

E-ALERT | Securities Enforcement

September 27, 2011

DISTRICT COURTS SPLIT ON SEC END-RUN AROUND SUPREME COURT *JANUS* DECISION

SECONDARY ACTORS MAY STILL FACE SEC ENFORCEMENT ACTIONS FOR OTHERS' MISSTATEMENTS

District court judges in New York and San Francisco recently reached opposite conclusions on the SEC's ongoing attempts to circumvent the Supreme Court's decision this past June in *Janus Capital Group, Inc. v. First Derivative Traders* 131 S. Ct. 2296 (2011). *Janus* sharply restricted the scope of securities fraud liability of investment banks, financial advisors, lawyers, accountants, and other "secondary actors" who merely participate in drafting or distributing false or misleading statements made by others. *Janus* held that, for purposes of civil liability under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5(b), the only party that may be held liable for making a false statement is "the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."¹

Although *Janus* was a private action, it limits the potential sweep of SEC enforcement actions alleging *primary* violations of Section 10(b) and Rule 10b-5(b) for others' misstatements, which can no longer be maintained against secondary actors. Unlike private plaintiffs, however, the SEC can charge secondary actors with aiding and abetting securities fraud. But the SEC has long preferred primary liability claims, because aiding-and-abetting claims require proof of additional elements. Not only must a primary violation (by another person or entity) be established, but the SEC also must show that the aider and abettor (1) had actual knowledge (or, for conduct post-dating the enactment of Dodd-Frank in July 2010, was reckless in not knowing) of the primary violation and of his role in furthering the violation, and (2) substantially assisted the primary violator.

The SEC has advanced two legal theories in an effort to avoid *Janus*'s restriction on primary securities fraud liability, without subjecting itself to the extra burdens of proving aiding-and-abetting liability. First, it has argued that *Janus* does not apply to claims alleging fraud in the sale of securities under Section 17(a) of the Securities Act of 1933. And second, it has tried to recast fraudulent misstatement claims as fraudulent "schemes" under subsections (a) and (c) of Rule 10b-5, which the Supreme Court did not discuss in *Janus*.

Both theories were rejected in a September 22 decision in the Southern District of New York. In *SEC v. Kelly*, No. 08-CV-4612 (CM), 2011 WL 4431161, Judge Colleen McMahon reasoned that, although *Janus* did not address Section 17(a)(2), numerous courts have held that the elements of a Section 17(a)(2) claim are essentially the same as those for a Rule 10b-5(b) claim.² Thus, she ruled, "it would be inconsistent for *Janus* to require that a defendant have made the misleading statement to be liable" under one, but not the other.³ Judge McMahon also rejected the SEC's theory that the defendant engaged in a fraudulent scheme based upon an alleged false statement that "the

defendant did not ‘make’.” She noted that permitting such a claim “would render the rule announced in *Janus* meaningless.”⁴

In sharp contrast, last month, in *SEC v. Daifotis*, No. C 11-00137 WHA, 2011 WL 3295139 (N.D. Cal. Aug. 1, 2011), Judge William Alsup of the Northern District of California gave the green light to the SEC’s use of Section 17(a)(2) to escape *Janus*’s strictures. He noted that the Supreme Court’s holding in *Janus* derived from its interpretation of the word “make” in Section 10(b) and Rule 10b-5(b), and found that that word is “absent from the operative language of Section 17(a).”⁵ Judge Alsup further held that *Janus*’s “stringent reading of the word ‘make’ followed from the Court’s prior decisions limiting the scope of implied rights of action under Rule 10b-5”—a rationale that he concluded does not apply to 17(a) since there is no private right of action under that statute.⁶

Judge Alsup’s ruling runs counter to the common understanding that Section 17(a)(2), Section 10(b), and Rule 10b-5(b) are coextensive, as each prohibits making a material misstatement. Judge McMahon’s ruling is consistent with this long-standing jurisprudence and also upholds the clear distinction between primary and secondary liability that the Supreme Court drew in *Janus*. Until the appellate courts weigh in, individuals and entities who participate in drafting or distributing statements made by others remain vulnerable to potential SEC enforcement actions alleging broad theories of primary securities fraud liability.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our securities enforcement practice group:

Tammy Albárran
David Bayless
David Kornblau

415.591.7066
415.591.7005
212.841.1084

talbarran@cov.com
dbayless@cov.com
dkornblau@cov.com

This information is not intended as legal advice. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

Covington & Burling LLP, an international law firm, provides corporate, litigation and regulatory expertise to enable clients to achieve their goals. This communication is intended to bring relevant developments to our clients and other interested colleagues. Please send an email to unsubscribe@cov.com if you do not wish to receive future emails or electronic alerts.

© 2011 Covington & Burling LLP, One Front Street, San Francisco, CA 94111-5356. All rights reserved.

¹ *Janus*, 131 S. Ct. at 2302.

² *Kelly*, at *5 (citations and internal quotation marks omitted).

³ *Id.*

⁴ *Id.*, at *4.

⁵ *Daifotis*, 2011 WL 3295139, at *5.

⁶ *Id.*, at *6.