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An Investment Adviser Cannot Be Sued in Private Action Under Rule10B-5 for Inaccurate Statements in a Mutual Fund Prospectus

BY THE SECURITIES LITIGATION AND ENFORCEMENT AND INVESTMENT MANAGEMENT PRACTICES

Supreme Court Resolves Circuit Split in *Janus Capital Group, Inc. v. First Derivative Traders*

In a highly anticipated 5-4 decision, the Supreme Court resolved a split in the circuits and held that an investment adviser to a mutual fund could not be sued under Rule 10b-5 in a private action for incorrect or misleading statements in a mutual fund prospectus, even though the adviser may have prepared those statements. In so holding, the Court addressed the meaning of a fundamental element needed to plead a private securities fraud claim under Section 10(b) of the Securities Exchange Act of 1934: what constitutes "making a statement" sufficient to hold a party liable for any alleged misstatements or omissions. In holding that the "maker" of a statement can only be someone who has ultimate authority over and actually makes the statement, [1] the Court found that only the fund (which is a separate legal entity), and not the investment adviser, can be deemed to "make" a statement in a fund prospectus. The Court's opinion likely will have far-reaching implications for investment companies, advisors, investment banks, attorneys, accountants, and other service providers who are involved in the preparation of documents, such as prospectuses, that are publicly disseminated to investors. [2]

Case Background

The appeal to the Supreme Court arose from a Fourth Circuit Court of Appeals reversal of a motion to dismiss in the *In re Mutual Funds Inv. Litig.* (*First Derivative Traders v. Janus Capital Group, Inc., et al.*), 566 F.3d 111 (4th Cir. 2009) ("*In re Mutual Fund Inv. Litig.*"). In that case, investors in Janus Capital Group common stock brought a putative securities fraud class action alleging that both Janus Capital Group ("JCG") and Janus Capital Management ("JCM") (which is the investment adviser to the Janus Mutual Funds ("Janus Funds")) were responsible for statements in the Janus Funds' prospectuses to the effect that the policies followed by Janus Funds did not allow market timing. JCG is the parent of JCM. Plaintiffs alleged these statements were untrue, resulted in a loss of assets in the Janus Funds which reduced management fees paid to JCM and thus, under the fraud-on-the-market theory,[3] caused Plaintiffs to purchase shares of JCG at inflated prices. While JCM acted as the investment advisor to Janus Funds, the prospectus was issued by Janus Funds, which like all mutual funds is a separate legal entity owned by fund shareholders and having its own board of directors. JCG successfully sought dismissal in the district court, based on Supreme Court precedent that no party is subject to secondary liability in a private securities fraud action.[4] On appeal, the Fourth Circuit

reversed, finding that the nature of the relationship between the two entities was such that interested investors could attribute the allegedly misleading statements of the Janus Funds to JCM.

In reaching its conclusion, the Fourth Circuit acknowledged a Circuit split on the issue. On one side of the split, the Second Circuit concluded "a secondary actor cannot incur primary liability for a statement not attributed to that actor at the time of its dissemination."[5] Stated differently, "a defendant must actually make a false or misleading statement . . . [a]nything short of such conduct is merely aiding and abetting, and no matter how substantial the aid may be, it is not enough to trigger liability under Section 10(b)."[6] The Ninth Circuit, however, found that a primary violation claim could be stated merely by alleging substantial participation in preparing the misleading statement.[7] Thus, the Fourth Circuit furthered the split when it concluded the attribution determination is "properly made on a case-by-case basis by considering whether interested investors would attribute to the defendant a substantial role in preparing or approving the allegedly misleading statement."[8]

Although the SEC, DOJ and U.S. Solicitor General filed briefs urging that the Supreme Court not hear the case[9], the Court granted *certiorari*. The Government's amicus briefs at the merits stage supported First Derivative's position, arguing that a person or entity should be found to have "made" a statement for purposes of Section 10(b) liability if the person "creates" that statement, i.e., "provides the false or misleading information that another person then puts into the statement."[10] The Government agencies, like First Derivative, pointed to the close relationship between a mutual fund and its investment adviser, and contended that both entities' liability for statements in the prospectuses should, in effect, be coequal.[11]

The Key Issues Decided By The Court

The Court's majority opinion resoundingly rejected the position espoused by First Derivative and the Government. In reversing the Fourth Circuit's ruling, the Court instead adopted the bright line 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."[12]

The Court found that the language in Rule 10b-5 imposing liability on a person or entity that "makes" was not ambiguous, and that be a a "maker" of a statement one must have actually made and have the ultimate authority over the statement.[13] "Without control, a person or entity can merely suggest what to say, not 'make' a statement in its own right."[14] The Court analogized to the relationship between a speechwriter and a speaker: "When a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it. And it is the speaker who takes credit – or blame – for what is ultimately said."[15]

The Court dismissed the Government's position that "make" should be defined as "create."[16] Turning to Webster's Dictionary, the Court found that the Government's position might make sense in some contexts (e.g., "to make a chair"), it failed to capture the meaning of "make" when "directed at an object expressing the action of a verb", i.e., the making of a statement.[17] Further, the Court noted that adopting the Government's position would be inconsistent with prior precedent.[18] In *Stoneridge*, the Court rejected a private Rule 10b-5 suit "against companies involved in deceptive transactions even when information about those transactions was later incorporated into false public statements."[19] The Court "[saw] no reason to treat participating in the drafting of a false statement differently from engaging in deceptive transactions, when each is merely an undisclosed act preceding the decision of an independent entity to make a public statement."[20]

The Court noted that its decision "follows from" the Court's earlier holding in *Central Bank*, under which a private action pursuant to Rule 10b-5 does not include suits against aider and abettors.[21] "Such suits – against entities that contribute substantial assistance to the making of a statement but do not actually make it – may be brought by the SEC [ ], but not by private parties."[22]

Finally, the Court refused to find that the adviser, JCM, "made" the statements merely because it may have participated in writing and disseminating the prospectuses – and did not address the unique and close relationship between advisors and mutual funds asserted by both First Derivative and the United States. In particular, the Court did not address the fact that mutual funds typically have no employees, they outsource all of their functions and therefore there are, in fact, no individuals, other than Fund's officer's (which are typically employees of the adviser or other service provider) or the Board of Directors, who could actually "make" a statement in a fund's prospectus. Nevertheless, the Court found that only the Fund "bears the statutory obligation to file the prospectuses with the SEC," and the evidence showed that only the Fund, not the advisor, did file them.[23] "Nor did anything on the face of the prospectuses indicate that any statements therein came from JCM rather than Janus Fund."[24]

In sharp contrast, the dissent took issue with the majority as misconstruing the Court's precedent in *Central Bank* and *Stoneridge.* Justice Breyer strongly opposed adopting a rule where to "make" a statement is limited to the person with ultimate authority.[25] "The English language does not impose upon the word "make" boundaries of the kind the majority finds determinative." Further, the dissent voiced concern over a potential flaw in the majority rule, posing the hypothetical that when "guilty management" writes a false prospectus for an innocent board of directors,[26] "*no one* could be found to have 'ma[d]e' a materially false statement – even though under common law the managers would likely have been guilty or liable."[27]

Potential Ramifications

While the Court's decision on its face purports to determine responsibility as between a mutual fund that makes a misleading statement and the investment advisor who drafted it, the decision's ultimate implications could be much greater. The Court's bright line rule affirms that, for purposes of private Rule 10-b-5 actions, the person or entity who "makes" a materially misleading statement is the person who actually states a fact and has the ultimate authority over that statement.

In the investment company context, this decision will likely have significant impact on fund companies and fund boards. In particular, since the role of a fund board is one of oversight, boards do not typically get very involved in the preparation of prospectuses. Yet, boards have responsibility to protect the interests of fund shareholders. Since the case will not permit a private claim against those service providers who include false statements in fund prospectuses, fund Boards will need to consider other mechanisms to hold these parties accountable and to protect fund shareholders,[28] including enhanced oversight and reporting obligations. Following *Janus Capital Group*, issuers must be all the more vigilant to assure that the information they are provided and the statements that are drafted for them to deliver are accurate and complete.

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[1] *Janus Capital Group v. First Derivative Traders*, 546 U.S. ---, No. 09-525, slip op. at 6 (June 13, 2011).

[2] Importantly, the Court noted that the Securities and Exchange Commission ("SEC") has authority to pursue fraud actions against those who aid in the drafting of untrue statements which appear in prospectuses, even though such persons cannot be sued under 10b-5 for actually "making" the statements. As a result, despite the Court's ruling, investment advisers and others involved in preparing prospectuses remain subject to fraud actions brought by the SEC for misstatements in a prospectus.

[3] The fraud-on-the-market theory adopted by the Supreme Court assumes that in an efficient market the price of a company's stock is determined by all the available material information regarding the company and thus it is presumed that investors who buy or sell stock at the market price rely upon the statement. *Basic v. Levinson*, 485 U.S. 224, 241-242, 247 (1988).

[4] *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 180 (1994) (no separate aiding and abetting liability in private securities action); *see also Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 156 (2008) (actor who provides assistance to a corporation that makes a misstatement in public documents cannot be held liable in a private securities fraud action under a scheme theory of liability).

[5] *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998).

[6] *Id.*

[7] *In Re Software Toolworks, Inc Sec. Litig.*, 50 F.3d 615, 628-29 (9th Cir. 1994).

[8] *Janus Capital Group*, 566 F.3d at 124.

[9] The Government filed an Amicus Curiae Brief insisting the Fourth Circuit correctly resolved the issue of whether investment managers "make" the statements investment funds issue to the public. *See* Brief for United States as *Amicus Curiae* Supporting Respondent at 12 *Janus Capital Group, Inc. v. First Derivative Traders*, 130 S. Ct. 1117 (2010) (No. 09-525).

[10] *Janus Capital Group*, No. 09-525, slip op. at 2.

[11] *See* Brief for United States as *Amicus Curiae* Supporting Respondent at 17-18, 130 S. Ct. 1117 (No. 09-525).

[12] *Janus Capital Group*, No. 09-525, slip. op. at 8.

[13] *Id.* at 6.

[14] *Id.* The Court further explained, "attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by – and only by – the party to whom it is attributed." *Id.*

[15] *Id.*

[16] *See id.* at 8.

[17] *Id.*

[18] *Id.*

[19] 552 U.S. at 161.

[20] *Janus Capital Group*, slip op. at 9

[21] 511 U.S. at 180.

[22] *Janus Capital Group*, slip op. at 7.

[23] This "evidence" consisted of the name of the Janus Funds as the registrant on the Janus Funds Registration Statement on file with the SEC.

[24] *Janus Capital Group*, slip op. at 11.

[25] *Id.*, slip op., dissent at 3.

[26] Scienter is a required element of a 10b-5 claim, such that a board of directors cannot be found liable for a primary 10b-5 violation if the board did not act with scienter.

[27] *Id.* slip op., dissent, at 10. Justice Breyer distinguished prior precedent from the issue in *Janus Capital Group*, and questioned whether the majority opinion actually undermined the precedent of *Central Bank*. which stated that "*any person or entity, including a lawyer, accountant, or bank who* employs a manipulative device or 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." *Id.* (emphasis in original).

[28] Under the Court's holding, a mutual fund is the only party that can be sued in a private action under 10b-5 for misstatement in its prospectus made by a service provider. Since the Fund is owned by its shareholders, the monetary liability for such false statements would fall to fund shareholders. Such lawsuits, if successful, could in certain circumstances have the effect of shifting fund assets from one class of shareholders (current shareholders) to another class of shareholders (former shareholders).