Janus: Supreme Court further clarifies Rule 10b-5 liability in private securities actions

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On June 13, 2011, the Supreme Court issued a 5-4 majority opinion in *Janus Capital Group v. First Derivative Traders*, in a closely watched appeal involving private actions for securities fraud. Once again, the Supreme Court has clarified in Janus the limited reach of the implied private right of action in securities cases against "secondary actors."

In a long line of securities cases involving issues of secondary actors and primary liability including *Central Bank of Denver* (no private right of action for "aiding and abetting liability") and *Stoneridge* (rejecting "scheme liability"), the Supreme Court again clarified that in the ordinary course, secondary actors (e.g. bankers, lawyers, investment managers/advisors, and consultants) are shielded from private securities litigation liability. In particular, the *Janus* majority ruled that an investment adviser would not be held liable in a private class action securities lawsuit for misrepresentations in a mutual fund prospectus, since the advisor was not the "maker" of the statements.

Background

Janus Capital Group (JCG) is a U.S. publicly traded financial institution, whose complex includes Janus Capital Management LLC (JCM or the "Advisor"). Janus Investment Funds (JIF or the "Fund") was created by JCG; however, JIF is a separate legal entity owned by JIF's mutual fund investors. As is common in the mutual fund industry, JCM provided investment advisory, management and administrative services to JIF and enjoyed interlocking corporate management through overlapping officers. Only one member of the Fund Board of Trustees was affiliated with JCM, and the Advisor and the Fund maintained legal independence from each other.

The underlying lawsuit in *Janus* is based on a near decade old New York State Attorney General investigation relating to "market-timing trade practices." The investigation centered on the issue that the parent company JCG alleged permitting market-timing in funds advised by JCM. The Fund had issued prospectuses describing its investment strategy and operations, specifying that they were discouraging market-timing practices by the implementation of new policies.

After learning of the regulatory investigation, investors removed $14 billion from the Janus funds, which influenced JCM's revenues, affected JCG's income, and caused a 25% decrease of JCG's stock price. As a result, in 2003, plaintiffs filed a suit against Janus Capital Group and Janus Capital Management for violation of Rule 10b-5 under the Securities Exchange act of 1934. Plaintiffs alleged that parent JCG and its wholly owned subsidiary JCM made false statements in mutual fund prospectuses filed by Janus Investment Funds, by participating in the prospectuses writing and its dissemination. Moreover, plaintiffs alleged that JCG should be responsible for advisor JCM's acts as a "controlling person." The District Court dismissed the suit for failure to state a claim; however, the Circuit Court reversed the District Court's decision. The Circuit Court noted that JCM's participation in the writing and dissemination of the prospectuses was sufficient to state a claim for primary liability under Section 10 and Rule 10b-5.

Supreme Court Review

The Supreme Court granted certiorari to address the question of whether JCM could be held liable in a private action under Rule 10b-5 for false statements included in the JIF's prospectuses.

The Supreme Court highlighted that a private right of action does not include suits against secondary actors, or aiders and abettors, who contribute "substantial assistance" to the making of the statement but do not actually make it. Such suits may be brought by the Securities and Exchange Commission itself, but not by a private party. Neither Section 10(b), nor Rule 10b-5 expressly creates a private right of action, but the courts have interpreted that such a private action is implied under Section 10(b). In recognizing such "implied action," the Supreme Court has indicated that it must be mindful to give "narrow dimensions" to a "right" that "Congress did not authorize when it first enacted the statute and did not expand when it revisited it."

The Supreme Court noted that 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. Therefore,

in order to be liable, JCM must have “made” the material misstatements in the prospectuses. The Supreme Court in reversing the Circuit Courts ruling held that JCM did not “make” such statements.

Because the false statements in the prospectuses were made by Janus Investment Funds, and not by the advisor JCM, the advisor and JCG cannot be held liable in a private action under Rule 10b-5. Janus Investment Funds “made” the statement and had ultimate control on the false statements included in its prospectuses. The Supreme Court appears to have rejected the government’s more expansive view of defining the word “make” as “create.”

Importantly for the mutual fund industry, the Supreme Court rejected arguments based on the companies’ relationship. Even if the Janus complex entities were closely related, they maintained legal independence, and corporate formalities were observed. Board composition restrictions and independence rules, prospectus filing requirements and responsibilities were followed and fulfilled by the appropriate Janus entity. This legal independence helped shield JCM and JCG from liability. Moreover, there was no allegation that JCM, in fact, filed the prospectuses and falsely attributed them to JIF, and nothing on the face of the documents indicates that any statements therein came from or were attributed to JCM, explicitly or implicitly. The Supreme Court indicated that any reapportionment of liability in the securities industry in light of close relationships between investment advisers and mutual funds is the responsibility of Congress, not the courts.

The Supreme Court concluded by interpreting that the “maker” of the statement is the person or entity with ultimate authority over the statement, including its content, and whether and how to communicate it. One who prepares a statement on behalf of another is not its maker.

Janus Decision Implications

The Supreme Court decision again clarifies that in the ordinary course secondary actors have protection from private rights of actions in the securities fraud arena. *Janus* could be seen as a recognition that Congress appears not to have tendered all of the government’s regulatory powers

against securities fraud to the private plaintiffs bar; the legislators kept back for the executive arm of the US government /SEC, the ability to enforce the U.S. Securities laws as they apply to potential aiding and abetting liability and secondary actors/primary liability for securities fraud.

By this judgment, the Court affirms that only a fund and its directors, officers and employees are generally liable for false and misleading statements included in the prospectuses. It reinforces their responsibilities, and their potential to be sued. The Fund trustees may be increasingly named as individual defendants for misstatements.

While the Supreme Court decision should foreclose primary liability for secondary actors (such as investment advisers, consultants, auditors and lawyers who do not "make" statements) in private securities actions; the *Janus* decision is partly based on the fact that the statement in question was not attributed to the investment adviser. It suggests that a secondary actor may be held primarily liable where the "maker" of the statement is not its issuer.

Janus is viewed as a victory for investment advisors and service providers regularly assisting publically traded companies. Being successfully dragged into a securities class action and being held liable under Rule 10b-5 appears less likely for service providers. Indeed, *Janus* appears to have already benefitted a law firm and its partner alleged to be liable for false statements made by Refco in certain of Refco's public filings. The Second Circuit dismissed the claims against the law firm/lawyer by applying its "bright line test" in determining primary liability. Post-Janus, the Supreme Court denied certiorari in that case, and the Second Circuit decision remains.

While secondary actors benefit from the favorable *Janus* decision and are expected to be less likely to be named in private securities fraud actions, they may still be exposed to action by the SEC for aiding and abetting liability and primarily liability in private actions when they directly or indirectly "make" a statement that triggers a securities fraud action.

Financial advisors, consultants, lawyers, auditors and other service providers regularly purchase errors and omissions liability insurance to protect against liability arising out of their professional services. *Janus* may assist in presenting an insured's risk profile to underwriters with a concomitant improvement in pricing and terms and conditions.

Integro's experts are happy to discuss the *Janus* matter with you, as well as recent regulatory developments, and their potential implications on your management risk program needs.

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About Integro

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