THE WHITTLING AWAY OF THE PRIVATE RIGHT OF ACTION UNDER RULE 10B-5: THE PSLRA, JANUS, AND THE FINANCIAL CRISIS

JAMIE HEINE†

Private plaintiffs face an uphill battle in pleading and proving securities fraud claims under Rule 10b-5.1 The Private Securities Litigation Reform Act of 19952 ("PSLRA") imposed heightened pleading standards on private plaintiffs bringing securities fraud cases. In the midst of a massive financial crisis that has engendered much public belief of widespread fraud, the Supreme Court in Janus Capital Group, Inc. v. First Derivative Traders3 continued its campaign to narrow the scope of the private right of action under 10b-5. The recent financial crisis highlights new challenges for plaintiffs in securities fraud actions and opportunities for defendants to shift the blame for plaintiffs' losses to someone else. This article examines the recent history of the private right to action under Rule 10b-5 and whether it serves its purpose of protecting investors. This article argues that the private right to action has been whittled away by Congress, the Supreme Court, and now the financial crisis, leaving investors ill protected.

I. INTRODUCTION

In March 2009, Bernie Madoff pled guilty to a sixty-five billion dollar Ponzi scheme, the largest in United States history.4 In June 2012, R. Allen Stanford was convicted of a seven billion dollar Ponzi scheme.5 In the second half of 2007, securities litigation spiked due to the financial crisis.6 Of the 100 securities class action filings in the

† J.D., University of Southern California, Gould School of Law 2013; B.A., University of California, Berkeley 2010.
latter half of 2007, nearly a quarter related to subprime mortgages.\textsuperscript{7} A similar trend continued into the first half of 2008.\textsuperscript{8} While the recent financial crisis highlights fraud in mortgages, lending, and complex financial products, examples of other types of securities fraud abound. In 2006, Nortel Networks settled for 2.4 billion dollars for securities fraud claims brought by former shareholders alleging that Nortel falsified accounting entries after the Internet bubble burst.\textsuperscript{9} Shareholders settled similar claims with AOL Time Warner for 2.5 billion dollars in 2005.\textsuperscript{10} Also in 2005, World Com shareholders settled for 6.2 billion dollars for claims that the company improperly classified expenses and inflated its revenue.\textsuperscript{11} No one can forget the Enron scandal, where Enron concealed losses by its special purpose entities and which the company settled for 7.2 billion dollars.\textsuperscript{12}

Securities fraud occurs when someone misrepresents material information concerning a security to investors, who rely on that information in purchasing or selling that security and suffer a loss due to the misrepresentation. Private plaintiffs have a private right of action against securities fraud under Section 10(b)\textsuperscript{13} of the Securities Exchange Act of 1934\textsuperscript{14} ("Exchange Act") and Securities and Exchange Commission ("SEC") Rule 10b-5\textsuperscript{15} thereunder. While not explicitly provided by statute, the judiciary has long read the private right of action into Section 10(b). This right of action allows private individuals to sue and recover for securities fraud. The private right of action has historically been read to be broad, but recent Supreme Court jurisprudence and Congressional legislation have significantly narrowed that right. This article describes the narrowing of this right and argues that the whittling away of the private right of action by Congress and the Supreme Court has resulted in an anti-fraud framework that does not adequately protect investors, one of the main purposes of such provisions in federal securities laws. In addition, the whittling away of this right has occurred in the midst of one of the greatest financial crises in history, at a time when an expansive right of action is necessary to protect investors. The financial crisis has also exposed

\textsuperscript{7} Id.


\textsuperscript{10} Id.

\textsuperscript{11} Id.

\textsuperscript{12} Id.


\textsuperscript{15} 17 C.F.R. § 240.10b-5 (2006).
additional weaknesses in the ability of plaintiffs to plead and prove securities fraud, a weakness on which defendants in securities fraud cases emerging from the financial crisis have preyed. Part II of this article describes the private right of action against securities fraud under Rule 10b-5 and the elements of this claim. Part III discusses Congressional action constraining the private right of action, focusing on the Private Securities Litigation Reform Act of 1995 (“PSLRA”) that raised pleading standards for private plaintiffs in securities fraud cases. Part IV discusses the Supreme Court’s narrowing of the private right of action over time, focusing on the notable recent case of Janus Capital Group, Inc. v. First Derivative Traders. Part V argues that the financial crisis has made it even more difficult for plaintiffs to prove loss causation and scienter in securities fraud claims arising out of activities during or leading up to the financial crisis. Part VI assesses the theories for limiting private enforcement of securities fraud and analyzes the future landscape of the private right of action, given the financial crisis, Congressional refusal to expand the private right of action, and lower courts’ interpretations of Janus. Part VI also argues that the current form of the private right of action does not sufficiently protect investors. Part VII concludes.

II. THE PRIVATE RIGHT OF ACTION AGAINST SECURITIES FRAUD UNDER RULE 10B-5

In response to the stock market crash of 1929 and the Great Depression, Congress enacted the Securities Act of 1933 (“Securities Act”) and the Securities Exchange Act of 1934 (“Exchange Act”). Together these laws comprise the primary framework of federal securities regulation in the United States. The main remedy for investors injured by violations of these statutes is Section 10(b) of the Exchange Act and the corresponding Securities and Exchange Commission

16. See infra notes 23-87 and accompanying text.
18. See infra notes 88-110 and accompanying text.
19. 131 S. Ct. 2296 (2011); see infra notes 111-226 and accompanying text.
20. See infra notes 227-65 and accompanying text.
21. See infra notes 266-348 and accompanying text.
22. See infra notes 266-348 and accompanying text.
26. Id.
("SEC") Rule 10b-5,\textsuperscript{28} prohibiting material misrepresentations or omissions and other fraudulent behavior in connection with a securities transaction.\textsuperscript{29} Shortly after Rule 10b-5's adoption, the United States District Court for the Eastern District of Pennsylvania found an implied private right of action in Rule 10b-5 that stemmed from tort principles and the intent of the Exchange Act "to regulate securities transactions of all kinds and . . . eliminate . . . all manipulative or deceptive methods in [securities] transactions.\textsuperscript{30} The Supreme Court's confirmation of this right followed in \textit{Superintendent of Insurance v. Bankers Life \& Casualty Co.},\textsuperscript{31} where the Court held that Section 10(b) and Rule 10b-5 must be interpreted flexibly.\textsuperscript{32} Thus, private parties have an established right of action under Rule 10b-5 and Section 10(b).\textsuperscript{33} Generally, the rationale for the creation and protection of this private right of action is what the courts have interpreted as Congress's intent to maximize enforcement of federal securities laws.\textsuperscript{34} Investors have used this implied private cause of action to sue both the parties who committed the fraud (the primary actors) and the parties who assisted in the fraud (the secondary actors).\textsuperscript{35} The Supreme Court has held that Rule 10b-5 "should be construed not technically and restrictively, but flexibly to effectuate its remedial purpose" and that the Court has "long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the [SEC].\textsuperscript{36}

A. \textbf{Primary Liability Under Section 10(b) and Rule 10b-5}

Under Section 10(b) of the Securities Exchange Act of 1934, one may not:

\textsuperscript{28} 17 C.F.R. § 240.10b-5 (2006).
\textsuperscript{29} GAO Report, supra note 25, at 3.
\textsuperscript{31} 404 U.S. 6 (1971).
\textsuperscript{32} St. Clair, supra note 30, at 389 (citing \textit{Superintendent of Ins. of N.Y. v. Bankers Life \& Cas. Co.}, 404 U.S. 6, 9-10, 12, 13 n.9 (1971)).
\textsuperscript{33} \textit{Superintendent of Ins. of N.Y.}, 404 U.S. at 13 n.9 (upheld by Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 165 (2008)).
\textsuperscript{34} GAO Report, supra note 25, at 3-4.
\textsuperscript{35} Id.
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 . . . in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.37

This language was clarified by Rule 10b-5 and subsequent court cases.38 Rule 10b-5 provides that the manipulative or deceptive act under Section 10(b) may be employing “any device, scheme or artifice to defraud,” making “any untrue statement of material fact” or omitting “to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading,” or engaging “in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.”39

Section 10(b) securities fraud plaintiffs must prove: (1) a material misrepresentation or omission; (2) scienter; (3) a connection to the sale or purchase of a security; (4) reliance; (5) damages; and (6) loss causation.40 These elements are described in detail below.

1. Material Misrepresentation or Omission

A plaintiff in a Rule 10b-5 action must prove that the defendant made a material misrepresentation.41 A misrepresentation can occur either by an affirmative misleading statement or an omission. The Supreme Court noted in a footnote in Basic, Inc. v. Levinson42 that if the misrepresentation occurs by omission, the omission is only fraudulent if there was a duty to disclose the omitted information.43 However, where a defendant makes disclosures, these disclosures must be complete and accurate.44 This means that, where a defendant discloses the risks involved in an investment, boilerplate or generic dis-

39. 17 C.F.R. § 240.10b-5.
41. See 17 C.F.R. § 240.10b-5.
closures will not suffice. Where the statement at issue is an opinion, such a statement may be an actionable misrepresentation if the statement did not reflect its speaker's actual opinion and the statement was in fact wrong. A misrepresentation or omission is material if it is substantially likely that a reasonable investor or shareholder would have found the information important to their decision to invest or vote. Where the information would have affected the price of the company's stock, the information is generally considered material. In *Central Bank of Denver v. First Interstate Bank of Denver*, the Supreme Court held that private plaintiffs could not bring cases for aiding and abetting misrepresentations or omissions. This means that private plaintiffs could only bring cases for primary violations of Rule 10b-5. However, this did not constrain the range of potential defendants that plaintiffs could charge with primary liability under Rule 10b-5.

2. *Scienter*

A plaintiff in securities fraud cases must prove that the defendant acted with the requisite scienter, for which negligence will not suffice. Instead, the defendant must have acted with intent to manipulate or deceive. Many circuit courts hold that recklessness is sufficient to meet this standard, although the Supreme Court has not confirmed this. Recklessness generally means that the defendant deliberately disregarded a risk of misleading investors, which he either knew or should have known. Courts are split on the degree of recklessness necessary to satisfy this element. In addition to recklessness, a plaintiff can prove scienter by proving that the defendant acted knowingly, meaning that the defendant knew or consciously dis-
regarded the fact that the plaintiff's loss was reasonably certain to result from his conduct.\textsuperscript{56}

3. \textit{Connection with the Purchase or Sale of a Security}

Plaintiffs must prove that the fraud occurred in connection with a securities transaction. Plaintiffs can satisfy this element by showing that the deceptive practice, misrepresentation, or omission "touche upon" the purchase or sale of a security.\textsuperscript{57} Most any transaction involving a security will do so and the transaction does not need to take place on an exchange.\textsuperscript{58} Where a misrepresentation or omission leads someone to not buy or not sell a security, there is no liability. For private actions, only the actual purchaser or seller of a security may recover under Rule 10b-5.\textsuperscript{59} This is often referred to as the "nexus" element.\textsuperscript{60}

4. \textit{Reliance}

Private plaintiffs must prove that they relied upon the material misrepresentation in purchasing or selling the security.\textsuperscript{61} Under the "fraud-on-the-market" theory, plaintiffs have a rebuttable presumption of reliance on misstatements and omissions, which "alleviates what would otherwise be an ‘unrealistic evidentiary burden’ imposed on investors who allege claims based on [Section] 10(b) and Rule 10b-5."\textsuperscript{62} This theory posits that reliance can be presumed where the misrepresentation is public because, at least in an efficient market, securities prices will reflect publicly available information.\textsuperscript{63} A defendant can rebut this presumption of reliance by showing that the misrepresentation did not cause a change in the security's price or that the plaintiff would have purchased or sold the security anyway.\textsuperscript{64} Where the cause of action is based on a defendant's deceptive device or practice, the plaintiff is not required to prove reliance.\textsuperscript{65} Additionally, reliance is presumed where the defendant failed to perform his duty to

\textsuperscript{56} Id.
\textsuperscript{58} Bankers Life & Cas. Co., 404 U.S. at 10.
\textsuperscript{59} Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2d Cir. 1952).
\textsuperscript{60} GAO Report, supra note 25, at 8.
\textsuperscript{61} See Dura Pharm., 544 U.S. at 341.
\textsuperscript{62} Pekarek & Shingle, supra note 36, at 3 (quoting Basic Inc., 485 U.S. at 225 (adopting a presumption of reliance where market is efficient)).
\textsuperscript{63} Basic, Inc., 485 U.S. at 247.
\textsuperscript{64} Id. at 248.
\textsuperscript{65} See 17 C.F.R. § 240.10b-5.
disclose material information, in other words, where the defendant omitted material information that he had a duty to disclose. 66

5. Loss

Plaintiffs must also prove that they incurred a loss and their recovery is limited to that amount. 67 The loss must be an actual economic loss, meaning that a plaintiff cannot allege a loss by claiming that the price of the security was inflated at the time of purchase. 68

6. Loss Causation

A plaintiff is required to prove that the misrepresentation or omission caused his loss. 69 To prove loss causation, a plaintiff must show that he would not have incurred the claimed loss “but for” the defendant’s fraudulent conduct. 70 Plaintiffs must also prove that the misrepresentation or omission foreseeably or proximately led to the claimed loss. 71 The longer the time that has elapsed since the alleged misrepresentation, the less likely the misrepresentation caused the loss. 72 While still unclear, it is possible that the plaintiff’s burden of proving causation includes negating extraneous events as the cause of the loss. 73

B. Secondary Liability Under Section 10(b) and Rule 10b-5

Secondary actors are generally those who assist in securities transactions, such as attorneys, accountants, underwriters, and credit rating agencies. 74 Many of these actors have been termed “gatekeepers” because of their role as intermediaries that verify the accuracy of corporate disclosures and their ability to stop fraudulent disclosures. 75 These actors may be responsible for aiding and abetting primary Rule 10b-5 violations.

Section 10(b) and Rule 10b-5 do not explicitly confer a private right of action for aiding and abetting liability, although historically

---

68. Heminway, supra note 51, at 391.
70. Heminway, supra note 51, at 391.
71. See AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 216-17 (2d Cir. 2000).
72. Dura Pharm., 544 U.S. at 343.
74. GAO Report, supra note 25, at 4.
75. Id.
courts have recognized such an action. To prove aiding and abetting liability, a plaintiff must prove: (1) the existence of a securities law violation by the primary (as opposed to the aiding and abetting) party; (2) 'knowledge' of this violation on the part of the aider and abettor; and (3) 'substantial assistance' by the aider and abettor in the achievement of the primary violation. For the first element as it relates to Section 10(b), there must be a Section 10(b) and Rule 10b-5 violation committed by a primary actor. The second element, knowledge of the violation, can be satisfied by actual knowledge or, in some courts, constructive knowledge. Most courts hold that this constructive knowledge can be satisfied by recklessness where the aider and abettor had a duty to the plaintiff. To prove substantial assistance, plaintiffs must prove that the aider and abettor's actions or inactions "were a substantial, proximate causal factor of the primary violation and loss." However, in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., the Supreme Court eliminated the private right of action for aiding and abetting liability and now only the government may pursue a violation of Rule 10b-5 under this theory. The Court has reaffirmed this decision in two subsequent cases, Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc. in 2008 and Janus Capital Group, Inc. v. First Derivative Traders in 2011.

III. THE PRIVATE SECURITIES LITIGATION REFORM ACT ("PSLRA") RAISES PLEADING STANDARDS FOR PRIVATE SECURITIES FRAUD PLAINTIFFS

Prior to 1995, both private plaintiffs and the SEC were obligated to plead securities fraud claims under the Federal Rules of Civil Procedure 8(a) and 9(b). Rule 8(a) establishes general pleading standards

77. This scintor requirement has been amended by the Dodd-Frank Act to "knowingly or recklessly." GAO Report, supra note 25, at 26.
78. Bromberg & Lowenfels, supra note 76, at 662-63 (noting that some courts take a more stringent view and require the aider and abettor to also have knowledge of his role in the fraud).
79. Id. at 670.
80. Id. at 671.
81. Id.
82. Id. at 701.
86. 131 S. Ct. 2296 (2011).
for all claims heard in federal court and Rule 9(b) establishes slightly higher pleading standards for claims sounding in fraud, with the exception of state of mind allegations in those claims. In 1995, Congress enacted the Private Securities Litigation Reform Act ("PSLRA"). The PSLRA creates heightened pleading standards for private plaintiffs, requires proof of loss causation, and automatically stays discovery when a defendant files a motion to dismiss. To meet the high pleading standards of the PSLRA, private plaintiffs must plead facts related to loss causation, scienter, and the falsity of the alleged misrepresentation. Generally, plaintiffs must prove facts concerning the "time, place, and content of the alleged misrepresentations." To sufficiently plead scienter, plaintiffs must plead with particularity "facts giving rise to a strong inference" of scienter. In considering the element of scienter at the motion to dismiss stage, courts will consider the entire complaint and take into account any plausible opposing inferences from the facts pleaded in the complaint. In *Dura Pharmaceuticals Inc. v. Broudo*, the Supreme Court interpreted the PSLRA to require plaintiffs to plead "each misleading statement," "facts giving rise to a strong inference" of scienter, and "that the defendants' misrepresentations 'caused the loss for which the plaintiff seeks to recover.'" The Supreme Court in *Tellabs* later clarified "strong inference" to mean "more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." Although the PSLRA did not explicitly require plaintiffs to plead loss causation with particularity, the Supreme Court read such a standard into the PSLRA in *Dura Pharmaceuticals*. "By stating that a private plaintiff must 'allege and prove' loss causation, the Court altered the plain language of the PSLRA, which states that the plaintiff has the 'burden of proving'

94. *Id.*
95. *Id.*
that the defendant’s conduct ‘caused the loss for which the plaintiff seeks to recover.’”

As a public agency, the SEC is not required to meet the PSLRA’s requirements and is only bound by the pleading standards in Federal Rules of Civil Procedure 8(a) and 9(b). The PSLRA was intended to reduce frivolous class action securities fraud cases, which were perceived to undermine confidence in securities markets. By codifying pleading standards, Congress hoped to keep out many abusive lawsuits and create uniform pleading standards.

The PSLRA also limits the amount that plaintiffs may recover for their losses in securities fraud cases. Under the PSLRA, if the plaintiff bases losses on the market price of the security, damages are limited to the difference between the price the plaintiff paid or received for the security and the security’s average trading price over the ninety-day period after the misrepresentation becomes public. This limitation is based on the “fraud-on-the-market” theory’s presumption that the market incorporates publicly available information into the price of a security. The PSLRA essentially limits recovery to the market value of the misrepresentation, which will be established once the market adjusts the security’s price based on information about the misrepresentation. However, this forces plaintiffs to choose between the benefit of a presumption of reliance and the cost of limited damages under the PSLRA because a plaintiff cannot both argue that the “fraud-on-the-market” theory permits the court to presume reliance and that he is entitled to calculate his losses independent of the price of the security.

In addition to the PSLRA, Congress passed the Securities Litigation Uniform Standards Act (“SLUSA”). SLUSA pushes state law securities class action plaintiffs into federal courts, forcing them to meet the PSLRA’s requirements.

The PSLRA makes the exercise of the private right of action against securities fraud more difficult. It raises pleading standards

---

103. Berens, supra note 102, at 40.
106. Id.
107. Id.
110. See Pekarek & Shingle, supra note 36, at 5 (citing 15 U.S.C. §§ 77p, 78bb(f)).
beyond those provided in the Federal Rules of Civil Procedure. It is a unique constraint on private plaintiffs because its heightened pleading standards do not apply to the Securities and Exchange Commission. Notably, the PSLRA raises the pleading standard for scienter, even though the Federal Rules of Civil Procedure allow state of mind allegations in fraud claims to be pled generally. In addition, the Supreme Court has read loss causation into the PSLRA’s list of elements to which its heightened pleading standards apply, even though the statute itself did not provide for this. The PSLRA deters plaintiffs from filing claims unless the plaintiff’s claims contain sufficient and specific factual matter to support the claim. Unfortunately, given the difficulty of acquiring evidence for complicated securities fraud claims, this can deter otherwise strong suits from being filed or can cause such suits to be thrown out for failure to state a claim.

IV. THE SUPREME COURT NARROWS THE SCOPE OF THE PRIVATE RIGHT OF ACTION UNDER RULE 10B-5

Since the 1970s the Supreme Court has been narrowing the private right of action against securities fraud. While the Supreme Court has long recognized a private right of action under Section 10(b) and had historically interpreted that right broadly, the past several decades represent a new era in Supreme Court securities fraud jurisprudence. The Supreme Court’s rulings have focused largely on secondary liability and secondary actors and the result has been an effective elimination of private plaintiffs’ ability to recover from these actors. The Supreme Court has continued to narrow the private right of action even in the height of the financial crisis’s fallout, where the need for an expansive right of action is at its greatest.

A. THE SUPREME COURT’S DECISION IN JANUS CAPITAL GROUP INC. V. FIRST DERIVATIVE TRADERS

In Janus Capital Group, Inc. v. First Derivative Traders,\(^\text{111}\) the Supreme Court held in a 5-4 decision that private plaintiffs cannot sue an investment adviser and parent capital group for securities fraud where an independent investment fund made the statements that caused the plaintiffs’ losses.\(^\text{112}\) There, investors who lost money when a parent capital group’s stock dropped twenty-five percent due to misrepresentations of its related, but independent, investment fund sued

\(^\text{111}\) 131 S. Ct. 2296 (2011).
the parent capital group and investment adviser of the fund for securities fraud.¹¹³

Janus Capital Group ("JCG") was the parent capital company that created Janus mutual funds.¹¹⁴ Janus Investment Fund was a trust into which the Janus mutual funds were organized.¹¹⁵ Janus Capital Management LLC ("JCM") was Janus Investment Fund's investment adviser and administrator.¹¹⁶ JCM was also the wholly-owned subsidiary of JCG.¹¹⁷ JCG created Janus Investment Fund, but Janus Investment Fund was a completely separate legal entity.¹¹⁸ Janus Investment Fund and JCM were also legally separate, even though all of the officers of Janus Investment Fund were officers of JCM and one Janus Investment Fund board of trustees member was associated with JCM.¹¹⁹

The investors' allegations concerned statements in mutual fund prospectuses issued by Janus Investment Fund.¹²⁰ These prospectuses "represented that the funds were not suitable for market timing and can be read to suggest that JCM would implement policies to curb that practice."¹²¹ In September 2003, the New York Attorney General filed a complaint against JCM and JCG alleging that JCG had secretly agreed to allow market timing in some funds run by JCM.¹²² Investors quickly pulled out of Janus Investment Fund's mutual funds, causing JCG's value to fall because JCM's management fees comprised a significant percentage of JCG's income and the management fees were based on the total value of funds held in Janus Investment Fund.¹²³ Ultimately, JCG's stock price dropped twenty-five percent from September 2, 2003, to September 26, 2003.¹²⁴

Investors who held JCG stock on September 2, 2003 sued JCG and JCM under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder, alleging that JCG and JCM "caused mutual fund prospectuses to be issued for Janus mutual funds and made them available to the investing public, which created the misleading impression that [JCG and JCM] would implement measures to curb mar-

¹¹⁴. *Id.* at 2299.
¹¹⁵. *Id.*
¹¹⁶. *Id.* These services included administrative and management services necessary to operate the Janus Fund. *Id.*
¹¹⁷. *Id.*
¹¹⁸. *Id.*
¹¹⁹. *Id.*
¹²⁰. *Id.* at 2296, 2300.
¹²¹. *Id.* at 2300.
¹²². *Id.*
¹²³. *Id.*
¹²⁴. *Id.*
ket timing in the Janus [mutual funds].” The investors claimed that if they had known this information, JCG’s stock price would have reflected the fact that investors would have been less interested in investing in the company. The investors contended that this was materially misleading and that they relied on JCG’s market price as an accurate reading of its value.

The district court dismissed the case for failure to state a claim. The United States Court of Appeals for the Fourth Circuit reversed, holding that the investors adequately alleged that JCG and JCM made the misleading statements in the prospectuses by “participating in the writing and dissemination of the prospectuses.”

The Supreme Court determined that the investors could not sue JCG and JCM for securities fraud in connection with the misrepresentations in Janus Investment Fund’s prospectuses because JCG and JCM did not “make” the statements in those funds. The Court announced the rule that “the maker of a statement is the entity with authority over the content of the statement and whether and how to communicate it.” The Supreme Court voiced concern over expanding the private right of action, since Congress did not explicitly provide for such a right. The Court also noted that the common meaning of “make” in the phrase “make a statement” is to “state.”

The Court went on to say that the person who makes a statement under Rule 10b-5 is the person “with ultimate authority over the statement, including its content and whether and how to communicate it. Without control, a person or entity can merely suggest what to say, not ‘make’ a statement in its own right.” In support of this argument, the Court cited Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., which held that private plaintiffs may not sue aiders and abettors under Rule 10b-5. The Court also cited Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc. for

125. Id.
126. Id.
127. Id. at 2301.
128. Id.
129. Id.
130. Id. at 2302 (finding the maker of a statement under Rule 10b-5 is the person with “ultimate authority” over the statement).
131. Id. at 2303.
132. Id. at 2301-02 (citing Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 165 (2008) (“[c]onsiders with the judicial creation of a private cause of action caution against its expansion.”)).
133. Id. at 2302.
134. Id.
the proposition that private plaintiffs cannot rely on the statements of a person or entity where “nothing the defendant did made it necessary or inevitable” that the statements would be false.\textsuperscript{138} Thus, the Court found, because JCG and JCM only provided substantial assistance in preparing the prospectuses, but Janus Investment Fund had “ultimate control” over the prospectuses, neither JCG nor JCM “made” the statements therein.\textsuperscript{139}

B. The Supreme Court’s History of Narrowing the Private Right of Action

\textit{Janus Capital Group Inc. v. First Derivative Traders}\textsuperscript{140} is not the first case in which the Supreme Court narrowed the private right of action under Rule 10b-5.\textsuperscript{141} In \textit{Lampf v. Gilbertson},\textsuperscript{142} the Supreme Court imposed a uniform statute of limitations on 10b-5 claims, holding that such claims must be brought within one year of the discovery of a cause of action.\textsuperscript{143} As discussed in Part II above, the Supreme Court in \textit{Central Bank}\textsuperscript{144} eliminated the private right of action for aiding and abetting securities fraud under 10b-5.\textsuperscript{145} There, the Court held that the text of Section 10(b) did not provide for private secondary liability so it is not clear that Congress intended for private plaintiffs to be able to sue aiders and abettors.\textsuperscript{146} The Court in \textit{Central Bank} did not, however, exclude the possibility that private plaintiffs could hold secondary actors liable for primary violations.\textsuperscript{147} But, \textit{Central Bank} did counter many circuit decisions that had recognized aiding and abetting liability in private actions.\textsuperscript{148} In fact, eleven circuits had upheld the private right of action against aiders and abettors of securities fraud.\textsuperscript{149} The SEC Chairman noted in testimony to Congress after \textit{Central Bank} that the decision was likely to interfere with private suits that serve as a “necessary supplement” to SEC enforcement.\textsuperscript{150} In \textit{Stoneridge Investment Partners v. Scientific-
Atlanta, the Supreme Court further restricted private plaintiffs' ability to sue secondary actors by prohibiting plaintiffs from using a "scheme liability" theory to prove reliance in a suit against secondary actors. Under "scheme liability," plaintiffs could hold a secondary actor liable for a primary violation of Rule 10b-5 where their conduct purposefully furthers a scheme to disseminate misrepresentations or material omissions to investors. Further, the Court in *Dura Pharmaceuticals, Inc. v. Broudo* added loss causation to the PSLRA's list of elements that private plaintiffs must plead according to the PSLRA's heightened pleading standards.

In 2011, the Court in *Erica P. John Fund, Inc. v. Halliburton*, found that private plaintiffs in class actions may invoke the fraud-on-the-market presumption at the class certification stage to show that common issues predominate as to loss causation. While seemingly a pro-plaintiff decision, the case merely clarified rather than expanded a presumption already available to plaintiffs in securities fraud. The court's decision essentially reserved loss causation as a question for the jury. In 2014, the case returned to the Supreme Court. The Court determined that *Basic's* reliance presumption applied at the class certification stage, but provided defendants the opportunity to rebut the presumption by showing a lack of price impact, which may ultimately provide another hurdle for private plaintiffs in the early stages of securities fraud litigation. As John Coffee has argued, the *Halliburton II* decision effectively strips the benefits plaintiffs received from the *Halliburton I* decision because "loss causation" and 'price distortion' will be decided at different points by different decision-makers under different legal standards, but involve the same

*Comm. on Banking, Hous., & Urban Affairs, 103rd Cong. 2 (1994) (statement of Arthur Levitt, Chairman, SEC).*

155. See supra Part II.
156. 131 S. Ct. 2179 (2011).
159. *Id.*
160. See *Halliburton Co. v. Erica P. John Fund, Inc. (Halliburton II), 134 S. Ct. 2398 (2014).*
161. See *id; John C. Coffee, Jr., Death by One Thousand Cuts, CLS BLUE SKY BLOG (Jun. 30, 2014), available at http://clsbluesky.law.columbia.edu/2014/06/30/death-by-one-thousand-cuts/ (noting that *Halliburton II* will make class actions more costly for plaintiffs who must respond to defendants' evidence of lack of price impact and that defendants will have an additional chance at an early stage of litigation to have claims against them thrown out).*
Because of the Court's shift toward narrowing the private right of action, some authors have termed the Supreme Court's post-1975 securities fraud jurisprudence the "Contraction Era." The Supreme Court's increasingly narrow interpretation of the private right of action began alongside the era of legislative and judicial deregulation of the financial sector. For instance, in 1978 the Supreme Court began allowing banks to use their home state's usury laws throughout the nation, which led to states significantly reducing their usury rate ceilings. Shortly thereafter, Congress passed legislation deregulating thrift institutions and allowing them to conduct commercial lending. Throughout the 1980s and 1990s, Congress continued to deregulate the financial sector, passing legislation reducing restrictions on interstate banking, increasing the amount of revenue bank holding companies could earn through investment banking, and eventually removing restrictions on affiliations between commercial banks, investment banks, and insurance companies. The Court's narrowing of the private right of action against securities fraud began around the same time. In Blue Chip Stamps v. Manor Drug Stores, Justice Rehnquist noted that private securities fraud actions were a "judicial oak which has grown from little more than a legislative acorn." In Ernst & Ernst v. Hochfelder and Santa Fe Industries v. Green, the Court declined to extend the private right of action to negligent conduct and fraud resulting from a breach of fiduciary duty. In Dura, the Court indicated that the purpose of the private right to action against securities fraud was to "maintain public confidence in the marketplace," not to protect investors. While federal securities fraud liability has expanded in some ways—such as in the realm of insider trading liability—the expansion has diverged from the goal of investor protection. "[W]hat was once the

162. Coffee, supra note 161.
163. E.g., Bromberg & Lowenfels, supra note 76, at 650-51.
165. Id.
166. Id.
171. See Ho, supra note 166, at 178 (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Santa Fe Indus. v. Green, 430 U.S. 462 (1977)).
172. Gillespie, supra note 40, at 170.
173. See Ho, supra note 168, at 185-86.
more conventional use of Rule 10b-5 to deter deceptive and distortive misstatements has been sharply limited, a trend starkly illustrated by the Supreme Court’s decisions in Central Bank, Stoneridge, and Janus. Since the 1970s, Congress and the Court have consistently embarked on a strategy to reduce restraints on businesses, especially in the financial sector. One of the Court’s primary ways of doing so has been through reducing investors’ rights to recover for securities fraud.

C. Does Janus Make Sense?

Janus Capital Group, Inc. v. First Derivative Traders improperly constrained the private right of action under Rule 10b-5. As the dissent points out in Janus:

[n]either common English nor this Court’s earlier cases limit the scope of ... [make] ... to those with ‘ultimate authority’ over a statement's content. To the contrary, both language and case law indicate that, depending upon 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 ultimate content-related responsibility.

The dissent also pointed out that Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A. was not instructive. Unlike Janus, which dealt with primary liability for a Rule 10b-5 violation, Central Bank dealt with secondary liability for those who aid and abet a violation. Thus, the majority was wrong to claim that holding the other way in Janus would undermine the authority of Central Bank, which explicitly said that secondary actors could potentially be liable for primary violations of Rule 10b-5. Similarly, Stoneridge Investment Partners v. Scientific-Atlanta was off-point. As the dissent points out, Stoneridge did hold that the particular secondary actors in that case could not be found liable to private plaintiffs under Rule 10b-5, but not because they did not “make” the statements. Instead, Stoneridge held that these actors did not have a duty to dis-

174. Id. at 186.
175. 131 S. Ct. 2296 (2011).
179. Id. at 2307-08.
180. Id. at 2308.
close their deceptive acts, so the plaintiffs could not reasonably have relied on those acts.\textsuperscript{183} Thus, \textit{Stoneridge} questioned the element of reliance, not whether a statement was made.\textsuperscript{184}

The Court in \textit{Janus} diverged significantly from the SEC's interpretation of its own Rule. The SEC had argued that “make” means “create.” Under that interpretation, private plaintiffs could sue any actor who provides false or misleading information, which another includes in a statement.\textsuperscript{185} In an amicus brief, Professors John P. Freeman and James D. Cox argued that the relationship between the mutual fund and its advisors was so close that the case was actually a cause of action against a primary actor.\textsuperscript{186} Freeman and Cox noted that JCM was in charge of drafting Janus Investment Fund's registration statements and investors would recognize that fact because Janus Investment Fund had no employees.\textsuperscript{187} In addition, JCM itself acknowledged that it was responsible for drafting the prospectuses, but the Court did not find it to have “ultimate authority” over the statements.\textsuperscript{188}

\textit{Janus} contravenes precedent, which allows actors such as JCG and JCM to be liable to private plaintiffs for securities fraud.\textsuperscript{189} For instance, in \textit{Herman & MacLean v. Huddleston},\textsuperscript{190} the Supreme Court noted that individuals who contribute to a registration statement but do not certify the statement could be held liable for primary securities fraud violations.\textsuperscript{191} In \textit{Central Bank}, the Court held that a “lawyer, accountant, or bank, who... 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.”\textsuperscript{192} Lower courts have indeed found actors lacking ultimate authority over a statement primarily liable for 10b-5 violations.\textsuperscript{193} In \textit{Anixter v. Home-Stake Pro-}

\begin{itemize}
\item \textsuperscript{183} Id.
\item \textsuperscript{184} Id.
\item \textsuperscript{185} See Pekarek & Shingle, supra note 36, at 2 (citing \textit{Janus}, 131 S. Ct. at 2303 (citing Brief for United States as Amicus Curiae at 14-15, Janus Capital Grp. v. First Derivative Traders, 131 S. Ct. 2296 (2011) (No. 09-525))).
\item \textsuperscript{186} Brief of John P. Freeman & James D. Cox. as Amici Curiae in Support of Respondent at 5-6, Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011) (No. 09-525).
\item \textsuperscript{187} Id.
\item \textsuperscript{188} St. Clair, supra note 30, at 400 (citing \textit{In re Mutual Funds Inv. Litig.}, 590 F. Supp. 2d 741, 747 (D. Md. 2008)).
\item \textsuperscript{189} \textit{Janus}, 131 S. Ct. at 2311 (Breyer, J., dissenting).
\item \textsuperscript{190} 459 U.S. 375 (1983).
\item \textsuperscript{191} \textit{Janus}, 131 S. Ct. at 2311 (citing \textit{Herman & MacLean v. Huddleston}, 459 U.S. 375, 386 n.22 (1983)).
\item \textsuperscript{192} Id. (citing \textit{Central Bank}, 511 U.S. at 191).
\item \textsuperscript{193} Id.
\end{itemize}
duction Co., the United States Court of Appeals for the Tenth Circuit found that an accountant could face primary liability for making false statements where the accountant issued a fraudulent opinion and certifications reproduced in a company prospectus, annual reports, and other documents, even though the accountant lacked ultimate responsibility for those documents.

D. The Fallout of Janus

The application of Janus Capital Group Inc. v. First Derivative Traders in lower courts indicates that Janus’s effect will be to constrain securities fraud plaintiffs. In SEC v. Kelly, a district court applied Janus to claims brought by the S.E.C. and further narrowed the scope of a Rule 10b-5 action by applying Janus to sub-sections (a) and (c) of 10b-5, not just sub-section (b). In Kelly, the SEC sued two AOL managers under Rule 10b-5 and Section 17(a) of the Securities Act of 1933 for their participation in the “negotiating, structuring, documenting, and approving of allegedly fraudulent round-trip transactions involving AOL [stock] between 2000 and 2003.” The SEC argued that the defendants could not be held liable under the Janus definition of “make” for violations of Rule 10b-5(b), but argued that the defendants could be liable for “scheme liability” under Rule 10b-5(a) and (c). Even though Janus said nothing about liability under subsections (a) and (c) of Rule 10b-5, the district court held that since the defendants did not make the statements under Janus’s standards, the subsection (a) and (c) claims should also be dismissed to avoid allowing “the SEC to allege that the conduct Janus held insufficient to establish primary liability under subsection (b) of Rule 10b-5 is scheme-related conduct that supports primary liability under subsections (a) and (c).” In Reese v. BP Exploration (Alaska) Inc., the United States Court of Appeals for the Ninth Circuit was forced to reverse its precedent in order to adhere to Janus. There, the Ninth Circuit found that BP Exploration (Alaska) (“BPXA”) could not be held primarily liable under 10b-5 because a legally separate trust com-

---

194. 77 F.3d 1215 (10th Cir. 1996).
195. Id. (citing Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1225-27 (10th Cir. 1996)).
200. See Pekarek & Shingle, supra note 36, at 23 (citing Kelly, 817 F. Supp. 2d at 342).
201. Id. at 24 (citing Kelly, 817 F. Supp. 2d at 344).
202. 643 F.3d 681 (9th Cir. 2011).
203. See Pekarek & Shingle, supra note 36, at 29.
pany, BP Prudhoe Bay Royalty Trust, was the entity legally obligated to file the materials in question with the SEC.\textsuperscript{204} The Ninth Circuit held that the trust agreement did not provide BPXA with the "ultimate authority" over the SEC filings and that the plaintiffs did not plead any facts suggesting otherwise.\textsuperscript{205}

Courts have also employed Janus and its predecessors to dismiss defendants who were allegedly involved in a scheme, but the defendants did not affirmatively make or communicate the alleged misrepresentations to plaintiffs. For instance, the United States Court of Appeals for the Second Circuit in Fenzzani v. Bear, Stearns & Co. Inc.\textsuperscript{206} dismissed the defendant, a principal investor in a pump-and-dump scheme, who allegedly furthered the scheme by allowing the broker-dealer to "park" securities in the investor's account in exchange for the broker-dealer's promise to repurchase the securities for a higher price.\textsuperscript{207} The plaintiffs alleged this system created a false impression of trading activity.\textsuperscript{208} Interpreting Janus to require that a defendant must affirmatively communicate the alleged misrepresentations, the Second Circuit found that the plaintiffs had failed to allege that the principal investor actually communicated any misrepresentations to them.\textsuperscript{209} While the dissent argued that Janus permits finding liability where an actor "has engaged in a manipulative transaction that sends a false pricing signal to the market or conveys a misleading impression to the investing public,"\textsuperscript{210} the majority found that Janus permits a finding of liability only where an actor directly communicates a statement.\textsuperscript{211}

Some lower courts have found or hinted that Janus does away with the group pleading doctrine.\textsuperscript{212} In contrast, other courts have

\textsuperscript{204} Id.
\textsuperscript{206} 716 F.3d 18 (2d Cir. 2013).
\textsuperscript{207} See Fenzzani v. Bear, Stearns & Co., Inc. et al., 716 F.3d 18 (2d Cir. 2013).
\textsuperscript{208} Fenzzani, 716 F.3d at 21-22.
\textsuperscript{209} Id. at 25.
\textsuperscript{210} Id. at 28 (Lohier, J., concurring in part and dissenting in part).
\textsuperscript{211} Id. at 23-24.

The group pleading doctrine (GPD) is an exception to the pleading requirement premised on the assumption that in cases of corporate fraud where the false or misleading information is conveyed in prospectuses, registration statements, annual reports, press releases, or other group-published information, it is reasonable to assume that these are the collective actions of the officers.
suggested the group pleading doctrine survives after Janus.\textsuperscript{213} Janus has also been used to defeat claims that an individual's role in a company implies that person has ultimate control over certain statements made by the company.\textsuperscript{214} Certain courts, however, have also found that, with respect to certain documents such as an offering memorandum that signed by executives, "ultimate authority" can be attributed to the executives to establish liability.\textsuperscript{215}

Further, courts have extended Janus to interpret state securities laws. An Iowa district court found Janus instructive and applied it to dismiss claims against defendants brought under the California Corporations Code against an underwriter of securities.\textsuperscript{216} The court reasoned that because the misrepresentations alleged were contained in a private placement memorandum for the securities, the underwriter did not have "ultimate authority."\textsuperscript{217} Other courts, however, have declined to apply Janus to common law fraud claims.\textsuperscript{218}

However, there does appear to be an effort among some lower courts to constrain Janus's effect, which courts have accomplished by

\begin{quote}


\textsuperscript{215} \textit{In re Lehman Bros. Sec. and ERISA Litig.}, 2013 WL 5730020, at *2, n.22 (S.D.N.Y Oct. 22, 2013) (finding that "Defendants undoubtedly had "ultimate authority" over [misstatements and omissions they allegedly certified] as chief executive officer and chief financial officer of a company . . . and the filings were explicitly attributed to the company in the offering memorandum."). (citing \textit{In re Fannie Mae 2008 Sec. Litig.}, 891 F. Supp. 2d 458, 473 (S.D.N.Y. 2012), aff'd, No. 12-3859, 2013 WL 1982534 (2d Cir. May 15, 2013) ("In the post-Janus world, an executive may be held accountable where the executive had ultimate authority over the company's statement; signed the company's statement; ratified and approved the company's statement; or where the statement is attributed to the executive.").


\textsuperscript{217} Hanson, 2014 WL 2434000, at *14.

\end{quote}
distinguishing Janus from cases at hand. For instance, in In re National Century Financial Enterprises Inc.,
private plaintiffs sued Credit Suisse for securities fraud for Credit Suisse’s role in misstatements in private placement memoranda ("PPMs") for bonds that National Century issued. If Janus controlled, only National Century could have "made" the statements since National Century had control over the PPMs. The court determined that Credit Suisse could be liable because "[e]ven if Credit Suisse did not author every word in the PPMs, it did communicate them to investors." In City of Roseville Employees’ Retirement System v. EnergySolutions Inc., plaintiffs sued ENV Holdings for securities fraud concerning statements about an offering in the registration statement of EnergySolutions. ENV Holdings and EnergySolutions had a similar relationship as JCG and Janus Investment Fund, with the same individuals serving as managers in each entity but retaining their status as legally separate. The court permitted ENV Holdings to be sued, despite Janus’s holding, because the registration statements indicated that ENV was EnergySolution’s sole shareholder, giving ENV control over the offering in question.

The Supreme Court has been consistently whittling away the private right of action under Rule 10b-5 since the 1970s. The narrowing of the private right of action began with the Supreme Court’s proposition that this right should be construed narrowly and has grown to eliminate the private right of action against secondary liability. The Supreme Court has severely constrained the private right of action against secondary actors in general.

V. THE FINANCIAL CRISIS EXPOSES THE DIFFICULTIES OF PROVING SECURITIES FRAUD

Many securities fraud lawsuits have been filed against securities issuers following the recent financial crisis. The financial crisis imposes additional difficulties on plaintiffs in these suits by making the elements of scienter and loss causation more difficult to prove. Vari-

221. Id. (citing Nat’l Century, 846 F. Supp. 2d 828).
222. Id.
225. Id. at 29 (citing EnergySolutions, Inc., 814 F. Supp. 2d at 417); Janus, 131 S. Ct. at 2299-300.
ous theories of securities fraud have emerged in these lawsuits and defendants have been able to successfully take advantage of the weaknesses in the private right of action in securities fraud cases arising out of the financial crisis.

Plaintiffs have struggled to prove that a particular defendant’s misrepresentation or omission caused their losses given that the entire financial market suffered losses. Where the alleged “loss coincides with a marketwide phenomenon causing comparable losses to other investors . . . a plaintiffs claim fails when ‘it has not adequately [pled] facts which if proven, would show that its loss was caused by the alleged misstatements as opposed to intervening events.’” 227 Scienter has also proved to be a difficult stumbling block for many securities fraud plaintiffs coming out of the financial crisis. One of the difficulties in proving scienter in cases resulting from the financial crisis is that the securities issuers themselves lost money on the very transactions that are in question. For instance, in In re Merrill Lynch, defendant Merrill Lynch responded to shareholders’ allegations that the company purchased billions of dollars of collateralized debt obligations (“CDOs”) it knew were losing value in order to secure fees on these transactions. As Merrill Lynch argued in its motion to dismiss:

The supposed fraud—involving management’s decision to purchase billions in high-rated CDOs, while they supposedly knew the positions were rapidly deteriorating in value, all in order to increase fees on a business line that contributed, at best, 2% of Merrill’s revenue—would have been economically senseless . . . . 228

Further, it is far from clear that securities issuers fully understood the riskiness of the transactions they structured. Collateralized debt obligations are a prime example of this. CDOs are a type of security where the underlying collateral includes various forms of securitized debt. 229 Typically, there are many different players and institutions involved in gathering, valuing, and structuring the debt underlying the CDOs and the debt goes through several layers of securitization. 230 Because the debt underlying the CDO is so far re-

228. Memorandum of Law, supra note 227, at 38 (quoting Lentell v. Merrill Lynch & Co., Inc., 396 F.3d 161, 174 (2d Cir. 2005)).
230. Id. at 40-42.
moved from the CDO itself, it is difficult for the large financial institutions that structure these products to know exactly what is in them. Especially where these products were based largely on residential mortgages, the issuers of these products may have made the same assumptions about the housing market that other market players did, namely that housing prices would continue to rise and a national housing bubble was impossible. It is entirely possible that the issuers themselves did not fully understand the risk in the CDOs they structured and sold. In addition, the financial crisis makes it difficult for plaintiffs to show intent where CDOs—the transactions largely at the heart of the financial crisis—were sold only to sophisticated investors, which theoretically have the capability to investigate the assets underlying the CDO.

A few plaintiffs have successfully pled intent and survived the motion to dismiss stage. One such plaintiff is Dodona. In Dodona I, LLC v. Goldman Sachs & Co., et al., Dodona successfully pled intent by pleading facts indicating that the CDOs at the heart of the alleged fraud were designed specifically as part of Goldman's strategy to reduce its exposure to the subprime mortgage market by offloading this exposure onto CDO investors. There, Dodona alleged that Goldman Sachs omitted information concerning the riskiness of the assets underlying the CDOs Dodona purchased from Goldman and that Goldman had taken a conflicting long-term position on the CDOs. Goldman Sachs issued a CDO called the Hudson 1 CDO in December 2006 and another CDO called the Hudson 2 CDO in February 2007 and sold both to Dodona. The plaintiffs alleged that Goldman Sachs knew of the risk of subprime mortgages by 2006,


236. See id.
before it structured the Hudson 1 and Hudson 2 CDOs. The plaintiffs alleged that Goldman Sachs learned of this risk through the due diligence it conducted on the mortgages backing the securities it pooled for the Hudson CDOs. The plaintiffs also alleged that Goldman Sachs had decided to minimize its risk in the subprime meltdown by reducing its overall long-term exposure to CDOs backed by subprime mortgages, a strategy Goldman decided to undertake before it originated the Hudson CDOs it sold to Dodona. Another key to Dodona’s success was that it pled facts indicating that Goldman became aware of the subprime meltdown in 2006 and that shortly thereafter Goldman began its program to reduce subprime risk. It is critical for plaintiffs making similar allegations to show when the issuer became aware of the fact that the subprime meltdown was going to seriously affect its CDOs. Plaintiffs will also need to plead facts demonstrating the role of the particular transaction at issue with regards to the issuer’s knowledge of trouble in the subprime market and its risk-reduction scheme.

In In re Citigroup Inc. Securities Litigation, shareholders of Citigroup sued Citigroup under Section 10(b), alleging that Citigroup caused them to purchase their stock at an inflated price due to Citigroup’s misrepresentations of its exposure to CDOs. The shareholders alleged that Citigroup did not disclose its over 45 billion dollar exposure to CDOs (CDOs that Citigroup underwrote) until November 2007, after the market knew that CDOs were likely to decline significantly in value. Specifically, the shareholders alleged that Citigroup had distinguished the CDOs from other “mortgage-related transactions” on its 2007 Form 10-Q filed with the SEC, even though the CDOs were comprised mostly of mortgages. The shareholders also alleged that Citigroup failed to take a write down on these CDOs until November 2007, much later than it should have given the market knowledge of the problems in the CDO market. The shareholders alleged that Citigroup should have been taking such write downs beginning in March 2007. By not taking these write downs, the shareholders alleged, Citigroup effectively overvalued its CDOs.

237. See id. at 19-21.
238. See id. at 27.
239. See id.
242. Id. (citing In re Citigroup Inc. Sec. Litig., 753 F. Supp. 2d at 217).
243. Id. (citing In re Citigroup Inc. Sec. Litig., 753 F. Supp. 2d at 220).
244. Id. (citing In re Citigroup Inc. Sec. Litig., 753 F. Supp. 2d at 222).
245. Id.
which inflated Citigroup’s revenue and led shareholders to invest in Citigroup.246 Additionally, Citigroup knew that the only way the CDOs would maintain their value or grow would be if housing prices continued to rise, which the market knew by March 2007 was no longer a valid assumption.247 These allegations survived Citigroup’s motion to dismiss.248 The court found that the shareholders provided enough statements and omissions to support the allegation that Citigroup indicated it had minimal exposure to CDOs when in fact it had tens of billions of dollars of such exposure.249 Additionally, the court focused on the fact that Citigroup created a duty to disclose its CDO exposure completely and accurately when it made any statements about its CDO exposure.250 The court also focused on scienter, noting that the shareholders satisfied federal pleading standards by alleging that Citigroup tried to minimize its CDO risk, altered the prospectuses of its CDOs to indicate that the problems in the subprime mortgage market were making CDOs riskier investments, and underwrote the CDOs, all of which indicate that Citigroup was aware of the risks in the CDOs.251

Various theories of securities fraud have emerged from the difficulties plaintiffs face in pleading and proving securities fraud coming out of the financial crisis. First, plaintiffs have tried to cast defendants as smart but sleazy.252 Under this type of theory, plaintiffs argue that defendants had full knowledge of the riskiness of the financial products they marketed and sold to investors, but covered that risk up in order to make a profit or reduce their own risk.253 In re Merrill Lynch & Co., Inc. Securities, Derivative, and ERISA Litigation,254 Merrill Lynch shareholders filed an action against Merrill Lynch that demonstrates this theory.255 The shareholders alleged that Merrill Lynch did not disclose its CDO exposure to shareholders until it was forced to take write downs on these CDOs, despite its awareness that mortgage defaults were on the rise.256 In particular, the plaintiffs pointed to Merrill Lynch’s compensation structure that

246. Id. (citing In re Citigroup Inc. Sec. Litig., 753 F. Supp. 2d at 222-23).
247. Id. (citing In re Citigroup Inc. Sec. Litig., 753 F. Supp. 2d at 224-25).
248. Id. (citing In re Citigroup Inc. Sec. Litig., 753 F. Supp. 2d at 234).
249. Id. (citing In re Citigroup Inc. Sec. Litig., 753 F. Supp. 2d at 235).
250. Id.
251. Id. (citing In re Citigroup Inc. Sec. Litig., 753 F. Supp. 2d at 235-37).
253. Id.
256. Id.
allegedly incentivized executives to hide the riskiness of the financial products they originated and sold.\textsuperscript{257} Merrill Lynch settled this case for 475 million dollars in 2009, with Merrill Lynch neither admitting nor denying these allegations.\textsuperscript{258} The plaintiffs in this case painted Merrill Lynch as greedy and corrupt, claiming that Merrill Lynch executives fraudulently covered up the company’s exposure to risky CDOs in order to bring home a higher salary.\textsuperscript{259} The defendants could not have mistakenly underestimated this risk, as the plaintiffs alleged, because Merrill Lynch “knew what those risks were and chose to knowingly or recklessly ignore Merrill’s systems and hide the truth from Merrill’s shareholders.”\textsuperscript{260}

Defendants have capitalized on the difficulties plaintiffs face in pleading and proving securities fraud coming out of the financial crisis. The second theory that has emerged is found largely in motions to dismiss and some court rulings on motions to dismiss. This is the “dumb but decent” theory.\textsuperscript{261} Under this theory, defendants in securities fraud cases (often securities issuers or other large financial companies) “relied on models and historical assumptions about risk and asset prices that turned out to be wrong.”\textsuperscript{262} Merrill Lynch’s motion to dismiss its shareholders’ complaint described above illustrates this theory.\textsuperscript{263} In its motion to dismiss, Merrill Lynch took advantage of the difficulties plaintiffs face in proving loss causation post-financial crisis. Merrill Lynch argued that it was the credit crisis that caused plaintiffs’ losses.\textsuperscript{264} Merrill Lynch also preyed on plaintiffs’ difficulties in proving scienter and, in doing so, subtly shifted the blame from itself to its regulators and the market as a whole. For instance, Merrill Lynch argued that “Merrill, like its peers and the market regulators, simply failed to predict the severity of the downturn and, in hindsight, Merrill’s risk management procedures were unable to pre-

\textsuperscript{257} Id. (citing Merrill Lynch Shareholders Complaint, supra note 255, at 30).
\textsuperscript{259} Id.
\textsuperscript{260} Id. (quoting Merrill Lynch Shareholders Complaint, supra note 255, at 39).
\textsuperscript{261} Id. (citing Brooks, supra note 252).
\textsuperscript{262} Id.
\textsuperscript{263} Id.
vent losses when a literally worst case scenario actually materialized."

The private right of action against securities fraud that occurred during or leading up to the financial crisis has been significantly weakened due to the financial crisis itself. The financial crisis makes it much more difficult to prove loss causation and scienter. While numerous securities fraud lawsuits arising from the financial crisis have been filed, few have survived the motion to dismiss stage due to the unique hurdles the financial crisis creates for plaintiffs. Ironically, while many believe that greed, corruption, and fraud plagued the financial sector and that this contributed to the financial crisis, it is more difficult than ever to paint defendants in that light and to successfully prove securities fraud cases. Defendants were quick to recognize this difficulty and capitalize on it in motions to dismiss. The difficulties in proving securities fraud claims arising from the financial crisis prevent private plaintiffs from holding defendants accountable for their actions that contributed to the financial crisis. By not being able to succeed in these claims and hold defendants accountable, large financial corporations can shift the blame for the financial crisis off themselves and onto their peer institutions and financial regulators.

VI. DOES THE CURRENT 10B-5 FRAMEWORK SUFFICIENTLY PROTECT INVESTORS?

The Supreme Court’s rulings in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*266 *Stoneridge Investment Partners v. Scientific-Atlanta,*267 and *Janus Capital Group Inc. v. First Derivative Traders,*268 Congress’s approval of higher pleading standards in the Private Securities Litigation Reform Act (“PSLRA”),269 and the impediments to proving intent and loss causation spawning from the financial crisis collectively structure the current Rule 10b-5 framework. Private plaintiffs may sue to recover against fraudsters, but may only sue those who “make” a statement (essentially, primary actors) for primary violations of Rule 10b-5. In exercising this narrowed right, plaintiffs are further constrained by the heightened pleading standards of the PSLRA and, in cases arising out of the financial crisis, the barriers the crisis poses to proving two of the most difficult elements generally to establish in securities fraud cases. The private

265. *Id.* (quoting *Merrill Lynch Motion to Dismiss*, supra note 264, at 9-10).
266. 511 U.S. 164 (1994).
right of action must also be understood in light of the broader federal securities fraud framework, in which the SEC has very broad enforcement powers and individuals have other avenues (such as common law fraud, negligent misrepresentation, and unjust enrichment)\textsuperscript{270} through which to pursue fraudsters.

One of the main goals of anti-fraud provisions in securities law is investor protection.\textsuperscript{271} A Senate Report accompanying the passage of the Securities Act\textsuperscript{272} and Securities Exchange Act\textsuperscript{273} explained that "[t]he purpose of this bill is to protect the investing public... The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation..."\textsuperscript{274} The goal of investor protection entails deterring fraudulent behavior that disrupts incentives in the securities market, maintaining fairness and openness of the securities market, and providing a platform for recovery for investors who are wronged. The narrowing of the private right of action by the Supreme Court, the high burdens imposed by Congress in the PSLRA, and the new impediments to proving these claims brought on by the financial crisis beg the question—does the current 10b-5 framework sufficiently protect investors?

The answer is a resounding no: the current 10b-5 framework does not meet its goal of protecting investors. Private plaintiffs have a very narrow right to enforce securities fraud laws, leaving it up to the SEC to wield its broader enforcement powers against fraudsters. Even if the SEC’s enforcement authority could bridge this gap, its authority has been significantly constrained by decisions questioning its settlement strategies.

A. PRIVATE VS. PUBLIC ENFORCEMENT: WHY THE PREFERENCE FOR PUBLIC ENFORCEMENT OF FEDERAL SECURITIES LAWS?

The whittling away of the private right of action under Rule 10b-5 by the Supreme Court and Congress prompts an inquiry into why public enforcement appears to be strongly preferred to private enforce-


\textsuperscript{274} 77 Cong. Rec. 2983 (1933).
ment of federal securities laws. There are strong arguments as to why private enforcement of federal securities laws is not needed, less desirable than public enforcement, or plainly harmful. As Amanda Rose argues, one reason why private enforcement may be less desirable than public enforcement is that it is difficult to achieve a deterrence equilibrium under a private enforcement regime.275

If overdeterrence appears to be a problem, for example, the public enforcer can adjust by ratcheting down the enforcement level; conversely, if underdeterrence appears to be a problem, the public enforcer can ratchet it up. With private enforcement, by contrast, adjustment of the enforcement level would require altering the incentives held out to private enforcers—i.e., alterations of the sanction (or, in lawyer-driven litigation, the law governing the award of attorneys' fees). This may be considerably more difficult to accomplish, at least in time to respond effectively to changed circumstences.276

Rose also argues that public enforcers can adjust their "enforcement priorities" to better target conduct intended to be proscribed by 10b-5.277 "Whereas the Commission might exercise its discretion and choose not to sanction a corporation for its agent's violation when it has taken appropriate care, or when the challenged disclosure or omission presents a close question on liability, private enforcers lack the incentive to exercise similar restraint."278 Yet, as Rose points out, his preference for SEC enforcement of Rule 10b-5 over private enforcement assumes that over-deterrence is bad and that there are no other advantages to private enforcement that outweigh the advantages of public enforcement.279 Rose also argues that the PSLRA's

276. Id.
277. See id. (noting such adjustment could be used to manage overbroad laws).
278. Id. at 1334.
279. Id. at 1331. Rose argues that these assumptions are valid in the context of Rule 10b-5 because Congress delegated enforcement authority to the SEC under Section 10(b) and the SEC's Rule 10b-5 is very broad, capturing more violators than Congress likely intended, but the SEC can more easily adapt its enforcement to those violators the rule was intended to target. Id. at 1332. For instance, Rose notes:

[T]he rule necessarily also captures cases where a corporation has taken appropriate care. After all, a corporation's failure to prevent a Rule 10b-5 violation may or may not, in a particular case, be the result of negligent oversight. Indeed, it may be extremely difficult for a board of directors to detect or prevent an officer's fraud, and the threat of massive class damages may prompt and unreasonably large investment in precautions that, at the end of the day, costs society more than it saves. Similarly, ambiguities in the legal standard mean that corporate officers may find it difficult to comply despite the best of intentions. The threat of liability may cause them to omit to disclose information that would benefit society (for fear that its disclosure will be deemed materially
heightened pleading standards, as well as the Supreme Court’s decisions in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* 280 and *Stoneridge Investment Partners v. Scientific-Atlanta,*281 represent Congress and the Court’s attempt to curtail private lawsuits that create a net social loss by incentivizing “excessive investment in precautions” compared to the social benefit of these suits.282

B. **The Current 10b-5 Framework Does Not Protect Investors**

Private plaintiffs currently have a right of action against securities fraud that has been significantly diminished in scope and made difficult to win in practice. As it stands, this right does not sufficiently protect investors.

1. **Investors Have No Recourse Against Secondary Actors and Limited Recourse Against Primary Actors**

Private plaintiffs can no longer pursue aiders and abettors of securities fraud under 10b-5, even though aiding and abetting liability has historically been an important component in the securities regulation framework. Courts have long recognized private actions for aider and abettor liability.283 The Court in *Janus Capital Group Inc. v. First Derivative Traders*284 whittles away the right of action under Rule 10b-5. Before *Janus*, anyone who “was sufficiently responsible for the statement—in effect, caused the statement to be made—and knew, or had reason to know, the statement would be disseminated to investors,” could be liable for a primary 10b-5 violation.285 “Unfortunately for defrauded investors, *Janus* represents further Supreme Court restriction on the right of private litigants to recover under Rule 10b-5.”286

There are situations in which *Janus* would prevent a private plaintiff from holding anyone liable for securities fraud. As the dissent in *Janus* rightly points out, one of these such instances is when management writes a prospectus for the board that contains materi-

---

282. Rose, supra note 275, at 1335.
283. See Ho, supra note 168, at 177.
285. See Pekarek & Shingle, supra note 36, at 29 (citing SEC v. KPMG, 412 F. Supp. 2d 349, 375 (S.D.N.Y. 2006)).
ally false statements. Management knows the statements are false, but the board and the public are blind to it.\textsuperscript{287} 

[U]ncrulpulous managers now have effective license to prepare prevaricating prospectuses and other misleading communications containing misrepresentations of material fact which, by design, may dupe the investing public, while the fabulist profits wildly and escapes securities fraud liability because the clever con cannot be found to have ‘made’ the materially false statement, due to the new \textit{Janus} doctrine.\textsuperscript{288} 

Intermediaries such as lawyers, accountants, or other advisers could also escape liability under \textit{Janus} even if they draft misleading statements, so long as their clients have ultimate control over them.\textsuperscript{289} \textit{Janus}'s result could well be “a manufactured loophole the likes of which the legislature had no apparent intention of creating” that “may have ushered in an era of agency capitalism where accountability for wrongdoing may become an endangered species.”\textsuperscript{290} 

2. \textit{The Financial Crisis Demonstrates the Ways in Which the Current 10b-5 Framework Fails to Protect Investors}

The financial crisis has exposed a significant weakness in the ability of federal securities laws to protect investors from fraud. In the midst of one of the worst financial crises in global history, where there is widespread belief that the financial markets were wrought with fraud, investors are left with an incredibly weak framework for enforcing their rights and recovering for such fraud. This is made worse by the fact that the nature of this financial crisis further impedes the ability to plead and prove two of the trickiest elements of a securities fraud claim arising out of the crisis: scienter and loss causation. At a time of financial turmoil when the private right of action against securities fraud is needed more than ever, that right is at its weakest in the history of federal securities laws.

The financial crisis engendered a widely-held belief of systematic defrauding of investors that contributed to the massive losses faced by investors and the public. “Wall Street” had become “Fraud Street,” full of “mustache-twirling villains” like the Fabulous Fab.\textsuperscript{291} Much of the public believed that greed and corruption prevailed in the finan-

\begin{itemize}
  \item \textsuperscript{287} Janus Capital Grp. v. First Derivative Traders, 131 S. Ct. at 2296, 2310 (2011) (Breyer, J., dissenting).
  \item \textsuperscript{288} See Pekarek & Shingle, supra note 36, at 13-14 (citing \textit{Janus}, 131 S. Ct. at 2310).
  \item \textsuperscript{289} \textit{Id.} at 14 (citations omitted).
  \item \textsuperscript{290} \textit{Id.} (citations omitted).
  \item \textsuperscript{291} Ben Steverman & David Bogoslaw, \textit{The Financial Crisis Blame Game}, BLOOMBERG BUSINESSWEEK (Oct. 18, 2008), http://www.businessweek.com/investor/content/ oct2008/pi20081017_956382.htm. “Fabulous Fab” refers to Fabrice Tourre, a Goldman
\end{itemize}
cial market. Accompanying this belief was the demand that someone be blamed and held accountable, as demonstrated by everything from politicians' speeches\textsuperscript{292} to the Occupy Movement\textsuperscript{293} to the sheer number of securities fraud lawsuits filed post-financial crisis.\textsuperscript{294} Despite this widespread belief, it is incredibly difficult for plaintiffs to hold defendants accountable for actions that contributed to plaintiffs' losses and to the financial crisis as a whole. A stronger right of action under Rule 10b-5 would ease these difficulties and allow plaintiffs to recover for some of their losses incurred during the financial crisis. Additionally, a stronger private right of action would provide the social benefit of holding defendants accountable for their contribution to the financial crisis and provide better incentives to prevent a similar crisis from occurring in the future. Instead, the weak private right of action allows defendants to shift the blame for investors' losses off themselves and onto market regulators who failed to properly police the market, peer institutions that must have been the ones acting fraudulently, or investors that just failed to do their due diligence. The weak private right of action is just part of the incredibly business-friendly legal environment created by Congress and the Supreme Court beginning in the 1970s. This environment encourages businesses to take on huge risks, since they are not accountable to investors. Investors lack sufficient protection against these risks and sufficient recourse against fraudulent business practices. The financial crisis highlights the disastrous effects of such a lax environment and the need for stronger investor protections.

3. Neither the SEC's Broad Enforcement Authority nor Other Securities Law Provisions Available to Private Plaintiffs Offer a Substitute that Effectively Protects Investors and the Future Landscape of Securities Fraud Enforcement Is Uncertain

Where private plaintiffs lack the right to bring an action or are unable to successfully bring an action against securities fraud, the SEC is the public agency with broad authority to bring such actions. While the SEC has effectively been charged with filling the holes left

\textsuperscript{294} See 2007: A Year in Review, \textit{supra} note 6, at 2; 2008 Mid-Year Assessment, \textit{supra} note 8, at 2.
by the whittled down private right of action under Rule 10b-5, the financial crisis poses new hurdles for the SEC as well. The SEC faces the same difficulties in proving scienter and loss causation after the financial crisis that private plaintiffs do. As a result, the SEC files some of its cases under Section 17(a) of the Securities Act, rather than under Section 10(b). Section 17(a) provides:

> It shall be unlawful for any person in the offer or sale of any securities (including security-based swaps) or any security-based swap agreement . . . by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser. 295

Section 17(a)296 is very similar to Section 10(b),297 but Section 17(a) is essentially an action for negligence.298 Most courts find that Section 17(a) is only available to the SEC, not private plaintiffs.299 Because Section 17(a) sounds in negligence, rather than intentional fraud, it is a much weaker enforcement mechanism. This means that, largely due to the effects of the financial crisis on pleading and proving scienter under Section 10(b) and Rule 10b-5, the SEC has often made a strategic choice to pursue defendants under Section 17’s lower scienter requirements. For example, in SEC v. Citigroup Global Markets Inc.,300 the SEC sued Citigroup under Section 17(a) for Citigroup’s negligent misrepresentations of the key terms of a 1 billion dollar synthetic CDO that Citigroup structured.301 There, the SEC alleged Citigroup sold this CDO to investors but withheld information that Citigroup had selected about half of the CDO’s underlying assets and was betting that those assets would underperform.302 Citigroup agreed to settle these allegations for 285 million dollars, but a federal

296. Id.
298. Steven R. Glaser, Similar Does Not Mean Identical: Confusing ’33 Act Section 17(a) with ’34 Act 19(b) Is Wrong, N.Y. L.J. (2011).
299. See Touche Ross & Co. v. Redington, 442 U.S. 560, 574-75 (1979) (expressing reluctance to imply a private right of action in 17(a)).
302. Id. at 11-15.
district court rejected the settlement.\textsuperscript{303} The Second Circuit vacated the district court’s decision and remanded for consideration of the settlement in light of clarified standards for settlement approvals.\textsuperscript{304} Similarly, the SEC brought a Section 17(a) claim against J.P. Morgan in \textit{SEC v. J.P. Morgan Securities LLC},\textsuperscript{305} alleging J.P. Morgan negligently failed to disclose that the same hedge fund that helped select the securities underlying a CDO bet against that CDO.\textsuperscript{306} The SEC settled these claims with J.P. Morgan for 153.6 million dollars, with J.P. Morgan neither admitting nor denying the allegations.\textsuperscript{307} Pursuing this strategy is an efficient choice for the SEC—Section 17 violations are easier to prove because they avoid the impediments to proving scienter that the financial crisis causes. But, it does not adequately protect investors. It does not make up for the enforcement gap created by the whitling away of the private right of action against securities fraud. In addition, after \textit{Janus}, even the Section 17(a) option is being constrained. In \textit{SEC v. Kelly},\textsuperscript{308} the court extended \textit{Janus} to claims brought under Section 17, requiring plaintiffs to prove that the defendant “made” a materially false statement or omission in the \textit{Janus} sense to prove a claim under Section 17(a).\textsuperscript{309} However, other district courts have declined to extend \textit{Janus} to Section 17(a).\textsuperscript{310} In \textit{SEC v. Mercury Interactive},\textsuperscript{311} the court held that Section 17(a) did not require a defendant to “make” a statement to be liable, because the statute uses the words “employ,” “obtain,” and “engage,” but does not use the word “make.”\textsuperscript{312} Similarly, in \textit{SEC v. Daifotis},\textsuperscript{313} the court held that \textit{Janus} should only be applied to statutes that use the same


\textsuperscript{304} SEC v. Citigroup Global Markets, Inc., 752 F.3d 285 (2d Cir. 2014).

\textsuperscript{305} No. 11-CV-04206, 2011 WL 4965843 (S.D.N.Y. Apr. 16, 2011).

\textsuperscript{306} Gallu, supra note 303 (citing Complaint at 3-4, SEC v. J.P. Morgan Sec. LLC, No. 11-CV-04206, 2011 WL 4965843 (S.D.N.Y. Apr. 16, 2011)).


\textsuperscript{308} 817 F. Supp. 2d 340 (S.D.N.Y. 2011).


\textsuperscript{310} See Pekarek & Shingle, supra note 36, at 30 (citing SEC v. Mercury Interactive, LLC, No. 5:07-cv-02822-JF\PVT, 2011 U.S. Dist. LEXIS 134580 (N.D. Cal. Nov. 22, 2011)).

\textsuperscript{311} No. 5:07-cv-02822-JF\PVT, 2011 U.S. Dist. LEXIS 134580 (N.D. Cal. Nov. 22, 2011).

\textsuperscript{312} See Pekarek & Shingle, supra note 36, at 30 (citing Mercury Interactive, LLC, No. 5:07-cv-02822-JF\PVT, 2011 U.S. Dist. LEXIS 134580, at *8).

\textsuperscript{313} No. 11-00137, 2011 WL 3295139 (N.D. Cal. Aug. 1, 2011)
language that Janus interpreted.\textsuperscript{314} In SEC v. Stoker,\textsuperscript{315} the court held that the Supreme Court’s emphasis on the word “make” in Janus indicates its attempt to distinguish that language from language present in other provisions, such as Section 17(a), to which Janus does not apply.\textsuperscript{316}

The future landscape of securities fraud enforcement is still developing in light of Janus. It is not entirely clear what the fallout of Janus will be. Certainly, it narrows the scope of the private right of action in some instances by limiting who may be brought as defendants in such cases. Janus also provides a loophole for actors who substantially affect statements to escape liability for securities fraud. But, as some courts have since held, Janus may also apply to the SEC, to Section 17(a), and to common law fraud. Or, as other courts have held, it may not.\textsuperscript{317} In SEC v. Pentagon Capital Management PLC,\textsuperscript{318} the court held that Janus does not apply to the SEC because Janus “was a private suit, not an enforcement action brought by the SEC. The Court emphasized this difference . . . ”.\textsuperscript{319} So far, Janus “has caused inconsistency and uncertainty among the courts instead of the predictability promised by precedent, with the uniform application and interpretation we expect of stare decisis.”\textsuperscript{320}

Additionally, the future landscape of securities fraud enforcement is uncertain due to recent court rulings restricting the SEC’s ability to settle. In the SEC’s suit against Citigroup described above, the agency and Citigroup agreed to a settlement in which Citigroup would neither admit nor deny the allegations in the SEC’s complaint.\textsuperscript{321} The Southern District of New York rejected this settlement because it “is neither fair, nor reasonable, nor adequate, nor in the public interest . . . because it does not provide the Court with a sufficient evidentiary basis to know whether the requested relief is justified under any of these standards.”\textsuperscript{322} The court argued that the SEC has a duty to

\begin{itemize}
\item \textsuperscript{315} 865 F. Supp. 2d 457 (S.D.N.Y. 2012).
\item \textsuperscript{316} SEC v. Stoker, 865 F. Supp. 2d 457, 465 (S.D.N.Y. 2012).
\item \textsuperscript{317} See, e.g., Allstate Ins. Co. v. Countrywide Fin. Corp., 824 F. Supp. 2d 1164, 1186 (C.D. Cal. 2011) (holding that Janus does not apply to common law fraud because the term “make” is not present and other concerns, such as duplicative control person liability, are not present).
\item \textsuperscript{318} 844 F. Supp. 2d 377 (S.D.N.Y. 2012).
\item \textsuperscript{320} See Pekarek & Shingle, supra note 36, at 32.
\item \textsuperscript{321} Gallu, supra note 303.
\end{itemize}
the public to provide it with some “truth in a matter of obvious public importance.” While this decision is currently under review, if it is upheld the SEC’s ability to effectively enforce anti-fraud securities laws will be significantly diminished. As a public agency, the SEC already lacks the resources to go after every instance of fraud. When it does so, it will often settle in order to avoid wasting resources. A “no admit, no deny” settlement strategy is effective because it allows the SEC to recover some amount of money for investors and provides some deterrent effect, but allows both the defendant and the SEC to end the case quickly and without a drawn out trial. Without this strategy, the SEC will have to either pursue a stricter settlement strategy where the defendant admits to at least some facts even if it does not admit to liability, or the SEC will have to go to trial more. Either of these options will likely further diminish SEC resources and reduce the number of cases the SEC can take on. The effect on the broader anti-fraud framework will be weaker protections for investors and a greater need for private enforcement, especially since private actors are permitted to enter into such settlements.

While great uncertainty remains with regard to the future landscape of 10b-5 actions, what is clear is that the current trend in the Supreme Court of whittling away the private right of action is not likely to be reversed any time soon. Additionally, it does not appear likely that Congress will take steps to legislate a stronger or more expansive private right of action. Congress has considered, but declined to pass, legislation providing for a private right of action against aiders and abettors. This was proposed in bills that Congress never enacted in 1956, 1957, 1959, 1960, and in an unenacted portion of the PSLRA in 1995. Congress also considered a similar amendment to Section 20 of the Exchange Act in 2009, in response to recent securities fraud cases including the Bernie Madoff Ponzi scheme. Congress had another opportunity to provide a private right of action against aiders and abettors in the Dodd-Frank Act, but declined to do so, even though it expanded the SEC’s authority with respect to aiders and abettors. The Dodd-Frank Act extended aider and abettor liability to the Securities Act, the Investment Company Act of 1940, and the

325. See Ho, supra note 168, at 181.
327. See Ho, supra note 168, at 181.
Investment Advisers Act of 1940.\textsuperscript{328} Instead of providing for a private right of action against aiders and abettors, Congress punt ed the issue by merely requiring the U.S. Government and Accountability Office to issue a report on the implications of providing for such a right.\textsuperscript{329}

Private plaintiffs do have some options besides Rule 10b-5 to subject both primary and secondary actors to liability. Likely, we will see more private actions brought under Section 11 of the Securities Act, which expressly provides for a private right of action against material misrepresentations or omissions in registration statements for new securities.\textsuperscript{330} Those who can be held liable under Section 11 include issuers, signatories, directors, underwriters, and experts who consent to being named as having certified or prepared any portion of the registration statement.\textsuperscript{331} Plaintiffs can also appeal to Section 12 of the Securities Act, which allows plaintiffs who buy or sell a security to hold anyone liable who offers or sells a security in violation of the registration requirements.\textsuperscript{332} Under Section 12(a)(1), plaintiffs may only recover the price they paid to purchase the security plus interest in exchange for returning the security.\textsuperscript{333} Under Section 12(a)(2), plaintiffs may recover from a securities seller where the seller makes material oral and written misrepresentations in connection with an offering or a sale.\textsuperscript{334} Both Section 11 and Section 12(a)(2) permit defendants to put on a "reasonable investigation" or "due diligence" defense.\textsuperscript{335} Section 15 of the Securities Act provides for control person liability for violations under Section 11 and Section 12. Unfortunately, these provisions are narrowly tailored and do not have as broad of a reach as Section 10(b) of the Exchange Act so they do not protect investors as well as a right of action under Section 10(b).

4. \textit{To Ensure That the Anti-Fraud Securities Laws Protect Investors, Congress Should Provide for a Private Right of Action for Secondary Liability and Against Secondary Actors}

Congress should legislate a private right of action against aiders and abettors of securities fraud. Providing for a private right of action against aiders and abettors of securities fraud deters primary actors from committing fraud and deters "gatekeepers" from participating in

\textsuperscript{328} Id. (citing 15 U.S.C. §§ 77o(b), 80a-48(b), 80b-9(f) (2006 & Supp. IV 2010)).
\textsuperscript{329} Id. (citing 15 U.S.C. § 829Z (2012)).
\textsuperscript{330} \textit{GAO Report}, \textit{supra} note 25, at 28.
\textsuperscript{331} Id.
\textsuperscript{332} Id.
\textsuperscript{333} Id.
\textsuperscript{334} Id. at 29.
\textsuperscript{335} Id. at 28-29.
fraudulent schemes.336 "Gatekeepers" are individuals such as auditors, credit rating agencies, and lawyers whose role it is to evaluate and assist in the production of SEC filings and other statements by primary actors such as corporations in the securities market.337 These individuals are employed by corporations either because of the corporation's own concern with compliance or because of statutory mandates such as Sarbanes-Oxley that are designed to prevent the dissemination of fraudulent information.338 Providing for a private right of action for secondary liability both deters primary actors from committing securities fraud, since gatekeepers are more likely to prevent the primary actor from making fraudulent statements and to report those statements if they are made, and deters aiders and abettors from participating in fraud schemes, since they could face liability not only from the SEC but from every shareholder they defraud.

Additionally, allowing secondary liability in private actions better compensates plaintiffs for their losses.339 For instance, primary actors often enter bankruptcy before private plaintiffs can recover, as occurred in the cases of Enron and WorldCom.340 Providing private plaintiffs with the ability to recover from secondary actors also promotes market confidence and, likely, investment activity.341 Finally, and perhaps most importantly, providing liability for aiders and abettors in private actions would bring the regime securities fraud regulation back within its purpose of protecting investors. Given the degree of influence secondary actors such as lawyer and auditors have over the content of statements issued by primary actors, "[t]he imposition of aiding and abetting liability would strengthen the incentives of all actors involved in the preparation of investment-related statements to ensure that those statements fully and truthfully disclose all material issues to investors."342

Even the SEC argues that private litigation is necessary to achieve an optimal level of deterrence. In testimony before the Senate Committee on Banking, Housing, and Urban Affairs' Subcommittee on Securities, then-Chairman of the SEC Arthur Levitt argued that

336. See Ho, supra note 168, at 183-84.
337. Id.
339. See Ho, supra note 168, at 184-85.
340. See id. at 185.
342. Id. at 186.
[l]egislation is also needed to restore aiding and abetting liability in private actions which are a necessary supplement to our overall enforcement program. They serve to deter securities fraud and to compensate injured investors. In fact, the Central Bank of Denver decision may affect private securities litigation even more severely than our enforcement program. . . . The private parties may have no alternatives, at least under Federal law.343

To the SEC, private enforcement helps “deprive defendants of their ill-gotten gains in order to deter future violations.”344 Even the Supreme Court has recognized the importance of private enforcement. In Basic, the court noted that private enforcement provides “an essential tool for enforcement of the 1934 Act’s requirements” and in Blue Chip Stamps v. Manor Drug Stores345 the Court noted that “private enforcement of Commission rules may [provide] a necessary supplement to Commission action.”346

Of course, permitting private plaintiffs to sue aiders and abettors increases the possibility of frivolous “strike suits” that just increase costs for secondary actors to do their jobs.347 But, private suits against aiders and abettors would still be subject to the strict pleading standards of the PSLRA that were designed to reduce such suits.348 Further, disallowing private suits against aiders and abettors does not necessarily reduce strike suits, so much as shift those suits to primary actors.

VII. CONCLUSION

The private right of action against securities fraud under Section 10(b)349 of the Securities Exchange Act of 1934350 and Rule 10b-5351 has been consistently whittled away by the Supreme Court and Congress over the last several decades. The whittling away of this right has occurred alongside significant deregulation of the financial market and has continued in the face of one of the world’s worst financial crises and a widespread belief that fraud contributed to the crisis. In

343. Levitt, supra note 150, at 14.
347. See Ho, supra note 168, at 187.
348. Id. at 189.
fact, the Supreme Court in Janus further narrowed the right of action during the fallout of the financial crisis and at the height of many securities fraud lawsuits stemming from activities during the financial crisis. The right of action has been narrowed even where the SEC has urged the right to be interpreted broadly. There are two categories of justifications for this narrowing: (1) Congress never explicitly provided for a private right of action under Section 10(b) so any judicially created right must be narrow and (2) private enforcement of securities fraud laws is either harmful, because private plaintiffs over sue, or unnecessary, because the SEC is better equipped to maintain an enforcement equilibrium. However, investors are not being sufficiently protected by the current 10b-5 framework. After the financial crisis—the time when investors need the private right of action the most—the right is at its weakest. The financial crisis presents additional obstacles to pleading and proving securities fraud in claims arising from the crisis. It also demonstrates the need for adequate recourse to help deter securities fraud and help compensate investors who are defrauded. Unfortunately, the trend in Congress and the Supreme Court indicates this recourse will not come any time soon.