Note

Recourse Under § 10(b) on Life Support: The Displacement of Liability and Private Securities Fraud Action after *Janus v. First Derivative*

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I. INTRODUCTION

At the height of the roaring stock market in the 1920s, one of the problems facing investors was the scarcity of companies in which to invest.[1] Market participants responded to the demand by issuing common stock in investment companies and/or investment trusts.[2] These new securities were structures in which an investment company would purchase and manage a securities portfolio for a pool of small investors.[3] The design of an investment trust was simple: a sponsor would execute a management advisory agreement with the trust the sponsor created, and in exchange, the sponsor would receive a management fee based on a percentage of the assets under management or the earnings the trust made.[4] The sponsor would run the day-to-day

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1. JOHN K. GALBRAITH, THE GREAT CRASH 1929, at 43 (1954).

2. *Id.* at 46; *see also* Karen Reams, *Wall Street in the Roaring Twenties*, YAHOO! VOICES (June 26, 2007), http://voices.yahoo.com/wall-street-roaring-twenties-403302.html (discussing the increase in market-related activity that led to an increase in investors and the development of new investment products to meet the demand).

3. GALBRAITH, *supra* note 1, at 47–48. The investment trusts of the 1920s are similar to the structure of a closed-end fund today, except without as much leverage as the products created in that era. *Id.*; *see also* BLACK'S LAW DICTIONARY 1116 (9th ed. 2009) (defining a closed-end fund as "[a] mutual fund having a fixed number of shares that are traded on a major securities exchange or an over-the-counter market").

4. GALBRAITH, *supra* note 1, at 50. For example, the manager would charge one percent annually on a portfolio that had one hundred thousand dollars in it, or if the fund met a threshold

operations of the trust, invest the assets, handle the administrative duties, and even provide some of the board members of the trust.[5] At the time, these investment vehicles were perceived as marvels of financial innovation and ingenuity.[6]

In late 1928, less than a year before the peak and subsequent crash of the market, Goldman, Sachs and Co. entered the then booming market with its sponsorship of an investment trust called the Goldman Sachs Trading Corporation ("GSTC").[7] The GSTC was an amazing success and later spawned the issuance of the Shenandoah Corporation and the Blue Ridge Corporation.[8] Despite the amazing success of the Goldman, Sachs and Co. issuances, the market experienced a historic crash, and the investment trusts suffered great losses.[9]

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gain of say five percent, the fund would take, as its fee, a portion of any further gain above that five percent. *See Mutual Fund Fees and Expenses*, SEC.GOV, http://www.sec.gov/answers/mffees.htm (last modified Nov. 4, 2011) (including a general discussion of different mutual fund fees).

5. GALBRAITH, *supra* note 1, at 50.

6. *See id.* at 52 (stating that some commentators regretted that there were not enough of these vehicles in circulation and that everyone could not benefit from "these new engines of financial progress").

7. *Id.* at 60; *see also* George Spritzer, *1929's Closed End Fund Craze: Lessons For Today*, SEEKING ALPHA (Feb. 5, 2007), http://seekingalpha.com/article/26041-1929-s-closed-end-fund-craze-lessons-for-today (noting that Goldman Sachs was the largest promoter of closed-end funds during the 1928-1929 time period).

8. GALBRAITH, *supra* note 1, at 61–62. GSTC raised $100 million at issuance. *Id.* at 61. Shenandoah and Blue Ridge raised $102.5 million and $142 million, respectively. *Id.* at 61–62. This is an astonishing collective amount given that it was raised in about nine months. *Id.* at 60–62. Today, that amount, adjusted for inflation, would be $4.57 billion, *see CPI Inflation Calculator*, BUREAU OF LABOR STATISTICS, http://www.bls.gov/data/inflation_calculator.htm (last visited Apr. 21, 2012), and that was only the amount raised at initial offering from mostly individual investors. *Id.* at 61. For a more descriptive explanation of how GSTC used leverage to create the new investment trusts called Shenandoah and Blue Ridge, see GALBRAITH, *supra* note 1, at 57–64.

9. *See* GALBRAITH, *supra* note 1, at 64–65. At a subsequent Senate Committee hearing investigating the market crash, the impacts to the GSTC offering were discussed in the following exchange:

> Senator Couzens: Did Goldman, Sachs and Company organize the Goldman Sachs Trading Corporation?
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> Mr. Sachs: Yes, sir.
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> Senator Couzens: And it sold its stock to the public?
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> Mr. Sachs: A portion of it. The firm invested originally in 10 percent of the entire issue for the sum of $10,000,000.
>
> Senator Couzens: And the other 90 percent was sold to the public?
>
> Mr. Sachs: Yes, sir.
>
> Senator Couzens: At what price?
>
> Mr. Sachs: At 104. That is the old stock . . . the stock was split two for one.
>
> Senator Couzens: And what is the price of the stock now?

These events preceded the enactment of federal securities laws and the formation of the Securities and Exchange Commission ("SEC"); hence, federal regulatory penalties for foul play were not an option for either investors seeking recourse or the federal government looking to prosecute potentially fraudulent actors.[10] Nevertheless, Goldman, Sachs and Co. was besieged with lawsuits from personal investors, the last of which settled in 1967.[11] Investments such as the GSTC, Shenandoah, and Blue Ridge—all three similar to today's mutual funds—were the driving force behind the well-constructed securities laws of the 1930s, and, along with the creation of the SEC, these federal securities laws have helped deter corporate actors from fraudulent activities.[12] Additionally, coupling these market watchmen with a

Mr. Sachs: Approximately 1 3/4.

Id.; *see also* Harry Wilson, *A Short History of Goldman Sachs in Losses*, FINANCIAL NEWS (Dec. 16, 2008), http://www.efinancialnews.com/story/2008-12-16/a-short-history-of-goldman-sachs-in-losses-1 (describing GSTC's performance as "one of the largest, swiftest, and most complete investment disasters of the twentieth century," leaving the Sachs family amazed at the damage caused to the firm's reputation and most Goldman Sachs partners, at the time, owing the firm money for years to recoup the loss).

10. *See* Deepa Sarkar, Cornell Law School Securities Law Clinic, *Why Securities Laws?*, LEGAL INFO. INST., http://www.law.cornell.edu/wex/securities_law_history (last visited Apr. 21, 2012) (asserting that, in many cases, promises made by companies and brokers about the companies they were promoting had little to no substantive basis or were wholly fraudulent leading to a speculative frenzy in which thousands of investors bought stocks in hopes of huge profits, and adding that prior to federal securities laws, investors mainly looked to state securities laws (known as blue sky laws); however, each state had its own interpretation and protections that could leave investors with limited options for recourse); *see also The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/about/whatwedo.shtml (last modified Apr. 11, 2012) (discussing the minimal support for federal regulation of the securities markets prior to the market crash of 1929 and noting that there was never serious pursuit of federal government involvement in the regulation of a company's financial disclosure requirement and the fraudulent sale of stock).

11. *See* Marco v. Bank of N.Y., 272 F. Supp. 636, 657 (S.D.N.Y. 1967) (dismissing all liability claims of liability against Walter E. Sachs because the claims were barred by statutes of limitations). The case resulted from the Blue Ridge Corporation investments, and the plaintiff pursued claims of breach of fiduciary duties by the directors of Blue Ridge in their handling of investments. *Id.* at 639.

12. *See The Investor's Advocate*, *supra* note 10 (stating that the SEC's mission is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation"). The SEC adds that in its oversight of exchanges, securities brokers and dealers, investment advisors, and mutual funds, its primary concern is "[promoting] the disclosure of important market-related information, maintaining fair dealing, and protecting against fraud." *Id.*; *see also A Brief History of Securities Regulation*, ST. WISCONSIN DEP'T OF FIN. INSTS., http://www.wdfi.org/fi/securities/regexemp/history.htm (last visited Apr. 21, 2012) (noting that, aside from the 1933 Act and the 1934 Act, Congress passed securities regulation that included the Public Utility Holding Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisors Act of 1940, all with the intention to regulate the securities industry).

robust private right of action under § 10(b) and SEC Rule 10b-5—"catchall" antifraud provisions designed to combat manipulative or deceptive actions that may occur during securities transactions[13]—added further deterrence, while enabling the private investor to seek remedies under federal law as opposed to the common law of contract.[14] Unfortunately, the recent United States Supreme Court decision, *Janus Capital Group v. First Derivative Traders*,[15] is the latest example of the Court's apparent desire to completely abolish the implied private right of action under § 10(b) and Rule 10b-5 and return to an era in which victims of securities fraud litigate their grievances based on the common law of contract—similar to investors of the GSTC.[16]

In today's market environment, protecting a broad application of the private right of action against securities fraud is imperative.[17] The SEC has faced funding restrictions, and the reduction in available resources has limited its oversight capabilities.[18] Also, anti-regulatory headwinds

13. *See* Eric C. Chaffee, Standing Under Section 10(b) and Rule 10b-5: The Continued Validity of the Forced Seller Exception to the Purchaser-Seller Requirement 1 (Aug. 2008) (unpublished manuscript), *available at* http://works.bepress.com/eric_chaffee/1 (discussing the reason Congress drafted § 10(b) and asserting that Rule 10b-5 is a powerful tool for fighting securities fraud).

14. *See* J. I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) (describing the private right of action as a necessary supplement to SEC because it is a means to deter fraudulent actions); *see also, e.g.*, Tamar Frankel, *Implied Rights of Action*, 67 VA. L. REV. 553, 555 (1981) (noting that one of the two significant principles of the *Borak* decision was the Court's emphasis on the deterrent effect of private enforcement). The Court has moved away from the *Borak* rationale for the implied right of action but has not specifically overturned it. Frankel, *supra*, at 553; *see also* Samuel Issacharoff, *Regulating After the Fact*, 56 DEPAUL L. REV. 375, 379 (2007) (statement of SEC Commissioner Harvey Goldschmid) ("Private enforcement is a necessary supplement to the work that the [SEC] does. It is a safety valve against the potential capture of the agency by industry.").

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

16. *See* Elaine A. Welle, *Freedom of Contract and the Securities Laws: Opting Out of Securities Regulation by Private Agreement*, 56 WASH. & LEE L. REV. 519, 547 (1999) ("The common law has not been, and in the near future is not likely to be, an adequate substitute for statutory protection. The federal securities laws . . . provide a national standard—a benchmark that promotes uniformity."); *see also* G. Robert Blakey & Scott D. Cessar, *Equitable Relief Under Civil RICO: Reflections on* Religious Technology Center v. Wollersheim*: Will Civil RICO Be Effective Only Against White-Collar Crime?*, 62 NOTRE DAME L. REV. 526, 562–64 (1987) ("The struggle for the soul of the nation is today being fought anew in the business community, bar associations, Congress, and the courts. It has many names: it is called 'strict constructionism'; it is called 'antitrust reform'; it is called 'tort reform' . . . .").

17. *See* Issacharoff, *supra* note 14 and accompanying text (discussing private enforcement of securities laws); *see also* Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime*, 55 FLA. L. REV. 937, 969 (2003) (asserting that private suits express community norms and have a deterrent effect when the threat of civil litigation enhances the risks for would-be fraudulent actors to engage in even marginally lawful conduct).

18. Zachary A. Goldfarb, *SEC Officials Say the Agency Lacks Cash for Full Oversight*,

in the political arena create obstacles for the SEC to carry out its objectives.[19] For regulators and investors alike, the apolitical private right of action under § 10(b) and Rule 10b-5 serves as an essential supplement to the ongoing focus of maintaining an orderly financial marketplace governed by the rule of law.[20]

This Note examines the history of the implied private right of action under § 10(b) and Rule 10b-5 and posits that the Court's decision in *Janus* has eviscerated this implied right so unmercifully that it will be difficult, if not impossible, for investors to seek redress for securities fraud through private litigation.[21] Part II of this Note provides a general background of securities fraud regulation with an emphasis on § 10(b) and Rule 10b-5 and the recognition of the implied private right of action.[22] It also chronicles both congressional and judicial retrenchment

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WASH. POST, Jan. 28, 2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/01/27/AR2009012703395.html (discussing testimony by SEC officials in front of a Congressional panel where they warned that the lack of money and staff was a detriment to the agency's ability to ensure comprehensive oversight). SEC chairman Mary Schapiro stated: "The amount of resources available to the SEC has not kept pace with the rapid expansion in the securities market over the past few years . . . either in terms of the number of firms or the explosion in the types of new and increasingly complex products . . . some of which were expressly designed to avoid SEC regulation and oversight." *Id.*

19. *See* Brian Powell, *Rep. Darrell Issa: The Face of Today's Deregulation Movement*, MEDIA MATTERS ACTION NETWORK BLOG (Mar. 24, 2011, 3:19 PM), http://politicalcorrection.org/mobile/blog/201103240018 (discussing Rep. Darrell Issa (R-CA), the chairman of the House Oversight and Government Reform Committee, who solicited letters from over 150 trade associations, conservative think tanks, and corporations, asking them for suggestions on which federal regulations he should be targeting for investigation); *see also* Christopher Maag, *Anti-Regulation Bank Regulator Draws Democrats' Ire*, CREDIT.COM BLOG (June 25, 2011), http://www.credit.com/blog/2011/06/this-time-the-anti-regulation-regulator-gets-noticed/ (statement of John Walsh, acting director of the Office of the Comptroller of the Currency) ("To put it plainly, my view is that we are in danger of trying to squeeze too much risk and complexity out of banking as we institute reforms to address problems and abuses stemming from the last crisis.").

20. *See* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1545–48 (2006) (asserting that, despite the lack of a compensatory rationale—in terms of investor loss recovery—for securities class actions, the private right of action does have a deterrence benefit, in that, corporate insiders face an expected penalty that exceeds their expected gain thereby reducing or removing any incentive for them to commit securities fraud); *see also* Welle, *supra* note 16, at 581 (discussing that those who propose that investors be protected by an efficient market, rather than standards of law, are misguided in thinking that all investors are knowledgeable, sophisticated, and have exposure to perfect information).

21. Edward Pekarek & Genavieve Shingle, The Make Believe of *Janus* 8–9 (Oct. 12, 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=1942748 (asserting that the *Janus* decision "may have ushered in an era that may only make the capital markets increasingly risky for the investing public, and stock market charlatans can almost be heard saying, 'go ahead, make my day'").

22. *See infra* Part II.A–C (discussing a history of federal securities law and the creation of the

of private recourse for securities fraud.[23] Part III discusses the progression of the *Janus* litigation, starting with a background of the case, and then proceeding from the district court's decision to the Supreme Court's majority opinion and dissent.[24] Part IV analyzes three areas of securities fraud litigation affected by the *Janus* decision: (1) primary/secondary liability for securities fraud; (2) what constitutes the "making" of a statement as it pertains to private action liability under securities laws; and (3) the Court's use of the "ultimate control over the content of a statement" test to shield investment advisors from liability under 10b–5.[25] Part V explores the potential impact of *Janus* on the future of securities fraud litigation—namely, that this decision may have the unintended effect of creating a new veil to liability for both managers in their role as agents of the corporation and some of the most important actors in the financial asset securitization industry.[26]

II. BACKGROUND

A. History of Securities Regulation

In response to the stock market crash of 1929 and the ensuing Great Depression, Congress stepped in to restore confidence in financial markets.[27] Congress enacted the Securities Act of 1933 ("1933 Act") to regulate public stock offerings and require that underwriters make specific disclosures prior to an initial public offering.[28] The 1933 Act

implied private right of action under § 10(b) and Rule 10b-5).

23. *See infra* Part II.D–E (discussing Congressional acts and Supreme Court decisions that have decreased the effectiveness of the implied private right of action under § 10(b)).

24. *See infra* Part III (discussing *Janus*'s case history).

25. *See infra* Part IV (discussing three areas of securities fraud affected by *Janus*).

26. *See infra* Part V (arguing the impacts of *Janus* on securities fraud litigation).

27. *See* John H. Walsh, *A Simple Code of Ethics: A History of the Moral Purpose Inspiring Federal Regulation of the Securities Industry*, 29 HOFSTRA L. REV. 1015, 1018 (2001) (describing the inspiration behind a new regulatory regime within the financial sector as "prohibiting conduct inconsistent with ethical principles; empowering the SEC to preserve the character of the securities industry by expelling the unfit; and requiring securities exchanges and associations to adopt rules enforcing just and equitable principles of trade"); *see also* Welle, *supra* note 16, at 534 (noting that investigations conducted prior to the enactment of federal securities laws revealed widespread fraud, manipulation, and victimization of investors).

28. Securities Act of 1933, 15 U.S.C. § 77b (2006) ("Whenever pursuant to this subchapter the Commission is engaged in rule-making and is required to consider whether an action is necessary or appropriate in the public interest, the Commission shall also consider . . . whether the action will promote efficiency, competition, and capital formation."); *see also The Laws that Govern the Securities Industry: Securities Act of 1933*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/about/laws.shtml (last modified Feb. 15, 2012) (referring to the 1933 Act as the "truth in securities" law).

requires a corporation to file a registration statement for the securities it plans on offering to the public.[29] The goal of requiring registration was to promote truthful, full disclosure of information and potential risks of investing in the securities being offered, so as to allow the public the ability to make informed investment decisions.[30] Shortly thereafter, Congress enacted the Securities Exchange Act of 1934 ("1934 Act"), which created the SEC to regulate the secondary market for securities transactions.[31] The 1934 Act was credited with helping to promote fair dealing within the U.S. capital markets.[32] Specifically, the Act provides the SEC with enforcement power to address fraudulent behavior that would otherwise diminish confidence among market participants and restrict the orderly flow of capital.[33] The orderly flow of capital is an important phenomenon for free-market economies and is built on foundations of trust and compliance within a structured system; without these characteristics, our economic system would struggle to exist.[34]

29. *See* Elisabeth Keller & Gregory A. Gehlmann, *A Historical Introduction to the Securities Act of 1933 & the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 330 (1988) (stating that the 1933 Act aimed to regulate the "instrumentalities of interstate commerce or the mails"); *see also* BLACK'S LAW DICTIONARY 1189 (9th ed. 2009) (defining an initial public offering as "[a] company's first public sale of stock; the first offering of an issuer's equity securities to the public through a registration statement").

30. *See* Keller & Gehlmann, *supra* note 29, at 338 (noting that, in a speech before Congress in March of 1933, President Roosevelt recommended that the purpose for the new laws be "for Federal supervision of traffic in investment securities in interstate commerce"). The President also said that the new legislation should not be considered a guarantee; rather, the benefit would be the full disclosure of information to the potential buyer. *Id.*; *see also Securities Act of 1933*, SECURITIES-FRAUD.COM, http://www.securities-fraud.com/laws.html (last visited Apr. 21, 2012) (describing elements of the 1933 Act and listing the requirements of the registration process).

31. Securities Exchange Act of 1934, Pub L. No. 73-291, 48 Stat. 881 (codified at 15 U.S.C. §§ 78a–78pp).

32. *See* Walsh, *supra* note 27, at 1068–69 (statement of Franklin D. Roosevelt at the signing of the Investment Advisers Act of 1940) ("[A] conscientious and successful effort ha[d] been made to require the investment banker, the broker, and the dealer, the security salesman, the issuer, and the great financial institutions themselves to recognize the high responsibilities they owe to the public.").

33. *See* 15 U.S.C. § 78d (laying out the establishment of the SEC and detailing its structure, functions, and powers of enforcement); *see also* Welle, *supra* note 16, at 534 (stating that the goal of federal securities regulation is to protect investors by prohibiting fraudulent manipulation and by requiring sufficient disclosure by public corporations in order to provide investors with enough information to make informed investment decisions).

34. *See* Keller & Gehlmann, *supra* note 29, at 340 (discussing the period following the stock market crash of the 1920s). Felix Frankfurter, special advisor to President Roosevelt, who was highly influential in the creation of Federal securities laws, stated:

> The great and buoyant faith in capitalism, in the competitive system, is largely deflated, and . . . it is not only a question of whether the system is just, but whether it works. When you have a system which is questioned by the masses, that system cannot last unless it wins back the loyalty and allegiance of the doubter.

While both Acts cover many areas that relate to securities regulation, § 10(b) of the 1934 Act has garnered the most influence in terms of the implied private right of action.

B. Section 10(b) and Rule 10b-5(b)

Section 10(b) of the 1934 Act generally prohibits any manipulation or deception that is intended to mislead investors during the course of a securities offering.[35] It is widely accepted that § 10(b) was an expansion of protections offered to investors that previously depended on state securities regulations and common law.[36] In 1942, pursuant to statutory language, the SEC promulgated Rule 10b-5(b), an anti-fraud provision proscribing the making of untrue statements or material omission in regard to material facts associated with the purchase or sale of a security.[37] The SEC promulgated a broad rule because it realized

Id.; *see also* Welle, *supra* note 16, at 568 (arguing that a diminished regulatory environment could erode investor confidence).

35. 15 U.S.C. § 78j.

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange--
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.; *see also* U.S. v. O'Hagan, 521 U.S. 642, 655 (1997) ("[Section 10(b) is] not an all-purpose breach of fiduciary duty ban, but trains on conduct that is manipulative or deceptive.").

36. *See* Herman & Maclean v. Huddleston, 459 U.S. 375, 388–89 (1983) (noting that securities laws were generally intended "to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct in the securities industry"); *see also* Robert A. Prentice, *Scheme Liability: Does It Have a Future After Stoneridge?*, 2009 WIS. L. REV. 351, 359 (asserting that the expansion purposes of § 10(b) are offered as a supplement to protections by common law fraud and state securities statutes that are often ill-equipped to adequately protect investors).

37. 17 C.F.R. § 240.10b-5 (2011).

> 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.; *see also* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472–73 (1977) (stating that the SEC that fraudulent activities in 1934 would not be the same as securities fraud fifty years into the future and so the broad rule would provide flexibility to deal with issues it did not/could not anticipate in 1934.[38]

C. Recognition of an Implied Private Right of Action under § 10(b) and Rule 10b-5

In addition to the SEC's power to enforce and prosecute securities fraud, a private right of action under § 10(b) and Rule 10b-5 was developed through judicial interpretation of the statute and the rule.[39] Although neither Congress nor the SEC intended to explicitly grant a private right of action for violations of § 10(b) and Rule 10b-5, the Supreme Court recognized such a rich right in a 1971 case, *Superintendent of Insurance of New York v. Bankers Life & Casualty Co.*[40] In *Bankers Life*, writing for the majority, Justice Douglas said that by instituting § 10(b), Congress did not merely seek to address corporate mismanagement; rather, Congress meant to regulate "deceptive devices and contrivances" that relate to securities transactions in general.[41] The standard to pursue a claim under § 10(b) was broad and the "in connection with" requirement found in § 10(b) included "[any] injury [suffered] as a result of deceptive practices *touching* [the] sale of securities and an investor."[42] The Court

adopted Rule 10b-5 pursuant to authority granted by § 10(b) of the 1934 Act, and that it gives the SEC "the power to adopt regulations to carry into effect the will of Congress as expressed by the statute"). However, the Court added that the SEC cannot exceed the power granted under § 10(b). *Id.*

38. *See* Prentice, *supra* note 36, at 360 (asserting that "Congress gave the Commission a broad charge so that it could attack frauds that Congress could not foresee in 1934," and together with § 10(b), they formed a sort of "catchall" provision to monitor fraud in the marketplace); *see also* Welle, *supra* note 16, at 535–36 (noting Congress recognized the "boundlessness of human ingenuity" and broadly drew the scope of the securities law to help achieve its goal of investor protection).

39. *See* Kardon v. Nat'l Gypsum Co., 73 F. Supp. 798, 802 (E.D. Pa. 1947) (recognizing the private right of action under the 1934 Act for the first time in federal court); *see also* Jonathan Eisenberg, *Beyond the Basics: Seventy-Five Defenses Securities Litigators Need to Know*, 62 BUS. LAW. 1281, 1331–34 (2007) (discussing implied private rights of action).

40. 404 U.S. 6, 13 (1971); *see also* Eisenberg, *supra* note 39, at 1331 (stating that prior to 1975, the Supreme Court's approach to the private right of action under § 10(b) was that "it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose").

41. *Bankers Life*, 404 U.S. at 12. The case was before the Court from the granting of a motion to dismiss, and the Court remanded, finding that a proper cause of action had been brought forth under § 10(b). *Id.* at 13–14.

42. *Id.* at 12–13 (emphasis added); *see also* Lewis D. Lowenfels & Alan R. Bromberg, *Rule 10b-5's "In Connection With": A Nexus for Securities Fraud*, 57 BUS. LAW. 1, 8 (2001) (noting that Justice Douglas, a former Chairman of the Securities and Exchange Commission, gave the

characterized "touching" as including any corporate manager malfeasance, misappropriation, or fraudulent action that had a securities connection as falling under the jurisdiction of Rule 10b-5—an inherently broad application of the Rule.[43]

Four years later, in what could be deemed its first act of retrenchment of the private right of action,[44] the United States Supreme Court decided *Blue Chip Stamps v. Manor Drug Stores*.[45] In *Blue Chip*, writing for the majority, Justice Rehnquist held that standing to bring a private cause of action under § 10(b) and Rule 10b-5 would be limited to purchasers or sellers of securities.[46] A group of plaintiffs had brought a class action against the defendants alleging that an "overly pessimistic" prospectus prepared by the defendants was misleading and caused the plaintiffs to refrain from buying stock that was later sold to the public at a higher price.[47] Justice Rehnquist was skeptical that these plaintiffs could prove that the misrepresentations actually caused the loss of opportunity.[48] He warned against trying to determine the mindset of market participants who claimed securities fraud despite not purchasing or selling an actual security.[49] Though the Court began to reign in the scope of coverage for private claims against securities fraud, federal

private right of action under § 10(b) a broad interpretation, allowing anything "touching" a securities transaction to be regulated under the law).

43. *See* Barbara Black, *Commentary: The Second Circuit's Approach to the 'In Connection With' Requirement of Rule 10b-5*, 53 BROOK. L. REV. 539, 547–48 (1987) (adding that the "in connection with" requirement was distinctive from a state-law fiduciary duties claim previously brought by investors who were harmed by securities fraud); *see also* Eisenberg, *supra* note 39, at 1288 (stating that under the Securities Litigation Uniform Standards Act ("SLUSA"), claims in connection with the purchase or sale of securities in class actions cannot be brought under state law or in state court).

44. *See* Lowenfels & Bromberg, *supra* note 42, at 10 ("*Blue Chip* clearly limited the scope of the holding in *Bankers Life* as well as the overall scope and coverage of 10b-5."); *see also infra* Part II.E (detailing more recent judicial retrenchment of private claims under § 10(b) and Rule 10b-5).

45. 421 U.S. 723 (1975). The Court reversed the court of appeals decision because respondents could not pursue the claim for lack of standing. *Id.* at 755.

46. *Id.* at 731; *see also* Lowenfels & Bromberg, *supra* note 42, at 10 (discussing the tone and words of *Blue Chip* as indicating the Courts intention to curb private actions under 10b-5).

47. *Blue Chip*, 421 U.S. at 726–27.

48. *See id.* at 746 ("The very real risk in permitting those in respondent's position to sue under Rule 10b-5 is that the door will be open to recovery of substantial damages on the part of one who offers only his own testimony to prove that he ever consulted a prospectus of the issuer, that he paid any attention to it, or that the representations contained in it damaged him.").

49. *See* Robert A. Prentice, *Section 12 of the 1933 Act: Establishing the Statutory Seller*, 40 ALA. L. REV. 417, 470–71 (1989) (arguing that the Court's interpretation was too narrow and that statutory sellers could include, but be limited to, those who solicit securities transactions such as stockbrokers).

legislative activity on the matter was, for the most part, nonexistent since the enactment of the 1933 and 1934 Acts.[50]

D. Congressional Private Action Reform

In time, the sense that private securities actions were becoming disproportionately non-meritorious grew.[51] In particular, market participants complained that the proliferation of "strike suits"[52] was causing deficiencies in the marketplace and increased costs to public firms that affected shareholder value.[53]

Congress responded by passing the Private Securities Litigation Reform Act of 1995 ("PSLRA"),[54] over a veto by President Clinton,[55]

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50. *See* Lowenfels & Bromberg, *supra* note 42, at 9 (describing the SEC's request to Congress in 1957, and again in 1959, to change wording of § 10(b) to include the phrase "any attempt to purchase or sell" in the statute, which would broaden the coverage of regulation—Congress never adopted the change, however). In the 1990s, Congress broke from an inactive posture and was active in passing securities legislation. *See* Eisenberg, *supra* note 39, at 1350 n.425 (discussing the National Securities Market Improvement Act ("NSMIA") passed in 1996 and the SLUSA in 1998). Also, the major legislative enactment relating to private securities litigation was the PSLRA in 1995. *Id.* at 1302–03.

51. H.R. REP. NO. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730. The legislative history of the PSLRA shows that Congress explicitly tried to address the issue of frivolous securities fraud filings stating, "routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer and with only faint hope that the discovery process might lead eventually to some plausible cause of action." *Id.*; *see also* Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1105 (1991) (stating that preventing frivolous suits is a good reason to deny private securities claims in the absence of congressional intent); Eisenberg, *supra* note 39, at 1288 (asserting that courts have deemed "puffery" as a non-actionable claim under private securities actions).

52. *See* Joshua D. Fulop, *Agency Costs and The Strike Suit: Reducing Frivolous Litigation Through Empowerment of Shareholders*, 7 J. BUS. & SEC. L. 213, 215 (2007) (defining a strike suit as litigation that is "usually based on no valid claim, brought either for nuisance value or to obtain a settlement").

53. *Id.* at 216.

54. Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 and 18 U.S.C.).

55. 141 CONG. REC. H15214 (daily ed. Dec. 20, 1995) (veto message of President Clinton) (describing his reservations about the bill, President Clinton said that the changes to the bill by a Conference Committee would "have the effect of closing the courthouse door on investors who have legitimate claims"); *see also* John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 352–53 (1996) (discussing the three main elemental objections President Clinton had with the bill including the (1) "heightened pleading requirements with regard to the defendant's state of mind," (2) the language of the Statement of Managers, which would be used by the courts as a guide to congressional intent, and (3) the "disparate treatment of plaintiffs and defendants under the bill's provision for sanctions for violations of Rule 11 of the Federal Rules of Civil Procedure").

to address alleged frivolous securities class action lawsuits.[56] Specifically, the PSLRA attempted to stem the escalation of suits brought by plaintiffs as an attempt to unearth fraud through discovery, which would, in turn, lead to settlement.[57] One of the most important legal changes to come from the PSLRA was the heightening of pleading requirements.[58] In a securities action, the plaintiff needs to show that the defendant acted with a "particular state of mind"—also known as "scienter."[59] Specifically, the plaintiff must show facts that give "rise to a strong inference" that the defendant acted with the required state of mind.[60] The PSLRA also included a provision that allowed a court to sanction an attorney who brings forth a frivolous securities fraud class action lawsuit.[61] Not surprisingly, statistics show that the number of

56. 5A CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE & PROCEDURE § 1301.1 (3d ed. 2004); *see also* Eisenberg, *supra* note 39, at 1392 (stating that Congress passed the PSLRA to impose "procedural protections to discourage frivolous litigation").

57. *See* WRIGHT & MILLER, *supra* note 56, § 1301.1 (adding that Congress was concerned that federal courts were not effectively applying Federal Rule 9(b) to prevent cases that were filed to simply unearth fraud during the discovery process); *see also* Avery, *supra* note 55, at 340 ("Despite the lack of clear statistical support, many observers believe that there is at least a strong public perception of a securities litigation crisis."). Testimony before a House Subcommittee emphasized that perception of a crisis in the U.S. securities litigation system could affect the competitiveness of the U.S. economy in the global marketplace. *Id.*

58. *See* Avery, *supra* note 55, at 357–58 (stating that due to the PSLRA, "the complaint [must] specify each statement alleged to have been misleading and the [reason or] reasons why the statement is misleading"); *see also* Eisenberg, *supra* note 39, at 1392 (discussing the differences between Rule 12(b)(6) and the stricter pleading standards of the PSLRA).

59. *See Securities Litigation Reform Proposals, S. 240, S. 667, and H.R. 1058: Hearings Before the Subcomm. on Sec. of the Senate Comm. on Banking, Housing, and Urban Affairs*, 104th Cong., 252 (1995) (testimony of Arthur Levitt, Chairman, SEC). Testifying before the subcommittee, Chairman Levitt described his reservations about the heightened pleading standards:

> The law should sanction corporations and individuals who act recklessly in connection with their disclosure obligations, because that is the only way to assure the markets of a continuous stream of accurate information. Any higher scienter standard would lessen the incentives for corporations and other issuers to conduct a full inquiry into areas of potential exposure, and thus threaten the process that has made our markets a model for nations around the world.

Id.; *see also* Avery, *supra* note 55, at 358 (noting that the heightened pleading standard was one of the reasons that President Clinton opposed the PSLRA).

60. *See* Avery, *supra* note 55, at 358 ("The court is required to dismiss a complaint that does not meet these statutory pleading requirements and all discovery is stayed during the pendency of any motion to dismiss, unless the court finds that any particularized discovery is necessary to preserve evidence or prevent undue prejudice."); *see also* Eisenberg, *supra* note 39, at 1392 (asserting that the PSLRA significantly increased the pleading standards beyond Rule 9(b)).

61. Stephen J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA*, 106 COLUM. L. REV. 1489, 1507 (2006). Congress mandated judicial review of every private securities suit, and if a violation was found, sanctions would be mandatory. *Id.* These sanctions would include the opposing party's attorney's fees and

class action filings drastically decreased after Congress enacted the PSLRA.[62] Today, most cases continue to settle due to the high cost of trial, and investors recover a smaller percentage of their losses since the large number of shareholders necessary to support such a class action dilutes the total recovery.[63] Congress intended for the PSLRA to eliminate frivolous law suits.[64] Instead, the resulting effect of the legislation has been to throw out the good with the bad: meritorious securities fraud claims have little chance of success as well.[65] Further, the disconnect between what Congress intended the PSLRA to do and the effect it actually had on securities litigation was widened by how the courts implemented the PSLRA.[66]

other expenses. *Id.* A study conducted as part of the article shows that the sanction provision rarely has been used during the first ten years of the Act. *Id.* at 1508. Surprisingly, through 2005, only four sanctions were imposed under the PSLRA mandate. *Id.*; *see also* Eisenberg, *supra* note 39, at 1322 (discussing a case where the court found the complaint to include vague allegations of fraud and stated that it would invite a motion for Rule 11 sanctions against the plaintiff).

62. *See* STANFORD LAW SCHOOL, SECURITIES CLASS ACTION CLEARINGHOUSE, http://securities.stanford.edu/ (last visited Apr. 21, 2012) (displaying research showing 991 federal securities class action lawsuits that were filed from 2001–2003; however, only 467 were filed from Aug. 2009–2011). A majority of the lawsuits filed in 2001 were equity-IPO related. The lawsuits after the credit crisis relate to bond/structured financial instrument-IPOs. These IPOs were restricted to institutional investors, while equity-IPOs were also available to retail investors. *See Securities Class Action Filings Decrease Moderately in First Half of 2011, According to Mid-Year Report By Stanford Law School and Cornerstone Research*, BUSINESSWIRE.COM (July 26, 2011, 9:00 AM), http://www.businesswire.com/news/home/20110726005738/en/Securities-Class-Action-Filings-Decrease-Moderately-2011 (statement of Stanford Law School Professor Joseph Grundfest) ("There appears to be a sea change in the structure of the class action securities fraud litigation business. The traditional claims that U.S.-based companies have been cooking their books or hyping their stocks are in sharp decline.").

63. *See* Choi & Thompson, *supra* note 61, at 1497–99 (stating that the study found that since the PSLRA, filings have shifted away from lower value claims, the time to settle has lengthened, the percentage of dismissals has varied, there has been an increase in large sum settlements, and cases against technology companies in the Ninth Circuit has declined).

64. *See* H.R. REP. NO. 104-369, *supra* note 51 and accompanying text (discussing the prevention of frivolous suits).

65. Stephen A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as Well as the Frivolous*, 40 WM. & MARY L. REV. 1055, 1087 (1999) ("The PSLRA has the obvious side-effect of throwing out the meritorious with the frivolous. This is problematic inasmuch as it sacrifices justice in order to chill the pursuit of weak claims.").

66. *See* Choi & Thompson, *supra* note 61, at 1490 (asserting that despite Congress's attempt at curbing frivolous law suits, the PSLRA did not dislodge the dominant plaintiff law firms, nor did it allow easy access to new entrants). Additionally, the legislation seemed to have spawned a new "repeat relationship" dynamic between certain plaintiff law firms and specific institutional investors. *Id.*

1. Judicial Treatment of the PSLRA

In the years following the enactment of the PSLRA, a circuit split developed regarding the level of particularity a plaintiff needed to plead to satisfy the "strong inference" requirement for scienter.[67] The Ninth Circuit adopted the most demanding standard for pleading scienter: the plaintiff needed to show strong circumstantial evidence with great detail and specificity and a description of how and why those statements were fraudulent with no concern for reckless behavior.[68] The Second Circuit—adopting the most liberal of approaches—required the plaintiff to establish that the defendant had a motive and opportunity to defraud or plead sufficient circumstantial evidence of reckless or conscious behavior.[69] Lastly, a number of circuits adopted an intermediate approach, which examined the plaintiff's allegations in their entirety.[70]

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67. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 21D(b)(1)–(2), 109 Stat. 737 (establishing the pleading requirements regarding a defendant's state of mind). The specific legislative text disputed was added after § 21C of the 1934 Act and read:

> (1) MISLEADING STATEMENTS AND OMISSIONS.—In any private action arising under this title in which the plaintiff alleges that the defendant—
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> > (A) made an untrue statement of a material fact; or
> >
> > (B) omitted to state a material fact necessary in order to make the statements made, in the light ofthe circumstances in which they were made, not misleading; *the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.*
>
> (2) REQUIRED STATE OF MIND.—In any private action arising under this title in which the plaintiff may recover money damages only on proof that the *defendant acted with a particular state of mind*, the complaint shall, with respect to each act or omission alleged to violate this title, *state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.*

Id. (emphasis added); *see also* Ramirez, *supra* note 65, at 1074 (asserting that the PSLRA pleading standards are a dramatic departure from general standards under the Federal Rules of Civil Procedure and questioning whether these standards can be satisfied at all without an explicit admission of intent to defraud). Discovery is denied to a plaintiff unless this heightened pleading standard is satisfied; "[t]hus, not only must a plaintiff allege facts 'giving rise to a strong inference' of fraud, the plaintiff also is denied discovery in aid of uncovering such facts." *Id.* at 1076.

68. *In re* Silicon Graphics, Inc. Sec. Litig., 183 F.3d 970, 974 (9th Cir. 1999). The Ninth Circuit instituted the requirement that plaintiffs "plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct." *Id.*

69. Ryan Lee Hart, Comment, *Deterrence and Fairness: Why the Current Financial Crisis Demands a Product-Oriented Relaxation of the PSLRA*, 5 SETON HALL CIR. REV. 411, 419–20 (2009); *see also* Eisenberg, *supra* note 39, at 1361 (discussing the Second Circuit's standard as part of the division amongst circuits as to the proper pleading standard necessary to satisfy the strong inference requirement).

70. Hart, *supra* note 69, at 420; *see also* Eisenberg, *supra* note 39, at 1362 (supporting the notion that "most courts of appeals have adopted a standard between that of the Second and the

Courts in this intermediate regime would weigh all allegations of motive and opportunity or recklessness in seeking a strong inference of scienter.[71]

2. The Supreme Court Strengthens the PSLRA

In 2007, the Supreme Court decided *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*[72] and resolved how the courts should uniformly construe the phrase "strong inference."[73] Writing for the majority, Justice Ginsburg presented three "prescriptions" that courts should follow: (1) faced with a motion to dismiss a § 10(b) action, courts must "accept all factual allegations in the complaint as true"; (2) courts must consider the complaint in its entirety; and (3) when determining whether the pleadings "give rise to a 'strong' inference of scienter, the court must take into account plausible opposing inferences . . . . A complaint will survive . . . only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference."[74] In adopting a stringent standard for pleading scienter, the Court reviewed Congress's objective in setting a uniform pleading standard, which was to curb perceived abuses of § 10(b) private actions.[75]

The *Tellabs* case highlights the interrelated workings of an explicit Congressional act—the PSLRA—and an obliging Supreme Court's response towards weakening the private right of action under § 10(b) and Rule 10b-5.[76] However, this was not the first time the Court moved to weaken an investor's right to seek private recourse at law.

Ninth Circuits").

71. Hart, *supra* note 69, at 420; *see also* Eisenberg, *supra* note 39, at 1362 ("It is important to recognize that even though recklessness is accepted as a form of scienter by many courts, the standard for recklessness is quite high.").

72. 551 U.S. 308 (2007).

73. *Id.* at 314.

74. *Id.* at 322–24; *see also* Jeffrey A. Barrack, *A Primer on Taking a Securities Fraud Class Action to Trial*, 31 AM. J. TRIAL ADVOC. 471, 476–77 (2008) (asserting that the clarification of pleading standards as set-forth by the PSLRA has propelled an industry trend that will see more private securities cases proceed to trial rather than end in settlement, and noting that since the PSLRA "only a half dozen securities fraud cases have made it to a jury").

75. *Tellabs*, 511 U.S. at 322; *see also* Charles W. Murdock, *Corporate Corruption and the Complicity of Congress and the Supreme Court—The Tortuous Path From Central Bank to Stoneridge Investment Partners*, 6 BERKELEY BUS. L.J. 131, 188 (2009) ("Congress and the federal courts are operating in a *fairyland world.* Unless the accountants decide to recast the financial statements, or the board of directors or a bankruptcy court initiates an investigation which is made public, or whistleblowers are found, *requiring specificity in pleading without discovery is an almost insurmountable hurdle*, particularly considering the degree of specificity which many federal courts have required." (emphasis added)).

76. *See* Murdock, *supra* note 75, at 209 (stating that the theme of his article was to highlight

E. Beyond the PSLRA: Judicial Retrenchment of the Implied Private Right of Action

Since the mid-1970s, the Supreme Court has consistently shown the propensity to narrow available options for investors seeking civil remedies using federal securities laws.[77] The Court's actions have included: shortening the statute of limitations, eliminating aiding and abetting, restricting rescission claims, and heightening the reliance standard.[78]

1. Shortening the Statute of Limitations

In *Lampf v. Gilbertson*,[79] the Court imposed a uniform statute of limitations to private securities actions that ended thirty years of lower court practice, which had used forum state statutes of limitations.[80] In *Lampf*, the defendant helped form limited partnerships to purchase and lease computer equipment.[81] Between 1979 and 1981, the plaintiffs invested in the partnerships with the expectation of receiving tax benefits from their investments.[82] The investments subsequently failed,

the belief that Congress and the Supreme Court have been complicit in creating an environment that does not hold corporate management accountable for their fraudulent actions against investors).

77. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 174 (2008) (Stevens, J., dissenting) ("I respectfully dissent from the Court's continuing campaign to render the private cause of action under §10(b) toothless."); *see also* Ramirez, *supra* note 65, at 1070 (describing the dismantling of private actions undertaken by the Supreme Court that goes back to the early 1990s).

78. *See infra* Part II.E.1–4 (detailing four Supreme Court cases that have narrowed the scope of the implied private right of action under § 10(b) and Rule 10b-5 and showing that each plaintiff was denied a remedy to his or her injury due to the narrowing of the scope of private action).

79. 501 U.S. 350 (1991).

80. *See* Richard H. Walker & J. Gordon Seymour, *Recent Judicial and Legislative Developments Affecting the Private Securities Fraud Class Action*, 40 ARIZ. L. REV 1003, 1007 (1998) (noting that the decision in *Lampf* came as a surprise because the question addressed by the Court was not raised by the certiorari petition and the decision reflected "an undercurrent of judicial dissatisfaction" with the state of private securities fraud actions).

81. *Lampf*, 501 U.S. at 352. The investments in this case are known as tax shelters, which were/are a popular means of reducing tax liability. *See* BLACK'S LAW DICTIONARY 1601 (9th ed. 2009) (defining a tax shelter as a "financial operation or investment strategy (such as a partnership or real-estate investment trust) that is created primarily for the purpose of reducing or deferring income-tax payments" and explaining that "[t]he Tax Reform Act of 1986—by restricting the deductibility of passive losses—sharply limited the effectiveness of shelters").

82. *Lampf*, 501 U.S. at 352; *see also* George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson From History*, 54 SMU L. REV. 209, 210–12 (2001) (discussing the growth of tax shelter activity from 1975–1986 using business structures such as partnerships, S corporations, limited partnerships, and LLCs). An essential goal of a tax shelter is creating a large amount of net losses for the owners of the enterprise compared to net income. *Id.* at 211.

and in late 1982 and early 1983, the Internal Revenue Service ("IRS") notified the plaintiffs that the limited partnerships were being investigated.[83] In 1985, the IRS disallowed the tax benefits that the plaintiffs claimed on their tax returns.[84] The defendant law firm, one of several defendants, had helped create the partnerships and prepared opinion letters regarding the anticipated tax consequences of the investments.[85] The plaintiff investors filed suit in November 1986 and June 1987 alleging they were misled into investing in the partnerships by misrepresentations made in offering materials and documents, including misrepresentations about the tax consequences.[86]

The United States District Court for the District of Oregon granted the defendant's request for summary judgment based on a failure to meet the statute of limitations by applying the limitations period of two years taken from the "most analogous" forum, in this case, Oregon.[87] The district court used "inquiry notice" to begin tolling, holding that 1982 was the time when the plaintiffs received notice from the IRS of an investigation into the partnerships.[88] The Ninth Circuit reversed, holding that an issue of material fact existed as to when the plaintiffs actually learned about the fraud, but agreeing with the use of the forum

83. *Lampf*, 501 U.S. at 352; *see also* Yin, *supra* note 82, at 214 (stating that during the 1970s and 1980s, curbing the use of tax shelters was a priority for all three branches of government).

84. *Lampf*, 501 U.S. at 352; *see also* Yin, *supra* note 82, at 217 (discussing methods, such as congressional acts in the 1980s, of preventing taxpayers from engaging in tax avoidance schemes by making the cost of doing so greater than the potential reward).

85. *Lampf*, 501 U.S. at 353; *see also* Jack Townsend, *The Role of the Taxpayer's Independent Lawyer in Tax Shelter Promotions with Promoter Opinions (10/8/11)*, FED. TAX CRIMES BLOG (Oct. 8, 2011, 12:11 PM), http://federaltaxcrimes.blogspot.com/2011/10/role-of-taxpayers-independent-lawyer-in.html ("The typical pattern for [tax shelter] transactions is that the taxpayers . . . were wealthy and engaged their own independent tax counsel with respect to the shelters rather than just rely upon the attorney tax opinions arranged or delivered by the promoters. Those independent tax counsel were often prominent and experienced tax attorneys.").

86. *Lampf*, 501 U.S. at 352–53; *see also* Townsend, *supra* note 85 (describing a recent case in the Northern District Court of California where the court penalized the taxpayer for entering into a tax shelter that he was sophisticated enough to know was too good to be true when he entered into a transaction that resulted in a $315.7 million tax basis for a $0.9 million offsetting options transaction).

87. *Lampf*, 501 U.S. at 353; *see also* BLACK'S LAW DICTIONARY 1546 (9th ed. 2009) (defining statute of limitations as "[a] law that bars claims after a specified period; specif., a statute establishing a time limit for suing in a civil case, based on the date when the claim accrued (as when the injury occurred or was discovered)").

88. *Lampf*, 501 U.S. at 353; *see also* Merck & Co., Inc. v. Reynolds, 130 S. Ct. 1784, 1797 (2010) (defining inquiry notice as existing when "the victim is aware of facts that would lead a reasonable person to investigate and consequently acquire actual knowledge of the defendant's misrepresentations" (quoting Great Rivers Coop. of Se. Iowa v. Farmland Indus., Inc., 120 F.3d 893, 896 (8th Cir. 1997))).

state limitations period.[89] This reversal gave the plaintiffs the opportunity to plead their case within the Oregon limitations period.[90]

The Supreme Court reversed again, holding that the statute of origin—i.e., the 1934 Act—should guide the limitations period when a claim is asserted under an implied cause of action arising under that statute.[91] The *Lampf* Court held that the statute of limitations applicable to causes of action that arise under § 10(b) must be one year after discovery of the cause of action and a repose period within three years of the violation.[92] These limitations and repose periods were the original periods drafted into the 1934 Act and applied to those causes of action that were *expressly* created by the Act.[93] Thus, the Court reasoned that the same limitations and repose periods should also apply to those causes of action *implicitly* created by the 1934 Act.[94] The Court also applied this new rule retroactively to the plaintiffs, barring them from a remedy despite the fact that they were entrenched in

89. *Lampf*, 501 U.S. at 354; *see also* 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) (stating that prior to *Lampf*, federal courts followed the well-established practice of borrowing the forum state's statute of limitations from the state cause of action most applicable to an implied federal claim under Rule 10b-5).

90. *Lampf*, 501 U.S. at 354.

91. *See Lampf*, 501 U.S. at 359 (stating that the uniform federal period that is indicated in the express causes of action under the 1933 and 1934 Acts provides the source for guidance in the implied right of action context); *see also* Lowenfels & Bromberg, *supra* note 89, at 310 (stating that with the adoption of a uniform federal statute of limitations for implied private actions under Rule 10b-5, the Court looked at limitations periods provided by Congress for express civil liability provisions in the 1933 and 1934 Acts).

92. *Lampf*, 501 U.S. at 360–61. In 2002, Congress explicitly modified the holding in *Lampf*, favoring those bringing private securities actions. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 804, 116 Stat. 745, 801 (2002) (codified as amended at 28 U.S.C. § 1658(b) (2000 & Supp. IV 2004)).

> (b) Notwithstanding subsection (a), a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47)), may be brought not later than the earlier of—
>
> (1) *2 years after the discovery of the facts constituting the violation*; or
>
> (2) *5 years after such violation*

Id. (emphasis added); *see also* Lowenfels & Bromberg, *supra* note 89, at 313 (discussing the Court's decision to fashion its new rule after § 9(e) of the 1934 Act rather than § 13 of the 1933 Act, thereby opting for an "actual notice" requirement rather than an "inquiry notice" requirement used by the district court).

93. *Lampf*, 501 U.S. at 359–60. Note, however, that the Court rejected the contention that the five-year limitations period contained in § 20 was more appropriate for § 10(b) actions. *Id.* at 361. This limitations period was added in 1988 and applied to remedies for insider trading, but not § 10(b) fraud. *Id.*

94. *Id.* at 361.

litigation for four-and-a-half years.[95] The Court's adoption of inquiry notice drew criticism from scholars who argued that, sometimes, victims of securities fraud do not have actual knowledge of the fraud until well after they are notified of potential wrongdoing.[96]

2. Elimination of Aiding and Abetting

In *Central Bank of Denver, N.A. v. First Interstate Bank, N.A.*,[97] the Court abolished any private right of action against aiding and abetting violations under § 10(b) and Rule 10b-5.[98] The case concerned the issuance of $26 million in bonds by a public authority in Colorado where the defendant, Central Bank of Denver, filled the role of indenture trustee.[99] The plaintiffs, including First Interstate Bank of

95. *Lampf*, 501 U.S. at 369 (O'Connor, J., dissenting). Justice O'Connor stated:

> [T]o apply the new limitation period in this case . . . respondents' suit is time barred under a limitations period that did not exist before today, the Court departs drastically from our established practice and inflicts an injustice on the respondents. The Court declines to explain its unprecedented decision, or even to acknowledge its unusual character.

Id.; *see also* Lowenfels & Bromberg, *supra* note 89, at 311 (stating that since the plaintiffs in *Lampf* filed their complaints more than three years after the alleged misrepresentations, their claims were time-barred).

96. *See* Walker & Seymour, *supra* note 80, at 1009 (stating that after *Lampf*, the trigger for the running of the one-year prong of the statute of limitations was the most frequently litigated issue in private securities fraud cases). Courts were split on whether tolling began at "inquiry notice" or "constructive notice" of the fraud. *Id.* As a result of courts using inquiry notice, a plaintiff can be barred from remedy if he learns about the actual basis for the cause of action one year after she should have suspected as much. *Id.*; *see also* Lowenfels & Bromberg, *supra* note 89, at 333–34 (opting for the "actual notice" standard rather than "inquiry notice," and claiming that "actual notice" gives plaintiffs a longer limitations period and may serve to balance the short three-year statute of repose, which has drawn criticism in debates concerning amendments to federal securities laws).

97. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994), *superseded in part by statute*, 15 U.S.C. § 78t (2006), *as recognized in* Doe v. Exxon Mobile Corp., 654 F.3d 11, 19 (D.C. Cir. 2011).

98. *Id.* at 192 (Stevens, J., dissenting) (stating that the majority did away with a long history of aider and abettor liability under § 10(b) and Rule 10b-5 and that "[i]n hundreds of judicial and administrative proceedings in every Circuit in the federal system, the courts and the SEC have concluded that aiders and abettors are subject to liability under § 10(b) and Rule 10b-5"); *see also* David A. Lipton, *Private Aiding and Abetting Claims Under Section 10(b)*, *in* 15A BROKER-DEALER REGULATION § 5:31 (2011) (asserting that the demise of the aiding and abetting claim for private parties under § 10(b) has made it more critical to be able to distinguish between primary and secondary liability when bringing a private cause of action).

99. *Cent. Bank*, 511 U.S. at 167; *see also* Bond Trustee Definition, INVESTOPEDIA.COM, http://www.investopedia.com/terms/b/bond-trustee.asp#axzz1c0g4wZXs (last visited Apr. 21, 2012). A bond trustee is defined as

> [a] financial institution with trust powers, such as a commercial bank or trust company, that is given fiduciary powers by a bond issuer to enforce the terms of a bond indenture. An indenture is a contract between a bond issuer and a bond holder. A

Denver, had purchased $2.1 million of the bonds.[100] Subsequently, the public authority defaulted, and the plaintiffs sued a list of actors, including the defendant, for a violation of § 10(b).[101] The plaintiffs claimed the defendant had actual knowledge that the land appraisal securing the bonds may have been overvalued, and despite this knowledge, it failed to complete an independent appraisal review until after the default.[102] The plaintiffs further argued that the defendant was secondarily liable for aiding and abetting the fraudulent violation of securities laws.[103]

The United States District Court for the District of Colorado granted the defendant's motion for summary judgment, but the Tenth Circuit reversed.[104] Upon review, the Supreme Court found that the language in § 10(b) was silent on aiding and abetting and noted that "the text of the statute controls our decision."[105] Reversing the appellate court's

> trustee sees that bond interest payments are made as scheduled, and protects the interests of the bondholders if the issuer defaults.

Id.

100. *Cent. Bank*, 511 U.S. at 168. In this case, the bonds in question were municipal bonds. *See* BLACK'S LAW DICTIONARY 204 (9th ed. 2009) (defining a municipal bond as "[a] bond issued by a nonfederal government or governmental unit, such as a state bond to finance local improvements" and stating that "[t]he interest received from a municipal bond may be exempt from federal, state, and local taxes").

101. *Cent. Bank*, 511 U.S. at 168.

102. *Id.* at 167–68; *see also* Junbo Wang, Chunchi Wu & Frank Zhang, *Liquidity, Default, Taxes and Yields on Municipal Bonds* 4 (Fed. Res. Bd., Div. of Res. & Stat. & Monetary Aff., Working Paper No. 2005-35), *available at* http://www.federalreserve.gov/pubs/feds/2005/200535/200535pap.pdf (noting that while municipal bonds have traditionally been considered the safest investment next to U.S. treasuries, there is evidence of municipal default since the late 1970s; in a survey of municipal bond issuance between 1977 and 1998, 1,765 out of a total of 253,850 (0.69%) issues were defaulted, with a face value of $24.9 billion out of a total of $375.5 billion).

103. *Cent. Bank*, 511 U.S. at 168. Plaintiffs sued the public authority, the 1988 underwriter, a junior underwriter, an AmWest Development director, and Central Bank for violations of § 10(b)—the first three as primarily liable and Central Bank as secondarily liable. *Id.*; *see also* Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CALIF. L. REV. 80, 80 n.4 (1981) (defining secondary liability as "the judicially implied civil liability which has been imposed on defendants who have not themselves been held to have violated the express prohibition of the securities statute at issue, but who have some relationship with the primary wrongdoer").

104. *Cent. Bank*, 511 U.S. at 168 (explaining that the Tenth Circuit Court of Appeals set forth the elements of aiding and abetting under § 10(b) as including: "(1) a primary violation of § 10(b); (2) recklessness by the aider and abettor as to the existence of the primary violation; and (3) substantial assistance given to the primary violator by the aider and abettor"); *see also* Simon Lorne, *Comment on "Just Desserts for Accountants,"* 38 ARIZ. L. REV. 555, 557 (1996) (stating that the Court granted certiorari in *Central Bank* on the question of the level of scienter necessary in an aiding and abetting context).

105. *Cent. Bank*, 511 U.S. at 173; *see also* Gary L. Goodenow, *Litigating the SEC's Ancillary*

decision, the Supreme Court reasoned that § 10(b) did not proscribe aiding and abetting violations and refused to accept the argument that the terms "directly and indirectly" in the section referred to aiding and abetting.[106] The dissent asserted that, in an apparent showing of judicial activism, the majority addressed a § 10(b) question that was not contemplated—and in fact, conceded—by the defendant in its petition for certiorari.[107]

3. Restriction of Rescission Claims[108]

In *Gustafson v. Alloyd Co.*,[109] the Supreme Court limited the right of rescission for victims of securities fraud to only those cases that arise with respect to public offerings of securities by an issuer that issues a prospectus as described in § 10(b).[110] In *Gustafson*, the defendants sold their interest in stock of Alloyd Co., Inc. to the plaintiffs.[111] While researching the company and its financial statements, the plaintiffs discovered that the defendants had merely estimated the company's

Enforcement Remedies Following Central Bank *and Its Progeny*, 21 AM. J. TRIAL ADVOC. 67, 78 (1997) (asserting that following the Court's strict adherence to the text of § 10(b) would prohibit the SEC from having any ancillary remedies in issues of securities statute interpretation).

106. *Cent. Bank*, 511 U.S. at 176; *see also* Goodenow, *supra* note 105, at 78 (noting that § 10(b) does not state that the SEC can sue for injunctive relief per se; therefore, it should not be allowed to use inherent equitable powers such as disgorgement, receivers, and accountings, which are ancillary remedies available to the SEC but not stated in the statute).

107. *Cent. Bank*, 511 U.S. at 194–95 (Stevens, J., dissenting) ("But instead of simply addressing the questions presented by the parties, on which the law was unsettled, the Court *sua sponte* directed the parties to address a question on which even the petitioner justifiably thought the law was settled, and reaches out to overturn a most considerable body of precedent."). *See generally* Melissa C. Nunziato, Comment, *Aiding and Abetting, A Madoff Family Affair: Why Secondary Actors Should be Held Accountable for Securities Fraud Through the Restoration of the Private Right of Action for Aiding and Abetting Liability Under the Federal Securities Laws*, 73 ALB. L. REV. 603 (2010) (arguing that Congress should restore the private right of action against those who aid and abet securities fraud, and that in the wake of the Bernie Madoff Ponzi scheme, not doing so would perpetuate further fraudulent conduct in the market and impede investor confidence).

108. Although the restriction of claims pertains to § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77b (2006), it is added to this Note because it follows a pattern of judicial retrenchment of the private right of action under federal securities laws.

109. 513 U.S. 561 (1995).

110. *Gustafson*, 513 U.S. at 578. The Court stated that it was not plausible to infer that Congress created the right to rescind for every casual communication between buyer and seller. *Id.* Congress meant to only allow rescission for claims arising from communications contained in a prospectus or other registered statement. *Id.*; *see also* Stephen M. Bainbridge, *Securities Act Section 12(2) After the* Gustafson *Debacle*, 50 BUS. LAW. 1231, 1231–32 (1995) (strongly criticizing the Court's decision, calling it "the most poorly-reasoned, blatantly results-driven securities opinion in recent memory").

111. *Gustafson*, 513 U.S. at 564. The transaction involved in this case was a private transaction, meaning it was not executed on a public exchange. *Id.*

inventory in preparation of filing financial statements instead of accurately stating it.[112] Despite that knowledge, the plaintiffs elected not to conduct a physical inspection of the inventory and settled for the defendants' representation that the financial statements were an accurate and complete assessment of the company's financial condition.[113] The parties indicated in their Stock Purchase Agreement that the purchase price would be adjusted to take account of any variance between estimates in the statements and actual amounts found in a year-end audit.[114] Although the audit uncovered a substantial inventory shortfall that the defendants agreed to make whole, the plaintiffs later sought rescission of the entire deal under fraud claims governed by § 12(2) of the 1933 Act, which gives buyers an express right of rescission against sellers that make material misstatements or omissions in a prospectus.[115]

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112. *Id.*; *see also* CHARLES J. JOHNSON & JOSEPH MCLAUGHLIN, CORPORATE FINANCE AND THE SECURITIES LAWS § 5.03, at 5-31 (4th ed. 2008) (describing the due diligence process as verifying the premises underlying the transaction and as a means to minimize financial loss to the investor).

113. *Gustafson*, 513 U.S. at 565; *see also* JOHNSON & MCLAUGHLIN, *supra* note 112, § 5.03, at 5-31 (asserting that effective due diligence cannot take place if the persons conducting the process are in the dark about the factors relating to the transaction).

114. *Gustafson*, 513 U.S. at 565; *see also Definition of Stock Purchase Agreement*, BUSINESSDICTIONARY.COM, http://www.businessdictionary.com/definition/stock-purchase-agreement.html (last visited Apr. 21, 2012). A stock purchase agreement is defined as an

> [a]greement between a closely-held or private firm and its shareholders for regulating the sale and transfer of firm's shares. It covers items such as who has the right of first refusal, and provides a mechanism for the purchase (redemption) of the shares of the shareholder who becomes bankrupt, is discharged, resigns, retires, becomes incapacitated, or dies.

Id.

115. *Gustafson*, 513 U.S. at 565; *see also* 15 U.S.C. § 77l(a) (2006).

> (a) In general
>
> Any person who–
>
> > (1) offers or sells a security in violation of section 77e of this title, or
> >
> > (2) offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading, . . . and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable, subject to subsection (b) of this section, to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, *to recover the consideration paid for such security* with interest thereon, less the amount of any income received hereon, upon the tender of such security, or for damages if he no longer owns the security.

Id. (emphasis added).

The United States District Court for the Northern District of Illinois granted summary judgment for the defendants, but the Seventh Circuit reversed.[116] Nevertheless, the Supreme Court disagreed with the Seventh Circuit and held that rescission liability[117] under § 12(2) did not apply to private or aftermarket securities transactions,[118] despite existing precedent that suggested the Seventh Circuit's reading of § 12(2) was reasonable.[119] The majority opinion focused on the term "prospectus," stating that under § 10(b), the term is confined to a document contained in a registration statement, which, by and large, is issued by an issuer of a security in an initial public offering.[120]

4. Heightened Reliance Standard

In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta*,[121] the Court created the requirement of "a kind of super-causation" for proving reliance.[122] The dispute in *Stoneridge* involved securities

116. *See Gustafson*, 513 U.S. at 566 (stating that the Seventh Circuit Court of Appeals reasoned that the "inclusion of the term 'communication' in the [1933] Act's definition of prospectus meant that the term 'prospectus' was defined 'very broadly' to include all written communications that offered the sale of a security"); *see also* BLACK'S LAW DICTIONARY 1342 (9th ed. 2009) (defining a prospectus as a "printed document that describes the main features of an enterprise and that is distributed to prospective buyers or investors" and explaining that "[u]nder SEC regulations, a publicly traded corporation must provide a prospectus before offering to sell stock in the corporation").

117. As used by the Court in this case, "rescission liability" means to "recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if [the purchaser] no longer owns the security." § 77l(a)(1)(2).

118. *Gustafson*, 513 U.S. at 578; *see also* Brian Murray, *Aftermarket Purchaser Standing Under § 11 of the Securities Act of 1933*, 73 ST. JOHN'S L. REV. 633, 637–38 (1999) (discussing thirty years of pre-*Gustafson* case law and explaining that "purchasers in the secondary market who can trace their stock back to an initial public offering . . . have standing to sue for violations . . . .").

119. *See* United States v. Naftalin, 441 U.S. 768, 777–78 (1979) (stating that while the 1933 Act was primarily concerned with regulating new issues, legislative history showed that Congress intended to prohibit fraud, deception, and misrepresentation in the sale of securities that were new offerings or secondary transactions).

120. *Gustafson*, 513 U.S. at 569; *see also* Peter V. Letsou, *The Scope of Section 12(2) of the Securities Act of 1933: A Legal and Economic Analysis*, 45 EMORY L.J. 95, 152 (1996) (stating that prior to *Gustafson*, § 12(2) was given a broad scope, and *Gustafson* radically altered the vision of § 12(2) of the 1933 Act).

121. 552 U.S. 148 (2008).

122. *Id.* at 168 (Stevens, J., dissenting) (noting two faulty premises on which the majority opinion relied: (1) a broad interpretation of *Central Bank*, and (2) "the view that reliance requires a kind of super-causation—a view contrary to both the [SEC] position . . . and our holding in *Basic Inc. v. Levinson*"); *see also* Basic Inc. v. Levinson, 485 U.S. 224, 246–47 (1988) (holding that the fraud-on-the-market theory can partly support a presumption of reliance, but the presumption is rebuttable).

violations made by Charter Communications, Inc., which was looking to inflate its earnings to meet revenue projections previously reported to the public.[123] Charter offered two of its suppliers, Scientific-Atlanta and Motorola—both defendants in the case—an additional twenty dollars for each cable box Charter purchased from them, in exchange for the two companies buying an equal amount of additional advertising from Charter.[124] The defendants agreed, and Charter was able to meet its earnings expectations.[125] In conjunction with the scheme, Charter filed financial statements with the SEC and reported the earnings to the public.[126] In the wake of *Central Bank*'s holding that eliminated aiding and abetting liability, the plaintiff proceeded with claims under § 10(b) and Rule 10b-5, naming the defendants as primary violators.[127]

The United States District Court for the Eastern District of Missouri dismissed the claims, holding that the defendants were vendors and customers, and the Eighth Circuit affirmed.[128] The Supreme Court

123. *Stoneridge*, 552 U.S. at 153; *see also Investor Resources*, CHARTER COMMUNICATIONS, http://phx.corporate-ir.net/phoenix.zhtml?c=112298&p=irol-irhome (last visited Apr. 21, 2012) (noting that Charter Communications is one of the largest cable entertainment and broadband communications companies, headquartered in St. Louis, Missouri, and employees approximately 16,700 people).

124. *Stoneridge*, 552 U.S. at 154; *see also* Kevin P. Dwight et. al, *Financial Institutions, Professionals Breathe Sigh of Relief—Supreme Court Stonewalls Plaintiffs' Attempt to Expand Liability for Securities Fraud in* Stoneridge Investment Partners, LLC v. Scientific-Atlanta Inc., MANATT, PHELPS, & PHILIPS, LLP, http://www.manatt.com/newsevents.aspx?id=5816 (last visited Apr. 21, 2012) ("Charter agreed to purchase its cable boxes from Scientific-Atlanta and Motorola at inflated prices. In return, the suppliers agreed to use the extra money to buy advertising from Charter, which capitalized its purchase of the boxes and recorded the suppliers' advertising purchases as revenue, in violation of generally accepted accounting principles.").

125. *Stoneridge*, 552 U.S. at 154; *see also* Dwight, *supra* note 124 (stating that the scheme worked and enabled Charter to report an additional $17 million in revenue for the year, which allowed them to meet their financial estimates for 2000).

126. *Stoneridge*, 552 U.S. at 155; *see also Sources for Corporate Financial Data*, UNIV. LIBRARY SYS., UNIV. OF PITTSBURGH, http://www.library.pitt.edu/guides/business/financials.html (last visited Apr. 21, 2012) (discussing the SEC requirement that companies selling stock to the public must file a number of reports with the SEC as a means of informing investors about the company).

127. *Stoneridge*, 552 U.S. at 155; *see also* Nicholas F. Schanbaum, Note, *Scheme Liability: Rule 10b-5(A) and Secondary Actor Liability After* Central Bank, 26 REV. LITIG. 183, 187 (2007) (discussing § 10(b) as prohibiting deceptive and manipulative conduct connected with the purchase or sale of a security, and Rule 10b-5 as specifically delineating the types of conduct barred by § 10(b)). Schanbaum asserted that after *Central Bank*, plaintiffs had to position what would have been a secondary violation for aiding and abetting as a primary violation of Rule 10b-5. *Id.* at 185.

128. *Stoneridge*, 552 U.S. at 156 (noting that there was a conflict among the courts of appeals "respecting when, if ever, an injured investor may rely upon § 10(b) to recover from a party that neither makes a public misstatement nor violates a duty to disclose but does participate in a scheme to violate § 10(b)"); *see also* Prentice, *supra* note 36, at 353 (noting that the Court in

determined that the key issue under review was whether "any deceptive statement or act [on the part of the defendants had] the requisite proximate relation to the investors' harm."[129] The Court held that no member of the investing public relied on, or had knowledge of, any act performed by the defendants and reasoned that this indirect chain of events was too remote from the investors to attach liability.[130] The dissent argued that the majority misapplied the holding in *Central Bank* and that its decision soundly weakened the implied private right of action under § 10(b).[131]

Blue Chip, *Lampf*, *Central Bank*, *Gustafson*, *Tellabs*, and *Stoneridge* all showcase the Supreme Court's systemic narrowing[132] of a plaintiff's

Stoneridge primarily evaluated the validity of "scheme liability" under subsection (a) of Rule 10b-5).

129. *Stoneridge*, 552 U.S. at 158–59; *see also* Prentice, *supra* note 36, at 361–62 (asserting that it is extremely likely that Congress intended for the SEC to outlaw "both schemes to defraud and fraudulent courses of business" when it enacted the 1934 Act).

130. *Stoneridge*, 552 U.S. at 159. Additionally, the Court dismissed the plaintiff's "scheme liability" argument, which alleged that the defendants' conduct had the purpose and effect of creating a false appearance of material fact to further a scheme to misrepresent Charter's revenue. *Id.* at 160. The Court explained that such a holding would "reach the whole marketplace in which the issuing company does business." *Id.*; *see also* Daniel A. McLaughlin, *Liability Under Rules 10b-5(a) & (c)*, 31 DEL. J. CORP. L. 631, 631 (2006) (describing scheme liability as involving a "defendant [who] neither spoke nor owed a duty to speak but instead engaged in business transactions that were misreported by the issuer"); Prentice, *supra* note 36, at 393 ("[T]he *Stoneridge* majority revised approximately four hundred years of fraud law by creating . . . an artificial dichotomy between primary and secondary liability. The majority opinion may also have rewritten a couple of hundred years' worth of fraud jurisprudence regarding the reliance element by arguably holding that *those who knowingly and actively participate in a fraud may avoid liability by simply staying in the shadows*." (emphasis added)).

131. *See Stoneridge*, 552 U.S. at 168–69 (Stevens, J., dissenting) (arguing that the majority failed to realize that this case was different from *Central Bank* because in that case, the bank did not engage in any deceptive acts and it did not itself violate § 10(b), but that respondents in this case directly produced documents and signed contracts—"deceptive devices"— to perpetuate a fraud); *see also* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994), *superseded in part by statute*, 15 U.S.C. § 78t (2006), *as recognized in* Doe v. Exxon Mobile Corp., 654 F.3d 11, 19 (D.C. Cir. 2011).

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

Id. (emphasis added); *see also* Ronald J. Colombo, *Cooperation With Securities Fraud*, 61 ALA. L. REV. 61, 89 (2009) (stating that the *Stoneridge* decision did not create a "blanket rule rejecting assertions of fraud-on-the-market in every situation where defendants' involvement in the fraud was nonpublic," but instead, gives rise to the notion that reliance is a factual determination that emphasizes the proximity to the fraud).

132. The Court also narrowed the scope of § 10(b) in another case not specifically covered in

options when seeking recourse for securities fraud under federal securities laws.[133] Each case resulted in some form of investor injury that escaped liability under the Court's interpretation of § 10(b) and other sections of federal securities laws such as § 12(2) of the 1933 Act.[134] This progeny of case law deviates from the intended purpose of securities regulation within the private context.[135] *Janus* only furthered that deviation.[136]

Although *Stoneridge* left the question of what constitutes primary and secondary liability under § 10(b) and Rule 10b-5 unanswered,[137] commentators speculated that the Court would use the opportunity presented by *Janus* to define a balanced and appropriate standard.[138] Interestingly, the Court's track record with private action litigation under § 10(b) and Rule 10b-5 (i.e., the narrowing of plaintiffs' rights) should have made the Court's decision in *Janus* highly predictable.[139]

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this Note. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (holding that a private cause of action for negligence will not lie under Rule 10b-5 in the absence of any allegation of scienter).

133. *See* Douglas M. Branson, *Running the Gauntlet: A Description of the Arduous, and Now Often Fatal, Journey for Plaintiffs in Federal Securities Law Actions*, 65 U. CIN. L. REV. 3, 6 (1996–1997) (stating that in the mid-70s the Supreme Court decided thirty-two out of forty federal securities law cases for the defendants, and in almost every one of these cases, the Court narrowed the utility of federal securities laws); *see also* Goodenow, *supra* note 105, at 79 (asserting that there is little doubt the Supreme Court is under a trend of restricting the scope of federal securities laws).

134. *See supra* Part II.E.1–4 (detailing the factual background of each case discussed in this background).

135. *See* Margaret V. Sachs, *Freedom of Contract: The Trojan Horse of Rule 10b-5*, 51 WASH. & LEE L. REV. 879, 880 (1994) (asserting that the 1934 Act was enacted as a means to end the "philosophy of caveat emptor" or "buyer beware").

136. *See* James D. Redwood, *To Make or to Mar: The Supreme Court Turns Away Another Securities Law Plaintiff*, 14 U. PA. J. BUS. L. (forthcoming 2012), *available at* http://papers.ssrn .com/sol3/papers.cfm?abstract_id=1942558 (asserting that the Court in *Janus*, "following a disturbing recent trend, has voluntarily chosen to bar the gates to securities plaintiffs") (footnote omitted).

137. *See* Colombo, *supra* note 131, at 89 (stating that the question still exists as to what the distinction would be between conduct classified as aiding and abetting and conduct classified as a primary violation by a secondary actor).

138. *See* Bruce D. Angiolillo & Jonathan K. Youngwood, *The Janus Debate: The Supreme Court May Clarify The Boundaries of Secondary Actor Liability Under § 10(b)*, 8 SEC. LITIG. REP. 1, 1 (2010) (discussing the briefs and oral arguments in *Janus* and the potential outcome of the case). The Fourth Circuit widened a circuit split when it found for plaintiffs, holding that an investment adviser to a mutual fund could be held primarily liable under § 10(b). *Id.* The Second, Fifth, and Eleventh Circuits found that only statements that are publicly made could create primary attribution and liability. *Id.* The Ninth Circuit, however, has used substantial participation or intricate involvement in preparation of the misleading statement to find liability. *Id.*

139. *See* Thomas A. Smith, *Betting on Supreme Court Outcomes*, RATIO JURIS BLOG (Sept.

III. DISCUSSION

Janus Capital Group, Inc. v. First Derivative Traders was argued before the Supreme Court on December 7, 2010.[140] Prior to the Court's decision on June 13, 2011, analysts believed the case would have far-reaching implications for the mutual fund industry, as well as collateral actors such as lawyers and accountants.[141] But *Janus* was years in the making, and, as this Note posits, the ramifications of its holding could end up reaching beyond these analysts' initial expectations.[142]

A. Factual Background of the Case

In September 2003, the New York Attorney General filed a complaint alleging that Janus Capital Group Inc. ("JCG") and Janus Capital Management LLC ("JCM") entered into secret arrangements with certain hedge fund investors to allow market-timing[143] transactions

11, 2006, 8:44 PM), http://ratiojuris.blogspot.com/2006/09/betting-on-supreme-court-outcomes.html (discussing the Washington Stock Exchange, which allows traders to bet on the outcome of future events, including the outcomes of U.S. Supreme Court decisions); *see also* Catherine Rampell, *Supreme Court Betting*, N.Y. TIMES (May 12, 2009, 1:28 PM), http://economix.blogs.nytimes.com/2009/05/12/supreme-court-betting/ (discussing "Intrade.com," an online prediction market that was taking bets on who would be the eventual replacement for Justice David Souter).

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

141. *See* Angiolillo & Youngwood, *supra* note 138 (discussing the anticipated affect the Court's decision would have on the understanding of primary and secondary liability under § 10(b)).

142. *In re* Mut. Funds Inv. Litig., 566 F.3d 111, 115 (4th Cir. 2009), *rev'd*, Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011). The original complaint for this case was filed in November 2003 by an individual investor, Craig Wiggins, in a Colorado federal court, but it was later moved to Maryland to be joined together with similar complaints and First Derivative Traders was appointed as lead plaintiff. *Id.* For a discussion of the unforeseen potential consequences of the Court's decision in *Janus*, see *infra* Part V.

143. *Janus*, 131 S. Ct. at 2300 n.1. The Court describes market timing as

> [a] trading strategy that exploits time delay in mutual funds' daily valuation system. The price for buying or selling shares of a mutual fund is ordinarily determined by the next net asset value (NAV) calculation after the order is placed. The NAV calculation usually happens once a day, at the close of the major U.S. markets. Because of certain time delays, however, the values used in these calculations do not always accurately reflect the true value of the underlying assets. For example, a fund may value its foreign securities based on the price at the close of the foreign market that could be expected to affect their price. If the event were expected to increase the price of the foreign securities, a market-timing investor could buy shares of a mutual fund at the artificially low NAV and sell the next day when the NAV corrects itself upward.

Id.; *see also* Stephen Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals*, 87 B.U. L. REV. 1021, 1041 (2007) (citing studies indicating that market timing reduces the returns of non-timing investors); James J. Park, *Rule 10B-5 and the Rise of the Unjust Enrichment Principle*, 60 DUKE L.J. 345, 380 (2010) (describing the act of market timing as harmful to mutual fund investors because of the increase in transaction costs to the fund—borne by all in exchange for investing "sticky assets"[144] in Janus Investment Funds ("Janus Funds").[145] JCG was a publicly traded company that wholly owned (and still owns) JCM as a subsidiary.[146] Ninety percent of JCG's revenue was derived from JCM's activities, and the two entities had extensive overlap in executive officers due to JCM's position as JCG's primary operating company.[147] The Janus Funds were a Massachusetts business trust established for the sole purpose of holding the Janus family of funds.[148] Although the trust was created by JCG, it was a separate legal entity owned entirely by its mutual fund investors and had its own board of trustees.[149] The Janus Funds had no assets apart from what it held for mutual fund shareholders, and all officers of

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investors of the mutual fund—that are generated by the frequent trading).

144. *See* SEC v. Treadway, 430 F. Supp. 2d 293, 298–99 (S.D.N.Y. 2006) (describing a scheme in which a mutual fund gave a hedge fund "market timing privileges in certain PIMCO funds in exchange for long-term or 'sticky asset' investments in other PIMCO funds"); *see also* Adam Shell, *Anatomy of a Tricky Trading Scheme*, USA TODAY (Sept. 5, 2003, 12:03 AM), http://www.usatoday.com/money/perfi/funds/2003-09-05-trading-scheme_x.htm (defining "sticky assets" as "money that is invested in a fund for a long period of time and generates fees for a fund company").

145. *Janus*, 131 S. Ct. at 2300; *see also* Shell, *supra* note 144 ("[M]arket timing hurts long-term shareholders by diluting their returns and resulting in higher trading costs. A fund's performance may also be hurt by the fact that fund managers must hold more cash to meet the redemptions caused by the timers' trades.").

146. *Janus*, 131 S. Ct. at 2299; *see also* BLACK'S LAW DICTIONARY 394, 1565 (9th ed. 2009) (defining a subsidiary corporation as one "in which a parent corporation has a controlling share" and further defining subsidiary as "[s]ubordinate; under another's control"); Dick Weil & Bruce Koepfgen, *Third Quarter 2011 Earnings Presentation*, JANUS CAPITAL GRP. 26 (Oct. 20, 2011), http://files.shareholder.com/downloads/JANUS/0x0x510109/1d5b1dde-e722-4cb0-bbec-113292e5ade1/3Q11_Earnings_Presentation_-_FINAL_10.19.11_.pdf (disclosing that JCG provides investment advisory services through three primary subsidiaries: JCM; INTECH Investment Management LLC; and Perkins Investment Management LLC).

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

148. *Id.*; *see also* John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165, 183–84 (1997) (asserting that many mutual funds have chosen to organize as a trust because it eliminates a layer of regulation, namely state corporation statutes); *Definition of Business Trust*, BUSINESSDICTIONARY.COM, http://www.businessdictionary.com/definition/business-trust.html (last visited Apr. 21, 2012) ("[A business trust is a] commercial organization managed by appointed trustees (who hold the title to the business' property) for the benefit of one or more beneficiaries. A business trust is treated as a legal entity by the tax authorities and must have (1) a business purpose, and (2) must function as a business."). Trusts also have the flexibility to eliminate corporate governance procedures that are obligatory under the corporate form. *Id.*

149. *Janus*, 131 S. Ct. at 2299; *see also* Langbein, *supra* note 148, at 184 (noting that a mutual fund established as a business trust does not have to hold routine shareholder meetings, thereby eliminating the costs of proxy solicitation and other meeting-related expenses associated with corporations).

the Janus Funds were officers of JCM.[150] Moreover, a member of the Janus Funds' board was an officer of both JCG and JCM.[151]

The Janus Funds retained JCM as investment advisor that would be in charge of the day-to-day management of the funds, including furnishing investment advice and recommendations, buying and selling securities, handling investor requests and inquiries, and providing general administrative, compliance, and accounting services for the funds.[152] Moreover, JCM helped create and disseminate the prospectus for the Janus Funds and made it available to the public through the website it shared with JCG.[153] For all intents and purposes, JCM ran the Janus Funds.[154] In exchange for these services, JCM received management fees based primarily on the amount of assets under management.[155] Therefore, the more assets JCM managed for the Janus Funds, the more revenue it generated for JCG.[156] Conversely, a drop in

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

151. *See* Brief for Respondent at 4, Janus Capital Grp. Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011) (No. 09-525), 2010 WL 4253501 at *4 (stating that the Janus Funds' Board of Trustees was chaired by the founder and former CEO of JCG, Thomas Bailey, and that every one of the Janus Funds' seventeen officers was a V.P. at JCM); *see also In re* Mut. Funds Inv. Litig., 566 F.3d 111, 131 (4th Cir. 2009), *rev'd*, Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011) (describing the entwinement of one officer in particular, Helen Hayes, who was a director of both JCG and JCM during the class period and a managing director of investments and a portfolio manager at JCM).

152. *Janus*, 131 S. Ct. at 2306 (Breyer, J., dissenting); *see also* Howard Schiffman, *The Relationship Between the Investment Advisor and the Mutual Fund: Too Close for Comfort*, 45 FORDHAM L. REV. 183, 183 (1976) (asserting that while the fund and its advisor are two separate legal entities, the conflicts of interest inherent in this relationship are obvious and have led to commentators describing the relationship as anomalous and incestuous).

153. *In re* Mut. Funds Inv. Litig., 566 F.3d at 116.

154. *Id.* at 115; *see also* INV. CO. INST., 2011 INVESTMENT COMPANY FACT BOOK (51st ed. 2011), *available at* http://www.ici.org/pdf/2011_factbook.pdf (noting that unlike other companies or industries, a mutual fund is typically managed by an external party and relies on the third party advisor to invest fund assets and carry out other business activities).

155. All mutual funds charge management fees based on assets under management. J. STODDARD HAYES, JR., ESTATE TAX & PERSONAL FINANCIAL PLANNING § 30:49 (2012), *available at* Westlaw 3 Est. Tax & Pers. Fin. Plan. § 30:49. For example, a $100 million fund may charge one percent annually for managing the fund. This generally means that at the end of every quarter (typically March, June, September, and December), the fund takes a snapshot of the assets in the fund and charges the fee. For instance, if the fund is worth $105 million at the end of March, one percent of that amount is $1,050,000 and divided by four would be $262,500. Therefore, the investment advisor will assess a fee of $262,500 for that three-month period. The money will be directly withdrawn from the cash balance of the mutual fund and paid to the investment advisor. Note that since the investment advisor controls all of the day-to-day operations of the fund, the advisors essentially pay themselves.

156. *Janus*, 131 S. Ct. at 2300. If a mutual fund advisor has $105 million of assets under management and charges a one percent annual fee, then the advisor will earn $1,050,000 for the year assuming the assets do not go up or down. If during the next year the advisor's assets under

the value of the assets under management resulted in a drop in the revenue JCM provided to JCG.[157]

The central issue in *Janus* revolved around statements that were made in the Janus Funds' prospectuses filed with the SEC, and then made available to the public through the Janus corporate website.[158] The warning against market-timing activity in the prospectus was not simple boilerplate language typically lost in the midst of a large legal document.[159] Instead, the evidence indicated that JCG and JCM employees/officers were well aware that the Janus Funds did not support or allow market timing as was stated in the prospectus.[160]

management increase to $120 million, the percentage stays the same at one percent, but the advisor will now earn $1.2 million because of the higher asset pool that is being managed.

157. *See In re Mut. Funds Inv. Litig.*, 566 F.3d at 118 (noting that after the Attorney General's complaint became public, there was a massive exodus of mutual fund investors causing a decrease in assets under management of JCM of $14 billion in a roughly six month period); *see also* Brief for Respondent, *supra* note 151, at 5 (stating that in SEC filings made by JCG, the company identified the number one risk to its business as "[a]ny decrease in the value of Janus' assets under management," which would negatively affect revenues and profits).

158. *In re Mut. Funds Inv. Litig.*, 566 F.3d at 116–17. The anti-market-timing policy listed in the prospectus of the Janus Mercury Fund states:

> Frequent trades in your account or accounts controlled by you can disrupt portfolio investment strategies and increase Fund expenses for all Fund shareholders. *The fund is not intended for market timing or excessive trading*. To deter these activities, the Fund or its agent may temporarily or permanently suspend or terminate exchange privileges of any investor who makes more than four exchanges out of the Fund in a calendar year and bar future purchases into the Fund by such investor. In addition, the Fund or its agent also may reject any purchase orders (including exchange purchases) by any investor or group of investors indefinitely for any reason, including, in particular, purchase orders that they believe are attributable to market timers or are otherwise excessive or potentially disruptive to the Fund.
>
> Orders placed by an investor in violation of the exchange limits or the excessive trading policies or by investors that the Fund believes are market timers may be revoked or cancelled by the Fund . . . .

Id. (emphasis added); *see also The Mutual Fund Prospectus*, *supra* note 153 (noting that a prospectus is usually one hundred-plus pages long and most of the information included is statutorily required).

159. *See* Ollivette E. Mencer, *Unclear Consequences: The Ambient Ambiguity*, 22 S.U. L. REV. 217, 217 (1995) (asserting that legal writing, in general, is not good, and leads to millions of dollars of needless expenses and a loss of respect for the legal profession).

160. *In re Mut. Funds Inv. Litig.*, 566 F.3d at 118 (quoting two internal emails by Janus employees). One employee stated:

> *Our stated policy* is that we do not tolerate timers. As such, we won't actively seek timers, but when pressed and when we believe allowing a limited/controlled amount of *timing activity will be in JCG's best interests* (increased profitability to the firm) we will make exceptions under these parameters.

Id. (emphasis added). Another employee added:

> My own personal recommendation is not to allow timing, period, and *follow the prospectus* . . . . [T]imers often hide multiple accounts and move on the same day

Some employees voiced their concerns about allowing these transactions to continue due to the negative impact they had on portfolio managers and investors, namely, market-timing increases fund fees paid by all mutual fund investors and hampers the portfolio manager's trading ability.[161] One such employee repeated the prospectuses' warning but nevertheless suggested that allowing a limited amount of market timing would be in JCG's best interest because it would lead to increased profitability.[162] Another employee suggested that the Janus Funds maintain the market-timing agreements they presently had but to not allow any future agreements.[163]

On September 3, 2003, the New York Attorney General filed its complaint.[164] By the end of the month, JCG shareholders lost twenty-three percent of their investment.[165] The assets held inside Janus Funds

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> which *could hurt other investors* and enrage the [portfolio managers] . . . . I don't think the static assets that we might be able to hold onto are worth the potential headaches, nor does this fall into our 'narrow and deep' focus. I suggest we maintain the timing agreements we have, but allow no more.

Id. (emphasis added). It is difficult to understand how JCM/JCG escaped primary liability in the face of this type of evidence that showcased clear control over the alleged market-timing activity and the knowledge of the affects it had on the company as a whole and, by extension, to the shareholders. *See infra* Part IV.C (exploring the "ultimate control" of statements and the Court's position in *Janus*).

161. *See In re Mut. Funds Inv. Litig.*, 566 F.3d at 117 (quoting an email from "a concerned [JCG] employee" to the CEO of Janus International Growth Fund). The employee stated:

> I'm getting more concerned w/ all of these market timers and how they are affecting our PM's [i.e., Portfolio Managers] trading activity. [Portfolio Managers] have voiced their sensitivity on a number of occasions re: this type of activity in JWF. I spoke to [a Janus employee] and confirmed that this is a big problem domestically and I want to avoid this at all cost before it gets too problematic offshore. Now that we have our exchange limitation in our prospectus, I would feel more comfortable not accepting this type of business because it's too difficult to monitor/enforce & it is very disruptive to the PM's & operation of the funds. Obviously, your call from the sales side.

Id. (footnote omitted).

162. *See supra* note 160 and accompanying text (quoting employee emails).

163. *See supra* note 160 and accompanying text (quoting employee emails).

164. *See* Amey Stone, *Can Janus Save Face?*, BLOOMBERG BUSINESSWEEK (Sept. 9, 2003), http://www.businessweek.com/bwdaily/dnflash/sep2003/nf2003099_2044_db014.htm (discussing New York Attorney General Eliot Spitzer's probe against Janus and four other mutual fund companies that allegedly gave a hedge fund (Canary Capital) special privileges in trading fund shares, which harmed returns for long-term mutual fund shareholders while benefiting the parent company); *see also Janus Announces New Measures Following Spitzer Pro*, ADVISORONE (Sept. 10, 2003), http://www.advisorone.com/2003/09/10/janus-announces-new-measures-following-spitzer-pro (noting that five days after the complaint was filed, JCG told fund shareholders who may have been adversely impacted by market-timing that it would reimburse them of losses).

165. *See* Janus Capital Grp. Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2300 (2011) ("JCG's stock price fell nearly 25 percent, from $17.68 on September 2 to $13.50 on September 26."); *see also* Stone, *supra* note 164 (adding that JCG stockholders were in good spirits leading

fell by $14 billion within six months, which affected future earnings.[166] Shareholders of JCG filed a class action suit naming both JCG and JCM as defendants.[167] The shareholders asserted that JCG and JCM violated § 10(b) and Rule 10b-5, and they also brought a "control person" claim against JCG under § 20(a) of the 1934 Act.[168] The defendants moved to dismiss pursuant to Rule 12(b)(6) for failure to state a claim.[169]

B. The District Court's Decision

In granting the motion to dismiss, the United States District Court for the District of Maryland held that even though the mutual fund prospectuses bore JCM's name and logo and were available on its website, these facts alone did not make JCM liable to JCG's shareholders for misrepresentations made in the prospectuses.[170] The court found that the nexus between JCM and JCG shareholders was too "tenuous" to allow liability.[171] It differentiated a prior and separate action brought by the Janus mutual fund investors against JCG and JCM, where the court denied a similar motion to dismiss.[172] In that case, the district court noted that JCG and JCM had made misrepresentations in a fraudulent "scheme" that resulted in a direct

up to the complaint because the company was in the midst of recovering from the bear market of the recent past and JCG's stock had gone from $10 in March to $19 by mid-July; however, in the two days following the filing of the complaint, JCG stock fell from $18 to $15.50).

166. *In re* Mut. Funds Inv. Litig., 566 F.3d 111, 118 (4th Cir. 2009), *rev'd*, Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011). Mutual fund shareholders do not like to see news that questions the ethical stature of those who are managing their money. Any news that implicates a manager's trustworthiness is predictably followed by an exodus of mutual fund investors and by extension a loss of profitability to the manager. *See* Stone, *supra* note 164 (noting that the market-timing problem caused major damage to Janus's reputation, and following a bad bear market, its funds took major losses due to its aggressive investment philosophy).

167. *Janus*, 131 S. Ct. at 2299; *see also In re Mut. Funds Inv. Litig.*, 566 F.3d at 115 (noting that the original complaint was filed by a JCG shareholder in November 2003 and later transferred from the District of Colorado to the District of Maryland and consolidated with the current class action that named First Derivative Traders as lead plaintiff).

168. *Janus*, 131 S. Ct. at 2300–01.

169. *In re* Mut. Funds Inv. Litig., 487 F. Supp. 2d 618, 620 (D. Md. 2007).

170. *Id.* at 621. For access to fund details, prices, overviews, and prospectuses and reports, see JANUS.COM, https://ww3.janus.com/Janus/Retail/StaticPage?jsp=jsp/umbrella/UmbrellaPage.jsp (last visited Apr. 21, 2012).

171. *Id.* at 623. The court refused to find similarities in authorities provided by the plaintiffs to substantiate a nexus. *See* Semerenko v. Cendant Corp., 223 F.3d 165, 177–78 (3d Cir. 2000) (finding shareholders in one corporation may have stated securities fraud claims against another company); *see also* Zelman v. JDS Uniphase Corp., 376 F. Supp. 2d 956, 958, 974 (N.D. Cal. 2005) (finding JDS liable to purchasers of equity-linked debt securities tied to JDS stock but issued by a Swiss Bank).

172. *In re Mut. Funds Inv. Litig.*, 487 F. Supp. 2d at 622.

injury to the mutual fund investors.[173] However, unlike the direct fraud perpetrated on the mutual fund investors in that case, the JCG shareholders in the present case were not the intended victims of the same fraudulent scheme.[174] Thus, the court held that a mutual fund investment advisor (JCM) that made misrepresentations to mutual fund investors could not be held liable under § 10(b) to shareholders of the parent company (JCG).[175] Moreover, the court distinguished the liability at issue in this case from the liability that an underwriter might face in similar circumstances.[176] The court noted that an underwriter—in contrast to an investment advisor—could be held liable for preparing and disseminating a prospectus containing misrepresentations and/or omissions[177] because it plays a "central role . . . in the issuance of securities and the special reliance placed on them by prospective investors."[178] Under the district court's view, this was not true of investment advisors.[179]

C. The Fourth Circuit's Reversal

The Fourth Circuit Court of Appeals reversed the district court's holding, finding that the plaintiffs pled with sufficient particularity that JCM made misleading statements.[180] The court found a causal

173. *Id.* *See generally In re* Mut. Funds Inv. Litig., 384 F. Supp. 2d 845 (D. Md. 2005) (containing the opinion of the related case the district court refers to that was brought by mutual fund investors in the Janus funds against JCG, JCM, and others).

174. *In re Mut. Funds Inv. Litig.*, 487 F. Supp. 2d at 622; *see also In re Mut. Funds Inv. Litig.*, 384 F. Supp. 2d at 856–57 (holding that market timing was a "'scheme or artifice to defraud' or, at least, 'a practice . . . or course of business which operates as a fraud or deceit' upon those who have been misled or lulled into purchasing mutual fund shares in ignorance of its occurrence").

175. *In re Mut. Funds Inv. Litig.*, 487 F. Supp. 2d at 624.

176. *Id.* at 621.

177. *Id.*; *see also* BLACK'S LAW DICTIONARY 1665 (9th ed. 2009) (defining an underwriter as "[o]ne who buys stock from the issuer with an intent to resell it to the public; a person or entity, esp. an investment banker, who guarantees the sale of newly issued securities by purchasing all or part of the shares for resale to the public").

178. *In re Mut. Funds Inv. Litig.*, 487 F. Supp. 2d at 621 (quoting *In re* MTC Elec. Tech. S'holder Litig., 993 F. Supp. 160, 161–62 (E.D.N.Y. 1997)); *see also* Samuel N. Allen, *A Lawyer's Guide to the Operation of Underwriting Syndicates*, 26 NEW ENG. L. REV. 319, 321 (1991) (discussing how the role of a managing underwriter is sought after by investment banks usually because that will entail the ability to "run the books," which is an important role that allows for the most control over the offering of the new issuance and will earn the greatest percentage of the gross spread in the offering).

179. *In re Mut. Funds Inv. Litig.*, 487 F. Supp. 2d at 621.

180. *In re* Mut. Funds Inv. Litig., 566 F.3d 111, 115 (4th Cir. 2009), *rev'd*, Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011); *see also* Bell Atl. Corp. v. Twombly, 550 U.S. 544, 555 (2007) (stating that to survive a motion to dismiss under Rule 12(b)(6), "[f]actual allegations must be enough to raise a right to relief above the speculative level, on the assumption

connection between the false or misleading statements and the decrease in JCG's share price that injured the JCG shareholders.[181] After recounting the allegations in the plaintiffs' complaint, the Fourth Circuit held that the plaintiffs had convincingly asserted that the misleading statements made in the funds' prospectus by JCM fraudulently induced investors to buy shares in the Janus funds.[182] Additionally, the court noted a claim originally made by the New York Attorney General that the market-timing accusations in the Janus Funds had caused a "crisis of confidence among [JCG] common stock investors," which, in turn, resulted in the sharp decrease in share price.[183] Moreover, the plaintiffs' complaint alleged that "'as a practical matter JCM runs' the Janus funds," and therefore, investors could have relied on statements in the prospectuses made by JCM.[184] The plaintiffs' argument was based on the "fraud-on-the-market theory."[185] This theory posits that when the allegedly fraudulent statements at issue become public, the market

that all the allegations in the complaint are true (even if doubtful in fact)" (internal citations omitted)).

181. *See In re Mut. Funds Inv. Litig.*, 566 F.3d at 118 (stating that "the misleading statements in the Janus funds' prospectuses stating the funds' policy of deterring market timing fraudulently induced investors to buy shares in the Janus funds," which led to higher amounts of invested assets that led to higher revenues and an inflated stock price); *see also* Stone, *supra* note 164 (quoting a number of stock analysts' negative outlooks on JCG stock following the probe by New York Attorney General Eliot Spitzer: "This puts them many steps back;" "[Allegations] represent a serious breach of investor trust and fiduciary duty;" "This clearly raises the stakes from a risk standpoint").

182. *In re Mut. Funds Inv. Litig.*, 566 F.3d at 118–21, 127; *see also* Lowenfels & Bromberg, *supra* note 89, at 4 (examining cases where investors that took part in transactions "in connection with" the purchase or sale of securities state fraud claims of being induced into purchasing the securities).

183. *In re Mut. Funds Inv. Litig.*, 566 F.3d at 118; *see also* Jeremy Adams, *BoA and Janus Under Fire in Spitzer's Fund Probe*, EFINANCIALNEWS.COM (Sept. 4, 2003), http://www.efinancialnews.com/story/2003-09-04/boa-and-janus-under-fire-in-spitzers-fund-probe (quoting New York Attorney General Eliot Spitzer as saying that the mutual fund operators violated their fiduciary duties to their long-term mutual fund holders, suggesting they were essentially bought off).

184. *In re Mut. Funds Inv. Litig.*, 566 F.3d at 125 (quoting Joint Appendix at 212, Janus Capital Grp. Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011) (No. 09-525)); *see also* Adams, *supra* note 183 (describing the allowances made for hedge funds to trade after hours that New York Attorney General Eliot Spitzer likened to "allowing people [to] place bets on a horse race after it has finished").

185. *In re Mut. Funds Inv. Litig.*, 566 F.3d at 123–24 (explaining the fraud-on-the-market theory). The court stated:

> [B]ased on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business, and misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.

Id. (quoting Basic Inc.v. Levinson, 485 U.S. 224, 241–42 (1988)).

price of the security reflects the publicly available information, and therefore, any investor who purchases the security at the market price is assumed to have relied on the statement.[186] The court agreed and held that the plaintiffs adequately stated a claim against JCM for liability under § 10(b).[187] Because JCM could be directly liable under § 10(b), the court also held that plaintiffs adequately pled that JCG could be liable under a § 20(a) "control person" theory, because, in reality, JCG exerted complete control over JCM.[188]

The court did, however, refuse to adopt either the "direct attribution"[189] or "substantial participation"[190] standard for pleading reliance; instead, it would make determinations on a case-by-case basis.[191] Accordingly, the court discussed the numerous examples of entwinement and overlap between JCG, JCM, and the Janus Funds.[192] These circumstances created sufficient allegations in the pleadings that JCM—and JCG by extension—played a substantial role as a primary violator of § 10(b) and Rule 10b-5 based on a fraud-on-the-market theory of reliance.[193]

D. The Supreme Court Grants Certiorari

In their petition for certiorari, the defendants asked the court to consider whether "a service provider [could] be held primarily liable in a private securities-fraud action" for assisting another company in making misstatements or for statements not directly attributable to the

186. *Id.*; *see also Basic Inc.*, 485 U.S. at 246–47 (discussing the fraud-on-the-market theory).

187. *In re Mut. Funds Inv. Litig.*, 566 F.3d at 127–28.

188. *Id.* at 129–30.

189. *See In re Mut. Funds Inv. Litig.*, 566 F.3d at 124 (defining direct attribution as "an inexact proxy for determining whether investors will attribute a publicly available statement to a particular person or entity").

190. *See id.* at 123 (describing the attribution required for attaching reliance to a party, "substantial participation or intricate involvement in preparing the misleading statement is sufficient to state a primary violation of § 10(b)").

191. *See id.* at 124 ("[T]he attribution determination is properly made on a case-by-case basis by considering whether interested investors would attribute to the defendant a substantial role in preparing or approving the allegedly misleading statement."); *see also* Davis Polk & Wardwell, *Investment Management Regulatory Update*, 1849 PLI/CORP 121, 134–35 (2010) (discussing circuit court use of direct attribution and substantial participation).

192. *In re Mut. Funds Inv. Litig.*, 566 F.3d at 115; *see also* Brief for Respondent, *supra* note 151, at 3–4 (stating that seventeen officers of the Janus Funds were also Vice Presidents at JCM, and that the Janus Funds' Board was chaired by the founder and former CEO of JCG).

193. *See In re Mut. Funds Inv. Litigation*, 566 F.3d at 131 ("[W]e conclude that plaintiffs have pled a viable claim of primary § 10(b) liability against JCM and have adequately pled that JCG may be liable as a control person of JCM under § 20(a)."); *see also supra* note 185 and accompanying text (discussing the fraud-on-the-market theory).

service provider.[194] In a sharply divided five-to-four decision, Justice Thomas, writing for the majority, reversed the Fourth Circuit and held that an investment advisor and its parent company could not be held liable in a private action under Rule 10b-5 for false statements included in mutual fund prospectuses that were "made" by the investment fund itself.[195]

1. Justice Thomas's Majority Opinion

The Court began its discussion by affirming the implied private right of action under § 10(b) adopted in *Bankers Life*; however, it noted its concern that the judicial creation should not be expanded, thus reiterating the "narrow dimensions" of the private right of action.[196] The Court held that "[o]ne 'makes' a statement by stating it."[197] It proclaimed that "[f]or purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement," using the relation between a speechwriter and a speaker as an analogy.[198] The Court discussed its holding in *Central Bank* to highlight that private actions against aiding and abetting were no longer allowed under securities laws and that if the plaintiffs' argument was affirmed, liability would expand drastically.[199] Control and authority over statements, the

194. Petition for Writ of Certiorari at I, Janus Capital Grp. Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011) (No. 09-525).

195. *Janus*, 131 S. Ct. at 2229, 2301–02; *see also* Janus Capital Group v. First Derivative Traders, ALLIANCE FOR JUSTICE BLOG, http://www.afj.org/connect-with-the-issues/the-corporate-court/janus-capital-group-v-first-derivative-traders.html (last visited Apr. 21, 2012) (asserting that the Court's decision "limited the power of private investors and the courts to hold [corporate] insiders [liable] for securities fraud").

196. *Janus*, 131 S. Ct. at 2301–02 (asserting that the narrow interpretation of the private right of action under § 10(b) is consistent with Congress's intent because Congress did not expressly authorize the right in the original statute and did not affirm or expand the right when it revisited the law); *see also* Eisenberg, *supra* note 39, at 1331 (noting that the Court abandoned its broad application of the implied right of action under § 10(b) in 1975 and "[has] not returned to it since").

197. *Janus*, 131 S. Ct. at 2302 (describing the definition of the word "make" and how it was grammatically used in the statute); *see also* BLACK'S LAW DICTIONARY 1041 (9th ed. 2009) (defining make as "1. To cause (something) to exist . . . 2. To enact (something) . . . 3. To acquire (something) . . . 4. To legally perform, as by executing, signing, or delivering (a document)").

198. *Janus*, 131 S. Ct. at 2302. In highlighting the "control" distinction of the rule, the Court goes on to say that "one who prepares or publishes a statement on behalf of another is not its maker." *Id.* Moreover, the Court ties attribution to the person/entity with ultimate control over the statement, describing the speechwriter/speaker analogy as "[e]ven 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 credit—or blame—for what is ultimately said." *Id.*; *see also* BLACK'S LAW DICTIONARY 1041 (9th ed. 2009) (showing that nowhere in any of the four different definitions provided by Black's Law Dictionary is there any mention of "control" as defining "make").

199. *See Janus*, 131 S. Ct. at 2302 n.6 (criticizing the dissent's interpretation of primary

Court added, would create a more transparent line to reliance on the part of those that are injured.[200] The plaintiffs argued that JCM had overwhelming control and a unique relationship with the mutual fund creating reliance and attribution.[201] Nevertheless, the Court disagreed by holding that "[w]e decline this invitation to disregard the corporate form," emphasizing that JCM and the Janus Funds were separate legal entities and that the Janus Funds had an independent board of trustees.[202] If this type of liability was allowed, Justice Thomas stated, the responsibility to address it should fall on Congress.[203] The Court also rejected the SEC's argument that the word "make" should be defined as "create" and that those who create or write a statement that is false or misleading to investors should be held liable as primary violators.[204] Instead, the Court elected to treat the drafting of a false statement as entirely different from taking part in a deceptive transaction, holding that drafting is merely an undisclosed act that precedes the act of a separate entity making a public statement.[205]

liability, saying that it would not limit liability much, if at all); *see also* Lorne, *supra* note 104, at 556 (discussing aiding and abetting after *Central Bank*).

200. *Janus*, 131 S. Ct. at 2309; *see also* Prentice, *supra* note 36, at 395–404 (discussing questions of reliance left unanswered after *Stoneridge*).

201. *Janus*, 131 S. Ct at 2298; *see also* Brief of Law Professors William A Birdthistle et al. as Amici Curiae Supporting Respondent at 10–15, Janus Capital Group, Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011) (No. 09-525) (arguing that investment managers exert an extraordinary degree of control over their mutual funds).

202. *Janus*, 131 S. Ct. at 2304; *see also* Brief of Law Professors, *supra* note 201, at 17 (asserting that allowing the petitioners argument to stand, which the Court did, would show potential future perpetrators that all they need to do in order to avoid certain forms of securities fraud is to structure a business to mirror the mutual fund industry).

203. *Janus*, 131 S. Ct. at 2304; *see also Worst Decisions, #3:* Janus Capital v. First Derivative, ALLIANCE FOR JUSTICE BLOG (Sept. 28, 2011), http://afjjusticewatch.blogspot.com/2011/09/worst-decisions-3-janus-capital-v-first.html (counting down the ten worst Supreme Court decisions of the 2010–11 term and noting that it would be difficult to imagine that Congress intended to open such a gaping loophole in securities law, as the Court did in *Janus*).

204. *See Janus*, 131 S. Ct. at 2303–04 ("This definition, although perhaps appropriate when 'make' is directed at an object unassociated with a verb . . . fails to capture its meaning when directed at an object expressing the action of a verb."). The Court used the SEC as a means to reject respondent's argument that JCG and JCM were violators because they made the prospectus available on their combined website, stating, "[W]e do not think the SEC 'makes' the statements in the many prospectuses available on its Web site." *Id.* at 2305 n.12; *see also* Brief for the United States as Amicus Curiae Supporting Respondent at 14, Janus Capital Group, Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011) (No. 09-525) (concluding that its interpretation follows that "one can 'make' a statement by 'creat[ing]' or 'writ[ing]' it, even if the statement's creator is not expressly identified").

205. *Janus*, 131 S. Ct. at 2304; *see also* Brief of Law Professors, *supra* note 201, at 20 (stating that petitioners had admitted that JCM attorneys drafted the prospectuses).

2. Justice Breyer's Dissenting Opinion

Justice Breyer, writing in dissent, opened by describing the many functions of JCM as an investment adviser to the Janus Funds.[206] Regarding the interpretation of the word "make," Justice Breyer criticized the majority for limiting the scope of the word without using prior case law or a common understanding of the English word, stating that many parties can take part in the making of a statement for purposes of § 10(b) and Rule 10b-5.[207] The dissent asserted that the majority misinterpreted *Central Bank* and looked past the holding that a secondary actor can still be held liable as a primary violator in a private cause of action for securities fraud if the requirements of Rule 10b-5 are met—which they were in *Janus*.[208] The dissent claimed that the majority rule created a foundation upon which guilty management could build a veil of protection against liability.[209]

IV. ANALYSIS

The *Janus* decision incited a strong reaction.[210] In Justice Thomas's short opinion, the Court set out to define areas of private securities

206. *Janus*, 131 S. Ct. at 2306 (Breyer, J., dissenting) (stating that along with each of the Janus Funds officers being JCM employees, JCM also "manages the purchase, sale, redemption, and distribution of the Fund's investments . . . prepares, modifies, and implements the Janus Funds' long-term strategies . . . [and] acting through those employees, carries out the Fund's daily activities"); *see also* Brief of Law Professors, *supra* note 201, at 13 (noting that the Court, the U.S. Senate, and the Executive Branch have all previously noted the extraordinary degree of control that managers maintain over their funds).

207. *See Janus*, 131 S. Ct. at 2306–07 (Breyer, J., dissenting) (stating that depending on the circumstances, "a management company, a board of trustees, individual company officers, or others, separately or together, might 'make' statements contained in a firm's prospectus—even if a board of directors has content-related responsibility" and adding that context is helpful in determining who made a statement and to whom it may be attributed); *see also* Cooper v. Pickett, 137 F.3d 616, 624 (9th Cir. 1997) (stating previous holdings where corporate defendants had been held directly liable under Rule 10b-5 for providing false or misleading information through third-parties).

208. *Janus*, 131 S. Ct. at 2308 (Breyer, J., dissenting); *see also supra* note 131 and accompanying text (quoting language from the Court's decision in *Central Bank* that listed secondary actors who could still be held liable as primary violators).

209. *Janus*, 131 S. Ct. at 2310–11 (Breyer, J., dissenting). Justice Breyer warned that the majority's adopted approach runs the risk of curtailing the SEC's authority to pursue prosecution against primary violators in the context of aiding and abetting without the knowledge of those who "control" the "making" of the statements. *Id.* at 2310. He concluded the discussion by convincingly stating, "I can find nothing in § 10(b) or in Rule 10b-5, its language, its history, or its precedent suggesting that Congress, in enacting the securities laws, intended a *loophole* of the kind that the majority's rule may well create." *Id.* at 2311 (emphasis added); *see also* Brief of Law Professors, *supra* note 201, at 15 (asserting that, if adopted, petitioners' argument would create a blueprint for widespread securities fraud).

210. *See* Jeffrey Gordon, Janus Capital Group v. First Derivative Traders*: Only the Supreme*

litigation, a decision that surprised legal analysts.[211] This Part explores several concepts that emerge from the *Janus* opinion within the context of securities fraud litigation that will impact future private securities action.[212]

A. Primary and Secondary Liability

Prior to *Central Bank*, an injured plaintiff could bring a § 10(b) private action against a primary actor—the defendant who made the material misrepresentation or omission—or a secondary/collateral actor—the defendant who aided and abetted another in making such a material misrepresentation or omission.[213] Until *Central Bank*, the difference between primary and secondary liability was moot—either actor was inherently liable under § 10(b) and Rule 10b-5.[214] As stated in Part II, the Court's decision in *Central Bank* was motivated by statutory language of § 10(b), or more precisely, the lack of clear statutory language creating a right of action for aiding and abetting.[215] In abolishing a private right of action against aiding and abetting, the Court addressed its concern with the unpredictability and uncertainty that unforeseen liability created for securities professionals.[216]

Court can "Make" a Tree, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REGULATION (June 29, 2011, 9:27 AM), http://blogs.law.harvard.edu/corpgov/2011/06/29/janus-capital-group-v-first-derivative-traders-only-the-supreme-court-can-"make"-a-tree/ (stating that this is "one of those cases that takes your breath away," and questioning why the Court is aiming to insulate fraudulent actors from accountability); *see also Worst Decisions #3*, *supra* note 203 (rating the *Janus* decision the third worst decision of the Court's 2010–2011 term).

211. *See* Gordon, *supra* note 210 (asserting that *Janus* will make it easier to shift liability from actual wrong-doers, creating uncertainty over the scope of "control person" liability under § 20(b) of the 1934 Act and may necessitate new rules by the SEC that will potentially lead to new litigation).

212. *Infra* Part IV.A–C.

213. *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, 701 (1997) (noting a successful aiding and abetting claim requires three elements: (1) a primary violation by another actor, (2) the defendant knew of the fraud and consciously furthered it, and (3) "the defendant substantially assisted the violation"); *see also* Eisenberg, *supra* note 39, at 1289 (stating that in *Central Bank*, the Court overturned thirty years of lower court precedent on aiding and abetting liability).

214. *See* Prentice, *supra* note 213, at 704 (discussing the needless act—prior to *Central Bank*—of distinguishing between forms of liability by lower courts because both theories were punished similarly); *see also* Eisenberg, *supra* note 39, at 1289 (stating that the Court acknowledged a concern that a clear framework for liability under aiding and abetting claims was needed).

215. *See supra* Part II.E.2 (discussing the elimination of private action claims for aiding and abetting after *Central Bank*).

216. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 188–89 (1994); *see also* Eisenberg, *supra* note 39, at 1289–90 (discussing *Central Bank*'s restoration

However, *Central Bank* sustained possible liability for collateral actors who met the required elements of primary liability under the scope of § 10(b) and Rule 10b-5.[217] Despite its attempt at clarity, the Court did not decide the proper method for courts to determine primary liability under § 10(b).[218] Therefore, commentators believed a collateral actor could still be held liable as a primary offender for participating in a fraud.[219]

The Court slightly clarified the uncertainty left after *Central Bank* with its decision in *Stoneridge*, where it solidified a plaintiff's need to show actual reliance on a violator's actions[220] and acknowledged its suspect view of scheme liability.[221] The Court emphasized the necessity of a "requisite causal connection" between the purported misrepresentation or omission and the plaintiff's reliance that led to the

of aiding and abetting liability in actions brought by the SEC, but not in actions brought by private plaintiffs).

217. *Cent. Bank*, 511 U.S. at 191; *see also* Eisenberg, *supra* note 39, at 1290–91 (discussing strategies that plaintiffs undertake to evade the impact of *Central Bank* by relying on different sections of SEC rules in order to substantiate primary violator claims against defendants who could most likely be considered secondary violators).

218. David R. Allen, Note, *A New Breath of Life for Private Rule 10B-5(B) Litigation After* Stoneridge*:* SEC v. Tambone *and Implied Statements By Collateral Actors*, 32 CARDOZO L. REV. 2093, 2097 (2011) (explaining that *Central Bank* did not directly address the proper scope of primary liability); *see also In re* MTC Elec. Tech. S'holders Litig., 898 F. Supp 974, 987 (E.D.N.Y. 1995) (stating that *Central Bank* created confusion among lower courts in trying to find a distinction between primary and secondary liability).

219. *See* Prentice, *supra* note 213, at 697 (asserting that liability would still attach to those that showed a significant participation in a fraud, despite not being the speaker of the misstatement or omission and adding that, "a 'participation' standard is certainly appropriate for determining the scope of [§] 10(b)/Rule 10b-5 primary liability of defendants in the aftermath of *Central Bank*").

220. *See* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 158 (2008) (stating that *Central Bank* concluded that § 10(b) implied private right of action does not extend to aiding and abetting claims and that their analysis—in *Stoneridge*—would seek to establish the elements of the conduct of a secondary actor that would hold the actor liable as a primary actor under the implied private right of action under § 10(b) and Rule 10b-5); *see also* Prentice, *supra* note 36, at 355 (asserting that, after *Stoneridge*, the Court continued to believe that the private right of action under securities laws should be construed very narrowly).

221. *See Stoneridge*, 552 U.S. at 160 (disclaiming the petitioners argument of scheme liability, stating that the argument "does not answer the objection that petitioner *did not in fact rely* upon respondents' own deceptive conduct" (emphasis added)); *see also* Prentice, *supra* note 36, at 355–56 (asserting that Rule 10b-5 is still a "valid SEC rule that clearly forbids schemes to defraud" and that "[n]othing in the language of the *Stoneridge* majority opinion is to the contrary"); Jonathan C. Dickey et al., Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*: The Supreme Court Rejects "Scheme" Liability*, INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR 4, Jan. 2008, at 1, *available at* http://www.gibsondunn.com/publications/Documents/Dickey-Stoneridge-Insights.pdf ("The Court's decision in *Stoneridge* is significant because of its rejection of theories of reliance that rest on chains of inference so attenuated as to extend 'the private cause of action under §10(b) . . . beyond the securities market.'").

injury.[222] Under this regime, a plaintiff does not have a private cause of action under § 10(b) or Rule 10b-5 unless she directly relied on the defendant's misstatement or omission.[223] Thus, because a plaintiff could be expected to rely on the statements of a collateral actor, the Court left open the chance of liability in such scenarios when it held that "[r]eliance by the plaintiff upon the defendant's deceptive acts is an essential element of the § 10(b) private cause of action."[224] However, this decision did not resolve the issue of how to discern "deceptive conduct" by non-speaking defendants who otherwise had no duty to disclose.[225]

Deceptive conduct or not, by finding that the misleading statements had been made by Janus Funds and not JCM, Justice Thomas drew a line between primary liability for the maker of a statement and the person or entity with ultimate control over the statement.[226] The maker of a statement without ultimate control would only be secondarily liable for aiding and abetting, but as the Court clarified in *Central Bank*, aiding and abetting cannot be pursued in private suits.[227] However, as Justice Breyer pointed out in his dissent, the question remains as to who would be held primarily liable if management was guilty of writing a false and misleading statement that deceives the board of directors and the public.[228] The answer seems to be no one, apparently, despite the fact that under common law agency doctrine, management would be

222. *Stoneridge*, 552 U.S. at 159; *see also* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 346 (2005) (holding that in order to prove damages in a securities fraud case, plaintiffs must prove a causal connection between the alleged misrepresentation and the subsequent decline in the stock's price).

223. *See* Prentice, *supra* note 36, at 363 (asserting that the Court in *Stoneridge* formulated its approach and reasoning for the decision for the purpose of narrowing the private right to sue in general); *see also* Eisenberg, *supra* note 39, at 1297 (noting that a key to defeating class certification in fraud-on-the-market theories of reliance is to show that individual issues of reliance defeat the predominance requirement).

224. *Stoneridge*, 552 U.S. at 159.

225. *See* Dickey, *supra* note 221, at 5 ("For now, the defendants bar applauds the result [in *Stoneridge*], and takes comfort in the strong policy statements issued by the Court in its opinion."); *see also* Prentice, *supra* note 36, at 398 (asserting that the most obvious meaning of the phrase "or indirectly" in the 1934 Act is that defendants can be liable under § 10(b) and Rule 10b-5 for issuing a statement they did not directly speak themselves).

226. Janus Capital Grp. Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2302 n.6 (2011) (noting that the dissent was correct in determining that *Central Bank* involved secondary liability but adding "for *Central Bank* to have any meaning, there must be some distinction between those who are primarily liable (and thus may be pursued in private suits) and those who are secondarily liable (and thus may not be pursued in private suits)").

227. *Id.* at 2302; *see also* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 176 (1994) (stating that aiding-and-abetting liability was not covered by § 10(b)).

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

held primarily liable as the principal's agent and not simply for aiding and abetting another.[229]

B. Defining Who "Makes" a Statement

The decisions in *Central Bank* and *Stoneridge* were also void of an explanation of how courts should determine what party "makes" a statement for purposes of liability under § 10(b) and Rule 10b-5, and *Janus* has filled the void in a manner that effectively leaves the private right of action under § 10(b) on life support.[230] In his result-driven opinion, Justice Thomas linked the Court's decisions in *Central Bank* and *Stoneridge* with the rule it adopted in *Janus*.[231] In comparing its holding to *Central Bank*, Justice Thomas asserted that to broaden the interpretation of the word "make" to include persons or entities without ultimate control over a statement would undermine precedent.[232] Conversely, in his dissent, Justice Breyer correctly pointed out that *Central Bank* is different than *Janus*.[233] He convincingly argued that the majority's new rule did not logically follow *Central Bank*.[234]

229. *Id.*

230. *See id.* at 2302–03 (majority opinion) ("Concerns with the judicial creation of a private cause of action caution against its expansion . . . we must give 'narrow dimensions . . . to a right of action Congress did not authorize' . . . the narrow scope that we must give the implied private right of action . . . we will not expand liability."); *see also* Stephen Metcalf, *Some Will Rob You With a Six-Gun, and Some With a Fountain Pen*, HANDSOME CAMEL BLOG (June 24, 2011), http://thehandsomecamel.wordpress.com/2011/06/24/some-will-rob-you-with-a-six-gun-and-some-with-a-fountain-pen/ (asserting that the *Janus* decision "basically gives large corporations a license to commit fraud as long as they set up a shell company to take the fall").

231. *Janus*, 131 S. Ct. at 2303 ("[The *Central Bank* and *Stoneridge* holdings] suggest the rule we adopt today: the maker of a statement is the entity with authority over the content of the statement and whether and how to communicate it. Without such authority, it is not "necessary and inevitable" that any falsehood will be contained in the statement . . . we will not expand liability beyond the person or entity that ultimately has authority over a false statement."); *see also* Prentice, *supra* note 36, at 409 (impressively foreshadowing that the "tone of both [*Central Bank* and *Stoneridge*] is *so unsympathetic to the private right to sue*, it could not surprise anyone if the majority of the Court were to hold that *only an author whose name is on a false statement at issuance can be liable*" (emphasis added)).

232. *Janus*, 131 S. Ct. at 2302. The Court added, "If persons or entities without control over the content of a statement could be considered primary violators who 'made' the statement, then aiders and abettors would be almost nonexistent." *Id.*; *see also* Prentice, *supra* note 36, at 409 (predicting that the Court could reach the result of attaching liability only to the person/entity whose name is on the statement by holding either "(1) that one does not make a false statement unless his name is on it, or (2) that reliance upon a defendant's identity (not just his statements or omissions) is necessary").

233. *Janus*, 131 S. Ct. at 2307 (Breyer, J., dissenting).

234. *See id.* ("[A] rule (the majority's rule) absolving those who allegedly did make false statements does not 'follow from' a rule (*Central Bank*'s rule) absolving those who concededly did not do so.").

Central Bank involved attaching liability to an individual helping someone else make a statement—i.e., secondary liability and aiding and abetting.[235] *Janus*, on the other hand, involved primary liability; JCM made the statements itself rather than aiding and abetting the Janus Funds in doing so.[236] Moreover, the Janus Funds could not make a representation about an act—market timing—over which they had no control.[237] JCM wrote the statements, made the deals with hedge funds, allowed the trades to go through, profited from the scheme, and JCM's actions alone directly caused injury to JCG's shareholders by fostering an aura of mistrust between JCM and mutual fund investors that led to an exodus of assets under management and considerably lower revenue for JCG.[238] As the dissent noted, it is a misapplication of justice to allow fraudulent actors to escape liability from private recourse in order to respect the "corporate form."[239]

Justice Thomas also stated that by adopting the new rule that ultimate control over a statement dictates who makes a statement for liability purposes under § 10(b), this decision aligns with the Court's decision in

235. *Janus*, 131 S. Ct. at 2308 (Breyer, J. dissenting).

236. *Id.*; *see also* Metcalf, *supra* note 230 ("[E]ven though employees of [JCM] actually wrote the misleading statements, even though they managed nearly every substantive aspect of the operation of the fund, they cannot be held responsible because they did not 'make' the statements. The 'person' under law who made the statements was the entity on whose behalf the offending prospectus was issued, [Janus Funds], which has no capital other than the money it invests for shareholders.").

237. The majority spent most of the opinion discussing the ultimate control and authority over the making of a statement—justifiably so given the reasons for granting certiorari. *Janus*, 131 S. Ct. at 2299–2305. However, nothing is mentioned in the majority opinion about the control over the act the prospectus deems to prohibit. *Id.* Market-timing activity was at the heart of the injury for both the fund shareholders and JCG stockholders. *Id.* at 2306 (Breyer, J., dissenting). Therefore, the Court should have at least addressed the potential issue of a corporate agent controlling or pursuing a fraudulent activity prohibited by securities law, rather than trying to avoid responsibility by simply using a conduit for legal liability purposes. This is a major hole in the opinion and will be further discussed *infra* Part V.A. *See* Brief of Law Professors, *supra* note 201, at 10 (stating that market-timing fraud involves control by investment managers of all operations of a mutual fund and can only be perpetrated with the assistance and willingness of the investment manager).

238. *See Janus*, 131 S. Ct. at 2299–2300 (describing the background of the case); *see also* Brief of Law Professors, *supra* note 201, at 10 ("An investment manager orchestrates a market-timing ruse first by luring prey [mutual fund investors], then setting predators [market timers] upon it.").

239. *See Janus*, 131 S. Ct. at 2304 (discussing the fact that, despite the plaintiffs' persuasive argument that investment advisers exercise significant influence over their funds, the Court would not disregard the corporate form); *see also* Brief of Law Professors, *supra* note 201, at 10 (asserting that the far-reaching mechanics of market-timing fraud reveals JCM's primary role in the violating § 10(b)).

Stoneridge.[240] That case, Justice Thomas argued, properly dismissed the plaintiff's complaint because the public did not rely on the parties' undisclosed deceptive acts.[241] The facts in *Stoneridge*, however, involved suppliers/customers of Charter Communications who aided and abetted the eventual misrepresentations.[242] Thus, it is true that the public could not have directly relied on the deceptive acts of this inside transaction.[243] However, unlike the transaction underlying *Stoneridge*, the overwhelming majority of shareholders and mutual fund investors in the investment manager industry directly rely on statements made by the investment advisors who run the day-to-day operations of their respective funds.[244] Despite the legal structure of the mutual fund industry, owners of investment manager stock—like JCG shareholders—and mutual fund investors invariably associate an investment manager with the mutual fund, meaning the relationship between the two is publicly understood to be that of one entity.[245] This relationship construct is completely different from the one in *Stoneridge*.[246]

240. *Janus*, 131 S. Ct. at 2303; *see also* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 166–67 (2008) (holding that an investor claim for a private right of action under § 10(b) and Rule 10b-5 needs to show direct reliance on the defendant's deceptive acts prior to the purchase or sale of securities).

241. *Janus*, 131 S. Ct. at 2303; *see also* Prentice, *supra* note 36, at 405 (stating that the Court in *Stoneridge* admitted that the defendants acted "in concert" with Charter Communications in the fraudulent scheme but reasoned, however, that the "concert[ed]" activity was not enough, publicly, to find them liable as primary violators).

242. *See Stoneridge*, 552 U.S. at 153 (noting that Scientific Atlanta, Inc. and Motorola were suppliers—by supplying cable boxes—and later customers—by buying advertising—of Charter Communications); *see also* Prentice, *supra* note 36, at 405 (asserting that the vendors should have been found liable under the rule of scheme liability because they knowingly took part in an illegal scheme).

243. *See Stoneridge*, 552 U.S. at 159 ("[Suppliers] had no duty to disclose; and their deceptive acts were not communicated to the public. No member of the investing public had knowledge, either actual or presumed, of [suppliers'] deceptive acts during the relevant times.").

244. *See* Joseph A. Franco, *A Consumer Protection Approach to Mutual Fund Disclosure and the Limits of Simplification*, 15 STAN. J.L. BUS. & FIN. 1, 57 (2009) (noting that, in today's environment, investors rely on sponsor generated investor information rather than SEC-mandated fund disclosures).

245. *See* Nancy L. Conlin, *Mutual Fund Expenses: Caveat Investor?*, 13 ANN. REV. BANKING L. 365, 371 (1994) (stating that, despite the growth in the mutual fund industry, the structure of fund distribution methods have remained relatively unchanged when looking at the relationship between a fund and its investment adviser/affiliate/sponsor); *see also* Nathan Hale, *Fund Investors Take a Hit from the Supreme Court*, CBS MONEYWATCH (June 20, 2011, 7:00 AM), http://moneywatch.bnet.com/investing/blog/fund-watch/fund-investors-take-a-hit-from-the-supreme-court/654/ ("[A]nyone who's spent two minutes thinking about it know that the notion that a mutual fund is independent of its advisor is laughable.").

246. *See Stoneridge*, 552 U.S. at 159 (discussing the lack of direct reliance the public had with

In his dissent, Justice Breyer discussed the clear distinctions between *Stoneridge* and *Janus*.[247] In *Stoneridge*, no one disputed the "making" of statements, and no one disputed that the defendants were, in fact, the "makers" of Charter's misstatements.[248] Rather, *Stoneridge* determined whether the defendant's actions were sufficiently disclosed for the court to find that the public directly relied on them.[249] The suppliers in *Stoneridge* had no duty of disclosure and their deceptive actions were never communicated to the public, so there were no grounds to support reliance.[250] Conversely, *Janus* involved express actions and statements that were intentionally disseminated to the public.[251] Given the obvious distinctions, Justice Breyer inquired as to how *Stoneridge* actually supported the majority's new rule.[252]

C. Ultimate Authority and the Role of an Investment Advisor

The majority addressed Justice Breyer's dissenting arguments by holding that respect for the "corporate form" instructs that those with "ultimate authority" over statements in registered materials should be held solely liable for purposes of the private right of action under § 10(b) and Rule 10b-5.[253] Certainly, this is a far dislocation from what

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the suppliers).

247. Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2309 (2011) (Breyer, J., dissenting).

248. *Id.*; *see also* Prentice, *supra* note 36, at 406–07 (discussing liability under scheme liability). Professor Prentice gives a hypothetical explaining how the non-makers of a statement should be found liable: "Parties who have knowingly entered into fraudulent transactions with B as part of a fraudulent scheme with the purpose of defrauding C should be liable when C relies upon their actions, even if those actions were publicized not by themselves, but by B." *Id.*

249. *Janus*, 131 S. Ct. at 2309 (Breyer, J., dissenting); *see also* Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75, 89–90 (1993) (discussing how notions of privity are associated with ultimate responsibility, which, in turn, justifies liability for providing false information).

250. *Janus*, 131 S. Ct. at 2309 (Breyer, J., dissenting); *see also* Langevoort, *supra* note 249, at 90 (asserting that courts [used to] define a duty to disclose when a party bears responsibility for preparing the alleged fraudulent misrepresentation).

251. *Janus*, 131 S. Ct. at 2309–10 (Breyer, J., dissenting); *see also* David R. Allen, *supra* note 218, at 2116 (discussing liability and duties in the dissemination of another party's statement).

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

253. *Id.* A direct contradiction with Justice Thomas's respect for the corporate form was noted in previous Supreme Court cases. *See also* First Nat'l City Bank v. Banco Para El Comercio Exterior de Cuba, 462 U.S. 611, 629–30 (1983) ("[O]ur cases have long recognized 'the broader equitable principle that the doctrine of corporate entity, recognized generally and for most purposes, will not be regarded when to do so would work *fraud or injustice*.' In particular the Court has consistently *refused* to give effect to the *corporate form* where it is interposed to defeat legislative policies." (emphasis added) (citations omitted) (quoting Taylor v. Standard Gas Co., 306 U.S. 307, 322 (1939))).

Justice Douglas adopted some forty years earlier in *Bankers Life*.[254] What is interesting about the majority's opinion in *Janus* is that its discussion of the "corporate form" and "ultimate authority" completely ignored the roles of the parties within the context of the case.[255]

As discussed in Part III.A, JCG was the parent company of JCM, an investment advisor responsible for running the Janus Funds.[256] The Janus Funds were separate legal entities solely created by JCG and run by a board of trustees for the purpose of holding assets owned by mutual fund shareholders.[257] In the prior 2010 session, the Court's opinion in *Jones v. Harris Associates* provided a glimpse into how the Court had come to understand the role of investment advisors in the mutual fund industry.[258] In *Harris Associates*, the Court noted that "the fund often 'cannot, as a practical matter sever its relationship with the adviser.'"[259] Moreover, the Court acknowledged that the make-up of

254. *See* Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 12–13 (1971) (discussing the broad interpretation of the implied private right of action under § 10(b) and Rule 10b-5); *see also* Lowenfels & Bromberg, *supra* note 89, at 310 ("[P]rivate actions . . . under . . . section 10(b) and Rule 10b-5 are the most common actions for relief by defrauded investors in our system of democratic capitalism . . . .").

255. *Janus*, 131 S. Ct. at 2304; *see also* J.J. McCaskill Co. v. United States, 216 U.S. 504, 515 (1910) ("[Protection for the corporate form] should not be carried so far as to enable the corporation to become a means of fraud or a means to evade its responsibilities. . . . [Courts increasingly] look beyond the corporate form to the purpose of it, and to the officers who are identified with that purpose.").

256. *See supra* Part III.A (describing the entwined structure of JCG, JCM, and the Janus Funds).

257. *In re* Mut. Funds Inv. Litig., 566 F.3d 111, 115 (4th Cir. 2009), *rev'd*, Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011); *see also* Lee McGowan, *Making Sense Out of the Structure of Mutual Funds*, ABOUT.COM, http://mutualfunds.about.com/od/mutualfundbasics/a/fundstructure.htm (last visited Apr. 21, 2012) (discussing the structure of mutual funds and noting that the only assets in a mutual fund are those invested by mutual fund shareholders).

258. *See* Jones v. Harris Assocs., 130 S. Ct. 1418, 1422 (2010) ("A mutual fund is a pool of assets, consisting primarily of [a] portfolio [of] securities, and belonging to the individual investors holding the shares in the fund. . . . [The typical business arrangement includes a] separate entity called an investment adviser [that] creates the mutual fund, which may have no employees of its own."); *see also* McGowan, *supra* note 257 (describing the different types of funds involved in *Janus* as including open-end mutual funds, closed-end mutual funds, exchange-traded funds, and unit investment trusts).

259. *See Harris Assocs.*, 130 S. Ct. at 1422 (quoting Burks v. Lasker, 441 U.S. 471, 481 (1979)) (involving mutual fund shareholders who sued the investment adviser of their mutual fund for breach of his fiduciary duty by allegedly overcharging fees for his management responsibilities); *see also* Sam Mamudi, *The Unseen Figures of Your Funds*, WALL ST. J. (May 3, 2010), http://online.wsj.com/article/SB10001424052748704100604575146040314631942.html (stating that records show very few instances when a fund board replaced a management company and discussing only one instance of note—in 2005—when the board of the Clipper Fund changed its manager for poor performance).

the mutual fund industry is distinct from other sectors of the American economy.[260] The relationship between a fund and its investment advisor, the Court added, "[is] fraught with potential conflicts of interest."[261] Furthermore, the Court recognized the problem of disinterested directors on the board of a fund.[262] Given this judicial interpretive backdrop, it is evident that distinct risks of ownership exist for stockholders of investment companies—like the plaintiffs in *Janus*.[263]

The mutual fund industry in the United States is massive and holds considerable influence in the corporate forum.[264] Investment companies manage just over $13 trillion in investor assets and control twenty-seven percent of U.S. corporate equities.[265] There are over sixteen thousand different investment companies currently managing

260. *Harris Assocs.*, 130 S. Ct. at 1422. One distinct characteristic of the fund industry is that a mutual fund board is not responsible simply for one fund; instead, many firms have one board to oversee an entire line of mutual funds managed by a particular investment manager. *See* Mamudi, *supra* note 259 ("Fund boards are stretched too thin.").

261. *Harris Assocs.*, 130 S. Ct. at 1422 (quoting Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 536 (1984)); *see also* Mamudi, *supra* note 259 (statement of industry expert Adam Bold) ("'The system as it's set up is adequate at best because boards are fulfilling their basic fiduciary duties . . . .' But the problem . . . is that's usually as far as the boards go.").

262. *Harris Assocs.*, 130 S. Ct. at 1428; *see also* Alan R. Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 165, 166 (2006) ("[T]he fund board operates without meaningful oversight . . . . Despite regular and continuing attempts by the SEC to strengthen board independence, the agency has failed to create true board independence or to give the board clear guidance."). Furthermore, "most fund boards are composed of industry-friendly, highly paid, long-serving directors . . . . The management firm selects the initial board, and new directors (including independent directors) are vetted by the management firm." *Id.* The realities inherent in mutual fund board make-up run counter to the argument made by Justice Thomas that the Janus Funds' board only had one "interested person" directly affiliated with JCG/JCM sitting on it; he argued that Janus Fund's board of trustees was more independent than required by statute. *Janus*, 131 S. Ct. at 2304.

263. *See Harris Assocs.*, 130 S. Ct. at 1422 (quoting *Daily Income Fund*, 464 U.S. at 536) ("Congress adopted the [Investment Company Act of 1940] because of its concern with the potential for abuse inherent in the structure of investment companies.").

264. *See* Conlin, *supra* note 245, at 365–66 (noting that, since the creation of the first mutual fund in 1924, the industry has achieved enormous success and has become the third largest type of financial institution in the U.S. behind commercial banks and life insurance companies); *see also* Stephen Bainbridge, *Mutual Fund Shareholder Activism*, PROFESSORBAINBRIDGE.COM BLOG (Mar. 28, 2011, 1:25 PM), http://www.professorbainbridge.com/professorbainbridgecom/2011/03/mutual-fund-shareholder-activism.html (discussing the large influence institutional investors—like mutual funds—have on corporate governance issues, such as executive compensation).

265. INV. CO. INST., *supra* note 154, at 8, 12. These statistics are as of the end of 2010. *Id.* The $13 trillion is comprised of $11.8 trillion in mutual funds, $241 billion in closed-end funds, $992 billion in exchange-traded funds, and $51 billion in unit investment trusts. *Id.* at 9.

assets in the United States.[266] Many of these investment companies, including some of the largest, are publicly owned corporations.[267] It follows that shareholders of these distinct corporations should be afforded protections consistent with the structural nuances of the industry.

In *Janus*, Justice Thomas declined the opportunity to enforce liability, specific to the investment company context, for fraudulent misrepresentations that caused actual shareholder injury.[268] The Court was likely concerned with the reciprocal effects of holding a service provider primarily liable for statements made by a separate legal entity with "ultimate control" over said statements.[269] Unlike lawyers and accountants, however, the characteristics of an investment advisor are so acute and specific to its industry that the Court could have fashioned a remedy for the shareholders who correctly sought justice for an injury that was caused directly by the corporation's agents.[270]

The rule adopted by the Court in Janus is unambiguous: for purposes of the private right of action under § 10(b) and Rule 10b-5, primary liability for material misrepresentations and/or omissions made in registered correspondence will only attach to the actors responsible for issuing the correspondence—i.e., ultimate control over the correspondence.[271] The Court's clarity invites negative implications for those seeking private action remedies under § 10(b) and Rule 10b-5.

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266. *Id.* at 16.

267. *See* Matt Krantz, *You Can Invest in Many Public Investment Companies*, USATODAY.COM (Mar. 31, 2010, 8:21 AM), http://www.usatoday.com/money/perfi/columnist/krantz/2010-03-31-investment-company-stocks_N.htm (noting that some of the largest U.S. asset managers that are publicly traded include Bank of New York Mellon, BlackRock, Franklin Resources, State Street, T. Rowe Price Group, and John Hancock, which is a unit of Manulife Financial, a large Canadian financial firm).

268. *See* Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2304 (2011) ("We decline this invitation to disregard the corporate form."). For a calculation of the dollar value of the loss associated with JCG's involvement in the market timing scandal, see *infra* note 279.

269. *See* Brief for Attorneys' Liability Assurance Society Inc., as Amicus Curiae Supporting Petitioners at 5, Janus Capital Grp., Inc., v. First Derivative Traders, 131 S. Ct. 2296 (2011) (No. 09-525) (arguing that lawyers, like other outside service providers, cannot be held liable in a private action under § 10(b) and Rule 10b-5 for statements not attributed to them).

270. *See* 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' . . . ."). Justice Breyer also stated that "this Court pointed out that 'certain individuals who play a part in preparing the registration statement,' including corporate officers, lawyers, and accountants, may be primarily liable even where 'they are not named as having prepared or certified' the registration statement." *Id.* at 2311 (quoting Herman & MacLean v. Huddleston, 459 U.S. 375, 386 n.22 (1983)).

271. *Janus*, 131 S. Ct. at 2303; *see also* Joseph B. Crace & Matthew M. Curley, *District*

V. IMPACT

Before the Court issued its decision in *Janus*, analysts pondered the effects the case would have on those most often responsible for the content contained in a mutual fund prospectus—namely, investment advisors to mutual funds, their attorneys, and accountants.[272] Yet, *Janus* may make it more difficult to attach liability in securities fraud contexts beyond the sphere of these usual statement makers.[273] Particularly, *Janus* may limit liability when securities fraud is perpetuated by the statements of corporate officers and in the asset securitization process.[274] Accordingly, this Part explores the impact of *Janus* on corporate officer liability through the lens of agency law and examines the potential "blueprint for fraud" for parties involved in the securitization of financial assets.[275]

Courts Grapple with U.S. Supreme Court's Janus *Decision*, THOMSON REUTERS NEWS & INSIGHT (Oct. 21, 2011), http:/newsandinsight.thomsonreuters.com/Securities/Insight/2011/10_-_October/District_courts_grapple_with_U_S__Supreme_Court's_Janus_decision/ (discussing recent district court decisions that have had to interpret the *Janus* rule).

272. *See* Angiolillo & Youngwood, *supra* note 138, at 1 and accompanying text (discussing the potential effects of the *Janus* decision).

273. *See infra* Part V.A–B (discussing corporate officer insulation and securitization fraud); *see also* Crace & Curley, *supra* note 271 (discussing three district court decisions that have applied the *Janus* decision and stating that one court noted that the *Janus* rule is limited to cases involving Rule 10b-5(b), while another court refused to apply the limits of *Janus* to a case involving a parent company and a wholly owned subsidiary).

274. *See* Dana M. Muir & Cindy A. Schipani, *Fiduciary Constraints: Correlating Obligation With Liability*, 42 WAKE FOREST L. REV. 697, 698 (2007) (asserting that although there are federal statutes governing corporate officer behavior, for the most part, state law fiduciary principles govern the conduct of corporate actors). *See generally* Coffee, *supra* note 20, at 1538 (arguing that, to deter securities fraud more effectively, damages should be imposed upon those parties that are directly culpable—specifically on individual corporate managers—instead of the corporation itself).

275. *See* Greg Stohr, *Mutual Fund Shareholder Suits Curbed by U.S. Supreme Court*, BLOOMBERG BUS. WK. (June 13, 2011, 4:41 PM), http://www.businessweek.com/news/2011-06-13/mutual-fund-shareholder-suits-curbed-by-u-s-supreme-court.html (statement of Chicago-Kent College of Law Professor William Birdthistle, who specializes in investment fund law and securities regulation and who filed a brief backing the Janus shareholders) ("It's a blueprint for operating companies to see what the investment companies are doing and to make themselves as bulletproof as the investment advisors."); *see also* Jeff McCord, *Supremes Make It Official: Wall St. and Corporate Execs are Above the Law When They Lie to the Investing Public*, ACTIVIST POST BLOG (June 15, 2011), http://www.activistpost.com/2011/06/supremes-make-it-official-wall-st-and.html (asserting the *Janus* decision essentially means that, "[u]nless a corporate Board itself makes a statement, the corporate entity has not spoken and neither it, nor the spokespeople themselves, bear responsibility for what corporate officers say or write").

A. Corporate Officer Insulation

At oral arguments in *Janus*, Justice Sotomayor asked the petitioner whether a company could escape liability by using another company as a means to make misleading statements to the public.[276] The petitioner responded by explaining the different courses of action one could pursue against secondary actors.[277] JCM faced and settled claims associated with a breach of fiduciary duty by fund shareholders and the SEC.[278] Remedy still escaped JCG shareholders, however, whom the actions of JCM and the market-timing scheme soundly injured.[279]

The relationships of organizations are subject to the laws of agency.[280] Under agency law, fiduciary duties exist when a principal

276. *See* Transcript of Oral Argument at 6, Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011) (No. 09-525), *available at* http://www.supremecourt.gov/oral_arguments/argument_transcripts/09-525.pdf (statement of J. Sotomayor) ("Do you mean to say to me that puppets become a legal defense for someone who intentionally manipulates the market information?").

277. *See* Transcript of Oral Argument, *supra* note 276, at 6 (statement of petitioner's counsel) ("Congress has drafted two statutes that deal with puppets. Section 20(b), which these plaintiffs have not invoked, makes it unlawful for one party to do indirectly what it would not be permitted to do directly. That's the puppet statute . . . . [T]here's also 20(a), which is the control person statute, also not invoked by these plaintiffs. Those are forms of secondary liability."); *see also* Welle, *supra* note 16, at 547 (asserting that state and common law are inadequate to adjudicate securities fraud).

278. *See* Christine Dugas & John Waggoner, *Janus to Pay $225M to Settle Charges*, USA TODAY (Apr. 27, 2004, 10:59 PM), http://www.usatoday.com/money/perfi/funds/2004-04-27-janus-settlement_x.htm (stating that, as part of their settlement with New York Attorney General Eliot Spitzer and Colorado Attorney General Ken Salazar, Janus agreed to pay $100 million in fines and restitution ($50 million in restitution to injured investors and $50 million in penalties) and reduce its fees by $125 million over five years); *see also Janus Agrees to Pay $225 Million to Settle Market Timing Probe*, ACCOUNTINGWEB.COM (Apr. 27, 2004), http://www.accountingweb.com/item/99084 ("Janus acknowledged . . . that ten investors were allowed to make short-term trades in seven funds."). The disclosure of events led to the resignation of Janus CEO Mark Whiston and the withdrawal of $16.1 billion in investor funds. *Id.*

279. *See* Hale, *supra* note 245 (stating that while the Janus settlement with mutual fund shareholders helped to recoup their losses, owners of JCG stock, who were saddled with losses from the stock price plummet arising from the scandal, have yet to recoup their losses); *see also* Janus Capital Group (JNS), WIKINVEST.COM, http://www.wikinvest.com/stock/Janus_Capital_Group_(JNS)/Earnings_Per_Share (last visited Apr. 21, 2012) (displaying excerpts from JCG's 10-k annual report from 2006, which lists JCG as having 229.5 million diluted common shares outstanding as of Dec. 31, 2003). Taking the shares outstanding and multiplying by the loss in stock price stated in the majority opinion results in an approximately $959,310,000 loss (17.68-13.50 = 4.18 x 229.5 = 959) in shareholder value from September 2 to September 26, 2003. *See* Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2300 (2011) (noting the stock price).

280. *See* Paula J. Dalley, *A Theory of Agency Law*, 72 U. PITT. L. REV. 495, 545 (2011) (stating that one of the important innovations of the Third Restatement of Agency was the inclusion of provisions that deal with agency law pertaining to organizations such as partnerships, corporations, and limited liability companies); *see also* Donald C. Langevoort, *Agency Law*

manifests assent to an agent that the agent shall act upon the principals behalf.[281] In the corporate context, this means the corporation will be bound by actions taken by managers during the course of employment.[282] Generally, shareholders can hold management liable for fraudulent activities that have a causal connection to a loss in shareholder value.[283] In *Janus*, managers committed securities fraud during the course of their employment, which was perpetrated through the Janus Funds, a conduit.[284] The alleged fraud caused shareholders to lose value.[285] Nevertheless, the Court decided that shareholders could, in this context, hold neither the principal corporation (JCG) nor the managers/agents (JCM) liable under § 10(b) or Rule 10b-5 for the damages because the defendants did not "make" the fraudulent statements.[286] In so doing, the Court ushered in a potential displacement of liability under agency law with respect to corporate managers.[287] The Court has introduced the use of "puppeteer

Inside the Corporation: Problems of Candor and Knowledge, 71 U. CIN. L. REV. 1187, 1191 (2003) (stating that just about every corporate employee who has discretionary duties serves as an agent of the corporation and that principles of agency are commonly invoked within the corporate law context).

281. RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) (defining agency as "the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act").

282. *See* Dalley, *supra* note 280, at 546 (discussing the actual authority extended to corporate officers by the corporation through the board of directors); *see also* Langevoort, *supra* note 280, at 1192–93 (discussing the ongoing issue of whether a corporation should be looked upon as a complex mix of people and contracts or as a standalone entity separate from individuals).

283. *See* Reinier Kraakman, Hyun Park & Steven Shavell, *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1733 (1994) ("Shareholder suits are the primary mechanism for enforcing the fiduciary duties of corporate managers."); *see also* Langevoort, *supra* note 280, at 1191–92 (stating that shareholders hold the board accountable through powers associated with derivative suits, voting, inspection, and appraisal rights).

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

285. *Id.* at 2300. After New York Attorney General Eliot Spitzer filed a complaint against JCG and JCM alleging market-timing issues, JCG stock fell almost twenty-five percent over the next several weeks, and the fund lost considerable assets from disgruntled mutual fund investors—thereby affecting the long-term profitability of JCG. *Id.*; *see also* Hale, *supra* note 245 (noting that stockholders lost considerable value resulting from the scandal).

286. *Janus*, 131 S. Ct. at 2305; *see also* Stohr, *supra* note 275 (noting that Justice Thomas focused on the legal distinction between JCG/JCM and the Janus Funds in finding no liability on the part of JCM managers).

287. *See* Stephen Juris, Janus Capital Group Inc. v. First Derivative Traders *and the Law of Unintended Consequences*, FORBES (Sept. 21, 2011), http://www.forbes.com/sites/insider/2011/09/21/janus-capital-group-inc-v-first-derivative-traders-and-the-law-of-unintended-consequences/ (stating that the broadly worded decision in *Janus* can result in unintended and likely unanticipated problems for the SEC in attaching primary liability to defendants under Rule 10b-5, instead of needing to seek claims of aiding and abetting or looking to different sections of the

capitalism," where corporate managers may be permitted to mislead, misstate, omit, and otherwise lie to the public and escape the strictures of § 10(b) and Rule 10b-5 as long as they do so through a separate entity.[288] Not only can this practice become widespread in the mutual fund arena, but also corporate managers in other industries could potentially shelter themselves from shareholder liability when making public statements.[289]

A fundamental principle of business is that the primary role of a corporation is to maximize shareholder wealth.[290] Yet, if corporate managers are not held liable for explicitly committing securities fraud while performing duties in their capacity as agents, then what use does § 10(b) or Rule 10b-5 have in the realm of private action?[291] Officers of publicly traded corporations work by the will of,[292] and on behalf of, the shareholders who own the enterprise.[293] If, while performing those

1934 Act).

288. *See* Editorial, *So No One's Responsible?*, N.Y. TIMES, June 15, 2011, at A26, *available at* http://www.nytimes.com/2011/06/15/opinion/15wed2.html?_r=2 (arguing that JCG/JCM used "legal ventriloquism to speak through the business trust and Janus Funds"); *see also* Angiolillo & Youngwood, *supra* note 138 ("Do you mean to say to me that *puppets* become a legal defense for someone who intentionally manipulates the market information?" (emphasis added) (quoting Transcript of Oral Argument, *supra* note 276, at 6 (statement of J. Sotomayor))).

289. *See* Brief of Law Professors, *supra* note 201, at 17 (stating that petitioner's position would lead to "[a]ny corporation publicly claiming to police the quality of its products while secretly soliciting payments to compromise that quality . . . [receiving] a clear path to evading legal liability").

290. *See, e.g.*, Virginia Harper Ho, *"Enlightened Shareholder Value": Corporate Governance Beyond the Shareholder-Stakeholder Divide*, 36 J. CORP. L. 59, 73 (2010) (noting the purpose of the corporation is to maximize shareholder wealth); Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273, 1278 (1991) (stating that although few would disagree that the welfare of the shareholder is the corporation's primary purpose, corporations are also subject to non-stockholder constituency statutes and notions of social responsibility).

291. *See* Ho, *supra* note 290, at 83 (asserting that management failure to appreciate environmental, social, and governance risks can hurt the company's, and by extension the shareholder's, future financial performance).

292. In fact, corporate managers and agents work by the will of the board of directors, but the shareholders vote the board of directors into office. MELVIN A. EISENBERG & JAMES D. COX, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIALS 213 (Robert C. Clark et al. eds., 10th ed. 2011).

293. *See* EISENBERG & COX, *supra* note 292, at 233–42. The authors discuss the special voting rules that can apply in the election of directors, including a staggered board, which is a board that is divided into two or more classes, each of which is elected separately for staggered terms (i.e., every two years). *Id.* at 233–42 This mechanism is seen as a defense against a takeover, but also as a means to entrench current management. *Id.* at 233–34. Cumulative voting is another rule where a shareholder takes the number of shares owned and multiplies that by the number of directors to be elected; this allows that shareholder to distribute votes in any way he would like. *Id.* at 236. Finally, there is plurality voting, which has come under heavy pressure

duties, they commit fraud through misleading statements made to the public—even indirectly through a conduit—they should be held liable to their shareholders through private recourse under § 10(b) and Rule 10b-5 if a causal connection to loss is proven.[294] Any other finding or conclusion would be an affront to the important role that private causes of action play in the marketplace and would serve to discredit the functionality of the legal system.[295]

B. Securitization Fraud

Financial securitization is a broad term,[296] and there are many financial assets that can form a securitized investment.[297] This Subpart focuses on private-label home mortgage-backed securities ("MBS").[298]

recently, and allows the nominee with the most votes to be elected, even if there is no majority amongst the nominees. *Id.* at 239. Many shareholder activists have called for states to change the default rule in corporate statutes from plurality to majority as a means to increase shareholder power. *Id.* at 240.

294. *See* Muir & Schipani, *supra* note 274, at 700 (stating that, within the corporate context, there is a danger in "a system that would allow individual fiduciaries to avoid liability by arguing that the wrongful act occurred in another fiduciary's area of responsibility—perhaps with the result that, through such finger pointing, no fiduciary is held liable"); *see also* Hale, *supra* note 245 (noting that stockholders have been denied the ability to recoup losses even though Janus admitted in their settlement to allowing secret deals that were a direct contradiction to its stated policies made to the public through the Janus Funds' prospectus).

295. *See* Redwood, *supra* note 136, at 3–4 (asserting that the *Janus* decision has turned the traditional method of analyzing a statute on its head).

296. *See* BLACK'S LAW DICTIONARY 1475 (9th ed. 2009) ("[Securitize means] [t]o convert (assets) into negotiable securities for resale in the financial market, allowing the issuing financial institution to remove assets from its books, and thereby improve its capital ratio and liquidity, and to make new loans with the security proceeds if it so chooses."); *see also Securitization Definition*, INVESTOPEDIA.COM, http://www.investopedia.com/terms/s/securitization.asp#axzz1cf2U2AYf (last visited Apr. 21, 2012) ("[Securitization is] [t]he process through which an issuer creates a financial instrument by combining other financial assets and then marketing different tiers of the repackaged instruments to investors. The process can encompass any type of financial asset and promotes liquidity in the marketplace.").

297. *See* Harold S. Novikoff et al., *New Developments in Structured Finance: Report by the Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York*, 56 BUS. LAW. 95, 97 (2000) (discussing the conventional assets to be securitized and sold to investors, which include credit cards, vehicle loans, home equity/subprime mortgages, manufactured housing, residential jumbo loans, and commercial real estate loans). Since 1995, sponsors have begun to securitize new asset classes: stranded cost recovery receivables, municipal tax liens, collateralized debt obligations, structured settlement payments, music royalties, and auto leases. *Id.* at 105–06.

298. *See, e.g.*, 12 C.F.R. § 1282.1 (2011) (defining a private label security as "any mortgage-backed security that is neither issued nor guaranteed by Fannie Mae, Freddie Mac, Ginnie Mae, or any other government agency"); Patricia A. McCoy, Andrey D. Pavlov & Susan M. Wachter, *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 1327, 1329 (2009) (discussing the advent of the private-label securitization market as deriving from the deregulation activities of the 1990s, and that originally, the private-

The growth in private-label MBS has been attributed, in part, to the creation of the housing bubble, which culminated in the financial crisis of 2008.[299] These securities have come under heightened scrutiny ever since.[300] Moreover, MBS litigation is prominent in current class action securities fraud jurisprudence.[301] Nevertheless, the profitability of the

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label market only securitized jumbo mortgages, which are larger than the conventional standards set by Fannie Mae and Freddie Mac); *see also Securitization Definition*, *supra* note 296 (further defining securitization).

> Mortgage-backed securities are the perfect example of securitization. By combining mortgages into one large pool, the issuer can divide the large pool into smaller pieces based on each individual mortgage's inherent risk of default and then sell those smaller pieces to investors . . . individual retail investors are able to purchase portions of a mortgage as a type of bond. Without the securitization of mortgages, retail investors may not be able to afford to buy into a large pool of mortgages.

Id.

299. *See* McCoy, Pavlov & Wachter, *supra* note 298, at 1330 (discussing the private-label market growing dramatically "from twenty-four percent of all mortgaged backed securities in 2003, totaling $586 billion, to a fifty-five percent share, totaling $1.19 trillion in 2005"); *see also* Benjamin J. Keys et al., *Did Securitization Lead to Lax Screening? Evidence from Subprime Loans*, 125 Q. J. ECON. 307, 353–54 (2010) (finding that securitization practices in the private-label mortgage-backed security market, particularly subprime loans, adversely affected the screening incentives of subprime lenders, thereby causing an increased number of risky loans to infest the marketplace). *But see* Ryan Bubb & Alex Kaufman, *Did Securitization Cause the Mortgage Crisis?*, THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Oct. 19, 2011, 9:18 AM), http://blogs.law.harvard.edu/corpgov/2011/10/19/did-securitization-cause-the-mortgage-crisis/ (discussing their findings that raise the question of whether securitization caused the crisis and asserting that the question is not as conclusive as some researchers and policymakers have held and that more evaluation needs to take place).

300. *See* RANDALL S. KROSZNER & ROBERT J. SHILLER, REFORMING U.S. FINANCIAL MARKETS: REFLECTION BEFORE AND BEYOND DODD-FRANK 66 (2011) (noting that, despite reforms to try and reignite the private-label MBS market, many market participants feel that loan originators have less incentive to carefully assess the likelihood of repayment of a particular mortgage if they sell the mortgage into an MBS-pool rather than if they were required to keep the loan on their own books); *see also What's Holding Back the Restart of the Private-Label MBS Market?*, MARKET PIPELINE BLOG (Feb. 17, 2011), http://marketpipeline.blogspot.com/2011/02/whats-holding-back-restart-of-private.html (statement of Michael A.J. Farrell, Chairman and CEO of Annaly Capital Management, Inc., before a House Subcommittee) (giving several reasons why the private-label market is not restarting, including: (1) rates are not conducive to excess risk of private-label MBS; (2) there are higher yielding alternatives in the MBSs that were issued during the crisis; (3) difficulty in securitizing newly-originated loans under heightened underwriting standards; (4) uncertainty over the future regulatory environment; and (5) most major institutional investors have guidelines that preclude them from taking the credit risk associated with private-label MBS at current price levels).

301. *See* CHRIS GAMAITONI, JASON STEWART & MIKE TURNER, COMPASS POINT RESEARCH & TRADING, LLC, MORTGAGE REPURCHASES PART II: PRIVATE LABEL RMBS INVESTORS TAKE AIM—QUANTIFYING THE RISKS, COMPASS POINT RESEARCH & TRADING, LLC 1–2 (2010), *available at* http://api.ning.com/files/fiCVZyzNTkoAzUdzhSWYNuHv33*Ur5ZYBh3S08zo*phyT79SFi0TOpPG7klHe3h8RXKKyphNZqqytZrXQKbMxv4R3F6fN5dI/36431113MortgageFinanceRepurchasesPrivateLabel08172010.pdf (asserting that, due to increased litigation activity

MBS market will not deter the marked participation of financial industry actors.[302] Considering the liability issues that have arisen since the 2008 crisis, however, market participants will be certain to seek methods of limiting liability exposure in the underwriting and distribution process.[303] This Subpart explores how *Janus* may help to achieve the goal of displacing liability from corporate benefactors going forward.[304]

1. The Securitization Food Chain

The process of securitizing "private-label" mortgage loans involves many parties.[305] In a typical securitization, the different parties could include: borrower/homeowner, mortgage broker/originator, lender, servicer, sponsor, depositor, trust/trustee, rating agency, insurer, underwriter, and investor.[306] It is interesting to note that in many cases

by investors of private-label MBS, liability exists for originators and underwriters of the initial securitizations, and providing a timeline of major mortgage-related litigation dating back from September of 2008 through August of 2010); *see also* Isaac Gradman, *The Government Giveth and It Taketh Away: The Significance of the Game Changing FHFA Lawsuits*, SUBPRIME SHAKEOUT BLOG (Sept. 15, 2011), http://www.subprimeshakeout.com/2011/09/the-government-giveth-and-it-taketh-away-the-significance-of-the-game-changing-fhfa-lawsuits.html (describing September 2, 2011 as a significant day in mortgage-crisis litigation because on that day the FHFA filed seventeen lawsuits against almost all of the world's largest banks seeking recovery of roughly two hundred billion dollars of mortgage-backed securities purchased by Fannie Mae and Freddie Mac).

302. *See* Kenneth F. Fick, *Securitized Profits: Understanding Gain On Sale Accounting*, J. ACCOUNTANCY (May 2008), http://www.journalofaccountancy.com/Issues/2008/May/SecuritizedProfits.htm (noting that despite the now less popular mortgage loan securitization model, big banks will continue to utilize securitization of assets because of the segregation of risk it offers, which allows for a greater degree of leverage for the banks, thereby increasing profit potential).

303. *See* GAMAITONI, STEWART & TURNER, *supra* note 301, at 1 (noting that the lawsuits brought forth by the Federal Home Loan Banks, the Federal Housing Finance Agency, and large investor groups are going after underwriters of the initial securitizations and generally claim that the underwriters made misrepresentations within the initial prospectus for the investments); *see also* Gradman, *supra* note 301 (discussing the reasons why plaintiffs are pursuing underwriters via the securities claim route as opposed to utilizing put-back rights inherent in the mortgage securities). Gradman also states that put-back claims—a method of getting the initial investment back from the issuer—have high initial procedural hurdles that make it difficult for investors to recover their investment from the underwriter. *Id.*

304. *Infra* Part V.B.1–2.

305. *See* Cagin Pabuccu, *Securitization Litigation: Classification of Theories of Liability*, 16.1 J. STRUCTURED FINANCE 65, 66 (2010) (noting that the large number of parties involved in the securitization process leads to the complexity of the investments).

306. Pabuccu, *supra* note 305, at 66. The progression of mortgage issuance to securitization would look something like the following: Jane Doe (borrower) goes into XYZ Mortgage Inc. (mortgage broker) to obtain a mortgage for her new home. XYZ shows Jane a 30-year loan offered by IndyMacy Bank (lender)—Jane accepts. IndyMacy sells Jane's loan to Lyman Bros.

of private-label securitization, as many as eight of ten different roles (mortgage broker, lender, servicer, sponsor, depositor, trust/trustee, insurer, and investor) could be filled by one investment bank through its many subsidiaries.[307] The process is laden with loan documents at every step, and since the bursting of the credit bubble in 2008, legal disputes have arisen among parties throughout the chain.[308] For the purposes of this Subpart, recourse sought by an investor against the investment bank will be examined.[309]

Investment Bank (underwriter), but maintains the responsibility of sending Jane monthly statements and collecting payments (servicer). Lyman Bros. sells the loan to Lyman Real Estate Inc. (depositor). Lyman Real Estate Inc. transfers Jane's loan, along with a thousand other loans it purchased from Lyman Bros., to Lyman Trust (trust/trustee). Lyman Trust pools these loans together to form a trust called MBS 1, the mortgage-backed security. MBS 1 gets Moodie's (rating agency) to rate the security and also gets GIA (insurer) to insure the entire pool against default. MBS 1 files a registration statement with the SEC. Upon approval of the filing, Lyman Trust transfers MBS 1 back to Lyman Real Estate Inc. Lyman Real Estate Inc. sells MBS 1 to Lyman Bros. Investment Bank. Lyman Bros. markets and sells the MBS to Illinois Lawyers Pension Fund, Ultra Safe Investments Bond Fund, and other institutions (investors).

307. *See* Press Release, Federal Housing Finance Agency, FHFA Sues UBS to Recover Losses to Fannie Mae and Freddie Mac (July 27, 2011) (on file with author) (describing that, in its suit against UBS, the FHFA, as plaintiff, listed as defendants UBS Americas, Inc. (corporate parent), UBS Real Estate Securities Inc. (depositor/lender), UBS Securities, LLC (underwriter), Mortgage Asset Securitization Transactions, Inc. (trust/trustee, also owned by UBS Americas), and four former UBS executives); *see also* Press Release, FHFA Sues 17 Firms to Recover Losses to Fannie Mae and Freddie Mac (Sept. 2, 2011), *available at* http://www.fhfa.gov/webfiles/22599/PLSLitigation_final_090211.pdf (discussing the seventeen complaints the FHFA filed to recover losses stemming from purchases of private-label MBSs that are similar to the UBS suit in July, and listing the seventeen banks as: Ally Financial Inc. f/k/a GMAC, LLC, Bank of America Corporation, Barclays Bank PLC, Citigroup, Inc., Countrywide Financial Corporation, Credit Suisse Holdings (USA), Inc., Deutsche Bank AG, First Horizon National Corporation, General Electric Company, Goldman Sachs & Co., HSBC North America Holdings, Inc., JPMorgan Chase & Co., Merrill Lynch & Co. / First Franklin Financial Corp., Morgan Stanley, Nomura Holding America Inc., The Royal Bank of Scotland Group PLC, and Société Générale).

308. *See* Pabuccu, *supra* note 305, at 66–76 (stating that actions between securitization parties include: breach of contract (subscription agreement, indenture agreement, reference pool side agreement, claims against trustees, claims against servicers); breach of representations and warranties (breach of warranty of sellers, of the receivables, of document defects, early payment warranty); tort claims (fiduciary duty, fraud: misrepresentation and non-disclosure); federal securities fraud claims (1933 Act, 1934 Act); and rating agency claims (same federal acts and negligent misrepresentation and fraud)).

309. *See infra* Part V.B.2. (discussing the potential for an investment bank to insulate itself from statements made in a prospectus); *see also* McCoy, Pavlov & Wachter, *supra* note 298, at 1357–58 (asserting that had there been laws imposing liability on investment banks and other securitizers for financing abusive loans, securitizers might have exercised real due diligence).

2. Potentially Insulating the Investment Bank from Sections of the 1933 Act

In many cases, an investor will sue an investment bank for fraud stemming from statements that were material misrepresentations, misleading, or omitted during the initial sales process—all prohibited under §§ 11 and 12(2) of the 1933 Act.[310] The plaintiff in such an action does not have to prove that the defendant acted with scienter, as promulgated under the PSLRA but does have to meet the PSLRA's heightened pleading standard.[311] This heightened pleading standard has

310. 15 U.S.C. § 77k (2006)—§ 11—states:

> (a) Persons possessing cause of action; persons liable
>
> In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue--
>
> > (1) every person who signed the registration statement;
> >
> > (2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
> >
> > (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;
> >
> > (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;
> >
> > (5) every underwriter with respect to such security.

15 U.S.C. § 77l(a)(2) holds liable any person who:

> (2) offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . . and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.

Id.; *see also* Pabuccu, *supra* note 305, at 73 (stating that the Court in *Gustafson* limited the scope of liability under § 12(2) by not extending coverage to secondary market transactions).

311. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 21D(b)(1)–(2), 109 Stat. 737 ("[T]he complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."); *see also* Pabuccu, *supra* note 305, at 73 ("[P]laintiffs must ensure that the complaint is sufficient in terms of clarity and sufficiency of the

led to a large number of dismissals by courts—specifically, in securitization litigation.[312] Heightened pleading makes it difficult for a plaintiff to bring a complaint in a securitization action due to the lack of information available to the plaintiff at the pleading stage.[313] Generally, plaintiffs in securitization actions file claims based on conversations with defendants and any publicly available information about the investment, such as a prospectus or a registration statement, but this limited available information makes getting through the pleading stage a difficult task.[314]

Adding to the heightened standard, the decision in *Janus* has created a potential blueprint for an investment bank to further shield itself from liability.[315] During the securitization process, the bank faces liability when making oral or written misstatements, misrepresentations, and/or omissions of material fact to investors during the initial offering of an MBS.[316] Most liability stemming from written communication comes from the registration statement, the filing of which is required when offering an MBS to investors.[317] After *Janus*, an investment bank can

claims. The [PSLRA] tightened the pleading standards.").

312. Pabuccu, *supra* note 305, at 73 (discussing that in securities fraud actions under § 11, "[t]here are significant numbers of dismissal motions granted to subprime securitization lawsuits . . ."); *see also* Hutchison v. CBRE Realty Fin. Inc., 638 F. Supp.2d 265, 277 (D. Conn. 2009) (granting the defendant's motion to dismiss after finding that the plaintiff failed to adequately plead the materiality of the omissions in the defendant's registration statement and prospectus).

313. *See Hutchison*, 638 F. Supp.2d at 275 (discussing the lack of adequately pleading materiality); *see also* Pabuccu, *supra* note 305, at 73 (stating that aside from well supported factual allegations, the plaintiffs need to adequately plead materiality).

314. *See* Walker & Seymour, *supra* note 80, at 1015 (discussing the coverage of § 10(b) as including "[a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met").

315. *See, e.g.*, Editorial, *supra* note 288 (asserting that JCG and JCM used legal ventriloquism to commit fraud through the mutual fund business trust they established); Stohr, *supra* note 275 (statement of Chicago-Kent College of Law Professor William Birdthistle) (asserting that the *Janus* decision has created a blueprint for companies looking to escape liability from statements they make); Gordon, *supra* note 210 (asking why the Court in *Janus* wants to insulate fraudulent corporate actors from liability).

316. *See* 15 U.S.C. § 77k (discussing liability for parties involved in an initial public offering); *see also* Pabuccu, *supra* note 305, at 72 (stating that § 11 imposes liability on a wide range of persons if a registration statement contains untrue statements of a material fact or omits material facts that would be required for an investor to make an informed decision).

317. *See* 15 U.S.C. § 77k (describing liability for misstatements made in a registration statement); *see also Registration Under the Securities Act of 1933*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/answers/regis33.htm (last visited Apr. 21, 2012) (listing the essential facts that a company needs to include in a registration statement: "[a] description of the company's properties and business; [a] description of the security to be offered for sale;

theoretically buffer that liability.[318] Consider this example: if a mortgage trust is set up by an investment bank as a separate legal entity with a board of directors, statements made in the registration statement are under the ultimate authority of the mortgage trust.[319] The trust can hire the investment bank, not as an underwriter, but as an asset advisor, distributor, and/or an administrative agent.[320] Even if the bank helps to pick the loans and sell the investments, it can argue that it is merely an advisor or a distributor of products, similar to a mutual fund advisor, leaving the trust as the entity solely in control of potentially misleading statements.[321] Hence, the investment bank would not be liable as a primary actor as defined by *Janus*.[322] Notwithstanding the influence and entwinement between the bank and the trust, a court could find it difficult to disregard the corporate form; a private right of action under federal securities laws may cease to be an option for an investor who may be defrauded in this scenario.[323]

[i]nformation about the management of the company; and [f]inancial statements certified by independent accounts").

318. *See supra* note 289 and accompanying text (referencing several commentators who feel that the Court is providing market actors a means by which to escape liability from securities fraud).

319. *See* Press Release, *supra* note 307 (noting that in the FHFA's complaint against UBS, one of the parties named was Mortgage Asset Securitization Transactions Inc. ("MAST"), a wholly owned subsidiary of UBS). The question raised by *Janus* would seem to indicate that if UBS had set up MAST as a standalone separate business trust, similar to the Janus Funds, could UBS Americas, UBS Securities, or UBS Real Estate Securities have been liable for statements made in the registration statement filed by MAST as to the loans in its portfolio? The situation in *Janus* does involve an initial public offering, which is governed under 1933 Act; however, the majority opinion in *Janus* did not specify as to limits of its new rule. Janus Capital Grp. Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2303 (2011). The Court simply stated, "[T]he maker of a statement is the entity with authority over the content of the statement and whether and how to communicate it. Without such authority, it is not 'necessary or inevitable' that any falsehood will be contained in the statement." *Id.*

320. *See* Brief of Law Professors, *supra* note 201, at 17 (asserting that if the defendants' argument in *Janus* wins, it would show potential future perpetrators that all they need to do in order to avoid certain forms of securities fraud is to structure a business to mirror the mutual fund industry).

321. *See In re* Mut. Funds Inv. Litig., 487 F. Supp. 2d 618, 621 (D. Md. 2007) (quoting *In re* MTC Elec. Tech. S'holder Litig., 993 F. Supp. 160, 161–62 (E.D.N.Y. 1997)) (noting that an underwriter could be liable for preparing and disseminating a misleading prospectus because of the "central role underwriters play in the issuance of securities and the special reliance placed on them by prospective investors"), *rev'd*, 566 F.3d 111 (4th Cir. 2009). The district court saw fit to include the distinction of an underwriter; however, the Court in *Janus* gave no such limitation. *See supra* note 320 (explaining the potential impact of the *Janus* decision).

322. *See Janus*, 131 S. Ct. at 2305 (concluding that since the misstatements in the Janus Funds' prospectus were made by the Janus Funds and not the investment advisor, the plaintiffs had not stated a claim against the advisor under Rule 10b-5).

323. A plaintiff would not use § 10(b) and Rule 10b-5 in this scenario because it involves an

VI. CONCLUSION

Leading up to the Great Depression, it was evident that the risk of facing legal action under common contract law did not serve as a deterrent for corporate managers.[324] Reckless corporate disregard for economic norms and negligently exposing investors to great risks was a function of the marketplace and compounded the effects of the ensuing depression.[325] The Congressional securities regulation of the 1930s served to effectively curtail much of the abuses and hold those who commit fraud duly accountable.[326] Federal courts saw fit to create and enforce an implied private right of action under § 10(b) and Rule 10b-5 as a means of further strengthening the legal options of investors.[327] Unfortunately, *Janus* is the latest in a long line of Supreme Court decisions in the past several decades that were meant to weaken and substantially narrow private action claims under § 10(b) and Rule 10b-5.[328] The Court—with Congress's help through legislation such as the PSLRA—has succeeded towards that end. Be that as it may, the market

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initial public offering and, more importantly, it would be incredibly difficult to show scienter at the initial offering stage without the help of discovery. *See* Murdock *supra* note 75, at 176 ("[A] plaintiff must provide, in great detail, all the relevant facts forming the basis of her belief. It is not sufficient for a plaintiff's pleadings to set forth a belief that certain unspecified sources will reveal, after appropriate discovery, facts that will validate her claim."); *see also* Ramirez, *supra* note 65, at 1074 (asserting that the scienter pleading requirement under the PSLRA has raised the question of whether it can be satisfied at all, unless there are explicit admissions of an intent to defraud).

324. *See* Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943) (discussing the business of investing, Judge Charles Clark pointedly stated that the "well-known 'blue sky laws' of 43 states have in fact proved inadequate"); *see also* Welle, *supra* note 16, at 533–34 (noting that federal securities laws were initially created to eliminate serious abuses found in unregulated capital markets and to supplant state laws that were designed to simply protect from fraudulent and unethical schemes).

325. *See* Larry Bumgardner, *Reforming Corporate America: How Does the Sarbanes-Oxley Act Impact American Business?*, 6 GRAZIADIO BUS. REV. (2003), *available at* http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/ (discussing fraudulent activities that took place prior to the market crash, including having publicists inflate stock prices, family insider trading, manipulation of the market and specific stocks, high salaries and interest-free loans for corporate executives, tax avoidance schemes, and investment banks allowing politicians and other corporate executives to buy initial offerings at artificially low prices).

326. *See Charles Hughes*, 139 F.2d at 437 ("The essential objective of securities legislation is to protect those who do not know market conditions from the overreaching of those who do.").

327. *See* Welle, *supra* note 16, at 550 (stating that rather than depending less on federal securities laws, we should encourage efforts that aim to strengthen and streamline those we have).

328. *See* Rochelle Bobroff, *Liberal Justices Miss the Point in Recent Court Access Cases*, ACS BLOG (June 16, 2011), http://www.acslaw.org/acsblog/liberal-justices-miss-the-point-in-recent-court-access-cases (noting that from the early 1990s up to his retirement, Justice Stevens tirelessly fought the five-vote conservative majority in their effort to erode the ability of private individuals to enforce progressive federal laws).

may be faced with having to deal with the unintended consequences inherent in a loosely regulated marketplace where private investors have minimal options for recourse.[329]

329. *See id.* (asserting that if the Court continues to restrict private rights of action under federal laws, individuals could find it difficult to bring forth actions related to discrimination, the right to monetary relief from corporate fraud, and the right of poor children to medical insurance to pay for developmental screening).