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U.S. Supreme Court Limits Liability Under Rule 10b-5

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In *Janus Capital Group Inc. v. First Derivative Traders*, 564 U.S. ___ (2011), issued Monday, June 13, 2011, the U.S. Supreme Court endorses a bright-line test on who can be held liable for **making a false statement to investors under Rule 10b-5 and Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b).** Rule 10b-5 makes it 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 § 240.10b5(b). The Court's opinion focuses on what it means to "make" a statement, and who can be liable for public statements an issuer makes.

The Facts

First Derivative Traders sued Janus Capital Group, Inc. ("Janus Capital") and Janus Capital Management LLC ("Janus Management"), a wholly owned subsidiary of Janus Capital, on behalf of a class of Janus Capital shareholders for alleged false statements in prospectuses issued by Janus Investment Fund ("Janus Fund"), a separate business trust wholly owned by investors in Janus Fund's mutual funds. Janus Management is the investment advisor and administrator for the Janus Fund mutual funds. The question before the Court was whether Janus Management made, and therefore could be held liable under Rule 10b-5, the alleged false statements in prospectuses issued by Janus Fund.

The Holding

In the 5-4 majority opinion by Justice Thomas, the Court reversed the Fourth Circuit and held that Janus Management did not make the statements in the Janus Fund prospectuses and could not be liable under Rule 10b-5. The Court explained that "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." While the Court acknowledged the "well-recognized and uniquely close relationship between a mutual fund and its investment advisor," that "investment advisors exercise significant influence over their client funds," and that Janus Management was "significantly involved in preparing the prospectuses," it held that because Janus Fund was a legally separate entity, had the statutory obligation to file the prospectuses with the SEC, and ultimate control over the content, it alone could be liable. The Court analogized its rule to a speechwriter and a speaker. While the speechwriter may draft a speech, the content of the speech is ultimately within the control of the speaker who delivers the speech, and the speaker ultimately takes the credit or the blame for the contents.

The Reasoning

The Court's opinion follows the precedent set by *Central Bank of Denver, N. A. v. First Interstate Bank of Denver, N. A.*, 511 U. S. 164 (1994) and ***Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc***., 552 U.S. 148 (2008) and establishes a clear distinction between primary and secondary actors. The majority reasoned that adopting the expansive definition of "make" proposed by First Derivative Traders and the SEC in its *amicus* brief would severely undermine the Court's earlier decision in *Central Bank* where it held that only the SEC, and not private litigants, had the ability to bring claims against secondary actors for “aiding and abetting” Rule 10b-5 violations. The Court noted that for *Central Bank* to have any meaning there must be a clear distinction between primary and secondary liability—primary actors are only those who have ultimate authority over the content of a statement and whether and how to communicate it. The Court's bright-line approach is consistent with its decision in *Stoneridge*, in which it refused to allow a private suit against a company whose deceptive business agreements were incorporated into another company's allegedly false financial statements.

The Implications

Individual and entity defendants in industries other than mutual funds are likely to argue that the Court’s holding applies to preclude their liability under Rule 10b-5. While lower courts will likely distinguish *Janus Capital* to preclude it from applying to corporate officers who certify an issuer’s SEC filings, the argument may be more persuasive in the case of other company employees or independent directors who have not certified the SEC filings or otherwise have ultimate authority in the content of the company statements and whether and how to communicate them. Perhaps the most persuasive argument would be with related entities structured similarly to the ones in *Janus Capital* where the entity making the public statements is not the entity in which investors hold shares and is legally independent. This is precisely one of the dissenting minority’s concerns—that a “guilty” management could draft a statement containing materially false statements and fool an “innocent” board of a legally independent entity into believing and issuing the statement and escape liability under the majority’s holding.

Aside from the Court’s holding on the meaning of “make” in the text of Rule 10b-5, it addressed two other issues under Rule 10b-5. In footnote 11, the Court clarifies that the phrase “directly or indirectly” in the text of Rule 10b-5 applies to how the statement is communicated to the investor once it is made, and cannot be interpreted to blur the line between primary and secondary violators. Although the Court declined to define precisely what it means to make a statement indirectly, it noted that at a minimum the indirect communication must attribute the statement to the original maker of the statement. Footnote 12 gives comfort to companies that are hesitant to post or link to documents such as relevant analyst or news reports on their website for fear that it could be held liable for any false or misleading statements in the documents. The Court clarifies that merely hosting a document on a website does not provide a basis for Rule 10b-5 liability because it does not indicate that the hosting entity adopts the document as it own statement or exercises control over its content.

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