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HOW TO AVOID THE CONSTRAINTS OF RULE 10B-5(B): A FIRST CIRCUIT GUIDE FOR UNDERWRITERS

ERIC H. FRANKLIN*

If an underwriter knows that a prospectus contains a material misrepresentation, may that underwriter use the prospectus to sell securities, or would that expose the underwriter to liability under Rule 10b-5(b)? The United States Court of Appeals for the First Circuit's surprising and rather disconcerting answer was delivered on March 10, 2010, in Securities and Exchange Commission v. Tambone. In Tambone, the First Circuit held that the Securities and Exchange Commission (SEC) could not hold underwriters liable for such misrepresentations if they did not draft the prospectus. Ostensibly, this holding is nothing more than a judicial check on the SEC's enforcement powers under Rule 10b-5(b). However, the practical result of this holding is disturbing. This decision not only provides a perverse incentive for prospectus drafters to be as ignorant as possible, but it also teaches unscrupulous underwriters how to use material misstatements without running afoul of Rule 10b-5(b). The decision sharply constrains the enforcement powers of the SEC and is in direct conflict with both the intent of Rule 10b-5(b) and the current desire to increase regulatory scrutiny of financial markets. Regardless of the outcome, U.S. Supreme Court review of this decision is vital. A reversal of the decision would represent a victory for investors and a blow to dishonest securities sales techniques, and an affirmation of the decision might inspire Congress to reinstate the SEC with the enforcement powers necessary to protect investors.

I. INTRODUCTION: AN UNDERWRITER'S DILEMMA

Imagine an underwriter. Given the poor economy that currently plagues our markets, it should not be a great exercise to imagine that our underwriter has found his job difficult of late.¹

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1. However undeserved, the author assumes a modicum of posterity by reminding future readers of the financial crisis of the late aughts, caused in

But perhaps this difficulty is unwarranted. After all, our underwriter does not make his livelihood trading in subprime mortgage-backed securities,² and he does not work for an investment bank that lavishes its employees with outrageous bonuses.³ Rather, our underwriter has made his salary selling mutual funds, a product that is neither the blame of the financial crisis⁴ nor a provider of year-end riches. Regardless, business is not good. Investors, justifiably wary of exotic securities, have turned a critical eye to more familiar investment vehicles, and our underwriter's product is not immune.⁵

Mutual funds, long the favored investment of the prudent,⁶ have been scrutinized by the Securities and Exchange Commission (SEC) due to a practice known as "market timing." Market timing, the trading of mutual-fund stock in a manner that exploits pricing inefficiencies, is not illegal.⁷ It is, however, costly, and the SEC

part by the trading of mortgage-backed securities.

2. Mortgage-backed securities have been defined, rather dryly, as "bonds issued by large financial institutions backed by pools of individual home mortgages." See Press Release, Office of the N.Y. State Att'y Gen. Andrew M. Cuomo, Attorney General Cuomo Announces Landmark Reform Agreements with the Nation's Three Principal Credit Rating Agencies (June 5, 2008), available at http://www.ag.ny.gov/media_center/2008/jun/june5a_08.html (announcing agreements with the nation's three principal credit rating agencies and defining mortgage-backed securities); see also Bruce D. Fisher, *A Simple Explanation of Some Legal and Economic Aspects of the Financial Meltdowns of Banks*, MICH. B.J., Mar. 2010, at 38, 41, available at <http://www.michbar.org/journal/pdf/pdf4article1655.pdf> (noting that mortgage-backed securities "formed the foundation for this crisis . . . [and after] the true nature of those assets became clear, they declined severely in value, the banks' lending capacity contracted, and the current financial crisis ensued.").

3. See, e.g., Graham Bowley, *Strong Year for Goldman, as It Trims Bonus Pool*, N.Y. TIMES, Jan. 21, 2010, at B1, available at <http://www.nytimes.com/2010/01/22/business/22goldman.html> (stating that "[d]espite a record 2009, [Goldman Sachs] announced that it had set aside only \$16.2 billion to reward its employees.") (emphasis added).

4. This may be an overstatement, as many mutual funds invested in asset-backed securities and contributed to the financial crisis, but we will ignore this fact to foster some sympathy for our protagonist.

5. Robert A. Robertson & Bradley W. Paulson, *A Methodology for Mutual Fund Derivative Investments*, 1 STAN. J.L. BUS. & FIN. 237 (1995) (stating that "[r]ecent events involving the use of derivative investments by mutual funds have cast some doubt onto a method of investing once considered 'safe,' and have revealed a need for guidelines on the use of these investments.").

6. See, e.g., Michael M. Grynbaum, *Fed Adds to Its Efforts to Aid Credit Markets*, N.Y. TIMES, Oct. 21, 2008, at B1, available at <http://www.nytimes.com/2008/10/22/business/economy/22fed.html> (stating that "[f]or decades, Americans have considered money-market mutual funds as safe as bank accounts.").

7. See Richard L. Levine et al., *Mutual Fund Market Timing*, FED. LAW., Jan. 2005, at 28, 30 (stating that though it involves "frequent trading in and out of a fund to exploit market inefficiencies," market timing is not illegal).

disfavors market timing because it harms long-term investors.⁸ Unfortunately for our underwriter, his mutual fund permits market timing, and he believes that his sales suffer as a result.

But our underwriter notices a happy mistake in the most recent draft of his mutual fund's prospectus. Someone (our underwriter does not know the culprit) included a detailed description of the mutual fund's prohibition on market timing. This is included despite the fact that our underwriter knows his mutual fund actively encourages market timing. Though untrue, our underwriter suspects that this statement might help his flagging sales.

While he may lack scruples, our underwriter is not ignorant. He knows, for example, that Rule 10b-5(b), promulgated under the Securities Exchange Act of 1934, prohibits anyone selling securities from making untrue statements of material fact.⁹ He also knows that this rule has an unsettling and vaguely sinister reach. Curious of his potential liability, he turns to recent case law to gauge his concern. To his surprise, a recent ruling in the United States Court of Appeals for the First Circuit gives our underwriter an opportunity to use the prospectus to sell his shares without running afoul of Rule 10b-5(b).

In *Securities and Exchange Commission v. Tambone*, with a similar set of facts, the First Circuit held that underwriters using such a misrepresentation are not liable under Rule 10b-5(b).¹⁰ Because the underwriters did not draft the prospectus, the First Circuit reasoned that they did not "make" the misrepresentation.¹¹ Rather, the First Circuit held that the underwriters merely *used* the misrepresentation, and they could not, therefore, be held liable under Rule 10b-5(b).¹²

The *Tambone* majority relied upon statutory construction and Supreme Court precedent to reach this rather disconcerting decision.¹³ The majority described the *Tambone* case as "one of those happy occasions when the language and the structure of a rule, the statutory framework that it implements, and the teachings of the Supreme Court coalesce to provide a well-lit decisional path."¹⁴ However, this rather confident characterization is belied by a lengthy and convincing dissent by Judge Kermit

8. SEC v. *Tambone*, 597 F.3d 436, 439 (1st Cir. 2010) (stating that "[a]ccording to the SEC, market timing, though not illegal per se, can harm other fund investors and, therefore, is commonly barred (or at least restricted) by those in charge of mutual funds.").

9. 17 C.F.R. § 240.10b-5(b) (2010).

10. *Tambone*, 597 F.3d at 449.

11. *Id.* at 443.

12. *Id.*

13. See *infra* Part VI (concluding that the Supreme Court should review the *Tambone* decision because the lower court was incorrect in its holding).

14. *Tambone*, 597 F.3d at 450.

Lipez.¹⁵

This article argues that the *Tambone* decision unnecessarily constrains the enforcement powers of the SEC, leaves our hypothetical underwriter free of liability, provides a perverse incentive for prospectus drafters to be as poorly informed as possible, and is contrary to both the intent behind Rule 10b-5(b) and the current desire to increase regulatory scrutiny of financial markets. This article also argues that the majority's policy-based rationale—discouraging frivolous lawsuits—does not justify limiting the SEC's enforcement power under Rule 10b-5(b). In order to fully appreciate the decision, Part II defines some necessary terms, briefly summarizes the SEC's allegations, and describes the procedural posture of the case. Part III discusses the *Tambone* decision, including a detailed analysis of the majority's justifications and the dissent's rebuttal. Part IV identifies and discusses the majority's policy reason for the decision: the concern over frivolous lawsuits. Part V posits that the desire to limit frivolous lawsuits, however praiseworthy, does not justify curtailing the enforcement powers of the SEC, and Part VI concludes with a hypothetical that exposes the potentially disastrous outcome of this decision.

II. SECURITIES AND EXCHANGE COMMISSION V. TAMBONE

A. Some Necessary Definitions

Before delving into the substance of the *Tambone* decision, it is necessary to explore some of the terms used in the complaint. More specifically, it is important to establish a basic understanding of mutual funds, the role of underwriters, market timing, the definition and purpose of a prospectus, and the origin and content of Rule 10b-5(b).¹⁶

1. Mutual Funds and Market Timing

A "mutual fund" is the more common name for a regulated investment company under the Investment Company Act of 1940.¹⁷ The SEC monitors mutual funds for compliance with the Investment Company Act,¹⁸ and the SEC's website provides the

15. *Id.* at 453 (Lipez, J., dissenting).

16. Although these are relatively familiar terms, it is important to note that the crux of this case turned, in part, on the definition of the word "make." See *infra* Part III.A (analyzing the various definitions the court came up with for the word "make").

17. 15 U.S.C. § 80a-3 (2004).

18. See §§ 80a-2(c), 80a-37(a) (The Commission "is empowered to make rules and regulations to the same extent, covering the same subject matter, and for the accomplishment of the same ends as the [Investment Company Act of 1940]" (internal quotations omitted); see also Jean W. Gleason et al., *Fund*

following, attractively succinct, definition:

A mutual fund is a company that brings together money from many people and invests it in stocks, bonds or other assets. The combined holdings of stocks, bonds or other assets the fund owns are known as its *portfolio*. Each investor in the fund owns shares, which represent a part of these holdings.¹⁹

Investment in a mutual fund differs from investment in more traditional companies. In a more traditional company, a share of stock represents a proportionate fraction of company ownership, the value of which is based on the aggregate market price of the company.²⁰ Because a mutual fund creates value through investment in other companies, the value of a mutual fund share is dependent on the collective value of the mutual fund's investments.²¹ Thus, it is often said that a single mutual fund share provides access to a diversified investment portfolio without the necessity of purchasing stock from multiple companies.²²

Director's Guidebook, 52 BUS. LAW. 229, 251 (1996) (noting that "[t]he SEC actively monitors each fund's operations for compliance with the [Investment Company Act of 1940], primarily through periodic on-site inspections of the books and records of the fund and adviser that are required to be maintained and through review of disclosure documents required to be filed with the SEC. Inspections for cause may also result from any of a number of events such as direct receipt by the SEC of an investor complaint, questions presented through a congressional inquiry, problems raised during SEC review of a filing, or issues identified by the SEC staff from newspaper articles or investment company advertisements.").

19. U.S. Securities and Exchange Commission, Mutual Fund Definition, <http://www.sec.gov/investor/tools/mfcc/mutual-fund-help.htm> (last visited Nov. 19, 2010) (*italics in original*); *see also* Laurin Blumenthal Kleiman & Carla G. Teodoro, *Forming, Organizing and Operating a Mutual Fund: Legal and Practical Considerations*, 1612 PLI/CORP 9, 13 (2007) (noting that mutual funds "are companies that hold pools of portfolio securities (and perhaps other assets such as options, futures, loans, cash or cash equivalents) and issue securities that provide investors with an interest in the pool.").

20. A share of corporate stock represents "a proportional part of certain rights in a corporation during its existence, and in the assets upon dissolution," and evidence of the stockholder's ratable share in the distribution of the assets on the winding up of the corporation's business. *Dep't of Treasury of Indiana v. Crowder*, 214 Ind. 252, 255, 15 N.E.2d 89, 91 (1938).

21. As described by the Supreme Court, "the business of a mutual fund consists of buying stock for its own account and of issuing and selling stock or other securities evidencing an undivided and redeemable interest in the assets of the fund." *Inv. Co. Inst. v. Camp*, 401 U.S. 617, 625 (1971) (internal quotations omitted); *see also* *United States v. Nat'l Ass'n of Sec. Dealers, Inc.*, 422 U.S. 694, 697-98 (1975) (noting that a mutual fund "invests in the securities of other corporations and issues securities of its own. Shares in [a mutual fund] thus represent proportionate interests in its investment portfolio, and their value fluctuates in relation to the changes in value of the securities it owns.").

22. 2 DUNCAN E. OSBORNE & ELIZABETH MORGAN SCHURIG, *ASSET PROTECTION: DOMESTIC AND INTERNATIONAL LAW AND TACTICS* § 28:101

More importantly, mutual fund shares differ from those of more traditional companies because there is no secondary market for mutual funds.²³ In other words, an investor wishing to sell mutual fund stock does not have the right to sell the share to another investor. Instead, a holder of mutual fund stock must tender the share to the mutual fund for a price equal to the net asset value at the time of redemption.²⁴ The determination of the net asset value of a mutual fund share is calculated by determining the aggregate value of the mutual fund's investments.²⁵ Although comprised of a number of securities, the values of which ebb and flow over the course of a trading day, the net asset value of a mutual fund (and, therefore, the value of a share of a mutual fund) remains fixed for that day.²⁶

Market timing is an investment strategy that takes advantage of the time delay in mutual-fund pricing.²⁷ Through

(2008) (stating that, in a mutual fund, "individual investors with mutual investment objectives . . . pool their resources in order to take advantage of the resulting economies of scale and diminished risk through diversification.").

23. Joseph Lanzkron, *The Hedge Fund Holdup: The SEC's Repeated Unnecessary Attacks on the Hedge Fund Industry*, 73 BROOK. L. REV. 1509, 1542 (2008) (noting that "shares of mutual funds are bought and sold back to the fund itself and are not traded on a secondary market exchange.").

24. See Gleason et al., *supra*, note 18 at 251 (stating that "[m]utual funds continuously offer their shares and are obligated, upon presentation to the fund, to redeem the shares for current net asset value within seven days after tender of the shares.").

25. See Jonathan R. Macey & Maureen O'Hara, *Regulation and Scholarship: Constant Companions or Occasional Bedfellows?*, 26 YALE J. ON REG. 89, 97 (2009) (stating that "[t]he value of the mutual fund is determined every day by calculating the value of each of the fund's investments; the value of each investor's shares, referred to as the "Net Asset Value" . . . , is then the mutual fund value divided by the number of outstanding shares in the mutual fund. Each share owned by an investor can be sold back to the mutual fund for the [net asset value]. Likewise, new or additional investments in the mutual fund are made by buying shares in the mutual fund at the appropriate [net asset value]."). Or, in the less transparent language of the Investment Company Act, shares of a mutual fund can only be sold and redeemed at a price that

bear[s] such relation to the current net asset value of such security . . . for the purpose of eliminating or reducing . . . any dilution of the value of other outstanding securities of such company or any other result of such purchase, redemption or sale which is unfair to holders of such other outstanding securities.

15 U.S.C. § 80a-22 (2006).

26. *DH2, Inc. v. U.S. SEC*, 422 F.3d 591, 592 (7th Cir. 2005) (stating that "[a] mutual fund's share price does not fluctuate throughout the trading day, but the prices of the securities held by the fund do. The ever-changing portfolio security prices are aggregated into a single daily fund price known as the net asset value . . . , which is generally fixed by a fund when the major U.S. stock markets close.").

27. See William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401, 1453 (2006)

market timing, an investor exploits the fact that the portfolio stock prices used to set a mutual fund's net asset value change after the net asset value is established.²⁸ To engage in this practice, also known as "time zone arbitrage," an investor trades on knowledge known but not yet reflected by the markets.²⁹ This is most likely to occur when a mutual fund contains securities traded on markets that span several time zones.³⁰ For example, if a mutual fund's investment portfolio contains securities traded in both New York and London exchanges, an investor in New York could know the closing price of a security traded in London about four hours before the close of the New York exchange.³¹ Because the value of a mutual fund is calculated using the closing prices of the securities in their respective exchanges, an investor savvy in foreign markets could buy or sell mutual fund shares based on the anticipated price changes due to economic news not accounted for in a mutual fund's net asset value.³²

(stating that "the term 'market-timing' has no fixed definition in the extensive investment advisory literature and regulations. As investigations by the SEC and others evolved, however, regulators eventually made clear that the market-timing of which they disapproved encompassed a variety of investing techniques involving arbitrage of mutual fund share prices through the use of timed transactions.").

28. *Kircher v. Putnam Funds Trust*, 547 U.S. 633, 637, n.4 (2006) (describing "market timing" as "exploit[ing] brief discrepancies between the stock prices used to calculate the . . . value [of the mutual fund shares] once a day, and the prices at which those stocks are actually trading in the interim.").

29. *S.E.C. v. Gann*, 565 F.3d 932, 934-35 (5th Cir. 2009) (stating that "[m]arket timers typically buy and sell shares of a mutual fund quickly to take advantage of minute, short-term differentials between a fund's value and the value of the securities it holds.").

30. As described by the SEC in a Congressional report, "[m]utual funds that invest in overseas securities markets are particularly vulnerable to market timers" who could buy or sell "fund shares based on events occurring after foreign market closing prices are established . . . , but before the events have been reflected in the fund's" net asset value. Brief for the Securities and Exchange Commission at 10-11, *S.E.C. v. Tambone*, 550 F.3d 106 (1st Cir. 2008) (No. 07-1834), 2007 WL 7076123.

31. *DH2, Inc.*, 422 F.3d at 593, n.1 (stating that "[t]he potential for exploiting stale market prices increases as one moves east, given the larger time zone disparities between eastern time and the Japanese or Hong Kong markets."); see also Eric Zitzewitz, *Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds*, 19 J.L. ECON. & ORG. 245, 246 (2003) (stating that "[i]nvestors can take advantage of mutual funds that calculate their [net asset values] using stale closing prices by trading based on recent market movements. For example, if the U.S. market has risen since the close of overseas equity markets, investors can expect that overseas markets will open higher the following morning. Investors can buy a fund with a stale-price [net asset value] for less than its current value, and they can likewise sell a fund for more than its current value on a day that the U.S. market has fallen.").

32. See Levin et al., *supra* note 7, at 30 (stating that "market-timers purchase or sell shares of mutual funds at the to-be-calculated but effectively 'stale' NAV in an attempt to benefit from the anticipated adjustment in the

Such a practice, although not specifically barred by rule or law,³³ has been recognized by the SEC as harmful to mutual fund investors that do not engage in market timing.³⁴ The frequent trading by market timers increases transaction costs at the expense of long-term investors.³⁵ In recognition of this harm, the SEC proposed a rule that requires mutual funds “to disclose in their prospectuses . . . the risks . . . of the frequent purchase and redemption of investment company shares, and the . . . policies and procedures with respect to such frequent purchases and redemptions.”³⁶ The proposal does not, however, indicate that market timing is illegal, and although some mutual funds have taken steps to prohibit market timing,³⁷ the practice continues to be an issue.³⁸

price of the foreign securities at their opening the next day”); *see also DH2, Inc.*, 422 F.3d at 593 (noting that those that practice market timing “make profits with slight risk to themselves, diverting gains from the mutual funds’ long-term investors while imposing higher administrative costs on the funds (whose operating expenses rise with each purchase and redemption).” (quoting *Kircher v. Putnam Funds Trust*, 403 F.3d 478, 481 (7th Cir. 2005))).

33. *See Levine et al.*, *supra* note 7, at 30 (stating that “no rule, regulation, or common law prohibits market timing.”).

34. *See Tambone*, 597 F.3d at 439 (stating that “[a]ccording to the SEC, market timing, though not illegal per se, can harm other fund investors and, therefore, is commonly barred (or at least restricted) by those in charge of mutual funds.”).

35. *Gann*, 565 F.3d at 935 (noting that mutual funds “object that market timers’ gains come at the expense of long-term investors and increase transaction costs, so such companies employ a number of strategies to discover and impede traders engaging in the practice.”).

36. Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Hearing, 68 Fed. Reg. 70402-01 (proposed Dec. 17, 2003).

37. *See Gann*, 565 F.3d at 935 (stating that “[b]rokers who time the market sometimes receive ‘block notices’ from funds in which they have bought and sold shares. A block notice typically informs the broker that he has run afoul of a fund’s restrictions and bars specified accounts controlled by the broker from future trades. Brokers can be identified by their registered representative number; clients can be identified by their account number or numbers. A block notice might bar trades under the broker’s number, the client’s account number, or the number attached to a brokerage or its branch office.”). *But see Zitzewitz*, *supra* note 31, at 245–46 (stating that “[d]espite the fact that this arbitrage opportunity has been understood by the industry for 20 years and heavily exploited since at least 1998, the fund industry was still taking only limited action to protect its long-term shareholders as of late 2002.”).

38. *See Zitzewitz*, *supra* note 32, at 245 (noting that “[d]espite . . . pressure from the Securities and Exchange Commission . . . , the vast majority of funds are not market-updating their prices to eliminate [net asset value] predictability and dilution, but are instead pursuing solutions that are only partly effective.”).

2. Underwriters and Prospectuses

Generally, an underwriter is any party that purchases securities from an issuer in connection with the issuer's distribution of such securities.³⁹ In basic terms, an underwriter matches buyers with sellers.⁴⁰ Responsible for the pricing,⁴¹ the sale,⁴² and the general organization of an issuance, the underwriter plays a vital role in a securities offering.

Often, the underwriter serves as the primary point of contact for investors. It has been suggested that investors seek out the underwriter not only because of the underwriter's relationship with the issuer,⁴³ but also because an underwriter's *raison d'être* is the evaluation of securities and their issuers.⁴⁴ On a more practical level, an investor might find comfort in the knowledge that the underwriter's profit is often linked to the success of the issuer.⁴⁵

39. See 15 U.S.C.A. § 77b(11) (2000) (defining an underwriter as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking."); see also Eric Seitz, *Underwriter Due Diligence: "It's [Not] a Whole New Ballgame,"* 61 SMU L. REV. 1633, 1638 (2008) (stating that "[i]n a securities offering, the basic role of an underwriter is to act as an intermediary between the issuer and the investor.").

40. *In re WorldCom, Inc. Sec. Litig.*, 308 F. Supp. 2d 338, 343 (S.D.N.Y. 2004) (defining an underwriter as a person who "buys securities directly or indirectly from the issuer and resells them to the public, or [] performs some act (or acts) that facilitates the issuer's distribution." (quoting *Ingenito v. Bermec Corp.*, 441 F. Supp. 525, 536 (S.D.N.Y.1977))).

41. Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711, 724 (2005) (stating that "the underwriter has primary responsibility for pricing the IPO shares and for distributing them.").

42. See *Tannenbaum v. Zeller*, 552 F.2d 402, 405 (2d Cir. 1977) (stating that "[t]he sale of fund shares to new investors is generally the responsibility of a 'principal underwriter' who is usually the adviser itself or a close affiliate.").

43. *Sanders v. John Nuveen & Co.*, 524 F.2d 1064, 1070 (7th Cir. 1975) (noting that "[a]n underwriter's relationship with the issuer gives the underwriter access to facts that are not equally available to members of the public who must rely on published information.").

44. Katina J. Dorton, *Auctioning New Issues of Corporate Securities*, 71 VA. L. REV. 1381, 1390 (1985) ("An issuer is only an occasional participant in the capital markets, but underwriters have frequent, direct contact with the markets and have developed an expertise in pricing securities."); see also *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 370 (2d Cir. 1973) (noting that an underwriter "is most heavily relied upon to verify published materials because of his expertise in appraising the securities issue and the issuer, and because of his incentive to do so. He is familiar with the process of investigating the business condition of a company and possesses extensive resources for doing so.").

45. See *Chris-Craft*, 480 F.2d at 370 (noting the underwriter "often has a financial stake in the issue," and thus "has a special motive to thoroughly

Due to the unique role of underwriters in securities issuances and the fact that they are privy to facts and data unavailable to the investing public, courts have imposed a duty upon underwriters to make an appropriate investigation into the offering⁴⁶ and the issuer.⁴⁷ As stated rather succinctly by an Alabama district court, underwriters are “under a duty to the investing public to make a reasonable investigation of the issuer . . . and to disclose material facts that he knew or that were readily ascertainable.”⁴⁸ Generally, this investigation must be vigorous enough to provide a reasonable person with confidence that the statements in the sales materials are true and comprehensive.⁴⁹ This investigation involves more than merely relying on the issuer’s attestation; an underwriter must take affirmative steps to test the veracity of the statements in the sales materials, otherwise known as the prospectus.⁵⁰

In basic terms, a prospectus is a document used by underwriters to sell a security. The Securities Exchange Act defines “prospectus” broadly to include any writing “which offers

investigate the issuer’s strengths and weaknesses.”).

46. *See id.* (noting that “[p]rospective investors look to the underwriter—a fact well known to all concerned and especially to the underwriter—to pass on the soundness of the security and the correctness of the registration statement and prospectus.”). *See generally* 3B HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, *SECURITIES AND FEDERAL CORPORATE LAW* § 12:42 (2d ed. 2003) (noting the underwriter’s significant role); *Hanly v. SEC*, 415 F.2d 589, 595–96 (2d Cir. 1969) (explaining that a securities dealer has a special relationship with a buyer to make decisions based on accurate information and not “accept blind recommendations.”).

47. *See Sanders*, 524 F.2d at 1070 (stating that “the relationship between the underwriter and its customers implicitly involves a favorable recommendation of the issued security. Because the public relies on the integrity, independence and expertise of the underwriter, the underwriter’s participation significantly enhances the marketability of the security. And since the underwriter is unquestionably aware of the nature of the public’s reliance on his participation in the sale of the issue, the mere fact that he has underwritten it is an implied representation that he has met the standards of his profession in his investigation of the issuer.”) (citations omitted).

48. *Shores v. M.E. Ratliff Inv. Co.*, No. CA 77-G-0604-S, 1982 WL 1559, at *3 (N.D. Ala. Jan. 18, 1982).

49. *SEC v. Dain Rauscher, Inc.* 254 F.3d 852, 858 (9th Cir. 2001) (citing *Municipal Securities Disclosure*, Exchange Act Release No. 34-26100, 41 SEC Docket 1131 (Sept. 22, 1988), 1988 WL 240748, at *20); *see also Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977) (noting that an underwriter has a duty to investigate, and recognizing further that an underwriter may be liable under Rule 10b-5 for reckless failure to investigate).

50. *See Escott v. BarChris Construction Corp.*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968) (stating that “[t]o effectuate the statute’s purpose the phrase ‘reasonable investigation’ must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of ‘date presented’ to them by the company . . . [Underwriters] may not rely solely on the company’s officers or on the company’s counsel.”).

any security for sale or confirms the sale of any security.”⁵¹ A prospectus contains general information about the offering, including issuer representations, the security’s cost, potential risks of the investment, and the issuer’s past performance.⁵² Although this description appears pleasantly pro-investor, commentators have criticized prospectuses as unduly protracted, complicated, and mind-numbing documents.⁵³ Indeed, it has been suggested that the prospectus disclosures are “boring intentionally, word analgesics to numb anxious buyers and sellers.”⁵⁴ Regardless of its efficacy, a prospectus includes important representations about the issuer and its business and is the only document required to be given to investors.⁵⁵

3. Rule 10b-5(b)

Rule 10b-5(b) of the Securities Exchange Act generally prohibits the use of misstatements in the sale of securities.⁵⁶ The rule, in relevant part, states that “[i]t shall be unlawful for any person, directly or indirectly, . . . [t]o make any untrue statement

51. 15 U.S.C.A. § 77b(10) (2000).

52. See LARRY D. SODERQUIST, UNDERSTANDING THE SECURITIES LAWS § 3:3.1 3–16 (4th ed. 2005) (detailing the elements of a prospectus); see also U.S. Securities and Exchange Commission, Prospectus Definition, <http://www.sec.gov/investor/tools/mfcc/prospectus-help.htm> (last visited Nov. 19, 2010) (defining a prospectus and providing information on how to obtain a prospectus).

53. See, e.g., Registration Form Used by Open-End Management Investment Companies, 63 Fed. Reg. 13,916 (June 1, 1998) (to be codified at 17 C.F.R. pts. 230, 232, 239, 240, 270, 274), available at <http://www.sec.gov/rules/final/33-7512r.htm#body4> (noting that “[m]any have criticized fund prospectuses finding them unintelligible, tedious, and legalistic.”). See also Daniel D. Bradlow & Jay Gary Finkelstein, *Training Law Students to be International Transactional Lawyers—Using an Extended Simulation to Educate Law Students About Business Transactions*, 1 J. BUS. ENTREPRENEURSHIP & L. 67, 69 (2007) (noting that “[a] securities prospectus is an extraordinarily complex document—and one of the most boring . . .”). But see Henry T. C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777, 843 (2000) (stating that “[p]erhaps surprisingly, investors consult the prospectus more than any other source of information about the mutual funds that they buy.”).

54. KURT ANDERSEN, *TURN OF THE CENTURY 430* (Random House, 1999).

55. See 15 U.S.C. § 77e(b)(2) (2004) (declaring that it is unlawful for any person “to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus.”). See also Kwang-Rok Kim, *The Electronic Disclosure System in the Korean Securities Market: What Do You File on the DART System in Korea?*, 29 OKLA. CITY U. L. REV. 597, 610 (2004) (noting that because “a prospectus contains very important information needed to make investment decisions, the U.S. federal securities laws prohibit transactions of securities if a prospectus is not first delivered to the investors.”).

56. 17 C.F.R. § 240.10b-5(b) (2010).

of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.”⁵⁷ To deduce the rule’s intent, it is illuminating to examine its origin.

Although Rule 10b-5(b) is one of the SEC’s primary tools in the regulation of today’s intricate securities transactions, the language of the rule was born out of a desire to stop a stunningly simple fraud.⁵⁸ Milton Freeman worked for a nascent SEC in the early 1940s⁵⁹ and was one of the authors of Rule 10b-5(b).⁶⁰ A colleague told Mr. Freeman that a company officer was purposely devaluing his company’s stock in order to purchase the stock at an artificially low price.⁶¹ Recounting the birth of Rule 10b-5(b) in almost comic detail, Mr. Freeman stated:

I called the Commission and . . . got on the calendar, and I don’t remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, “Well,” he said, “we are against fraud, aren’t we?” That is how it happened.⁶²

This rather romantic reminiscence illustrates the simplicity of the rule’s intent: to protect investors from corporate fraud. Indeed, early interpretations allowed the rule to reach virtually any conduct that resulted in a fraud upon investors.⁶³

B. SEC v. Tambone: *The Parties*

Tambone involved a registered broker-dealer called Columbia Funds Distributor, Inc. (“Distributor”).⁶⁴ James Tambone was a co-president of Distributor and Robert Hussey was a managing

57. *Id.*

58. Milton V. Freeman, *Administrative Procedures*, 22 BUS. LAW. 891, 916 (1967).

59. *Id.* at 891.

60. *Id.* at 922 (describing, with an unabashed hubris, that Rule 10b-5 is “the biggest thing that had ever happened”).

61. Freeman, *supra* note 59, at 922 (recalling that “the president of some company in Boston . . . [was] going around buying up the stock of his company from his own shareholders at \$4.00 a share, and he [was] telling [the shareholders] that the company [was] doing very badly, whereas, in fact, the earnings [were expected] to be quadrupled and [the price of the stock would] be \$2.00 a share for this coming year.”).

62. *Id.* The amusingly superfluous aside as to whether the Commission met “that morning or after lunch” is included to emphasize the iconic position that the rule has assumed.

63. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212 (1976) (noting that Rule 10b-5(b) “could be read as proscribing, respectively, any type of material misstatement or omission, and any course of conduct, that has the effect of defrauding investors, whether the wrongdoing was intentional or not.”).

64. *Tambone*, 597 F.3d at 438.

director.⁶⁵ The First Circuit goes through great pains to describe the “tangled web of interlocking entities” at issue in this case, but the only entities germane to the discussion are Distributor, Columbia Management Group (“Management”) and Columbia Management Advisors, Inc. (“Advisors”).⁶⁶ Distributor, a wholly-owned subsidiary of Management, acted as an underwriter by selling shares and distributing prospectuses for over 140 mutual funds.⁶⁷ Such prospectuses, and the representations therein, were drafted by employees of Advisors.⁶⁸ There was no allegation by the SEC that either Mr. Tambone or Mr. Hussey were employees of either Management or Advisors during the relevant time period.⁶⁹

C. Facts and Procedural Posture

The SEC alleged that, despite a representation in the prospectus to the contrary,⁷⁰ the Columbia family of mutual funds allowed market timing and that Tambone and Hussey intentionally used this falsehood to sell shares in violation of Rule 10b-5(b).⁷¹ The SEC also charged the defendants with breaching an implied representation that they had a reasonable basis to believe that the prospectus was accurate and complete.⁷²

At district court, the defendants were granted a motion to dismiss based on a lack of the particularity requirement of Federal Rule of Civil Procedure 9(b)⁷³ and a failure to state a claim.⁷⁴ On

65. *Id.* at 439.

66. *Id.* at 438.

67. *Id.* at 439.

68. *Id.*

69. *Id.*

70. See Complaint at 13, *SEC v. Tambone*, 550 F.3d 106 (D. Mass. 2006), (No. 06-10885 NMG), 2006 WL 1726133 (quoting a disclosure used in a number of prospectuses). The disclosure states:

The Fund does not permit short-term or excessive trading in its shares. Excessive purchases, redemptions or exchanges of Fund shares disrupt portfolio management and increase Fund expenses. In order to promote the best interests of the Fund, the Fund reserves the right to reject any purchase order or exchange request particularly from market timers or investors who, in the advisor’s opinion, have a pattern of short-term or excessive trading or whose trading has been or may be disruptive to the Fund.

Id.

71. Brief for SEC, *supra* note 30, at 2 (alleging that the defendants “marketed and sold fund shares by means of the misleading prospectuses, allowing the prospectuses to be disseminated and referring clients . . . to the prospectuses for information on the funds.”).

72. *Tambone*, 597 F.3d at 440.

73. FED. R. CIV. P. 9(b) (“In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake.”).

74. *SEC v. Tambone*, 473 F. Supp. 2d 162, 168 (D. Mass. 2006) (holding that the defendants could not be held liable as primary violators for misstatements that the defendants did not draft).

appeal, a divided panel of the First Circuit reversed in part, holding that the SEC properly alleged that Tambone and Hussey made false statements.⁷⁵ The defendants petitioned for, and were granted, en banc review on the Rule 10b-5(b) claim by the First Circuit.⁷⁶

III. THE FIRST CIRCUIT'S HOLDING, ITS RATIONALE, AND A REBUTTAL

The majority opinion in *Tambone*, drafted by Judge Bruce M. Selya, ultimately held that the SEC's interpretation of Rule 10b-5(b) was untenable.⁷⁷ To reach this conclusion, the majority held that the definition of "make" in Rule 10b-5(b) was too narrow to encompass the defendants' acts, and that a breach of an underwriter's implied duty did not give rise to primary liability under Rule 10b-5(b).⁷⁸ As discussed below, however, the majority's arguments are dissected, point-by-point, by Judge Kermit Lipetz's persuasive dissent.

A. The Definition of "Make" in Rule 10b-5(b)

The core inquiry in *Tambone*, as framed by the majority, is whether Tambone and Hussey made untrue statements within the meaning of Rule 10b-5(b).⁷⁹ Asserting that the crucial word in Rule 10b-5(b) is "make," the majority set out to test the SEC's proposed definition.⁸⁰ Although it has been said that "[n]o honest and reasonable citizen could have difficulty in understanding the meaning of 'untrue,' 'material fact,' 'any omission to state a material fact,' 'in light of the circumstances under which they were made,' or 'misleading,'" the majority found it necessary to define "make."⁸¹ To divine the word's definition, the majority applied three traditional methods of statutory construction: determination of the ordinary meaning of the word,⁸² analysis of the structure of Rule 10b,⁸³ and review of Supreme Court precedent.

75. SEC v. *Tambone*, 550 F.3d 106, 135 (1st Cir. 2008).

76. *Tambone*, 597 F.3d at 441.

77. *Id.* at 450.

78. *Id.*

79. *Id.* at 442.

80. See *id.* (declaring "make" the "pivotal word"). The majority's definitional odyssey reminds the author of President Bill Clinton's famous quote that his answer "depends on what the meaning of the word 'is' is." See Kenneth Starr, *A Referral to the United States House of Representatives pursuant to Title 28, United States Code, § 595(c)*, H. R. Doc. 105-310, at 125, n.1091 (1998).

81. See *United States v. Persky*, 520 F.2d 283, 287 (2d Cir. 1975) (quoting *Coplin v. United States*, 88 F.2d 652, 657 (9th Cir. 1937)).

82. *Smith v. United States*, 508 U.S. 223, 228 (1993) ("When a word is not defined by statute, we normally construe it in accord with its ordinary or natural meaning.").

83. *Affiliated Ute v. United States*, 406 U.S. 128, 152-53 (1972) (stating that "the second subparagraph of [Rule 10b] specifies the making of an untrue

1. The Ordinary Meaning of “Make”

Faced with an undefined term in a statute, the majority followed the traditional rule of statutory construction of resorting to the word’s ordinary meaning.⁸⁴ To do this, the majority consulted dictionary definitions,⁸⁵ noting that Black’s Law Dictionary’s definition of “make” is to “cause (something) to exist” and that Webster’s Third New International Dictionary defines “make” as to “create [or] cause.”⁸⁶ Using these references, the majority settled on a definition that stressed the actual *creation* of the misstatement,⁸⁷ and was quick to emphasize that the Commission’s proposed definition of “make”—something akin to “delivery”—conflicted with this definition.⁸⁸

The majority confirmed this definition by examining the use of other verbs in Rule 10b. The majority found the verb used in Rule 10b-5(a) illuminating. Rule 10b-5(a) prohibits the “employ[ment]” of a device, scheme or artifice to defraud.⁸⁹ Characterizing “employ” as more expansive than “make,” a characterization that itself is dubious,⁹⁰ the majority held that the drafters deliberately chose a more narrow verb for of Rule 10b-5(b).⁹¹ The implication is that had the drafters of Rule 10b-5(b) used the word “employ” rather than “make,” the Commission’s

statement of a material fact and the omission to state a material fact. The first and third paragraphs are not so restricted.”).

84. *Engine Mfrs. Ass’n v. S. Coast Air Quality Mgmt. Dist.*, 541 U.S. 246, 252 (2004) (stating that “[s]tatutory construction must begin with the language employed by Congress and the assumption that the ordinary meaning of that language accurately expresses the legislative purpose.” (quoting *Park ‘N Fly, Inc. v. Dollar Park & Fly, Inc.*, 469 U.S. 189, 194 (1985))). *See also In re Hill*, 562 F.3d 29, 32 (1st Cir. 2009) (noting that, in general, words in a statute carry their ordinary meanings if not specially defined).

85. *See Johnson v. Aljian*, 490 F.3d 778, 780 (9th Cir. 2007), (stating that the court “follow[s] the common practice of consulting dictionary definitions to clarify their ordinary meaning [] and look to how the terms were defined at the time [the statute] was adopted.” (alterations in original) (internal quotation marks omitted) (quoting *United States v. TRW Rifle 7.62X51mm Caliber*, 447 F.3d 686, 689 (9th Cir. 2006))).

86. *Tambone*, 597 F.3d at 443 (citing WEBSTER’S THIRD NEW INT’L DICT. 1363 (2002); BLACK’S LAW DICT. 1041 (9th ed. 2009)).

87. It is important to note, however, that the majority was careful to state: “This case does not require us to set forth a comprehensive test for determining when a speaker may be said to have made a statement.” *Id.* at 443.

88. *Id.* (“It is enough to say that the SEC’s purported reading of the word is inconsistent with each of these definitions.”).

89. 17 C.F.R. § 240.10b-5(b) (2010).

90. *See generally infra* Part III.A.1.

91. *Tambone*, 597 F.3d at 443 (citing the rule’s [10(b)] grant to the SEC of “broad authority to proscribe conduct that ‘use[s] or employ[s]’ any ‘manipulative or deceptive device or contrivance.’”).

allegations might have been appropriate. However, according to the majority, to adopt the Commission's interpretation of "make" would be to ignore the difference between "employ" and the "significantly different (and narrower) verb contained in Rule 10b-5(b)."⁹² The majority stated, in a moment of hyperbolic condescension, that "[w]ord choices have consequences, and this word choice virtually leaps off the page."⁹³ Suggesting that the Commission's definition would overstep the intended regulatory reach of Rule 10b-5(b),⁹⁴ the majority refused to entertain the Commission's proposed definition of "make."⁹⁵

In dissent, Judge Lipez pointed out that the majority was perhaps a bit too selective in the chosen definitions of "make." Hinting that the majority took an ultra-literal approach,⁹⁶ the dissent asserted that "it defies ordinary experience to say that a statement can only be 'made' by the physical or manual act of writing or transcribing or speaking words."⁹⁷

To support the claim that it is common to say that one "makes" a statement through conduct, the dissent highlighted dictionary definitions of "make" that do not exclusively refer to acts of creation.⁹⁸ For example, The Random House Dictionary defines "make" to include acts such as "delivering" and "putting forth."⁹⁹ If the majority were to have used this definition, the SEC's allegation that the defendants *made* the misrepresentation by *delivering* the prospectus would be credible.¹⁰⁰

Rather than merely suggesting an alternate definition, the dissent forwarded a rather convincing reason to use this definition: precedent. The dissent cites the United States Court of Appeals for the Fourth Circuit's decision in *Reass v. United States*, which held that a statute's reference to "making" a false statement should encompass not only the composition of the statement, but also the communication of the statement.¹⁰¹ Thus, the majority's definition

92. *Id.* (characterizing the difference as "obvious").

93. *Id.*

94. *See id.* (refusing to permit the administrative rule to sweep more broadly than its language permits).

95. *Id.* at 447. (noting that 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.").

96. *See id.* at 458 (Lipez, J., dissenting) (noting that "the statutory language [of Rule 10b-5(b)] is broad enough to encompass less literal forms of 'making' a statement.").

97. *Id.* (internal quotations omitted) (quoting *State v. O'Neil*, 135 P. 60, 63 (1913)).

98. *Id.*

99. *Tambone*, 597 F.3d at 458 (Lipez, J., dissenting) (quoting THE RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 1161 (2d ed. 1987)).

100. *Id.*

101. *See Tambone*, 597 F.3d at 458 (Lipez, J., dissenting) (interpreting the word "make" in a federal mortgage fraud statute to include "communicating

of “make” is arguably too narrow, and there is persuasive (albeit nonbinding) authority supporting the SEC’s suggested definition.¹⁰²

2. Defining “Make” through Examination of the Structure and Intent of Rule 10b-5

Not content to rely upon a selectively-chosen dictionary definition of “make,” the First Circuit majority examined the statute that Rule 10b-5(b) drafters used as a model: section 17(a) of the Securities Exchange Act.¹⁰³ Section 17(a) states, in relevant part, that it is illegal to “obtain money or property by means of any untrue statement of a material fact.”¹⁰⁴ The court noted the difference between this language and Rule 10b-5(b), stating that “the drafters of Rule 10b-5 had before them language that would have covered the ‘use’ of an untrue statement of material fact,” and that the authors of Rule 10b-5 “easily could have copied that language.”¹⁰⁵ The result of this difference, according to the majority, is that Rule 10b-5(b) was deliberately drafted in a more restrictive manner to encompass a more narrow family of activities.¹⁰⁶

In dissent, Judge Lipez noted that the majority’s interpretation failed to give proper deference to the intent of the drafters of Rule 10b-5(b).¹⁰⁷ Regardless of the rule’s predecessor, the SEC’s interpretation of the word “make” is necessary to “fulfill the objective of Congress and the Commission to punish ‘any untrue statement of a material fact’ made with knowledge or reckless disregard for its truth.”¹⁰⁸ The dissent argued that if an

[the statement] and not merely composing” the statement. (quoting *Reass v. United States*, 99 F.2d 752, 755 (4th Cir. 1938)).

102. *See id.* (noting that “the fact remains that the [Fourth Circuit] did not confine ‘making a statement’ to the literal meaning on which the majority insists.”).

103. *See Persky*, 520 F.2d at 287 (citing *Hooper v. Mountain States Securities Corp.*, 282 F.2d 195, 201, n.4 (5th Cir. 1960) (noting that Section 17(a) “is almost identical to, and indeed was the model for, Section 10(b) and Rule 10b-5.”).

104. 15 U.S.C. § 77q(a)(2) (2010).

105. *Tambone*, 597 F.3d at 464. The court suggests, it would seem, a Rule 10b-5(b) that would read as follows:

[I]t shall be unlawful for any person, directly or indirectly . . . to obtain money or property by means of any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading

Id. at 444, n.5 (emphasis added).

106. *See id.* at 434 (noting that “the drafters—who faithfully tracked section 17(a) in other respects—deliberately eschewed the expansive language of section 17(a)(2).”).

107. *Id.* at 459 (Lipez, J., dissenting).

108. *Id.* (quoting Rule 10b-5(b)).

underwriter delivers a prospectus to investors with the knowledge that it contains a misstatement, it “takes no stretch of the language of Rule 10b-5(b) to view such an underwriter as having attested to the accuracy of the prospectus contents.”¹⁰⁹ Although admitting that the rule “contemplates some range of conduct narrower than the statute’s all-encompassing ‘use or employ,’” the dissent stressed that this does not foreclose the possibility “that particular uses of statements by particular players in the sale of securities . . . constitute the ‘making’ of implied statements.”¹¹⁰ Thus, the majority allowed a rather pedantic examination of Rule 10b-5(b)’s predecessor to trump the intent of the rule.

3. *Supreme Court Precedent and “Primary” vs. “Secondary” Liability under Rule 10b-5*

After satisfying itself that both the ordinary dictionary meaning of “make” and the statute’s use of more expansive verbs were contrary to the SEC’s proposed definition, the majority argued that Supreme Court cases were in conflict with the SEC’s interpretation.¹¹¹ The majority noted that the Supreme Court has not addressed the question of the definition of the word “make” in Rule 10b-5(b), but stated that the SEC’s definition would cause tension in the Supreme Court’s rulings regarding primary and secondary liability under Rule 10b-5(b).¹¹²

In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, the Supreme Court established a private right of action under Rule 10b against “primary” (as opposed to “secondary”) violators of securities laws.¹¹³ In the context of Rule 10b, a primary violator is the party responsible for the misrepresentation or untrue statement, and a secondary violator would be any party that, for example, aids or abets in the making of the misrepresentation or untrue statement.¹¹⁴

In *Central Bank*, a public building authority issued bonds to finance a public improvement project.¹¹⁵ The value of the bonds dramatically decreased, and several bondholders sued a number of

109. *Id.* at 459 (Lipez, J., dissenting). The dissent continues to state that, through such delivery, the underwriters “have knowingly ‘made’ an implied-false-statement to investors that the prospectus accurately describes the fund’s risks.” *Id.* (“By [an underwriter’s] recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation.” (quoting *Hanly*, 415 F.2d at 597)).

110. *Id.* at 459 (Lipez, J., dissenting).

111. *Tambone*, 597 F.3d at 443.

112. *Id.*

113. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191.

114. *Id.*

115. *Id.* at 167.

parties under Rule 10b-5.¹¹⁶ Rule 10b-5(a), in relevant part, makes it unlawful to “directly or indirectly . . . use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance.”¹¹⁷ The plaintiffs argued that the “directly or indirectly” language of Rule 10b-5 should extend to cover parties that aid and abet the employment of a manipulative or deceptive device.¹¹⁸ After review of the statutory language, the *Central Bank* court disagreed, noting that the “directly or indirectly” language does not give rise to aiding and abetting liability.¹¹⁹ The court reasoned that to impose such liability on parties who give “a degree of aid” to primary violators would reach parties outside the intended penumbra of the rule.¹²⁰

The *Tambone* majority held that the SEC’s interpretation of Rule 10b-5(b) was contrary to *Central Bank*.¹²¹ Although the majority acknowledged that *Central Bank* did not address the definition of “make” in Rule 10b-5, the majority viewed *Central Bank* as relevant. The majority’s concern was that the SEC’s interpretation would obscure the Supreme Court’s distinction between primary and secondary liability.¹²² Noting that “courts must be vigilant to ensure that secondary violations are not shoehorned into the category reserved for primary violations,” the majority held that the SEC’s proposed interpretation would impermissibly extend primary liability of Rule 10b-5(b).¹²³ Quoting the United States Court of Appeals for the Second Circuit, the majority concluded that “[i]f *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable [as a primary violator] under section 10(b). Anything short of such conduct is merely aiding and

116. *Id.* at 168.

117. 17 C.F.R. § 240.10b-5 (2010) (citing *Cent. Bank*, 511 U.S. at 164).

118. *Cent. Bank*, 511 U.S. at 164.

119. *Id.* at 176 (noting that “federal courts have not relied on the ‘directly or indirectly’ language when imposing aiding and abetting liability under § 10(b) . . .”).

120. *See id.* (stating that “[w]hen Congress wished to provide a remedy to those who neither purchase nor sell securities, it had little trouble in doing so expressly.” (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 734 (1975))).

121. *Tambone*, 597 F.3d at 445–46 (Lipez, J., dissenting) (noting that the Commission’s interpretation would be “in tension with Supreme Court precedent” and that “[a]llowing the SEC to blur the line between primary and secondary violations in this manner would be unfaithful to the taxonomy of *Central Bank*.”).

122. *Id.* at 446 (“The SEC’s position poses a threat to the integrity of [the primary and secondary] dichotomy.”).

123. *See id.* (stating that “[r]eading ‘make’ to include the use of a false statement by one other than the maker would extend primary liability beyond the scope of conduct prohibited by the text of Rule 10b-5(b).” (citing *Cent. Bank*, 511 U.S. at 188)).

abetting.”¹²⁴

The dissent found the majority’s reliance on *Central Bank* misplaced. Before tackling the substance of the argument, the dissent noted that *Central Bank*’s holding was concerned with a suit brought by a private plaintiff, not the SEC.¹²⁵ The majority’s decision, therefore, ignored the fact that the core issue of the *Tambone* case involves the SEC’s authority to bring claims.¹²⁶ *Central Bank* settles the question of whether a private party can bring a Rule 10b-5(b) claim against aiders and abettors.¹²⁷ *Central Bank* does not, however, settle the question of whether the SEC can bring a Rule 10b-5(b) claim against them.

Further, by exaggerating the holding of *Central Bank*, the dissent charged the majority with artificially extending the case’s reach.¹²⁸ The *Central Bank* decision only addressed the question of whether Rule 10b extends to those secondary actors that aid and abet a primary violation.¹²⁹ The issue in front of the *Tambone* court, however, did not involve aiding and abetting. Rather, the issue was whether Tambone and Hussey were primary violators of Rule 10b-5(b).¹³⁰ Thus, the primary/secondary dichotomy established in *Central Bank* is not threatened by the SEC’s proposed interpretation of Rule 10b-5(b), and the basis of the majority’s holding is questionable.¹³¹

124. *Id.* at 447 (quoting *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997)).

125. *Id.* at 445.

126. *Id.* (“Although the [Central Bank] Court focused on the text of the provisions, it also emphasized the element of reliance (which was not satisfied in that case), as well as a set of policy considerations that arise exclusively in the context of private securities litigation.” (citing *Cent. Bank*, 511 U.S. at 173–78, 180, 188–89)).

127. *Id.* (“Indeed, the Court has consistently distinguished between the broad contours of the SEC’s ‘express statutory authority to enforce [Rule 10b-5],’ and the ‘narrow dimensions of the implied right of action.’” (quoting *Merrill Lynch, Pierce, Fenner & Smith v. Dabit*, 547 U.S. 71, 79–81 (2006); *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 167 (2008))); *see also* *SEC v. Zandford*, 535 U.S. 813, 819 (2002) (stating that “[t]o effectuate its remedial purposes, the [Securities Exchange] Act should be construed flexibly, not technically and restrictively.”).

128. *Tambone*, 597 F.3d at 454 (Lipez, J., dissenting) (pointing out that the majority’s argument “overstates the substance” of *Cent. Bank*).

129. *Id.* (citing *Cent. Bank*, 511 U.S. at 167).

130. *Id.* at 455 (Lipez, J., dissenting). The dissent noted that the issue is not secondary liability, but rather “whether the defendants’ acts are ‘sufficient to show that they made the [alleged] material misstatements and omissions . . . such that they can be held primarily liable.’” *Id.* (internal quotations omitted) (quoting *SEC v. Wolfson*, 539 F.3d 1249, 1258 (10th Cir. 2008)). The dissent specifically framed the issue as “whether the defendants *themselves* ‘engage[d] in the manipulative or deceptive practice.’” *Id.* (emphasis in original) (quoting *Wolfson*, 539 F.3d at 1258).

131. *See id.* at 456 (Lipez, J., dissenting) (noting that the issue before the court is not the primary/secondary dichotomy, but rather “whether the defendants have ‘made’ a statement, which unquestionably would subject

B. The Implied Statement Theory

As noted above, the SEC did not assert that the defendants drafted the misrepresentations in the prospectus. Rather, the SEC alleged that Tambone and Hussey, by delivering the prospectus to investors, implied that the statements in the prospectus were true and complete.¹³² This implied statement theory is based on an underwriter's duty to investigate the nature and circumstances of an offering.¹³³ The *Tambone* majority dismissed the possibility of any implied statements by the defendants, noting that the SEC's interpretation would create "mischief" by creating a burdensome duty for underwriters.¹³⁴ However, as argued by the dissent, this duty is not unprecedented and deserves proper deference.¹³⁵

1. The Breach of the Implied Duty of Underwriters

The SEC asserted that Tambone and Hussey should be held primarily liable for their "implied, but false, representations to investors as to the accuracy of the disclosures made in the prospectuses."¹³⁶ To back up this claim, the Commission cited the duty of underwriters to conduct a reasonable investigation¹³⁷ and argued that an underwriter's recommendation of a security implies that the underwriter has a reasonable basis for belief in the accuracy of the material representations in a prospectus.¹³⁸ To bolster this argument, the SEC cited Seventh Circuit,¹³⁹ Eighth Circuit,¹⁴⁰ and Ninth Circuit¹⁴¹ decisions.¹⁴² The SEC argued that

them to primary liability.").

132. See Brief for SEC, *supra* note 30, at 26 (stating that "as securities professionals directing the offer and sale of shares on behalf of the underwriter; Tambone and Hussey made their own implied (but false) representation to investors that they had a reasonable basis for a belief that the key representations in the prospectuses were truthful and complete.").

133. See *Dain Rauscher, Inc.*, 254 F.3d at 857 (citing *Hanly*, 415 F.2d at 595-96) (stating that "[a] securities professional has an obligation to investigate the securities he or she offers to customers.").

134. *Tambone*, 597 F.3d at 447.

135. *Id.* at 455 (Lipez, J., dissenting).

136. Brief for SEC, *supra* note 30, at 37.

137. See *id.* (stating that "[a]n underwriter by participating in an offering constructively represents that statements made in the registration materials are complete and accurate. The investing public properly relies upon the underwriter to check the accuracy of the statements and the soundness of the offer; when the underwriter does not speak out, the investor reasonably assumes that there are no disclosed material deficiencies." (quoting *Chris-Craft*, 480 F.2d at 370)).

138. Municipal Securities Disclosure, 53 Fed. Reg. 37778-01 (Sept. 22, 1988).

139. See *Sanders*, 524 F.2d at 1070 (stating that "[t]he relationship between the underwriter and its customers implicitly involves a favorable recommendation of the issued security.").

140. *Alton Box Board Co. v. Goldman Sachs & Co.*, 560 F.2d 916, 922 (8th Cir. 1977) ("[B]y holding the notes out as being creditworthy, Goldman Sachs represented that it had made a thorough investigation on which it based its

this implied duty prevents an underwriter from both “deliberately ignor[ing]” facts that he has a duty to know and “recklessly stat[ing] facts about matters of which he is ignorant.”¹⁴³ An underwriter, according to the SEC, must “analyze sales literature and must not blindly accept recommendations made therein.”¹⁴⁴

2. Chiarella v. United States

Although recognizing an underwriter’s duty to investigate the nature and circumstances of an offering, the First Circuit majority held that this implied duty does not necessarily lead to the conclusion that an underwriter “makes” a representation to investors that all the statements in the prospectus are true and complete.¹⁴⁵ Such an interpretation, according to the majority, “would be tantamount to imposing a free-standing and unconditional duty to disclose” and would be contrary to Supreme Court precedent.¹⁴⁶ To support this claim, the majority cited the Supreme Court’s holding in *Chiarella v. United States*.¹⁴⁷

In *Chiarella*, an employee of a financial printer, privy to corporate takeover bids printed by his employer, used this knowledge to purchase stock of potential targets.¹⁴⁸ The employee sold the stock for a profit once the takeover attempts were made public.¹⁴⁹ The employee was indicted, in part, for violation of Rule 10b-5.¹⁵⁰ The Supreme Court held that the employee was not liable under the rule, noting that “one who fails to disclose material information prior to the consummation of a transaction

recommendation.”)

141. See *Dain Rauscher, Inc.*, 254 F.3d at 857–58 (noting that underwriters have “a duty to make an investigation that would provide [the underwriter] with a reasonable basis for a belief that the key representations in the statements provided to the investors were truthful and complete.”).

142. Brief for SEC, *supra* note 30, at 37–40.

143. *Id.* at 39.

144. See *id.* at 39, n.18 (stating that an underwriter “cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation, he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation.” (quoting *Harity v. S.E.C.*, 415 F.2d 589, 597 (2d Cir. 1969))).

145. *Tambone*, 597 F.3d at 442 (citing *Dain Rauscher, Inc.*, 254 F.3d at 857).

146. *Id.*

147. See *id.* at 448 (stating that Supreme Court precedent “instructs that a party’s nondisclosure of information to another is 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.” (emphasis in original) (quoting *Chiarella v. United States*, 445 U.S. 222, 228 (1980))).

148. *Chiarella*, 445 U.S. at 224.

149. *Id.*

150. *Id.*

commits fraud *only when he is under a duty to do so*. And the duty to disclose arises when one party has information ‘that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.’¹⁵¹ Thus, *Chiarella* stands for the proposition that one must disclose material information only in the face of a pre-existing duty. If the nondisclosing party has no duty, the party cannot be held liable under Rule 10b-5.

3. *The Majority’s Reliance on Chiarella, and the Dissent’s Rebuttal*

The *Tambone* majority, citing *Chiarella*, averred that a duty to disclose can only be imposed when there is a fiduciary or similar relationship between the parties.¹⁵² Noting that the SEC’s theory requires disclosure of information without “the required showing of a fiduciary relationship,” the majority implied that underwriters have no such relationship with investors.¹⁵³ After dismissing the SEC’s arguments and precedents as a “cobbled together . . . bricolage of agency decisions and statements” in large part because they predate *Central Bank*, the majority upheld the dismissal of the SEC’s claims.¹⁵⁴

To rebut the majority’s cursory dismissal of the implied duty theory, the dissent cited a litany of decisions where underwriters have been held subject to Rule 10(b).¹⁵⁵ The United States Court of Appeals for the Ninth Circuit’s decision in *Securities and Exchange Commission v. Dain Rauscher, Inc.*, for example, held that an underwriter’s failure to make a sufficient investigation of the truth and accuracy of a disclosure document was a genuine issue of fact.¹⁵⁶ The dissent also cited decisions: (i) holding that an underwriter’s delivery of a prospectus was enough to state a claim under Rule 10b-5;¹⁵⁷ (ii) permitting private allegations of Rule 10b-5 violations against underwriters;¹⁵⁸ and (iii) finding underwriter

151. *Chiarella*, 445 U.S. at 228 (emphasis added) (quoting Restatement (Second) of Torts § 551(2)(a) (1976)).

152. *Tambone*, 597 F.3d at 442.

153. *See id.* at 448 (noting that “a party’s nondisclosure of information to another is 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 or confidence.’” (quoting *Chiarella*, 445 U.S. at 222)).

154. *Id.* at 449–50.

155. *Id.* at 460–61.

156. *See Dain Rauscher, Inc.*, 254 F.3d at 858 (noting that an underwriter “has an obligation to investigate the securities he or she offers to customers.”).

157. *See In re U.S.A. Classic Sec. Litig.*, No 93 Civ. 6667 (JSM), 1995 WL 363841, at *5 (S.D.N.Y. June 19, 1995) (upholding a complaint that alleged that underwriters “individually and in concert, directly and indirectly . . . engaged and participated in a course of conduct and conspiracy to conceal adverse material information.”).

158. *See generally In re MTC Elec. Techs. S’holder Litig.*, 993 F. Supp. 160,

liability for intentional material misstatements in a prospectus.¹⁵⁹

The dissent's numerous citations along with those cited by the SEC together cast doubt on the majority's dismissive treatment of the underwriter's duty to investors. Noting that underwriters play a unique role in the issuance of securities, the dissent highlighted a history of judicial recognition of their duty.¹⁶⁰ Citing the D.C. Circuit, the dissent noted that underwriters have a "heightened obligation" to ensure proper disclosure.¹⁶¹ Underwriters, privy to information largely withheld from investors, have a "concomitant duty to investigate and confirm the accuracy" of the representations in the sales materials they distribute.¹⁶² Through delivery of sales material to an investor, an underwriter represents that he has reviewed the sales material, and that he has a reasonable basis to believe that the representations contained therein are true and correct.¹⁶³

Thus, relying on the cited precedent, the dissent stated that "the knowing or reckless use of a prospectus containing false statements involves the underwriter's own implied statement falsely affirming the accuracy of the prospectus content."¹⁶⁴ The majority justified its dismissal of this precedent because it pre-dates the *Central Bank* decision.¹⁶⁵ But, as noted by the dissent, *Central Bank's* holding has little to do with underwriter duties¹⁶⁶ and, therefore, does not conflict with the SEC's theory of liability.

C. A Summary of the Majority's Substantive Arguments

Thus, the majority's substantive arguments are, at best, open

162 (E.D.N.Y. 1997); *Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. 303, 315-16 (S.D.N.Y. 1996).

159. See generally *In re Enron Corp. Sec. Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 612 (S.D. Tex. 2002).

160. *Tambone*, 597 F.3d at 461 (stating that "[t]hese precedents reflect the unique position of underwriters as securities insiders whose role is 'that of a trail guide—not a mere hiking companion,' and who are relied upon by investors for their 'reputation, integrity, independence, and expertise.'" (quoting *Dolphin and Bradbury, Inc. v. S.E.C.*, 512 F.3d 634, 640-41 (D.C. Cir. 2008))).

161. *Dolphin and Bradbury, Inc.*, 512 F.3d at 640-41.

162. *Tambone*, 597 F.3d at 461 (citing *Chris-Craft*, 480 F.2d at 370; *Sanders*, 524 F.2d at 1073).

163. See *Tambone*, 597 F.3d at 461-62 (noting that "the relationship between the underwriter and its customers implicitly involves a favorable recommendation of the issued security . . . [A]s an underwriter selling the [security, the underwriter] made an implied representation that it had reasonable grounds for belief that the [securities] would be paid at maturity." (quoting *Sanders*, 524 F.2d at 1073)).

164. *Id.*

165. See *id.* (noting that "[t]he majority attempts to discredit some of this inconvenient precedent because it pre-dates *Central Bank*.").

166. *Tambone*, 597 F.3d at 461-62.

to question. To hold that the defendants' actions did not fall within the ordinary meaning of the rule, the majority settled upon an unduly narrow definition of "make"¹⁶⁷ and relied upon a structural analysis of the rule that utterly ignored the drafter's intent.¹⁶⁸ The Supreme Court precedent cited by the majority was irrelevant,¹⁶⁹ and the majority's dismissal of the SEC's implied statement theory failed to properly appreciate the well-established duty of underwriters to investigate an offering. Thus, given the relatively weak substantive arguments for the holding, it is not surprising that the majority provided a policy-based rationale near the close of its opinion to explain its decision.

IV. POLICY REASONS UNDERLYING THE MAJORITY'S DECISION

Despite declaring that the analysis of case law provided a "well-lit decisional path,"¹⁷⁰ the majority provided a policy-based argument, hinting that the decision was not quite so clear-cut. In holding the SEC's argument untenable, the majority stated that "[a]dopting the SEC's implied statement theory would pave the way for suits against securities professionals for nondisclosure of material information without the required showing of a fiduciary relationship."¹⁷¹ Although ostensibly an argument against eschewing an element of a violation (for example, the existence of a fiduciary duty), this statement smacks of a fear of frivolous lawsuits.¹⁷²

Although prevention of frivolous lawsuits is an admirable goal, the First Circuit majority gives this concern too much deference. It is true that frivolous lawsuits create an undue burden on the judicial system, but the majority eases this burden to the detriment of the SEC's enforcement powers. As Supreme Court precedent dictates, the concern of frivolous lawsuits should not trump the judiciary's primary responsibility to provide a forum

167. See *supra* Part III.A.1 (analyzing the various definitions the court came up with for the word "make").

168. See *supra* Part III.A.2 (applying context of Rule 10b-5 to the meaning of the word "make").

169. See *supra* Part III.A.3 (analyzing Supreme Court cases holding that the SEC's interpretation of the word "make" was overbroad).

170. *Tambone*, 587 F.3d at 450.

171. *Id.* at 448.

172. The concurrence latches onto this fear, characterizing the SEC's interpretation of Rule 10b-5 as "alarmingly ambitious" and expressing concern that it would expose "virtually anyone involved in the underwriting process" to liability. *Id.* at 450, 452 (Boudin, J., concurring). Asserting that "[n]o one sophisticated about markets believes that multiplying liability is free of cost," the concurrence supported the majority's decision to limit the SEC's enforcement capabilities in order to minimize these costs. *Id.* at 452 (Boudin, J., concurring).

for aggrieved parties.¹⁷³

A. *The Problem of Frivolous Lawsuits*

The threat of frivolous lawsuits, long a justification for judicial action, has been widely reflected in the legislative history of a number of statutes. For example, the legislative history of the Prison Litigation Reform Act of 1995¹⁷⁴ illustrates that the core purpose of the statute was to curb frivolous litigation by prison inmates,¹⁷⁵ and the Class Action Fairness Act of 2006 “was generally seen as a response to frivolous class actions.”¹⁷⁶ Further, the legislative history of Title VII indicates that punitive damages under the act were limited to egregious circumstances¹⁷⁷ due to a congressional desire to “prevent excessive litigation costs,”¹⁷⁸ and the Portal-to-Portal Act of 1947¹⁷⁹ was amended with an intent to “lessen the number of frivolous lawsuits.”¹⁸⁰

Beyond statutes, courts have been known to cite the threat of frivolous lawsuits as a justification for certain decisions. A district court in the Southern District of New York stated that courts have a “constitutional duty to enjoin the filing of frivolous lawsuits in order to preserve judicial resources.”¹⁸¹ A court in the Southern District of Texas expressed this sentiment more forcefully (or

173. See *infra* Part VI (asserting policy rationale behind the SEC’s interpretation of liability for underwriters).

174. 11 U.S.C. § 523 (2010).

175. See Jessica Feerman, *Symposium, Pro Se Litigation Ten Years After AEDPA, “The Power of the Pen”: Jailhouse Lawyers, Literacy, and Civic Engagement*, 41 HARV. C.R.-C.L. L. REV. 369, 381 (2006) (stating that “[a]ccording to advocates of the [PLRA], prisoners had ‘tied up the courts with their jailhouse lawyer antics for too long[,] . . . making a mockery of our criminal justice system,’ and a reform bill would ‘help put an end to the inmate litigation fun-and-games.’”) (citations omitted).

176. Michael A. Satz, *Mandatory Binding Arbitration: Our Legal History Demands Balanced Reform*, 44 IDAHO L. REV. 19, 62 (2007) (citing Anna Andreeva, *Class Action Fairness Act of 2005: The Eight Year Saga is Finally Over*, 59 U. MIAMI L. REV. 385, 398–99, 404–05 (2005)).

177. 42 U.S.C. § 1981a(b)(3) (2010).

178. See generally Jason P. Pogorelec, *Under What Circumstances Did Congress Intend to Award Punitive Damages for Victims of Unlawful Intentional Discrimination Under Title VII?*, 40 B.C. L. REV. 1269, 1304-1305 (1999).

179. 29 U.S.C. § 216(b) (2010).

180. Louise Sadowsky Brock, *Overcoming Collective Action Problems: Enforcement of Worker Rights*, 30 U. MICH. J.L. REFORM 781, 798 (1997).

181. *Lacy v. Principi*, 317 F. Supp. 2d 444, 449 (S.D.N.Y. 2004) (citing *In re Martin-Trigona*, 737 F.2d 1254, 1261 (2d Cir. 1984)); see also *Gelabert v. Lynaugh*, 894 F.2d 746, 748 (5th Cir. 1990) (stating that “[l]ike every other pastime, recreational litigation has its price; . . . sanctions . . . are imposed for the very purpose of causing the would-be pro se prisoner litigant, with time on his hands and a disposition to retaliate against the system, to think twice before cluttering our dockets with frivolous or philosophical litigation.”).

suffered from a faulty caps-lock key) by stating that it

makes every reasonable effort to provide a forum for those truly aggrieved. However, the case at bar is pure frivolity and a manifest abuse of judicial process. Such frivolity wastes judicial resources, prevents utilization of the Court by those who truly need judicial action, and also feeds the public's apprehensions regarding abusive and frivolous lawsuits. Plaintiff's counsel is more than welcome to bring cases of merit in this Court; HOWEVER, FUTURE CASES LIKE THIS WILL RESULT IN HARSH SANCTIONS.¹⁸²

The obvious victim of frivolous lawsuits is the defendant forced to defend meritless claims, but, however melodramatic, the United States Court of Appeals for the Eighth Circuit expressed a concern for the health of the entire judicial process by stating that the "public inevitably suffers when a vindictive plaintiff squanders limited judicial resources by prosecuting frivolous lawsuits."¹⁸³

B. The Threat of Frivolous Lawsuits Does Not Justify Limiting SEC Enforcement Power

Although judicial decisions have often barred plaintiff recovery to avoid a potential onslaught of frivolous lawsuits,¹⁸⁴ it is important to weigh the threat of frivolous claims against the much greater evil of denying a forum for claims with merit. The Supreme Court has solved this balancing act with the admonition that the threat of frivolous claims should not influence a judicial decision.¹⁸⁵ As eloquently stated by Justice Souter, "[t]o the degree . . . claims are meritorious, fear that there will be many of them does not provide a compelling reason . . . to keep them from being heard."¹⁸⁶ In the Supreme Court's decision in *Tower v. Glover*, the court noted that it would be inappropriate to rule simply "in order to prevent inundation of the federal courts with frivolous lawsuits," and held that "[i]t is for Congress to determine whether [particular] litigation has become too burdensome to state or

182. *Uherek v. Houston Light and Power Co.*, 997 F. Supp. 789, 795 (S.D. Tex. 1998) (emphasis in the original).

183. *Am. Family Life Ass. Co. of Columbus v. Teasdale*, 733 F.2d 559, 570 (8th Cir. 1984).

184. *See, e.g.*, *Amato v. Bernard*, 618 F.2d 559, 566–68 (9th Cir. 1980) (requiring exhaustion of remedies under the Employee Retirement Income Security Act); *see also Higginbottom v. Carter*, 223 F.3d 1259, 1260–61 (11th Cir. 2000) (stating that "Congress passed the [Prison Litigation Reform Act] to reduce frivolous prisoner lawsuits.").

185. *See Bivens v. Six Unknown Named Agents of Federal Bureau of Narcotics*, 403 U.S. 388, 410 (Harlan, J., concurring) (stating "I simply cannot agree . . . that the possibility of 'frivolous' claims . . . warrants closing the courthouse doors There are other ways, short of that, of coping with frivolous lawsuits.").

186. *Hein v. Freedom From Religion Found., Inc.*, 551 U.S. 587, 640, n.1 (2007).

federal institutions and, if so, what remedial action is appropriate."¹⁸⁷ As noted by the *Tower* court, the judiciary does not have the authority to make decisions based upon what a court would "judge to be sound public policy."¹⁸⁸

This sentiment is echoed by the dissent. Although plaintiffs may try to stretch the SEC's interpretation of Rule 10b-5, the dissent stressed that this "predictable and familiar phenomenon" should not convince courts to limit the enforcement powers of the SEC.¹⁸⁹ Further, the SEC's interpretation does not give litigious plaintiffs free-rein to wreak havoc on the judicial system, as a plaintiff would still be required to meet the stringent requirements of pleading a securities claim, which requires pleading the allegation of fraud with particularity, and ultimately proving reliance, causation, and monetary damages.¹⁹⁰

Given the procedural bars in place to frustrate meritless claims, the dissent dismissed the majority's policy concern.¹⁹¹ Noting that there are "significant barriers" designed to address the majority's concern, "the way to protect against overreaching by private plaintiffs is to strictly enforce those requirements—not to deny the SEC the full scope of its enforcement duty."¹⁹²

V. POLICY REASONS FAVORING THE SEC'S INTERPRETATION

Given the dissent's well-reasoned arguments, policy considerations were the probable tipping factor for the majority's decision.¹⁹³ For example, it is not unlikely that the majority might have reached for the Random House Dictionary over Webster's International if it felt that the policy so dictated. However, the only stated policy reason for the majority's decision was to avoid frivolous lawsuits. This consideration, laudable as it might be,

187. *Tower v. Glover*, 467 U.S. 914, 916, 923 (1984).

188. *Id.* The court went on to state, "We do not have a license to establish immunities from § 1983 actions in the interests of what we judge to be sound public policy." *Id.* at 922-23.

189. *Tambone*, 597 F.3d at 456 (Lipez, J., dissenting).

190. *Id.* at 463 (Lipez, J., dissenting).

191. *See id.* (Lipez, J., dissenting) (noting that "unlike the SEC," a private plaintiff must "meet the standard requirement that allegations of fraud be pleaded with particularity [and] also must prove reliance on the alleged misrepresentation, economic loss, and loss causation."). The dissent suggests that "[t]he reliance requirement, in particular, weakens [the majority's] concern that private litigants will be able to bring impermissible aiding and abetting claims in the guise of primary claims." *Id.* at 463-64 (Lipez, J., dissenting).

192. *See id.* at 456 (Lipez, J., dissenting) (quoting the SEC's brief and noting that "[p]olicy considerations concerning private litigation can have no relevance in defining the scope of primary liability under Section 10(b) in a Commission enforcement action.").

193. *See supra* Part III.C (reiterating how the *Tambone* majority provided a policy-based rationale for its decision).

comes at the expense of narrowing the SEC's enforcement power. Constricting that power not only conflicts with the intent of Rule 10b-5(b), but also runs contrary to the current desire of the executive and the American public to increase government regulation of markets. Further, and perhaps most unfortunately, the majority provided a blueprint for underwriters and prospectus drafters to avoid SEC enforcement of Rule 10b-5.

A. "Well, we are against fraud, aren't we?"

To argue that policy considerations weigh in favor of the SEC's interpretation of Rule 10b-5, it is illuminating to recall Mr. Pike's statement that suggested that the SEC, in the very least, should have the authority to prevent fraud.¹⁹⁴ While it is absurd to suggest that the majority is not "against fraud," the decision strips the SEC of the tools necessary to prevent and investigate it.

As noted by Judge Lipez in his dissent, the majority's myopic method of interpreting Rule 10b-5(b) ignores the intent of the rule's drafters.¹⁹⁵ Following the majority's holding, the dissent hypothesized that

[a]n underwriter could well know that the representations in a prospectus are false even when the individual who actually wrote the words were unaware of the inaccuracies. In those circumstances, an underwriter who knowingly gives investors a prospectus containing falsehoods could not be held liable in an SEC enforcement action for aiding and abetting the unwitting drafter, who did not himself commit fraud. If such an underwriter could not be held responsible as a primary offender, the underwriter would . . . be free from liability under Section 10(b) whatsoever.¹⁹⁶

As implied by the dissent's incredulous tone, this absurdity is the result of the majority's holding. The majority's decision leaves the SEC powerless to prosecute the unscrupulous underwriter and an ignorant prospectus drafter under Rule 10b-5(b). This decision is even more disturbing when one considers its potential reach, as it is not limited to underwriters that trade in mutual fund stock. Any underwriter using a prospectus containing a misrepresentation may sell securities free from Rule 10b-5(b) liability as long as the underwriter had no drafting responsibility. In the face of the *Tambone* decision, Mr. Pike's question, once rhetorical, is now colored with a sense of unintended profundity.

194. Freeman, *supra* note 58, at 922.

195. See *Tambone*, 597 F.3d at 459 (Lipez, J., dissenting) (stating that "[a]s the SEC explains in its en banc brief, this understanding of what it means to 'make' a statement is necessary to fulfill the objective of Congress and the Commission to punish 'any untrue statement of a material fact' made with knowledge or reckless disregard for its truth." (quoting Rule 10b-5(b)).

196. *Id.*

B. "We will not go back"

The *Tambone* decision not only flies in the face of Rule 10b-5(b)'s intent, but it is patently contrary to the current desire to achieve investor protection through greater regulatory scrutiny of financial markets. One would be hard-pressed to find anyone willing to state that the U.S. financial markets need less regulation.¹⁹⁷ Even the most ardent supporters of free markets have, albeit reluctantly, admitted that more regulation is necessary.¹⁹⁸ President Barack Obama, both as candidate¹⁹⁹ and President, has stressed the need for more regulation of markets, not less.²⁰⁰ Promising future financial regulatory reform, President Obama warned investment firm executives that "[w]e will not go back to the days of reckless behavior and unchecked excess that was at the heart of this crisis, where too many were motivated

197. See, e.g., *A special report on the world economy: Taming the beast: How far should finance be re-regulated?*, *ECONOMIST*, Oct. 11, 2008, at 66 (noting that "[a] financial system that ends up with the government taking over some of its biggest institutions in serial weekend rescues and which requires the promise of \$700 billion in public money to stave off catastrophe is not an A-grade system. The disappearance of all five big American investment banks—either by bankruptcy or rebirth as commercial banks—is powerful evidence that Wall Street failed 'the test of the marketplace.' Something has gone awry.").

198. See Sewell Chan, *Looking Back, Greenspan Says Wall Street Needs a Tighter Rein*, *N.Y. TIMES*, Mar. 19, 2010, at B1 (noting that Alan Greenspan, "famous for his libertarian leanings and hands-off approach to Wall Street" and "who has long argued that the market is often a more effective regulator than the government, has now adopted a more expansive view of the proper role of the state.").

199. See Christopher Cooper & Kara Scannell, *Campaign '08: Obama to Receive Endorsement of 3 Former SEC Chairmen*, *WALL ST. J.*, May 14, 2008, at A7 (quoting SEC Chairman William Donaldson as saying that then-Senator Obama recognized the "need to take a good hard look at how things are organized [and] just exactly what went wrong in terms of the regulatory oversight that we have.").

200. See David Leonhardt, *A Free-Market-Loving, Big-Spending, Fiscally Conservative Wealth Redistributionist*, *N.Y. TIMES*, Aug. 24, 2008, at MM30 (noting that "in Obama's view, the risks to market-based capitalism now have more to do with too little regulation than too much."). See also Michael H. Ginsberg, *The "Great Recession" and New Challenges in Product Liability and Environmental Coverage Cases*, 2010 WL 561454, at *6 (2010) (noting that "[w]e have seen that the Obama Administration is pro-federal regulation in many ways; therefore, I think we will see a push toward regulation of the financial markets once we get past the current health care reform movement"); Raymond H. Brescia, *Trust in the Shadows: Law, Behavior, and Financial Re-Regulation*, 57 *BUFF. L. REV.* 1361, 1418 (2009) (noting that "[t]he Obama Administration has set forth a series of principles that should reform the regulation of credit default swaps and other derivatives, these include the following: the development of standardized and regulated trading platforms; the imposition of capital requirements for issuers of derivatives; the introduction of mechanisms to improve transparency of derivatives; and the identification of clear regulatory authority over the derivatives market.").

only by the appetite for quick kills and bloated bonuses.”²⁰¹ This is not mere political bluster, as the President’s 2011 budget proposal increases spending for financial market regulators by fifty-five percent.²⁰²

Although obscured by our country’s frustratingly partisan political environment, President Obama’s push to regulate markets has been largely endorsed by public opinion.²⁰³ In a 2008 poll, nearly seventy-five percent of Americans believed the financial crisis was caused, in part, by a failure of government oversight of financial markets.²⁰⁴ As the financial crisis has affected international markets as well, governmental regulation of financial markets also has international support.²⁰⁵ Many commentators echo this desire, indicating that the general thrust of public opinion is in favor of greater governmental oversight of financial markets.²⁰⁶

The *Tambone* decision is in direct conflict with this goal. Rather than expanding (or simply maintaining) the SEC’s power to investigate and prosecute fraud, this decision sharply constrains

201. Andrew Ross Sorkin, *A Tough Crowd on Wall Street*, N.Y. TIMES, Sept. 15, 2009, at B1.

202. Elizabeth Williamson & Kara Scannell, *Obama’s Budget Proposal: Market Regulators Set to Get Boost*, WALL ST. J., Feb. 2, 2010, at A6.

203. See *Voters Champion Free Market But Want More Regulation*, RasmussenReports.com, Dec. 29, 2008, http://www.rasmussenreports.com/public_content/business/general_business/december_2008/voters_chamption_free_market_but_want_more_regulation (noting that a “majority of voters (52%) . . . believe there is a need for more government regulation of big business.”) (last visited Nov. 19, 2010).

204. See David Pierson, *Stricter business controls sought*, L.A. TIMES, Oct. 15, 2008, available at <http://articles.latimes.com/2008/oct/15/business/finance-poll15> (citing a Los Angeles Times/Bloomberg poll finding that “nearly three-quarters of respondents thought the lack of regulation was partly responsible for the current financial and housing crises” and that “stronger regulation of financial markets was . . . the top issue for the presidential candidates to address in the remaining weeks of the campaign.”).

205. See Press Release, GlobeScan & Program of International Policy Attitudes, *Erosion of Support for Free Market System: Global Poll* (Apr. 15, 2008), available at http://www.worldpublicopinion.org/pipa/pdf/apr08/Free_Markets_April08_pr.pdf (citing a GlobeScan poll of 9,357 respondents in eighteen countries that found that in “17 of the 18 countries a majority (15 countries) or a plurality (two countries) agreed that ‘the free enterprise system and the free market system work best in society’s interest when accompanied by strong government regulation.’”).

206. David Kusnet, *Renewed Deal*, N.Y. TIMES, Jan. 16, 2009 (citing economist Jeff Madrick’s argument that America “faces social and economic challenges requiring higher taxes, increased public investment and more rigorous regulation of corporate conduct.”). See also Floyd Norris, *A Retreat From Global Banking*, N.Y. TIMES, July 24, 2009, at B1 (stressing “the need to get the financial system working again, without public guarantees for everything in sight and with enough safeguards and regulation to avoid a new crisis.”).

the scope of Rule 10b-5(b). In taking policy considerations into account, the majority should have held that the need for more regulation of financial markets trumped the fear of frivolous claims.

VI. CONCLUSION: A GUIDE TO AVOID RULE 10B-5(B)

Although *Tambone* involved a “tangled web of interlocking entities,”²⁰⁷ only two entities are necessary to frustrate the intent of Rule 10b-5(b) and stymie an SEC enforcement action: a parent and a subsidiary. The parent would hire the prospectus drafters and the subsidiary would hire the underwriters. The drafters would be free to make any representation necessary to project a solid investment, so long as the drafters have no actual knowledge of any misstatement in these representations.

If, for example, the drafters know that investors are generally wary of litigation, they need only state that there is no such litigation pending against the parent and believe the veracity of this representation. The underwriters will be able to use this representation to sell the shares. The actual truth of the representation is, under the *Tambone* decision, of no consequence. Even if the underwriters know that the parent has a potentially devastating lawsuit on the horizon, they need not fear liability under Rule 10b-5(b). By simply *delivering* the prospectus, the underwriters are not *making* the representation. The *Tambone* decision provides a guide for avoiding what has been one the SEC’s most useful tools in enforcing securities laws and dissuading unscrupulous practices.

Regardless of the outcome, Supreme Court review of this decision is crucial. A reversal of the decision would represent a victory for investors and a blow to dishonest securities sales techniques. An affirmation of the decision would also be welcome, as it would hopefully spur Congress to amend the language of the statute to restore the Commission with the enforcement powers necessary to protect investors.

207. *Tambone*, 597 F.3d at 438.