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Supreme Court Creates Bright Line Test Under Rule 10b-5

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The U.S. Supreme Court has found that a party that assists in the drafting and dissemination of a misleading statement related to the sale of a security—but that is not the legal entity ultimately responsible for the statement—will not be subject to liability for securities fraud under Securities and Exchange Commission Rule 10b-5.

Janus Capital Management LLC (JCM) is the investment adviser for a trust of mutual funds known as the Janus Investment Fund (JIF) and assisted with the drafting of JIF prospectuses which stated that JIF funds did not engage in the controversial practice of "market-timing." When allegations surfaced in a lawsuit that certain JIF funds did engage in market-timing, the shares of JIF's corporate parent Janus Capital Group, Inc. (JCG) fell, and investors in JCG sued JCM for securities fraud under SEC Rule 10b-5.

Rule 10b-5 states that it is unlawful for any person to "make" a misleading statement in the sale of a security. Investors argued that JCM, which is a separate legal entity from JIF, had made the misleading statement for purposes of Rule 10b-5 liability by participating in the writing and dissemination of the misleading JIF prospectuses. The district court granted the motion to dismiss and the U.S. Court of Appeals for the Fourth Circuit reversed.

The Supreme Court in a 5-4 decision reversed the Fourth Circuit, holding that, in order for liability to attach under Rule 10b-5, the defendant must have ultimate authority over the content of the statement, including "whether and how to communicate it." Because JIF was the entity that filed the prospectuses with the SEC, JCM could not be subject to liability under Rule 10b-5. A detailed discussion of the case will be the subject of an upcoming Katten Client Advisory. (*Janus Capital Group, Inc. v. First Derivative Traders*, No. 09-525, 2011 WL 2297762 (U.S.) (June 13, 2011))