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SECOND CIRCUIT REVIEW

Expert Analysis

Court Reverses Jury Verdict for SEC in Market Timing Case


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This month, we discuss *SEC v. O'Meally*,[1] in which the U.S. Court of Appeals for the Second Circuit overturned a jury verdict in favor of the Securities and Exchange Commission against a mutual fund broker for using an allegedly deceptive market timing strategy. The court's opinion, written by Judge Dennis Jacobs and joined by Judge Guido Calabresi and Judge Rosemary S. Pooler, focused on the sufficiency of the evidence to support a negligence finding under Sections 17(a)(2) and (a)(3) of the Securities Act of 1933. The court held that the evidence presented by the SEC was insufficient to support a finding of negligence, and reversed the judgment.

Background

From 1994 to 2003, Frederick O'Meally worked as a licensed broker for Prudential Securities. On behalf of his clients, mainly money managers at hedge funds, O'Meally traded shares of mutual funds using a strategy known as market timing. This tactic, a form of arbitrage, involved numerous short-term trades in a fund's shares to exploit perceived inefficiencies in pricing.

Market timing is legal. But it can disadvantage long-term investors by increasing a fund's transaction costs, impairing a fund's ability to maintain liquidity, and limiting a fund's ability to invest in long-term assets.[2] As a result, mutual funds, which are long-term in nature, often attempt to combat market timing strategies by restricting their use. And, while pursuing a market timing strategy is legal in and of itself, doing so deceptively is not.

In this case, a number of funds in the 60 accounts that O'Meally managed sought to restrict the use of market timing. These funds identified transactions associated with O'Meally's financial advisor number and attempted to prohibit O'Meally from further trading. With Prudential's support, the funds sent "block notices" to O'Meally, alerting him that his market timing practices had violated the funds' regulations, and precluded him from trading with specific accounts.

Nevertheless, O'Meally continued to engage in market timing on behalf of his clients. He hid his activity by trading in the blocked accounts under new financial advisor and customer account numbers. During the relevant period of January 2001 to September 2003, he became one of the most successful traders at Prudential, earning approximately $3.8 million.[3]

Prior Proceedings

In 2006, the SEC brought a civil action against O'Meally and a number of co-defendants in the Southern District of New York. In addition to Section 17(a) of the Securities Act, the SEC alleged that O'Meally had violated Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5. While his co-defendants settled, O'Meally chose to go to trial. A five-week jury trial concluded in December 2011.

At trial, the SEC sought to demonstrate that O'Meally understood the instructions of the funds and Prudential to refrain from market timing, and that he intentionally disregarded those instructions through deceptive practices. O'Meally countered by introducing evidence demonstrating that the fund policies were vague, that Prudential supervisors sanctioned his tactics, and that his use of multiple financial advisor account numbers was meant for legitimate purposes.

At the close of evidence, O'Meally moved for judgment as a matter of law under Rule 50 of the Federal Rules of Civil Procedure.[4] He argued that the SEC had offered insufficient evidence to sustain a negligence conviction, as the SEC centered its case on proving intentional conduct. And, O'Meally argued, the SEC failed to introduce expert evidence to show an applicable standard of care that would determine negligence. The district court reserved its ruling until after the jury verdict.

The jury found that O'Meally did not engage in any intentional misconduct. But it convicted O'Meally of negligently violating Sections 17(a)(2) and (a)(3) of the Securities Act with respect to six particular funds.[5]

After the jury found O'Meally negligent, he renewed his Rule 50 motion challenging the sufficiency of evidence regarding negligence. The district court rejected O'Meally's argument that the SEC had failed to offer evidence sufficient to establish negligence, holding that the jury could have found negligence "with regard to either [i] the specialized and technical aspects of his job or [ii] the common task of reading and heeding emails from a supervisor."[6]

The district court also dismissed O'Meally's suggestion that negligence could not be established absent expert testimony regarding the appropriate stan-

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dard of care, because the second theory behind O'Meally's negligence—concerning the "common task of reading and heeding emails from a supervisor"—did not require such testimony.[7] Under this second theory of liability, the district court sustained the negligence verdict.

O'Meally was ordered to pay a penalty of $60,000, disgorgement of over $440,000 in fees he had earned, and prejudgment interest. O'Meally appealed to the Second Circuit, arguing that the district court erred by denying his Rule 50 motion.

The Second Circuit's Decision

Reviewing the district court's denial of the Rule 50 motion de novo, the court began its decision by referencing the relevant provisions of Section 17. Sections 17(a)(2)-(3) of the Securities Act make it unlawful for any person in the offer or sale of securities: "(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."[8] The court noted that scienter is not required for a conviction under these provisions; negligence is sufficient.

The court explained, however, that under either theory as to how O'Meally acted negligently—either (1) by unreasonably making false or misleading statements to the relevant mutual funds, or (2) by unreasonably failing to follow emailed instructions from his Prudential supervisors—the evidence at trial was insufficient to support a verdict.

With respect to the first potential ground for conviction, the SEC argued on appeal that O'Meally made false or misleading statements to the mutual funds by using alternative financial advisor and customer account numbers to conceal his trading activity. The SEC emphasized that the mutual funds "dictated the 'law' to be followed by O'Meally,"[9] and O'Meally thus acted negligently toward the funds themselves.

The court rejected this argument, noting that while the funds' prospectuses may have prohibited market timing, these restrictions were applied inconsistently. Indeed, many of the SEC's own witnesses from the funds admitted that exceptions were made to allow market timing, despite clear written policies proscribing the practice. The court explained that, if the funds were making exceptions to market timing restrictions for other brokers, it was not unreasonable for O'Meally to believe he could engage in the same behavior. Whether a specific exception was made for O'Meally was beside the point. And, Prudential's own compliance and legal departments had in fact approved O'Meally trading practices on multiple occasions.

The court next addressed O'Meally's argument that negligence could not be established without expert testimony regarding the appropriate conduct of a person in O'Meally's position. The court explained that expert testimony regarding appropriate conduct was unnecessary because the only evidence offered by the SEC at trial concerned deliberate acts. The SEC had not referenced negligence in its opening or closing arguments, and negligence was not brought to the jury's attention until the jury charge was given.

The O'Meally decision represents a rare instance of the Second Circuit overturning a jury verdict in favor of the SEC based on the sufficiency of the evidence.

The SEC's trial strategy—combined with the otherwise lawful nature of market timing, the absence of bad faith from O'Meally, and the mixed signals from the funds and Prudential—rendered any potential expert testimony irrelevant. The court concluded that any such testimony could not "have cured the central problem: the jury could not do more than speculate as to how a broker in O'Meally's position breached a standard of care (whatever it might be said to be)."[10]

Ultimately, the court rejected any negligence theory premised on O'Meally's failure to obey the funds' prohibitions of market timing. Referring to the SEC's version of this theory as a "gross simplification," the court concluded that no reasonable juror could have found O'Meally acted negligently toward the funds by continuing to trade using market timing.[11]

The court also rejected the SEC's second theory of negligence liability: that O'Meally unreasonably failed to obey Prudential's instructions to heed the funds' policies regarding market timing, and thus acted negligently toward Prudential. It noted that, while Prudential's "ostensible policy" was to comply with trading instructions from the funds, it in fact encouraged its traders to interpret these instructions "in the narrowest sense, so that only the specific [financial advisor] and customer numbers expressed in the letters were to be blocked; and otherwise, it was business as usual."[12] And, as with the first theory of liability, Prudential's legal and compliance teams—and O'Meally's supervisors—had approved of his continued trading in accounts other than those specifically referenced in the "block notices." The court concluded that no reasonable juror could have convicted O'Meally under this negligence theory.

After rejecting both theories of liability, the court considered the SEC's strategic choice at trial to pursue "a theory of scienter or nothing."[13] It noted that the SEC had failed to introduce any evidence on the appropriate standard of care for a negligence conviction, and had instead focused solely on intent and recklessness in its summation. On appeal, the SEC argued that it had in fact meant to pursue a negligence theory, pointing out references to negligence in the joint pretrial statement and jury charge (and to the fact that violations of Sections 17(a)(2)-(3) do not require proof of scienter). But the court rejected this argument, characterizing the SEC's mentions of negligence at trial as "stray references," and holding that the jury could not have reasonably convicted O'Meally given the "complete and utter failure of proof by the Commission."[14]

Implications

The O'Meally decision represents a rare instance of the Second Circuit overturning a jury verdict in favor of the SEC based on the sufficiency of the evidence. The case is noteworthy for the court's relatively harsh rebuke of the SEC's trial strategy, particularly at a time when the SEC has publicly emphasized its increased willingness to take matters to trial.[15]

1. 752 F.3d 569 (2d Cir. May 19, 2014).
2. Id. (citations omitted).
3. Id. at 572.
4. Fed. R. Civ. P. 50.
5. The six funds are American Century Funds, American Funds, Goldman Sachs Funds, Hartford Funds, PIMCO, and Van Kampen Funds.
6. *SEC v. O'Meally*, No. 06-6483-cv, 2012 WL 1969300 at *3-4 (S.D.N.Y. May 30, 2012).
7. Id. at *4-5.
8. 15 U.S.C. §§77q(a)(2)-(3).
9. *SEC v. O'Meally*, 752 F.3d 569, at 574.
10. Id. at 575.
11. Id.
12. Id. at 576.
13. Id.
14. Id. (internal quotation omitted).
15. Mary Jo White, Chairwoman, Securities & Exchange Comm'n, The Importance of Trials to the Law and Public Accountability (Nov. 14, 2013) (transcript available at http://www.sec.gov/News/Speech/Detail/Speech/1370540374908).