CLIENT UPDATE

SECOND CIRCUIT CURTAILS THE TERRITORIAL REACH OF CRIMINAL LIABILITY UNDER SECTION 10(b)

NEW YORK
Sean Hecker
shecker @debevoise.com

Matthew E. Kaplan
mekaplan@debevoise.com

Bruce E. Yannett
beyannettl@debevoise.com

DC
Paul R. Berger
prberger@debevoise.com

Colby A. Smith
casmith@debevoise.com

Jonathan R. Tuttle
jrtuttle@debevoise.com

Ada Fernandez Johnson
afjohnson@debevoise.com

On August 30, 2013, the United States Court of Appeals for the Second Circuit unanimously held that Section 10(b) of the Securities Exchange Act of 1934 ("Section 10(b)") does *not* apply to extraterritorial conduct, "regardless of whether liability is sought criminally or civilly." Interpreting the scope of the Supreme Court's landmark ruling in *Morrison v. National Australian Bank Ltd.*,[1] the Second Circuit's significant decision in *United States v. Vilar, et al.* means that a criminal defendant may be convicted of fraud under Section 10(b) only if the defendant engaged in fraud "in connection with" a security listed on a United States exchange or a security "purchased or sold" in the United States. In reaching its conclusion, the court rejected the government's attempts to distinguish criminal liability under Section 10(b) from the civil liability at issue in *Morrison*, holding that "[a] statute either applies extraterritorially or it does not, and once it is determined that a statute does not apply extraterritorially, the only question we must answer in the individual case is whether the relevant conduct occurred in the territory of a foreign sovereign."

FACTUAL BACKGROUND

Beginning in the mid-1980s, investment managers and advisors Alberto Vilar and Gary Tanaka offered select clients the opportunity

[1] 130 S. Ct. 2869 (2010).

to invest in "Guaranteed Fixed Return Deposit Accounts" ("GFRDA"), promising high, fixed-rate interest, and representing that an overwhelming majority of funds would be invested in high-quality, short-term deposits. Despite Vilar and Tanaka's claim that the GFRDA program would invest no more than twenty-five percent in publicly traded emerging growth stocks, they invested all of the funds in technology and biotechnology stocks. Following the burst of the dot-com bubble in 2000, the value of the investments held by the GFRDA dropped, and Vilar and Tanaka could not pay the promised rates of return.

In June 2002, with the GFRDA scheme unraveling, Vilar and Tanaka approached a long-standing client with the opportunity to invest in a Small Business Investment Company ("SBIC"). Vilar and Tanaka misrepresented that they were approved for an SBIC license, which allowed them to obtain matching funds from a federal program for the SBIC investments. The client invested $5 million in the SBIC, and Vilar and Tanaka drew on the funds to meet personal obligations. In early 2005, the scheme was fully exposed when the client requested that her money be returned, only to find that Vilar could not comply with the request.

In 2006, the Department of Justice ("DOJ") indicted Vilar and Tanaka on twelve separate counts, including securities fraud and investment advisor fraud. A jury in the Southern District of New York found Vilar and Tanaka guilty on the securities-related counts, and the District Court sentenced Vilar and Tanaka to prison and ordered both to pay almost $35 million in restitution and to forfeit more than $54 million. Vilar and Tanaka appealed their convictions to the Second Circuit.

THE SECOND CIRCUIT'S DECISION

On appeal, the defendants argued that their convictions for securities fraud could not stand because their conduct was extraterritorial and therefore not within the reach of Section 10(b). The defendants relied on *Morrison*, arguing that it limited Section 10(b) liability to domestic securities transactions, and that the defendants' companies fell outside Section 10(b)'s reach because they were deliberately designed and organized as offshore entities. In their brief to the Second Circuit, defendants argued that "offshore was the name of the game—to avoid domestic regulation, ensure secrecy, and to avoid domestic taxation." In response, the government argued, in part, that *Morrison*'s geographic limits applied only in the civil context and provided no bar to the defendants' criminal convictions.

In reviewing the threshold question of whether Section 10(b) applies extraterritorially in criminal actions, the Second Circuit held that "the general rule is that the presumption against extraterritoriality applies to criminal statutes, and Section 10(b) is no exception." The court divided its analysis into two parts. First, the court rejected the government's reliance on *U.S. v. Bowman*,[2] holding that *Bowman* stands for the proposition that the presumption against extraterritoriality *does* apply to criminal statutes, "except in situations where the law at issue is aimed at protecting 'the right of the government to defend itself.'" Because the purpose of Section 10(b) is to prohibit "[c]rimes against private individuals or their property," as opposed to a right of the government to protect itself, the court held that Section 10(b) is precisely the kind of statute for which the presumption against extraterritoriality applies. Second, the court held that the question of Section 10(b)'s extraterritorial reach had "in unmistakable terms" been decided by the Supreme Court in *Morrison*, noting that "[a] statute either applies extraterritorially or it does not." Therefore, the only question still left to be decided by the court was whether the conduct at issue occurred domestically or not.

The court then turned to the specific facts of *Vilar* to determine whether the transactions were "domestic" so as to bring them within the jurisdictional reach of the Exchange Act. In *Absolute Activist Value Master Fund Ltd. v. Ficeto*,[3] decided by the Second Circuit last year, the court held that a domestic transaction occurs when the parties incur irrevocable liability to carry out the transaction within the United States or when title is passed within the United States. On this point, the government argued, and the court agreed, that defendants' conduct was "domestic" under *Morrison* because aspects of the transactions at issue were "domestic transactions in other securities." Specifically, as to the GFRDA fraud, the court was persuaded that the transactions were domestic based on the fact that the victims entered into and renewed their investment agreements in Puerto Rico and New York. The court noted that the defendants' "intention to engage in foreign transactions" was "entirely irrelevant" to the question of Section 10(b)'s extraterritorial reach and similarly rejected a defense argument that their intention to evade United States law was "evidence of their innocence." Finding that the District Court record was replete with correspondence between the defendants and the victims, indicating they met in Puerto Rico to discuss the GFRDA program and committed to invest while in Puerto Rico, the court concluded that the record had evidence "concerning the formation of the contracts" and "the exchange of money," which was "precisely the sort that we indicated may suffice to prove that irrevocable liability was incurred in the United States." Accordingly, the

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[2] 260 U.S. 94 (1922).

[3] 677 F.3d 60 (2d Cir. 2012).

court upheld the defendants' convictions under Section 10(b). Significantly, however, the Second Circuit rejected the government's argument that the transactions were domestic because the GFRDA was marketed and sold to customers in the United States and because investors were directed to wire funds to a New York bank. The court reiterated that such facts are insufficient to demonstrate a domestic transaction for purposes of Section 10(b).

IMPACT OF THE *VILAR* DECISION

Although the *Vilar* decision provides much needed clarity on the question of whether *Morrison's* limits on the extraterritorial application of Section 10(b) reach criminal actions, the decision once again brings to the forefront the confusion around the impact of Section 929P(b) of the Dodd-Frank Act of 2010 ("Dodd-Frank"), which was enacted ostensibly to make *Morrison* inapplicable to SEC and DOJ actions. Although the intent of Congress in enacting Section 929P(b) appears to have been directed at making clear that *Morrison*'s bright line test does not apply to SEC or DOJ actions, the actual wording of the statute addresses only the "jurisdiction" of the "district courts of the United States" and not the substantive legal question of what conduct the law was intended to cover. Last month, a district court in Illinois was the first to comprehensively address the ambiguity of Section 929P(b), expressing skepticism that the provision could be interpreted to nullify *Morrison*'s bright line rule on the extraterritorial reach of the Securities Exchange Act.[4] Although the facts and conviction at issue in *Vilar* predate Dodd-Frank, the fact that the Second Circuit's decision is entirely silent on the question of Section 929P(b)'s applicability may be yet another signal that courts are reluctant to interpret the clear language of Section 929P(b) as anything more than a provision addressing the district court's jurisdiction. It remains to be seen how this issue will develop over the coming months. We expect that the SEC and DOJ will continue to press courts to apply Section 929P(b) in order to expand the government's ability to reach extraterritorial conduct.

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Please do not hesitate to contact us with any questions.

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[4] *See SEC v. A Chicago Conv. Ctr. LLC, et al.*, No. 13 C 982, 2013 WL 4012638, *1 (N.D. Ill. Aug. 6, 2013).