The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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Federal Appeals Court Reverses Dismissal of SEC Action Against Executives of Fund Distributor Alleging Fraud in Connection with Market Timing Arrangements

[23133]

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TO: BROKER/DEALER ADVISORY COMMITTEE No. 48-08
CLOSED-END INVESTMENT COMPANY MEMBERS No. 65-08
COMPLIANCE MEMBERS No. 66-08
SEC RULES MEMBERS No. 142-08
SMALL FUNDS MEMBERS No. 73-08 RE: FEDERAL APPEALS COURT REVERSES DISMISSAL OF SEC ACTION AGAINST EXECUTIVES OF FUND DISTRIBUTOR ALLEGING FRAUD IN CONNECTION WITH MARKET TIMING ARRANGEMENTS

The U.S. Court of Appeals for the First Circuit has reversed a district court's dismissal of an action brought by the Securities and Exchange Commission against two former executives of the principal underwriter and distributor of a mutual fund complex. [1]

In December 2006, the district court dismissed the action, in which the SEC alleged that the two former executives committed fraud and aided and abetted fraud by the distributor, finding that the SEC's complaint did not provide the detail required to support allegations of fraud. [2] Specifically, the complaint alleged that the executives entered into, approved, and permitted arrangements allowing certain preferred customers to engage in short-term trading in certain mutual funds, while at the same time offering those funds for sale using prospectuses that represented that such short-term trading was

prohibited. The district court held that the executives could not be held primarily liable for false statements in the prospectuses because they did not make the statements contained in the prospectuses.

The First Circuit reversed the dismissal. It held that the scope of conduct prohibited by Section 17(a)(2) of the Securities Act of 1933 is broader than the comparable antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and its implementing rule, Rule 10b-5. Specifically, it held that under Section 17(a)(2) a defendant may be held liable for "using" a false or misleading statement as a means "to obtain money or property," regardless of the source of the statement. In contrast, Rule 10b-5 "renders it unlawful 'to make any untrue statement of a material fact... in connection with the purchase or sale of any security.'" Thus, the Commission's allegations fell within the prohibitions established by Section 17(a)(2), and should not have been dismissed.

The First Circuit further held that the Commission adequately alleged a primary violation under Rule 10b-5. The court explained that underwriters have a statutory duty to review and confirm the accuracy of the prospectus. In light of this duty, an underwriter "impliedly makes a statement" to investors that the information contained in the prospectus is accurate. The SEC's allegation that the executives made such "implied statements" to investors while knowing, or being reckless in not knowing, that the prospectuses contained false statements about the funds' market timing practices was therefore actionable under Rule 10b-5.

One judge dissented as to the court's ruling with respect to Rule 10b-5, calling it "nothing less than a rewriting of that rule."

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endnotes

[1] SEC v. Tambone, 2008 U.S. App. LEXIS 24457 (Dec. 3, 2008).

[2] SEC v. Tambone, 473 F. Supp. 2d 162 (D. Mass. 2006).
