ALERTS AND UPDATES

Supreme Court Holds Mutual Fund Investment Adviser Not Liable for Misleading Statements in Fund's Prospectus

June 23, 2011

On June 13, 2011, in *Janus Capital Group, Inc. v. First Derivative Traders*,[1] the U.S. Supreme Court held that a mutual fund investment adviser and administrator could not be held liable under federal securities laws for alleged misrepresentations in the prospectuses issued by the mutual fund itself. The Supreme Court concluded that the only person or entity that may be held liable in a private action for having "ma[d]e any untrue statement of a material fact" within the meaning of Rule 10b-5 and Section 10(b) of the Securities Exchange Act[2] is the one "with ultimate authority over the statement, including its content and whether and how to communicate it"—in this case: the mutual fund itself.[3] Liability does not extend to "[o]ne who prepares or publishes a statement on behalf of another" or otherwise participates in the drafting of an allegedly false statement.[4]

In *Janus*, the mutual funds at issue were organized in a Massachusetts business trust (the "Fund"). The Fund's investment adviser and administrator (the "Fund Adviser") was a wholly owned subsidiary of the public company that also created the Fund. Nevertheless, and significantly, the Fund was a separate legal entity owned entirely by mutual fund investors. For example, while all of the Fund's officers were also officers of the Fund Adviser, only one member of the Fund's board of trustees was associated with the Fund Adviser.

The Fund issued prospectuses that: (1) represented that the funds were not suitable for market timing[5] and (2) could be read to suggest that the Fund Adviser would implement policies to curb that practice.[6] Notwithstanding these representations, the New York attorney general filed a complaint against the Fund Adviser and its parent company, contending that the parent entered into secret arrangements to permit market timing in several funds run by the Fund Adviser. When those allegations became public, investors withdrew significant amounts of money from the Fund's mutual funds.

The plaintiff in *Janus* represented a class of investors who claimed to have been misled into buying shares of stock at a premium by prospectuses misrepresenting the Fund's use of market timing. The plaintiff maintained that the Fund Adviser was liable under the federal securities laws because the Fund Adviser participated in the writing and dissemination of the prospectuses, thereby "mak[ing]" the misleading statements contained in the documents. The district court rejected the claim against the Fund Adviser, but the U.S. Court of Appeals for the Fourth Circuit reversed and reinstated it, finding that the Fund Adviser "ma[d]e" a misleading statement by creating and drafting the prospectuses.

The Supreme Court reversed, holding that one "make[s]" 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."[7] While the Fund Adviser might have suggested what to say in the prospectuses, the Fund itself still "ma[d]e" the statements in its own right. As the Supreme Court explained, "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."[8] To rule otherwise, the Court held, would be inconsistent with recent Supreme Court precedent emphasizing that private causes of action may not be brought against persons or entities that contribute substantial assistance to the making of a statement, but do not actually make it.[9]

To avoid dismissal, the plaintiff invited the Supreme Court to recognize the "well-recognized and uniquely close relationship between a mutual fund and its investment adviser." Despite a compelling argument that investment advisers exercise significant influence over their client funds, the Court declined to disregard the corporate form, as the Fund and its Fund Adviser were legally separate entities that observed corporate formalities.[10] Regardless of whatever advisory role the Fund Adviser played, the Fund itself filed the prospectuses, which contained nothing indicating that any statements came from the Fund Adviser rather than the Fund.[11] Moreover, the fact that the Fund Adviser provided online access to the prospectuses on its website was not a basis for liability because "[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."[12]

For Further Information

If you have any questions about this *Alert*, please contact Kelly D. Eckel, Matthew M. Ryan, any member of the Securities Litigation Practice Group, or the attorney in the firm with whom you are regularly in contact.

Notes

1. *Janus Capital Group, Inc. v. First Derivative Traders*, 2011 U.S. LEXIS 4380 (U.S. June 13, 2011).
2. The SEC promulgated Rule 10b-5 pursuant to authority granted under §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b). Under Rule 10b-5, it is unlawful for "any person, directly or indirectly, . . . [t]o make any untrue statement of a material fact" in connection with the purchase or sale of securities. 17 CFR § 240.10b-5(b).
3. *Janus*, No. 09-525, slip op. at 6.
4. *Id.*
5. As the Supreme Court explained, market timing is a trading strategy that exploits time delay in mutual funds' daily valuation system. The price for buying or selling shares of a mutual fund is ordinarily determined by the next net asset value (NAV) calculation after the order is placed. The NAV calculation usually happens once a day, at the close of the major U.S. markets. However, because of certain time delays, the values used in these calculations do not always accurately reflect the true value of the underlying assets. *Janus*, slip op. at 2 n.1.
6. Although market timing is legal, the practice can harm other investors in the mutual fund, as recognized by the Supreme Court in *Janus. Janus*, slip op. at 3.
7. *Janus*, slip op. at 6.
8. *Id*. at 7.
9. *See Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008); Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994). The Supreme Court noted that the SEC may itself bring these claims against those who provide such substantial assistance. *Janus*, slip op. at 7 (citing 15 U.S.C.A. § 78t(e)).
10. *Janus*, slip op. at 10. As the Court explained, "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." *Id.*
11. *Id*. at 10–11.
12. *Id*. at 12 n.12.