To read the transcript of the oral argument in *Janus Capital Group, Inc. v. First Derivative Traders,* please click here.

The Supreme Court Considers the Liability of Investment Advisers in Federal Securities Fraud Cases

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The Supreme Court heard oral arguments yesterday in *Janus Capital Group, Inc. v. First Derivative Traders*, No. 09-525, a case in which the Court is expected to determine whether an investment adviser to a family of mutual funds who allegedly helps draft and disseminate the allegedly misleading prospectuses of those mutual funds can be held liable in a private action, even if the allegedly misleading statements on their face are not directly attributed to the adviser.

Section 10(b) of the Securities Exchange Act of 1934 and Securities Exchange Commission Rule 10b-5 permit private litigants to sue for material misstatements or omissions in prospectuses. Although the Supreme Court held in *Central Bank of Denver v. First Interstate Bank of Denver* that there is no "aiding and abetting" liability in private lawsuits under Section 10(b) and Rule 10b-5, the Court left open the possibility and extent of secondary actor liability: "Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5 . . . ." 511 U.S. 164 (1994). In 2008, the Court clarified the scope of secondary actor liability, holding that a secondary actor can be liable only if the secondary actor itself made a misstatement or engaged in a manipulative act that is disclosed to the public. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008). However, a circuit split has developed over what a secondary actor must do to "make" a misstatement under *Stoneridge*. The Fourth Circuit has held that under certain circumstances, participation by a secondary actor in another company's misstatements may expose the secondary actor to liability in private actions, even when those statements are not directly attributed to the secondary actor. In contrast, the Sixth and Eighth Circuits have held that secondary actors' participation in other companies' misstatements was insufficient to extend § 10(b) liability. And the Second, Fifth, and Eleventh Circuits have adopted a bright-line attribution rule, finding that § 10(b) applies only to statements that were publicly attributable to the defendant at the time the statements were made. The Court's decision in *Janus* may resolve this circuit split and offer guidance as to whether a company that plays a role in drafting another company's prospectuses and other statements may be sued by investors for those misstatements, and the extent to which a misrepresentation must be attributed to a secondary actor for that actor to be held liable.

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BACKGROUND

Section 10(b) and Rule 10b-5 prohibit the use of manipulative or deceptive devices or contrivances, and bar the making of untrue statements or material omissions of material fact, in connection with the purchase or sale of securities. 15 U.S.C. § 78(j); 17 C.F.R. § 240.10b-5. Private plaintiffs may recover for a "fraud on the market" under these provisions if they can prove, among other things, that the defendant made a material misrepresentation or omission and that the misstatement or omission was publicly attributed to the defendant.

Janus involves alleged misstatements in prospectuses for funds in the Janus family of mutual funds ("the Funds"). Petitioner Janus Capital Group Inc. ("JCG") created the Funds, which were managed by its wholly-owned subsidiary, Petitioner Janus Capital Management LLC ("JCM"). JCM also served as the Funds' investment adviser. The Funds represented in their prospectuses that their fund managers discouraged and took measures to prevent market timing, which involves rapidly trading in and out of a mutual fund to take advantage of inefficiencies in how the fund values its shares. JCG and JCM later admitted that they had negotiated with certain hedge funds to permit market timing in the Funds. Eventually, these market timing practices were exposed when the New York Attorney General filed a complaint in September 2003, alleging that JCG and JCM's executives permitted substantial market timing contrary to the Funds' express policies. The complaint triggered widespread withdrawals from the Funds, and JCG's stock price fell by 23 percent.

In late 2003, JCG shareholders brought suit against JCG and JCM under Section 10(b) and Rule 10b-5, alleging that they were injured by the fall in JCG's stock price after the alleged misstatements were revealed. The district court granted Petitioners' motion to dismiss, finding that Respondents had failed to plead that JCG made material misstatements in the prospectuses or that those statements were directly attributed to it. The lower court also dismissed the claims against JCM because it held that JCM did not owe a duty to JCG's shareholders.

On appeal, the Fourth Circuit reversed and remanded, holding that Respondents had sufficiently pled that JCM "made" the allegedly misleading prospectus statements by participating in the drafting and dissemination of the prospectuses, and that JCG could be held liable as a control person of JCM. The Fourth Circuit also held that Respondents had adequately pled the public attribution element of the fraud-on-the-market theory, and thus were entitled to a presumption that they relied on the misstatements. Although the prospectuses did not explicitly name JCG and JCM as drafters, the court found that the statements in question were attributable to JCM because "interested investors would infer that JCM played a role in approving the content of the Janus fund prospectuses . . . ." *In re Mut. Funds Inv. Litig.*, 566 F.3d 111, 127 (4th Cir. 2009). In drawing this conclusion, the Fourth Circuit articulated a new standard for pleading the public attribution element of fraud-on-the-market reliance: a plaintiff need only allege "facts from which a court could plausibly infer that *interested investors* would have known that the defendant was responsible for the statement at the time it was made, *even if the statement on its face is not directly attributed to the defendant*." *Id*. at 124 (emphasis added). The court further stated that the attribution determination should be 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 statements." *Id*. Applying this new standard, the court found that interested investors would have known that JCM played a role in preparing or approving the content of the Janus fund prospectuses because the prospectuses identified JCM as investment adviser to the Funds

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and because JCM was responsible for day-to-day management of the funds. The court held that the "interested investor" standard was not satisfied regarding JCG, however, because it would not be apparent to interested investors that a parent company participates in the approval or drafting of prospectuses issued by individual funds. The Fourth Circuit's attribution standard contrasts with the majority of circuits that have considered the issue, which require direct attribution as a prerequisite to presuming reliance.

SUMMARY OF THE ARGUMENT

At oral argument, Petitioners' counsel began by arguing that the Fourth Circuit's standard would undermine the Court's rulings in *Central Bank* and *Stoneridge* and would authorize a flood of litigation against every service provider that helps draft a company's prospectus. Justice Sotomayor asked whether, under Petitioners' argument, a company could escape liability by using another company as a conduit to make misleading statements to the market: "Do you mean to say to me that puppets become a legal defense for someone who intentionally manipulates the market information?" Petitioners' counsel responded that "Congress has drafted two statutes that deal with puppets"—sections 20(a) and 20(b) of the Securities Exchange Act of 1934, neither of which were invoked by Respondents. Under those provisions, counsel argued that secondary liability was permitted. Justice Ginsburg asked whether JCM itself "made the decision that violated the policy" against market timing. Petitioners' counsel conceded that JCM made the decision, but argued that it was not a primary actor with respect to JCG's shareholders under Section 10(b) and Rule 10b-5. Rather, Petitioners' counsel maintained that JCM's liability lay with Fund shareholders for breach of fiduciary duty—an issue that had already been pursued and resolved in private litigation and through an SEC enforcement action that resulted in a $100 million settlement.

Justices Kagan and Ginsburg asked Petitioners' counsel whether JCM's in-house counsel drafted the Funds' prospectuses. Petitioners' counsel admitted that the prospectuses were drafted by JCM's in-house counsel, who were paid by JCM. Petitioners' counsel argued, however, that "once [in-house counsel] draft materials and present them to their client, it becomes the client's statement when adopted by the client. . . . Only [the client] can make the statement." Justice Kennedy asked whether, if "JCM is really the day-to-day manager . . . of the Fund, . . . it should be chargeable as if it and the Fund are the same for purposes of making the statement?" Petitioners' counsel reiterated that "the investment company, the mutual funds, are separately owned, separately governed." As such, JCM could not have primary liability for the statements by the Funds, and Respondents had chosen not to sue under other statutory provisions permitting secondary liability.

Respondents' counsel argued that "this case is not about service providers, but it is about Janus Capital Management being the primary violator." Justice Scalia asked whether JCM "made" the misleading statements at issue, noting: "If someone writes a speech for me, one can say he drafted the speech, but I make the speech." Respondents' counsel argued that here, the Funds had no employees of their own—"All of this is outsourced management." Justice Scalia followed up, stating: "[T]he Fund may have a cause of action against JCM, but what's crucial here is whether . . . you can establish that it is JCM who made the representation to the public, and I don't see how you can get there."

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Respondents' counsel responded that JCM "made" the public misrepresentation "when they issued the prospectus," "used their address," and "filed [the prospectus] and disseminated it on their website." Justice Scalia replied, "If I carry a letter over and file it on behalf of some principal, does it become my letter?" Respondents' counsel also urged the Court to address such relationships between mutual funds and their advisers, to avoid creating "a road map for other people to commit fraud" by holding that companies may make fraudulent statements through "shell companies." Chief Justice Roberts replied: "But they're going to hit a pretty big bump in the road when the SEC brings an action against them, including potential criminal actions."

The United States as amicus curiae also argued, siding with Respondents and asking the Court to affirm the Fourth Circuit's decision. The United States' counsel argued that "making" a statement involves "creat[ing] the statement," either directly or indirectly. "[I]f [one] writes the statement or provides the false information that's used to construct the statement or allows the statement to be attributed to him," and if that person is "using a conduit," that person should be considered "a primary violator." Justice Kagan expressed concern with the government's position, noting that it "is really pretty broad and that it might apply to a range of factual situations that are not before us." The United States' counsel replied that the Court's holding could be confined to the mutual fund situation by "analogiz[ing] it to the cases involving corporate employees . . . where a corporate employee drafts a statement that's issued in the company's name." Justice Scalia replied, "Congress has made it very clear that investment advisers are not to be treated like employees. You . . . want us to undo a clear distinction that Congress has made."

IMPLICATIONS

In deciding this case, the Court is expected to clarify the potential private securities litigation liability of investment advisers that allegedly participate in other companies' misstatements. Allowing the Fourth Circuit's decision to stand could substantially increase the amount of litigation against secondary actors, such as bankers, lawyers, investment and financial advisers, accountants, and other outside professionals involved in the review of a company's public statements. Adoption of a more stringent standard, on the other hand, could greatly reduce secondary actors' potential for liability.

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