New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 250—NO. 79
TUESDAY, OCTOBER 22, 2013

SECOND CIRCUIT REVIEW

Expert Analysis

# Section 10(b) Liability Does Not Apply To Extraterritorial Criminal Conduct

By **Martin Flumenbaum** And **Brad S. Karp**

This month, we discuss *United States v. Vilar*,[1] in which the U.S. Court of Appeals for the Second Circuit considered whether criminal liability under Section 10(b) of the Securities Exchange Act of 1934 applies to the purchase and sale of securities outside of the United States.[2] The court's opinion, written by Judge José A. Cabranes and joined by Judge Jon O. Newman and Judge Chester J. Straub, addressed an issue left unsettled following the Supreme Court's 2010 decision in *Morrison v. National Australia Bank*,[3] which held that civil liability under Section 10(b) does not apply to an extraterritorial purchase or sale of securities. *Morrison*, however, did not address the applicability of Section 10(b) criminal liability to extraterritorial conduct. Affirming the district court's opinion, the court held that Section 10(b) and its implementing regulation, Rule 10b-5, do not apply to extraterritorial conduct, regardless of whether the liability is criminal or civil.[4]

### Background

This case arises from a criminal conviction of Alberto Vilar and Gary Alan Tanaka in the U.S. District Court for the Southern District of New York. Vilar and Tanaka were prominent investment managers and advisers, who at the peak of their careers were responsible for managing more than $9 billion in investments for their clients. Vilar and Tanaka principally managed their clients' investments through three main entities: (1) Amerindo Investment Advisors Inc. (Amerindo U.S.), an investment adviser registered with the Securities and Exchange Commission; (2) Amerindo Investment Advisors Inc. (Amerindo Panama), a Panamanian corporation that managed investments offered to U.S. investors; and (3) Amerindo Investment Advisors (UK) Ltd. (Amerindo U.K.), a United Kingdom corporation that managed a portfolio of U.S. emerging growth stocks for U.K. investors.

From the mid-1980s until 2005, Vilar and Tanaka told clients, among them Lisa Mayer and Graciela Lecube-Chavez, that their money was invested in Guaranteed Fixed Rate Deposit Accounts (GFRDAs). Those investments were represented to be stable and low-risk. Indeed, according to Vilar and Tanaka, the GFRDAs would be predominantly invested in high-quality, short-term deposits, such as Treasury bills, providing investors a high, fixed rate of interest over a set term. The remainder of the capital from the GFRDAs would be invested in publicly traded emerging growth stocks.

Contrary to what Vilar and Tanaka promised investors, the GFRDAs were volatile and risky investments. Unbeknownst to investors, Vilar and Tanaka invested all of the funds from the GFRDAs in technology and biotechnology stocks.

After the dot-com bubble "burst" in the fall of 2000, the value of the investments held in the GFRDAs fell drastically. Vilar and Tanaka were unable to pay the promised rates of return, and many of the GFRDA investors subsequently lost millions of dollars.

In June 2002, as the GFRDA scheme was unraveling, Vilar and Tanaka approached a long-standing client, Lily Cates, about an opportunity to invest in a Small Business Investment Company (SBIC). The SBIC was an investment vehicle that receives government benefits. Vilar represented to Cates that he and Tanaka had acquired the necessary SBIC license, which would have allowed the SBIC to obtain matching funds from the federal government's Small Business Administration. In fact, however, Vilar and Tanaka did not have an SBIC license and had been denied the license multiple times.

Relying on Vilar and Tanaka's misrepresentations, Cates invested $5 million in the phony SBIC, which Vilar and Tanaka used to fulfill their various personal and corporate obligations, ranging from paying part of a settlement agreement with former investors to making payments on a personal mortgage. By early 2005, Cates had grown suspicious of Vilar and Tanaka after she had tried to close her account and was told that she would have to make her request to a separate foreign entity with which she had no previous dealings. Subsequently, Cates reported Vilar and Tanaka to the SEC.

### District Court Case

Following the SEC's initial inquiry, the Department of Justice indicted Vilar and Tanaka on Aug. 15, 2006, charging them with 12 separate counts, including two counts of securities fraud in violation of Rule 10b-5 relating to the SBIC scheme (Count Two) and the GFRDA scheme (Count Three).

With respect to the SBIC scheme, the government asserted that Vilar and Tanaka lied to Cates about the nature of her SBIC investment, particularly Vilar's misrepresentations about obtaining the SBIC license. With respect to the GFRDA scheme, the government asserted that Vilar and Tanaka misrepresented the investment mix backing the GFRDAs to their investors.

On Nov. 19, 2008, after a nine-week jury trial before Judge Richard Sullivan in the Southern District of New York, Vilar was convicted on all 12 counts and Tanaka was convicted on three counts and acquitted on the remaining counts. Both were convicted of securities fraud relating to the GFRDA scheme; only Vilar was convicted

MARTIN FLUMENBAUM *and* BRAD S. KARP *are members of Paul, Weiss, Rifkind, Wharton & Garrison. They specialize in complex commercial litigation and white-collar criminal defense matters.* HARRY M. JACOBS, *a law clerk at the firm, assisted in the preparation of this column.*

of securities fraud relating to the SBIC scheme. Vilar was sentenced to 108 months imprisonment and Tanaka was sentenced to 60 months imprisonment. The district court ordered both defendants to pay nearly $35 million in restitution and forfeit over $54 million.

**Second Circuit Opinion**

On appeal, the Second Circuit considered whether the Supreme Court's limits on the geographic scope of Section 10(b) liability established in *Morrison* apply to criminal prosecutions brought pursuant to that statute. In *Morrison*, the Supreme Court rejected the extraterritorial application of Section 10(b) and Rule 10b-5 and held that "Section 10(b) reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security *listed on an American stock exchange*, and the purchase or sale of any other security *in the United States*."[5] *Morrison* dealt specifically with civil liability.

Defendants argued, among other things, that they could not be held criminally liable for securities fraud because their fraudulent conduct in the GFRDA scheme and the SBIC scheme[6] occurred outside the United States and therefore was not governed by Section 10(b) or Rule 10b-5. They contended that the Supreme Court's holding in *Morrison*, which was decided after Vilar and Tanaka were convicted, limited Section 10(b) and Rule 10b-5 liability to fraud committed in connection with "transactions in securities listed on domestic exchanges, and domestic transactions in other securities," and that the court's holding extends equally to cases of criminal as well as civil liability.[7] The government argued that *Morrison's* geographic limitations apply only in cases involving civil liability, or, in the alternative, that Vilar and Tanaka's illegal conduct consisted of domestic transactions.

The Second Circuit explained that, in general, the presumption against extraterritoriality applies to criminal statutes. Only in rare situations, such as where the purpose of a law is to protect the right of the government to defend itself, does the presumption against extraterritoriality not apply to criminal statutes.[8] The court then held that Section 10(b) is not an exception to the general presumption and that the statute does not apply extraterritorially. The court based its reasoning on the "commonsense notion that Congress generally legislates with domestic concerns in mind"[9] and "the presumption that United States law governs domestically but does not rule the world."[10] Therefore, the court held, a criminal statute has no extraterritorial application unless it provides a clear indication that it applies extraterritorially.

Moreover, the court explained that the presumption against extraterritoriality is a tool for statutory interpretation that must be applied consistently in every case. Once it is determined that a statute does not apply extraterritorially, the statute must be interpreted the same way in each case involving that statute. The court noted that the Supreme Court had already unambiguously determined in *Morrison* that Section 10(b) liability does not apply extraterritorially. Therefore, the only issue it needed to address here was whether the conduct in question occurred extraterritorially. In other words, the court needed only to determine whether Vilar's and Tanaka's conduct had a sufficient domestic nexus to violate Section 10(b).

Under *Morrison*, a defendant may be convicted of securities fraud under Section 10(b) or Rule 10b-5 only if the defendant has engaged in fraud relating to either (1) a security listed on an American exchange, or (2) a security purchased or sold in the United States. Because the GFRDAs and SBICs at issue in this case were not listed on an American exchange, Vilar and Tanaka could only be found guilty of violating Section 10(b) if they engaged in fraud in connection with a domestic purchase or sale of securities.

> The Second Circuit addressed an issue left unsettled following the Supreme Court's 2010 decision in 'Morrison.'

The court applied the standard articulated in a prior Second Circuit case, *Absolute Activist*, to determine whether the GFRDA and SBIC securities were purchased or sold in the United States.[11] Under the framework laid out in *Absolute Activist*, a "securities transaction is domestic when the parties incur irrevocable liability to carry out the transaction within the United States or when title is passed within the United States."[12] In other words, a domestic transaction occurs when a purchaser incurs irrevocable liability to take and pay for a security or a seller incurs irrevocable liability to deliver a security while the defendant is physically located within the United States.

The court proceeded to clarify the type of conduct that constitutes a domestic purchase or sale of securities. Applying the *Absolute Activist* framework, the court determined that the securities at issue were "purchased or sold in the United States."

With respect to the GFRDA scheme, Lisa Mayer entered into and renewed her investment agreement with Vilar and Tanaka in Puerto Rico.[13] Vilar and Tanaka then sent a letter confirming Mayer's investment to her home in Puerto Rico. Additionally, Graciela Lecube-Chavez received and signed commitment forms for her GFRDA investment and sent the required money to fund her account while located in the United States.

With respect to the SBIC scheme, Lily Cates met with Vilar at his apartment in New York to discuss her potential investment. Cates then executed the required documents to invest in the SBIC in her apartment in New York, and transported those documents by messenger in New York.

This evidence of the "formation of the contracts" and "the exchange of money" occurring domestically was sufficient to prove the incurrence of irrevocable liability in the United States, thus rendering Vilar's and Tanaka's conduct a domestic transaction.[14] The court therefore upheld Vilar's and Tanaka's convictions, explaining that there was no plain error in their convictions relating to the territoriality of their conduct and the evidence fully supported the jury's verdict.

**Implications**

The Second Circuit's decision in *Vilar* clarifies that Morrison applies equally to criminal and civil cases, making clear that Section 10(b) liability does not apply to extraterritorial conduct. As a result, prosecutors will be limited in their ability to seek criminal liability for extraterritorial purchases or sales of securities. To bring a criminal prosecution under Section 10(b) for securities fraud relating to an international transaction of a security not listed on an American exchange, prosecutors will be required to demonstrate some domestic geographic nexus.

Now that the Second Circuit has articulated that Section 10(b) liability does not apply to extraterritorial conduct, the determinative question will become whether the conduct at issue is domestic in nature. *Absolute Activist* provided a framework for determining what constitutes a domestic securities transaction, and *Vilar* further clarified the type of conduct considered domestic. Ambiguity exists, however, as to what conduct might provide a sufficient domestic nexus, and the resolution ultimately remains a factual question for a jury.

1. No. 10-521-cr; 10-580-cr; 10-4639-cr, __F.3d__, 2013 WL 4608948 (2d Cir. Aug. 30, 2013).
2. 15 U.S.C. §78j.
3. __U.S.__, 130 S. Ct. 2869 (2010).
4. 17 C.F.R. §240.10b-5.
5. *Morrison*, 130 S. Ct., at 2877 (emphases added).
6. Only Vilar made arguments on appeal about the securities fraud relating to the SBIC scheme since Tanaka was acquitted on this count.
7. Id. at 2884.
8. See, e.g., *United States v. Gatlin*, 216 F.3d 207 (2d Cir. 2000) (holding that a statute that prohibits crimes against the U.S. government may be applied extraterritorially even absent clear evidence that Congress intended such an application).
9. *Vilar*, 2013 WL 4608948, at *5 (quoting *Smith v. United States*, 507 U.S. 197, 204 n.5 (1993)).
10. Id. (quoting *Kiobel v. Royal Dutch Petroleum*, __U.S.__, 133 S. Ct. 1659, 1664 (2013).
11. *Absolute Activist Value Master Fund v. Ficeto*, 677 F.3d 60 (2d Cir. 2012).
12. *Vilar*, 2013 WL 4608948, at *19 (quoting *Absolute Activist*, 677 F.3d at 69).
13. According to *United States v. Acosta-Martinez*, "the default rule presumes the applicability of federal laws to Puerto Rico." 252 F.3d 13, 20 (1st Cir. 2001).
14. *Absolute Activist*, 677 F.3 at 70.