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***En Banc* First Circuit Rejects SEC’s Attempt to Broaden Scope of Primary Liability for Securities Fraud Under “Implied Representations” Theory**

On March 10, 2010, the *en banc* United States Court of Appeals for the First Circuit rejected efforts of the U.S. Securities and Exchange Commission to significantly broaden the scope of “primary liability” under the principal securities fraud provisions, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated by the SEC thereunder, through a theory of “implied representations.” *SEC v. Tambone*, No. 07-1384 (1st Cir. Mar. 10, 2010).

The SEC had argued that Rule 10b-5 provisions making it unlawful “to make any untrue statement” of material fact in connection with a securities sale should reach what the SEC claimed were “implied” representations by individual securities professionals concerning the accuracy of offering documents distributed in connection with an underwritten sale of shares that was directed by those professionals. Reversing an earlier decision by a three-judge panel of the First Circuit, the full court held that that SEC’s position was contrary to the text of Section 10(b) and Rule 10b-5, and also inconsistent with U.S. Supreme Court opinions holding that liability as a primary violator of the Exchange Act may not be predicated upon mere “aiding and abetting” conduct. (*Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008); *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).) The First Circuit’s decision suggests that federal courts will continue to reject efforts — whether by regulators or private litigants — to weaken the force of *Stoneridge* and *Central Bank* and broaden the scope of primary liability under the securities fraud laws so as to reach persons with only peripheral connections to the claimed fraudulent conduct.

The Underlying Dispute

Tambone arose from an SEC “market timing” enforcement action against two senior executives of a registered broker-dealer that served as an underwriter and marketer of certain mutual funds (the sponsor of which was a separate, affiliated entity of the broker-dealer). The SEC alleged that the funds’ prospectuses had falsely represented that the funds did not permit customers to engage in “market timing,” a short-term trading practice designed to profit from inefficiencies in mutual fund share pricing.

The SEC further alleged that the defendant executives knew of (or recklessly ignored) the prospectus’s allegedly false statements concerning “market timing” and entered into arrangements that in fact allowed preferred customers of the funds to engage in “market timing.” The SEC alleged that the defendants used the prospectuses to sell mutual fund shares by “allowing [the prospectuses] to be disseminated and referring potential clients to them.”

The SEC's "Implied Representations" Theory

The SEC brought its Section 10(b)/Rule 10b-5 enforcement action under dual theories. In addition to a theory of secondary, "aiding and abetting" liability (based on Congress's expressly having given the SEC secondary liability enforcement authority to assert "aiding and abetting" claims notwithstanding the *Central Bank* holding that private litigants could recover under Rule 10b-5 only by showing a primary violation, see 15 U.S.C. § 78t(e)), the SEC also charged the defendant executives with primary liability for the alleged fraud.

The SEC's theory of primary liability rested on two grounds. First, the SEC contended that "the defendants 'made' the misrepresentations by using the prospectuses to sell mutual funds." Second, the SEC argued that "the defendants impliedly made false representations to investors to the effect that they had a reasonable basis for believing that the key representations in the prospectuses were truthful and complete." In support of the second, implied representation theory, the SEC contended that securities professionals involved in an offering have a "special duty" to reasonably investigate the truthfulness of statements in the prospectus. The SEC did not base its position on any contention that the prospectus statements at issue were attributable to the defendants, or that liability should exist because the defendants had been substantially involved in preparing the prospectuses.

The *En Banc* Ruling

The full First Circuit emphatically rejected the SEC's primary liability theories. The court held that a securities professional does not "make" a statement by using the statement of another person or entity to sell securities, or by directing the offering or sale of securities. The court rejected the SEC's contention that by such actions the professional is impliedly making statements regarding the accuracy of the prospectus for those securities.

The court declined to "set forth a comprehensive test" for determining when a speaker "makes" a statement, but noted that the SEC's position was inconsistent with accepted dictionary definitions of the word "make," such as "to create or cause," "to compose," or "to cause (something) to exist."

The court also supported its conclusion by focusing on the language used in Rule 10b-5. It noted that while Congress in Section 10(b) had prohibited conduct that "use[s] or employ[s]" any "manipulative device or contrivance," the SEC in adopting its implementing Rule 10b-5(b) had prohibited only "a specific subset" of such conduct, prohibiting only the "mak[ing]" of a false statement without also including prohibitions against the "use" or "employ[ment]" of a false statement. The court drew a contrast with another well-known securities fraud statute, Section 17(a) of the Securities Act of 1933, which makes it unlawful "to obtain money or property by means of any untrue statement of material fact," language that the court characterized as an example of how to prohibit the "use" of a false statement without regard to who created or composed it. Finding that the difference in language between Rule 10b-5(b) and these broader statutory provisions was meaningful and purposeful, the court declined "to rewrite an administrative rule to sweep more broadly than its language permits," in light of "the limitation that the drafters deliberately built into Rule 10b-5(b)."

The court further buttressed its conclusion by noting that the SEC's position was "in tension with modern Supreme Court precedent" rejecting the concept of primary liability for aiding and abetting securities fraud. Because imposing liability for primary securities fraud violations is not just the province of SEC enforcement actions but is also available in private securities fraud lawsuits, "courts must be

vigilant to ensure that secondary violations are not shoehorned into the category reserved for primary violations.” The court held that the SEC sought to impose primary liability for conduct “that constitutes, at most, aiding and abetting,” and that the SEC’s position would “blur the line between primary and secondary violations . . . [and] would be unfaithful to . . . *Central Bank*.”

The court also noted that considerations of policy supported its decision. The court noted that the SEC’s position would impose an “unprecedented duty” on securities professionals working for underwriters, who could be held liable for remaining silent even when they did not have a fiduciary duty to speak — a prospect seemingly at odds with the U.S. Supreme Court’s landmark holding in *Chiarella v. United States*, 445 U.S. 222 (1980), that a securities fraud claim can only be based on nondisclosure when there is a duty to speak based on a confidential or fiduciary relationship.

Lastly, despite the judicial doctrine of general deference to agency interpretations of statutory provisions, the court held that the SEC’s “claim of a ‘longstanding administrative interpretation’” consistent with its litigation position in *Tambone* was “wildly exaggerated.” The court noted that the prior statements to which the SEC pointed all predated the Supreme Court’s *Central Bank* ruling which had redefined the scope of primary violations under the securities fraud laws, and that none of these prior statements involved any articulation of the “implied representations” theory upon which the SEC now relied.

In a concurring opinion, two First Circuit judges noted several additional policy and legislative history considerations that undercut the SEC’s position. First, they noted that in the wake of *Central Bank*, Congress acted to give only the SEC, but not private litigants, the power to pursue secondary liability claims. Accepting the SEC’s new theory of primary violations, they said, “would undo this deliberate legislative compromise,” and could have the effect of imposing private securities liability upon “virtually anyone involved in the underwriting process,” raising the cost of capital in ways harmful to the public. Moreover, adopting the SEC’s proposed expanded view of what constitutes a primary violation was not necessary for the SEC to fulfill its mission in any event, because the SEC’s enforcement authority already includes the explicit power to pursue aiding and abetting claims.

Implications of the Court’s Ruling

Tambone serves as a reminder that courts are likely to exercise great caution in entertaining securities fraud liability theories that would effectively allow private securities plaintiffs to circumvent the holdings of *Central Bank* and *Stoneridge* by enabling them to pursue claims for what is essentially aiding and abetting or other secondary activity. While *Tambone* is not likely to be the final word concerning the parameters of primary liability for securities fraud in the mutual fund underwriting context, the decision signals that the law in this area (barring action by Congress or further rulemaking by the SEC) is likely to remain stable.

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