What *Janus* Meant: The First Wave of Court Decisions Interpreting the Supreme Court’s “Ultimate Authority” Test in Securities Cases

BY THE SECURITIES LITIGATION AND ENFORCEMENT GROUP

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The Supreme Court’s decision in *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (June 13, 2011), sent a powerful signal when it held that the investment advisor to a mutual fund could not be held primarily liable under Section 10(b) of the Securities Exchange Act for statements in the fund’s prospectus, because the investment advisor did not have “ultimate authority” over the statements.

The *Janus* decision already has impacted the securities fraud landscape. The Court’s ruling appears straightforward – no primary liability except for those who have ultimate authority or control over the content and dissemination of a statement. In the six months since *Janus* was decided, courts have applied the ruling in cases involving related corporate entities, corporate officers, and major shareholders. The Ninth Circuit has noted that “[Janus] sets the pleading bar even higher in private securities fraud actions seeking to hold defendants primarily liable for the misstatements of others.”

Yet just how high the pleading and proof bar has been set outside the mutual fund and investment advisor context remains an open question. Different federal courts – even within the same district – have come to different conclusions. Until higher courts rule on the scope of *Janus*, the uncertainty created by these differing lower court decisions could blur the *Janus* “bright line rule.” And plaintiffs have begun to cast their nets wider, looking for alternative theories to avoid dismissal under *Janus*.

The “Ultimate Authority” Standard Set by *Janus*

The *Janus* saga began when investors in Janus Capital Group common stock brought a putative securities fraud class action alleging that both Janus Capital Group (“JCG”) and Janus Capital Management (“JCM”) (the investment adviser to the Janus Mutual Funds) were responsible for statements in the Janus Funds’ prospectuses about the company’s policies against market timing. When these statements turned out to be untrue, claimed the plaintiffs, investors pulled assets out of the Janus Funds which in turn reduced management fees paid to JCM and, under the fraud-on-the-market theory, caused the plaintiff investors to purchase shares of JCG, the parent company of JCM, at inflated prices.
The Supreme Court held that neither JCM nor its parent JCG could be held primarily liable for the misleading statements in the fund prospectuses. The Court ruled that to “make a statement” for purposes of liability under Section 10(b) and Rule 10b-5 requires that the person or entity must have the ultimate authority over the statement. In order to “make” a statement, said the Supreme Court, a person must actually control the making of it.

In *Janus*, the Court overturned a Fourth Circuit Court of Appeals decision that held the investment advisor may be held primarily liable for statements made in a mutual fund prospectus. The Supreme Court noted that the investment advisor maintained substantial control over the fund, but the fund was a separate legal entity that observed corporate formalities, maintained its own board of directors, and issued the prospectus for which the plaintiffs sought redress. The Court refused to extend the implicit private right of action under Section 10(b) to those individuals or entities that exert control over the entity that issued the prospectus. The Court’s opinion, written by Justice Clarence Thomas, found that liability could not arise simply because the alleged primary violator was “significantly involved” in preparing the statement, or “assisted” the entity with ultimate control over the crafting of the statement. The Court analogized that the maker of a statement is not the speechwriter, but the speaker.

**Limitations on Primary Liability for Securities Fraud**

In context, *Janus* is one decision in a long line of recent Supreme Court cases limiting the scope of the private right of action under Section 10(b) and Rule 10b-5. As the *Janus* opinion points out, the right must be given “narrow dimensions” because “Congress did not authorize [a private right of action] when it first enacted the statute and did not expand [it] when it revisited” the issue. Instead, the right has been implied. To state a claim, the plaintiff must allege that in connection with the purchase or sale of a security, the defendant made a materially false statement or omitted a material fact, with scienter, and that the plaintiff relied on the misrepresentation causing the plaintiff injury.

The Supreme Court over the years expanded the implicit private right of action by adopting the fraud-on-the-market theory and permitting private securities litigants the presumption of reliance to bring class action claims under Rule 10b-5.

In its recent decisions, up to and including *Janus*, however, the Court has steadily limited the private right of action. These have included *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 180 (1994), which determined there was no separate aiding and abetting liability in a private securities action, and *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 156 (2008), which held that a company or individual who provides assistance to a corporation that makes a misstatement in public documents cannot be held liable in a private securities fraud action under a scheme theory of liability.

The Court’s clear-cut refusal in *Janus* to extend primary liability to those who assist or participate in making a statement – even in the context of the close relationship between a mutual fund and its investment advisor – would seem to be an unambiguous direction to lower courts that only those who control or have authority over the statement can be liable to investors.

Following *Janus*, several lower courts have dismissed claims that might have survived prior to it being handed down. A few courts have struggled in applying the *Janus* rule in areas other than the mutual fund / investment advisor context.
Corporate Affiliates

Generally speaking, courts since Janus have been more apt to dismiss suits alleging primary Rule 10b-5 violations where the plaintiff alleges that a corporate affiliate – e.g. in a parent and subsidiary relationship – should be held liable as the “maker” of a statement of another separate, albeit related, corporate entity. In Reese v. BP Exploration (Alaska) Inc., the Ninth Circuit reviewed whether a party that was both the creator of an energy exploration trust and was authorized to file the trust’s required documents with the SEC (“BPXA”), could be held liable for misstatements in the offering documents of the legally distinct trust.6 The Court of Appeals said it could not. Affirming the grant of a motion to dismiss, the Court determined that despite BPXA’s authorization to make the trust’s filings, under Janus it did not have the “ultimate authority” over the content of those filings.7

Two decisions in the context of a major corporate shareholder came to sharply different conclusions. In The City of Roseville Employees’ Retirement System v. EnergySolutions, Inc., 2011 WL 4527328, -- - F. Supp. 2d. --- (S.D.N.Y. Sept. 30, 2011), the plaintiffs brought a Rule 10b-5 class action claiming that the corporation, EnergySolutions, Inc. (“ES”), issued an IPO registration statement containing materially false statements about the financial picture of its nuclear waste disposal business. Plaintiffs sued not only ES, but also its sole stockholder ENV Holdings, Inc. (“ENV”) and a number of officers and board members. The court refused to dismiss ENV.

The City of Roseville court acknowledged key similarities between the defendant in Janus and ENV: the company, ES, was a legally distinct entity from ENV, ES issued the Registration Statement, and the statements were “most prominently attributed to ES and the individual defendants, not ENV.” But the court also noted important distinctions: ENV was the sole shareholder at the time of the IPO and would retain a controlling interest after the IPO, and the registration statement expressly stated ES would be a controlled company and referenced an indemnification for ENV for material misstatements or omissions. Citing these distinctions, the court held that a reasonable jury could find that ENV’s role went well beyond that of a “‘speechwriter draft[ing] a speech,’ because, . . . , ENV had control over the content of the message, the underlying subject matter of the message, and the ultimate decision of whether to communicate the message.”8

Conversely, another court in the same district, just two weeks after City of Roseville was issued, came to the opposite conclusion based on Janus. In In Re Optimal U.S. Litig., No. 10 Civ. 4095 (SAS), 2011 WL 4908745 (S.D.N.Y. Oct. 14, 2011), the plaintiffs sued for alleged misstatements in the Bahamian equivalent of prospectus statements issued by the fund entity, Multiadvisors, about its Optimal Strategic U.S. Equity Fund, all of whose assets turned out to be invested in Bernard Madoff’s fund. Among other defendants, plaintiffs sued the fund’s investment manager, OIS, based on the theory that OIS controlled Multiadvisors. In disagreeing with Plaintiff’s position, the court found that because OIS owned 100% of the voting shares of Multiadvisors, OIS could appoint and remove Multiadvisors directors at will, and the CEO of OIS was also a director of Multiadvisors, the “attempt to avoid Janus by conflating shareholder control with ‘ultimate authority’ [is] unavailing.”9 The “board manages the business affairs . . . [and] has the authority to alter the [prospectus] without consulting shareholders.” Under the “formalistic approach” to Rule 10b-5 liability the Supreme Court adopted in Janus, and given the “narrow scope” Janus afforded to such liability, OIS could not be liable, because “Multiadvisors, not OIS, ‘made’ the statements.”10

The decisions in City of Roseville and In Re Optimal U.S. Litig. demonstrate the difficulties that some courts have had in applying the “ultimate authority” test set down in Janus. The judge in City of Roseville found that sole ownership was a key indicator of control sufficient to permit a plaintiff’s
primary liability claim to survive the motion to dismiss, while the court in *In Re Optimal U.S. Litig.* ruled that sole ownership was not determinative, because while an owner may select the board, the board maintains the ultimate authority to issue or alter a prospectus without further consent.

**Corporate Officers and Management**

In *In re Merck & Co., Inc. Sec. Derivative & ERISA Litig.*, a New Jersey district court grappled with the implications of *Janus* when the alleged misstatements are those of corporate officers. There, the investor plaintiffs claimed that Merck had overstated the commercial viability of its anti-inflammatory pain reliever Vioxx, by downplaying the possible link between the drug and an increased risk of heart attack or stroke. One corporate officer, an Executive Vice President ("EVP") and president of Merck Research Laboratories, argued he could not be primarily liable for misstatements made by the corporation in light of *Janus*, because he did not have ultimate authority over the statements. The district court rejected his claims, finding the class plaintiffs had sufficiently pled a primary violation.

As the *Merck* court noted, *Janus* "[did] not alter the well-established rule that a corporation can act only through its employees and agents." The court found that the EVP "takes the *Janus* holding out of context." *Janus* involved a different factual scenario involving distinct legal entities, whereas the EVP was an officer of Merck at the time of the statements, signed SEC forms, and was quoted in articles and reports in his capacity as a corporate officer. "He made the statements pursuant to his responsibility and authority to act as an agent of Merck, not as in *Janus*, on behalf of some separate and independent entity."

In a positive result for officers and directors faced with claims based on a statement made by another corporate officer, at least one district court in the Ninth Circuit has held that liability does not extend under *Janus* to the officer or director that did not make the statement. In *In re Coinstar Inc. Sec. Litig.*, No. C11-133MJP, 2011 WL 4712206 at *10 (W.D. Wash. Oct. 6, 2011), the plaintiff, a state retirement system, sought to hold three officers, the COO, Treasurer and GC, liable for misstatements that the CEO and CFO made at industry conferences about the finances and prospects of Coinstar’s DVD rental system business, Redbox. The court found that, "[w]hile the Supreme Court in *Janus* considered whether a business entity could be held liable for a prospectus issued by a corporate entity, its analysis applies equally to whether [the individual defendants] may be held liable for the misstatements of their co-defendants." Accordingly, the court dismissed the allegations against the other officers, because those individuals did not have ultimate authority over the false statements made by others at conferences.

Similarly, several courts have applied the rationale of *Janus* not only to corporate entities, but to corporate insiders as well. In *Hawaii Ironworkers Annuity Trust v. Cole*, No. 3:10CV371, 2011 WL 3862206 at *5 (N.D. Ohio Sept. 1, 2011), an Ohio district court found that four former officers who participated in creating alleged misstatements about a company’s financial results to inflate its earnings could not, in light of *Janus*, be primarily liable under Rule 10b-5. The court pointed out that Plaintiffs’ own complaint alleged that defendants, who were lower-level officers, were acting in response to a “mandatory directive” from the company’s CEO, CFO and other top management to manipulate underlying data in order to produce more favorable results that could then be included in the company’s earnings reports. Despite finding that liability could not attach, the court reiterated the same concern expressed by Justice Breyer in his dissenting opinion in *Janus* that the *Janus* rule could result in no one being held liable for a misleading statement; "the possibility of guilty management and [an] innocent board was the thirteenth stroke of the new rule’s clock."
Mutual Funds and Advisors

Relatively few securities fraud actions involving mutual funds and primary violations of Rule 10b-5 have been decided in the wake of Janus, which was to be expected given that Janus shut the door on investment advisor liability for misstatements in fund prospectuses. Even the SEC has throttled back on its claims in some pending cases. In S.E.C. v. Daifotis, No. C 11-00137WHA, 2011 WL 3295139 at *4 (N.D. Cal. Aug. 1, 2011), the SEC agreed that in light of Janus certain alleged misstatements could not be adequately pled as having been “made” by the defendants. In Daifotis, the SEC brought an enforcement action against two executives of a subsidiary of Charles Schwab Corporation. The SEC alleged the executives made false statements, or substantially contributed to the creation of the misstatements, regarding their management of a Schwab fund. In the court’s original order on June 6, 2011, the court found that the SEC’s complaint adequately alleged primary violations for statements made in fund marketing materials. After Janus, the court granted defendants’ motion to reconsider, and modified its order on August 1, 2011 by dismissing, without opposition from the SEC, the claims that defendants substantially participated in the creation of misstatements in marketing materials.

The Ramifications of Janus: Alternative Theories of Liability Will Proliferate

In the wake of Janus, defendants will continue to advocate for a very limited scope of potential liability given the Court’s narrow interpretation of to “make a statement.” Plaintiffs will likely try various other avenues to impose liability upon advisors to mutual funds, parent corporations, and corporate officers. Several such alternative claims have already emerged.

Plaintiffs will likely put more emphasis on alleging scheme liability and deceptive practices claims under Rule 10b-5(a) and (c). In response to this effort so far, defendants have argued that Janus imposed a specific attribution requirement on claims brought by Rule 10b-5(a) and (c), with little success. In Hawaii Ironworkers Annuity Trust, defendants argued that Stoneridge Inv. Partners LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008), and Janus, read together, required plaintiff to allege that misstatements were specifically attributed to defendants in order to support a claim under Rule 10b-5(a) and (c). The court rejected this argument, noting that the Court’s language in Janus makes no reference to attribution, and refused to hold that attribution is always necessary for Rule 10b-5(a) and (c) claims. This issue may be the subject of appeals in the near future. The Supreme Court in Janus did reaffirm the viability of its decision in Stoneridge, by finding “no reason to treat participating in the drafting of a false statement differently from engaging in deceptive transactions, when each is merely an undisclosed act preceding the decision of an independent entity to make a public statement.”

Similarly, the SEC has already tried, and failed, to use Rule 10b-5(a) and (c) as a “back door into liability for those who help others make misstatements under Rule 10b-5(b). In S.E.C. v. Kelly, the SEC voluntarily dropped its claims of primary violations under Rule 10b-5(b), but insisted it could pursue scheme liability under Rule 10b-5(a) and (c) based upon the same alleged conduct. The district court dismissed the claims, noting that scheme liability cannot be premised on the mere facilitation or preparation of misrepresentations. While noting that the Supreme Court in Janus did not address scheme liability under Rule 10b-5(a) and (c), the Kelly court cautioned that “where the primary purpose and effect of a purported scheme is to make a public misrepresentation or omission, courts have routinely rejected the SEC’s attempt to bypass the elements necessary to impose ‘misstatement’ liability under subsection (b) by labeling the alleged misconduct a ‘scheme’ rather than a misstatement.”
As another tactic, plaintiffs will likely continue to argue that the court should ignore the corporate form, relying on an alter ego theory based on an alleged failure to observe corporate formalities. In *In Re Optimal U.S. Litig.*, the court rejected this theory, but noted that there “will soon be a case where a court must decide whether a corporate veil-piercing theory can be used to avoid the legal strictures that would otherwise bar a Rule 10b-5 claim under *Janus.*” Based on *Janus*, however, such a veil-piercing theory should be rejected because of the Court’s clear mandate: “We decline this invitation to disregard the corporate form.” Arguments that rely on corporate veil-piercing in other contexts to impose liability under Rule 10b-5 would likely be met with a similar rejection from the Court – so long as “corporate formalities were observed” and the requisite degree of independence among the entities has been maintained.

Finally, plaintiffs may increasingly seek to impose “control person” liability under Section 20(a) of the Exchange Act. However, secondary liability under Section 20(a) cannot exist unless primary liability under Section 10(b) is first established against the actual “maker” of the statement. The ruling in *Janus* may not provide an additional ground to dismiss a control person claim at the pleading stage, but post-*Janus*, a plaintiff must plead and prove primary violations by the maker of the statements as well as control person liability against the non-maker before any liability will attach. As one example, the court in *In Re Optimal U.S. Litig.* stated that the plaintiff had sufficiently alleged control person liability against the investment manager which controlled the fund that made the statement, without reaching the issue of whether the controlled entity had the scienter necessary for primary liability under Rule 10b-5.

**Conclusion**

The *Janus* decision will continue to shape both the plaintiffs’ bar’s claims alleging securities fraud, and defendants’ arguments for dismissal of such claims. Within six months of the Supreme Court’s decision, *Janus* has already led to a variety of applications in the district courts. It will take time for appeals courts to weigh in on the issues. Investment advisors, parent corporations, boards of directors, and management teams alike should continue to be mindful of the post-*Janus* landscape. In addition to pursuing post-*Janus* Section 10(b) and Rule 10b-5 cases through the Circuit Courts of Appeals and to the Supreme Court, private securities plaintiffs will attempt to find new avenues and theories to advance such claims. In light of the path laid out in the Supreme Court’s decisions in *Janus, Central Bank*, and *Stoneridge*, those claims should continue to be defeated, but there may be more turns in the road than initially appeared.
If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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1 Reese v. BP Exploration (Alaska) Inc., 643 F.3d 681, 693 n.8 (9th Cir. 2011).
3 The Supreme Court, in Superintendent of Insurance v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971), approved the implicit private right of action for a Rule 10b-5 claim. In Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975), the Court affirmed that this private right was limited to the purchase or sale of a security.
4 Section 10(b), as implemented by Rule 10b-5, makes it "unlawful for any person . . . [t]o make any untrue statement of 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." 17 C.F.R. § 240.10b-5(b). See Ganino v. Citizens Utils. Co., 228 F.3d 154, 161 (2d Cir. 2000).
6 Reese v. BP Exploration (Alaska) Inc., 643 F.3d 681 (9th Cir. 2011).
7 Id. at 693 n.8.
8 The City of Roseville Employees’ Retirement System v. EnergySolutions, Inc., 2011 WL 4527328 at *18 (quoting Janus, 131 S.Ct. at 2302). Regarding the individual defendants, the court considered each separately, and found several were potentially liable based on Janus because they signed the registration statement, while others, who were not yet on the Board but would join it after the IPO, escaped liability because they did not sign the registration statement and appeared to have no authority over its contents. "As to other statements, such as those made in press conferences or in press releases, there is no allegation that anyone other than ES and the direct issuers of those statements had authority over their content." Id. at *17, *18.
10 Id.
12 On November 28, 2011, another district court denied a corporate officer defendant’s attempt to shield liability for public statements. In S.E.C. v. Carter, No. 10 C 6145, 2011 WL 5980966 (N.D. Ill. Nov. 28, 2011), the CEO defendant allegedly originated the idea for two press releases, approved, and had his name as the contact at the end of each press release. The court found the S.E.C. adequately alleged primary Rule 10b-5 liability and noted that, "like a speaker, the [CEO] may not have authored the contents of the press releases, but was made aware of them and knew that he would be held accountable." Id. at *2.
14 Id.
16 Id. The court noted that, whether or not the "group pleading" doctrine survived Janus, "this is not [a] case where the false statements appeared in annual reports or a press release that 'is the collective action of officers and directors.'" Id. (citation omitted).
17 Janus, 131 S. Ct. at 2310 (J. Breyer dissenting).
18 One case, S.E.C. v. Gabelli, 653 F.3d 49 (2nd Cir. 2011), involved market timing in a mutual fund, similar to the facts in Janus. However, in Gabelli, the SEC sought civil penalties against the Chief Operating Officer of the fund for alleged misstatements in a memorandum read by investors that the COO authored and posted on the website of the Gabelli Funds' parent company. Id. at 55. No issue of ultimate authority was raised, likely because there was no question the COO "made" the statements in the memorandum.
19 The S.E.C. did successfully advance a Rule 10b-5 claim in S.E.C. v. Landberg, No. 11 Civ. 0404 (PKC), 2011 WL 5116512 at *3-4 (S.D.N.Y. Oct. 26, 2011). In Landberg, the SEC brought an enforcement action against the CFO of an investment advisor group, in part, for violating Section 10(b) and Rule 10b-5. The CFO allegedly generated false accounting statements and other marketing materials that misrepresented the financial performance of certain investment funds and participated in a scheme to conceal the fraud. Id. at 1-2. The court found the SEC sufficiently pled its claims despite the absence of any statements directly attributable to the CFO. Id. at 4. The court found that the claims should not be dismissed in light of Janus, stating, “Rule 10b–5 provides additional bases for the SEC’s claim beyond the making of fraudulent statements.” Regardless, the court stated, the SEC’s complaint sufficiently pled facts to support a finding that the statements were “implicitly attributed” to the CFO, which is “strong evidence that [the CFO] was the maker of those statements, thereby satisfying Janus.” Id.

*Id.* at *3-4.


Rule 10b-5 states, "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, . . . (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 purchaser sale of any security." 17 C.F.R. 240.10b-5. Scheme liability is difficult to prove as it "hinges on the performance of an inherently deceptive act that is distinct from an alleged misstatement." *S.E.C. v. Kelly*, No. 08 Civ. 4612 (CM), 2011 WL 4431161 at *3, ---F. Supp. 2d.-- (S.D.N.Y. Sept. 22, 2011).


*Janus*, 131 S. Ct. at 2303-2304.

See *Kelly*, 2011 WL 4431161 at *3.

*Id.*

*Id.* (citations omitted).