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HEADLINE: Second Circuit's Broad View Of Manipulation

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IN A RECENT opinion affirming securities fraud and mail fraud convictions of members of a small brokerage firm stemming from the manipulation of penny stocks,[1] the Second Circuit reinforced its broad interpretation of the Rule 10b-5 "in connection with" requirement in manipulations cases.

Section 10(b) prohibits the use "in connection with the purchase or sale of any security" of "any manipulative or deceptive device or contrivance . . ."[2] Rule 10b-5 makes it unlawful "[to] employ any device, scheme or artifice to defraud" or "[to] engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."[3]

In *U.S. v. Russo,*[4] the Second Circuit rejected appellants' assertion that fraudulent short sales of high-value stocks were not sufficiently connected to the manipulation of the market for two penny stocks to support their conviction under §10(b) of the Securities Exchange Act of 1934[5] and SEC Rule 10b-5 thereunder.[6] Instead, the Second Circuit ruled that their short sales were part of their overall manipulative scheme and constituted a manipulative device under §10(b) and Rule 10b-5.

The defendants in *Russo* worked at a small broker, Kureen & Cooper (K&C), which traded in and under-wrote initial public offerings of penny stocks. K&C's customer accounts as well as its own trading accounts were handled by Evans & Co., a larger brokerage firm that acted as clearing broker.

K&C underwrote the IPO's of the stock of Lopat and EAS, high-risk start-up companies, for which K&C received hefty commissions as well as warrants entitling it to buy large amounts of the stock at set prices after one year.

These warrants gave K&C the incentive to establish markets for the Lopat and EAS stock so that their prices would rise above the warrant price. K&C also acted as the principal market maker for Lopat and EAS, holding itself out as ready to buy and sell the stock at prices it posted on NASDAQ.

Unfortunately for K&C, the prices of Lopat and EAS started heading south soon after their IPOs. This created a problem for K&C, which was so thinly capitalized that if it bought stock it had to sell most of it the same day in order to maintain the minimum net capital required by federal securities regulations. K&C feared it would be forced to sell Lopat and EAS on the market at reduced prices and risk triggering a snowball effect as holders sold their shares back to K&C before further price drops.

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[1] "Penny stocks" are stocks generally valued at under $ 5 per share and are traded over the counter on the National Association of Securities Dealers Automated Quotation (NASDAQ) system.

[2] 15 USC §78j(b) (1994).

[3] 17 CFR. §240.10b-5 (1995).

[4] 74 F3d 1383 (2d Cir. 1996).

[5] 15 USC §78j(b) (1994).

[6] 17 CFR §240.10b-5 (1995).

The Scheme

Faced with this crisis, and the possibility of putting itself out of business, the defendants devised a scheme to manipulate Lopat and EAS stock so that much of it remained off the market and the prices did not decline.

The scheme involved three components: (1) unauthorized placement of Lopat and EAS stock in customers' accounts; (2) the "parking" of Lopat and EAS stock in customers' accounts in exchange for guaranteed profits; and (3) the buy-up of Lopat and EAS shares, financed with credits in K&C's trading account generated by fraudulent short sales of high-value stocks.

The scheme kept large portions of Lopat and EAS stock off the market and created the appearance of demand for the stock.

Part one, the unauthorized placements, was in essence a stock-kiting scheme in which the defendants moved stock from account to account in order to create the appearance of market activity. Defendants placed blocks of Lopat or EAS stock in a customer's account without authorization, after which K&C's accounts would be credited with the stock "sold" at the NASDAQ-quoted price.

Then the customer received a surprise in the mail: a confirmation of a purchase that he or she had not ordered. When the customer called K&C to question the bogus trade, he or she would be told there was a mistake, and the stock would be bought back or the trade canceled. Often, defendants would then place the same block of stock in another customer's account without authorization. This practice allowed K&C to keep large blocks of Lopat and EAS off the market and out of K&C's account while also creating an impression of interest in the stock and avoiding the need to sell it for lower prices on the market.

Part two of the scheme involved keeping Lopat and EAS stock off the market by parking it in customer accounts with a guarantee that K&C would buy back the stock at a small pre-arranged profit.

After one or two weeks, K&C would buy the stock back and immediately park the same stock with another customer. This too had the effect of keeping Lopat and EAS stock off the market and creating an impression of activity in the stock.

Unlike the unauthorized placements, however, this part of the scheme required K&C to come up with money to pay the small set profit to the friendly customer who held the stock. To finance this activity and to generate the money to buy up Lopat and EAS shares that were being sold back by customers, defendants turned to part three of the scheme, which led to their most significant issue on appeal.

Part three consisted of the short sales[7] high-value stocks to finance the purchases of Lopat and EAS required in parts one and two. Defendants discovered that through an accounting glitch at Evans, its clearing broker, K&C could obtain credits for short sales without having to put up the required margin and in violation of the rule that proceeds of a short sale must stay frozen until the seller covers the sale.

K&C failed to notify Evans that it was making the short sales, as was required by their clearing arrangement, and K&C made the sales through its regular cash trading account, which permitted short sales of only penny stocks, rather than through a special margin account that was supposed to be used for short sale of high-value stock.

In fact, K&C did not have a special margin account for high-value stock short sales, the clearing arrangement did not permit K&C to make such sale, and K&C did not have sufficient capital to put up the required margin for such sales.

Nevertheless, until Evans discovered the error, K&C used the fraudulent short sale credits to finance the purchase of Lopat and EAS stock and to pay the parking profits to its customers, thus allowing it to keep large portions of Lopat and EAS stock off the market and to manipulate the price upward.

Convictions Appealed

In March 1994, after a two and a half month trial, the jury returned guilty verdicts against the defendants on nearly every count of a 19-count indictment for: conspiracy,[8] mail fraud,[9] and securities fraud.[10] On appeal, the Second Circuit, in an opinion by Senior Judge James Oakes, showed primary interest in defendants' argument had to be reversed, because the short sales were not made "in connection with" the manipulative scheme. This issue is addressed in greater detail below.

The court also rejected defendants' contention that the jury should have been instructed on the meaning of "parking," in light of the fact that the government changed its definition of parking throughout the case.

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[7] A short sale is one in which a seller agrees to sell stock it does not own and then borrows the stock from a broker to tender to the buyer.

The seller pays a fee while it borrows the stock and eventually has to cover the short sale by returning an equivalent amount of the stock to the broker. These sales are closely regulated and the seller is required to put up a margin equal to at least 50 percent of the value of the stock. 12 CFR §220.19(a) (1995).

Furthermore, proceeds from the sale must be frozen until the seller covers the short sale. *Russo*, 74 F3d at 1388.

[8] 18 USC §371 (1994)

[9] 18 USC §1341 (1994).

[10] 15 USC §§78j(b) and 78ff (1994).

The Second Circuit disagreed, finding that the term "parking" "is not a legal term requiring jury explanation. Rather, it is a business term that describes conduct which may or may not rise to the level of a 10b-5 violation."[11]

Likewise, the panel rejected appellants' objection to the government's expert witness who described the scope and impact of the manipulative scheme on the stock prices. The court found that the expert testimony fell within the standard set forth in its 1988 decision in *U.S. v. Scop*,[12] "because [the testimony] focused solely on factual conclusions and did not involve any legal characterizations."[13]

Appellants' other contentions regarding jury instructions, sufficiency of the evidence, and the prosecution's rebuttal summation were also rejected.

Broad View

Appellants' primary and most legally significant contention was that the district court erred in permitting the jury to base a conviction on any one of the three types of market manipulation listed in the indictment: unauthorized placement, parking and short sales.

Appellants argued that the fraudulent short sales deceived only Evans the clearing broker and were not sufficiently connected to K&C's purchases of Lopat and EAS stock to be considered part of the manipulative scheme within the meaning of Rule 10b-5.

The government countered that the use of the ill-gotten funds from the short sales kept Lopat and EAS off the market in order to manipulate their prices and was, therefore, a manipulative device.

The Court of Appeals was, in its words, "confronted with two interpretations of the Rule 10b-5 "in connection with" requirement, one narrow and one broad."[14]

Although the court observed that there was no direct precedent or comparable fact pattern, it was not without guidance: "The law of the Supreme Court and this circuit regarding the scope of 10b-5 is extensive and supports the government's position."[15]

The court reviewed the line of Supreme Court and Second Circuit cases mandating a broad interpretation of §10(b) and Rule 10b-5 "in accordance with congressional intent to minimize fraud in securities trading."[16]

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[11] 74 F3d at 1393.

[12] 846 F2d 135, 139-40, modified, 856 F2d 5 (2d Cir. 1988).

[13] 74 F3d at 1395.

[14] Id. at 1390.

[15] Id.

[16] Id. at 1390-91, citing *Basic Inc, v. Levinson*, 485 U.S. 224 (1988); *Chiarella v. United States*, 445 U.S. 222, 226 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 203 (1976); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972); *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6 11 n.7 (1971); *In re Ames Dep't Stores Inc. Stock Litigations*, 991 F2d 953, 964-67 (2d Cir. 1993).

It recognized that although the short sales did not affect the markets for Lopat and EAS through actual trading, they enabled K&C to create a false impression of demand for the stock and the shield prices from the realities of the market. Without the money generated through the short sales, the appellants would not have been able to keep large blocks of Lopat and EAS off the market or finance the other elements of the kiting scheme, thereby misleading the public as to the value of the Lopat and EAS stock.[17]

Given that conclusion and its expansive interpretation of Rule 10b-5, the Second Circuit concluded that "the short sales were sufficiently connected to the manipulation scheme as to constitute a violation of §10(b) and Rule 10b-5. . . "[18]

The court gave short shrift to defendant's point that the short sales themselves, were not manipulative, were not sales of Lopat or EAS stock, and thus did not deceive buyers of Lopat or EAS.

The defendants analogized their case to that of a person who had made false statements on a loan application to obtain funds with which to carry out a manipulative scheme. In such a case, defendants argued, the false statements would not support a 10b-5 conviction. The court rejected this argument without squarely addressing it, but rather emphasizing that the short sales were an "integral part" of the multifaceted scheme.

The *Russo* opinion raises a number of points of interest. First, the Second Circuit persisted in its broad view of 10b-5's "in connection with" requirement, notwithstanding continual signals from the Supreme Court that the "expansive" reading of Rule 10b-5 is not without limits.

The result in *Russo*, however, is no surprise, given the Second Circuit's rulings on the "in connection with" requirement in other contexts. Perhaps the most notable example of its voyage on uncharted (by the Supreme Court) 10b-5 seas is the misappropriation theory of insider trading under 10b-5.

Since the Supreme Court reversed the Second Circuit's insider trading ruling *U.S. v. Chiarella*,[19] the Second Circuit has forged ahead with a line of cases that broadly construe 10b-5 to permit conviction (or SEC civil enforcement actions) even if the victim of the fraud is not a market participant.[20]

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[17] 74 F3d at 1391.

[18] Id. at 1392.

[19] 445 U.S. 222 (1980).

[20] *United States v. Teicher*, 987 F2d 112 (2d Cir.) (stating the 10b-5 prohibits trading while in knowing possession of misappropriated, material, nonpublic information; government need not prove causal connection between the information and the transaction) cert denied, 114 S.Ct. 467 (1993); *United States v. Chestman*, 947 F2d 551 (2d Cir. 1991) (en banc), cert. denied, 112 S.Ct. 1759 (1992); *SEC v. Materia*, 745 F2d 197 (2d Cir. 1984), cert, denied, 471 U.S. 1053 (1985); *United States v. Newman*, 664 F2d 12 (2d Cir. 1981), cert denied, 464 U.S. 863 (1983).

The fraud (usually an intentional breach of a duty of trust or confidence) is still "in connection with" the subsequent purchase or sale of securities. On the other hand in 1987, the Supreme Court split 4-4 on this theory of 10b-5 liability,[21] and the Fourth Circuit in *U.S. v. Bryann*[22] recently created a split in the circuits by rejecting the misappropriation theory under 10b-5.

Russo is thus notable for approving 10b-5 liability in a case in which establishing the nexus between the short sales and the manipulation required some dexterity by the government and the court.

Second, *Russo* shows the unnecessary risks the government runs when it overcharges a case by loading multiple theories of culpability into a single count. The government alleged and proved that the defendants brazenly engaged in unauthorized "sales" into customer accounts and parking of shares in customer accounts to manipulate the prices of K&C's house stocks.

There was no need to lump in the short sales as a third theory of manipulation. (Of course, hindsight is 20/20, and for the government there is no appeal from an acquittal.)

The short sales funded the manipulation and thus, as the court found after extended analysis, were "connected" to the manipulation. But more careful crafting of the indictment would have obviated this knotty issue on appeal.

Third, even had the *Russo* defendants prevailed on their interesting have been hollow, because they would be remained convicted on multiple counts of mail fraud.

For defendants who receive confirmations of trades in the mail, call their broker from another state or country, or manipulate stock on a national securities exchange, the mail fraud, wire fraud, and §9(a)(2) manipulation[23] statutes remain a criminal threat.

Of course, given that the SEC cannot prosecute mail and wire fraud, a narrowed 10b-5 could be a Pyrrhic victory for defense counsel who would no longer be able to argue to the U.S. Attorney's Office that an adequate civil enforcement alternative exists.

Fourth, in rejecting defendants' parking argument, the *Russo* court reminded us all that "parking" --which has sinister connotations resonating in highly publicized cases from the 1980s -- is not per se a crime.

Granted, no one engages in parking unless they are up to no good. An effort to hide beneficial ownership is generally motivated by an intent to deceive someone, often a regulator.

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[21] *Carpenter v. United States*, 484 U.S. 19 (1987).

[22] 58 F3d 933 (4th Cir. 1995).

[23] 15 USC §§78i(a)(2) and 78ff.

But "parking" is not a crime; rather, it can be a means to commit civil or criminal violations of laws relating to manipulation,[24] tax evasion,[25] capital requirements,[26] or 13D filing rules.[27] Because parking itself defines a business practice but not a crime, the *Russo* court rejected defendants' contention that the trial judge should have charged the jury on "parking."

[24] *United States v. Mulheren*, 938 F2d 364 (2d Cir. 1991); *United States v. GAF Corp.*, 928 F2d 1253 (2d Cir. 1991); *Sec v. Lewis* 90 Civ. 5129 (SDNY Aug. 6, 1990).

[25] *United States v. Regan ("Princeton Newport")*, 937 F2d 823 (2d Cir. 1991), cert. denied, *sub nom. Zarzecki v. United States*, 504 U.S. 940 (1992); *United States v. Bilzerian*, 926 F2d 1285 (2d Cir.), cert denied, 502 U.S. 813 (1991).

[26] *Mulheren*, 938 F2d 364 (hung jury).

[27] *Bilzerian*, 926 F2d 1285.