The Asset Management Industry
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Appellate Court Holds Executives of Fund Underwriter Cannot be Held Liable Under Rule 10b-5 for Misrepresentations in Fund Prospectus

[24379]

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TO: BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 16-10
BROKER/DEALER ADVISORY COMMITTEE No. 22-10 RE: APPELLATE COURT HOLDS EXECUTIVES OF FUND UNDERWRITER CANNOT BE HELD LIABLE UNDER RULE 10B-5 FOR MISREPRESENTATIONS IN FUND PROSPECTUS

In a case of first impression, the United States Court of Appeals for the First Circuit has rejected the attempts of the Securities and Exchange Commission (SEC) to hold senior executives of a fund underwriter liable for a violation of Rule 10b-5 under the Securities Exchange Act of 1934 for misrepresentations in fund prospectuses used to distribute the funds' shares. [1] In particular, the court rejected an expansive definition of the word "make" as used in Rule 10b-5 and held that one does not

> . . . 'make' a statement within the purview of the rule by merely using or disseminating a statement without regard to the authorship of that statement or, in the alternative, that securities professionals who direct the offering and sale of shareholders on behalf of an underwriter impliedly 'make' a statement, covered by the rule, to the effect that the disclosures in a prospectus are truthful and complete.

On this basis, the court affirmed the lower court's holding that granted the Defendants' motion to dismiss the SEC's Rule 10b-5 claims. [2] The facts of this case and the court's holding are briefly summarized below.

Background

The two Defendants in this case were the co-president and managing director of a registered broker-dealer that was the principal underwriter and distributor of over 140

mutual funds. As such, they were, in part, responsible for distributing prospectuses to the retail distributors of the mutual funds for delivery to fund investors and prospective investors. In its complaint, the SEC alleges that the Defendants co-led a working group that recommended that all the funds adopt a consistent position against market timing in their prospectuses. These efforts resulted in revising all of the funds' prospectuses to include representations regarding the funds' "strict prohibition" on short-term or excessive trading (i.e., market timing).

After the prospectuses were revised to include this language, the SEC alleges that the Defendants affirmatively approved or knowingly allowed frequent trading in certain mutual funds in violation of this "strict prohibition" language in the prospectuses.In particular, the SEC alleged that, "despite the language in the prospectuses expressing hostility toward market timing – the existence of which [the Defendants] allegedly either know or recklessly ignored – the Defendants jointly and severally entered into, approved, and/or knowingly permitted arrangements allowing certain preferred customers to engage in market timing forays in at least [16] different funds" and "the Defendants used the prospectuses in their sales efforts by allowing them to be disseminated and referring potential clients to them." Based on this conduct, the SEC's complaint alleged that the Defendants had violated Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 under the '34 Act. [3] It also alleged that they aided and abetted the distributor's primary violations of Section 15(c) of the Exchange Act and the fund adviser's violation of Section 206 of the Investment Advisers Act of 1940. [4] In response, the Defendants filed a motion to dismiss the SEC's complaint against them. With respect to the SEC's 10b-5 allegations, the Defendants argued that the SEC failed to plead any actionable misstatements on their part. The SEC countered that the Defendants "made" false statements actionable under 10b-5 by participating in the prospectus drafting process that led to inclusion of the market timing information and by using the resulting prospectuses in their sales efforts.

The District Court granted the Defendants' motion to dismiss and held that the SEC's allegations on this issue "were too conclusory and attenuated." The SEC appealed. On appeal, the case was considered twice by the court – first by a three-judge panel and then by the entire court. The three-judge panel reversed the District Court's decision to dismiss, which reinstated the SEC's 10b-5 claims against the Defendants. The Defendants asked the full court to reconsider the three-judge panel's decision, which the court agreed to do. On reconsideration, the full court reversed the three-judge panel's decision and upheld the Defendants' motion to dismiss the Rule 10b-5 claim. The following discussion is from the decision issued by the full court.

The Court's Decision

The court began its analysis by noting that the case presented it with the two part question "of whether a securities professional can be said to 'make' a statement, such that liability under Rule 10b-5(b) may attach, either by (i) using statements to sell securities, regardless of whether the statements were crafted entirely by others, or (ii) directing the offering and sale of securities on behalf of an underwriter, thus making an implied statement that . . . [the prospectus representations] are truthful and complete." According to the court, the answer to each part of this two-part question is "no."

In the court's view, the "pivotal word" in the text of Rule 10b-5 is "make," as in "to make a statement." The court consulted representative dictionaries that defined the term to mean

“to create or cause” (Webster’s) and “to cause something to exist” (Black’s Law Dictionary). The court found the SEC’s purported definition to be “inconsistent” with these definitions and noted the concept that “one can ‘make’ a statement when he merely uses a statement created entirely by others cannot follow.”

The court noted that the SEC did not argue on appeal that the Defendants made the alleged misstatements through their involvement with the preparation of the prospectuses. As such, the court considered whether the Defendants could be secondarily liable under Rule 10b-5 for aiding and abetting a violation of the rule. It began its review by noting that a private right of action under Rule 10b-5 can only be filed against a primary violator – not secondary violators. It noted that the court “must be vigilant to ensure that secondary violations are not shoehorned into the category reserved for primary violations.” Accordingly, it reviewed the line between primary violations and mere aiding and abetting in Rule 10b-5 actions. The court noted that two divergent strains of authority have evolved on aiding and abetting liability. One holds that “substantial participation or intricate involvement in the preparation of fraudulent statements” is enough to establish a primary violation. The other strain involves a “bright-line” test and requires proof “both that the defendant actually made a false or misleading statement and that it was attributable to him at the time of public dissemination.” In the view of the court, however, “the conduct for which the SEC strives to hold the defendants liable as primary violators – the use and dissemination of prospectuses created by others – does not satisfy either test. . . . The SEC’s attempt to impute statements to persons who may not have had any role in their creation, composition, or preparation falls well short.” Moreover, it found that the SEC’s attempt to hold the Defendants liable under Rule 10b-5 “poses a threat to the integrity” of the dichotomy between primary and secondary violations.

The court then discussed the “mischief” of the SEC attempting to impose on securities professionals who work for underwriters an “unprecedented” duty. In the view of the SEC and the court, securities professionals working for underwriters do, in fact, have a duty to investigate the nature and circumstances of an offering. The SEC’s allegations attempt to expand this duty, however, by arguing “that such securities professionals impliedly ‘make’ a representation to investors that the statements in a prospectus are truthful and complete.” According to the court, if it were “to give credence to this theory, the upshot would be to impose primary liability under Rule 10b-5 on these securities professionals whenever they fail to disclose material information not included in a prospectus, regardless of who prepared the prospectus.” Based on its review, the court upheld the lower court’s dismissal of the SEC’s 10b-5 claims.

A concurring opinion to the court’s opinion notes that that the word “‘make’, in reference to a statement, ordinarily refers to one authoring the statement or repeating it as his own; one who lends to a friend a book is not normally deemed to ‘make’ the statements in the book.” According to the concurring opinion, in their role as mutual fund underwriters, the Defendants “were required by law to furnish prospectuses to broker-dealers selling [the] funds and to investors to whom they sold directly.” While the Defendants “held significant positions” at the underwriter, “there is no obvious stopping point to the SEC’s argument that, as underwriters, they could be held to make statements in the mutual funds’ prospectuses. . . . virtually anyone involved in the underwriting process might, under the SEC’s ‘making a statement’ theory, be charged and subject to liability in a suit under section 10(b).” This opinion notes that “nothing justifies the adventure proposed by the [SEC].”

In a dissenting opinion, two judges state that their colleagues on the court who joined the

majority opinion "misguidedly allow concerns about excessive private litigation to influence their judgment on the scope of public enforcement by the [SEC]." In their view, "the language of section 10(b) and Rule 10b-5, the underwriter's role and duties in the securities market, and decades of case law . . . inescapably permit the SEC to procede against [the Defendants] for making false statements within the purview of Rule 10b-5(b)."

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endnotes

[1] See SEC v. Tambone, 597 F.3d 436 (1st Cir., March 10, 2010).

[2] Because the Rule 10b-5 claim was the only issue considered during this interlocutory appeal, the SEC's remaining claims against the Defendants remain intact and pending.

[3] Section 17(a) of the Securities Act governs fraudulent interstate transactions. Section 10(b) of the '34 Act governs the use of fraudulent or manipulative devices. Rule 10b-5 under the '34 Act prohibits engaging in manipulative and deceptive devices, including making any untrue statement of a material fact.

[4] Section 15(c) of the Exchange Act prohibits engaging in manipulative, deceptive, and fraudulent devices of contrivances. Section 206 of the Investment Advisers Act governs prohibited transactions by investment advisers. The only claim considered by the 1st Circuit on appeal related to the SEC's allegations under Section 10(b) and Rule 10b-5.