

ClientAlert

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Supreme Court Rejects 10b-5 Liability For Investment Advisor Who Participated In Drafting But Did Not Itself Issue Allegedly Misleading Prospectuses

A sharply divided U.S. Supreme Court held that an investment advisor is not liable for securities fraud under SEC Rule 10b-5 for allegedly misleading statements contained in prospectuses issued by mutual funds that were managed and administered by the advisor. *Janus Capital, Inc. v. First Derivative Traders*, 2011WL 2297762 (June 13, 2011). The *Janus Capital* decision continues the Supreme Court's trend rejecting attempts to impose securities fraud liability upon actors who did not directly perpetrate a fraud or directly make any misleading public statements. What made this result in *Janus Capital* particularly notable was the defendant's especially close relationship to the actual perpetrator of the alleged fraud, and how intimately involved the defendant was in drafting the allegedly misleading statements — and yet still the Supreme Court refused to impose liability.

Although *Janus Capital* has broad implications, its outcome turned on the judicial interpretation of a single word: “make.” Under Rule 10b-5, it is unlawful “to *make* any untrue statement of a material fact.” The plaintiffs in *Janus Capital* argued that the investment advisor, even though it did not issue the prospectuses, “made” the statements in the prospectuses because the advisor had a “uniquely close relationship” with the fund and was significantly involved in preparing and disseminating the prospectuses. The Supreme Court rejected this argument, holding that only the person or entity who actually issued the prospectus could be said to have “made” the statements, and thus only the issuer could be held liable under Rule 10b-5.

While *Janus Capital* involved claims against an investment advisor, the decision will provide important protection for all persons and entities who participate in drafting or preparing prospectuses or other statements, such as investment bankers, accountants, and lawyers. These participants, even where they make no public statements themselves, have been the target of securities fraud plaintiffs seeking additional sources of recovery. In *Janus Capital*, the Supreme Court shut the door on a theory of liability — participation in the preparation of an allegedly misleading statement made by another — that could have exposed a broad array of participants in the securities markets to potentially huge damages claims in situations where their role was merely to assist with drafting and disseminating another entity's public statements. Even so, the Supreme Court hinted in its decision that *Janus Capital* may not be the “final word” on the matter.

Background

Janus Investment Fund is a family of mutual funds created by Janus Capital Group, Inc. (“JCG”) and advised and administered by Janus Capital Management LLC (“JCM”). Although all of the officers of Janus Investment Fund were also officers of JCM, Janus Investment Fund had its own board of trustees and was otherwise a distinct legal entity.

Janus Investment Fund filed prospectuses with the SEC that described the investment strategy and operations of its mutual funds. Some of these prospectuses represented that the funds were not suitable for “market timing” — a trading strategy that exploits the time delay in a fund’s daily valuation system and is allegedly harmful to other fund investors — and that policies would be implemented to curb the practice.

In September 2003, the New York Attorney General brought an action against JCG and JCM alleging that JCG entered into secret arrangements that would permit certain clients to engage in market timing in several funds managed by JCM. These allegations were ultimately settled by JCG and JCM for a total of \$225 million in reduced management fees, civil penalties, and disgorgements to fund investors.

Once the Attorney General’s action became public, JCG’s stock price fell dramatically. A JCG stockholder, First Derivative Traders, filed a securities class action against JCG and JCM alleging that the prospectuses contained material misstatements concerning the funds’ policies against market timing.

The U.S. Court of Appeals for the Fourth Circuit reversed the district court’s dismissal of the complaint for failure to state a claim. It held that “JCG and JCM, by participating in the writing and dissemination of the prospectuses, *made* the misleading statements contained in the documents” (emphasis in original). JCM appealed, and the U.S. Supreme Court reversed the Fourth Circuit and dismissed the case.¹

The Supreme Court’s Decision

The Supreme Court held that JCM did not “make” the statements in the prospectuses, and thus could not be held liable under Rule 10b-5 for any misstatements contained therein, even though JCM had participated in drafting and disseminating the prospectuses. Justice Thomas, writing for the Court, adopted a narrow definition of who “makes” a statement:

“For purposes of Rule 10b-5, the maker of a statement is the person or entity 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. One who prepares or publishes a statement on behalf of another is not its maker.”

The Court explained that this rule “might best be exemplified by the relationship between a speechwriter and a speaker. Even 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.”

The Supreme Court explained that its holding followed from its earlier decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), which held that Rule 10b-5 liability does not extend to lawsuits against “aiders and abettors” who merely contribute “substantial assistance” to the making of a statement. The Supreme Court also noted that its decision was supported by its ruling in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008) (discussed in a prior [Chadbourne Client Alert](#)), which rejected Rule 10b-5 liability against persons who made no public statements but simply agreed to the allegedly deceptive business arrangements that helped a public company issue misleading financial statements.

¹ As to JCG, however, the Fourth Circuit had further held that because investors would not have inferred that JCG had a role in preparing or approving the content of the prospectuses, JCG could only be held liable for the statements as a “control person” of JCM. This portion of the Fourth Circuit decision was not reviewed by the Supreme Court.

The Supreme Court held that in these circumstances “JCM did not ‘make’ any of the statements in the Janus Investment Fund prospectuses; Janus Investment Fund did.” The Court noted that only Janus Investment Fund — not JCM — was obligated to file the prospectuses with the SEC, that there was no allegation that JCM had actually filed the prospectuses and falsely attributed them to the Fund, and there was nothing in the prospectuses that indicated that any statements came from JCM rather than the Fund. Thus, “[a]lthough JCM, like a speechwriter, may have assisted Janus Investment Fund with crafting what Janus Investment Fund said in the prospectuses, JCM itself did not ‘make’ those statements for purposes of Rule 10b-5.”

The Supreme Court rejected the plaintiffs' argument that, because of the “well recognized and uniquely close relationship between a mutual fund and its investment advisor,” the advisor should be understood to be the “maker” of statements by its client mutual fund. The Court “decline[d] this invitation to disregard the corporate form.” It was undisputed that “the corporate formalities were observed” and Janus Investment Fund’s board of trustees was more independent than required. Accordingly, there was no basis to impose securities fraud liability on JCM.

Analysis

Janus Capital marks the slamming of yet another door against expansive theories of vicarious securities fraud liability that could expose to significant securities fraud liability a wide range of persons involved in preparing or disseminating public statements, or at least subject them to lengthy litigation without any clear path toward early dismissal.² Indeed, *Janus Capital* is a particularly notable step in this trend because, while earlier Supreme Court decisions like *Central Bank* and *Stoneridge* involved claims against third parties who were arguably one or more steps removed from the wrongful statements, in *Janus Capital* the defendant was more closely tied to the actual perpetrator. A dissenting opinion by Justice Breyer pointed out that the relationship between JCM and its client fund “could hardly have been closer” and JCM’s “involvement in preparing and writing the relevant statements could hardly have been greater.” Indeed, it could be argued that there was little or nothing that separated the advisor and the fund other than the barest “corporate formalities.” The result is that shareholders in a mutual fund misled by the fund’s prospectus or other fund statements will have no remedy under Rule 10b-5 other than against the very fund whose assets belong to the shareholders, while nominally outside advisors who were at the center of the misleading disclosure at issue escape all Rule 10b-5 liability.

It is not necessarily unusual — particularly in a post-*Central Bank/Stoneridge* world — that a plaintiff’s only Rule 10b-5 remedy may be against an entity with limited or no assets. Consistent with this, in *Janus Capital* the Fund did not have any assets apart from those it held for shareholders, a situation that is likely true for most if not all mutual funds. As the Supreme Court pointed out, however, if this outcome is disquieting, it is up to Congress to remedy any inequities that result from the correct interpretation of Rule 10b-5 in this setting.

Where Do Securities Fraud Plaintiffs Go From Here?

Even in the context of Rule 10b-5 claims, *Janus Capital* still may not be the “final word” on the matter.

² Indeed, since *Stoneridge*, several federal courts of appeal have issued rulings similarly rejecting 10b-5 claims against secondary actors who did not themselves directly make the statements that were claimed to be misrepresentations. See Chadbourne client alerts dated March 26, 2010 (“[En Banc First Circuit Rejects SEC’s Attempt to Broaden Scope of Primary Liability for Securities Fraud Under ‘Implied Representations’ Theory](#)”) and May 6, 2010 (“[No Securities Fraud Liability for Persons Who Merely Participate in Drafting False or Misleading Statements if Those Statements Are Not Attributed to Them](#)”).

First, while *Janus Capital* held that only the issuer of a prospectus should be deemed to have “made” the statements contained therein for Rule 10b-5 purposes, the Court’s definition of who “makes” a statement — i.e., the person or entity with “ultimate authority” over the statement — could provide fertile ground for litigation in circumstances where the persons with ultimate authority are not so readily identifiable. Indeed, even in cases involving prospectuses, while *Janus Capital* noted that the prospectuses at issue did not “directly or indirectly” attribute any statements to the advisor rather than to the Fund, in other mutual fund cases it might be less clear that prospectus statements could not be attributed to anyone other than the fund.

Second, while in *Janus Capital* all corporate formalities apparently had been observed, there may be other cases in which there will be some question about how well the corporate form was respected. Such questions could create an “opening” for securities fraud plaintiffs to try to exploit.

Finally, even as *Janus Capital* closed one door on liability, it may have opened another. In a somewhat tantalizing footnote, the Supreme Court left open the possibility that a person who participates in drafting statements may be held vicariously liable for securities fraud under Section 20(b) of the Securities Exchange Act, which makes it unlawful to violate the Act “through or by means of any other person.” Section 20(b), which has historically been considered generally superfluous in Rule 10b-5 cases, may now become a new focus of securities fraud litigation as plaintiffs’ lawyers continue to seek opportunities to avail themselves of recovery against the maximum number of participants in securities activity. For the time being, however, participants in the securities markets can breathe a little easier, knowing that the Supreme Court has rejected the latest attempt by securities fraud plaintiffs to impose liability on persons involved in drafting and disseminating the public statements that were ultimately issued by others.

For More Information

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