SEC v. Tambone: First Circuit Rejects the SEC's Approach to Scope of Rule 10b-5(b)

BY JOHN R. FAHY

Brokers and other intermediaries often find themselves the last prospective defendants standing after a securities fraud collapses. However, a major new case from the First Circuit on the scope of Securities and Exchange Commission (SEC) Rule 10b-5(b) may provide brokers and intermediaries with protection against claims based on distributing someone else's statement. The First Circuit held in *SEC v. Tambone*[1] that using a statement is not the same as making a statement, and the defendant must directly or indirectly make a statement to be found primarily liable under Rule 10b-5(b) under the Securities Exchange Act of 1934.

Rule 10b-5 provides a private cause of action for securities fraud violations.[2] It can also be generally enforced by the SEC[3] and specifically enforced by the Financial Industry Regulatory Authority (FINRA) against its members and associated persons.[4] Rule 10b-5 makes it unlawful for "any person" "directly or indirectly" in connection with the purchase or sale of securities to employ "any device, scheme, or artifice to defraud,"[5] "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading,"[6] or "[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."[7]

Large amounts of Rule 10b-5 caselaw focused on defining materiality[8] and scienter.[9] Rule 10b-5 was limited in 1994 when the Supreme Court held in *Central Bank* that there was no aiding and abetting cause of action under the Exchange Act.[10] Congress then added Section 20(e) to the Exchange Act to restore the SEC's right to pursue aiding and abetting actions, but it did not provide the ability for any other party to enforce an aiding and abetting claim.[11] Thus, private litigants and FINRA must allege and prove primary liability under Rule 10b-5 to pursue a cause of action.

In 2008, the Supreme Court further limited claims under Rule 10b-5(a)'s scheme liability provisions by requiring that the defendants be tied to an actual fraudulent statement to have scheme liability.[12] The Supreme Court reasoned that such acts require reliance by private litigants on the defendant's statements. The Court went on to hold that a false statement to an issuer of securities that the issuer knows is false does not satisfy that requirement because investors could not have relied on that statement.[13] The Court determined not to use the scheme approach of Rule 10b-5(a) to, in substance, resurrect aiding and abetting claims against secondary defendants.

Given this background, the scope of Rule 10b-5(b) became hugely important for secondary securities fraud defendants and those who want to sue them. On March 10, 2010, the First Circuit issued its *Tambone* en banc opinion defining the scope of "to make" under Rule 10b-5(b).[14] The *Tambone* defendants were executives of a mutual fund distributor broker-dealer affiliated with the mutual funds' sponsor. The mutual fund prospectuses made various statements hostile to short-term market timing purchases and sales. The SEC alleged that the defendants knew or recklessly ignored these statements hostile to short-term market timing and allowed certain preferred customers "to engage in market timing forays" in the funds, and made material misrepresentations and omissions in the prospectuses.[15] The SEC further alleged that the defendants "made" false statements within the meaning of Rule 10b-5(b) by "using the prospectuses in their sales efforts, allowing the prospectuses to be disseminated and referring clients to them for information."[16]

> First, the SEC argued 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. This implied statement theory rested on the premise that a securities professional engaged in the offering of securities has a "special duty" to undertake an investigation that would provide him with a reasonable basis for believing that the representations in the prospectus are truthful and complete. Therefore, the theory goes, a securities professional "makes" an implied representation to investors that the prospectus is truthful and complete when he engages in an offering.[17]

The First Circuit rejected both SEC approaches and held that the defendants did not "make" those statements under Rule 10b-5(b) and thus have no primary liability. The court noted that Section 10(b) of the Exchange Act prohibited the "use" of manipulative and deceptive devices, but that, in writing Rule 10b-5(b), the SEC chose the term "make" instead of "use," that the SEC's choice of the more restrictive term "make" was deliberate, and that the SEC cannot now allege that "make" really means "use" under Rule 10b-5(b).[18] Thus, the persons found to have primary liability under Rule 10b-5(b) actually need to make the statements, not just use them.

Further, the First Circuit was greatly concerned with how the SEC's Rule 10b-5(b) standard would affect private litigation in light of the 1994 *Central Bank* case limiting aiding and abetting liability. The court said:

> Refined to bare essence, the SEC, through the instrumentality of Rule 10b-5(b), seeks to impose primary

liability on the defendants for conduct that constitutes, at most, aiding and abetting (a secondary violation). Allowing the SEC to blur the line between primary and secondary liability would be unfaithful to the taxonomy of *Central Bank*. . . . Allowing courts to imply that "X" has made a false statement with only a factual allegation that he passed along what someone else wrote would flout a core principal that underpins the *Central Bank*. We decline the SEC's invitation to go down that road.[19]

The First Circuit focused on the duties owed by underwriters in the Rule 10b-5(b) context. The court said that "securities professionals working for underwriters have a duty to investigate the nature and circumstances of an offering . . . (and that) the SEC theorizes that such securities professionals impliedly 'make' a representation to investors that statements in a prospectus are truthful and complete."[20] The First Circuit said that:

> If we were to give credence to this theory, the upshot would be to impose primary liability under Rule 10b-5(b) on these securities professionals whenever they fail to disclose material information not included in a prospectus, regardless of who prepared the prospectus. That would be tantamount to imposing a free-standing and unconditional duty to disclose.[21]

The First Circuit held that the nondisclosure of information involving those other than the issuer:

> [I]s actionable under Rule 10b-5 only when there is an independent duty to disclose the information arising from 'a fiduciary or other similar relation of trust and confidence' between the parties. . . . Fidelity to that requirement demands that we reject the SEC's notion that a breach of duty to investigate [under Sections 11 and 12 of the Securities Act of 1933], without more, is a breach of a duty to disclose (and thus should be treated as a primary violation under Rule 10b-5(b)).[22]

On March 26, 2010, the SEC's solicitor, Jacob Stillman, told SEC Speaks conference attendees that it was too early to determine if the SEC was going to appeal the *Tambone* decision to the Supreme Court.

The *Tambone* case is very significant to brokers and other securities intermediaries because it provides a defense against allegations that a defendant should be liable under the anti-fraud provisions of federal securities laws for statements made in prospectuses and private placement memoranda created by others through the mere act of distributing those statements. In the wake of the court's holding in *Tambone*, distribution of someone else's statement does not necessarily mean adopting that statement as one's own for the purposes of Rule 10b-5 liability.

The SEC and a bankruptcy court have recently taken several actions against issuers of purported private placements sold by brokers that each involved several hundred million dollars of investor funds. Receivers[23] and a bankruptcy trustee[24] have been appointed. With receivers and a trustee in place of the issuers, victimized investors have been pursuing claims against brokers that sold these private placements. The *Tambone* case may provide some protection against making the brokers vicariously responsible for the issuers' statements. However, brokers or other intermediaries may theoretically remain liable under Rule 10b-5(b) for their own statements regarding due diligence[25] or investor suitability.[26]

The *Tambone* case may also be used to interpret other rules with similar language. For example, SEC Rule 10b-9 provides for liability for "any person, directly or indirectly, in connection with the offer or sale of any security, *to make any representation*" (emphasis added) regarding the specified units, price, and time requirements of an offering and then not follow through on those representations.[27] Both Rule 10b-5(b) and Rule 10b-9 were promulgated under the SEC's authority under Section 10(b) of the Exchange Act. Additionally, both rules use precisely the same phrase: "to make" modified by "directly or indirectly." Consequently, the same limitations should apply to both rules. Securities professionals can't be held primarily liable under Rule 10b-5(b) and 10b-9 for statements in offering documents that they did not make and only disseminated and referred prospective investors to as part of their sales efforts.

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Endnotes

1. SEC v. Tambone, No. 07-1384, 2010 U.S. App LEXIS 5031 (1st Cir. Mar. 10, 2010).
2. Superintendent of Ins. of N.Y. v. Bankers Life Casualty Co., 404 U.S. 6, 13 n.9, 12 S. Ct. 165, 169 n.9 (1971); 15 U.S.C. § 78u-4(b).
3. 15 U.S.C. § 78u.
4. 15 U.S.C. § 78s(d) and (e).
5. 17 C.F.R. § 240.10b-5(a).
6. 17 C.F.R. § 240.10b-5(b).
7. 17 C.F.R. § 240.10b-5(c).
8. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 96 S. Ct. 2126 (1976); Basic Inc. v. Levinson, 485 U.S. 224, 231-32; 108 S. Ct. 978, 983 (1988).
9. Tellabs, Inc. v. Makor Issuers & Rights, Ltd., 551 U.S. 308, 319, 127 S. Ct. 2499, 2509 (2007); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12, 96 S. Ct. 1375 (1976).
10. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994).
11. 15 U.S.C. § 78t(e).

12. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 128 S. Ct. 761 (2008).

13. *Id.*

14. *Supra* note 1.

15. *Id.* at *7.

16. *Id.* at *9.

17. *Id.* at *10-11.

18. *Id.* at *16-23.

19. *Id.* at *25, 27.

20. *Id.* at *30.

21. *Id.* at *30-31.

22. *Id.* at *31-32 (citing Chiarella v. United States, 445 U.S. 222, 228, 100 S. Ct. 1108 (1980); Fortson v. Winstead, McGuire, Sechrest & Minick, 961 F.2d 469, 472 (4th Cir. 1992); SEC v. Cochran, 214 F.3d 1261, 1264 (10th Cir. 2000)).

23. SEC Litigation Release No. 20901 (Feb. 17, 2009); SEC v. Stanford Int'l Bank, No. 3:09-CV-0298-L (N.D. Tex.); SEC Litigation Release No. 21118 (July 7, 2009); SEC v. Provident Royalties, LLC, No. 3:09-CV-1238-L (N.D. Tex.); SEC Litigation Release No. 21165, (Aug. 3, 2009); SEC v. Med. Capital Holdings, Inc., No. 8:09-cv-00818-DOC-RNB (C.D. Cal.).

24. *In re* DBSI Inc., 407 B.R. 159 (Bankr. D. Del. 2009).

25. S. Cherry St., LLC v. Hennessee Group LLC, 573 F.3d 98 (2nd Cir. 2009).

26. Robert N. Clemens Trust v. Morgan Stanley DW, Inc., 485 F.3d 840 (6th Cir. 2007); Lehman Bros. Commercial. Corp. v. Minmetals Int'l Non-Ferrous Metals Trading Co., 179 F. Supp. 2d 159, (S.D.N.Y. 2001).

27. 17 C.F.R. § 240.10b-9; SEC v. Howard, 376 F.3d 1136, 1139 (D.C. Cir. 2004).