Supreme Court Agrees to Clarify Scope of "Primary" Liability Under the Federal Securities Laws

The last day of the Supreme Court's term is generally headlined by the release of some of the term's most important rulings, and this year was no different. Not to be lost among yesterday's blockbuster decisions, however, is the Supreme Court's agreement to hear a case that will decide the scope of liability for collateral participants in the securities markets. The Court granted the petition for certiorari in *Janus Capital Group v. First Derivative Traders* to clarify the distinction between "primary" and "secondary" conduct in securities transactions. Because private plaintiffs may only hold "primary" players liable under the antifraud provisions of the securities laws, the case will resolve whether many individuals and entities—including parent corporations, individual officers, and service providers like investment advisers, attorneys, and accountants—are "primary" defendants who can be privately sued. The decision threatens to significantly broaden the class of defendants that can be sued in private class action securities litigation.

The *Janus* case arises out of mutual fund "market timing" allegations that emerged in 2003. The case began when the New York Attorney General charged a hedge fund with improper "market timing" trading in certain mutual funds. First Derivative Traders subsequently brought a private action against Janus Capital Management (JCM), as the investment adviser to the Janus mutual funds, as well as its public holding company parent, alleging that they were responsible for purportedly misleading statements in Janus fund prospectuses. First Derivative alleged that the prospectuses misleadingly disclosed that the Janus funds' managers did not permit, and took active measures to prevent, market timing in the Janus funds, when in fact JCM had entered into "secret arrangements to allow several hedge funds to engage in market timing transactions" in the Janus funds.

The district court dismissed the First Derivative complaint. It held that because JCM did not actually prepare the prospectuses or directly make any statement, the complaint only stated a claim for "aiding and abetting" a securities law violation. "Aiding and abetting" is a form of "secondary" liability that cannot be enforced by a private plaintiff since the Supreme Court's decision in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). The U.S. Court of Appeals for the Fourth Circuit reversed. It held that the complaint stated a viable claim for "primary liability" by alleging that by "*participating* in the writing and dissemination of the prospectuses" JCM and its parent effectively *made* the misleading statements in the documents, even though they did not *issue* the prospectuses. The Fourth Circuit also held that the statements could be fairly attributed to JCM under a "substantial participation" theory. Although the statements were not directly attributable to JCM, interested investors "would have inferred that if JCM had not itself written the policies in the Janus fund prospectuses regarding market timing, it must *at least have approved* those statements."

JCM petitioned the Supreme Court to review the Fourth Circuit's ruling. JCM argued that the decision highlighted a split of authority in the Courts of Appeals over the scope of "primary liability" in private securities actions. The Supreme Court indicated its interest in the *Janus* petition in January of this year, when the Court invited the Solicitor General to file a brief expressing the views of the United States. The Solicitor General responded to the Court's invitation by urging the Court to deny the writ of certiorari. According to the Solicitor General's brief, the Fourth Circuit was correct because JCM was not a mere "service provider" to the Janus funds; it was alleged to be responsible for the funds' day-to-day management. According to the Solicitor General, that distinguished JCM from corporate "outsiders" like lawyers or accountants who have been found not to be "primary" actors in securities transactions.

On June 28, 2010, the Supreme Court agreed to review the Fourth Circuit's decision. The Court's recent decisions have generally adopted a narrow view of the scope of the antifraud provision's implied remedy. Whether that narrow view will continue to command a majority of the Supreme Court in *Janus* could have significant implications for many collateral participants in securities transactions—including investment managers, distributors, parent companies, their respective officers and directors, and lawyers and accountants. Among the important questions that the Supreme Court is likely to answer in deciding *Janus* are:

- Whether "primary" liability may be established by "substantial participation" in a securities transaction, or whether "primary" liability requires a false or misleading statement directly attributable to the actor named in a securities suit;
- Whether permitting a plaintiff to plead reliance through "substantial participation" in the preparation of filings is consistent with the Court's prior decisions restricting the availability of "secondary" liability under Rule 10b-5; and
- What degree of attribution or participation is required for collateral participants to be targeted as "primary" players in securities class actions.

The practical import of these questions is significant. Currently, only the SEC or Department of Justice may assert "secondary" liability claims such as "aiding and abetting." But an expansive interpretation of "primary" actors in *Janus* could paint targets on the backs of multiple participants in the process for issuing securities and making periodic disclosures. The *Janus* case has the potential to exponentially increase the volume of securities litigation and vastly expand the number and identity of defendants sued in such cases.

The case is likely to be heard early in the next Supreme Court term, which begins this coming October. A decision can be expected by late 2010 or early 2011.

If you would like to discuss these or any securities law issues, please contact any member of the Ropes & Gray Securities Litigation or Appellate groups, or your usual Ropes & Gray advisor.