

## Supreme Court Establishes Bright-Line Rule for 10b-5 Liability, But Questions Remain: *Janus Capital Group, Inc. v. First Derivative Traders*<sup>1</sup>

June 21, 2011

On June 13, in an important victory for the investment management industry, the U.S. Supreme Court held that mutual fund adviser Janus Capital Management LLC (JCM) and its parent, Janus Capital Group, Inc. (JCG), could not be held liable in a private suit under Rule 10b-5 under the Securities Exchange Act of 1934 (the 1934 Act)<sup>2</sup> for allegedly false statements contained in a mutual fund prospectus because the Janus Investment Fund itself, rather than the adviser, “made” the statements in the prospectus. In a 5-4 majority opinion written by Justice Thomas, the Court held that the “maker” of a statement for purposes of Rule 10b-5 liability is the person or entity “with ultimate authority over the statement, including its content and whether and how to communicate it.”<sup>3</sup> Applying this rule to the facts underlying the case, the Court held that neither JCM nor JCG was the “maker” of the statements in any of the fund prospectuses, notwithstanding that JCM assisted with their preparation, because the Janus Investment Fund itself had ultimate authority over the statements as they were filed with the Securities and Exchange Commission (SEC).<sup>4</sup> Analogizing JCM’s role to that of a speechwriter, the Court held that no liability and no private right of action existed against JCM or JCG for securities fraud where none of the statements in the prospectuses were made by or attributed to JCM.<sup>5</sup>

The *Janus* decision continues the Court’s recent trend of strictly construing the judicially-created implied private right of action under Rule 10b-5, and provides some bright-line rules for determining primary liability under those claims. Although the Court identified some open questions that are likely to be the subject of further litigation in the wake of *Janus*, the Court’s interpretation of Rule 10b-5 provides more certainty for participants in the financial markets to know when they have and have not “made” a statement that will potentially subject them to Rule 10b-5 liability. However, while it is now apparent

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1. No. 09-525, slip op. 564 U.S. \_\_\_\_ (June 13, 2011).

2. Rule 10b-5 provides that it is unlawful for “any person, directly or indirectly, . . . (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.” 17 C.F.R. § 240.10b-5.

3. *Janus*, No. 09-525, slip op. at 6. Justices Roberts, Scalia, Kennedy, and Alito joined Justice Thomas’s majority opinion. Justices Ginsburg, Sotomayor, and Kagan joined Justice Breyer’s dissenting opinion.

4. *Id.* at 4, 10–11.

5. *Id.* at 6–7, 10–11.

what constitutes the “making” of a statement for Rule 10b-5 purposes, the decision addresses the issue only in the very specific context of a fund prospectus with no attribution. As a result, the *Janus* decision leaves investment advisers and funds with further issues to consider:

- Funds and advisers will want to consider whether their own offering documents are clear that statements are attributed or not attributed to a third party. In addition to review, this may trigger further consideration of attribution among the various parties that contribute to the prospectus drafting process.
- Mere posting of a prospectus on a website will not result in the website owner being deemed to have “made” the statements in the prospectus. However, the prospectus is a discrete “stand-alone” document. Consideration will have to be given to who “makes” statements about funds that appear elsewhere on a website, in fund “fact sheets,” and in other marketing materials. Consideration should also be given to more express attribution and nonattribution for statements in these materials.

## **Background**

The plaintiff, First Derivative, sought to represent a class of shareholders of the adviser’s parent, JCG, a publicly traded company. JCG created the Janus Investment Fund and, in typical industry fashion, organized it as a Massachusetts business trust that would house various “series” or funds. The Janus Investment Fund functioned as the legal entity in the Janus fund complex and maintained a board of directors that included only one member associated with JCM. Statements in the fund prospectuses represented that the funds did not permit, and took active measures to prevent, market timing. First Derivative contended that investors bought shares of JCG at inflated prices and then lost money when market timing practices authorized by JCM and JCG became known to the public. First Derivative sought to hold both JCM and JCG liable for fraud under Section 10(b) of the 1934 Act and Rule 10b-5 thereunder and attempted to hold JCG liable as a control person of JCM under Section 20(a) of the 1934 Act. First Derivative alleged that JCM and JCG were responsible for the allegedly misleading statements appearing in Janus fund prospectuses.

## **The Underlying Action**

The district court dismissed First Derivative’s complaint for failure to state a claim,<sup>6</sup> concluding that there were no statements in the complaint or the prospectuses that were directly attributable to JCG, and there could be no claim for aiding and abetting liability under Rule 10b-5 pursuant to the decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*<sup>7</sup> The district court also dismissed the complaint against JCM, finding that First Derivative failed to demonstrate that the alleged fraud occurred “in connection with” the purchase or sale of a security because a mutual fund investment adviser owes no duty to its parent’s shareholders and, thus, no nexus existed between the class, as shareholders of the parent entity JCG, and JCM. The U.S. Court of Appeals for the Fourth Circuit reversed the district court’s decision,<sup>8</sup> holding that First Derivative sufficiently demonstrated that the misleading statements were attributable to JCM. The court stated that interested investors would infer that the adviser played a role in preparing or approving the content of the funds’ prospectuses, and that, in light of publicly available

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6. *In re Mut. Funds Inv. Litig.*, 487 F. Supp. 2d 618 (D. Md. 2007).

7. 511 U.S. 164 (1994).

8. *In re Mut. Funds Inv. Litig.*, 566 F.3d 111 (4th Cir. 2009).

information, interested investors would have inferred that if the adviser had not itself written the policies in the prospectuses regarding market timing, it must at least have approved these statements. The Fourth Circuit found that the complaint did not plead an adequate claim of primary liability against JCG, but held that the complaint adequately pled that JCG was liable as a control person of JCM under the 1934 Act.

### The Supreme Court Decision

On appeal to the Supreme Court, First Derivative argued that an investment adviser is the “maker” of statements by its client mutual funds for purposes of Rule 10b-5 in the manner of “a playwright whose lines are delivered by an actor.”<sup>9</sup> The Supreme Court disagreed, ultimately likening the adviser–mutual fund relationship to that of an unsung speechwriter and the public speaker who ultimately bears responsibility for what is said and how it is communicated.<sup>10</sup> The Court concluded that in order to be a “maker” of the statement, a person must have “ultimate authority over the statement, including its content and whether and how to communicate it,” and explained that “[w]ithout 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.” Finding the definition of “make” to be unambiguous, the Court stated that, “[a]lthough the existence of the private right is now settled, we will not expand liability beyond the person or entity that ultimately has authority over a false statement.”<sup>11</sup>

While *Janus* was decided in the context of advisers to mutual funds, it has broader implications in its narrow interpretation of Rule 10b-5. The Court went to great lengths to place the *Janus* opinion in the context of two other decisions addressing the narrow scope of the private right of action implied under Rule 10b-5. First, the Court was careful to note that the *Janus* interpretation of Rule 10b-5 is consistent with the decision in *Central Bank*, in which the Court held that the Rule 10b-5 private right of action does not include suits against aiders and abettors.<sup>12</sup> The Court in *Janus* expressed concern that finding JCM liable for the statements would be tantamount to reintroducing liability for aiding and abetting the making of the statement by the funds. Second, the Court stated that the *Janus* decision is consistent with its decision in *Stoneridge Investment Partners, LLC v. Scientific Atlanta Inc.*,<sup>13</sup> in which the Court found no liability for persons whose deceptive acts were unknown to the public and on which the public, therefore, could not have relied. The Court pointed out that in *Stoneridge* it found that nothing done by the defendants made it “necessary or inevitable” that the primary offender would itself make use of the deceptive information provided by the secondary participants.<sup>14</sup> Similarly, the definition of “make” adopted by the Court in *Janus* keys on the notion that nothing made it “necessary or inevitable” that the funds, which had ultimate authority over the content of the prospectuses, would have “made” the statements regarding JCM and market timing, even with JCM involved in the drafting process.

In reaching its holding, the Court rejected the argument that the U.S. Government asserted in its amicus brief that “to make” should be interpreted as “to create,” which would have allowed a private right of action against a person who provides false or misleading information to another when that information is

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9. *Janus*, No. 09-525, slip op. at 9.

10. *Id.* at 12.

11. *Id.* at 8, 9 n.8.

12. 511 U.S. at 180. The SEC retains the ability to proceed directly against aiders and abettors under Rule 10b-5.

13. 552 U.S. 148, 166–67 (2008).

14. *Id.* at 161.

incorporated by another into a statement.<sup>15</sup> Citing *Stoneridge*, the Court disagreed with this interpretation, stating that it 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.”<sup>16</sup>

The Court also rejected First Derivative’s argument that the uniquely close relationship between a mutual fund and its investment adviser invites a finding that the adviser had control over the making of the prospectus statements.<sup>17</sup> The Court observed that (1) despite significant influence by the adviser over the fund, both entities observed all corporate formalities in keeping themselves completely separate, in Janus’s case even beyond the requirements of the law; (2) it is Congress’s responsibility to address any reapportionment of liability that might be needed based on the closeness of the relationship between advisers and funds; and (3) to do otherwise would be inconsistent with *Stoneridge*’s narrow interpretation of the private right of action.<sup>18</sup>

In applying its interpretation of “to make” to the Janus facts, the Court recognized that Janus Investment Fund, as registrant, rather than JCM, was required by statute to file prospectuses with the SEC. Moreover, the Court noted that Janus Investment Fund (again as registrant) had actually filed the prospectuses at issue, and there was no allegation or indication on the face of the prospectuses that the adviser made the allegedly false statements in the prospectuses.<sup>19</sup> Although First Derivative argued that JCM was “significantly involved in preparing” the prospectuses, the Court found that this assistance, which was “subject to the ultimate control of Janus Investment Fund, does not mean that JCM ‘made’ any statements in the prospectuses.”<sup>20</sup> In holding that JCM had not “made” the allegedly misleading statements, the Court also noted that merely providing access to the prospectuses on JCM’s website did not support liability, explaining that “[m]erely hosting a document on a Web site does not indicate that the hosting entity adopts the document as its own statement or exercises control over its content.”<sup>21</sup> The Court did not address, however, statements that are made on the Web or in print that are less self-contained than the fund’s registration statement.

### **Open Questions and Practical Implications of the Decision**

Although it significantly narrowed the scope of potential liability under Rule 10b-5, the Court also left open a few questions that are likely to be the subject of future litigation.

- Indirect statements: Rule 10b-5 provides that it is unlawful for a person “directly or indirectly” to make any untrue statement. The Court explained that “indirectly” in Rule 10b-5 “merely clarifies that as long as a statement is made, it does not matter whether the statement was communicated

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15. *Janus*, No. 09-525, slip op. at 8. In addition, the Court in a footnote “expressed skepticism over the degree to which the SEC should receive deference regarding the private right of action” under Rule 10b-5.

16. *Id.* at 9.

17. *Id.*

18. *Id.* at 9–10

19. *Id.* at 11. The Court observed that, under Rule 10b-5, “as long as a statement is made it does not matter whether the statement was communicated directly or indirectly to the recipient,” but, regardless of how the communication is made, “attribution is necessary.” *Id.* at \*11 n.11.

20. *Id.* at 12.

21. *Id.* at 12 n.12.

directly or indirectly to the recipient.”<sup>22</sup> Thus, the first step in determining liability under the Court’s analysis in *Janus* is identifying whether a statement was “made” by a person with ultimate authority over the statement.<sup>23</sup> The Court, however, did not define when “indirect” communications of “made” statements might lead to Rule 10b-5 liability, other than to say that attribution, at a minimum, is required for liability to attach.<sup>24</sup> The Court left unanswered whether attribution alone could be enough for an “indirect” statement to lead to liability.<sup>25</sup>

- Attribution: On the subject of attribution itself, the Court noted that “in the ordinary case, 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.”<sup>26</sup> The Court did not further explain what it meant by attribution “implicit from surrounding circumstances,” although we know that in *Janus* the Court rejected the close relationship of investment adviser and mutual fund and the participation of the adviser in the drafting of the prospectus as establishing that the statements could implicitly be attributed to JCM. Investment advisers and similarly situated parties that routinely interact with entities that themselves will be “making” statements under the rule set forth in *Janus* should carefully monitor communications to ensure that those entities are not attributing statements to their advisers in public statements.
- Public statements: In addition, the Court in *Janus* noted that the plaintiff had not alleged that any of the statements that JCM made to the fund were themselves “public” statements that could lead to liability under the fraud-on-the-market theory as described in *Basic Inc. v. Levenson*.<sup>27</sup> Investment advisers should attempt to manage their communications so that statements that are not intended for wide dissemination or for attribution to the adviser do not become publicly available.

Notwithstanding these open issues, in establishing a “clean line” for Rule 10b-5 liability drawn at the point of “ultimate authority over a statement,”<sup>28</sup> the *Janus* Court’s interpretation provides more certainty in allowing participants in the financial markets to know when they have and have not “made” a statement that will potentially subject them to Rule 10b-5 liability.

- For pooled investment vehicles (including not only mutual funds but also exchange-traded funds and commodity- and currency-based exchange-traded vehicles), this means that it is the registrant that will be deemed to be “making” statements in prospectuses, absent some indication of attribution to another.
- It is unclear how *Janus* will impact commodity- and currency-based exchange-traded vehicles that do not typically have boards of trustees/directors but whose sponsors are deemed to be “issuers” under Section 1(a)(4) of the Securities Act of 1933. With respect to these entities, industry practice has been that either the trust (through its appointed officers) or the sponsor (on behalf of the registrant) would sign the registration statement. In light of *Janus*, however, the question remains

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22. *Id.*

23. *Id.* at 11 n.11.

24. *Id.*

25. *Id.*

26. *Id.* at 6.

27. *Id.* at 10 n.9 (citing 485 U.S. 224, 227-28 (1988)).

28. *Id.* at 7 n.6.

as to whether sponsors or managers of such products would be able to absolve themselves of being deemed to have made a statement for Rule 10b-5 purposes (unless such statement is otherwise attributed to them) if the trust rather than the sponsors signs the registration statement, notwithstanding the fact that such sponsors are statutorily deemed to be issuers of the shares.

After the *Janus* decision, as long as parties observe corporate formalities and make clear who has ultimate authority for a statement and who does not, exposure to Rule 10b-5 claims will be manageable. The more difficult question may be how various parties will agree to allocate responsibility for “making” statements in light of the Court’s bright-line test.

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