# The Supreme Court Holds That Mutual Fund Investment Advisers Are Not Statement "Makers" for the Purposes of Rule 10b-5 Liability

On June 13, 2011, in *Janus Capital Group, Inc. v. First Derivative Traders*,[1] the Supreme Court of the United States addressed the issue of whether a mutual fund investment adviser may be held liable in a Rule 10b-5 private cause of action for false and misleading statements contained in the fund's prospectuses. In reversing the United States Court of Appeals for the Fourth Circuit, the Court held, in a sharply divided 5-4 decision, that the defendant investment adviser was not the "maker" of the challenged statements to satisfy a securities fraud claim under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), and SEC Rule 10b-5.[2]

## I. Background and Procedural History

Section 10(b) of the Exchange Act empowers the Securities and Exchange Commission authority to issue regulations for the protection of the public and investors. SEC Rule 10b-5 states:

> "It shall be 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."

While neither Section 10 of the Exchange Act nor Rule 10b-5 expressly authorizes a private right of action, the Court has recognized an implied private right of action under Section 10.[3] The Court outlined six elements plaintiffs must prove to sustain a private action under Section 10(b): (1) defendant made an omission or misrepresentation that was material, (2) scienter, (3) a nexus between the statement and the purchase or sale of a security, (4) reliance upon the statement, (5) monetary loss, and (6) loss causation.[4]

Janus Capital Group, Inc. ("JCG") is a publicly traded company that established several mutual funds in a Massachusetts business trust (the "Fund"). Though created by JCG, the Fund is legally separate from JCG and completely owned and operated by the mutual fund investors.[5] JCG has a wholly owned subsidiary, Janus Capital Management LLC ("JCM"), which advised the Fund as its investment adviser and administrator.[6] The Fund and JCM shared officers but only one member of the Fund's board of trustees was associated with JCM, significantly less than the number of "interested persons" permitted by statute.[7] The Fund filed prospectuses, as required by

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1 No. 90-525, slip op. (2011), *available at* http://www.supremecourt.gov/opinions/10pdf/09-525.pdf. Citations to the Court's decision are to the slip opinion.

2 *Id*. at 1, 5; *see also In re Mutual Funds Investment Litigation*, 566 F.3d 111, 115 (4th Cir. 2009).

3 *See Janus Capital Group* at 5 (citing *Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971)).

4 *See In re Mutual Funds Investment Litigation*, 566 F.3d at 119 (quoting *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 157 (2008)).

5 *See Janus Capital Group* at 2.

6 *Id.* at 1-2.

7 *See id.* at 2 (noting that the Fund and JCM "maintain legal independence").

the federal securities laws, detailing investment strategy, policies and procedures of the mutual funds to investors. The Fund stated in the prospectuses of many of their funds that management disapproved of market timing[8] and that they implemented policies that would prevent market timing within their funds.[9]

In September 2003, the New York Attorney General alleged JCM and JCG had entered into "secret arrangements" allowing market timing in their funds managed by JCM.[10] The publicity surrounding the complaint resulted in investors removing funds from the mutual funds and subsequently a drastic drop in JCG stock price.[11]

Respondent First Derivative Traders ("First Derivative") filed suit on behalf of a class of JCG stockholders alleging that JCM and JCG violated Section 10(b) and Rule 10b-5 by "caus[ing] mutual fund prospectuses to be issued for [the Fund] and ma[king] them available to the investing public, which created the misleading impression that JCG and JCM would implement measures to curb market timing in the Janus [funds]."[12] First Derivative claimed that JCG and JCM misled the public as to a material issue and they relied on this information in making their investment in the Fund.[13]

Judge Motz, for the District Court of Maryland, granted defendants' motion to dismiss for failure to state a claim focusing on the fact that First Derivative did not allege facts indicating that JCG made misstatements and there was not a sufficient nexus between shareholders of JCG, plaintiffs, and JCM as the investment adviser to satisfy a Rule 10b-5 claim.[14]

The United States Court of Appeals for the Fourth Circuit reversed the district court's dismissal.[15] The Court of Appeals focused on the fact that JCG and JCM participated in the "writing and dissemination of the prospectuses" to satisfy the fraud on the market requirement that defendant make public, material misrepresentations.[16]

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8 "Market timing is a trading strategy that exploits time delay in mutual funds' daily valuation system." Mutual fund shares are priced by the next net asset value ("NAV") which is calculated once daily following closure of the U.S. markets. Various values used to calculate a fund's NAV may not truly represent the value of the fund because of events that have occurred during the time delay from close of a foreign market to close of the U.S. markets. "For example, a fund may value its foreign securities based on the price at the close of the foreign market, which may have occurred several hours before calculation. But events might have taken places after the close of the foreign market that could be expected to affect their price. If the event were expected to increase the price of the foreign securities, a market-timing investor could buy shares of a mutual fund at the artificially low NAV and sell the next day when the NAV corrects itself upward." *Janus Capital Group* at n.1.

9 *See Janus Capital Group* at 2; *see also In re Mutual Funds Investment Litigation*, 566 F.3d at 116.

10 *Janus Capital Group* at 3. These allegations were settled in 2004 with JCG and JCM paying $50 million in civil penalties and $50 million in disgorgement along with a reduction in their fees by $125 million.

11 *See id.* (noting a nearly 25 percent price drop "from $17.68 on September 2, to $13.50 on September 26").

12 *Id.* at 3-4.

13 *See id.* First Derivative also claimed "control person" liability of JCG for JCM's actions. Because the Court found that JCM did not "make" materially misleading statements, JCG should not be liable as a control person of JCM. *See id.* at 10.

14 *In re Mutual Funds Inv. Litigation*, 487 F. Supp. 2d 618, 622-24 (D.Md. 2007).

15 *In re Mutual Funds Investment Litigation*, 566 F.3d 111, 119 (4th Cir. 2009).

16 *See id.* at 121, 127-128 (noting that "given the publicly disclosed responsibilities of JCM, interested investors would infer that JCM played a role in preparing . . . prospectuses" where they would not infer that JCG "played a role" in the

## II. The Supreme Court's Decision

Writing for the Court, Justice Thomas focused on the word "make" in assessing JCM's Rule 10b-5 liability and held that JCM had not "made the material misstatements in the prospectuses" for the purposes of Rule 10b-5 liability.[17] In addressing the issue of whether an investment adviser can be held liable in a private action under Rule 10b-5, Justice Thomas acknowledged concerns about expanding the scope of a judicially created cause of action, such as the private cause of action for securities fraud.[18] In support of the Court's holding, Justice Thomas noted:

> One "makes" a statement by stating it. . . . 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.[19]

The Court noted that this rule follows from its opinion in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), where the Court concluded that no Rule 10b-5 private right of action should stand against aiders and abettors, those that provide "substantial assistance" to the creation of a prospectus but do not actually make it. The Court sought to draw a "clean line" between primary and secondary liability, stating that primary liability may result in private suits and secondary liability may not.[20] Justice Thomas also noted the present interpretation of *Central Bank* was supported by the *Stoneridge* decision assigning ultimate authority to the company, or the "maker" itself.[21]

The Court dispensed with the Government's contention that "make" should mean "create" as contrary to the *Stoneridge* precedent and the meaning of the word when it is "expressing the action of a verb . . . ."[22] Additionally, the Court determined that consideration of the "uniquely close relationship" between the mutual fund and its investment adviser would ignore the corporate form and the fact that the two entities are legally distinct.[23] Next, Justice Thomas noted the fact that JCM posted the prospectuses on its web site was an insufficient basis from which to assign Rule 10b-5 liability.[24]

Finally, First Derivative claimed that JCM's "significant involvement" in the preparation of the prospectuses was sufficient to hold JCM liable. In rejecting this contention, Justice Thomas compared the

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preparation of the prospectuses; thus, JCG could only be liable under §20(a) as a "control person" not as having "made" the statements).

17 *Janus Capital Group* at 5 (internal quotations omitted).

18 *Id.* at 6, noting that "we must give 'narrow dimensions . . . to a right of action Congress did not authorize when if first enacted the statute and did not expand when it revisited the law." (quoting *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 167 (2008).

19 *Janus Capital Group* at 6.

20 *Id.* at 7 and n.6. (noting that the "maker is the person or entity with ultimate authority over a statement and others are not").

21 *Id.* at 8.

22 *Id.* at 8.

23 *Id.* at 9-10.

24 *Id.* at 12.

assistance to that of a speechwriter, where the speaker is the ultimate party responsible for the statements. The Court held that any assistance JCM provided was not the equivalent of JCM making the misleading statements.[25]

Justice Breyer, in dissent, argued that "[t]he specific relationships alleged among Janus Management, the . . . Fund, and the prospectus statements warrant the conclusion that Janus Management did 'make' those statements."[26]

## III. Significance of the Decision

The Court's ruling creates a "clean line" that allows for greater predictability in the application and scope of the implied private right of action under Section 10(b) and Rule 10b-5. Had plaintiffs prevailed in this case, the impact would have been significant, implicating a potentially never-ending list of potential defendants-management, accountants, lawyers, public relations professionals, or any number of individuals from legally separate entities who assist in the preparation of offering documents.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.

[25] *Id.* at 12.

[26] *Id.* at 11 (Breyer, J. dissenting).