SEC v. *TAMBONE*: THE US COURT OF APPEALS FOR THE FIRST CIRCUIT REJECTS THE SEC'S ATTEMPT TO IMPOSE RULE 10B-5 PRIMARY LIABILITY FOR "IMPLIED" STATEMENTS

Last week, in a closely-watched case, the United States Court of Appeals for the First Circuit, sitting *en banc*, upheld the dismissal of Rule 10b-5 securities fraud claims brought by the US Securities and Exchange Commission (SEC) against two officers of a firm that underwrote and marketed mutual funds. The SEC alleged that by distributing mutual fund prospectuses that allegedly contained false statements, the two men had made implied statements endorsing the truth of the prospectuses and thereby violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5(b) promulgated thereunder. Rule 10b-5(b) makes it unlawful, in connection with the purchase or sale of any security, "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading."[1] Rule 10b-5(b) is the most common basis for private class action securities fraud suits alleging violations of Section 10(b). The First Circuit rejected the SEC's "expansive interpretation" as "inconsistent with the text of the rule" and the structure of the securities laws, and "in considerable tension with Supreme Court precedent."[2] Circuit Judge Boudin and Chief Judge Lynch, concurring, went even further and, in much harsher language, criticized the "alarmingly ambitious use" that the SEC sought to make of Rule 10b-5.[3]

BACKGROUND: THE SEC ALLEGES RULE 10B-5(B) LIABILITY FOR "IMPLIED STATEMENTS"

Tambone arose out of alleged "market timing," or rapid in-and-out trading, by investors in certain mutual funds. The SEC alleged that prospectuses issued by the funds' sponsor, Columbia Management Advisors, Inc. (Columbia Advisors), falsely stated that the funds maintained a "strict prohibition" against market-timing when in fact the funds allegedly allowed certain favored clients to engage in regular and substantial market timing trades.[4] In February 2005, the SEC settled an enforcement action against Columbia Advisors, and its wholly owned subsidiary, Columbia Fund Distributor, Inc. (Columbia Distributor), a broker-dealer which underwrote and marketed the funds, as well as three former Columbia executives.[5] Pursuant to the settlement, the two firms agreed to pay US$70 million in disgorgement and a US$70 million civil penalty.

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Thereafter, the SEC sued Tambone and Hussey, who were officers of Columbia Distributor. The SEC alleged that defendants had violated Section 17(a) of the Securities Act and made false statements in violation of Section 10(b) of the Securities Exchange Act and Rule 10b-5(b), and also alleged that the defendants had aided and abetted violations of Section 10(b) and Rule 10b-5 and other securities laws by Columbia Advisors and Columbia Distributor.

Tambone and Hussey moved to dismiss the complaint. With respect to the Section 10(b) and Rule 10b-5 claims, defendants sought dismissal on the grounds that they did not "make" any actionable misstatements. In particular, they asserted that the alleged misstatements in the prospectus were made by Columbia Advisors, which issued the prospectus, not by them or their employer, the Columbia Distributors broker-dealer. The SEC opposed the motion, arguing that because the defendants had reviewed the market timing language, had each signed selling agreements warranting that the prospectuses were accurate, served as senior officers of the underwriter which offered the funds for sale (and accordingly, owed a "special duty" to ensure the accuracy of the fund prospectuses), the defendants engaged in sufficient conduct to "make" the challenged statements within the meaning of Rule 10b-5(b). The district court granted the motion to dismiss in its entirety.[6]

The SEC appealed the decision and a divided First Circuit panel reversed, with Judge Selya dissenting with respect to the reversal on the Section 10(b) and Rule 10b-5 claims.[7] In appealing dismissal of the 10b-5 claim, the SEC focused on two theories: (1) that the "defendants 'made' the misrepresentations by using the prospectuses to sell the mutual funds;" and (2) in doing so, "defendants impliedly made false representations to investors…that they had a reasonable basis for believing that the key representations in the prospectuses were truthful and complete."[8] Notably, the SEC dropped several arguments it had advanced below, including that: the defendants "reviewed and commented on the market timing statements" before they were included in the prospectuses; the defendants signed "selling agreements …vouch[ing] for the accuracy" of the prospectuses; "the defendants made the alleged misstatements through their involvement with the preparation of the prospectuses"; and the defendants violated other subsections, (a) and (c) of Rule 10b-5.[9]

The First Circuit panel accepted the SEC's argument that the defendants had violated Rule 10b-5(b) by making "implied representations." The panel held that, under the federal securities laws, officers of underwriters have a "duty to review confirm the accuracy" of the prospectuses and other fund materials they distribute.[10] Thereafter, the First Circuit granted defendants' petition for *en banc* review only with respect to the Section 10(b) claims.[11]

THE FIRST CIRCUIT REJECTS THE SEC'S THEORY AS CONTRARY TO RULE 10B-5(B)'S REQUIREMENT THAT A DEFENDANT "MAKE" A STATEMENT AND IMPROPERLY BLURRING THE LINE BETWEEN PRIMARY AND SECONDARY LIABILITY

The First Circuit *en banc* rejected the SEC's "implied misrepresentation" theory as "inconsistent with the text of [Rule 10b-5(b)] and with the ordinary meanings of the phrase 'to make a statement.'"[12] Observing that the "pivotal word in the rule's text is 'make,'" the court cited common dictionary definitions, including "create [or] cause," "compose," and "cause to exist."[13] It concluded that the SEC's "implied statement" reading of "make" was inconsistent with those definitions. The court also noted that the SEC's proposed expansive definition of "make" ignored the differences between that word and other portions of Rule 10b-5 that make it illegal to "use or employ" manipulative devices.[14] The *en banc* court thus rejected the SEC's position that the rule should be construed in light of the broader language of Section 10(b) making it illegal to "use or employ…any manipulative or deceptive device" because "[t]he scope of Rule 10b-5 is coextensive with the coverage of § 10(b)."[15] As the court explained, the breadth of Section 10(b) is not matched by the specific subsection of the rule at issue.[16]

Moreover, the court reasoned, the SEC's theory that an individual could be liable for impliedly making a statement actually made by someone else should be rejected as in tension with the Supreme Court's decision in *Central*

Bank of Denver v. *First Interstate Bank of Denver*, 511 U.S. 164 (1994) and later cases and legislation which have recognized a clear line between primary and secondary securities fraud liability.[17] In *Central Bank*, the Supreme Court held that the implied private right of action under Section 10(b) extends only to "primary" violators who actually make false statements and not to "secondary" violators who do not make the statements but only aid and abet such primary violations. The First Circuit explained that the SEC's theory would obliterate that dichotomy, which Congress ratified in the provisions of the Private Securities Litigation Reform Act (PSLRA) clarifying the SEC's authority to bring secondary "aiding and abetting" claims—as the SEC in fact did in *Tambone*—but refusing to authorize "aiding and abetting" claims brought by private litigants.[18] As the concurrence recognized, accepting the SEC's "implied statement" reading of Rule 10b-5(b) would open the door to private 10b-5 actions against secondary actors that Congress had refused to authorize and other circuits have repeatedly rejected.[19] "Congress and the Supreme Court have struck a balance; the SEC is obliged to respect it."[20]

Finally, the *en banc* court rejected the SEC's position that the "implied statement" theory could appropriately be applied at least to certain types of securities professionals, such as executives of the underwriters, based on their roles in the securities industry and attendant responsibility.[21] The court criticized this approach as improperly seeking to "impos[e] a free-standing and unconditional duty to disclose."[22] Imposition of such a duty, the court stated, "flies in the teeth" of the Supreme Court's holding in *Chiarella* v. *United States*, 445 U.S. 222 (1980), that nondisclosure of information is actionable only when there is an independent duty to disclose arising from a fiduciary relationship or other similar relationship of trust and confidence.[23]

THE SIGNIFICANCE OF *TAMBONE*

Tambone is significant for several reasons. First, the *Tambone* court rejects the SEC's view that underwriters or securities professionals owe a "special duty" under Rule 10b-5(b) to ensure the accuracy of prospectuses. *Tambone* rejects a reading of Rule 10b-5(b) that would interpret and apply its prohibitions based solely on a defendant's profession or status, as opposed to his or her actual role (or lack thereof) in making challenged statements. While the holding is of particular importance to underwriters, the analysis is potentially more broadly applicable to accountants, lawyers, and others who work in the securities industry, although notably the court did not address whether this aspect of its holding is in tension with provisions of the Securities Act of 1933 (such as Section 11) which outline the duties of underwriters and professionals in reviewing offering materials.

Second, the *Tambone en banc* decision showed no deference to the SEC's expansive interpretation of its own rule to pursue individuals who are not alleged personally to have engaged in forbidden conduct. While the lack of deference to the SEC in and of itself is notable, similar efforts by the SEC construe its powers expansively have faced scrutiny from other courts. For example, last year, a New Jersey federal court dismissed 10b-5(b) claims by the SEC against individuals who did not draft or sign public disclosures, that did not contain statements attributed to them.[24]

Third, *Tambone* extends to the context of an SEC enforcement action the distinction between primary and secondary liability developed from private securities fraud litigation that the Supreme Court recognized in *Central Bank*, that Congress ratified in the PSLRA, and that the Supreme Court again confirmed in *Stoneridge Inv. Partners, LLC* v. *Scientific Atlanta, Inc.*[25] In particular, the *Tambone* court expressed concern that the broad interpretation of Rule 10-b(5)(b) urged by the SEC would establish a scope of primary liability so broad as to undermine the limits on liability the Supreme Court and Congress recognized in distinguishing between primary and secondary liability. *Tambone* also recognized that because Rule 10b-5(b) applies to all actions, the interpretation of its substantive prohibition cannot reasonably turn on whether the plaintiff is the SEC or a private shareholder.

Fourth, it is important to recognize that *Tambone* does not address key, unresolved questions as to what it means to "make" a false or misleading statement under Rule 10b-5(b). *Tambone* addresses only the theory the SEC chose to litigate on appeal—that an individual could be liable for "making" a statement he had no involvement in preparing or issuing, merely because he reviewed and subsequently distributed a prospectus containing the statement. Thus, as the court noted, it was not called upon to address or resolve the narrower, but highly significant issue on which the courts of appeal remain divided: what level of actual participation suffices to "make" a statement under Rule 10b-5(b)?[26] The courts remain divided on this issue, with some adhering to the so-called "bright line" test, under which a primary violation is established only where the challenged statement was both actually made by the defendant and publicly attributed to him, while others have held that "substantial participation or intricate involvement" in preparing the statement will suffice.[27] The question of which approach is right remains open for resolution by the First Circuit—and perhaps eventually, by the Supreme Court.

We hope that you have found this advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

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(ENDNOTES)

1 17 C.F.R. § 240.10b-5(b).

2 *Securities & Exchange Comm'n* v. *Tambone*,__F.3d __, 2010 WL 796996 at 1 (1st Cir. March 10, 2010) (*en banc*).

3 *Id.* at 11 (Boudin, J., and Lynch, C.J., concurring).

4 *Id.* at 2-3.

5 *Securities & Exchange Comm'n* v. *Tambone*, 550 F.3d 106, 116 n.15 (1st Cir. 2008) (hereafter, Tambone I), withdrawn, 573 F.3d 54, 55 (1st Cir. 2009), reinstated as to claims other than 10b-5 claims, 2010 WL 796996 at 11 .

6 *Securities & Exchange Comm'n* v. *Tambone*, 473 F.Supp.2d 162 (D. Mass. 2006).

7 *Tambone I*, 550 F.3d 106, 144; *id.* at 149.

8 2010 WL 796996 at 3-4.

9 *Id.*

10 *Tambone I*, 573 F.3d at 134-35.

11 2010 WL 796996 at 4. Although the court vacated the entire panel opinion upon granting the petition for *en banc* review, *id.*, it subsequently reinstated the portions of the panel opinion reversing the dismissal of the Section 17 and aiding and abetting claims, *id.* at 11.

12 *Id.* at 1. Judge Lipez, who wrote the original panel opinion, dissented, along with Judge Torruella.

13 *Id.* at 5. The dissent, however, noted that several other dictionary definitions were consistent with the SEC's interpretation.

14 In a similar vein, the court noted that the SEC's approach ignored the linguistic differences between Rule 10b-5(b) and Securities Act Section 17, upon which it was modeled. Section 17(a)(2) more broadly prohibits obtaining money or property "'by *means* of any untrue statement of material fact.'" *Id.* at 6, citing 15 U.S.C. §77q(a)(2) (emphasis supplied).

15 *Id.* at 16-17 (Lipez and Torruella, dissenting) (citing *SEC* v. *Zandford*, 535 U.S. 813, 816 n.1 (2002)).

16 *Id.* at 6.

17 *Id.* at 7.

18 2010 WL 796996 at 7, citing 15 U.S.C. § 78t(e). *See also id.* at 12 (Boudin and Lynch, concurring).

19 *Id.* at 12 and n.14.

20 *Id.* at 13.

21 *Id.* at 18-21.

22 *Id.* at 9.

23 2010 WL 796996 at 9.

24 *SEC* v. *Lucent Technologies*, 610 F. Supp. 2d 342 (D.N.J. 2009).

25 552 U.S. 148 (2008).

26 2010 WL 796996 at 8. The First Circuit held that the SEC had waived its "entanglement" theory, presented for the first time on appeal, that an individual can be a primary violator of Rule 10b-5(b) by providing information to another party which serves as the basis of a misleading statement by that party. *Id.* at 10.

27 Compare *Wright* v. *Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998); *Ziemba* v. *Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir.2001); *Anixter* v. *Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir.1996) with *Howard* v. *Everex Sys. Inc.*, 228 F.3d, 1057, 1061 n. 5 (9th Cir. 2000) (substantial participation).