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Supreme Court Limits Liability of Mutual Fund Advisor for Fund Prospectus Misstatements

The Supreme Court continues to limit private rights of action under the Securities Exchange Act of 1934 (Exchange Act) Section 10(b) and Rule 10b-5. In *Janus Capital Group, Inc. v. First Derivative Traders*, a significant victory for mutual fund sponsors, the Court ruled that shareholders can seek Rule 10b-5 redress only against parties with “ultimate authority”¹ over a statement in controversy. Although the Court’s opinion intimates that fund advisors may be liable under other theories of liability, it ruled that a legally separate advisor entity cannot be viewed as having “made” the false statements in the fund entity’s prospectus and, therefore, cannot be held directly liable under Rule 10b-5 where the fund entity has the ultimate authority over the false statements. This is a bright line test that should limit mutual fund advisor liability in Rule 10b-5 private actions—but not necessarily actions by the Securities and Exchange Commission.

Background

Janus Capital Group, Inc. (JCG), a publicly traded company, wholly owns Janus Capital Management LLC (JCM), which serves as the investment advisor of mutual funds that were separate series of Janus Investment Fund, a Massachusetts business trust (Janus Funds). First Derivative Traders (First Derivative), representing a class of shareholders of JCG, claimed that false statements concerning the Janus Funds’ policies prohibiting market timing in Janus Fund shares were made in the Janus Funds’ prospectuses by JCM. Revelations arising from a September 2003 complaint filed by the New York State Attorney General against JCG and JCM indicated that market timing activities occurred in Janus Fund shares, causing Janus Fund investors to redeem a significant quantity of their fund shares. This redemption activity caused the mutual fund fees of JCM, which were a significant portion of JCG revenues, to decline, and thereby negatively affected the price of JCG stock held by the First Derivative class of shareholders.

Although JCG created the Janus Funds and JCM was retained as the funds’ advisor and administrator, the Janus Funds was found to be a separate legal entity owned in its entirety by mutual fund investors. In addition, corporate formalities maintained the legal independence of the Janus Funds from JCM and JCG. Only one member of the Janus Funds board of trustees was associated with JCM (indicating greater independence of the board than is required by the Investment Company Act of 1940) even though all of the trust officers were also JCM officers.

¹ *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. ---, slip op. at 10-12 (2011) (Janus) (decided 5-4 with a dissenting opinion by Justice Breyer).

If you have any questions about the *Janus* decision, please contact your Katten Muchin Rosenman LLP attorney, or any of the following members of Katten’s **Financial Services Practice**.

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First Derivative filed a class action under Rule 10b-5 asserting that JCG and JCM included false statements in mutual fund prospectuses filed by the Janus Funds. The district court dismissed the action for failure to state a claim.² The Fourth Circuit Court of Appeals reversed the district court's decision, holding that First Derivative had sufficiently alleged that JCM and JCG "made" the misleading statements in the prospectuses by participating in the drafting and distribution of such prospectuses.³ Further, the Fourth Circuit found that investors would infer that JCM had a role in preparing or approving the content of the prospectuses, but that the same would not be inferred about JCG, which could only be liable as JCM's "control person" under Section 20(a) of the Exchange Act.

On appeal, the Supreme Court addressed whether JCM could be held liable in a Rule 10b-5 private action for false statements included in Janus Funds' prospectuses. First Derivative argued that JCM made the misleading statements, but sought to hold JCG liable as only a control person of JCM under Section 20(a). The Supreme Court only needed to answer the question of whether JCM could be held liable for making the statements, as no claim against JCG as a control person would have standing unless a claim could be made against JCM.

Summary of the Supreme Court Decision

Rule 10b-5 prohibits any person from, among other things, making any untrue statement of material fact in connection with the sale or purchase of securities.⁴ The Supreme Court noted that neither Section 10(b) of the Exchange Act nor Rule 10b-5 thereunder expressly creates a private right of action. The Supreme Court previously established that Exchange Act Section 10(b) and Rule 10b-5 implied a private right of action.⁵ Consequently, and in accord with its prior precedent, the *Janus* Supreme Court narrowly delineated the scope of a Rule 10b-5 private action.⁶ Justice Thomas's *Janus* opinion held that, for Rule 10b-5 purposes, the person who "makes" a statement is the person with ultimate authority over such statement, including its content and whether or how it is communicated. If there is no control over a statement, a person can only suggest what another should say, not "make" the statement itself. A person or entity that publishes or prepares a statement on behalf of another is not the statement's maker. Justice Thomas analogized this to the relationship between a speechwriter and the one making the speech, where the speechmaker "owns" the speech made and the speechwriter is not held accountable for it.

First Derivative argued that the close relationship between a mutual fund and its investment advisor should cause the advisor to be viewed as the maker of its client mutual funds' statements. The Supreme Court rejected this argument and declined to disregard the corporate entity distinctions between Janus Funds and JCM. The Supreme Court noted that it was undisputed that the corporate formalities between Janus Funds and JCM were observed and refused to reapportion liability in the securities industry due to the close relationship between mutual funds and their investment advisors. The Supreme Court stated that such reapportionment of liability was Congress' responsibility.

The Supreme Court found that JCM did not "make" any of the statements in the funds' prospectuses, Janus Funds did. The Court reasoned that Janus Funds was the only entity that had a statutory obligation to file registration statements with the SEC. Janus Funds did file such registration statements and there were no allegations that JCM itself filed the prospectuses and falsely attributed them to Janus Funds. Finally, nothing on the face of the prospectuses indicated that any statements in them came from JCM rather than Janus Funds. The Supreme Court held that any assistance JCM rendered in preparing statements for inclusion in the Janus Funds' prospectuses were "suggestions," which were subject to Janus Funds' ultimate authority, and did not mean that JCM "made" any of the statements. Consequently, the Supreme Court determined that First Derivative failed to state a claim against JCM under Rule 10b-5 and reversed the Fourth Circuit. As such, no claim could be brought against JCM or JCG as a control person of JCM.

² *In re Mutual Funds Inv. Litigation*, 487 F. Supp. 2d 618, 620 (D. Md. 2007).

³ *In re Mutual Funds Inv. Litigation*, 566 F.3d 111, 121 (4th Cir. 2009).

⁴ Rule 10b-5 makes it "unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, . . . [t]o 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. . . ." 17 CFR §240.10b-5(b).

⁵ *Janus*, 564 U.S. ---, slip op. at 5-6 (citing *Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13, n. 9 (1971)).

⁶ *Id.* at 6.

Implications

The *Janus* Supreme Court declined to expand liability for private actions under Rule 10b-5. Instead, the Supreme Court emphasized the importance of who has the ultimate authority over statements for Rule 10b-5 purposes. *Janus* stands for the bright line general principal that private plaintiffs may not sue under Rule 10b-5 someone who provides information that another person puts into a false or misleading statement as long as such statement is subject to the other's ultimate control.

Nevertheless, the *Janus* principal does not serve as an absolute shield for mutual fund advisors against liability for their mutual funds' misstatements. For one thing, the *Janus* fact pattern was highly unusual. Future courts looking at *Janus* may confine its bright line principle to similar fact patterns and refuse to apply it in other circumstances where, for example, mutual fund shareholders directly sue the fund's advisor for false statements in the fund's prospectus.

Moreover, both the *Janus* majority and dissenting opinions noted that alternate remedies and potential sanctions remain available in the registered investment company context even if primary liability under Rule 10b-5 is absent in a private action. Notably, the SEC may file claims against mutual funds and their advisors, including direct claims under Rule 10b-5 as well as Rule 10b-5 aiding and abetting actions. Even where an advisor is deemed not to have "made" a mutual fund's false or misleading statement in accordance with *Janus*, fund shareholders may be able to seek redress against the advisor as the "controlling person" of the fund under Section 20(a) of the Exchange Act.

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