund Shareholders

This Note contends that if the Janus mutual fund shareholders themselves had used a derivative suit to sue the investment adviser for misrepresentations, the adviser would have been found liable. This is because the adviser “makes” misrepresentations to the fund when it supplies false information to be included in a prospectus.²¹⁶ Similarly, a hedge fund adviser or the arranger of an asset-backed security is “making statements” to the fund when it supplies information to be included in offering materials.²¹⁷

However, in *In re Optimal U.S. Litigation*,²¹⁸ hedge fund investors were only allowed to proceed in private suit against the fund’s adviser on Section 20(a) control person grounds.²¹⁹ In other words, the adviser was unable to be held primarily liable for statements in the hedge fund’s prospectus, with the court using *Janus* as the authority.²²⁰ Instead, the fund itself was said to be the primary violator.²²¹ The only reason scienter was attributable to the fund to complete the primary violation was because the CEO of the adviser, who knew of the fraud, was president of the board of the directors.²²² Additionally, the adviser was only deemed a control person because the rest of the board was removable at will by the adviser, who owned 100 percent of the voting shares of the fund.²²³ A similar analysis with respect to scienter would not work with a mutual fund board because the adviser is not a control person of the fund, or the responsible individual does not have dual role, (i.e., a member of both the board and management).²²⁴

2. Misapplication of *Janus* to Corporate Insiders

Courts have also read the reasoning of *Janus* broadly in its application to corporate insiders. A number of courts have used the “ultimate authority”

²¹⁶ See *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011) (“The phrase at issue in Rule 10b-5, ‘[t]o make any . . . statement,’ is thus the approximate equivalent of ‘to state.’” (alterations in original)).

²¹⁷ *Id.*

²¹⁸ No. 10 Civ. 4095(SAS), 2011 WL 4908745 (S.D.N.Y. Oct. 14, 2011).

²¹⁹ *Id.* at *6.

²²⁰ *Id.*

²²¹ *Id.* at *7-8.

²²² *Id.* at *8.

²²³ *Id.*

²²⁴ See Brief for Petitioners at 28-29, *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011) (No. 09-525), 2010 WL 3501188.

test to allow individuals to avoid responsibility for making misstatements.²²⁵ Often, the SEC and private litigants wish to charge responsible corporate insiders as individuals for their role in perpetrating securities fraud;²²⁶ in fact, it is generally unlikely that a Section 10(b) case can proceed past the pleadings without a culpable individual, since the individual's scienter is attributed to the responsible corporate entity through respondeat superior.²²⁷ Under the reasoning of *Janus*, however, plaintiffs' ability to charge individuals for statements issued by a corporation has been challenged, with at least one district court specifically finding that a corporate officer without "ultimate authority" over the contents of a filing could not "make" a statement in a corporation's communications.²²⁸ If that reading becomes popular, the SEC will have to charge responsible individuals as merely "aiding and abetting" the corporation's violation. In at least one case, "[t]he SEC concede[d] that *Janus* foreclosed its ability to assert a misstatement claim under subsection (b) of Rule 10b-5 against" the individual defendants.²²⁹ Meanwhile, another district court judge held that "[a]s the CFOs who signed and certified the statements, [the individual defendants] were the persons with ultimate authority and control over the content of the statements and whether and how they were communicated. As such, they were the 'makers' of such statements."²³⁰ The question of whether individuals can be charged at all and, if so, which ones have "ultimate authority," will be debated in the lower courts. Additionally, the question of whether the culpable state of mind of an individual without "ultimate authority" can still

²²⁵ See *SEC v. Kelly*, 817 F. Supp. 2d 340, 344 (S.D.N.Y. 2011); *Haw. Ironworkers Annuity Trust Fund v. Cole*, No. 3:10CV371, 2011 WL 3862206, at *3 (N.D. Ohio Sept. 1, 2011).

²²⁶ See, e.g., *Haw. Ironworkers Annuity Trust Fund*, 2011 WL 3862206, at *1 (plaintiffs brought suit against four officers of a company).

²²⁷ See Donald C. Langevoort, *Words From On High About Rule 10b-5: Chiarella's History, Central Bank's Future*, 20 DEL. J. CORP. L. 865, 894 (1995) ("By statutory definition, then, corporations can violate Rule 10b-5, and some form of agency law reasoning is necessary to construct an application of how and when.").

²²⁸ Compare *In re Merck & Co. Sec., Derivative & "ERISA" Litig.*, Nos. 05-115 (SRC), 05-2367 (SRC), 2011 WL 3444199, at *25 (D.N.J. Aug. 8, 2011) (finding that the holding in *Janus* was limited to cases involving a "separate and independent entity" and could not "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."), with *Haw. Ironworkers Annuity Trust Fund*, 2011 WL 3862206, at *3 (stating that "nothing in the Court's decision in *Janus* limits the key holding—the definition of the phrase 'to make . . . a statement' under Rule 10b-5(b)—to legally separate entities" and holding that officers who supplied fraudulent accounting for use in public filings did not have "ultimate authority" over the contents of those filings (alteration in original) (quoting *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011))).

²²⁹ *Kelly*, 817 F. Supp. 2d at 343.

²³⁰ *SEC v. Das*, No. 8:10CV102, 2011 WL 4375787, at *6 (D. Neb. Sept. 20, 2011).

be used to plead scienter for the primary violation remains to be addressed.²³¹

3. Misapplication to Section 17(a)

Another example of a lower court reading *Janus* in an overly broad manner is in the court's potential application of *Janus* to Section 17(a) of the Securities Act of 1933 ("Securities Act"). Section 17(a) is substantially similar to Rule 10b-5 but applies only to the sale or offering of securities.²³² The overlap in language has led many courts to construe the two sections identically.²³³ However, the test announced in *Janus* highlights a now notable difference: Section 17(a)(2) prohibits "obtain[ing] money or property by means of any untrue statement" whereas Rule 10b-5(b) prohibits "mak[ing] any an untrue statement."²³⁴

Despite the difference in the language describing conduct, at least one district court, in *SEC v. Kelly*,²³⁵ applied the reasoning of *Janus* to Section 17(a), dismissing the portions of the SEC's complaint that alleged primary liability under both Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act because the defendants did not "make" the fraudulent revenue statements at issue.²³⁶ The court reasoned that "numerous courts

²³¹ *But see In re Optimal U.S. Litig.*, No. 10 Civ. 4095(SAS), 2011 WL 4908745, at *7 (S.D.N.Y. Oct. 14, 2011) (only imputing scienter to the fund because the CEO of the adviser was also the President of the board of the fund).

²³² Section 17(a) of the Securities Act makes it

unlawful for any person in the offer or sale of any securities or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley 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.

15 U.S.C. § 77q(a) (2006).

²³³ *See Kelly*, 817 F. Supp. 2d at 345.

²³⁴ *Compare* Securities Act § 17(a), 15 U.S.C. § 77q(a)(2), with 17 C.F.R. § 240.10b-5 (2012).

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

²³⁶ *Id.* at 345. However, a number of other courts have come to the opposite conclusion. For example, a federal district court judge in California refused to apply *Janus* to Section 17(a) of the Securities Act or Section 34(b) of the Investment Company Act of 1940. *SEC v. Daifotis*, No. C 11-00137 WHA, 2011 WL 3295139, at *4 (N.D. Cal. Aug. 1, 2011). The court reasoned that "*Janus* was very specifically a decision about claimed violations of Rule 10b-5," noting that the applicable conduct in Section 17(a) is "'to obtain money or property'" and that "*Janus*'s 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." *Id.* at *5-6 ((second emphasis added) (quoting 15 U.S.C. § 77q(a)(2))).

have held that the elements of a claim under Section 17(a) are ‘essentially the same’ as those for claims under Rule 10b-5.”²³⁷ This reasoning is contrary to the Supreme Court’s strict focus on the text of the applicable statute or rule, but it is consistent with the legislative history of Rule 10b-5.²³⁸

Section 17(a)(2) violations do not require scienter, which makes it less likely that the application of the *Janus* test to it will significantly interfere with the SEC’s ability to bring aiding and abetting suits against responsible parties. However, another potential quirk of applying *Janus* to Section 17(a) is that plaintiffs will likely have to specifically address the conduct element of Section 17(a)(2)—“obtain[ing] money or property”—because of the *Janus* Court’s focus on the exact text of the applicable law.²³⁹ For instance, in *SEC v. Kelly*, the defendants were senior managers at America Online (“AOL”) who engineered “round-trip transactions” with at least six companies, allowing AOL to improperly report around \$1 billion in revenue.²⁴⁰ That revenue was reported in periodic filings with the SEC.²⁴¹ Does that action constitute AOL “obtaining money” through the material misstatement?²⁴² AOL shares are certainly traded in the secondary market (i.e., on an exchange) during the period in which it reported false revenues, and presumably, the inflated revenues led to an inflated stock price. However, the sale of AOL stock on an exchange means that the appreciation in value went to individual sellers. If AOL did not engage in a public offering of securities, did it not “obtain money” through its misstatement?²⁴³

And, again, the issues with pleading both scienter and conduct arise—the individuals who had the requisite scienter certainly didn’t obtain money

²³⁷ *Kelly*, 817 F. Supp. 2d at 345.

²³⁸ *Id.* (“[T]he Second Circuit has recognized that the SEC’s ‘only purpose’ in adopting Rule 10b-5 was to make the same prohibitions contained in Section 17(a)—which applies in connection with the ‘offer and sale’ of a security—applicable to ‘purchasers’ of securities as well.”); see also Adoption of Rule 10b-5, Exchange Act Release No. 3230, 1942 WL 34443 (May 21, 1942) (“The new rule closes a loophole in the protections against fraud administered by the [SEC] by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase.”); Milton V. Freeman, *Administrative Procedures*, 22 BUS. LAW. 891, 922 (1967) (Milton Freeman, who wrote Rule 10b-5, explaining the drafting process: “I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where ‘in connection with the purchase or sale’ should be, and we decided it should be at the end.”). Mr. Freeman also described the Commissioners’ review of the rule, explaining that “[n]obody said anything except [Commissioner] Sumner Pike who said, ‘Well, . . . we are against fraud, aren’t we?’” *Id.*

²³⁹ *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011).

²⁴⁰ *SEC v. Kelly*, 765 F. Supp. 2d 301, 305 (S.D.N.Y. 2011).

²⁴¹ *Id.* at 305-17.

²⁴² Cf. *Gustafson v. Alloyd Co.*, 513 U.S. 561, 576 (1995) (narrowly defining the term “prospectus” and finding that private parties’ entitlement under Section 12(2) of the Securities Act to rescission of a sale of securities made pursuant to a prospectus with material misstatements is limited to public offerings of securities and does not reach private sales or secondary market trading).

²⁴³ *Contra United States v. Naftalin*, 441 U.S. 768, 774-77 (1979) (finding that Section 17(a) applies to secondary trading).

or property through their actions. If AOL's conduct does not fall in a strict textual reading of Section 17(a), the SEC would be forced to use Section 10(b) instead, and the problems of proving scienter would remain.

Adding another wrinkle to the analysis, the *Kelly* Court also refused to allow the SEC to allege that the defendants' misconduct fell into Rule 10b-5(a) or (c) because "the primary purpose and effect of a purported scheme [was] to make a public misrepresentation or omission."²⁴⁴ The court reasoned that scheme liability cannot attach unless the conduct itself is "inherently deceptive," and that the round-trip transactions at issue "*became* deceptive only through AOL's misstatements in its public filings."²⁴⁵ Therefore, the SEC cannot avoid having to plead a corporation's "scienter" by charging the individual with a primary violation under scheme liability. The SEC is rendered completely unable to charge these individuals with primary violations of the anti-fraud provisions of the federal securities laws. Given the Supreme Court's continued focus on private securities litigation, this limit on public enforcement is misguided. Such a drastic result could be avoided using a more narrow reading of *Janus*.

CONCLUSION

In *Janus Capital Group*, the Supreme Court quickly rectified a problem in its securities law precedent: the unfounded focus on reliance in determining whether a defendant was a primary or secondary violator of Section 10(b). By using the element of reliance as a distinguishing factor, the Court attempted to promote its policy goal of limiting private litigation without limiting the SEC's enforcement powers. *Janus* correctly re-focused the inquiry on conduct, and defined a primary actor for purposes of Rule 10b-5 as the actor with "ultimate authority" over a statement. However, the case's convoluted procedural posture and mutual fund setting have led critics and lower courts to apply the test too broadly, such that victims of fraud are left with no remedy and wrongdoers are shielded. Congress's quick reaction to *Central Bank* indicates that a result such as this will likely lead to a legislative response. By refusing to define primary conduct for over fifteen years, and then finally narrowing it to such an extent that the result is potentially untenable to many, the Court has likely inadvertently led to an expansion of rights under Section 10(b), and Congress may respond just as quickly as it did to *Central Bank*.

²⁴⁴ SEC v. Kelly, 817 F. Supp. 2d 340, 343 (S.D.N.Y. 2011). Another court has held to the contrary. See Haw. Ironworkers Annuity Trust Fund v. Cole, No. 3:10CV371, 2011 WL 3862206, at *5-6 (N.D. Ohio Sept. 7, 2011) (individual defendant who lacked "ultimate authority" over statements could not be liable under 10b-5(b), but the claim could proceed under 10b-5(a) and (c)).

²⁴⁵ Kelly, 817 F. Supp. 2d at 344.