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In This Issue:

- Sitting en banc, the First Circuit vacated a key portion of its prior panel decision and affirmed the district court's dismissal of the SEC's Section 10(b)/Rule 10b-5 claim against two mutual fund underwriters.
- The court rejected the SEC's argument that a person who uses a false statement drafted by others to sell securities is liable for "making" that statement under Rule 10b-5.
- While this ruling closes one door to primary violator liability, others doors may yet remain open depending on the specific allegations of each case, and the First Circuit declined to choose sides in the current circuit split regarding the scope of primary liability.

SEC v. TAMBONE: The First Circuit Reverses Course on What It Means to "Make" a Statement Under the Securities Laws

The First Circuit's en banc ruling in *SEC v. Tambone*, No. 07-1384 (Mar. 10, 2010), vacated a key part of a prior ruling by a three-judge panel (Business Crimes Perspectives - February 2009), and provides important guidance on the scope of "primary violator" liability under Section 10(b) of the 1934 Exchange Act and Rule 10b-5 thereunder.

Background

This First Circuit decision is the latest chapter in a "market timing" enforcement saga which began in early 2005 when the Securities and Exchange Commission announced that it had reached a $140 million settlement with Columbia Management Advisors, Columbia Funds Distributors and three former employees in connection with alleged undisclosed market timing arrangements in the Columbia funds. At that same time, the SEC filed an enforcement action in the District of Massachusetts against James Tambone and Robert Hussey, senior executives of a broker-dealer, Columbia Funds Distributors.

As the principal underwriter and distributor of the Columbia mutual funds, Columbia Funds Distributors sold shares in the funds and disseminated fund prospectuses to investors. A different entity, Columbia Management Advisors, drafted the prospectuses which included representations that the Columbia funds prohibited market timing. The SEC alleged that despite their awareness of these statements in the prospectuses, Tambone and Hussey distributed the prospectuses while simultaneously allowing certain preferred customers to engage in market timing in the Columbia funds. The SEC asserted that this conduct violated Section 17(a) of the Securities Act of 1933 and Rule 10b-5, an SEC rule promulgated under Section 10(b) of the Securities Exchange Act of 1934.

Tambone and Hussey did not settle with the SEC, but instead moved to dismiss the complaint. In 2006, U.S. District Judge Nathaniel Gorton dismissed all of the SEC's claims. Both Section 17(a) and Rule 10b-5, he reasoned, require the SEC to plead (and ultimately prove) that each defendant "personally made either an allegedly untrue statement or a material omission." Because the SEC did not allege 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).

In late 2008, a divided panel of the First Circuit reversed and reinstated all of the SEC's primary and aiding and abetting claims. Even though it was undisputed that neither Tambone nor Hussey had actually made the false or misleading statements in the Columbia fund prospectuses, the majority (in an opinion written by Judge Lipez) concluded that they could be held liable as primary violators for "using" those statements to sell mutual fund shares. The majority first observed that the language of Section 17(a) is broader than Rule 10b-5 and allows for liability even when the defendant did not personally make a false statement, so long as he obtained "money or property by means of any untrue statement of material fact" in the offer or sale of securities. 15 U.S.C. § 77q(a)(2). Rule 10b-5, by contrast, prohibits persons from "mak[ing] any untrue statement of material fact" in connection with the purchase or sale of securities. Nevertheless, in the panel majority's view, a defendant who "impliedly" made a false statement was subject to liability under both of these provisions, and because underwriters (like Tambone and Hussey) had a duty to confirm the accuracy of material they distribute, they "impliedly" represented to potential investors that the information in the prospectuses they used to sell the Columbia funds was truthful and complete.

Judge Selya agreed with the majority on the SEC's Section 17(a) and aiding and abetting claims, but vigorously dissented on the Section 10(b)/Rule 10b-5 claim, calling the implied representation theory (among other things) an exercise in "judicial adventurism," a "radical departure" from settled precedent, and an "unwarranted usurpation of legislative and administrative authority." In 2009, the First Circuit ordered the case to be reheard en banc.

The En Banc Ruling

In rare cases of "exceptional importance," the First Circuit may require a case decided by one of its three-judge panels to be reheard by the entire court. This was one of those rare situations, and so the *Tambone* case was reheard by six judges, including the two circuit judges on the original three-judge panel and the four other active judges on the First Circuit. On en banc rehearing, a four-judge majority (Lynch, Selya, Boudin, and Howard) rejected the panel's reasoning and affirmed Judge Gorton's decision to dismiss the SEC's primary violator claims under Section 10(b) and Rule 10b-5.[1]

The main issue was what it means to "make a statement" under Rule 10b-5(b). The rule provides that "[i]t shall be unlawful for any person, directly or indirectly, . . . [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 the light of the circumstances under which they were made, not misleading." 17 C.F.R. § 240.10b-5(b).

Focusing on the plain language of this rule, the en banc majority concluded that the phrase "to make any untrue statement" does not impose liability on persons who merely "use" statements drafted by others to sell securities. First, the majority reasoned, allowing liability for "use" would be inconsistent with accepted dictionary definitions of the word "make," *i.e.*, to create, compose, or cause to exist. Second, the fact that Congress and the SEC included the terms "use" and "employ" in Section 10(b) and in a different subsection of Rule 10b-5 (not the subsection that applies to "statements") suggests that deliberate legislative and regulatory choices were made to exclude liability for the mere use of statements. Similarly, the majority concluded that the difference between the text of Section 17(a) ("by means of any untrue statement of a material fact") and the text of Rule 10b-5 ("to make any untrue statement") indicates that the drafters of Rule 10b-5 eschewed that more expansive language.

Finally, the en banc majority reasoned, adoption of the SEC's expansive proposed interpretation of Rule 10b-5 would undermine efforts by the Supreme Court to draw a clear boundary between primary and secondary liability for securities fraud – an issue of particular importance to private investor lawsuits. In its 1994 ruling in *Central Bank of Denver v. First Interstate Bank of Denver*, the Supreme Court rejected Section 10(b) liability for those who assist the fraudulent conduct of others. Congress subsequently authorized "aiding and abetting" liability for SEC enforcement actions, but not for private lawsuits. "If *Central Bank*'s carefully drawn circumscription of the private right of action is not to be

[1] All six judges participating in the en banc rehearing agreed that it was error to dismiss the SEC's Section 17(a) and aiding and abetting claims, and the court reinstated the portions of the panel opinion addressing those claims.

hollowed," the majority explained, "courts must be vigilant to ensure that secondary violations are not shoehorned into the category reserved for primary violations."

Judge Selya concluded the majority opinion by describing the case as "one of those happy occasions when the language and structure of a rule, the statutory framework that it implements, and the teachings of the Supreme Court coalesce to provide a well-lit decisional path." Far less cheerful were Judges Lipez and Torruella, who argued in dissent that the majority overstated the significance of *Central Bank*, understated the unique responsibilities that underwriters owe to potential investors, and interpreted the language of Rule 10b-5 in artificial isolation. Citing "the long accepted understanding that underwriters 'make' implied statements to investors about the accuracy and completeness of prospectuses they are using to induce investments," the dissenters contended that the alleged use of the false fund prospectuses by Tambone and Hussey was sufficient to establish a primary violation.

Tambone Take Aways

The en banc ruling in *Tambone* pulled the First Circuit back from an expansive view of Rule 10b-5 generally unsupported by other federal case law, and brought it more in line with several current Supreme Court themes: close adherence to statutory and regulatory text and narrow construction of judicially-created remedies like the private right of action under Section 10(b)/Rule 10b-5. The ruling provides some useful guidance on securities fraud litigation in the First Circuit and raises at least two important questions left to be answered by future cases.

- ***Limited deference to SEC***

  First, *Tambone* demonstrates that there are limits to the deference that courts will provide to the SEC, even when it comes to interpretation of the agency's own regulations. The en banc majority in *Tambone* "freely accept[ed] the principle that the existence of a longstanding pattern of administrative interpretation might well call for *Chevron* deference," but nevertheless disparaged the "bricolage" of authorities presented by the SEC in support of its expansive interpretation of Rule 10b-5 as "wildly exaggerated," irrelevant, and obsolete after *Central Bank*.

  Furthermore, just as complaints filed by ordinary plaintiffs in federal court are now subject to a more demanding level of scrutiny under the Supreme Court's rulings in *Ashcroft v. Iqbal* and *Bell Atlantic v. Twombly*, *Tambone* and other rulings reflect an increased willingness by First Circuit courts to disregard SEC fraud allegations that fail to satisfy the particularity requirement imposed by Federal Rule of Civil Procedure 9(b) and to dismiss implausible claims for relief. In its 2009 ruling in *SEC v. Papa*, for example, the First Circuit upheld the dismissal of aiding and abetting claims against three corporate officials, finding that the SEC's general and conclusory allegations in that complaint were an inadequate foundation for even secondary liability (*i.e.*, for aiding and abetting); the SEC had not even bothered to appeal the dismissal of its primary liability claims against these three defendants.

- ***Concern about private lawsuits***

  A major factor driving the majority's analysis in *Tambone* was its concern that a ruling for the SEC might open the floodgates to private, lawyer-driven shareholder litigation. This concern has been at the forefront of the Supreme Court's recent securities jurisprudence. In its 2007 ruling in *Tellabs v. Makor Issues & Rights*, for example, the Court cited "nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests and manipulation by class action lawyers" as grounds for setting a high bar for the pleading of scienter. The First Circuit identified the same concern here, writing that the SEC "may select its defendants sensibly; but private litigants have their own incentives." The fact that the SEC's expansive view of what it means to "make a statement" under Rule 10b-5 would also apply to private lawsuits clearly influenced the majority judges, and in dissent Judge Lipez criticized them for allowing "concerns about excessive private litigation to influence their judgment on the scope of public enforcement by the Securities and Exchange Commission." However, as

Judge Boudin pointed out in his concurring opinion: "No one sophisticated about markets believes that multiplying liability is free of cost. And the cost, initially borne by those who raise capital or provide audit or other services to companies, gets passed along to the public."

- ***Other enforcement mechanisms***

  Another important factor in the majority's analysis was the availability of other enforcement mechanisms. As discussed, the First Circuit unanimously allowed the SEC to proceed with its claims against Tambone and Hussey under Section 17(a) and for aiding and abetting primary violations of Section 10(b) and Rule 10b-5 by Columbia Management Advisors and Columbia Funds Distributors. Furthermore, as Judge Boudin observed in concurrence, other provisions of the Securities Act of 1933 establish civil liability for underwriters who fail to conduct reasonable investigations into the prospectuses they distribute, and "private litigants are free to sue the actual authors of misstatements in the prospectus under section 10(b) itself." Adoption of the SEC's proposed theory of liability under Rule 10b-5 was therefore unnecessary to remedy the alleged misconduct.

What may be next?

The resolution of some questions raised by the en banc decision in *Tambone* will have to await a future case.

First, *Tambone* does not necessarily foreclose the SEC from pursuing similar conduct by underwriters in a future Rule 10b-5 action. As a result of the SEC's failure to allege sufficient facts and its waiver of certain arguments during the *Tambone* proceedings, the First Circuit declined to address several alternate theories of liability under Rule 10b-5. It remains unresolved, for example, whether an underwriter might be held liable as a primary violator for having "made" the alleged misstatements through her involvement in the prospectuses' preparation. Nor did the First Circuit rule out reliance on the "entanglement test" discussed in its 2002 ruling *In re Cabletron Systems*, under which underwriters and other securities professionals can be held liable for adopting or placing their "imprimatur" on misrepresentations that appear in reports drafted by outside analysts.

And even the en banc court's treatment of the "implied misstatement" aspect of the initial panel decision may lead to further litigation. The en banc court accepted the SEC's premise that securities professionals working for underwriters have a duty to investigate the nature and circumstances of an offering with which they are involved, but rejected the SEC's position that this duty necessarily results in an implied representation by those professionals that all statements contained in a prospectus distributed by the underwriter are truthful and complete. However, as Judge Boudin's concurring opinion notes, the SEC did not allege that Tambone or Hussey "explicitly represented as true to investors the prospectuses' market timing provisions or that they even discussed the prospectuses with investors." It remains to be seen what the First Circuit would do with a complaint alleging that an underwriter made a more affirmative and explicit representation along these lines.

Finally, the en banc majority noted that other federal circuit courts are split on the test for what level of personal involvement in a statement is enough to constitute a primary violation: while some circuits require the plaintiff to prove only a defendant's "substantial participation or intricate involvement in the preparation of fraudulent statements," others require proof that the defendant actually made the statement and that it was attributable to him at the time of public dissemination. Noting that both tests are "poorly suited to public enforcement actions," the First Circuit concluded that it was unnecessary to choose between the two, since the SEC's allegations did not satisfy even the more lax "substantial participation" test. Thus it remains to be seen which test the First Circuit will eventually adopt, and whether the Supreme Court will see enough of a divergence between the two tests to resolve the question conclusively.

Therefore, while the en banc ruling in *Tambone* closes one door to primary violator liability, others doors may yet remain open, depending on the specific allegations of each case.

And the lines on the entire field may be redrawn by legislation being considered by Congress, including proposals that would do away with the bar on private lawsuits for secondary (aiding and abetting) liability, thus making the distinctions drawn in this case largely inconsequential.

As a result of the economic crisis, the increased focus on corporate fraud by regulatory and law enforcement agencies (Business Crimes Alert - February 5, 2010), the possibility of legislative changes with intended (and unintended) consequences, and the ever-changing composition of the judiciary, the scope of liability for federal securities fraud is likely to remain a hot issue in the years ahead.

Tony Mirenda, Robin Toone and Dan Marx are attorneys in Foley Hoag's Business Crimes Group. They represent corporations, officers, directors and other individuals in criminal, regulatory, administrative and civil proceedings. If you would like additional information on this topic, please contact Tony Mirenda at amirenda@foleyhoag.com, Robin Toone at rtoone@foleyhoag.com or Dan Marx at dmarx@foleyhoag.com or contact your Foley Hoag lawyer. For more Alerts and Updates on other topics, please visit www.foleyhoag.com.