

Supreme Court to Review Direct Liability of Investment Adviser for Prospectus Disclosure

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At the end of its term, the Supreme Court granted *certiorari* in *Janus Capital Group, Inc. et al., v. First Derivative Traders*, Case No.09-525, and will address whether an investment adviser can be held primarily liable under Section 10(b) of the Securities and Exchange Act of 1934 ("Exchange Act") for participating in drafting or approving allegedly misleading statements in a mutual fund prospectus. *Janus Capital* will be an important case to watch, not only for investment companies and their advisers, but for other service providers such as accountants, attorneys and, consultants that are involved in preparing prospectuses and similar documents that are ultimately disseminated to investors.

In prior decisions ranging from *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), to more recently *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), the Supreme Court has made clear that there is no aiding and abetting liability in private Section 10(b) securities fraud actions. Under *Stoneridge*, an actor who provides assistance to a corporation that makes a misstatement in public documents cannot be held liable in a private securities fraud action under a scheme theory of liability. But the *Janus Capital* case on its face involves primary rather than secondary liability.

At the heart of the case is whether Janus Capital Management LLC, adviser to the Janus Funds, and its parent company, Janus Capital Group, Inc., are liable for statements made about market timing in certain of the Funds' prospectuses. The Fourth Circuit¹ found that plaintiffs' complaint had sufficiently pleaded a claim, at least against the adviser, Janus Capital Management. According to the Fourth Circuit, investors would have attributed statements in the prospectus to it because of Janus Capital Management's role as investment adviser to the Funds. While a plaintiff must allege that a misleading statement can be "attributed" to the defendant in order to claim reliance based on a fraud-on-the-market theory, the different Circuit Courts require different degrees of attribution. The Supreme Court may resolve this apparent Circuit split when it decides *Janus Capital* next term. In doing so, the Court may decide the issue in a way that impacts issues of liability for secondary actors resolved in *Stoneridge*.

Liability for Misleading Prospectus

Plaintiff First Derivative Traders filed a class action on behalf of itself and other Janus Capital Group shareholders in November 2003, alleging that both Janus Capital Group and Janus Capital Management were responsible for statements in the prospectuses representing that the Funds had

policies against market timing and took measures to prevent such practices.² The plaintiffs claimed that those statements were false and misleading because secret arrangements with hedge funds actually allowed these favored investors to engage in such market timing transactions.

After a precipitous drop in the price of Janus Capital Group shares – caused by public disclosure by then New York attorney general Eliot Spitzer about Janus' and other firms' market-timing deals – plaintiffs sued, claiming they bought at inflated prices and lost money when the price fell. In May 2007, the district court dismissed the case, rejecting direct liability because the complaint “contain[ed] no allegations that [Janus Capital Group] actually made or prepared the prospectuses, let alone that any statements contained therein were directly attributed to it,” and noting that *Central Bank* defendants could not be subject to aiding and abetting liability for the misleading statements.³ The district court also ruled that plaintiffs failed to plead a claim against Janus Capital Management because a mutual fund investment adviser owed no duty to its parent's shareholders.

The Fourth Circuit reversed, ruling that the complaint contained adequate allegations of attribution to “implicate” Janus Capital Management (although those allegations were insufficient to “reach” Janus Capital Group). Even though the statements in the prospectuses were not *directly* attributable to Janus Capital Management, the Fourth Circuit found that based on that entity's role as the Funds' investment adviser, investors would have known that Janus Capital Management drafted or approved the statements in the prospectuses. In reaching this conclusion, the Fourth Circuit discussed the split among the Circuits on the test for attribution, noting that the Second and Eleventh Circuits mandate that the actor “make” the statements and that they be publicly attributed to him at the time made, while the Ninth Circuit holds that public attribution is not required and “substantial participation” in preparing the misleading statement suffices for primary liability under Section 10(b).

In *Janus Capital*, the Fourth Circuit adopted a singular test of its own that requires a “case-by-case” determination that is more akin to the Ninth Circuit's “substantial participation” test,⁴ but importing the concept of what a reasonable investor would know or infer based on the relative roles of the players involved. In the Court's words, plaintiffs showed sufficient attribution because, “given the publicly disclosed responsibilities of JCM [as investment adviser to the Funds], interested investors *would infer* that JCM *played a role* in preparing or approving the content of the Janus fund prospectuses....”

Key Role of Investment Adviser

The *Janus Capital* decision is distinctive because of the stress it places on the relationship of the investment adviser to the funds and parent company/fund sponsor in the context of mutual funds companies. By analogy, the *Janus Capital* court noted that, even in Circuits requiring “direct attribution,” auditors and corporate officers can be primarily liable for statements issued by the corporation or analysts that are not directly attributable to those auditors or officers. Such liability turns on whether the statement was “adopted” and requires a court to analyze the “relationship between the defendant and the entity or analyst issuing the allegedly misleading statement.”

By the same token, the *Janus Capital* court pointed to numerous facts and commentary showing that investment advisers to mutual funds are responsible for the day-to-day management of the funds.⁵ The Fourth Circuit noted that the *Janus Capital* plaintiffs averred that the Funds had no separate management or assets, and that all of the Funds' officers were executives at the adviser. Plaintiffs also alleged that Janus Capital Management's involvement included “participating in the writing and dissemination of the prospectuses.” Based on the overall context, and the specific facts alleged in the

complaint, the *Janus Capital* Court held that these allegations sufficiently stated a claim that Janus Capital Management played a role in drafting or approving the prospectuses at issue.

In the petition for writ of *certiorari*, Janus Capital Group and Janus Capital Management argued that the Fourth Circuit's holding in *Janus Capital* (1) "created" a split from the other Circuits as well as the Supreme Court by allowing claims against Janus Capital Management to proceed even though that company did not make any of the statements in the prospectus, and (2) "exacerbated" a Circuit split by requiring only "substantial participation" in the preparation of a misstatement rather than "direct attribution" for such statement. They also stressed that the Funds, which were not named defendants in the action, were separate legal entities that were registered as investment companies under the Investment Company Act of 1940 and were governed by separate boards of trustees with separate legal counsel from Janus Capital Group and Janus Capital Management. Although Janus Capital Management provided investment advisory and administrative services to the Funds, the Funds – not Janus Capital Group or Janus Capital Management – bore the costs of preparing and disseminating the prospectuses.

The plaintiffs, in opposing the petition, argued that the Fourth Circuit's decision did not evidence any conflict among the Circuits. They insisted the underlying decision was in accord with the Supreme Court's holding in *Stoneridge*, because Janus Capital Management helped prepare the alleged misstatements and investors had reason to believe the statements were "the work of" Janus Capital Management, consistent with "mutual fund industry custom." The plaintiffs also claimed that the Fourth Circuit's ruling would not have a "chilling impact" on service providers or professionals who assist in the preparation of SEC filings – such as lawyers and accountants – because the ruling turned on "facts that were unique to the case at bar." According to the plaintiffs, Janus Capital Management was "not a mere 'service provider'" but, as is typical, handled all of the Funds' operations including the preparation and dissemination of the prospectuses at issue.

Notably, the Supreme Court granted *certiorari* even though the U.S. Solicitor General – which the Court had asked to weigh in on the case – along with the SEC and the DOJ, all filed a brief siding with the plaintiffs and urging that the Court should not hear the case.

Conclusion – The Implications Within and Outside the Investment Management Industry

While the facts of the *Janus Capital* case and the defendants involved are limited to the mutual fund industry, it is unclear whether the analysis and rationale applied will be extended to service providers and other actors outside of that industry. Although the Supreme Court may explicitly limit its eventual decision to those facts, and that industry, the attribution cases cited by the Fourth Circuit are not so limited. It is easy to envision the plaintiffs' bar trying to expand the reach of the Fourth Circuit's investment adviser standard to encompass a wide range of secondary actors. Such tactics would, of course, be an attempted end-run around *Central Bank* and *Stoneridge* and hopefully will be foreclosed by the Supreme Court in its ruling on this case.

Paul Hastings will closely follow this case and will provide an update with analysis of the Supreme Court's ruling once a decision is reached.

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¹ *In re Mutual Funds Investment Litigation (First Derivative Traders v. Janus Capital Group, Inc., et al.)*, 566 F.3d 111 (4th Cir. 2009).

² "Market timing" refers to trading in and out of a mutual fund to take advantage of time zone differences and other inefficiencies in the way the fund values its shares. A number of highly-publicized cases related to market timing were filed by the SEC, the New York Attorney General's office, and private investors against fund companies.

³ *In re Mutual Funds Investment Litigation (Wiggins, et al., v. Janus Capital Group, Inc., et al.)*, 487 F. Supp. 2d 618 (2007).

⁴ That test was set forth in *In re Software Toolworks Inc. Sec. Litig.*, 50 F. 3d 615, 628-29 (9th Cir. 1994) and cited in *Howard v. Everex Sys., Inc.*, 228 F. 3d 1057, 1061 (9th Cir. 2000).

⁵ The Supreme Court recently referred to similar materials in *Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418, 1422 (2010), in describing the investment adviser's role in managing the mutual fund's investments, selecting its directors, and providing other services.