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First Circuit, Sitting En Banc, Clarifies What It Means To "Make" A Statement Under SEC Rule 10b-5(b)

In *Securities & Exchange Commission v. Tambone*, No. 07-1384, 2010 U.S. App. LEXIS 5031 (1st Cir. Mar. 10, 2010) (*en banc*), the United States Court of Appeals for the First Circuit, sitting *en banc*, vacated the three-judge panel's prior holding and affirmed the district court's dismissal of a Rule 10b-5 claim asserted by the Securities & Exchange Commission ("SEC") against defendants James Tambone and Robert Hussey. In doing so, the First Circuit clarified what it means to "make" a statement under Rule 10b-5(b) promulgated under Section 10(b) of the Securities Exchange Act of 1934 ("1934 Act").

Defendants were officers of Columbia Funds Distributor, Inc., which served as principal underwriter for Columbia mutual funds. As underwriters, they were required to furnish prospectuses to broker-dealers selling the funds and to investors who purchased them directly. The prospectuses were drafted by a separate entity. Those prospectuses contained language stating that "market timing" trading (the practice of frequent buying and selling to exploit inefficiencies in mutual fund pricing) was not permitted within those funds. The SEC alleged that despite the language in the prospectuses, the defendants allowed certain preferred customers to engage in market timing trading, which amounted to the making a false statement of material fact within the meaning of Rule 10b-5(b), 17 C.F.R. § 240.10b-5(b). The District of Massachusetts granted defendants' motion to dismiss with respect to this claim, holding that the allegations that defendants participated in the drafting and their subsequent use of the prospectuses were too conclusory. In *Securities & Exchange Commission v. Tambone*, 550 F.3d 106, 149 (1st Cir. 2008), a panel of the First Circuit disagreed, holding that by using the prospectuses, defendants implicitly stated that the prospectuses were truthful and complete.

In its *en banc* review, the First Circuit disagreed with the panel's prior holding, and affirmed the district court's dismissal. The decision rested largely on what it meant to "make" a statement under Rule 10b-5(b). The SEC argued that defendants had made statements by (i) using statements to sell securities, regardless of whether those statements were crafted by others, and (ii) directing the offering and sale of securities on behalf of an underwriter, thereby implicitly stating there was a reasonable basis to believe representations in the prospectus were truthful and complete. The First Circuit looked to the meaning of the term as defined by the dictionary and the context of its use, and then contrasted its use with language of other sections within the 1934 Act.

The Court first distinguished the terms “make” and “use,” both as they are defined and as they are used in the 1934 Act. Significantly, Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994), the Court noted that the SEC sought to impose primary liability on the defendants for conduct that constituted aiding and abetting (secondary liability). Without establishing a rule to determine what qualifies as a primary violation, the Court held that use and dissemination of a prospectus that contains a false statement cannot qualify as primary liability. Defendants’ behavior falls more appropriately into the category of “use” of a false statement, rather than the making of one.

This holding is significant in that sets forth a bright line rule protecting securities professionals working for underwriters from primary liability under Rule 10b-5(b) where the prospectus is prepared by a third party. While such professionals do have a duty to investigate the circumstances of an offering, they have no duty to disclose. Additionally, the holding limits the liability of any other persons who present information that was drafted or created by a third party, thereby ensuring that the liability rests with the person who initially makes the misstatement. While it is likely that the decision will be appealed to the Supreme Court, it provides guidance and some protection for underwriters and others who rely on the representations of third parties.

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