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PAUL MARCUS

The Use of Criminal Statutes to Regulate Financial Markets in the United States

Historically, violations relating to financial markets¹ in the United States have been primarily addressed in non-criminal settings. Private civil actions² and administrative enforcement actions³ have been utilized widely over the past fifty years. Today, however, Americans see considerable activity in the criminal justice system

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1. The discussion here is principally of federal securities laws, not offenses relating to banking or derivatives markets. Many other laws can be raised as well. See, for instance, these statutes: money laundering, 18 U.S.C §§ 1956, 1957; false statements, 18 U.S.C. § 1001; public utility holding company, 15 U.S.C. § 79; investment company, 15 U.S.C. §§ 80a, 80b; bank secrecy, 12 U.S.C § 1951-1959; bank holding company, 12 U.S.C. § 1841-1850. See generally, Pichholtz, *Securities Crimes*.

2. The implied civil action for damages under the Securities Exchange Act of 1934 is of particular significance, 15 U.S.C. § 78j(b). Though the statute itself does not set out any right for individuals to file suit for fraudulent behavior, the courts have consistently inferred such a right from the text of the statute and its legislative purpose. *Central Bank v. First Interstate Bank*, 511 U.S. 165 (1994); *Superintendent of Insurance v. Bankers Life and Casualty Co.*, 404 U.S. 6 (1971). Recognition of the private action, however, has resulted in decades of complex litigation concerning the meaning and scope of the civil suit. All of these difficult questions have been explored by United States courts in connection with the securities laws as applied to private civil claims: which individuals have standing to bring an action, what behavior constitutes fraud, are the parties required to be in a fiduciary relationship, what state of mind by the defendant is required, can the plaintiff demonstrate a causal link between the fraud and the loss, what is the appropriate measure of damages?

Recently, Congress expanded the litigation options available to private investors by passing the Insider Trading and Securities Fraud Enforcement Act of 1988, which complements the judicially created rights under the Securities Exchange Act of 1934. Even more recently, however, Congress imposed limitations on private actions in the Private Securities Litigation Reform Act of 1995. Pub. L. 104-67, 108 Stat. 737. Potentially, the Act may substantially alter the manner in which private rights of action are utilized in the securities fraud area. At this time, however, it appears too early to determine if that potential will in fact be realized. See Pitt, Groskaufmanis, Hardison & Johnson, "Promises Made, Promises Kept: The Practical Implications of the Private Securities Litigation Reform Act of 1995," 33 *San Diego L. Rev.* 845 (1996).

3. The federal administrative agencies chiefly responsible for bringing enforcement actions are the Securities Exchange Commission, (SEC) (for securities law violations), the Board of Governors of the Federal Reserve System (for banking law violations), and the Commodity Futures Trading Commission (for violations relating to exchange-traded derivatives).

designed to limit abuse in the markets. This prosecutorial activity falls into two categories: traditional sorts of general criminal offenses as applied to market abuses, and specific statutes designed for financial crimes. Each of the two is important and shall be explored in this article.

CONSPIRACY

The conspiracy offense is widely charged by both state and federal prosecutors.⁴ It is especially helpful in connection with financial crimes, as such crimes often involve multiple defendants joining together to engage in market abuses. Conspiracy consists of an agreement between two or more people formed for the purpose of committing a crime. The offense combines a high state of mind requirement and a relatively low act element. Intent on the part of the defendants to agree and also to achieve the object of the conspiracy must be shown.⁵ Once an agreement is established, however, any limited act of preparation completes the offense.

In most conspiracy cases, the prosecution is presented with a completed substantive crime, and there is normally no direct evidence of the formation of the conspiracy.⁶ As a result, most conspiracy cases are proven through circumstantial evidence. Occasionally, evidence of prior contacts or a relationship between the co-conspirators is used to demonstrate agreement, but most often the inferences are drawn from the defendants' joint participation in the criminal acts.

While the agreement requirement is followed in most American jurisdictions, some states use a unilateral approach allowing for prosecution of an individual who erroneously believes she has reached an agreement with another. That other person feigns agreement and does not have a true interest in joining the criminal enterprise. Most often this person would be an undercover police officer. The majority, "meeting of the minds" requirement would not allow prosecution in such a situation to go forward. The reasoning here is that there is no heightened danger of group criminal action when only one person genuinely intends to follow through with the object of the agreement. The unilateral approach promotes such prosecutions, mandating only that a defendant believe that there is an agreement. The notion is that even a unilateral actor is culpable in that she has intent, has a

4. See Marcus, "Criminal Conspiracy Law: Time to Turn Back from an Ever Expanding, Ever More Troubling Area," 1 *Wm. & Mary Bill of Rights J.* 1 (1992).

5. *United States v. Ciocca*, 106 F.3d 1079, 1084 (1st Cir. 1997).

6. Marcus, *supra* n. 4.

guilty mind, and has done everything in her power to plot the commission of a crime.⁷

The conspiracy offense can be a powerful prosecutorial tool. Each member of the group is held responsible for the crimes of co-conspirators if those crimes are committed in furtherance of the plan, and are reasonably foreseeable to the parties.⁸ Other principles governing conspiracy cases similarly support prosecution efforts. Of special benefit are rules as to co-conspirator declarations, venue, joinder of parties, and application of statutes of limitations.⁹

Punishment for convicted conspirators can be severe. In general, the commission of the substantive offense and a conspiracy to commit it are viewed as separate and distinct offenses, they do not merge.¹⁰ Moreover, consecutive sentences for the two crimes may be given.¹¹ In addition, a single agreement with multiple objects may give rise to multiple punishment for conspiracy. When such an agreement violates two or more statutory provisions describing specific conspiracy offenses, there are separate crimes if each provision requires proof of a fact that the other does not. Hence, distinct prosecutions under such specific conspiracy statutes is viewed as appropriate, even though only one agreement can be shown.¹²

Most American jurisdictions have enacted conspiracy statutes. In the federal system, specific statutes cover conspiracy in a host of areas.¹³ The federal government also has a general conspiracy statute, 18 U.S.C. Sec. 371, which is divided into two components. The first makes it a crime for two or more persons to conspire "to commit any offense against the United States." The second makes it a crime to conspire "to defraud the United States or any agency thereof in any manner for any purpose." This latter provision makes the statute more expansive in its reach, for it encompasses "not only conspiracies that might involve the loss of government funds, but also 'any conspiracy for the purpose of impairing, obstructing, or defeating the lawful function of any department of government.'"¹⁴ This interpretation of the law has particular significance to the prosecution of financial crimes.

The conspiracy charge is used often in connection with financial crimes. The money laundering statute prohibits transactions involving proceeds of criminal activity with intent to promote the unlawful

7. See generally, Paul Marcus, *Prosecution and Defense of Criminal Conspiracy Cases*, § 2.04 (1997).

8. *Pinkerton v. United States*, 328 U.S. 640 (1946).

9. Marcus, *supra* n. 4.

10. *Pinkerton v. United States*, *supra*, 328 U.S. at 643.

11. *Id.*

12. *Albernaz v. United States*, 450 U.S. 333 (1981).

13. With drug offenses, under Title 18 of the U.S. Code, for example. *Id.*

14. *United States v. Johnson*, 383 U.S. 169, 172 (1966).

activity, or with intent to violate the Internal Revenue Code, or with knowledge that the transaction is designed to avoid currency transaction reporting requirements.¹⁵ The law also contains a separate conspiracy provision which highlights the seriousness of the offense: "Any person who conspires to commit any offense defined in this section . . . shall be subject to the same penalties as those prescribed for the offense the commission of which was the object of the conspiracy."¹⁶

While the language of the money laundering statute is fairly direct, issues with application have regularly surfaced especially in conspiracy prosecutions. See, for instance, *United States v. Stavroulakis*,¹⁷ where the defendant was approached by an undercover FBI agent who expressed an interest in laundering money derived from narcotics transactions. The defendant agreed, but he decided to tell his co-conspirator that the money came from gambling, because that individual "appeared to have scruples about laundering narcotics money."¹⁸ The court determined that the government had properly proven a conspiracy to launder unlawfully acquired money, as it is not necessary that the conspirators agree on the source of the unlawful money. It is only essential that the cash is represented to have come from one of the many illegal activities enumerated.¹⁹

Questions may also be raised as to evidence of a true conspiracy to control the funds. In *United States v. Schmidt*,²⁰ the defendant and another person had an initial meeting with undercover Internal Revenue Service agents, at which an operation to divide large sums of money into smaller, non-reportable amounts was discussed. Only at later meetings, with the defendant alone, did the agents tell him that the funds to be laundered were the proceeds of illegal activity. Throughout the meetings, the defendant used the term "we" in describing the scheme, but he asserted that he and his friend served different functions. The conspiracy conviction was affirmed with the court deciding that evidence concerning a defendant's meetings with government agents at which a money laundering operation was discussed was sufficient. A jury could draw the inference that a conspiracy existed between the defendant and the purported co-conspirator rather than simply between the one defendant and the government agent.²¹

Conspiracy may also be charged in connection with statutes regulating financial markets such as the Securities and Exchange Act of

15. 18 U.S.C. Sec. 1956.

16. 18 U.S.C. Sec. 1956(h).

17. 952 F.2d 686 (2d Cir. 1992), cert. denied 112 S. Ct. 1982.

18. *Id.* at 688.

19. *Id.* at 691.

20. 947 F.2d 362 (9th Cir. 1991).

21. *Id.* at 367-68.

1934, discussed *infra*. These statutes, enforced by the Securities Exchange Commission, make it "a criminal offense 'willfully' to violate any of their provisions, any related rule, or related order."²² The general federal conspiracy provision, 18 U.S.C. Sec 371, may then be used to charge a conspiracy to commit an "offense against the United States."²³ Such cases also often include a charge of conspiring "to defraud the United States by impeding, impairing, obstructing and attempting to defeat the lawful functions of . . . the [SEC] in the protection of the investing public."²⁴ Consistent with the usual merger rules, there is no improper multiplicity in charging conspiracy along with a substantive violation of the securities statutes.²⁵ Moreover, the availability of civil penalties does not violate double jeopardy principles when a conspiracy charge is brought, as in *United States v. Merriam*.²⁶ There, criminal indictments for conspiracy were offered against two defendants who had previously been given lifetime bars in proceedings conducted by the SEC and the National Association of Securities Dealers. The court held that the criminal proceedings were not precluded by the doctrine of double jeopardy because Congress intended the SEC and NASD sanctions to be remedial, not punitive.

Increasingly, criminal conspiracy charges are used in punishing banking and revenue violations. Historically, the "conspiracy to defraud the United States" language of Section 371 related primarily to the loss of government funds, such as with tax evasion.²⁷ As noted earlier, the statutory language has since been construed to include a larger variety of cases. For example, the creation of artificial tax losses is covered by the conspiracy statute as an act that would interfere with or obstruct a lawful government function by deceit, craft or trickery.²⁸

The Bank Secrecy Act requires that all transactions in currency of more than \$10,000 with financial institutions be reported by the financial institution conducting the transaction.²⁹ In complying with this statute, financial institutions file currency transaction reports (CTRs). In recent prosecutions, bank tellers and other officials who evaded the CTR reporting duties that were binding on them have been charged with conspiracy to commit an offense against the United States.³⁰ Bank customers who commit "money structuring"

22. Louis Loss & Joel Seligman, *Securities Regulation* 4751 (1996).

23. *Id.* at 4770.

24. *United States v. Guterma*, 281 F.2d 742, 745 (2nd Cir. 1960), cert. denied 364 U.S. 871.

25. *United States v. Groover*, 957 F.2d 796 (10th Cir. 1992).

26. 108 F.3d 1162 (9th Cir. 1997).

27. Marcus, *supra* n. 7, Sec. 9.02.

28. *Id.* at Sec. 9.02[3].

29. 31 C.F.R. Secs. 103.22(a)(1), 103.27(a).

30. *United States v. Puerto*, 730 F.2d 627 (11th Cir. 1984).

by dividing large amounts of cash into smaller, non-reportable transactions may be charged with conspiracy to defraud the United States. The theory behind such a charge is that the conspiracy contemplates obstructing the government function of receiving CTRs when the customers *avoid* the incurring of reporting duties.³¹

RICO

In 1970, Congress passed the Organized Crime Control Act which contained the Racketeer Influenced and Corrupt Organizations statute, more commonly known as "RICO".³² RICO was primarily enacted to combat organized crime; many states have adopted their own versions which usually track federal law.³³ Nearly all of these RICO statutes contain a civil remedy component as well, with elements equivalent to the criminal RICO provision.³⁴

The RICO statute requires a showing:

- 1) that a person;
- 2) conduct a pattern;
- 3) of racketeering activity or collection of an unlawful debt;
- 4) directly or indirectly through;
 - A) investment in;
 - B) maintenance of an interest in, or;
 - C) participation in;
- 5) an enterprise;
- 6) the activities of which affect interstate commerce.³⁵

The most important elements of RICO are the pattern of racketeering activity and the enterprise. The government must prove a connection between these provisions. The pattern of a racketeering activity consists of two or more specific crimes committed within 10 years of each other. In *Sedima v. Imrex Co.*³⁶ the United States Supreme Court noted that a pattern is not necessarily sustained simply by proof of two acts. The Court wrote that "continuity plus relationship" combines to create a pattern.³⁷ The pattern element was further clarified in *H.J. Inc. v. Northwestern Bell Telephone Co.*³⁸ There the Court stated that Congress envisioned "a concept of sufficient breadth that it might encompass multiple predicates within a

31. *United States v. Richter*, 610 F. Supp. 480, 486 (N.D. Ill. 1985), *aff'd sub nom. United States v. Mangovski*, 785 F.2d 312 (7th Cir. 1986). See generally, *United States v. Vasquez*, 53 F.3d 1216 (11th Cir. 1995).

32. 18 U.S.C. 1962.

33. *Marcus*, *supra* n. 7, § 4.03.

34. *Id.*

35. *McDonough v. National Home Ins.*, 108 F.3d 174, 177 (8th Cir. 1997); *Mira v. Nuclear Measurements Corp.*, 107 F.3d 466, 473 (7th Cir. 1997).

36. 473 U.S. 479 (1985).

37. *Id.* at 496 n. 14.

38. 492 U.S. 229 (1989).

single scheme that were related and that amounted to, or threatened the likelihood of, continued criminal activity.³⁹

The enterprise element refers to "any individual, partnership, corporation, association, or other legal entity, an any union or group of individuals associated in fact although not a legal entity."⁴⁰ For some time, lower courts disagreed on the application of the term in connection with illegal operations. *United States v. Turkette*,⁴¹ held that "neither the language nor the structure of RICO limits its application to legitimate enterprises."⁴²

While RICO is used often with drug and violent crimes, it is also applied to financial offenses. Among the acts listed as parts of racketeering activity in the statute are: financial institution fraud, embezzlement from pension and welfare funds, laundering of monetary instruments, and illegal monetary transactions in property.⁴³

Two of the most well known cases in the area involve quite different forms of criminal activity. In *United States v. Bledsoe*,⁴⁴ the government, after charging a RICO violation, proved that the defendants were involved with a fraudulent scheme to sell securities of agricultural cooperatives. In essence, the prosecution theory was that the defendants engaged in fraud in attempting to manipulate buyers of these securities. The court focused carefully on the association of the individuals into an enterprise, as required by the statute.

The defendants in *United States v. Cauble*,⁴⁵ were members of the highly publicized "Cowboy Mafia". The group engaged in wide ranging criminal activities ranging from distribution of marijuana to misapplication of bank funds. All these activities were brought together for trial under a RICO charge, with the government successfully arguing that the various distinct criminal acts constituted a pattern pursued for illegal gain by the enterprise.

FRAUD

Abusers of the financial markets may also face prosecution by the United States under the mail fraud and wire fraud laws. These statutes are important because of the "breadth, flexibility and ease of application to almost every variant of fraudulent conduct."⁴⁶

39. *Id.* at 237.

40. 18 U.S.C. § 1961(4).

41. 452 U.S. 576 (1981).

42. *Id.* at 587.

43. 18 U.S.C. § 1961(1)(c).

44. 674 F.2d 647 (8th Cir. 1992).

45. 706 F.2d 1322 (5th Cir. 1983).

46. Pickholz, *supra* n. 1, § 5.05 [1], page 5-48. The author there states:

Mail and wire fraud . . . not only stand alone as serious substantive offenses, but they also serve as the ubiquitous handmaidens to virtually every securities fraud violation, act as predicate offenses to establish a "pattern of racketeering."

The mail fraud statute reads, in part:

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representation, or promises . . . for the purposes of executing such scheme or artifice or attempting to do so, places in any post office or authorized depository for mail matter . . . shall be fined under this title or imprisoned not more than five years, or both. If the violation affects a financial institution, such person shall be fined not more than \$1,000,000 or imprisoned not more than 30 years, or both.⁴⁷

The wire fraud statute similarly forbids the furtherance of a fraud, prohibiting such activities by use of wire, radio or television.⁴⁸ In the context of financial markets, the mail and fraud statutes "reach a universe of deceitful activity, including insider trading, market manipulation, fraudulent offering and reporting schemes, and conversion of customer funds."⁴⁹ The mail and wire fraud statutes are even more flexible in the securities context. These statutes do not require the scheme to be in connection with the purchase or sale of securities, and plans based on a breach of fiduciary duty or misappropriation are also within the scope of them.⁵⁰

The elements of proof for a mail fraud conviction consist of a scheme or artifice to defraud, the use of the United States mails in furtherance of the scheme, and an intent on the part of the defendant to defraud.⁵¹ To prove wire fraud, the prosecution must additionally show use of an interstate wire service or electronic communications to further the scheme.⁵² These statutes are powerful tools, for each mailing or wire transmission in furtherance of a single plan to de-

teering activity" under the RICO statute, and constitute a "specified unlawful activity" sufficient to implicate the harsh federal money laundering statutes.

Id. at 5-49.

47. 18 U.S.C.A. § 1341.

48. 18 U.S.C.A. § 1343.

49. Pickholz, *supra* n. 1, § 5.05[1] at 5-49.

50. Id.

51. *Dreher v. United States*, 115 F.3d 330, 332 (5th Cir. 1997); *United States v. Loaya*, 107 F.3d 257, 260 (4th Cir. 1997); *United States v. Slevin*, 106 F.3d 1086, 1089 (2nd Cir. 1996); *United States v. Bonnanno*, 852 F.2d 434, 440 (9th Cir. 1988), cert. denied, 488 U.S. 1016 (1989).

Courts have also found that a conviction for mail fraud "does not require that the defendant actually intended to use the mails, but only that he acted with knowledge that the mails would be used in the ordinary course of business." *United States v. Czubinski*, 106 F.3d 1069, 1073 (1st Cir. 1997); *United States v. Earles*, 955 F.2d 1175 (8th Cir. 1992); *Bacchus Indus. v. Arvin Indus.*, 939 F.2d 887 (10th Cir. 1991); *United States v. Parker*, 839 F.2d 1473, 1482 (1988).

52. *Forsyth v. Humana, Inc.*, 114 F.3d 1467, 1481 (9th Cir. 1997); *United States v. Czubinski*, 106 F.3d 1069, 1073 (1st Cir. 1997); *United States v. Earles*, 955 F.2d 1175 (8th Cir. 1992); *Bacchus Indus. v. Arvin Indus.*, 939 F.2d 887 (10th Cir. 1991).

fraud is a distinct offense for which courts may impose separate sentences.⁵³

Courts have traditionally found that any scheme intended to deprive another of property or money through deceit is a "scheme or artifice to defraud" under the fraud statutes.⁵⁴ Courts were in conflict, however, over the question of the statutes including schemes to deprive of the intangible right to honest services. The Supreme Court explicitly rejected the inclusion of intangible rights in *McNally v. United States*.⁵⁵ In response, Congress enacted § 1346 in 1988, overruling *McNally* and defining the meaning of "scheme or artifice to defraud" to include "a scheme or artifice to deprive another of the intangible right of honest services."⁵⁶

Prosecutors may often combine traditional fraud offenses with specific securities charges in combatting market abuses, as in *United States v. Mackay*.⁵⁷ There, the defendants were convicted of both mail fraud and securities fraud for improperly gaining control of an insurance company through stock purchases and using facilities of interstate commerce in the process. Though the charged behavior was a single course of action, the court of appeals affirmed the two convictions. The court found that "the essentials of mail fraud are proof of a scheme to defraud plus the use of the mails to execute or further this scheme or design . . . each mailing is regarded as a separate crime even though it relates to essentially the same fraudulent scheme."⁵⁸

*United States v. Carpenter*⁵⁹ is a leading Supreme Court decision in the fraud area, presenting an excellent example of how the federal fraud statutes have been successful weapons against the misappropriation of confidential information in the securities context. A reporter for The Wall Street Journal was a co-author of a daily investment advice column reporting on various stocks and companies. The column frequently had an impact on those stocks mentioned in the column. A stockbroker promised the reporter part of the profits in return for advance notice of the substance of the column. This agreement was in direct violation of The Wall Street Journal's policy that all news information belongs solely to the Journal and is

53. *Badders v. United States*, 240 U.S. 391, 394 (1916).

54. Some courts have gone beyond this basic proposition. In *United States v. Marchese*, 46 F.3d 1020 (10th Cir. 1995), cert. denied, 115 S. Ct. 2251 (1995), the government alleged that the defendants, without revealing who controlled the stocks and without disclosing that the brokers were receiving kickbacks, induced customers to transfer funds to those brokers. The court of appeals held that a charge of mail fraud does not have to prove pecuniary loss or be able to trace the alleged kickbacks.

55. 483 U.S. 350 (1987).

56. 18 U.S.C.A. § 1346.

57. 491 F.2d 616 (10th Cir. 1974), cert. denied, 416 U.S. 972.

58. *Id.* at 619.

59. 484 U.S. 19 (1987).

deemed confidential prior to publication. The reporter and the stockbroker were convicted of violating not only Rule 10b-5, but also the federal mail and wire fraud statutes.

The Court unanimously affirmed the fraud convictions, finding that "the conspiracy here to trade on the Journal's confidential information is not outside the reach of the mail and wire fraud statutes. . . . The Journal's business information that it intended to be kept confidential was its property . . ." ⁶⁰ The Court added that "it is sufficient that the Journal has been deprived of its right to exclusive use of the information, for exclusivity is an important aspect of confidential business information and most private property for that matter."⁶¹ Interestingly, the mail and wire fraud statutes were not utilized because of the method used of exchanging information between the reporter and the stockbroker; rather the fraud statutes were implicated by the circulation of the newspaper.

Using the wires and the mail to print and send the Journal to its customers [did in fact] satisfy the requirement that those mediums be used to execute the scheme. . . . Had the column not been made available to Journal customers, there would have been no effect on stock prices and no likelihood of profiting from the information leaked by [the reporter].⁶²

SPECIFIC MARKET RELATED CRIMINAL STATUTES

Securities violations in the United States are addressed in a variety of contexts, as indicated previously: administrative hearings, civil actions, broad criminal prosecutions. In part, because of the cumbersome SEC referral process and the complexity of securities law, historically relatively few criminal proceedings were initiated under the securities laws.⁶³ In the past two decades, however, SEC enforcement lawyers and Department of Justice prosecutors have begun to bring more criminal prosecutions against securities violators in order to provide effective deterrence and to maintain investor confidence in response to perceived widespread securities problems.⁶⁴ Such prosecutions can be brought under two principal statutes.

60. *Id.* at 28.

61. *Id.* at 26-27.

62. *Id.* at 28.

63. Baird, *A Practical Guide to the 'Criminalization' of Securities Cases*, C640 ALI-ABA 7, 9 (1991).

64. *Id.* at 10.

The Securities Act of 1933

The 1933 Act provides criminal penalties for violations. Although criminal liability itself is created in Section 24 of the Act,⁶⁵ the violations occur under two basic provisions of the Securities Act—registration and antifraud.

Section 5 of the Act makes it illegal for an individual to sell any unregistered security through interstate commerce unless a specific exemption exists.⁶⁶ The section specifically prohibits the use of mails or any means of interstate commerce either to sell unregistered (or nonexempt) securities or to carry securities for sale or for delivery after sale.⁶⁷ It further provides that it is unlawful for any person to use the mails or any means of interstate commerce to transmit a prospectus for a security unless the prospectus meets certain requirements or to deliver a security unless accompanied by an SEC-approved prospectus.⁶⁸

The reach of Section 5 is broad. Some courts have liberally construed the requirement of use of mails or interstate commerce by holding the floor of a national securities exchange a means of communications which would satisfy the jurisdictional requirements of the Act.⁶⁹ Almost anyone can be held criminally liable, not just the technical issuer, but also the underwriter or dealer.⁷⁰ Moreover, ignorance of the securities laws is not a defense.⁷¹

In addition to criminal liability for Section 5 violations, the 1933 Act also provides for criminal penalties for the violation of the antifraud provisions in Section 17.⁷² Section 17(a) requires proof by the government of both material misrepresentations (or omissions) in a registration statement, and an intent to violate the law.⁷³ The courts generally find that the intent requirement “relates to the action con-

65. 15 U.S.C. § 77x. Section 24 provides that any person who willfully violates any provisions, rules and regulations of the statute in filing a registration statement is guilty of a felony and subject to a fine and/or imprisonment.

66. See 15 U.S.C. § 77e. “Registration” refers to the process whereby an issuer of securities obtains clearance from the SEC as to the written documentation, specifically the “registration statement,” of which the prospectus is a part. This clearance must be obtained before the securities are sold, and thus assures the investing public that the issuer does not make materially false or misleading statements in the written documentation used by the issuer to persuade investors to buy the securities.

67. See 15 U.S.C. § 77e(a). “Exempt” securities are those that may be sold, or offered for sale, without an SEC-approved registration statement.

68. See 15 U.S.C. § 77e(b).

69. See, e.g., *United States v. Re*, 336 F.2d 306, 315 (2d Cir. 1964), cert. denied, 379 U.S. 904 (1964).

70. *United States v. Wolfson*, 405 F.2d 779 (2d Cir. 1968), cert. denied, 394 U.S. 946 (1969).

71. *Id.*

72. 15 U.S.C. § 77q(a).

73. *Id.* The standard for materiality, set forth not in the 1933 Act but rather in the landmark case of *TSC v. Northway*, 426 U.S. 438 (1976) is (in essence) whether a reasonable investor would want to know of the fact in making an investment decision.

stituting fraudulent, misleading or deceitful conduct, but not as to the knowledge that the instrument is a security.⁷⁴

The Securities Exchange Act of 1934

While the 1933 Act governs the issuance of securities in the primary market—initial public offerings—the 1934 Act concerns secondary market trading of securities—buying and selling of securities that already have been issued. The most widely litigated criminal provision of the 1934 Act, and indeed federal securities law generally, is Section 10, and the corresponding SEC Rule 10b-5 of the 1934 Act.⁷⁵ Section 10(b) makes it illegal to use “any manipulative or deceptive device” in the purchase and sale of any security in contravention of the rules and regulations the SEC may establish for the public interest or for the protection of public investors.⁷⁶ Rule 10b-5 prohibits making any materially false statements “in connection” with the purchase and sale of securities.⁷⁷ The Rule requires a demonstration of material misrepresentations or omissions that a reasonable shareholder would consider.⁷⁸ Not all courts require a showing of intent to violate the law for a Rule 10b-5 or Section 10(b) prosecution. A “realization” of a wrongful act may be all that is needed.⁷⁹

Much of the controversy since the mid 1980's concerning Section 10(b) and Rule 10b-5 relates to insider trading prosecutions.⁸⁰ For many years, insider trading violations were premised upon two conflicting theories, classical and misappropriation.⁸¹ Under the classi-

74. *Brown v. United States*, 578 F.2d 1280, 1284 (9th Cir. 1978), cert. denied, 439 U.S. 928 (1978). Consistent with the usual rules of proof in criminal cases, the intent need not be shown by direct evidence. *United States v. Vasen*, 222 F.2d 3, 7 (7th Cir. 1955); *Aiken v. United States*, 108 F.2d 182 (4th Cir. 1939); *United States v. Vandersee*, 279 F.2d 176 (3d Cir. 1960), cert. denied, 364 U.S. 943 (1961).

75. Section 10, 15 U.S.C. § 78j; Rule 10b-5, 17 C.F.R. § 240.10b-5. See A Jacobs, *Litigation and Practice Under Rule 10b-5* (Securities Law Series, Clark Boardman Callaghan).

76. 15 U.S.C. § 78j(b).

77. 17 C.F.R. § 240.10b-5.

78. *Id.*

79. See, e.g., *Arthur Lipper Co. v. SEC*, 547 F.2d 171, 181 (2d Cir. 1976), cert. denied, 434 U.S. 1009 (1978); *United States v. Charnay*, 537 F.2d 341, 351-52 (9th Cir. 1976), cert. denied, 429 U.S. 1000 (1976); *United States v. Dixon*, 536 F.2d 1388, 1397 (2d Cir. 1976); *United States v. Koenig*, 388 F. Supp. 670 (S.D.N.Y. 1974).

80. But not all. The Securities Exchange Act prohibits manipulation of exchange listed securities through Section 9, making it illegal “[t]o effect . . . a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading . . . or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.” 15 U.S.C. § 78j(a)(2). Also, disclosure and filing violations are found in Sections 12, 13, 14 and 16, § 78 l, m, n, and p. Section 12 of the Act additionally requires certain companies to register and file periodic reports. Moreover, sections 13 and 14 provide for the protection of investors by requiring full disclosure and giving public shareholders adequate information with which to respond to tender offers.

81. See generally, Bayne, “Insider Trading and the Misappropriation Theory,” 30 *Loy. L.A. L. Rev.* 487 (1997).

cal theory, a person who is an "insider" of a corporation with fiduciary duties violates Rule 10b-5 by buying and selling securities on the basis of material, nonpublic information.⁸² Misappropriation theory extends the reach of Rule 10b-5 to "outsiders."⁸³ It imposes liability for fraud on any person who:

- (1) misappropriates material nonpublic information
- (2) by breaching a duty arising out of a relationship of trust and confidence and
- (3) uses that information in a securities transaction
- (4) regardless of whether he owed any duties to the shareholders of the traded stock.⁸⁴

The premise of this theory is that the trader breached a fiduciary obligation to the "giver" of material nonpublic information, regardless of any particular tie to the transaction.

A considerable body of caselaw supports the misappropriation theory in insider trading cases. For instance, the court in *United States v. Newman*,⁸⁵ affirmed the conviction of investment bankers who exploited their clients' secret takeover plans. The court held that the investment bankers' transactions breached their fiduciary duties of confidentiality and loyalty to their employers even though they did not owe a duty to the corporation whose securities were traded.⁸⁶ See also *SEC v. Clark*,⁸⁷ where the Ninth Circuit reviewed the conviction of an employee who used material, nonpublic information regarding his employer's plans to acquire another company. The court wrote that the "misappropriation theory fits comfortably within the meaning of 'fraud' in § 10(b) and Rule 10b-5."⁸⁸

However, other courts attacked the misappropriation theory. In *United States v. Bryan*,⁸⁹ for instance, the court decided that the principle will not support a conviction where the giver of misappropriated information is not a purchaser or seller or is not connected with or in any way interested in the securities transactions itself.⁹⁰ The court found that reading the words of Section 10(b), "in connection with the purchase or sale of any security," did not support the use of the misappropriation theory.⁹¹ Furthermore, the breach of

82. *United States v. O'Hagan*, 92 F.3d 612, 616 (8th Cir. 1996).

83. *S.E.C. v. Cherif*, 933 F.2d 403, 409 (7th Cir. 1991), cert. denied, 502 U.S. 1071 (1992).

84. *United States v. Bryan*, 58 F.3d 933, 944 (4th Cir. 1995).

85. 664 F.2d 12 (2d Cir. 1981), cert. denied, 464 U.S. 863 (1983).

86. *Id.* at 16.

87. 915 F.2d 439 (9th Cir. 1990).

88. *Id.* at 449. See also, *United States v. Mylett*, 97 F.3d 663 (2d Cir. 1996).

89. 58 F.3d 933 (4th Cir. 1995).

90. *Id.* at 952-53.

91. *Id.* at 946-47.

duty under the misappropriation theory did not entail "deception" within the language of Section 10(b).⁹²

The Eighth Circuit in *United States v. O'Hagan*⁹³ adopted the *Bryan* court's reasoning in reversing the conviction of an attorney who used material, nonpublic information. In *O'Hagan*, Grand Met hired a law firm to assist with a possible tender offer for common stock of the Pillsbury Company. A partner in the firm began purchasing call options on Pillsbury stock before Grand Met announced its tender offer for the stock, and later sold the call options for a large profit.⁹⁴ The court wrote that "fraud under Rule 10b-5 cannot be construed more broadly than its statutory enabler, deception."⁹⁵ Section 10(b) requires both deception and false statements "in connection with the purchase or sale of any security."⁹⁶ According to the appeals court, misappropriation theory mandates neither deception nor the "in connection with" requirement of the Act. Only a breach of a duty to the parties to the securities transaction would be sufficient to give rise to Section 10(b) criminal liability.⁹⁷

The issue has now been clearly resolved by the United States Supreme Court, with its decision reversing the Eighth Circuit in *O'Hagan*.⁹⁸

O'Hagan Case

The Supreme Court held that misappropriation theory could form the basis of criminal liability under Rule 10(b). Justice Ginsberg, for the majority, wrote that the purpose of misappropriation theory is to "protect [the] integrity of the securities markets against abuses by outsiders to [a] corporation who have access to confidential information that will affect [the] corporation's securities price when revealed, *but who owe no fiduciary or other duty to that corporation's shareholders*."⁹⁹ In order for criminal liability under Rule 10(b) to exist, there is a statutory requirement that there be "deceptive" conduct "in connection with" a securities transaction.¹⁰⁰ The deception here was not between the parties in the securities transaction, but was in actions of a source of the information. In accordance with the

92. *Id.* at 949-50.

93. 92 F.2d 612 (8th Cir. 1995).

94. *Id.* at 614.

95. *Id.* at 615.

96. *Id.* at 617.

97. *Id.*

98. 117 S. Ct. 2199 (1997).

99. *Id.* at 2207 (emphasis added). It will be recalled that the purchaser of call options was a private lawyer whose client was the prospective acquirer, Grand Met, and the options concerned stock in the prospective target company, Pillsbury. Thus, it would be difficult—if not impossible—to use classical insider trading theory, because the lawyer owed no fiduciary duty to shareholders of Pillsbury.

100. *Id.* at 2206.

statutory language, the government also must prove a person “willfully” violated Rule 10(b) in order for criminal liability to exist. In the majority’s opinion, this mandate was enough to discount O’Hagan’s argument that the misappropriations theory is too indefinite to support the imposition of criminal liability.¹⁰¹

The Court found that the “deceptive” conduct requirement was met when the lawyer for Grand Met used the confidential information he obtained for his own personal gain in the trading of securities without informing the source of the information, his law firm, of his intentions to do so.¹⁰² Of course, had he fully disclosed his intentions to the source of the information there would be no criminal liability, because the necessary “deceptive” conduct requirement would not have been met.¹⁰³ The Court also held that the misappropriation theory satisfies the statutory requirement that the deceptive use of information be “in connection with the purchase or sale of security,” because the “fraud is consummated, not when he obtains the confidential information, but when, without disclosure to the principal, he uses the information in purchasing or selling securities.”¹⁰⁴ The doctrine, however, could not be used in all fraud cases:

The misappropriation theory would not . . . apply to a case in which a person defrauded a bank into giving him a loan or embezzled cash from another, and then used the proceeds of the misdeeds to purchase securities. . . . The proceeds would have value to the malefactor apart from their use in a securities transaction, and the fraud would be complete as soon as the money was obtained.¹⁰⁵

Because such a situation would not satisfy the “in connection with” trade in securities requirement of Rule 10(b), no criminal liability would apply. The Court concluded with a strong statement in support of the rationale for the misappropriation theory.

The misappropriation theory comports with § 10(b)’s language, which requires deception “in connection with the purchase or sale of any security,” not deception of an identifiable purchaser or seller. The theory is also well-tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence. (Trading on misappropriated information “undermines the integrity of, and investor confidence in, the securities markets”). Although informational disparity is inevitable in the securities markets, investors likely would hesitate to ven-

101. *Id.* at 2214.

102. *Id.* at 2211.

103. *Id.* at 2209.

104. *Id.*

105. *Id.*

ture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law. An investor's informational disadvantage vis-a-vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill.¹⁰⁶

CONCLUSION

Numerous criminal statutes are used to regulate financial securities markets in the United States. In this article, some of the most significant such laws have been considered. They include general criminal offenses tailored to emphasize market abuses, laws such as conspiracy, RICO and fraud. In addition, the specific Federal securities laws, the 1933 and 1934 Acts, have criminal provisions that can be utilized effectively in this area.

The particular features of the individual statutory approaches appear to matter far less than a commitment on the part of the government to attack vigorously abuses in the financial markets. This sort of commitment, when combined with the potent civil actions available, will move to ensure public confidence to an area in which skepticism is often present.

106. *Id.* at 2210. In general, insider trading laws are increasingly common in other countries and, to varying degrees are motivated in part by U.S. insider trading jurisprudence. In recent years, for example, Hong Kong, Malaysia, Indonesia, Thailand, and the Philippines have enacted such laws. However, aside from problems of enforcement, a critical issue is whether misappropriation theory, and the Court's above-quoted conclusion, will be adopted in foreign jurisdictions.