

Money Voices: New Legal Challenge for Fund Execs

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It's a standard practice in the mutual fund industry for officers and employees of fund distributors to use a prospectus written by others during the sales process. This practice was recently called into question by a United States Court of Appeals for the First Circuit decision. The ruling puts distributors' employees at risk of personal liability for material misstatements or omissions in sales documents that they did not author.

The decision extends the reach of the Securities and Exchange Commission's enforcement power and places additional burdens on mutual fund complexes. More importantly, this decision may arm private plaintiffs with a weapon they did not previously wield. As a result, if the ruling stands, it will pose more risk for fund distributors and broker-dealers and their employees and will require increased expenditures on education, compliance and other preventative measures.

SEC v. Tambone arose from the market-timing scandal that erupted in 2003. The commission sued two senior executives of Columbia Funds Distributor, Inc., the principal underwriter for the Columbia Mutual Funds. In response to market-timing activity, the funds added language to their prospectuses that they did not permit any market timing. The SEC alleged that the executives subsequently made arrangements to allow favored investors to make "round trips" in exchange for "sticky asset" investments in other vehicles. The commission charged that the executives were liable for the prospectus statements even though they had not drafted the documents because these executives apparently "knew" the included information was false.

The First Circuit ruled that the executives had a duty to confirm the accuracy and completeness of the prospectuses used to sell the funds. The court held that the use of a prospectus to sell securities by an individual who knows that the document contains a misstatement is an "implied [mis]statement" that is actionable under the securities laws. This decision adds to the SEC's arsenal by establishing "primary" liability for remote (or "secondary") actors. Now, employees of a distributor who "use" an issuer's prospectus to sell shares can be personally liable if they either knew or should have known the prospectus contained misrepresentations.

Until this decision, fund purchasers had no legal grounds against individuals who "aided or abetted" prospectus disclosure violations. By making remote-sales employees prospectively liable for prospectus misstatements they did not make, the ruling broadens the array of targets mutual fund shareholders can sue. That in turn expands the plaintiffs' bar's litigation options against mutual fund complexes.

Tambone blurs the fault line between "primary" violators and remote players in the mutual fund sales chain. Unless it is modified or reversed, the decision should give pause to any executive or employee involved in the issuance and sale of public securities. The court's decision dramatically expands the familiar scope of the securities laws and could represent a tectonic shift in the landscape of litigation and liability that mutual fund complexes and broker-dealers face.

Industry professionals would be well-advised to conduct a comprehensive review of their prospectuses and annual reports. They should institute strict education and compliance programs to ensure that employees in the sales effort understand the impact of this decision. Moreover, fund companies should rely on their in-house and outside counsel to help establish policies and procedures that will make it harder for the SEC or private plaintiffs to establish a knowing violation of the securities laws.

Ropes & Gray counsel R. Daniel O'Connor contributed to this article.