No. 07–1384

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff–Appellant,

v.

JAMES TAMBONE; ROBERT HUSSEY,

Defendants–Appellees.

On Appeal from the United States District Court
for the District of Massachusetts

BRIEF FOR SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AS AMICUS CURIAE SUPPORTING APPELLEES AND SUPPORTING REHEARING *EN BANC*

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The Securities Industry and Financial Markets Association (SIFMA) is a trade association that brings together the shared interests of more than 600 securities firms, banks, and asset managers. SIFMA has no parent corporation, and no publicly held corporation holds 10% or more of its stock.

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INTEREST OF *AMICUS CURIAE*

The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of more than 600 securities firms, banks and asset managers locally and globally through offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. More information about SIFMA is available at http://www.sifma.org. SIFMA submits this brief in response to the Court's February 23, 2009 order inviting amici, specifically including SIFMA, to address the panel majority's implied-statement theory as a basis for primary liability under Rule 10b–5(b). All parties have consented to the filing of this brief.

SUMMARY OF ARGUMENT

Without support from statute or case law, the panel majority held that a mutual-fund underwriter "impliedly makes a statement" to potential investors that it has a reasonable basis to believe that the information contained in a prospectus is truthful and complete. 550 F.3d 106, 132, 135. The panel majority further held that employees of the underwriter also make this implied statement irrespective of what they actually say. *Id.* Thus, under the panel majority's unprecedented opinion, underwriters and their employees can be liable under § 10(b) of the Securities Exchange Act of 1934 and Rule 10b–5 for false statements in the mutual-fund prospectuses regardless of whether they actually *make* statements in the prospectus within the meaning of Rule 10b–5(b).

The Court should grant *en banc* review and reject this novel theory. By imposing liability based on a fictitious "statement" implied from the defendants' *status* as employees of an underwriter rather than on an affirmative misrepresentation, the panel majority disregarded both the plain language of § 10(b) and Rule 10b–5(b) and the Supreme Court's repeated admonition that courts must exercise caution and restraint in interpreting § 10(b). The panel majority's innovative and expansive holding also circumvents the settled rule that nondisclosure does not violate § 10(b) absent a duty to disclose. And it creates substantial uncertainty regarding the duties and liabilities of underwriters, their employees, and others who might be deemed to make implied statements in light of their role in the securities industry—uncertainty that private plaintiffs will no doubt exploit by bringing nuisance suits of the very kind Congress and the Supreme Court have taken pains to eliminate.

Nor is the panel majority's theory necessary to ensure the integrity of mutual-fund prospectuses. As this very case illustrates, the SEC already has the tools it needs. In § 17(a)(2) of the Securities Act of 1933, Congress empowered the SEC to bring enforcement actions against anyone, including an underwriter, who sells securities "by means of" any untrue statement of material fact. And, in § 104 of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Congress gave the SEC authority to pursue underwriters who aid and abet primary violations of § 10(b). Tellingly, the panel majority held that the

SEC has stated a claim against these same defendants under both provisions.

Because Congress has already enacted legislation that provides the SEC with the authority it needs to regulate mutual-fund prospectuses, the practical effect of the panel majority's decision will not be more effective law enforcement, but only an unwarranted judicial expansion of a statute that affords the plaintiffs' bar an implied private right of action. By fashioning a new and ill-defined theory of primary liability, the panel majority promotes the filing of costly strike suits lacking in legal merit but bearing substantial nuisance value. This Court should grant *en banc* review and reject the implied-statement theory.[1]

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[1] This brief addresses only the questions presented in this Court's request for *amicus* briefs. It does not address whether the SEC has pleaded with particularity facts supporting any basis for sustaining its complaint other than the implied-statement theory accepted by the panel majority.

ARGUMENT

I. THE IMPLIED-STATEMENT THEORY IS INCONSISTENT WITH § 10(b) AND RULE 10b–5 AS INTERPRETED BY THE SUPREME COURT.

A. The Supreme Court has repeatedly stressed the importance of judicial restraint in § 10(b) cases.

Two cardinal principals have guided the Supreme Court's interpretation of § 10(b) and Rule 10b–5. *First*, the Court has repeatedly held that in determining "the scope of conduct prohibited by § 10(b), the text of the statute controls." *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994); *see also id.* at 177 ("It is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of the conduct prohibited by the statutory text."); *Stoneridge Invest. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 768 (2008); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200 (1976). This is true whether the suit is brought by the SEC or a private plaintiff. *See Aaron v. SEC*, 446 U.S. 680, 691 (1980); *see also Clark v. Martinez*, 543 U.S. 371, 378 (2005) (holding that the words in a statute must have a single meaning even if applied in different contexts); *Dirks v. SEC*, 463 U.S. 646, 664 n.24 (1983) ("Without legal limitations, market participants are forced to rely on the reasonableness of the SEC's litigation strategy, but that can be hazardous . . . .").

Second, the Court has instructed that Congress, not the courts, must take the lead if § 10(b) is to be extended beyond its present boundaries. *See Stoneridge*, 128 S. Ct. at 773 ("The decision to extend the cause of action is for Congress, not for us."); *Central Bank*, 511 U.S. at 177–78; *see also Correctional Servs. Corp. v. Malesko*, 534 U.S. 61, 67 (2001) (internal quotation marks omitted) (explaining that the Supreme Court has "retreated from [its] previous willingness to imply a cause of action where Congress has not provided one). Specifically, the Supreme Court has warned against judicial expansions of § 10(b) that would "nullify the effectiveness of the carefully drawn procedural restrictions on th[e] express actions" provided by §§ 11 and 12, *Ernst*, 425 U.S. at 210, or create primary liability for conduct that by its nature constitutes mere aiding and abetting, *see Stoneridge*, 128 S. Ct. at 771–72, particularly when Congress has not extended the private right of action beyond primary liability.

The Supreme Court has strictly adhered to these principles for important reasons, not the least of which is that judicial improvisation creates uncertainty in "an area that demands certainty and predictability." *Central Bank*, 511 U.S. at 188 (internal quotation marks omitted); *see also Pinter v. Dahl*, 486 U.S. 622, 652–54 & n. 29 (1988). Moreover, judicial expansion of statues for which there is an implied cause of action, such as § 10(b), upsets the careful balance that the securities laws strike between compensating fraud victims and protecting capital markets from the damaging effects of frivolous litigation. As the Supreme Court has recognized, "litigation under 10b–5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975). When parties' legal obligations are unclear, "plaintiffs with weak claims" can use "extensive discovery and the potential for uncertainty . . . to extort settlements from innocent companies." *Stoneridge*, 128 S. Ct. at 772. "This uncertainty and excessive litigation can have ripple effects," depriving newer and smaller companies of access to capital markets and ultimately injuring "investors, the intended beneficiaries of the statute." *Central Bank*, 511 U.S. at 189.

Congress has not been silent in striking this balance, but has actively and repeatedly legislated in this area. In §§ 11 and 12 of the Securities Act, for example, Congress specifically addressed underwriters' liability for using false or misleading prospectuses. *See* 15 U.S.C. §§ 77k, 77*l*. And in 1995, Congress enacted the PSLRA, Pub. L. No. 104–67, 109 Stat. 737 (1995), in an "effort to deter or at least quickly dispose of those suits whose nuisance value outweighs their merits." *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 82 (2006). In the PSLRA, Congress responded to *Central Bank* by authorizing the SEC to bring enforcement actions against aiders and abettors. 15 U.S.C. § 78t(e). But Congress specifically rejected the SEC Chairman's recommendation to create a private cause of action for aiding and abetting. *See Stoneridge*, 128 S. Ct. at 768–69. Recognizing this balance that Congress has struck, the Supreme Court has chosen not to unsettle it. *See, e.g.*, *id*. at 771–72. This Court should fear to tread where the Supreme Court has refused to go.

B. Following The Supreme Court's Guidance, This Court Should Reject The Panel Majority's Expansive Interpretation Of § 10(b) And Rule 10b–5.

Following the Supreme Court's guidance, this Court should grant *en banc* review and reject the panel majority's implied-statement theory because it (1) conflicts with the text of § 10(b) and Rule 10b–5(b); (2) expands the § 10(b) cause of action beyond its present boundaries by making nondisclosure actionable absent a duty to disclose; and (3) creates uncertainty regarding the duties and liabilities of underwriters and others whose role in the securities industry might potentially be deemed to create implied statements.

1. *The implied-statement theory conflicts with the plain language of § 10(b) and Rule 10b–5(b).*

Because the SEC did not appeal the dismissal of its claims under Rule 10b–5(a) and (c), it must show that the defendants violated Rule 10b–5(b). To be liable under Rule 10b–5(b), a person must either "make a[n] untrue statement of a material fact" or "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." Either way, the defendant must make a statement—one that is either untrue or misleadingly incomplete. *See, e.g., Regents of the Univ. of Cal. v.*

Credit Suisse First Boston (USA), Inc., 482 F.3d 372, 384 n.20 (5th Cir. 2007) ("[T]o allege a cause of action under rule 10b–5(b), a plaintiff still must allege that a defendant said *something*."), *cert denied*, 128 S. Ct. 1120 (2008).[2]

The panel majority's implied-statement theory violates the plain language of Rule 10b–5(b) by imposing liability on defendants who did not *make* a statement in any ordinary sense of the word. The implied-statement theory does not require the defendant to have had any role—public or private—in drafting or endorsing a statement in a prospectus. Indeed, there would be no need to resort to a fictitious statement if the defendants had made an actual one.

The only actual statements at issue were those contained in the prospectuses, and the panel majority understandably did not determine

[2] The panel majority mistakenly asserted that Rule 10b–5(b) is coextensive with § 10(b). 550 F.3d at 132 n.34 ("Rule 10b–5(b) implements with some specificity this broad prohibition of section 10(b). It does not narrow the prohibition."). Even assuming that Rule 10b–5 is coextensive with § 10(b), it does not follow that one subsection of the Rule is coextensive with the entire statute. If that were true, Rule 10b–5(a) and (c) would be superfluous, and they plainly are not: By their terms, Rule 10b–5(a) and (c) reach fraudulent *conduct*, whereas Rule 10b–5(b) reaches only false or misleading *statements*. Insider trading, market manipulation, and omissions that are fraudulent solely by reason of a duty to disclose are all examples of conduct that has traditionally been pursued only under subsections (a) and (c).

that the defendants had made any of those statements, which were made by the issuer. Instead, the panel majority's decision was premised on an implied-in-law representation that supposedly attached to the defendants simply by virtue of their status as employees of the underwriter. But to equate an implied representation with the affirmative making of a statement required by Rule 10b–5(b) is to disregard the language of the Rule, contrary to the Supreme Court's settled methodology.

The implied-statement theory also violates the plain language of § 10(b). Because the scope of Rule 10b–5 "cannot exceed the power granted the Commission by Congress under § 10(b)," *Ernst*, 425 U.S. at 214, the SEC must show that the defendants "use[d] or employ[ed]" a "deceptive device or contrivance" within the meaning of § 10(b)—whichever subsection of the Rule it invokes. Here too, however, the implied-statement theory founders on the text. The verbs "use" and "employ," while broad, are not limitless. As active verbs, both at least require some overt conduct by the defendant. In no ordinary sense of the words do they impose liability for nonfeasance based on a legal fiction. *See e.g.*, *id* at 199 n.20; *Aaron*, 446 U.S. at 695–96.[3]

By creating liability for nonfeasance in the absence of a preexisting duty to disclose, the implied-statement theory threatens to capture conduct that is neither "deceptive" nor a "device or contrivance." In theory, under the panel majority's rule, an underwriter could violate § 10(b) whenever it sells securities knowing that it has not conducted a reasonable investigation into the accuracy and completeness of the prospectus—*even if the prospectus is in fact accurate and complete*. But § 10(b) is a prohibition on fraud, not a code of professional responsibility. *See Chiarella v. United States*, 445 U.S. 222, 234–35 (1980) ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud."). Although an underwriter's failure

[3] Although an implicit representation can be found in affirmative conduct, *see Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588, 596 (2001), such a finding must be based on specific conduct pleaded and proved in a particular case, not on the defendant's mere status as a "securities professional." As this Court has recently observed, to find "a representation implied by conduct," "the link between the conduct and the implication is typically tight," and disregarding this rule "converts [a misrepresentation] cause of action into liability for negligence—without the limitations otherwise applicable to negligence claims." *In re TJX Cos. Retail Security Breach Litig.*, 2009 WL 806891, at *4 (1st Cir. Mar. 30, 2009).

adequately to investigate the accuracy of statements in a prospectus may be a failure to comply with industry and professional standards, it is not a deceptive device or contrivance, and it should not be treated as fraud.

2. *The implied-statement theory expands § 10(b) by making nondisclosure actionable absent a duty to disclose.*

The implied-statement theory is also fatally inconsistent with Supreme Court and Circuit precedents governing § 10(b) claims premised on a failure to disclose material facts. The gravamen of the SEC's complaint is not that the defendants "made" the statements in the prospectus, but that they failed to disclose the existence of the market-timing arrangements, and that their role as underwriters created a duty to disclose that the statements made by others on the subject were inaccurate. The Supreme Court has long held, however, that "[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak." *Chiarella*, 445 U.S. at 235. This rule applies equally whether in a criminal proceeding, as in *Chiarella*, in an SEC administrative proceeding, *Dirks*, 463 U.S. at 657, or in a civil lawsuit. The panel majority's holding eviscerates *Chiarella*'s duty-to-disclose rule.

"The proposition that silence, absent a duty to disclose, cannot be actionably misleading, is a fixture in federal securities law." *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1202 (1st Cir. 1996). "[T]he 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." *Chiarella*, 445 U.S. at 228 (alteration and internal quotation marks omitted); *see also Central Bank*, 511 U.S. at 180 (under *Chiarella*, nondisclosure is "actionable only where duty to disclose arises from specific relationship between two parties"). No such relationship exists—nor does the SEC even attempt to show that one exists—between each individual employee of an underwriting firm and mutual-fund purchasers (let alone the securities markets as a whole).

Nor does an underwriter's supposed duty to *investigate* the accuracy of the prospectus create a duty to disclose under § 10(b). To the extent that a duty to investigate exists at all, it has been implied from the "general antifraud provisions" of the securities laws. *See* Municipal Securities Disclosure, 53 Fed. Reg. 37778, 37787 (proposed

Sept. 28, 1988). And a duty that derives only from the general antifraud provisions of the securities laws does not trigger a duty to disclose under § 10(b). As the Supreme Court explained, "'[b]ecause the disclose-or-refrain duty is extraordinary, it attaches only when a party has legal obligations other than a mere duty to comply with the general antifraud proscriptions in the federal securities laws.'" *Dirks*, 463 U.S. at 657.[4]

[4] *See also SEC v. Cochran*, 214 F.3d 1261, 1264–65 (10th Cir. 2000) (looking to state common law to determine whether an underwriter had a duty to disclose); *Fortson v. Winstead, McGuire, Sechrest & Minick*, 961 F.2d 469, 472 (4th Cir. 1992) ("[T]he duty to disclose material facts arises only where there is some basis outside the securities laws, such as state law, for finding a fiduciary or other confidential relationship."); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 496 (7th Cir. 1986) ("[The duty to disclose] does not come from § 10(b) or Rule 10b–5; if it did the inquiry would be circular. The duty must come from a fiduciary relation outside securities law."). Indeed, it is questionable whether a duty to disclose may arise in the absence of "a fiduciary or quasi-fiduciary confidential relationship." *In re Enron Corp. Secs., Deriv. & ERISA Litig.*, 2009 WL 565512, at *26, 29 (S.D. Tex. Mar. 5, 2009). The court in *Enron* rejected a proposed duty to make disclosures to the entire market based upon the defendants' status as underwriters of one class of a public company's securities. *Id.* at *30. And, as noted, *Chiarella* provides that "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." 445 U.S. at 228 (internal quotation marks and alteration omitted).

Indeed, this case does not present any of the circumstances that this Court has stated may create a duty to disclose: the defendants were not corporate insiders trading on confidential information; they had not made inaccurate, incomplete, or misleading prior disclosures; and no specific statute or regulation required disclosure. *See SEC v. Tambone*, 417 Supp. 2d 127, 134–35 (D. Mass. 2006); *Shaw*, 82 F.3d at 1202 n.3 & 1222 n.37; *see also Cooperman v. Individual Inc.*, 171 F.3d 43, 49–50 (1st Cir. 1999); *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22, 27 (1st Cir. 1987).

Although the SEC points to an underwriter's potential liability under § 11, this Court has previously held that § 11 creates no disclosure duties of its own, but simply creates a private civil remedy for nondisclosure of items required to be disclosed by specific regulatory disclosure requirements. *See Shaw*, 82 F.3d at 1202, 1204–05, 1207, 1209 (looking to specific SEC disclosure rules to support nondisclosure claims under § 11). The only rule cited by the SEC, Rule 15c2–8, requires only that the underwriters *distribute* copies of the prospectus, not make statements passing on or supplementing its contents. *See* 17

C.F.R. § 240.15c2–8.[5] Relying on the § 11 *remedy* to create a *duty* enforceable under § 10(b) would effectively create a hybrid cause of action allowing private plaintiffs and the SEC alike to evade the distinct requirements of each statute.

Accordingly, the defendants did not have a duty to disclose any false statements in the prospectus. Absent any affirmative misrepresentations on their part, that should be the end of the matter.

3. ***The implied-statement theory will unsettle the law and create uncertainty.***

If allowed to stand, the panel majority's novel theory of § 10(b) liability would create precisely the kind of uncertainty that Congress and the Supreme Court have sought to eliminate.

First, in basing the central element of the § 10(b) cause of action—the misrepresentation—on an implied statement, the panel majority left unclear how the other elements will apply under its new theory. In an action under § 10(b), the SEC must show materiality, scienter, fraud in connection with the purchase or sale of securities, and conduct within the statute of limitations and within the territorial jurisdiction of the

[5] The SEC did, however, charge the defendants here with aiding and abetting a violation of § 15(c)(1) by the broker-dealer, a claim that was upheld by the panel majority. *See* 550 F.3d at 147.

United States—all to be pleaded with particularity under Rule 9(b). A private action must additionally show reliance and loss causation, to be pleaded under the standards set out by Congress in the PSLRA.

When affirmative conduct is alleged, the standards for pleading and proof of these other elements are well settled. But when the core conduct is a legal fiction, as it is here, the industry lacks meaningful guidance on what rules will apply. How, for example, is materiality to be determined? Does it turn on the materiality of the misstatements in the prospectus, or on the materiality of the underwriter's implied statement that it had a reasonable basis for believing the prospectus to be accurate and complete? If the latter, is an underwriter's implied statement presumed to be material given investors' purported reliance on underwriters' expertise and access to information? Must a private plaintiff show reliance on the implied statement itself, or is it sufficient to show reliance on the misstatement in the prospectus? Or is reliance presumed under the rule that when the case "involv[es] primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery"?[6] Is scienter presumed from the failure to make the required

[6] *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972).

investigation? The panel suggested that the defendants' "duty to review the accuracy of the prospectus disclosures" permitted the SEC to meet a lower standard for scienter for aiding and abetting. 550 F.3d at 144–45. Are loss causation and inquiry notice determined from the time when the underwriter's lack of diligence is disclosed, or from the disclosure of the facts misstated in the prospectus? The Fourth Circuit, faced with a similar argument, found itself "acutely uncomfortable" with a theory of § 10(b) liability under which "every element of fraud—materiality, reliance, scienter, and proximate cause of damages—is inferred or can be presumed." *Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*, 132 F.3d 1017, 1035 (4th Cir. 1997). Judicial reluctance to grapple with these questions is understandable; they demand difficult policy choices much better suited to decisionmaking by the legislative branch.

Second, the panel majority did not explain why or to what extent the duties of an institutional underwriter devolve upon the underwriter's employees, a subject on which Congress has legislated specifically and recently in the control-person and aiding-and-abetting statutes. The panel majority simply assumed without analysis or citation of authority that the defendants shared in the duties of their employer, Columbia Distributor. But why is that? Does every employee of an underwriting firm have a duty to confirm the accuracy of every prospectus the firm distributes? Does the duty attach to all executives of the firm? To all employees? Does it extend beyond mutual funds to the entire securities market? The panel majority did not say.

Third, the panel majority's decision opens the door for the SEC and private plaintiffs to argue that other market participants should be deemed to have made implied statements in light of their roles in the securities industry. Does a specialist on an exchange's trading floor impliedly represent that he complies with the exchange's rules?[7] Does an outside accountant's duty to review a company's quarterly financial statements create an implied representation that the statements are accurate?[8] The Second Circuit has rejected similar claims, *see*

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[7] *See United States v. Finnerty*, 533 F.3d 143, 149 (2d Cir. 2008) (rejecting government's argument that NYSE specialist's violation of NYSE rules gave rise to § 10(b) liability given investors' "background assumption of compliance with NYSE rules").

[8] *See Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, 154–55 (2d Cir. 2007) ("Public understanding that an accountant is at work behind the scenes does not create an exception to the requirement that an actionable misstatement be made by the accountant. Unless the public's understanding is based on the accountant's articulated statement, the source for that understanding—whether it be a regulation, an

supra nn. 7–8, but the panel majority's novel ruling invites fresh efforts to conjure up new theories of liability.[9]

The SEC offers no answers as to how courts might resolve these questions. Instead, it ignores much of the caselaw in order to pretend that the panel majority broke no new ground. But like the panel majority, the SEC fails to cite *a single case* in which a court has held an underwriter primarily liable under § 10(b) on an implied-statement theory. Most of the cases the SEC cites were decided long before *Central Bank*—indeed, long before *Ernst* and *Chiarella*—and either rested expressly on an aiding-or-abetting theory or failed to distinguish between primary and secondary liability.[10] Others relied on the notion,

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accounting practice, or something else—does not matter.") (citation omitted).

[9] This Court should reject the implied-statement theory regardless of whether it follows the Second Circuit's bright-line "attribution" rule. SIFMA notes, however, that since *Stoneridge*, the Seventh and Ninth Circuits have required affirmative, public communication by the defendant, *see In re Peregrine Sys., Inc. Secs. Litig.*, 2009 WL 186165 (9th Cir. Jan. 23, 2009) (unpub.); *Pugh v. Tribune Co.*, 521 F.3d 686, 696–97 (7th Cir. 2008), and the Second Circuit has extended that requirement to criminal prosecutions in which reliance is not an element. *See Finnerty*, 533 F.3d at 148–51.

[10] *See, e.g., Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 370 (2d Cir. 1973) ("An underwriter is liable under § 14(e) *as an aider and abettor* of the issuer if he was aware of a material falsity in the

repudiated by the Supreme Court in *Ernst*, that an underwriter's negligent investigation was itself sufficient to support § 10(b) liability.[11] All of these cases hearken back to the "heady days" in which courts would create and expand causes of action as a matter of judicial policymaking, an activity that the Supreme Court has long since "abandoned." *Malesko*, 534 U.S. at 75 (Scalia, J., concurring). Indeed, the Supreme Court has decided that this exercise merely causes the judicial head to spin trying to divine rules of law that are better laid down by Congress. *See Alexander v. Sandoval*, 532 U.S. 275, 287 (2001). Finally, neither of the post-*Central Bank* cases the SEC cites held that an underwriter's implied representation qualified as a

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registration statement or was reckless in determining whether material falsity existed.") (emphasis added).

[11] *See Sanders v. John Nuveen & Co.*, 524 F.2d 1064, 1066, 1071 (7th Cir. 1975) (holding that an underwriter "who acted in the mistaken but honest belief" that the issuer's financial statements were accurate was subject to liability under § 10(b) because the underwriter's "investigation . . . was deficient" and "an appropriate investigation would have revealed the fraud"), *vacated and remanded for reconsideration*, 425 U.S. 929 (1976), *and repudiated on remand by* 554 F.2d 790, 793 (7th Cir. 1977); *Hanly v. SEC*, 415 F.2d 589, 596 (2d Cir. 1969) (holding that in an enforcement proceeding under § 10(b) against salesmen who made affirmative recommendations to customers, "proof of specific intent to defraud is irrelevant" because "'the common law standard of deceptive conduct has been modified in the interests of broader protection for the investing public so that negligent insider conduct has become unlawful'").

statement under Rule 10b–5(b) or otherwise triggered primary liability under § 10(b).[12] As a basis for imposing primary liability for an alleged misstatement, the implied-statement theory is original to the panel majority.

4. ***The SEC is not entitled to deference.***

Because § 10(b) and Rule 10b–5 unambiguously preclude liability based on implied representations as opposed to affirmative misrepresentations, the SEC's belated plea for deference fails. But even if the statute or rule were ambiguous, the SEC would not be entitled to deference because it has not adopted the implied-statement theory in a regulation or other formal interpretation governing § 10(b) actions. As a mere litigation position—and one raised for the first time on appeal at that—the SEC's interpretation is entitled to no deference. *See Massachusetts v. FDIC*, 102 F.3d 615, 621 (1st Cir. 1996).

The SEC contends that the Court should defer to Municipal Securities Disclosure, 53 Fed. Reg. 37778 (dealing with municipal-bond

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[12] *See Dolphin & Bradbury, Inc. v. SEC*, 512 F.3d 634, 639 (D.C. Cir. 2008) (noting that the only issue on appeal was whether substantial evidence supported the SEC's finding of scienter); *SEC v. Dain Rauscher, Inc.*, 254 F.3d 852, 854, 857–58 (9th Cir. 2001) (addressing only whether underwriter acted recklessly or negligently).

official statements), and the administrative decisions cited therein. But those decisions—which do not even attempt to parse the language of § 10(b) or Rule 10b–5 and which predate the Supreme Court's decisions in *Central Bank, Ernst*, and *Chiarella*—do not hold that an underwriter's implied representation is a "statement" supporting primary liability under Rule 10b–5(b). All they do is purport to impose an implied duty on underwriters to have a reasonable basis for belief in the accuracy of disclosure documents. To the extent that these decisions purport to impose primary liability under § 10(b) for an underwriter's mere violation of that duty, they conflict with Supreme Court precedent – both *Ernst*'s holding that § 10(b) liability may not be premised upon negligence and *Chiarella*'s holding that nondisclosure does not violate § 10(b) absent a duty to disclose. Accordingly, even if the SEC's prior decisions were worthy of deference, they would lend no support to the SEC's innovative theory in this case.

II. THE PANEL MAJORITY'S HOLDING UNNECESSARILY AND IMPERMISSIBLY EXPANDS THE § 10(b) PRIVATE RIGHT OF ACTION.

A. The SEC has adequate means to reach underwriters who use false or misleading prospectuses.

The implied-statement theory is also unnecessary for the SEC to regulate the kind of conduct alleged in the complaint. As this case shows, the SEC already has ample tools with which to pursue underwriters who use misleading prospectuses to sell securities.

§ 17. For example, the SEC may bring a civil enforcement action against "any person" who violates § 17(a)(2) of the Securities Act. This provision makes it "unlawful for any person in the offer or sale of any securities . . . to obtain money or property by means of" a false or misleading statement of material fact. 15 U.S.C. § 77q(a)(2). The panel has already held that § 17 reaches these defendants' conduct on the theory that they obtained money by means of a false statement, regardless of whether they personally made the false statements. 550 F.3d at 125–29.

Indeed, under the panel majority's own analysis, § 17 is a more useful tool for the SEC to regulate underwriters than is an implied-statement theory under § 10(b). Section 17(a)(2) is satisfied by negligence whereas § 10(b) requires the SEC to prove scienter. *Aaron*, 446 U.S. at 695–96. Moreover, the limitations of § 17 compared to § 10(b)—that it provides no private right of action and reaches only sellers, not purchasers of securities—are of no moment to the SEC's power to pursue underwriters.

Aiding and Abetting. In addition, under § 104 of the PSLRA, the SEC may bring a civil enforcement action against "any person that knowingly provides substantial assistance to another person in violation of" Exchange Act provisions and rules such as § 10(b) and Rule 10b–5, as well as § 15(c) and Rule 15c1–2. 15 U.S.C. § 78t(e). The SEC must show that the drafter of the prospectus committed a primary violation and that the defendant knowingly and substantially assisted the fraud. *See* 550 F.3d at 144. The panel majority found that the SEC sufficiently alleged aiding and abetting here. *Id*. at 144–47. The only modest distinction in available remedies is that the SEC cannot seek an officer/director bar against aiders and abettors. *See* 15 U.S.C. §§ 78u(d)(2) & 78u–3(f).

In short, the panel majority's expansive interpretation of § 10(b) adds little to the SEC's already well-stocked arsenal. In its 27-page brief, the SEC fails to offer any argument that its enforcement efforts would in any way be compromised by rejection of the panel majority's rule. There is thus no need to stretch § 10(b) to ensure the integrity of the underwriting process.

B. The panel majority's holding impermissibly expands the § 10(b) private right of action.

The main practical effect of the panel majority's holding will be to open the floodgates of private litigation. As the SEC acknowledges, "[t]he panel holding would apply to private party suits." Br. 23. The SEC attempts to minimize this expansion of the § 10(b) private right of action by arguing that plaintiffs are unlikely to sue under § 10(b) because they can sue under §§ 11 and 12. But this argument ignores the significant limitations Congress has placed on a private plaintiff's ability to sue under §§ 11 and 12. Because of these limitations, plaintiffs are unlikely to neglect their newfound cause of action under § 10(b).

First, the class of potential plaintiffs under § 10(b) is much larger than under §§ 11 and 12. Section 11 "limit[s] putative plaintiffs to the narrow class of persons consisting of those who purchase securities that are the direct subject of the prospectus and the registration statement."

Krim v. PCOrder.com, Inc., 402 F.3d 489, 495 (5th Cir. 2005) (internal quotation marks omitted). Accordingly, aftermarket purchasers—those who did not purchase in the initial offering—"must demonstrate the ability to 'trace' their shares to the faulty registration." *Id.* at 495–96. Because "it is often impossible to determine whether previously traded shares are old or new," *Barnes v. Osofsky*, 373 F.2d 269, 272 (2d Cir. 1967), the tracing requirement is a significant obstacle for plaintiffs, who bear the burden of proof, in attempting to proceed under § 11 as compared to § 10(b), which covers the entire secondary market.

The class of potential plaintiffs under § 12 is even narrower. Section 12 expressly imposes a privity requirement: The defendant is liable only "to the person purchasing [the] security *from him*." 15 U.S.C. § 77*l*(a) (emphasis added); *see also Pinter*, 486 U.S. at 642 ("[T]he language of § 12(1) contemplates a buyer-seller relationship not unlike traditional contractual privity."). Section 10(b), by contrast, provides a cause of action to anyone who purchases or sells a security in reliance on the misrepresentation, and "privity of dealing or even personal contact between potential defendant and potential plaintiff is the exception and not the rule." *Blue Chip Stamps*, 421 U.S. at 745.

Second, Congress in 2002 added a significantly longer statute of limitations under § 10(b)—without altering the shorter period for claims under §§ 11 and 12. Under §§ 11 and 12, the plaintiff must sue "within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence," subject to an outside limit of three years. 15 U.S.C. § 77m. Under § 10(b), the plaintiff must sue within "2 years after the discovery of the facts constituting the violation," subject to an outside limit of five years. 28 U.S.C. § 1658(b). Plaintiffs thus have a further incentive to prefer § 10(b).

Third, in an action under § 11 or § 12, the court may require the plaintiff to post a bond for costs, including attorneys' fees, and may assess costs at the conclusion of the litigation if the court finds that the suit was without merit. 15 U.S.C. § 77k(e). As the Supreme Court has explained, Congress viewed the provision for attorneys' fees as among "the most important" of the 1934 amendments to the Securities Act, in part because it was designed "to deter actions brought solely for their potential settlement value." *Ernst*, 425 U.S. at 210 n.30 (internal quotation marks omitted). "This deterrent is lacking in the § 10(b) context, in which a district court's power to award attorneys' fees is sharply circumscribed." *Id.*

Given these procedural limitations on the §§ 11 and 12 private causes of action, the SEC's assurance that plaintiffs are unlikely to sue under § 10(b) is cold comfort. Far from showing that the § 10(b) private right of action is superfluous, "[t]hese procedural limitations indicate that the judicially created private damages remedy under § 10(b)—which has no comparable restrictions—cannot be extended" to conduct not covered by the language of § 10(b) and Rule 10b–5. *Id.* at 210 (footnote omitted). "Such extension would allow causes of action covered by §§ 11 [and] 12 . . . to be brought instead under § 10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions." *Id.*

To be sure, there are limits on the § 10(b) private right of action that do not apply in SEC enforcement actions, such as reliance, economic loss, and loss causation, as well as the heightened pleading requirements of the PSLRA. But as noted above, even the application of these requirements will doubtless be tested by the plaintiffs' bar under the panel majority's opinion. Well aware of these very real costs, the Supreme Court has refrained from expanding the scope of § 10(b) and has left it to Congress to balance the competing interests in designing causes of action. With respect, the *en banc* Court should do the same.

CONCLUSION

For these reasons, the Court should grant *en banc* review and reject the panel majority's implied-statement theory.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on this 24th day of April 2009, I caused two copies each of the foregoing brief to be served on counsel for appellant and appellees at the addresses listed below by overnight courier for next day delivery and delivered the requisite copies of the brief to the clerk by overnight courier.

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