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Supreme Court Grants Certiorari in Mutual Fund Market Timing Case

Court to Address Scope of “Primary” Liability for Outside Service Providers and Professionals

On June 28, 2010, the Supreme Court granted certiorari in *Janus Capital Group, Inc. v. First Derivative Traders*, No. 09-525, to review a decision by the Fourth Circuit that reinstated a federal securities fraud complaint. This case presents the Court with the opportunity to address significant issues of interest to investment advisers and other outside professionals who provide services to issuers, including the contours of “primary” liability under Section 10(b) of the Securities Exchange Act and Rule 10b-5 — a critical question that has divided the lower federal courts since 1994, when the Supreme Court held that there can be no “aiding and abetting” liability in private civil actions under those provisions. *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

The case arose from regulatory investigations into market timing of mutual fund shares in several large fund families.¹ Plaintiff is a shareholder of Janus Capital Group (“Janus Capital”), a public company whose subsidiary Janus Capital Management LLC (“JCM”) provides investment advisory and management services to the Janus family of mutual funds. Plaintiff alleges that the prospectuses for the Janus funds misleadingly stated that the funds had policies designed to prevent market timing. Plaintiff further alleges that, when it came to light that the funds in fact permitted select investors to engage in market timing, other investors withdrew assets from the funds. As a result, according to the complaint, the value of JCM’s advisory and management business, and hence the market price of Janus Capital shares, declined. Based on the alleged misstatements in the mutual fund prospectuses, plaintiff asserts claims under Section 10(b) and Rule 10b-5 against Janus Capital and JCM, on behalf of a purported class of Janus Capital shareholders.

A panel of the Fourth Circuit reversed a district court ruling that dismissed the action under Rule 12(b)(6). The panel observed that, although “the fund prospectuses [were] unattributed on their face” to Janus Capital or JCM, plaintiff had alleged that both entities “helped draft the misleading prospectuses” and disseminated them to the public. This allegation, the panel held, sufficiently identified Janus Capital and JCM, for purposes of pleading fraud under Rule 9(b), as “makers” of the supposed misleading statements. The panel next considered whether the allegations of plaintiff’s complaint, if true, were sufficient to impose

¹ Market timing is a practice involving frequent buying and selling of mutual fund shares to exploit pricing inefficiencies. Although the practice is not illegal *per se*, it may harm mutual fund investors by, for example, causing the fund to incur additional costs and thereby diluting the fund’s net asset value.

liability on Janus Capital and JCM under Section 10(b) and Rule 10b-5. Recognizing that the courts of appeals had “diverged” concerning whether and how a statement must be attributed to the defendant in order to ground liability, the panel concluded that — at least when a plaintiff relies on the “fraud on the market” presumption that the Supreme Court recognized in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) — liability under Section 10(b) and Rule 10b-5 can attach if “interested investors . . . would attribute the allegedly misleading statement to the defendant.”

Applying that rule to the case before it, the panel noted, among other things, plaintiff’s allegations that JCM was “responsible for the day-to-day management of [the] investment portfolio and other business affairs of the funds” and statements in the prospectuses describing JCM’s management role. Thus, the panel concluded that “if JCM had not itself written the policies in the Janus fund prospectuses regarding market timing, it must at least have approved those statements,” and found that circumstance “sufficient to support the adequacy of plaintiff’s pleading of fraud-on-the-market reliance as to JCM.” However, as to Janus Capital, the publicly-traded holding company, the panel held that it would not “be apparent to the investing public that [JCM’s] parent company, which sponsors a family of funds, participates in the drafting or approving of prospectuses issued by the individual funds.” Accordingly, the panel reinstated plaintiff’s securities fraud claim against JCM. The panel held that Janus Capital (JCM’s parent company), while it could have no direct federal securities fraud liability, might be liable as a “control person” of JCM under section 20(a) of the Securities Exchange Act. Janus Capital and JCM then filed a certiorari petition with the Supreme Court, seeking review of the Fourth Circuit’s decision.

Interestingly, at the Supreme Court’s invitation, the Acting Solicitor General submitted a brief urging the Court to deny the petition for a writ of certiorari. The government conceded that several courts of appeals — most recently, the Second Circuit in *Pacific Investment Management Co. LLC v. Mayer Brown LLP*, 603 F.3d 144 (2d Cir. 2010) (“*PIMCO*”) — have held that “primary” liability under Section 10(b) and Rule 10b-5 arises only for statements directly and explicitly attributed to the defendant at the time of dissemination. However, the government contended that *PIMCO* and other decisions imposing a “bright line” attribution rule apply only to “secondary” actors such as attorneys, accountants and other outside professionals. The government attempted to harmonize the Fourth Circuit’s ruling with those decisions by arguing that JCM, although nominally a legal entity separate from the fund itself, was essentially an “insider” of the Janus funds and allegedly caused them to make the alleged misleading statements. In response, Janus Group and JCM pointed to the diverse views that federal appellate courts have expressed regarding the degree to which a statement must be attributed to the defendant in order to give rise to primary (as opposed to “aiding and abetting”) liability. Janus Group and JCM also noted provisions in the Investment Company Act of 1940 designed to address conflicts of interest by ensuring the independence of funds from their managers.

Rejecting the Acting Solicitor General’s arguments, the Supreme Court granted certiorari and agreed to review the Fourth Circuit’s ruling. The case is an important one for investment advisers, but also attorneys, accountants, underwriters and other outside professionals who advise issuers in connection with their disclosures. To date, the courts of appeals have taken various approaches to the imposition

of “primary” liability under Section 10(b) and Rule 10b-5. These approaches range from the Second Circuit’s “bright line” rule in *PIMCO* and *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998), to approaches under which a defendant’s substantial participation in the preparation of a statement — with no public attribution at all — is sufficient to ground liability. These various approaches have, for example, left uncertainty about the scope of potential liability for outside professionals who participate in the prospectus writing process. The Supreme Court’s decision promises to clarify this area of the law and assist “secondary” actors in assessing the degree to which their performance of services may expose them to federal securities law liability.

If you have any questions or need additional information, please feel free to contact any member of our Litigation or Financial Services Departments. This memo was authored by the following attorneys:

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