SULLIVAN & CROMWELL LLP

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# Private Securities Fraud Claims Under Section 10(b) Based on False or Misleading Statements

## U.S. Supreme Court Holds that Private Actions May Be Brought Only Against Parties With Ultimate Authority Over the Content and Issuance of the Alleged Misstatements


### SUMMARY

In recent years, the U.S. Supreme Court has interpreted the judicially created private right of action for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 to impose liability only on "primary" violators who were actually responsible for making the alleged misstatements in question. In *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), and *Stoneridge Investment Partners, LLC* v. *Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), the Supreme Court rejected private securities fraud lawsuits that relied on theories of "aiding and abetting" and "scheme liability," because the defendants did not "make" the alleged misstatements.

In a 5-4 opinion in *Janus Capital Group, Inc.* v. *First Derivative Traders*, No. 09-525 (June 13, 2011), the Supreme Court resolved a disagreement among the lower courts over what it means to "make" an alleged misstatement by holding that Section 10(b) claims can be brought only against parties with "ultimate authority" over an alleged misstatement. Accordingly, the Court dismissed claims against a mutual fund adviser for alleged misstatements contained in the prospectuses of mutual funds it advised and managed. In doing so, the Supreme Court held that there was no reason to disregard the corporate separateness of the adviser and the funds, noting that the funds' board of trustees had ultimate control over the prospectuses the funds issued. *Janus* has significant implications for individuals and entities that either help securities issuers prepare and publish public disclosures or that may have significant influence over the content of those disclosures.

## BACKGROUND

Janus Capital Group, Inc. ("JCG") is a publicly traded company that created the Janus family of mutual funds. Each such fund is a series of a Massachusetts business trust called Janus Investment Fund ("JIF"). JIF retained Janus Capital Management LLC ("JCM"), a wholly owned subsidiary of JCG, to be the funds' adviser and administrator.

In September 2003, the New York Attorney General filed a complaint alleging that JCG entered into secret agreements to allow certain investors to engage in market timing in certain funds advised by JCM. After the complaint became public, investors withdrew significant amounts of money from JIF funds, leading to a reduction in the amount of JCM's management fees (which were based on assets under management) and a 25% decline in JCG's stock price.

First Derivative Traders ("FDT") brought a putative securities fraud class action under Section 10(b) of the Exchange Act on behalf of JCG's shareholders, alleging that statements about market timing in the JIF funds' prospectuses were materially misleading. FDT named both JCG and JCM as primary defendants, on the theory that both defendants, through their alleged control over JIF, had effectively "made" the alleged misstatements in JIF's prospectuses. As evidence that investors would believe that JCM controlled JIF and so was responsible for the accuracy of JIF's statements, FDT cited, among other things, that JIF's prospectuses contained JCM's logo on them and that JCM made the prospectuses available on its website. FDT also brought claims under Section 20(a) against JCG based on the theory that, even if JCG were not a primary violator of Section 10(b), it was liable as a "control person" for JCM's violation of Section 10(b).

The district court granted JCG and JCM's motions to dismiss, holding that JCG and JCM could not be liable to JCG's shareholders for alleged misstatements in prospectuses directed to investors in JIF's funds. The U.S. Court of Appeals for the Fourth Circuit affirmed in part and reversed in part. The Fourth Circuit held that FDT's allegations that JCG and JCM participated "in the writing and dissemination of the prospectuses" were sufficient to establish that JCG and JCM made the alleged misstatements. The Fourth Circuit further held that, although reasonable investors could attribute JIF's alleged misstatements to JCM because of its role as mutual fund adviser and administrator, they would not attribute the alleged misstatements to JCG simply because of its status as JCM's parent company and the parent of the distributor of the JIF funds. Accordingly, the court affirmed dismissal of the Section 10(b) claims against JCG, but reinstated the Section 10(b) claims against JCM (and the corresponding Section 20(a) "control person" claims against JCG).

## SUPREME COURT'S OPINION

In a 5-4 opinion, the Supreme Court held that JCM was not liable under Section 10(b) and Rule 10b-5 for the alleged misstatements in the JIF funds' prospectuses, because JCM itself did not have "ultimate authority" over the prospectuses' content and issuance. In doing so, the Court emphasized that the private right of action under Section 10(b)/Rule 10b-5 is an extra-textual, judicially created right that must be given "narrow dimensions."

*First*, looking to Rule 10b-5's statement forbidding "any person, directly or indirectly, . . . [t]o make any untrue statement of a material fact" in connection with the purchase or sale of securities, the Court reasoned that the phrase "make . . . any statement" was the grammatical equivalent of "to state," thus strongly implying that Rule 10b-5 covers only those persons or entities that actually "state" something. It logically follows, the Court stated, that a person "who prepares or publishes a statement on behalf of another is not its maker." Rather, the Court explained, "in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by—and only by—the party to whom it is attributed." The Court then fashioned the following rule: "For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."

*Second*, the Supreme Court highlighted that its interpretation requiring a showing that the defendant had "ultimate authority" over the issuance of the alleged misstatement comported with its prior opinions in *Central Bank* and *Stoneridge*, noting that allowing plaintiffs to bring Section 10(b) claims against those who simply helped prepare or disseminate an alleged misstatement would strip "any meaning" from those opinions.

Turning to the facts of the case, the Supreme Court concluded that both JIF and JCM had respected their corporate separateness, and that ultimate authority over the statements in JIF's prospectuses lay with JIF's trustees. Accordingly, it was only JIF, and not JCM, that "made" the alleged misstatements.

In reaching its decision, the Court rejected a rule urged by the United States and the Securities and Exchange Commission ("SEC") in their joint *amicus curiae* brief that would have defined "make" to mean "create," on the grounds that this interpretation was inconsistent with both the text of Rule 10b-5 and the Court's precedents. In a footnote, the Court held that because the meaning of "make" was not ambiguous, it did not need to consider the Government's assertion that it should defer to the interpretation the SEC had urged in prior cases, observing that the Court had "previously expressed skepticism over the degree to which the SEC should receive deference regarding the private right of action," and that this case was "not the first time th[e] Court has disagreed with the SEC's broad view of § 10(b) or Rule 10b-5."

In footnotes, the Court stated that it was not addressing (i) the ability of plaintiffs to bring claims under Section 20(b) of the Exchange Act against "entities that act through innocent intermediaries," or (ii) whether secondary actors may still face primary liability for "indirect" statements that, although not directly communicated by the secondary actor itself, are nonetheless attributed to the actor either expressly or implicitly. As to the latter issue, the Court declined to "define precisely what it means to communicate a 'made' statement indirectly," because there was no indication that any of the challenged statements in the prospectuses were "quoting or otherwise repeating a statement originally 'made' by JCM."

Justice Breyer (joined by Justices Ginsburg, Sotomayor, and Kagan) dissented. In Justice Breyer's view, FDT had pleaded sufficient facts to infer reasonably that JCM, through its relationship with JIF, was responsible for making the alleged misstatements in JIF's prospectuses. Justice Breyer expressed concern that, under the Court's opinion, there would be no liability under Section 10(b) for *anyone* if "guilty management writes a prospectus (for the board) containing materially false statements and fools both board and public into believing they are true." In that scenario, management would not be liable because it did not "make" the alleged misstatements, and the board would not be liable because it did not have the requisite knowledge.

## IMPLICATIONS OF THE SUPREME COURT'S OPINION

The Supreme Court's opinion in *Janus* could have significant implications for (i) those, such as accountants, consultants, and attorneys, who help securities issuers prepare and publish public disclosures, and (ii) those, such as advisers and corporate parents, that may be alleged to have significant influence over an issuer's business affairs and public disclosures. In ordinary cases, neither of these groups has "ultimate authority" over the alleged misstatements, and *Janus* effectively resolves the disagreement among lower courts by holding that significant influence over an issuer's public disclosures, standing alone, is not enough to state a claim.

At the same time, the Court left open possible avenues for the plaintiffs' bar to bring securities law claims against such entities and individuals. For example, the plaintiffs' bar may seek to bring Section 20(b) claims against entities and individuals, such as corporate parents and fund advisers, based on allegations that they used unsuspecting boards of subsidiaries or funds to commit securities fraud. As Justice Breyer noted in his dissent, "'[t]here is a dearth of authority construing Section 20(b),' which has been thought largely 'superfluous in [Section 10(b)] cases'", so the legal strength of any such potential claims is largely untested.

As the Court itself noted, *Janus* is in keeping with the Court's decisions in *Central Bank* and *Stoneridge* of limiting the parties against whom plaintiffs may bring a Section 10(b) private right of action. This trend reflects the Court's stated concern, among others, that an expansive application of the Section 10(b) private right of action has a negative effect on the competitiveness of U.S. financial markets.

However, it is worth noting that the Supreme Court reaffirmed the ability of the SEC (as opposed to private parties) to bring suits against aiders and abettors of securities fraud, *i.e.*, "entities that contribute 'substantial assistance' to the making of a statement but do not actually make it."

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