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## COURT REINS IN SEC'S EXPANSIVE "PRIMARY LIABILITY" THEORY

by  
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In *SEC v. Tambone*, an *en banc* panel of the U.S. Court of Appeals for the First Circuit rejected the Securities and Exchange Commission's ("SEC") attempt to impose primary liability for "implied" misstatements. 597 F.3d 436 (1<sup>st</sup> Cir. 2010). The court analyzed whether defendants "made" an actionable misstatement within the meaning of Rule 10b-5(b) of the Securities Exchange Act of 1934 ("1934 Act"), which renders it unlawful "to make any untrue statement of a material fact...in connection with the purchase or sale of any security." Interpreting the word "make" broadly, the SEC sought to hold defendants primarily liable for securities fraud when they did not author the alleged misstatements in mutual fund prospectuses. Rather, as underwriters, defendants sold the mutual funds and disseminated the prospectuses to investors. *Id.* at 439.

The Court found the SEC's "expansive interpretation" of Rule 10b-5(b) inconsistent with the text and structure of the rule and in considerable tension with Supreme Court precedent. *Id.* at 438. Consequently, *Tambone* affirmed the district court's dismissal of the Section 10(b) and Rule 10b-5(b) securities fraud claims. *Id.* This decision not only reins in the SEC's expansive primary liability theory, but signifies that Federal courts are increasing their scrutiny of the SEC's ever more aggressive enforcement position.

**Background.** In *Tambone*, two broker-dealer executives sold shares in the Columbia mutual funds using prospectuses that allegedly falsely represented that the funds did not permit "market timing" (*i.e.*, the frequent buying and selling of a mutual fund's shares). *Id.* at 439. Despite this clear prohibition, defendants purportedly allowed certain preferred customers to engage in market timing in 16 different funds. *Id.* at 440. The SEC charged both executives with primary violations of Section 17(a) of the Securities Act of 1933 and Section 10(b) and Rule 10b-5 of the 1934 Act and with aiding and abetting the primary violations of others.

The district court dismissed the complaint because the challenged statements were drafted by the funds' sponsors, not the defendants. *Id.* at 441. The SEC nevertheless claimed defendants "made" a false statement by, *inter alia*, using the prospectuses in their sales efforts and serving as executives of the funds' underwriter and, thus, owing a "special duty" to ensure the prospectuses' accuracy. The district court found these arguments unconvincing. *Id.* at 440; *see also SEC v. Tambone*, 473 F. Supp. 2d 162 (D. Mass. 2006).

The SEC appealed, and a divided First Circuit panel reversed the district court. On appeal, the SEC advanced its "implied representation" theory that defendants were primarily liable for securities fraud because (1) they used the prospectuses to sell mutual funds; and (2) in doing so, impliedly "made" a false statement to investors that the prospectuses' disclosures were accurate. *Tambone*, 597 F.3d at 441. The court accepted this theory, holding underwriters have a "duty to review and confirm the accuracy" of the prospectuses and the fund materials they distribute. *SEC v. Tambone*, 550 F.3d 106, 134 (1<sup>st</sup> Cir. 2008).

The First Circuit granted *en banc* review of the Rule 10b-5(b) claim only.

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**The En Banc Opinion.** The *en banc* panel’s well-reasoned opinion affirmed the district court’s dismissal of the Rule 10b-5(b) claim, rejecting the SEC’s “implied representation” theory for three reasons.

*First*, the SEC’s expansive interpretation of “make” in Rule 10b-5(b) was inconsistent with the word’s ordinary meaning and with the statutory text. Absent any suggestion that the rule’s drafters intended some “exotic meaning,” the word should be given its ordinary meaning: to “create [or] cause,” “compose,” and “cause (something) to exist.” *Tambone*, 597 F.3d at 442-43. The court then analyzed the statute, the rule, and related antifraud provisions, which render it unlawful to “use” or “employ” deceptive practices and thus prohibit broader conduct. The court concluded that Rule 10b-5(b) was intentionally drafted more narrowly and does not extend beyond the “making” of a misrepresentation. *Id.* at 444-45.

*Second*, the court held that the SEC’s position would undermine Supreme Court precedent distinguishing between primary and secondary violators. *Central Bank of Denver v. First Interstate*, 511 U.S. 164 (1994), held that under Rule 10b-5, private plaintiffs may sue only primary violators of Section 10(b).<sup>1</sup> *Id.* at 445-46. In light of this, the SEC’s expansive interpretation of the rule threatened to “shoehorn” secondary violations “into the category specifically reserved for primary violations.” *Id.* at 446. The Court refused to blur the *Central Bank* distinction between primary and secondary violations.

*Third*, the SEC’s theory effectively imposes upon securities professionals who work for underwriters an unprecedented and unconditional duty to disclose. *Tambone*, 597 F.3d at 447-48. Yet under *Chiarella v. United States*, 445 U.S. 222 (1980), a nondisclosure is actionable only where a defendant has an *independent* duty to disclose the information arising from “a fiduciary or other similar relation of trust and confidence” between the parties. *Id.* at 228. Imposing a free-standing duty to disclose, the court stated, “flies in the teeth of Supreme Court precedent.” *Tambone*, 597 F.3d at 447-48. And while the court agreed that underwriters have a special set of responsibilities that go with marketing securities, it quickly pointed out that the SEC has other, more appropriate enforcement tools to address the conduct at issue. *Id.* at 449.

The concurring opinion echoed the majority, noting that the conduct charged is already covered by Section 20(e)’s aiding and abetting remedy available to the SEC under the 1934 Act. Moreover, the SEC’s expansive reading of Rule 10b-5(b) means that “virtually anyone involved in the underwriting process” could be subject to Section 10(b) liability. *Id.* at 452. Equally problematic is that the SEC’s definition of “make,” if adopted, also would apply to private plaintiffs, opening the floodgates of vexatious securities litigation. *Id.*

**Conclusion.** At a time when the SEC is stepping up its enforcement policies, asking Congress for new enforcement powers and using existing laws creatively to widen its enforcement reach, the *Tambone en banc* decision is significant. The court notably rejected the premise that securities professionals, by virtue of their profession, owe a “special duty” to ensure the accuracy of a prospectus that would then subject them to primary liability for securities fraud. As the concurrence wrote, underwriters who fail to reasonably investigate the prospectuses they distribute are already subject to claims under existing provisions of the Securities Act of 1933. *Id.* at 452.

Also significant is the court’s lack of deference to the SEC’s interpretation of its own rule. This signifies that the SEC is facing increased judicial scrutiny of the strategies and legal theories it is advancing in enforcement actions. Because the SEC maintains incredible discretion in deciding what cases to bring and what violations to charge, judicial challenges to theories that broaden the scope of liability become even more crucial. The *Tambone* decision brings a sigh of relief to securities professionals, at least until the SEC comes up with another way to test the boundaries of primary liability.

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<sup>1</sup>The following year, Congress passed the 1934 Act’s Section 20(e) to clarify that the SEC may sue aiders and abettors, or those who knowingly provide substantial assistance to primary violators. 15 U.S.C. § 78t(e). And while the SEC has urged Congress to extend this same right to private parties, it has declined to do so. *Tambone*, 597 F.3d at 446. As the concurrence concluded, “Congress and the Supreme Court have struck a balance; the SEC is obliged to respect it.” *Id.* at 453.