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SEC v. Tambone: The First Circuit Broadly Interprets Primary Liability Under the Federal Securities Laws – and Adds to an Existing Circuit Split

Given the widely anticipated increase in regulatory enforcement activity as a result of the current financial crisis (Business Crimes Alert – January 5) and the change in administration, participants in the securities industry—and particularly underwriters—should pay careful attention to the First Circuit's recent decision in *Securities & Exchange Commission v. Tambone,* No. 07-1384 (Dec. 3, 2008). This decision addressed the scope of conduct for which a person may be held liable, in a SEC civil enforcement action, as a "primary violator" of Section 17(a) of the 1933 Securities Act, Section 10(b) of the 1934 Exchange Act, and Rule 10b-5.

Background

The Tambone decision is the latest development in a SEC civil enforcement action that dates back to 2005, when the SEC announced a $140,000,000 settlement with Columbia Management Advisors, Columbia Funds Distributors, and three former employees. That settlement was the third largest in Massachusetts for 2005, but it did not end the case.

James Tambone and Robert Hussey, former executives of Columbia Funds Distributors, did not settle with the SEC, but rather moved to dismiss the Commission's complaint against them. The two defendants argued that the SEC had failed to plead adequately its claims under Section 17(a), Section 10(b), and Rule 10b-5. Judge Gorton, of the District of Massachusetts, agreed. In fact, he twice granted the defendants' motions, dismissing the SEC's original complaint in January 2006 and its amended complaint almost one year later in December 2006.

The District Court's Ruling

Starting from the proposition that the elements of Section 17(a) and Section 10(b) are "substantially the same," Judge Gorton noted that both provisions require the SEC to plead (and, ultimately, to prove) that a defendant "engaged in fraudulent conduct," meaning that the defendant "must have *personally* made either an allegedly untrue statement or a material omission." (Emphasis added.) Because the SEC had not alleged that Tambone or Hussey "made any statements to investors, misleading or otherwise," Judge Gorton concluded that the SEC had failed to plead fraud with the particularity required by Federal Rule of Civil Procedure 9(b), and accordingly, dismissed the SEC's complaint. In reprising his ruling, and dismissing the SEC's amended complaint, Judge Gorton emphasized the "problem of attribution," explaining that "[t]he major flaw with the SEC's complaint was then, and continues to be, a failure to attribute misleading statements to either Tambone or Hussey."

The Appeals Court's Reversal

The legal victory won by Tambone and Hussey proved short-lived. The SEC appealed, and in December 2008, a divided panel of the First Circuit ruled in favor of the government and reinstated the civil enforcement action against both defendants. The appeals court ruled that the SEC had adequately alleged "primary violations" of Section 17(a), Section 10(b), and Rule 10b-5. That decision broke significant legal ground in this circuit. It also provoked a vigorous dissent from Judge Selya concerning the scope of primary liability under Section 10(b) and Rule 10b-5.

In short, the First Circuit ruled that Tambone and Hussey could be held liable as primary violators of the federal securities laws, notwithstanding the undisputed fact that neither had personally made any of the material false statements in the prospectuses that they distributed concerning the Columbia mutual funds. As Judge Lipez explained in the majority opinion: "we conclude that Tambone and Hussey may be held primarily liable for *using* false or misleading fund prospectuses to sell mutual fund shares." (Emphasis added.)

The statements in question appeared in prospectuses for various funds in the Columbia family and related to market timing practices in those funds. (Essentially, the statements represented that certain market timing practices were not permitted in the relevant mutual funds.) The falsity of these statements was not in dispute. Nor was there any dispute that persons employed by an independent entity, Columbia Advisors, had penned the prospectuses – not Tambone or Hussey. At most, according to the SEC's allegations, Tambone and Hussey had "reviewed" and "offered comments" on the prospectuses generally. Yet the SEC contended that Tambone and Hussey could be held liable because, as underwriters, they had special duties to their investors, and by distributing prospectuses that they knew (or were reckless in not knowing) contained material false statements, the two defendants "impliedly made" material false statements that the prospectuses were complete, accurate and truthful.

That is enough, according to the First Circuit. Differing with Judge Gorton, the First Circuit held that the elements under Section 17(a) and Section 10(b) are not substantially the same – even though, as the appeals court acknowledged, it had previously employed the identical analysis for these two claims. Rather, the First Circuit warned that the "scope of conduct" prohibited by Section 17(a) "may, in certain circumstances, be broader" than that prohibited by Section 10(b). The First Circuit further held that neither provision requires the SEC to show that a defendant personally "made" any material false statement. The appeals court's rejection of an "attribution" requirement is a significant development, exposing those who have not personally made false statements to liability as primary violators of the federal securities laws.

"Using" False Statements – Liability Under Section 17(a)

Because the SEC claimed that Tambone and Hussey had allegedly "used" false statements, the First Circuit focused on Section 17(a)(2), which makes it unlawful for any person, in the offer or sale of securities, to "obtain money or property by means of any untrue statement of material fact." Noting that Section 17(a)(2) "does not state . . . that the seller must himself make [an] untrue statement," the First Circuit concluded that "primary liability may attach under section 17(a)(2) even when the defendant has not himself made a false statement in connection with the offer or sale of a securities." Put another way, the appeals court cautioned that Section 17(a)(2) reaches "conduct that may not be prohibited" under Section 10(b) or Rule 10b-5.

Having interpreted Section 17(a) to sweep broadly and prohibit the "use" of any material false statement, even one "made" by another person, to obtain money in the offer or sale of securities, the First Circuit determined that the SEC's allegations against Tambone and Hussey were adequate. The amended complaint alleged that both men had done just that – knowingly (or, at least, recklessly) used the material false statements in the fund prospectuses to sell shares of Columbia mutual funds.

"Impliedly" Making False Statements – Liability Under Section 10(b)

Turning to Section 10(b) and Rule 10(b)-5, which prohibit any person from "mak[ing] any untrue statement of material fact" in connection with the purchase or sale of securities, the First Circuit framed the issue as "what it means to 'make' a statement for the purposes of Rule 10b-5."

According to the First Circuit, one need not actually "make" a false statement to be liable as a primary violator of Section 10(b) and Rule 10b-5. A defendant may be liable if he or she "impliedly makes" a false statement. This expansive

interpretation presents special problems for underwriters, such as Tambone and Hussey, because as the First Circuit explained:

> In light of [an underwriter's] duty to review and confirm the accuracy of the material in the documentation that it distributes, an underwriter impliedly makes a statement of its own to potential investors that it has a reasonable basis to believe that the information contained in the prospectus it uses to offer or sell securities is truthful and complete.

In other words, "a defendant, by virtue of his role in the securities market and his statutory duties, [may] make an implied statement without actually uttering the words in question." And although the First Circuit's holding focused on the special duty of underwriters, its broad reasoning arguably applies to other actors in the securities industry, as well.

As with Section 17(a), under this broad interpretation of Section 10(b) and Rule 10b-5, it was not hard for the First Circuit to conclude that the SEC had alleged fraud with adequate particularity against Tambone and Hussey. The amended complaint charged that Tambone and Hussey were underwriters and that, in offering and selling Columbia funds, they used prospectuses that contained false statements about market timing practices. By virtue of their position and special duty as underwriters, the defendants "impliedly made" statements that the prospectuses contained no such false statements.

The concept of an implied false statement in *Tambone* is complex, as it appears to require (i) an actual false statement by one person (e.g., "market timing is prohibited in our mutual funds"), (ii) an implied false statement by another person (e.g., "this statement about market timing is truthful"), and (iii) knowledge or recklessness regarding the *actual* false statement by the person who makes the *implied* false statement. The need to assess what a defendant knew, or should have known, about another person's false statement may transform the analysis of potential liability under the federal securities laws. Instead of a fairly straightforward objective determination (i.e., did the defendant "make" a material false statement), a more searching, fact-bound inquiry may be required (i.e., did the defendant "impliedly make" a material false statement by distributing information that the defendant knew, or was reckless in not knowing, contained a material false statement). If so, a defendant accused by the SEC of "impliedly making" a false statement may find it difficult to persuade a court to dismiss such charges early in any enforcement proceeding and before extensive discovery.

This expansive and novel interpretation of primary liability under Section 10(b) and Rule 10b-5 drew Judge Selya's vigorous dissent. Claiming that his colleagues had taken the "path-breaking step" of "rewriting" Section 10(b) and Rule 10b-5, Judge Selya variously called their decision an exercise in "judicial adventurism," a "radical departure" from settled precedent interpreting the federal securities laws, and an "unwarranted usurpation of legislative and administrative authority." Relying on the dictionary as well as judicial authorities, Judge Selya reasoned that to "make" a statement means to "create" or "cause" the statement, and that a person cannot make a statement, if another person created or caused it.

What Next?

The consequences of *Tambone* may be far-reaching. Prior to the First Circuit's ruling, there was already a circuit split regarding the scope of liability under Section 10(b) and Rule 10b-5. The Second Circuit applies a strict "attribution" test, see *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998), while the Ninth Circuit employs a "substantial participation" test, see *Howard v. Everex Sys., Inc.*, 228 F.3d 1057 (9th Cir. 2000). In *Tambone*, the First Circuit disclaimed taking sides in that split, but its ruling arguably introduced a third approach – the "implied statement" theory of liability. The First Circuit's approach is not only novel, but according to Judge Selya, "captures a much broader range of conduct that either of the existing tests." There is a distinct possibility that this growing circuit split will draw the Supreme Court's attention, given its careful consideration over the years to the scope of liability under Section 10(b) and Rule 10b-5. While it is impossible to predict whether the Supreme Court would take a case raising this issue – or how it would decide such a case – recent rulings, such as *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008), suggest that the Supreme Court is leery of expansive judicial interpretations of liability under Section 10(b), particularly for private rights of action, which are themselves a judicial creation under the federal securities law.

In the meantime, at least in the First Circuit, the *Tambone* decision may have granted the SEC a wider berth in which to operate as it pursues civil enforcement actions related to the current financial crisis. The Commission need not limit its focus, under Section 17(a), Section 10(b), and Rule 10b-5, to those persons who have actually made material false statements. Rather, it may press claims against any person who, in the offer or sale of securities, "uses" another person's material false statement to obtain money, or any person who, by virtue of her role in the securities markets, "impliedly makes" any material false statement in connection with the purchase and sale of securities. As a result, a broad cast of people involved in the securities industry may be subject to SEC scrutiny. The *Tambone* decision may also be cited in efforts to expand the scope of liability in private securities actions.

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