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Second Circuit Limits Criminal Prosecution of Securities Fraud

Last week, the U.S. Court of Appeals for the Second Circuit limited the reach of criminal prosecutors in cases involving foreign securities and foreign transactions, providing defense counsel with ammunition to challenge such prosecutions. The court's holding also affects sentencing issues, such as relevant conduct under the Sentencing Guidelines and restitution orders issued pursuant to the Mandatory Victim Restitution Act.

In *Morrison v. National Australia Bank Ltd.*, the U.S. Supreme Court limited the extraterritorial reach of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, finding that they applied only if the securities fraud was in connection with (1) a security listed on a U.S. exchange, or (2) a security purchased or sold in the United States. *Morrison* was a civil case, however, and the Court left open the question whether the same conclusion would be reached in a criminal case.

Last week, in *United States v. Vilar and Tanaka*, the Second Circuit had "no problem" holding that criminal liability under Section 10(b) and Rule 10b-5 was cabined in the same way as civil liability, and that they did not apply to extraterritorial conduct. Notwithstanding the ease with which the court reached this conclusion, *Vilar* is still important. First, the court provided a helpful analysis of the facts that could prove that transactions not involving U.S. listed securities are nevertheless "domestic" and thus subject to prosecution in the United States. Second, *Vilar* serves as a reminder that decisions regarding the scope of

criminal conduct may also affect sentencing issues such as "relevant conduct" under the Sentencing Guidelines and restitution under the Mandatory Victim Restitution Act.

Vilar and Tanaka were convicted of lying "to clients about the nature and quality of certain investments." They engaged in two main schemes. First, they offered a select group of clients the opportunity to invest in "Guaranteed Fixed Rate Deposit Accounts" ("GFRDA"), and promised a high, fixed rate of return from funds invested in high-quality instruments such as U.S. Treasury bills and publicly traded emerging growth stocks. Instead of making these investments, Vilar and Tanaka sought to exceed the high "guaranteed" rates of return, and invested their clients' money in technology and biotechnology stocks, the value of which plummeted when the dot-com bubble burst. Second, as the GFRDA scheme was falling apart, Vilar and Tanaka approached a long-standing client about investing in a Small Business Investment Company ("SBIC"). After the client made a \$5 million investment in the SBIC, Vilar and Tanaka drew on her funds to meet various personal and corporate obligations, including a donation to Vilar's alma mater and a settlement with a former GFRDA investor. When the SBIC investor requested the return of her money, and was directed to an entity with which she never dealt, she reported the matter to the SEC. After Vilar lied to the SEC hoping to obscure the SBIC scheme, an indictment and convictions of both Vilar and Tanaka followed. The SEC also pursued civil charges against them.

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After their convictions, the Supreme Court decided *Morrison*, which limited civil securities fraud liability to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities." Vilar and Tanaka argued that their convictions should be reversed, claiming that *Morrison* applied equally in the criminal context. Despite the apparent significance of the issue, the Second Circuit had "no problem" ruling that *Morrison* applied to criminal securities fraud actions. The court concluded that the "presumption against extraterritoriality" applied equally to criminal statutes, and also to Section 10(b) and Rule 10b-5, finding no basis for excluding criminal statutes from the rule that bars extraterritorial application absent a clear contrary indication from Congress.

But, in the part of the opinion that should be most interesting for criminal and civil practitioners alike, the Second Circuit let Vilar and Tanaka's convictions stand based on an analysis of the factual record that it found satisfied the test in *Morrison*; that is, that Vilar and Tanaka committed fraud "in connection with domestic securities transactions."

Given that the government did not claim that the securities at issue were listed on American exchanges, the court had to determine whether the conduct at issue involved a "domestic" purchase or sale of securities. To answer this question, the court applied a test it articulated in a civil case it decided after *Morrison* called *Absolute Activist Value Master Fund Ltd. v. Ficeto*: do the facts prove that the parties incurred "irrevocable liability" to carry out the transaction within the United States or that title passed within the United States?

What sort of conduct meets this test? Under the court's *Absolute Activist* decision, some conduct clearly did not. For example, the marketing and sale of the GFRDA securities to customers based in the United States, and directions to investors to wire funds to a New York bank, were insufficient to demonstrate a domestic securities transaction for the purposes of Section 10(b).

However, with respect to the GFRDA purchases, the record contained other sufficient facts regarding the "formation of the contracts," and the "exchange of money" that showed that "irrevocable liability was incurred in the United States." For example, correspondence between Vilar and a victim family showed that the victims committed to the GFRDA investment in Puerto Rico. And other evidence showed that the family reinvested their money in the GFRDA when a family member was in Puerto Rico. Similarly, Vilar sent a series of letters to another victim that showed that the victim was in New York when she received and signed the commitment forms for her GFRDA and sent the money required for opening her account. Regarding the SBIC scheme, the investor executed the documents necessary to invest in the SBIC in her New York apartment and handed those documents to a New York messenger.

The court's ruling on the extraterritorial reach of Section 10(b) and Rule 10b-5 also affected two sentencing issues: the calculation of the Sentencing Guidelines and the extent of the court's restitution order.

Vilar and Tanaka's Sentencing Guideline range largely derived from a calculation of the losses resulting from the criminal offense. Here, the district court calculated these losses as between \$20 million and \$50 million, which included losses suffered

by domestic purchasers and other victims who purchased securities abroad. Given the court's conclusion that foreign transactions could not form the basis of a criminal offense, the question left was whether losses from foreign transactions may nevertheless constitute "relevant conduct" and be properly included in the offense level calculation under the Sentencing Guidelines. The court sent this question back to the district court for consideration on remand. So, stay tuned.

The court did order a recalculation of a \$35 million restitution order issued under the Mandatory Victim Restitution Act ("MVRA"). Restitution under the MVRA is payable by defendants only to their "victims," and then only for "loss caused by the specific conduct that is the basis of the offense of conviction." While the general rule is that losses from "relevant conduct" may be considered under the Sentencing Guidelines, restitution for such losses is not allowed. Thus, the court ruled that the district court must re-calculate restitution, excluding from that amount losses suffered by investors who purchased securities abroad. Simply put, under the court's holding, these investors are "not victims of the offense."

In cases involving the fraudulent sale of foreign securities, *Morrison* and *Vilar* will require prosecutors to develop facts tying the defendants' and victims' transactions to the United States. In some cases, like *Vilar*, this may not be too difficult. But defendants and their counsel should carefully consider whether they can challenge an American prosecution of an allegedly fraudulent securities scheme where the conduct involved foreign securities and the transactions were conducted on foreign soil.