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

EN BANC SUPPLEMENTAL BRIEF OF *AMICUS CURIAE* THE CENTER FOR AUDIT QUALITY IN SUPPORT OF DEFENDANTS-APPELLEES

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INTEREST OF THE CENTER FOR AUDIT QUALITY AS *AMICUS CURIAE*

The Center for Audit Quality ("CAQ") is a public policy organization that seeks to aid investors and the capital markets by advancing constructive suggestions for change rooted in the audit and accounting profession's core values of integrity, objectivity, honesty, and trust. The CAQ is dedicated to helping increase public confidence in the auditing process and to maintaining high standards in the accounting profession.

On April 28, 2009, this Court granted the CAQ leave to file an *amicus curiae* brief in support of rehearing this case *en banc*. On July 22, 2009, the Court granted rehearing *en banc* and invited the CAQ and other *amici* to file supplemental briefs. Pursuant to that order, the CAQ respectfully submits this brief in support of defendants-appellees.[1]

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[1] During the interval between the CAQ's first *amicus* brief and this filing, Christopher Joralemon, one of three counsel of record for defendant Robert Hussey, joined the law firm of Gibson, Dunn & Crutcher LLP, counsel for the CAQ in this matter. This was an unexpected development. There is no conflict between Mr. Hussey and the CAQ, and each of the parties has stated that it does not object to Gibson Dunn's representation of Mr. Hussey and its continued representation of its preexisting client, the CAQ. Gibson Dunn attorneys representing the CAQ, who practice in the firm's Washington, D.C. office, have not conferred about the substance of the brief with Mr. Joralemon, who practices in the firm's New York office, or with any of the other attorneys representing Mr. Hussey.

BACKGROUND

This case concerns the distinction between primary and secondary liability under Section 10(b) of the Securities Exchange Act of 1934. 15 U.S.C. § 78j(b). The Panel declined to adopt the tests that other circuits have used to differentiate between primary violators and secondary violators. *SEC v. Tambone*, 550 F.3d 106, 139–40 (1st Cir. 2008). Instead, it ruled that a "defendant[] by virtue of his role in the market," in addition to "his statutory duties," may "make an implied statement without actually uttering the words in question." *Id*. at 133. The Panel held that defendants Tambone and Hussey were subject to *primary* liability under Section 10(b) and Rule 10b-5(b), even though they did *not* "make misleading representations" expressly. *Id*. at 135, 140, 149.

Judge Selya wrote a separate opinion, dissenting from the majority's interpretation of what it means to *make* a statement. *Id*. at 149–54 (concurring in part and dissenting in part). Judge Selya concluded that the majority "stretches the concept of primary liability beyond what . . . the Supreme Court would countenance and allows the SEC to cast a wider net than any court has ever thought possible." *Id*. at 150.

A majority of the full court voted to rehear this case *en banc*.

ARGUMENT

I. The *En Banc* Court Should Correct The Panel Decision To Avoid Uncertainty In The Securities Laws

The Panel decision should be harmonized with the decisions of the Supreme Court and other circuits to avoid confusion and inconsistency in the application of the securities laws from circuit to circuit. As set forth below, the Panel decision misapplies the law in at least two ways. First, it treats the defendants' omissions as misstatements, undermining the requirement of proving a duty to speak. Second, it imposes primary liability on secondary actors for misstatements made by others, thereby enabling private plaintiffs to circumvent the Supreme Court's holding that there is no private liability for aiding and abetting a violation of Section 10(b). *See Cent. Bank v. First Interstate Bank*, 511 U.S. 164, 191 (1994).

These departures from settled law will generate confusion and costs for market participants and investors. The Panel's holding offers no clear limit as to what constitutes an "implied misstatement," or when an actor's "role" or "statutory duties" are such that he risks primary liability for "making" such "implied misstatements." As a result of the holding, accountants, in particular, would face a resurgence of claims—consistently rejected after *Central Bank*—that their speech is implied even in clients' unaudited disclosures about financial matters, such as disclosures in earnings releases and in the management's discussion and analysis section of periodic reports filed with the SEC. Such claims would increase the cost

of audit services and "may prove more costly . . . to investors and the capital markets as a whole." Francine A. Ritter, Note, *Accountability of the Independent Accountant as Auditor in the Wake of* Central Bank*: Does the Implied Private Right of Action Survive Under Section 10(b) and Rule 10b-5*, 31 Suffolk U. L. Rev. 873, 887 (1998). Increased litigation risks and uncertainty will be bad for investors and the markets. *See, e.g.*, Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 Duke L.J. 945, 962 (1993) ("Overbreadth and uncertainty deter beneficial conduct and breed costly litigation.").

II. The Panel Decision Disregards The Settled Framework For Analyzing Omissions Liability

Section 10(b) covers three types of "deceptive or manipulative" conduct: "misstatements, omissions by one who has a duty to disclose, and manipulative trading practices." *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 128 S. Ct. 761, 769 (2008) (quoting *In re Charter Commc'ns, Inc., Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006)). Of critical importance here is the distinction between the first two categories, misstatements and omissions.[2]

[2] The third category, "manipulative trading practices," refers "generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977).

It is settled law that "[w]hen an allegation of fraud is based upon nondisclosure"—that is, an omission rather than a false statement—"there can be no fraud absent a duty to speak." *Chiarella v. United States*, 445 U.S. 222, 235 (1980); *see also Milton v. Van Dorn Co.*, 961 F.2d 965, 968 n.4 (1st Cir. 1992). A duty to speak generally arises only when there is "insider trading, a statute requiring disclosure, or an inaccurate, incomplete, or misleading prior disclosure." *Winer Family Trust v. Queen*, 503 F.3d 319, 329 (3d Cir. 2007).

The Panel departed from this settled framework. In this case, the issuer, Columbia Advisors, made the disputed statements in its prospectuses; the defendants, executives of the principal underwriter for the issuer, at most omitted to disclose the inaccuracies when they distributed the prospectuses to investors. *Tambone*, 550 F.3d at 111. Yet the Panel held that these *omissions* were "implied statement[s]"—distinct from "silence where there is a duty to disclose"—and did not require the SEC to satisfy its burden to prove a duty to speak. *Id.* at 132–33 (citation and emphasis omitted). That holding blurs the distinction between misstatements and omissions, disregards *Chiarella* and numerous subsequent decisions, and creates new uncertainty about when silence—even for those who have no duty to speak—can lead to liability.

Furthermore, while the well-established omissions framework assesses liability with regard to *particular information* that defendants are duty-bound to

disclose, the Panel's novel analysis could create liability relating to any information that the public *believes* secondary actors should obtain in performing their functions. *See, e.g.*, *id*. at 134 (asserting that investors rely on the reputation and expertise of underwriters, who "have access to information of substantive interest and consequence to investors"). This additional ambiguity about the scope of liability could create confusion over which matters secondary actors should investigate in their work, given that there may be a disconnect between what the public believes secondary actors should know and what secondary actors actually do know. Ultimately, secondary actors will never be sure when they are at a risk of incurring liability for "implied misstatements." What is certain, however, is that these secondary actors will now face a new wave of suits under the "implied misstatement" theory adopted by the Panel.

Notably, the Second Circuit has rejected such open-ended liability. In *Shapiro v. Cantor*, 123 F.3d 717 (2d Cir. 1997), for example, investors asserted a Section 10(b) claim against an accounting firm that had prepared accurate financial projections included in private placement offering memoranda for what turned out to be a set of sham partnerships. The plaintiffs alleged that the accounting firm was liable under Section 10(b) for failing to disclose damaging facts about one of the principals. *See id*. at 722. Relying on *Chiarella*, the Second Circuit held that the firm had no obligation to disclose the omitted facts. *See id*. at 721–22.

Similarly, in *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998), private plaintiffs sued an accounting firm under Section 10(b) over misstatements in a corporation's press release, even though the release had expressly said that the statements were unaudited. *See id.* at 171. Like the SEC here, the plaintiffs argued that investors understood the press release to be "an implied statement" by the accounting firm that the financial information was accurate. *Id.* at 173. But the Second Circuit held that even without the "unaudited" disclaimer, the accounting firm could not have been liable under Section 10(b), because the firm's private advice to the corporation had never been communicated to the public. The Second Circuit refused "to ignore the absence of any mention of Ernst & Young in [the corporation's] press release and focus instead on what the market might have *implicitly* 'understood' about Ernst & Young's involvement in that press release." *Id.* at 176–77 (emphasis added). Instead, it correctly held that the firm was not liable for failing to disclose information that it had no duty to disclose.[3]

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[3] The SEC erroneously relies on Judge Posner's discussion of omissions and implied representations in *Midwest Commerce Banking Co. v. Elkhart City Centre*, 4 F.3d 521, 524 (7th Cir. 1993). *See* Reply Br. of SEC Regarding Reh'g *En Banc* (hereinafter "SEC Reh'g Reply") 12–13. *Midwest* concerned common law fraud, not Section 10(b). 4 F.3d at 523. Judge Posner has elsewhere observed, consistent with the rule of the Supreme Court, that "one who fails to disclose material information prior to the consummation of a transaction commits fraud [under Section 10(b)] only when he is under a duty to do so." *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 445 (7th Cir. 1987) (Posner, J., dissenting) (quoting *Chiarella*, 445 U.S. at 228).

III. The Panel Decision Would Enable Private Plaintiffs To Plead Forbidden Aiding-And-Abetting Claims As "Implied Misstatement" Claims

Unlike the SEC, "a private plaintiff may not maintain an aiding and abetting suit under § 10(b)." *Cent. Bank*, 511 U.S. at 191. Congress enacted the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104-67, 109 Stat. 737, "to protect investors and to maintain confidence in our capital markets" in response to "significant evidence" of abusive litigation practices. H.R. Rep. No. 104-369, at 31 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 730, 730 (Conf. Rep.). Following the Supreme Court's decision in *Central Bank*, lawmakers deliberated over the merits of allowing private aiding-and-abetting claims and concluded "that amending the 1934 Act to provide explicitly for private aiding and abetting liability actions under Section 10(b) would be contrary to S. 240's goal of reducing meritless securities litigation." S. Rep. No. 104-98, at 19 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 698. Congress thus precluded private plaintiffs from asserting aiding-and-abetting claims, while authorizing the SEC to pursue them. *See id.*; 15 U.S.C. § 78t(e).

The Panel decision erases that distinction. The disputed statements in this case are mutual fund prospectuses prepared by someone other than the defendants. "As issuer and sponsor, Columbia Advisors was primarily responsible for creating the content of the prospectuses . . . ." *Tambone*, 550 F.3d at 111. The Panel did

not find that the defendants *wrote* those prospectuses; they merely "were responsible for overseeing the distribution of fund prospectuses." *Id*. at 141; *see also id*. at 116, 124, 143, 149. Overseeing distribution, however, is not *making* a misstatement. At most, such activity (if undertaken with scienter) could be deemed to be aiding and abetting another person's misstatement. If, as the Panel reasoned, participation by secondary actors amounts to an implied representation that they have "a reasonable basis to believe" that the statement made by the primary actor is true, *id*. at 135, then all secondary liability for misstatements becomes primary liability. Conflating these forms of liability may appear to have a minor effect on actions brought by the SEC, which can always pursue secondary liability under an aiding-and-abetting theory. It would have a major impact on private litigation, however, because it would invite private plaintiffs to attempt to revive the aiding-and-abetting liability that Congress prohibited by calling it primary liability for "implied misstatements."

The Supreme Court has made clear that Section 10(b) may not be interpreted in a way that eviscerates the distinction between primary and secondary liability. Last year, the Court rejected the theory of "scheme liability," explaining that the theory "would put an unsupportable interpretation on Congress' specific response to *Central Bank* in § 104 of the PSLRA." *Stoneridge*, 128 S. Ct. at 771. "Were we to adopt this construction of § 10(b)," the Court said, "it would revive in substance

the implied cause of action against all aiders and abettors except those who committed no deceptive act in the process of facilitating the fraud; and we would undermine Congress' determination that this class of defendants should be pursued by the SEC and not by private litigants." *Id*.

Stoneridge recognized that Congress foreclosed any expansion of primary liability under Section 10(b) to reach conduct understood to be within the scope of secondary liability at the time that Congress enacted the PSLRA. In the PSLRA, the Court explained, "Congress accepted the § 10(b) private cause of action as *then defined but chose to extend it no further*." *Id.* at 773 (emphasis added). Although omissions liability existed at that time for defendants "with a duty to disclose," *id*. at 769, the "implied statement" liability adopted by the Panel did not. This post-PSLRA expansion of primary liability to reach such "implied misstatements" is contrary to the Supreme Court's decision in *Stoneridge* and the command of the PSLRA.

The Second Circuit has repeatedly rejected similar efforts to evade *Central Bank*. Recently, the Second Circuit rejected a theory of "implied misstatement" in a class action brought against an accounting firm. *See Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147 (2d Cir. 2007). The plaintiffs claimed that the accounting firm's so-called "regulatory obligation" to review (but not audit) a company's quarterly unaudited financial statements meant that by failing to correct

them, the accounting firm had made a misstatement—even though the accounting firm did not purport to audit the filings, there was no audit opinion, and the filings were not attributed to the firm when disseminated. *See id.* at 154. In the plaintiffs' words, "'the market understood' the company's allegedly false press release 'as an implied assertion' of accuracy by the defendant accountant." *Id.* at 155.

In an opinion joined by Justice O'Connor (sitting by designation), Chief Judge Jacobs rejected the plaintiffs' theory. Citing *Central Bank*, he concluded that "[p]ublic 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." *Id.* at 155. He explained that "[u]nless the public's understanding is based on the accountant's *articulated* statement, the source for that understanding—whether it be a regulation, an accounting practice, or something else—does not matter." *Id.* (emphasis added). Several other circuits are in accord with this approach. *See, e.g.*, *Fidel v. Farley*, 392 F.3d 220, 235 (6th Cir. 2004); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226–27 (10th Cir. 1996).

The SEC argues that it is not required to prove that defendants "actually" make misstatements under Rule 10b-5(b). SEC Reh'g Reply 5. The text of Rule 10b-5(b), however, provides that it is unlawful "[t]o make any untrue statement of

a material fact." 17 C.F.R. § 240.10b-5(b). The text of the rule leaves no doubt that "make" means "actually make," and not something less.[4]

The SEC's reliance on its own "shingle theory" and related cases concerning fraudulent fee markups by broker-dealers is misplaced. *See* SEC Reh'g Reply 6–8. These cases correctly utilize the framework for assessing *omissions* liability by applying special disclosure duties that a securities dealer assumes by "hanging out its professional shingle." *Grandon v. Merrill Lynch & Co.*, 147 F.3d 184, 192 (2d Cir. 1998) (citation omitted); *see also United States v. Szur*, 289 F.3d 200, 211 (2d Cir. 2002) ("[W]e are concerned only with the alleged omissions of material fact . . . ."). They hold that liability arises from a relationship of "trust and confidence"

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[4] The Fourth Circuit recently held that defendants "*made* . . . misleading statements" by "participating in the writing and dissemination" of false prospectuses. *In re Mut. Fund Invs. Litig.*, 566 F.3d 111, 121 (4th Cir. 2009). The court examined the defendants' roles as an investment adviser and asset management firm not to determine whether those roles "imply" statements, but rather to determine whether the complaint sufficiently pleaded that investors would conclude that the defendants "played a substantial role in drafting or approving the allegedly misleading prospectuses." *Id.* at 124. That is not the analysis that the Panel applied here. As Judge Selya recognized, the SEC abandoned any argument that liability arises from the defendants' contributions, if any, to drafting the prospectuses. *Tambone*, 550 F.3d at 151, n.52.

Notably, the Fourth Circuit's opinion shows that attribution is relevant to assessing primary liability even when a plaintiff (like the SEC) does not bear the burden of proving reliance: although the plaintiffs invoked the fraud-on-the-market doctrine and were thus entitled to a presumption of reliance, the court nonetheless held that they must "prove that interested investors (and therefore the market at large) would attribute the allegedly misleading statement to the defendant." *In re Mut. Fund Invs. Litig.*, 566 F.3d at 124.

between a broker-dealer and its customer. *Szur*, 289 F.3d at 211 (quoting *Chiarella*, 445 U.S. at 228); *see also Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 269, 274 (3d Cir. 1998) (duty of best execution). The Panel did not base liability on a similar relationship here.

The excessive markup cases are also distinguishable because they concern statements of fees with an undisputed origin: statements made by broker-dealers. Here, by contrast, the defendants deny having "made" any statements at all. The SEC cites no cases that support the proposition that defendants can make a statement actionable under Rule 10b-5(b) "without actually uttering the words in question." *Tambone*, 550 F.3d at 133. Only the Panel has made that leap.

Contrary to the SEC's assertion, the Fifth Circuit did *not* find "implied representations" in *Southland Securities Corp. v. INSpire Insurance Solutions, Inc.*, 365 F.3d 353, 373 (5th Cir. 2004). *See* SEC Reh'g Reply 7–8. The court held that a complaint failed "to properly plead *any* section 10(b) or Rule 10(b)(5) violations," except certain express statements that have no relevance here. *Id.* at 383. Furthermore, *Southland* concerns claims that an issuer should be liable for misleading investors about a security analyst's express misstatements. *Id.* at 373. The decision quoted by *Southland* and, in turn, the SEC held that an issuer can become subject to *omissions* liability arising from a duty to correct errors in third-party reports that it becomes entangled in preparing. *Elkind v. Liggett & Myers,*

Inc., 635 F.2d 156, 163 (2d Cir. 1980); *see also Navarre Corp. Sec. Litig.*, 299 F.3d 735, 743 (8th Cir. 2002). This form of liability is distinct from the claims at issue here because it concerns omissions and arises from a defendant's recognized duty to disclose certain corrective statements about *itself*. The SEC has not pursued omissions liability here and fails to cite any authority for the proposition that the defendants had a duty to correct a third party's misstatements about that third party.[5]

If private plaintiffs can premise primary liability on silent conduct that merely relates to the misstatements of another speaker, *Central Bank*'s prohibition of private aiding-and-abetting claims and *Stoneridge*'s rejection of scheme liability will become dead letters in this Circuit. Secondary actors in the securities markets will be subjected to liability simply for performing their roles "behind the scenes" and become embroiled, repeatedly, in costly litigation; and a new, undefined, and

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[5] The SEC's citation to other "implied misrepresentation" cases is equally unavailing. *See* SEC Reh'g Reply 8–9. The D.C. Circuit's holding that spoken opinions are implicitly made in good faith, *see Weiss v. SEC*, 468 F.3d 849, 855 (D.C. Cir. 2006), does not support the contention that an unspoken "role" is an actionable statement under Rule 10b-5(b). As noted above, the common law cases the SEC cites are inapplicable to the federal securities laws. *See supra* note 3. The Court should also reject the theories that the SEC raised for the first time at the rehearing stage in its reply brief. *See* SEC Reh'g Reply 13–14 (asserting liability for failures to correct errors and insider selling). Arguments made on appeal normally cannot be made for the first time in a reply brief. *See Esso Standard Oil Co. v. Rodriguez-Perez*, 455 F.3d 1, 6 (1st Cir. 2006).

unbounded layer of legal liability will develop in direct contravention to legislative judgments expressly made by Congress.

CONCLUSION

The Court should affirm the decision of the district court with respect to Rule 10b-5(b).

Dated: September 3, 2009

Respectfully submitted,

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1. This *amicus* brief contains 3598 words, excluding the parts of the brief exempted by Federal Rule of Appellate Procedure 32(a)(7)(B)(iii), and it complies with the 15-page limit set forth in this Court's order of July 22, 2009.

2. This *amicus* brief complies with the typeface requirements of Federal Rule of Appellate Procedure 32(a)(5) and the type style requirements of Federal Rule of Appellate Procedure 32(a)(6) because it has been prepared in a proportionally spaced typeface using Microsoft Word 2003 in 14-point Times New Roman font.

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CERTIFICATE OF SERVICE

I hereby certify that on September 3, 2009, fourteen paper copies and one electronic copy of the foregoing *En Banc* Supplemental Brief of *Amicus Curiae* the Center For Audit Quality in Support of Defendants-Appellees were filed by overnight mail with the Clerk of the Court. I further certify that two copies were served on the following counsel by commercial carrier for next-day delivery:

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