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Supreme Court Limits Primary Liability Under Rule 10(b)(5)

A divided United States Supreme Court issued its highly anticipated ruling yesterday in *Janus Capital Group, Inc. v. First Derivative Traders*, Case No. 09-525, holding that Janus Capital Management ("JCM"), the investment advisor to a series of mutual funds known as the Janus Investment Fund (the "Fund"), did not "make" the misstatements contained in the Fund's prospectuses it helped to prepare and, therefore, cannot be held primarily liable under Section 10(b) of the Securities Exchange Act of 1934 (the "Act") and Securities and Exchange Commission Rule 10(b)(5). In so holding, the Court narrowly defined the "maker" of a statement as "the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." Because the Fund—not JCM—retained ultimate authority over the content and dissemination of its prospectuses, the Court held that the Fund—not JCM—made the misstatements at issue.

The Underlying Action

Plaintiffs are shareholders of Janus Capital Group ("JCG"), a publicly traded financial services company. JCM is a wholly owned subsidiary of JCG that provides investment advisory and administrative services to mutual funds, including a series of mutual funds known as the Fund. JCM participated in the writing and dissemination of the prospectuses for the Fund. According to the complaint, the prospectuses falsely represented that the Fund had policies to prevent a practice known as "market timing" when, in fact, managers of various individual funds had been secretly permitting market timing transactions to occur for years.[1] Plaintiffs purportedly relied upon these representations in deciding to purchase shares of JCG and were ultimately damaged when the funds' market timing practices became public and the price of JCG's shares plummeted.

In 2007, plaintiffs filed a complaint against JCG and JCM alleging violations of Section 10(b) and Rule 10(b)(5).[2] The district court dismissed the claims against JCG on the ground that the complaint "contain[ed] no allegations that JCG actually made or prepared the prospectuses, let alone that any statements therein were attributable to it." *In re Mutual Funds Inv. Litigation*, 487 F. Supp. 2d 618 (D. Md. 2007). The Court also dismissed the claims against JCM on the ground that a mutual fund advisor owes no duty to its parent's shareholders and, therefore, there was no nexus between the plaintiffs and JCM.[3]

Related practice areas:

Shareholder and Securities Litigation

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On appeal, the Fourth Circuit reversed, holding that the complaint adequately pleaded a claim for primary liability against JCM (although not against JCG).[4] *In re Mutual Funds Inv. Litigation*, 566 F.3d 111 (4th Cir. 2009). Specifically, the Court held that the false statements at issue were "sufficiently attributable" to JCM because, based on JCM's publicly disclosed role as the Fund's investment advisor, investors would infer that JCM "played a role in preparing or approving the content of the Janus fund prospectuses." In reaching its holding, the Fourth Circuit acknowledged the circuit split regarding the degree to which a misrepresentation must be attributable to the defendant for primary liability to attach. While the Second and Eleventh Circuits require that the misrepresentation be directly and publicly attributable to the defendant, the Ninth Circuit requires only that the defendant have substantially participated in the making of the false statement. Recognizing that the Fourth Circuit has declined to adopt either of these standards, the Court instead concluded that "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."

In light of the circuit split on this significant issue concerning primary liability under Rule 10(b)(5), the Supreme Court granted certiorari.

The Majority Opinion

In a 5-4 decision, the Supreme Court reversed the Fourth Circuit's ruling, holding that JCM could not be held primarily liable under Rule 10(b)(5) because it did not "make" the misstatements in the Fund's prospectuses. Specifically, the Supreme Court adopted a narrowly crafted rule that 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 such authority," the Court emphasized, "it is not 'necessary or inevitable' that any falsehood will be contained in the statement." By analogy, the Court explained that "[e]ven 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."

In reaching its holding, the Court rejected petitioner's argument that JCM should be considered the "maker" of the false statements in the prospectuses because of its "well-recognized and uniquely close relationship" with the Fund and the "significant influence" JCM exercised over the Fund as a result. Despite acknowledging this "relationship of influence," the Court declined to extend liability to JCM on this ground. The Court explained that to do so would be to extend primary liability under Rule 10(b)(5) in a way that resembles—but is even broader than—the basis for control liability already provided for under Section 20(a) of the Act. "Any reapportionment of liability in the securities industry in light of the close relationship between investment advisers and mutual funds is properly the responsibility of Congress and not the courts," emphasized the Court.

The Dissent

In the dissenting opinion, Justice Breyer (joined by Justices Kagan, Ginsburg, and Sotomayor) opined that neither the English language nor legal precedent could support the rule adopted by the majority that a

"maker" of a false statement must have "ultimate authority" over the content and dissemination of the statement. In rejecting the "ultimate authority" rule, he concluded that "depending on 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." In this case, he wrote, the "specific relationships alleged among Janus Management, the Janus Fund, and the prospectus statements warrant the conclusion that Janus Management did 'make' those statements."

The Private Right of Action under Rule 10(b)(5) Post-Janus

With its decision in *Janus*, the Supreme Court has further narrowed the scope of liability under Rule 10(b)(5). This decision follows a number of previous rulings wherein the Court made it more difficult for investors to sue secondary actors for securities fraud. Now, investors' ability to prosecute primary actors for violations of Rule 10(b)(5) has likewise been limited.

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[1] Market timing refers to the practice of rapidly trading in and out of a mutual fund to take advantage of inefficiencies in the way the fund values its shares.

[2] Plaintiffs also brought a claim against JCG for control person liability under Section 20(a) of the Act.

[3] The district court dismissed the Section 20(a) claim against JCG as well.

[4] Although the Fourth Circuit dismissed the primary liability claims against JCG, it upheld claims against JCG under Section 20(a) of the Act.