Supreme Court to Consider Scope of "Service Provider" and "Non-Speaker" Liability in Securities Fraud Litigation

On December 7, the Supreme Court heard oral argument in *Janus Capital Group, Inc.* v. *First Derivative Traders*. The Court's decision promises to be an important one as this case presents the Court with the opportunity to clarify two key elements of private securities fraud claims: (1) what it means to "make" a false or misleading statement under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5(b) promulgated thereunder; and (2) what level of attribution is required to satisfy the reliance element of a private securities fraud claim.

How the Court clarifies what it means to make a statement under Section 10(b) is of interest to corporations, firms, and individuals involved in the preparation of securities filings not only because of the implications for shareholder litigation, but also because the Supreme Court's pronouncements may have relevance to government enforcement proceedings.

I. Factual and Legal Background

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

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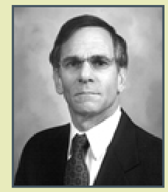

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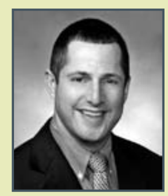

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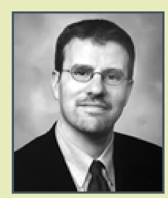

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As presented to the Supreme Court, the *Janus* case involves two issues. First is whether, for purposes of assessing liability to shareholders under the securities laws, Janus Capital Management "made" the false statements in the prospectus. Rule 10b-5(b) of the Securities Exchange Act of 1934, which is the most common basis for private class action securities fraud, makes it unlawful, in connection with the purchase or sale of any security, "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading." In prior cases, most notably *Stoneridge Inv. Partners, LLC* v. *Scientific-Atlantic, Inc.*, 552 U.S. 148 (2008) and *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 180, 191 (1994), the Supreme Court has held that there is no private right of action against secondary parties for aiding and abetting securities fraud committed by a primary violator. The *Janus* case involves the question of whether a "service provider"—here an investment adviser—who was involved in the preparation and dissemination of an allegedly misleading securities prospectus but whose name is not publicly associated with the filing can be held primarily liable in a civil litigation asserting violations of the securities laws.

The district court dismissed the Section 10(b) claims against both JCM and JCG, finding that the plaintiffs had failed to adequately plead the necessary elements against either party. The district court dismissed the complaint as to JCG because there were no allegations that JCG made or prepared the prospectuses and there were no statements in the prospectus attributable to JCG. The district court dismissed the complaint against JCM based on a finding that JCM, as fund manager, did not owe a duty to the parent JCG's shareholders under the facts as alleged. The Fourth Circuit reversed, holding that the allegations that JCM had "participat[ed] in the writing and dissemination of the prospectuses" was sufficient to satisfy the requirement that JCM "made the misleading statements contained in the documents."

The second question presented to the Supreme Court is whether, in these circumstances, the private investor plaintiffs can establish that they relied on Janus Capital Management, given that the prospectuses which contained the allegedly misleading statements were not issued in its name. Civil litigation asserting violations of Rule 10b-5(b) requires proof of reliance on the allegedly misleading statement. While the Supreme Court has previously held that reliance may be presumed (although the presumption may be rebutted) where there is a public misrepresentation and the security trades on an efficient market, the Court has also suggested that such a presumption is not appropriate where the misleading statements are not publicly attributed to the defendant.

With regard to the second question, the Fourth Circuit held that a securities plaintiff can establish reliance under a fraud-on-the-market theory by alleging facts from which the court could infer that investors would "attribute to the defendant a substantial role in preparing or approving the allegedly misleading statement." The Fourth Circuit held that this requires a "case by case" inquiry into whether interested investors would have known that a defendant was responsible for the statement at the time it was made "even if the statement on its face is not directly attributed to the defendant." In this case, the Fourth Circuit panel determined "interested investors would attribute to JCM a role in the preparation or approval of the allegedly misleading prospectuses" because, notwithstanding the fact that a mutual fund is its own company, an "investment advisor is well known to be intimately involved in the day-to-day operations of the mutual funds it manages."

II. Summary of Legal Positions

A. What does it mean to "make" a statement?

Rule 10b-5(b) prescribes the "making" of an untrue or materially incomplete statement, and thus the question of what it means to "make" a false or misleading statement and who can be liable for "making" a statement is of central importance to firms and professionals that assist entities that make public securities filings. In *Central Bank*, the Supreme Court held that the implied private right of action under Section 10(b) extends only to "primary" violators who actually make false statements and not to "secondary" violators who do not make the statements but only aid and abet such primary violations. Congress ratified this distinction in the Private Securities Litigation Reform Act (PSLRA), providing authority for the Securities and Exchange Commission (SEC) to bring aiding-and-abetting claims but not extending that authority to private litigants. The Supreme Court again confirmed the primary/secondary liability distinction in *Stoneridge.*

Nevertheless, what level of actual participation suffices to "make" a statement, and thus what separates primary from secondary violators, has divided the Federal Courts of Appeal which have developed several different tests. Several circuits, most notably the Second, Tenth, and Eleventh have adopted a "bright line" test, under which a primary violation is established only where the challenged statement was both actually made by the defendant and publicly attributed to him. Others, including the Fourth and Ninth Circuits have held that "substantial participation or intricate involvement" in preparing the statement will suffice. The *Janus* case thus presents the Court with the opportunity to provide a measure of guidance to the lower courts by deciding the appropriate test for making an unlawful statement under Rule 10b-5(b).

Relying on *Central Bank* and *Stoneridge*, JCM argues that the Supreme Court should confirm a "bright-line distinction between issuers and non-issuers" wherein primary liability in cases premised on alleged misstatements in prospectuses, registration statements or other documents is "limited to the issuer and certain of its employees." Under this standard, JCM argues (as the District Court concluded) that JCM cannot have primary liability as a matter of law because it is merely a "service provider" to Janus Funds, and under *Central Bank*, persons or entities "who provide services" to an issuer in connection with an offering are secondary actors and cannot be held liable in a private Rule 10b-5 action unless "all the requirements for primary liability are met." Similarly, JCM argues that Lead Plaintiff cannot meet its pleading burden because the challenged statements were made by the Trust comprising the Janus Funds -- a separate legal entity from JCM, and accordingly JCM did not "make" the challenged statements.

In response, Plaintiff First Capital Management argues that it alleged in its complaint that JCM spoke directly to the market by making statements regarding its market-timing policy in public prospectuses. JCM "both wrote (i.e., created) its policy regarding market timing in the Janus Funds and caused the Funds' prospectuses to be issued and disseminated containing that policy." Plaintiff also argues that because of the close relationship between a mutual fund and its investment advisers, characterizing JCM as a "secondary actor" is not accurate, and that exempting mutual fund investment advisers would "provide a roadmap for unscrupulous companies to commit securities fraud." In the brief submitted by the United States Solicitor General on behalf of the Plaintiff, the government echoed this theme, arguing that "an investment adviser's managerial role makes it essentially a corporate insider...perform[ing] the 'insider' functions that corporate officers and employees ordinarily would...distinguishes it from a true secondary actor like an accountant, lawyer, or bank." The Solicitor General also noted that the issue was of significant interest to the federal government's interest in enforcement of the securities laws, noting that the SEC has long taken the position that Rule 10b-5 should be interpreted as allowing primary liability for both directly or indirectly making a statement "when a person, acting alone or with others, creates a misrepresentation."[1]

1 Earlier this year, the First Circuit *en banc* rejected similar arguments by the SEC in the context of a civil fraud action against employees of an underwriter as "inconsistent with the text of [Rule 10b-5(b)] and with the ordinary meanings of the phrase 'to make a statement.'" *See S.E.C.* v. *Tambone,* 597 F.3d 436, 438 (1st Cir. 2010) *(en banc).* Our advisory discussing the First Circuit's *Tambone* decision can be found at the following link: http://www.arnoldporter.com/resources/documents/Advisory--SEC_v_Tambone_The_US_Court_of_Appeals_for_the_First_Circuit_Rejects_The_SEC's_Attempt_31710.pdf.

B. Establishing Reliance under a Fraud-on-the-Market Claim

While reliance is an element of a private securities fraud claim, the Supreme Court held in *Basic* v. *Levinson*, 485 U.S. 224 (1988) that a rebuttable presumption of reliance can be supported by the so-called "fraud-on-the-market" theory. The fraud-on-the-market theory is based on the premise that, in an efficient securities market, the price of a stock is determined by all available public material information and investors can rely on that market price. Under the *Basic* decision, reliance can be presumed when alleged misleading statements or omissions become public because it can be assumed that an investor who buys or sells stock at the market price relies on the statement.

The presumption of reliance is complicated, however, when the alleged primary violator is not the person or entity to whom the alleged misleading statement is attributed. In *Stoneridge*, the Court addressed this issue and held that plaintiffs could not show reliance upon any of the defendants' actions in the decision to purchase or sell securities because "[n]o member of the investing public had knowledge, either actual or presumed, of respondent's deceptive acts during the relevant times." In the specific facts of *Stoneridge,* the presumption of reliance did not extend to claims against the issuer's suppliers, who purportedly agreed to arrangements that allegedly allowed a cable company to issue misleading financial statements. Central to the Court's analysis that the *Stoneridge* plaintiffs could not establish reliance was that the supplier defendants in that case (i) had made no public statements and (ii) the suppliers' allegedly misleading acts were not communicated to the investing public. Accordingly, the Court held that the allegations were too remote to satisfy the element of reliance.

Relying on *Stoneridge*, JCG and JCM argue that Plaintiff failed to plead a legally sufficient theory of reliance. First, JCG and JCM argue that to invoke the *Basic* presumption of reliance, a plaintiff must prove that the specific defendant made a public misrepresentation. In its brief, JCM argues that the presumption of reliance is "categorically inapplicable" to secondary actors, and can apply only to "express speakers" and thus "cannot be applied in cases against defendants who did not themselves speak to the market." JCG and JCM also argue, alternatively, that reliance cannot be presumed absent express and contemporaneous attribution of the statement to the defendants because absent express attribution, plaintiffs cannot prove that they relied on the defendants' statements rather than the statements of others.

In response, Plaintiffs argued that JCM was responsible for the statements in the Janus Fund prospectuses, and that even without direct attribution to either JCG or JCM, a reasonable investor in JCG would have expected that JCG and JCM were responsible for the statements in the Janus Funds Prospectuses because JCG and JCM managed the Janus Funds. Additionally, Plaintiffs note that lower courts have regularly imposed liability on corporate insiders for misrepresentations issued in the corporation's name. Finally, Plaintiffs argued that creating a direct-attribution requirement would subvert the purpose of the federal securities laws by enabling entities to mislead the securities markets without fear of liability so long as they avoid express attribution of their misstatements.

III. Oral Argument and Potential Significance of Decision

No clear sentiment as to how the Justices might rule emerged from the oral argument. The Justices probed at length the factual allegations concerning what JCM, as investment fund manager, did and did not do; for what purposes JCM could be considered an agent of the investment funds; and whether there were general principles that could be drawn to clarify the distinction between principal actors and aiders and abettors. For example, Justice Breyer inquired whether the criminal law concept of making false statements through a conduit may be applicable and the Justices more generally wrestled with how Section 10(b) and Rule 10b-5 intersected with other provisions of the federal securities laws, notably control person liability under Section 20(a) and SEC actions for aiding and abetting under Section 20(e), which may be a better fit for the facts presented to the Court than primary liability under Section 10(b). The questions and comments of the Justices during oral argument ranged from concern by Justices Ginsberg and Kagan that JCM may escape liability even though it was in the "driver's seat" and "drafted the relevant statement" to Justice Scalia's skepticism at plaintiffs' and the SEC's interpretation that one who "creates" a statement can be said to have "made" a statement for liability purposes even when the statement was not attributed."I would not say I'm making a speech indirectly if I have drafted the speech...The person for whom I drafted the speech is making the speech," Justice Scalia noted.

Although it is unclear how the Supreme Court will rule in the *Janus* case, it is clear that, whatever its decision, the ruling will have a significant impact on investment advisers, corporate officers, and professionals and professional firms that provide advice or assist in the preparation of securities filings. A ruling that such entities or individuals can be considered to "make" misrepresentations by participating in the preparation of securities filings would expose them to potential liability. Similarly, a ruling that suggests that investors can be presumed to have relied on such actors would significantly facilitate a plaintiff's ability to establish liability.

The Court's decision could also potentially have ramifications for the federal government's efforts to enforce the securities laws. The Solicitor General, which had urged the Supreme Court to deny *certiorari*, expressed concern with a Supreme Court decision that would limit the ability of the Securities and Exchange Commission and the Department of Justice to bring enforcement actions under Rule 10b-5 for persons who participate in the preparation of securities filings.

A decision is expected next spring.

We hope that you have found this client advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

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