Case No. 07-1384

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff-Appellant,

v.

JAMES TAMBONE, ROBERT HUSSEY,
Defendant-Appellees.

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

SUPPLEMENTAL BRIEF REGARDING REHEARING *EN BANC* OF APPELLEE JAMES TAMBONE

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INTRODUCTION

This supplemental brief is submitted pursuant to the Court's July 22, 2009 order granting rehearing en banc on the application of Rule 10b-5(b) to the SEC's claims. The SEC's theory of liability, as set forth in its most recently filed brief before this Court, is that an underwriter may be liable under Rule 10b-5(b) for "implied representations to potential investors," which representations investors "have a reasonable basis to believe … are accurate and complete." Reply Brief of the Securities and Exchange Commission Regarding Rehearing En Banc (SEC Reply Brief) at 1 (emphasis added).[1] But the Supreme Court has never held that an underwriter has a duty to investigate the accuracy of statements in a prospectus, much less that a purported breach thereof creates liability for an "implied" representation, or that an underwriter's use of a prospectus constitutes an "implied" statement in the first instance. And there is no doctrinal basis for this Court to create such a duty from the disparate theories on which the SEC now relies.

[1] This supplemental brief will not re-argue points that are set forth in Tambone's Petition for Panel Rehearing and Rehearing En Banc (Petition), his Responsive Brief in Support of Petition for Rehearing En Banc (Responsive Br.), or his panel brief (Panel Br.). It primarily addresses the SEC's "implied representation" theory, as articulated by the SEC in the en banc proceedings.

I. "IMPLIED REPRESENTATIONS" AND RULE 10b-5(b).

A. Overview

Mr. Tambone has argued throughout this litigation that the "bright line/making test," e.g., Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, 511 U.S. 164, 177-178 (1994); Wright v. Ernst & Young LLP, 152 F.3d 169, 174-175 (2d Cir. 1998), is dispositive of the SEC's Rule 10b-5(b) claims. E.g., Petition at 2-10; Responsive Br. at 10-21; Panel Br. at 17-29. Under Central Bank and precedent in five courts of appeal, it must be alleged that a defendant personally made statements in order to set forth a primary liability claim. Wright, 152 F.3d at 174-175 (collecting cases). Since 1998, the SEC has repeatedly advocated that "to make" means "to create" and, indeed, recently affirmed that position in a Second Circuit amicus brief. SEC Amicus Brief at 6-11 & n. 3, Pacific Mgmt Co. LLC et al. v. PIMCO, No. 09-1619-CV (2d Cir.) (filed Aug. 6, 2009); See Responsive Br. at 12-13, n.13.

If the bright line test is applied, the SEC's "implied representation" theory should fail at the outset. Responsive Br. at 10-21. But the SEC's claim against Tambone should fail, regardless of the test that this Court ultimately adopts, because the Complaint fails to plead any basis for imposing primary liability against Tambone. His merely having reviewed and commented on unidentified market-timing representations before such representations were included in unidentified prospectuses – particularly in the absence of any allegations setting forth his purported comments or whether any such comments were incorporated into the prospectuses – cannot be sufficient to state a claim that he "made" a false statement under Rule 10b-5(b). Nor do the allegations in the Complaint, when viewed as a whole fill this gap.

B. The Pleading Standards.

To state a claim under Rule 10b-5(b), the SEC must allege facts showing that the defendant: "(1) made a material misrepresentation or a material omission as to which he had a duty to speak, or used a fraudulent device; (2) with scienter; (3) in connection with the purchase or sale of securities." SEC v. Monarch Funding Corp., 192 F.3d 295, 308 (2d Cir. 1999); accord Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341-42 (2005). "[I]nformation is material only if its disclosure would alter the 'total mix' of facts available to the investor and 'if there is a substantial likelihood that a reasonable shareholder would consider it important' to the investment decision." Lucia v. Prospect Street High Income Portfolio, Inc., 36 F.3d 170, 175 (1st Cir. 1994) (quoting Basic, Inc. v. Levinson, 485 U.S. 224, 231-32 (1988)).

The SEC must also satisfy the heightened pleading standard for fraud under Fed. R. Civ. P. 9(b), Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1217 (1st Cir. 1996). Rule 9(b) requires "specification of the time, place, and content of an alleged false representation" and the complaint therefore must "explain why the challenged statement or omission is misleading by ...

provid[ing] some factual support for the allegations of fraud." Greebel v. FTP Software, Inc., 194 F.3d 185, 193 (1st Cir. 1999) (quotations omitted).[2]

The SEC's "implied representation" theory founders, in the first instance, on these well-established pleading standards. As the Supreme Court has recently reaffirmed, "[t]o survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.'" Ashcroft v. Iqbal, 129 S.Ct. 1937, 1949 (2009) (quoting Bell Atlantic Corp. v. Twombly, 550 U.S. 544, 570 (2007)). "Two underlying principles guide [this Court's] assessment of the adequacy of … pleadings" under Iqbal and Twombly. See Maldonado v. Fontanes, 568 F.3d 263, 268 (1st Cir. 2009). First, "conclusory statements are 'not entitled to the assumption of truth.'" Id. (quoting Iqbal, 129 S.Ct. at 1949); accord Glassman v. Computervision Corp., 90 F.3d 617, 628 (1st Cir. 1996) (court need not credit "bald assertions"). Second, "[w]here the well-pleaded facts do not permit the court to infer more than the mere possibility of misconduct, the complaint has alleged – but it has not shown – that the

[2] Thus, the complaint must "(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent." Suna v. Bailey Corp., 107 F.3d 64, 68 (1st Cir. 1997). "The requirement that supporting facts be pleaded applies even when the fraud relates to matters peculiarly within the knowledge of the opposing party." Romani v. Shearson Lehman Hutton, 929 F.2d 875, 878 (1st Cir. 1991) Also, "[w]here allegations of fraud are . . . based only on information and belief, the complaint must set forth the source of the information and the reasons for the belief." Id. at 878; Greebel, 194 F. 3d at 194 (same).

pleader is entitled to relief," and the allegations are insufficient. Maldonado, 568 F.3d at 268 (internal quotations and citations omitted).[3]

C. The SEC Failed to State a Claim Against Mr. Tambone.

The SEC alleged "on information and belief" that Mr. Tambone made an "implied representation" because he "reviewed and provided input into market timing language that was incorporated into certain of the prospectuses" and "signed hundreds" of agreements on behalf of Columbia Distributors, which agreements allegedly represented and warranted that the prospectuses would not be misleading. JA-18-20 (Compl. ¶¶10, 35-37, 40, 42). The heart of the claim is that "a number of Columbia funds" began including a market timing provision, (set forth in paragraph #35 of the Complaint,) in unidentified fund prospectuses "in the fall of 2000" and that by "the spring of 2001 the rest of the Columbia funds … began including" the provision in their prospectuses. Id. at ¶¶35, 38. The SEC, however,

[3] This Court "will scrutinize a post-discovery motion to dismiss even more stringently than a pre-discovery motion" and the fact that discovery has been conducted "is relevant to a court's evaluation of sufficient particularity." In re Cabletron Systems, Inc., 311 F.3d 11, 33 (1st Cir. 2002). Although the Complaint was dismissed before formal discovery had commenced, the SEC, under 15 U.S.C. §78u, had conducted a full investigation before filing its initial complaint in February 2005, during the course of which it took the testimony of at least 23 witnesses, including Mr. Tambone and Mr. Hussey, and conducted voluminous document discovery. See Hussey Mem., (filed 5/31/05) (JA-115) (SEC afforded opportunity for further investigation after first motion to dismiss was allowed).

never alleges that Mr. Tambone created wrote, made, drafted, reviewed, edited, approved or adopted that provision. Id.[4]

What the SEC actually alleges is that, "from at least 1998 and continuing through summer 2003," Mr. Tambone Co-President of Columbia Distributor "entered, approved, or knowingly allowed at least six … arrangements with investment advisers, hedge funds and brokers allowing them to engage in frequent trading in particular mutual funds." JA-21 (Compl. ¶44). "Columbia Advisors knew and approved of all but one of these arrangements." Id. See Compl. ¶35 (providing that the advisor had discretion to approve market timing so long as, in the advisor's opinion, it was not short term, excessive or disruptive).[5] As to the selling agreements,

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[4] Specifically, the SEC alleged, "on information and belief Hussey … and Tambone" reviewed "the market timing representations" – not the market timing provision set forth in the Complaint (¶35) – "before they were included in the prospectuses" and communicated their comments on "these representations" to in-house counsel for Columbia Advisors, which was then involved in drafting the representations. Id. at ¶36 (emphasis added). The only supporting allegations are that, on April 28, 2000, Mr. Tambone provided comments on a document transmitted to him by in-house counsel, which addressed "the approach for policing and eliminating market timers" which Columbia Advisors was "in the process of implementing internally," id. -- not on the proposed prospectus. Also, in May 2000, Mr. Tambone "received e-mails from in-house counsel regarding the proposed amendment of the language addressing market timing." On May 10, 2000 Mr. Tambone sent an unidentified e-mail to Hussey "regarding market timers" and Hussey "sent an e-mail to in-house counsel with his comments on the proposed prospectus language." Id. at ¶37. On May 15, 2000 Mr. Tambone "sent an e-mail to in-house counsel with his comments on the issue." Id.

[5] "… the Fund reserves the right to reject any purchase or 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

there are no allegations as to "when the … agreements were signed, to which mutual funds they pertained, who the parties to the agreement were, what prospectuses the parties to the agreement received or when those parties bought or sold mutual funds in which market timing was occurring." SEC v. Tambone, 473 F. Supp. 2d 162, 167 (D. Mass. 2006); JA 53-54; Compl. ¶¶40-42. With respect to the six investors, the SEC alleged the following:

D.R. Loeser. From late 1998 through mid-2000, D.R. Loeser (Loeser) traded in Columbia Growth Stock (Growth Stock) and Columbia Young Investor (Young Investor). Id. at ¶¶81-82. The SEC alleges that, in February 2000 – approximately one year before the market timing provision set forth in the Complaint (¶35) first appeared – Mr. Hussey "sent an e-mail to Mr. Tambone referring to existing 'profitable relationships' including Loeser" and that Loeser made 20 "round trips" in the first five months of 2000. Id. at ¶81-83. Three months later, Loeser stopped trading in Growth Stock in May 2000, which was before the provision first appeared in the prospectus in February 2001. Id. at ¶81, 87.

Daniel Calugar. In April 1999, Calugar "reached an arrangement approved by Hussey" and the investment advisor, to trade in Young Investor and Growth Stock "throughout 2000" and in Growth Stock "from January 2000 through February 2001" – once again, before the market timing provision set forth in the Complaint (¶35) appeared in either prospectus in

has been or may be disruptive to the Fund." Compl. at ¶35. (emphasis added).

February 2001. Id. at ¶¶73-74, 87.[6] With respect to Mr. Tambone, the SEC alleged only that approximately one year before the provision first appeared, Hussey sent an e-mail to him shortly after January 2000, in which he referred to Calugar as a "profitable relationship[]" that Hussey "felt they could manage." Id. at ¶72.

Ritchie Capital Management, Inc. From January 2000 through September 2003, Ritchie traded in the Newport Tiger Fund (Newport Tiger) and Growth Stock, making "most of its trades" in Newport Tiger. Id. at ¶¶61- 62. The SEC made no allegations as to Mr. Tambone and Newport Tiger. Id. at ¶¶61-66. The SEC alleged only that, in "early 2003" Mr. Tambone, Mr. Hussey and the "Columbia Advisors' portfolio manager for [Growth Stock] who was involved in the negotiations" approved a "sticky-asset" arrangement. Id. at ¶65. Ritchie made "approximately 18 round trips … in Growth Stock from June 2002 to September 2003" which, on average, is 1.2 round trips per month, which the SEC did not allege was excessive. Id.

Ilytat, L.P. From April 2000 through October 2003, Ilytat, a hedge fund, traded in six Columbia Funds. Id. at ¶¶45-60. The only allegations concerning Mr. Tambone are that "[i]n or before October 2000," he "approved or become aware of" an "arrangement" in Newport Tiger and, in

[6] Although the SEC alleges that Calugar traded in unspecified funds from February 2001 through August 2001, there are no allegations of the number of trades during that period or that the trading was excessive. Id. at ¶75.

June 2000 and March 2001 – before the market timing provision set forth in the Complaint (¶35) first appeared in the Newport Tiger prospectus in May 2001 – he received two e-mails from Columbia Advisors "expressing concern about Ilytat's trading activity and the harm that this trading activity could have on the fund and its investors." Id. at ¶¶46-49, 51.[7]

Edward Stern. In "late 2002 and early 2003," Stern traded in three Columbia stocks.[8] Id. at ¶67. In "early 2003," despite the market timing provision in the funds' prospectuses, Stern "entered into an arrangement with Columbia Distributor, approved by Tambone" which would have permitted "three round trips per month in each" of the funds. Id. Stern withdrew from the arrangement "only a couple of weeks after making the investment" and the SEC does not allege that any trades were made. Id.

In "late 2002 or early 2003" Stern entered into another arrangement with Columbia Distributor -- not Mr. Tambone -- approved by the portfolio manager, which permitted Stern "to make one round trip each month" in the Columbia High Yield Fund, resulting in, on average, less than one trip per month from November 2002 through July 2003. Id. at ¶68. There are no

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[7] While in October 2000, the portfolio manager noted possible "damage to the fund's performance" no such actual harm was ever alleged to have occurred despite the SEC's full investigation. Id. at ¶¶49-51. Nor is it alleged that the portfolio manager rejected trades, which was well within his discretion. Id. at ¶35. Moreover in response to the October, 2000 e-mail, Mr. Hussey informed Mr. Tambone that the Ilytat arrangement "followed the[] guidelines" of bringing the trading to the attention of the management team and monitoring it to ensure the investment management team's comfort. Id. at ¶49.

[8] Growth & Income, Select Value and Growth Stock.

allegations that the trading was excessive, and the SEC alleges only that Mr. Tambone failed to disclose the Stern arrangement or trading. Id. at ¶¶67-69.

Sal Giacolone. In "late 2000" Mr. Tambone and "the head of the Newport Fund Group,"[9] approved a "sticky asset" arrangement with Giacolone, a broker, which permitted Giacolone to make four round trips per month. Id. at ¶77. Giacolone traded from "November 2000 through April 2001," and ceased trading before the market timing provision set forth in the Complaint (¶35) was included in the fund's prospectus in May 2001. Id. at ¶¶46, 78. The SEC alleged that in early 2001 one of Tambone's subordinates "halted efforts" to stop Giacolone's trading in "early 2001", but the purported interference is the subordinate's suggestion to "contact[]" an unknown person "before cancelling any trades." Id. Nor did the SEC allege whether this action or a subsequent termination of Giacolone's trading occurred before or after the market timing provision set forth in the Complaint (¶35) first appeared in the fund prospectus in May 2001. Id. at 79.[10]

[9] This is Newport Pacific Management, an advisor which was included in the Liberty Advisory Services Corp., the predecessor advisor to Columbia Advisors. See Compl. at ¶22.

[10] Although the SEC alleges that prospectuses for "various" Columbia Funds from 1998 through 2000 stated that "shareholders would be limited in the number of exchanges they could make during a given period," the SEC identifies only the Acorn Fund Group, in which it is alleged "investors would generally be permitted to make only up to four round trip exchanges per year." Id. at ¶32. The SEC alleges that, beginning in May 1999, some Acorn fund prospectuses represented that "[t]he Acorn funds do not permit market timing and have adopted policies to discourage this practice." But, there are no allegations that Mr. Tambone knew, much less approved of any

Thus, the SEC never pled with the requisite particularity that Mr. Tambone "made" a misleading statement that appeared in fund prospectuses. Under Iqbal, the Complaint cannot be read to allege that Mr. Tambone reviewed the market timing provision set forth in the Complaint (¶35). And, even if that were not so, the SEC, as the district court correctly noted, failed to "identify the substance of the comments made by either Mr. Tambone or Mr. Hussey in the e-mails" or "allege that any of the language reviewed or proposed by either defendant was ever actually incorporated" in a prospectus. SEC v. Tambone, 473 F. Supp. 2d 162, 166 (D. Mass 2006).[11] This leaves the allegations insufficient to state a claim. See In re Cabletron Systems, Inc., 311 F.3d 11, 33 (1st Cir. 2002) (complaint "fail[ed] to connect [defendant] specifically to any of the … misleading statements" in

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arrangement or trading in the Acorn funds. Id. at ¶33, 54-58, 88. Nor are there any allegations that Mr. Tambone played any role in the language in the prospectuses. No such allegation could have been made because Wanger Asset Management, which managed the Acorn funds, was not acquired by Liberty (Columbia's predecessor) until October 2000. Consella A. Lee, Liberty Financial Closes Buy of Wanger Asset Management, Dow Jones Newswires (Oct. 2, 2000), available at http://www.lexis.com.

[11] As found by the district court, simply because "the information [communications with in-house counsel] is subject to the attorney client privilege does not relieve the SEC of the burden to allege fraud with particularity." Tambone, 473 F.Supp. 2d at 166-67; Greebel, 194 F.3d at 193. Moreover, the SEC failed to allege when, or even if, prospectuses including the ¶35 language were used or distributed, much less that those prospectuses pertained to funds in which market timing had occurred. See In re Mutual Funds Inv. Litig., 566 F.3d 111, 118-21 (4th Cir. 2009) (claim against asset-management firm dismissed because complaint failed to allege firm actually made or prepared prospectuses, although stating that firm assisted in drafting and made prospectuses available on website).

Form 10-K that defendant did not sign). Nor does the Complaint as a whole allege facts to support a claim that Tambone engaged in knowing and intentional misconduct which would support a claim that he intended to deceive and defraud. See Maldonado, 568 F.3d at 268. See Point III, infra.

II. NEITHER THE "SHINGLE THEORY" NOR THE "ENTANGLEMENT THEORY" SUPPORT IMPOSING LIABILITY UNDER RULE 10b-5(b) FOR AN "IMPLIED REPRESENTATION."

For the first time in this litigation, the SEC has argued in its en banc reply brief, that "implied representation" liability can be justified under the so-called "shingle" and "entanglement" theories. SEC Reply Brief at 6-8. Neither theory can salvage the SEC's claim against Mr. Tambone.

A. The "Shingle Theory."

The shingle theory developed in administrative proceedings, typically involving securities brokers who, after gaining their customers' confidence, failed to disclose mark-ups and then sold securities to them at over-market prices. The brokers were sanctioned for either actually knowingly making false statements, e.g., Duker v. Duker, 6 S.E.C. 386, Release No. 34-2350, 1939 WL 36426 at *1-3 (1939) (broker induced customer to sell shares, then resold shares to same customer at higher price, "knowing that the customer was unaware of the market price"), or having played such an integral role in others' statements that they were deemed to have caused the statement to be made. United States v. Szur, 289 F.3d 200 (2d Cir. 2002) (defendant masterminded scheme to charge exorbitant commissions in which co-

conspirator made statements to customers). At the shingle theory's core is the long-standing principle that "a dealer may not exploit the ignorance of his customer to exact unreasonable profits resulting from a price which bears no relation to the prevailing price." Mark David Anderson, 56 S.E.C. 840, 2003 WL 21953883 at *6-7, 9 (2003) ("dealer violates the anti-fraud provisions when he charges retail customers prices that are not reasonably related to the prevailing market price").

By its very nature, the practice is fraud per se, and causes harm. Id. Market timing, on the other hand, is neither illegal or per se fraudulent, as the SEC conceded in the Complaint (Compl. ¶28) ("market timing is not itself illegal") – and here, the SEC, following a complete investigation, has failed to allege that whatever market timing took place in the Columbia funds actually caused any harm.

Moreover, to the extent that the SEC relies upon mark-up cases that address the issue under an "implied representation" rubric, the "key to these cases is that a fiduciary or person in a position of trust and confidence fails to disclose a material fact" who proffers "advice" to a customer. Louis Loss & Joel Seligman, Securities Regulation, §9-C-1 at 3816 (3d ed. 2007); see, e.g., Duker 1939 WL 36426 at *2-3, (in "gaining its customer's confidence [broker] impliedly represented that it would deal fairly with them"; ["i]nherent in the relationship between a dealer and his customer is the vital representation that the customer will be dealt with fairly" and that it is not "fair dealing … to exploit trust and ignorance for profits far higher than might be realized from an informed customer"). Other shingle-theory decisions appear to address the issue in the context of omission/duty to disclose, with the duty arising out of the same relationship of trust or confidence. Loss, at 3816 & n.16 citing Sec. Ex. Act. Rel. 24,368,38, SEC Dock. 158, 159 n.12 1987 ("[a]lthough some cases have not been couched in terms of disclosure, the commission believes that the gravamen of a mark-up violation under the federal securities laws is charging excessive markups without disclosure"); see e.g., Charles Hughes & Co. Inc. v. SEC, 139 F.2d 434, 435-36 (2d Cir. 1943).

In Charles Hughes, the Court held that the broker was "under a special duty, in view of its expert knowledge … not to take advantage of its customers' ignorance of market conditions." Id. at 437. It held that by working their way into the confidence of widowed customers, such that the customers placed complete control of their securities in the brokers' hands, the failure to reveal true market price of securities and sale to the customers at 40% over-market violated their duty to their customers. Id. at 437 ("[t]he key to the success … was the confidence in itself which it managed to instill in its customers" and, "[o]nce that confidence was established, the failure to reveal the mark-up pocketed by the firm was both an omission to state a material fact and a fraudulent device").[12] "There exists an implied

[12] The Court did *not* hold that a misrepresentation had been made under Rule 10b-5(b), because there was conflicting evidence as to whether the brokers had made the statements. 139 F.2d at 436.

representation that broker dealers charge their customers securities prices that are reasonably related to the prices charged in an open … market" and that "the securities dealer creates an implied duty to disclose excessive markups by 'hanging out its professional shingle.' " Grandon v. Merrill Lynch & Co., Inc., 147 F.3d 184, 192 (2d Cir. 1998).

However, Rule 10b-5(b) liability cannot be predicated on the shingle theory, based on such an alleged omission, because the SEC "failed to identify a relationship" between investors and Tambone that "could give rise to a duty", Chiarella v. United States, 445 U.S. 222, 232-33 (1980).[13] It also failed to allege facts supporting such a relationship or duty. Responsive Br. at 10-13. Rather, the SEC alleged only that Mr. Tambone owed a "special duty" to investigate the accuracy of the prospectuses to those to whom the funds were marketed. Compl. at ¶11. But "there can be no fraud absent a duty to speak" under § 10(b). Chiarella, 445 U.S. at 235. See Responsive Br. at 23 & n.23; Panel Br. at 32-34.[14]

[13] The SEC's suggestion (SEC Reply Brief at 13-14) that Mr. Tambone could be liable as an "insider trader" under Chiarella should not be considered, because the SEC never alleged insider trading, even in a conclusory fashion, the argument was never raised in the district court and here the SEC raises it in a "perfunctory manner." United States v. Zannino, 895 F.2d 1, 17 (1st Cir. 1990). Nor has the SEC cited any authority for the proposition that a charge of insider trading may be brought against a distributor's employee based on the distributor's sale of securities in the normal course of business.

[14] Neither Grandon nor SEC v. First Jersey Secs. Inc., 101 F.3d 1450, 1458 (2d Cir. 1996) (broker's director and owner held primarily liable for failure to disclose that firm was buying securities from customers and reselling at up to 150% markup to other customers and scheme required some branch offices to sell and others to buy, which scheme was coordinated at firm's

As the district court noted, there can be a duty to correct prior inaccurate statements. SEC v. Tambone, 417 F. Supp. 2d 127, 134 (D. Mass. 2006); see Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1202 & n.3 (1st Cir. 1996) (duty to disclose may also arise where "an insider trades in the company's securities on the basis of nonpublic material information" or "when a statute or regulation requires disclosure"). Mr. Tambone, however, could not owe any such duty to correct prospectus statements, because, as set forth in his earlier briefs, he did not make those statements in the first instance. Responsive Br. at 10-21. As this Court has suggested, only one who makes an initial statement owes a duty to correct errors in that statement. Shaw, 82 F.3d at 1202 (duty to disclose if "corporation has previously made a statement of material fact that is either false, inaccurate, incomplete, or misleading in light of the undisclosed information"); see also Tambone, 417 F. Supp. 2d at 135.

Without such a duty, Mr. Tambone cannot be liable based on a failure to correct Columbia Advisors' allegedly false statements. "The proposition that silence, absent a duty to disclose, cannot be actionably misleading, is a fixture in federal securities law." Shaw, 82 F.3d at 1202.[15]

headquarters and owner orchestrated scheme), are inconsistent with, or discuss, Chiarella's holding that "silence, in connection with the purchase or sale of securities may operate as fraud actionable under §10(b) … [b]ut such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between" parties to a transaction." 445 U.S. at 230.

[15] The SEC relies on SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972), for the proposition that a broker who actively distributes shares can be liable for a failure to correct a prospectus. SEC Reply Brief at

In the end, the basis for the SEC's shingle theory for "implied representation" liability turns on whether a duty to investigate exists in the Rule 10b-5(b) context. SEC Reply Brief at 14-15. The SEC has not pointed to any duty to investigate in the statutory scheme, as there is none.[16] In rejecting a similar attempt to fabricate a duty where none existed, the Supreme Court in Chiarella, 445 U.S. at 234, "emphasized … [that] the 1934 Act cannot be read more broadly than its language and the statutory scheme reasonably permit." Id. (citations and internal quotations omitted). See Responsive Br. at 18-21. In short, liability cannot rest upon a non-existent "duty." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 191-93 & n.9 (1976) (rejecting Seventh Circuit's holding that liability could be based on common

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13. There, the distributor's principal committed a "garden variety type of fraud" resulting in the "misappropriation of the proceeds" of an offering. Id. at 1090-95 (principal "demanded special compensation as a condition to participating in the ... offering," was "paid in securities rather than cash," as prospectus required, went forward with distribution although he "knew that a valid closing had not occurred," and defaulted on a loan issuer "had guaranteed with proceeds from the offering"). In holding the principal liable under both § 17(a) and Rule 10b-5, the court did not identify which subsections were applicable; the conduct could have been deemed a "scheme, or artifice to defraud," § 17(a)(1); Rule 10b-5(a), or a "practice, or course of business which operates or would operate as a fraud," § 17(a)(3); Rule 10b-5(c). In addition, to the extent the decision could be read, as the SEC reads it, to suggest that the defendant owed a duty to correct misstatements in the prospectus that the defendant had not himself made, that reading would be inconsistent with Shaw, 82 F.3d at 1202.

[16] The SEC also mistakenly relies (SEC Reply Brief at 13-14) on Sanders v. John Nuveen, 524 F.2d 1064, 1070 (7th Cir. 1975), vacated and remanded, 425 U.S. 929 (1976), on remand, 554 F.2d 790 (7th Cir. 1977), on subsequent appeal, 619 F.2d 1222 (7th Cir. 1980), for the proposition that an underwriter makes an implied representation that the underwriter has investigated an issuer. See Responsive Brief at 20 & n.20.

law an accountant's purported statutory "duty of inquiry" under §17(a) of the 1933 Act and the related duty to disclose any material irregularities that were discovered). See Responsive Br. at 18.

B. The "Entanglement Theory."

The SEC also relies on decisions addressing statements by securities analysts and the circumstances under which such statements may be attributed to company officials who "by their activity made an implied representation that the information they have reviewed is true or at least in accordance with the company's views." Southland Sec. Corp. v. INspire Ins. Solutions, Inc., 365 F.3d 353, 373 (5th Cir. 2004); see In re Navarre Corp. Sec. Litig., 299 F.3d 735, 743 (8th Cir. 2002); Elkind v. Liggett & Myers, Inc. 635 F.2d 156, 163 (2d Cir. 1980). This is the "entanglement theory," first enunciated in Elkind, a decision which focuses on optimistic predictions or forecasts in analyst reports, based on statements made by a company or its employees that turn out to be incorrect; often involving trading prior to a company's demise.[17]

In Southland, the defendant CEO actually made the statements. And, the Fifth Circuit, while recognizing that "[g]enerally, securities issuers are not liable for statements or forecasts disseminated by securities analysts or

[17] The continuing vitality of Elkind, Southland and Navarre is questionable in the Second, Fifth and Eighth Circuits as those cases were all decided before those circuits adopted the "bright line" test. Wright, 152 F.3d at 174-175; Regents of the Univ. of Cal. v. Credit Suisse First Boston, 482 F.3d 372, 385-390 (5th Cir. 2007); In re Charter Commc'ns, Inc. Sec. Litig., 443 F.3d 987, 992 (8th Cir. 2006).

third parties," held that the CEO had "sufficiently entangled [himself] with the analysts' forecasts" that it was fair "to render those predictions 'attributable to [him].'" Id. at 373 (citation omitted). That is, "by virtue of [his] activity," the defendant personally had "made an implied representation" that information he had reviewed was "true or at least in accordance with the company's views." Id. at 373, 379, 383 (citations omitted). No such facts were pled against Tambone, and there is no basis for invoking the entanglement theory. Elkind, 634 F.2d at 162-63.[18] See Navarre, 299 F.3d at 743, 748 (news correspondent's statement predicting likelihood of IPO and publicizing company's confirmation of same, held not sufficient entanglement).

This Court has endorsed the entanglement test for third party analyst statements, but has emphasized that entanglement between the defendants and the analysts must be "significant and specific" not merely "casual and speculative," or the defendants must either adopt or place their imprimatur on the statements. Cabletron Systems Inc., 311 F.3d at 37-38. "[A]n entanglement claim will be rejected if it merely suggests or assumes that company insiders provided information on which analysts or other outsiders based their reports." Id. at 38. In Cabletron, the Court held that the

[18] In Elkind, company employees "reviewed and commented upon" analyst reports "to correct errors and other misunderstandings." Id. at 159, 163. But the employees either made no comment on, or made non-committal statements on earnings projections, and the Court held that the company had not "placed its imprimatur, expressly or impliedly, on the market projections." Id. at 159-60, 163.

complaint adequately pled a claim against those defendants who were alleged to have actually provided information to the analysts on whether a crucial computer component would be shipped according to plan (when they knew that would not be), signed the Form 10-K, made insider stock sales, or participated in specifically pled intentionally fraudulent conduct, including fictitious sales and inventory parking. Id. at 41. On the other hand, this Court held that the complaint failed to state a claim against defendant Oliver who although he received reports from the quality control databases showing problems with the computer part, he neither signed the Form 10-K nor traded stock, and the complaint failed "to connect him specifically to any of the misleading statements." Id.

Thus, Cabletron requires rejection of the entanglement test as a basis for pleading a claim against Mr. Tambone, because the SEC's allegations are insufficient "to connect [Mr. Tambone] specifically to any of the misleading statements." Id. at 41.[19] Moreover, the SEC's allegations do not plead

[19] The SEC cites Weiss v. S.E.C., 468 F.3d 849, 854-56 (D.C. Cir. 2006), and similar decisions for the proposition that "a statement of opinion includes an implied representation that the speaker rendered an opinion in good faith and with a reasonable basis." Id. SEC Reply Brief at 8. In Weiss, bond counsel for a school authority wrote opinion letters to a bond purchaser, in one of which the lawyer made misstatements that the notes were not arbitrage bonds (which are prohibited and which the school board improperly had issued on his advice); that is, the defendant actually made the statement in the first instance. 468 F.3d at 854-56; see Wharf (Holdings) Ltd. v. United Int'l Holdings, 532 U.S. 588, 596-97 (2001) (sale of option to buy stock, while secretly intending from the beginning never to honor the option, as memorialized in company documents violates §10(b) because secret reservation was misrepresentation); Kowal v. MCI Commc'ns, Corp., 16 F.3d 1271, 1277 (D.C. Cir. 1994) (complaint dismissed for failure to

Tambone's "significant and specific" involvement in the allegedly misleading statements" Id. at 38.

C. The SEC Cannot Rely on a Common-Law Liability Theory.

Finally, the SEC argues that, "under general principles of tort law, either an express or an implied statement can give rise to a claim for fraudulent representation." SEC Reply Brief at 6-7. The Supreme Court has repeatedly rejected attempts by plaintiffs and the SEC to apply tort law to the securities laws, as the Court recently reaffirmed in Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, 552 U.S. 148, 128 S. Ct. 761, 771 (2008). In Stoneridge, the Court in rejecting plaintiffs' argument that under common law action for fraud, there could have been a finding of reliance on the facts alleged stated:

> Even if plaintiffs assumption is correct, it is not controlling. Section 10(b) does not incorporate common-law fraud into federal law." [citation omitted] (Section 10(b) must not be construed so broadly as to convert every common law fraud that happens to involve securities into a violation") (citation omitted) …

Id.; see Pinter v. Dahl, 486 U.S. 622, 641, 649 (1988) (holding "seller" in § 12(l) of the 1933 Act is limited to person who passes title, offers or solicits securities and rejecting broader contention based in tort doctrine that persons who participate in sales should also be deemed sellers where "no congressional intent to incorporate tort law doctrines of reliance and causation into § 12(l)"); Blue Chip Stamps v. Manor Drug Stores, 421 U.S.

plead with particularity defendant MCI's projections and statements of optimism).

723, 744 (1975) (phrase "in connection with the purchase or sale of any security" in Rule 10b-5 is limited to actual purchasers and sellers; rejecting SEC's attempt to expand provision to include plaintiffs who would have had common-law misrepresentation claim). See Responsive Br. at 11-15. Because a "duty to investigate" and "implied statement" are not found in the statute and do not find "unmistakable support in the history and structure of the legislation" this Court cannot "tak[e] such liberty with the statutory language", Blue Chip, 421 U.S. at 756 (Powell, J. concurring), by inserting those concepts into the statute.[20] Superimposing a duty to investigate and "implied" statements, neither of which appear anywhere in the statutory scheme, on §10(b) or Rule 10b-5(b) is an unsupportable foundation on which to ground primary liability.

III. THE SEC'S "IMPLIED REPRESENTATION" THEORY WOULD DILUTE THE STATUTORY SCIENTER REQUIREMENT.

The scienter element requires the SEC to allege facts showing that the defendant acted with "the intent to deceive, manipulate or defraud." Ernst, 425 U.S. at 193-94 & n.12. That is, the defendant must be shown to "either consciously intend[] to defraud or … act[] with a high degree of recklessness." Miss. Public Employees Ret. Sys. v. Boston Scientific Corp.,

[20] The SEC mistakenly relies on Good v. Altria Group, Inc., 501 F.3d 29, 41 (1st Cir. 2007), aff'd, 129 S.Ct. 538, 545 (2008), which addresses a misrepresentation in the context of a duty not to deceive, as codified in a state statute, to determine whether the state-law claim was preempted by the Federal Cigarette Labeling and Advertising Act. SEC Reply Brief at 8-9.

523 F.3d 75, 85 (1st Cir. 2008). Scienter under Rule 10b-5 "comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence." Greebel, 194 F.3d at 198-99; accord Hoffman v. Estabrook & Co., Inc, 587 F.2d 509, 516-17 (1st Cir. 1978) (allegations that underwriter failed to investigate and review draft offering memorandum, which underwriter knew to be incorrect, insufficient to allege scienter).[21] The "complaint must contain factual allegations, either direct or circumstantial" with respect to scienter; mere negligence is not enough. Geffon v. Micrion Corp., 249 F.3d 29, 35 (1st Cir. 2001). The sufficiency of scienter must be determined by reviewing the complaint as a whole. N.J. Carpenter's Pension & Annuity Funds v. Biogen, IDEC Inc., 537 F.3d 35, 45 (1st Cir. 2008).

As set forth in Point I, supra, the SEC failed to allege that Mr. Tambone made, reviewed, edited or approved the Prohibition that is at the heart of the SEC's claims. See SEC v. PIMCO Advisors Fund Mgmt. LLC, 341 F. Supp. 2d 454, 459 (S.D.N.Y. 2004) (complaint stated claim against distributor's CEO, who signed disclosure limiting round trips and signed market-timing arrangement, but not against advisor's CEO, who did not sign documents). Moreover, Columbia Advisors' approval of the arrangements

[21] "Reckless" means "that the actor has intentionally done an act of unreasonable character in disregard of a risk known to him or so obvious that he must have been aware of it, and so great as to make it highly probable that harm would follow." Hoffman, 587 F.2d at 509 (quoting W. Prosser, Law of Torts 185 (4th ed. 1971).

with all but one of the investors (Compl. at ¶44) -- which the SEC never challenged as an abuse of the advisor's discretion or after a full investigation alleged that there was actual harm to the investors or the funds -- leads inescapably to inferences that the advisor had determined that the trading was not excessive, that the determination was the advisor's to make, that Mr. Tambone knew the advisor had the expertise and discretion to make that determination and that an arrangement with approval was entirely consonant with the Prohibition.[22] See O'Brien v. DiGrazia, 544 F.2d 543, 546 n.3 (1st Cir. 1976) ("when a complaint omits facts that, if they existed, would clearly dominate the case, it seems fair to assume that those facts do not exist"). "A statement cannot be intentionally misleading if the defendant did not have sufficient information at the relevant time to form an evaluation that there was a need to disclose certain information and to form an intent not to disclose it." Biogen, 537 F.3d at 44-45, 49 (complaint did not adequately

[22] The investment advisor is "an independent entity" which "provides [the fund] with investment advice, [and] management services." In re Fidelity/Micron Sec. Litig., 964 F. Supp. 539, 543 (D. Mass. 1997). See Responsive Br. at 7. The investment advisor "determines the composition of the funds, including the instruments to be purchased, exchanged, retained or sold, the amounts of cash and other investments, and the timing of the execution of those transactions." In re Mutual Fund Inv., 566 F.3d at 126-27 (internal citations omitted). "The SEC has also noted that '[a]s a result of their extensive involvement, and the general absence of shareholder activism, investment advisers typically dominate the funds they advise.' " Id. at 127 (quoting Role of Independent Directors of Investment Companies: Final Rule, 66 Fed. Reg. at 3735 n.3 (Jan. 16, 2001)). In sum, "[t]he fund's portfolio management is the responsibility of the investment adviser … which … selects someone from its staff to serve as the fund's portfolio manager." Clifford E. Kirsch, Mutual Fund Regulation, § 6:1 (2d ed. 2005 & Supp. 2009); see In re Mutual Fund Inv., 566 F.3d at 126-27.

allege that statements concerning new drug were materially misleading or that defendants acted with scienter where complaint did not establish defendants were aware of facts, at the time they made their predictions, that failure to provide additional information was misleading); Hoffman, 587 F.2d at 517 (insufficient allegations of scienter where underwriter of offering memorandum knew of significant engineering and mechanical difficulties with product and reviewed drafts of offering memorandum).[23]

Yet, the SEC's "implied representation" theory would nonetheless impose liability. As this Court has stated, "[i]ntent to deceive means intent to say something ... that is not believed to be true, or, if strictly true, is hoped will be understood in an untruthful sense." Geffon, 249 F.3d at 35 (citation omitted; emphasis added). Scienter may be established either "by proving knowing conduct" or "reckless statements of misleading facts" Id. If knowing conduct is alleged, the plaintiff must show "more than mere proof that the defendants knowingly made a particular statement" i.e., that "defendants knew (i) that the statement was false or misleading, and (ii) that

[23] As to the "hundreds" of selling agreements Tambone signed, there are no allegations connecting them to any of the funds or investors. See Tambone, 473 F. Supp. at 167. In addition, the SEC did not allege that all funds in the Columbia mutual fund complex were governed by the standard selling agreement, but only that the sales from Columbia Distributors to the broker-dealers were "generally governed" by standard selling agreements. Compl. at ¶40. That Tambone signed agreements does not entitle the SEC to an inference of scienter, as the SEC also alleged there are 140 funds in the Columbia mutual fund complex, id. at ¶1, all of which Tambone managed, and for which many such selling agreements, totally unrelated to the allegations, would have been signed.

it was made in reference to a matter of material interest to investors." Id. (citations omitted). If recklessness is offered to show scienter, the plaintiff must allege and prove "a highly unreasonable omission, involving not merely simple, or even inexcusable, negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious the actor must have been aware of it." Id. at 35-36 (citations omitted); Hoffman, 587 F.2d at 509. Here, as set forth above there are no allegations of "knowing conduct" either with respect to the Prohibition itself or with respect to the arrangements and trading.[24]

If "implied representations" can take the place of actual statements under §10(b) and Rule 10b-5(b), these stringent requirements will be diluted to the point of all but disappearing from the statutory scheme. And this, of course, the courts cannot do. E.g., Central Bank, 511 U.S. at 175; Ernst, 425 U.S. at 212-213 ("administrative history of the Rule … mak[es] clear that when the Commission adopted the rule it was intended to apply to activities that involved scienter or "intentional wrongdoing.")

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[24] Cf. PIMCO, 341 F. Supp. 2d at 459-460, 464-65 (distributor's CEO signed disclosure specifically limiting round trips, signed the market timing arrangement with Canary permitting it to trade on a multi-billion scale (within months) in several funds, knew the trading harmed the funds monetarily as alleged, admitted trading was disruptive and failed to disclose the disruptive practices to the Board of Trustees or investors); SEC v. Druffner, 517 F. Supp. 2d 502, 506-08 (D. Mass. 2007) (use of numerous broker identification numbers and nearly 200 brokerage accounts to carry out market timing, many in defendant's name, including new accounts opened after old accounts were blocked).

CONCLUSION

For the foregoing reason and for the reasons set forth in prior briefs submitted in this matter, James Tambone respectfully requests that the Court affirm the district court's dismissal of the SEC's Section 10(b) claim against him.

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