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District Court, Applying *Janus* Broadly, Rules Against the SEC in Securities Fraud Case

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In this article, the authors discuss a recent decision that suggests that the lower federal courts are inclined to apply the U.S. Supreme Court's decision in Janus Capital Group, Inc. v. First Derivative Traders *broadly to limit securities fraud claims in both private and public sector litigation.*

In *Securities and Exchange Commission v. Kelly*, *et al.,*[1] District Judge Colleen McMahon applied the U.S. Supreme Court's decision in *Janus Capital Group, Inc. v. First Derivative Traders*,[2] against the Securities and Exchange Commission ("SEC") and dismissed securities fraud claims against two defendants, neither of whom, the court found, had "made a misstatement as *Janus* requires." Judge McMahon's ruling is significant because it applies *Janus* to dismiss securities fraud claims brought by the government, as opposed to private litigants, and suggests that the lower federal courts are inclined to apply *Janus* broadly to limit securities fraud claims in both private and public sector litigation.

Interestingly, although the SEC conceded that *Janus* had foreclosed liability for both defendants under subsection (b) of Exchange Act Rule 10b-5, it argued that "scheme liability" claims under subsections (a) and (c) of Rule 10b-5, as well as claims under Section 17(a) of the Securities

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Act of 1933, had survived *Janus* because these claims did not hinge on the word "make," which was the linchpin of the Supreme Court's decision in *Janus*. Judge McMahon did not agree, holding that the SEC could not circumvent *Janus* by couching its theory of liability as "scheme liability" where the alleged misconduct involved material misstatements or omissions as opposed to otherwise illegal conduct, and that *Janus* applied to Section 17(a) claims because "both provisions [Rule 10b-5 and Section 17(a)] have the same functional meaning when it comes to creating primary liability."

THE *JANUS* DECISION

In *Janus*, the Supreme Court adopted a rule of narrow construction for Rule 10b-5 cases and held that only the "maker" of a false or misleading statement — meaning a "person or entity with ultimate authority over the statement" — could be liable under Rule 10b-5. In doing so, the Court rejected the claim that Janus Capital Management ("JCM"), an investment adviser, could be liable for alleged misstatements in a prospectus issued by Janus Investment Fund, a mutual fund for which JCM had served as investment adviser, based on the allegation that JCM had helped draft and disseminate the misstatements. Perhaps most importantly, the Supreme Court adopted a general rule of narrowly construing Rule 10b-5 that seemed to apply not only in private actions, but in SEC proceedings and criminal cases as well.

JUDGE MCMAHON'S DECISION IN *SEC v. KELLY*

In May 2008, the SEC brought a civil injunction action against, among others, Steven Rindner and Mark Wovsaniker, former senior managers of America Online, Inc. ("AOL"). The SEC alleged that, between 2000 and 2003, defendants engineered a series of so-called "round-trip transactions" with more than a half-dozen companies, enabling AOL's public parent company to report approximately $1 billion in online advertising revenue improperly. Significantly, although the SEC alleged that Rindner and Wovsaniker were responsible for the company's implementation of, and accounting for, the transactions, no public statements were attributed to either of them. Defendants' motions for summary judgment on the Rule 10b-5 and Section 17(a) claims initially were denied by Judge McMahon in January 2011, in part on the grounds that primary liability was appropriate under those claims "if the individual was sufficiently responsible for the statement — in effect, caused the statement to be made — and knew or had reason to know that the statement would be disseminated to investors."[3] Defendants renewed their motions in the wake of the Supreme Court's *Janus* decision, arguing that the Supreme Court had drawn a new bright line rule for primary liability under Section 10(b) and all three subsections of Rule 10b-5, and, by extension, Section 17(a) of the Securities Act.

Judge McMahon agreed. In a noteworthy decision that dismissed the SEC's Rule 10b-5 and Section 17(a) claims, but not its aiding and abetting claims under the Exchange Act, against defendants Rindner and Wovsaniker, Judge McMahon accepted defendants' arguments that scheme liability under subsections (a) and (c) of Rule 10b-5 was not available where "the primary purpose and effect of a purported scheme is to make a public misrepresentation or omission." In such circumstances, the court held, permitting primary liability "when the defendant did not 'make' the misstatement would render the rule announced in *Janus* meaningless." The court articulated a standard focused strictly on speakers or makers of false statements: "Although conduct can itself be deceptive, as the SEC argues, this case is not about conduct that is itself deceptive — it is about conduct that became deceptive only through AOL's misstatements in its public filings."

Significantly, the court also agreed with defendants that *Janus* precluded primary liability under Section 17(a) of the Securities Act, notwithstanding differences in the language of Section 17(a) and Rule 10b-5 that at least one appellate court has suggested supports the conclusion that Section 17(a) covers non-speakers.[4] The court here focused on the fact that, given the similarities between Section 17(a) and Rule 10b-5 in terms of the misconduct that both statutes were intended to address, "it would be inconsistent for *Janus* to require that a defendant have made the misleading statement to be liable under subsection (b) of Rule 10b-5, but not under subsection (2) of Section 17(a)."

SIGNIFICANCE OF *SEC v. KELLY*

The court's decision in *SEC v. Kelly* is significant because the court applied *Janus* to preclude securities fraud claims asserted by the government, as opposed to a private litigant. What is particularly intriguing about the court's decision in *SEC v. Kelly* is that, notwithstanding the Supreme Court's concern in *Janus* with the deleterious effects of excessive private litigation, the bright line rule that it announced applies broadly to all Rule 10b-5 claims, both by private and government plaintiffs, and even applies to claims, such as Section 17(a), for which no private right of action exists.

SEC v. Kelly has already been followed by an administrative law judge in dismissing Rule 10b-5 and Section 17(a) claims in an administrative proceeding brought by the SEC. In *Matter of John P. Flannery and James D. Hopkins*,[5] Chief Administrative Law Judge Brenda P. Murray dismissed securities fraud claims against two former members of State Street Global Advisors' senior management after finding that they were not responsible for, and did not have ultimate authority over, certain false statements that the SEC had attempted to attribute to them. In dismissing the securities fraud claims, Administrative Law Judge Murray expressly declined to follow *SEC v. Daifotis,*[6] which had held that *Janus* did not apply to the SEC's claims under Section 17(a) of the Securities Act because "the word 'make,' which was the very thing the Supreme Court was interpreting in *Janus*, is absent from the operative language of Section 17(a)" and the rationale of *Janus* "did not apply in the context of Section 17(a) because there is already no implied right of action for Section 17(a) claims."

It remains to be seen whether Judge McMahon's opinion represents a significant setback for the SEC's enforcement program. The court allowed the SEC to proceed against the defendants on an aiding and abetting theory for Rule 10b-5, and allowed the recordkeeping charges to remain. But, as is further demonstrated by the ALJ's decision in *Matter of John P. Flannery and James D. Hopkins*, the difference between persons who assist, and persons who speak is a distinction with real consequences, and one that the SEC should take into account in future charging decisions.

NOTES

[1] No. 08 Civ. 4612, 2011 WL 4431161 (S.D.N.Y. September 22, 2011).
[2] *Janus Capital Group, Inc. v. First Derivative Traders*, __ U.S. __, 131 S. Ct. 2296 (2011).
[3] *SEC v. Kelly*, 765 F. Supp. 2d 301, 319 (S.D.N.Y. 2011).
[4] *See SEC v. Tambone*, 550 F.3d 106, 127 (1st Cir. 2008).
[5] Initial Decision Release No. 438 (October 28, 2011).
[6] No. C 11-00137, 2011 WL 3295139 (N.D. Cal. Aug. 1, 2011).