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U.S. Supreme Court Limits Reach of Primary Liability in Securities Fraud Cases

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On June 13, 2011, in a 5–4 decision, the U.S. Supreme Court narrowed the circumstances under which a defendant can be held liable in a private action under Rule 10b-5 for "making" a false or misleading statement. The decision, *Janus Capital Group, Inc., et al. v. First Derivative Traders*, 564 U.S. ___ (2011), No. 09-525, slip op., June 13, 2011, held that an investment adviser did not "make" statements contained in prospectuses of the adviser's mutual fund clients, even though the adviser may have assisted the mutual funds in preparing the statements. The decision has important implications not just for mutual funds and their advisers, but for all investment advisers, accountants, and others who provide services to issuers of securities. The decision may also have broader ramifications in securities litigation brought under Rule 10b-5.

Janus is another in a long line of cases in which plaintiffs sought to overcome the Supreme Court's holding in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). In *Central Bank*, the Supreme Court rejected a private action for aiding and abetting liability under federal securities laws. Ever since, plaintiffs have struggled to hold secondary actors in the securities markets—such as banks, financial advisers, accountants, and lawyers—liable for securities fraud.

In *Janus*, plaintiffs sought to assert securities fraud claims against a group of mutual funds' investment adviser, Janus Capital Management LLC (JCM), and its parent company, Janus Capital Group Inc. Plaintiffs alleged that JCM made misrepresentations about the mutual funds' rules prohibiting market timing. Recognizing that they could not establish liability by claiming that Janus aided and abetted the mutual funds' representations, plaintiffs alleged that JCM actually "made" the representations at issue, even though the prospectuses containing the alleged misrepresentations were not attributed to JCM.

The Supreme Court rejected plaintiffs' theory that JCM "made" the statements. Writing for the Court, Justice Thomas offered a succinct but forceful primer in plain English, and concluded that "[o]ne 'makes' a statement by stating it." He analogized to the relationship between a speechwriter and a speaker: "Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it. And it is the speaker who takes the credit—or blame—for what is ultimately said."

Control is therefore the key factor distinguishing speechwriting from speechmaking, and it is control that the Court now uses to define the scope of liability under Rule 10b-5. "The rule we adopt today," Justice Thomas wrote, is that "the maker of a statement is the entity with authority over the content of the statement and whether and how to communicate it."

In defending its new rule, the Court noted that its conclusion of who "makes" a statement is consistent with its precedent that Rule 10b-5's private right of action does not extend to suits against aiders and abettors. *Central Bank*, the Court reminded litigants, prohibited private actions under Rule 10b-5 against those who aided and abetted securities fraud. Construing the phrase "make a statement" to include those who do not control the content of a statement would, the Court ruled, "substantially undermine *Central Bank.*"

The Court also rejected the argument that, in light of the relationship between an investment adviser and a mutual fund, the adviser "should generally be understood to be the 'maker' of the statements by its client mutual fund." Even though the officers of the mutual funds at issue were all employees of JCM (the adviser), the Court stressed that corporate formalities were observed and that all but one of the directors were not "interested persons" of the funds, as defined in Section 2(a)(19) of the Investment Company Act of 1940. In Justice Thomas's words, therefore, the Court does not view the investment adviser as "a playwright whose lines are delivered by an actor" (the mutual fund prospectus).

In its most specific application—in the world of mutual funds and their advisers—*Janus* both limits advisers' liability under Rule 10b-5, and raises significant questions for mutual fund directors. Most importantly, if investment advisers did not "make" the statements contained in a mutual fund's prospectuses, who did? The mutual fund's directors signed the registration statements of the mutual funds on whose boards they sit. Yet *Janus* suggests that individual directors, alone, cannot be considered to have "made" the statements because they alone do not have "authority over the content of the statement and whether and how to communicate it"; only the board as a whole does.

While *Janus* does not by itself increase potential liability of boards or individual directors, directors should nevertheless take care to satisfy themselves that the funds maintain a rigorous process to ensure that investment, legal, and compliance disclosures are adequate.

Janus may have significant implications beyond the world of mutual funds and their advisers. In announcing a bright-line rule to determine who "makes" a statement for purposes of Rule 10b-5, the Court has resolved an area of uncertainty. Many circuits previously applied highly fact-specific tests, such as whether an individual or entity had "substantially participated in" or was "intimately involved with" the statement, to determine whether the individual or entity was primarily liable under Rule 10b-5. Today's decision eliminates these tests. Now, only the "speechmaker" is on the hook for alleged misstatements; the speechmaker's staff of speechwriters (including, potentially, investment advisers, accountants, lawyers, and others who provide services to securities issuers) is not.

Janus may therefore prove to limit the expansive theories of liability that plaintiffs have been pushing since the Court's decision in *Central Bank*. Indeed, in tying its decision in *Janus* to *Central Bank*, the Court seems to be enforcing the line between enforcement actions the SEC may bring and private actions. As it noted before explaining its holding, the Court approached the question of who "makes" a statement "mindful that we must give 'narrow dimensions . . . to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.'" The decision restricts Rule 10b-5's liability for "making" a statement to those narrow dimensions.

Justice Breyer's dissenting opinion, joined by Justices Ginsburg, Sotomayor, and Kagan, disagreed with the majority's construction of the phrase, "make a statement." As Justice Breyer put it: "Every day, hosts of corporate officials make statements with content that more senior officials or the board of directors have 'ultimate authority' to control." He later asked, "What is to happen when guilty management writes a prospectus (for the board) containing materially false statements and fools both the board and public into believing they are true?" The dissent worries that the majority's new rule immunizes such "guilty management" from liability under Rule 10b-5. Whether the majority's rule provides such immunity remains to be seen.

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