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Intent-Based Theory Of Liability In Hwang Creates Ambiguity

By **Edward Imperatore** (April 5, 2024, 11:25 AM EDT)

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In May, Bill Hwang, founder of Archegos Capital Management, will be tried in the U.S. District Court for the Southern District of New York on charges of racketeering conspiracy, securities fraud, market manipulation and wire fraud, for allegedly participating in a sweeping scheme to manipulate the prices of securities in Archegos' portfolio and defraud investment banks.

In announcing Hwang's arrest, the U.S. Attorney's Office for the Southern District of New York alleged that Hwang's "historic" and "stunning" scheme sought to keep the market "in the darkness."

But a closer inspection of the indictment reveals that Archegos' allegedly unlawful securities trading, which involved executing trades in the open market, lacks traditional indicia of illegality. The allegations and surrounding legal framework are far from clear-cut and highlight the need for courts to clarify the legal standard defining "market manipulation."

Background on U.S. v. Hwang

The Hwang indictment alleges two interrelated schemes. First, it alleges that Hwang and co-conspirators at Archegos lied to investment banks about the size and nature of its investments to obtain billions of dollars in liquidity for securities trading. Second, it alleges that Hwang engaged in a market manipulation scheme by:

- "Undert[aking] securities transactions at particular times, and in particular sizes or volume, to affect the closing price of the relevant stocks," including "purchases of hundreds of thousands of shares in those short periods of time";

- "Direct[ing] traders to use limit order prices above the prevailing market prices in the final minutes of the trading day," including "orders for stocks that could be filled automatically up to the above-market prices he set";

- "Instruct[ing] his traders to trade in certain stocks before the market opened, when liquidity was low ... in an effort to have greater impact on the price of the stock than at times of day when more of the stock was being bought and sold"; and

- "Coordinat[ing] certain trades with a close friend and former colleague ... to create and use additional capacity."[1]

The government alleges a so-called naked market manipulation scheme, meaning that it involves transactions executed on the open market.

The government's theory is noteworthy because Hwang and his co-conspirators are not alleged to have engaged in traditional forms of market manipulation, such as spoofing or wash trading, or making misrepresentations to the market. All trades were apparently fully executed.

In contrast to insider trading and spoofing, which are typically the subject of detailed employer rules and training, the trading at issue in the Hwang case is not alleged to violate any industry standard, employer prohibition or exchange rule.

The Government's Theory of Market Manipulation

The government's expansive theory draws from ambiguity in Second Circuit case law defining "market manipulation."

While acknowledging that the trading patterns alleged in the indictment could be lawful in certain circumstances, the government argues that its theory of manipulation under Sections 9(a) and 10(b) of the Securities Exchange Act is valid because "trades that might be lawful if not accompanied by manipulative intent can nonetheless form an unlawful market manipulation scheme when that intent is present."[2]

In support, the government relies primarily on Second Circuit precedent from civil cases brought by private plaintiffs.[3] It further argues that it "need not prove that the intent to defraud was the only intent or even the primary intent of the defendant. A defendant may have the required intent to defraud even if the defendant was motivated by other lawful purposes as well."[4]

But the government's theory in the Hwang case is difficult to square with U.S. v. Mulheren,[5] perhaps the U.S. Court of Appeals for the Second Circuit's most significant criminal market manipulation decision. In Mulheren, which arose from the investigation of disgraced Wall Street financier Ivan Boesky, the Second Circuit in 1991 tossed the trial conviction of a market trader because the evidence was insufficient to support the jury's verdict.

Mulheren appears to contradict the government's theory in the Hwang case in two respects.

First, the Mulheren court expressed "misgivings about the government's view of the law" that "when an investor, who is neither a fiduciary nor an insider, engages in securities transactions in the open market with the sole intent to affect the price of the security, the transaction is manipulative and violates Rule 10b-5."[6]

Second, the court held that the government had failed to prove that the defendant purchased common stock "for the sole purpose" of raising its price to benefit a person with substantial holdings of the stock rather than with an intent to invest.[7]

Mulheren thus suggests that (1) manipulative intent, standing alone, is insufficient to establish manipulation; and (2) the prosecution must prove that intent to defraud was the sole intent of the defendant.

In opposing Hwang's motion to dismiss the indictment, the government struggled to distinguish Mulheren, dismissing the language quoted above as "dictum" and claiming that "it is not clear exactly what caused the Mulheren court to have 'misgivings.'"[8]

Mulheren casts doubt on the government's intent-based theory of manipulation in the Hwang case and its argument that intent to defraud can be proven even if the defendant is motivated in part by lawful purposes.

Courts in the Southern District of New York have followed Mulheren's reasoning. For example, in U.S. v. Tuzman, a criminal market manipulation case tried in 2017, U.S. District Judge Paul Gardephe instructed the jury without objection of the government that it must find the defendant had engaged "in conduct with the sole intent to ... create a false impression of market activity."[9]

The government's theory is also arguably in tension with the Second Circuit's observation in Set Capital v. Credit Suisse Group in 2021 that "[w]hile a defendant may manipulate the market through open-market transactions, some misrepresentation or nondisclosure is required."[10] According to the Second Circuit, "[d]eception is the gravamen of a claim for market manipulation, and 'the market is not misled when a transaction's terms are fully disclosed.'"[11]

The government rejoins that the only deception it is required to prove is "the deception inherent in engaging in market transactions with the intent to deceive investors."[12] In other words, the government reads deception and intent as one and the same.

Analysis and Takeaways

The government's decision to charge a market manipulation scheme in the Hwang case appears to have been driven by two practical considerations.

First, the government paired its manipulation theory with an independent and more straightforward theory that Hwang and others made affirmative misrepresentations to banks to obtain liquidity. The misrepresentation theory strengthens the manipulation theory because it helps to explain the allegedly unlawful means Hwang employed to carry out the manipulation scheme.

Second, two alleged co-conspirators who reported to Hwang have pled guilty to conspiring to commit the manipulation and misrepresentation schemes, and are cooperating with the government. The government thus will attempt to use the cooperators' testimony that they intended to manipulate the market and understood that their conduct was wrongful as a proxy to show Hwang's allegedly criminal state of mind.

In these circumstances, the government undoubtedly viewed the Hwang case as an attractive vehicle to push the bounds of criminal market manipulation.

Today, more than 30 years after Mulheren was decided, there remain compelling reasons why the Second Circuit expressed "misgivings" in Mulheren about the intent-based theory of manipulation that the government embraces in the Hwang case. As Mulheren highlights, the government's theory of manipulation in the Hwang case is problematic for several reasons.

As an initial matter, by arguing in favor of an intent-based standard of manipulation, the government relies on circular logic: A trader engages in manipulation if they intend to engage in manipulation. This logic conflates two separate elements of the charged offenses — manipulation and intent — and creates an unworkable standard for jurors to follow. If manipulation is defined only by reference to intent, jurors are left without a framework to infer manipulation from circumstantial evidence.

The indictment in the Hwang case, moreover, offers little clarity to market participants about the line between lawful trading and market manipulation. To be sure, trading patterns alleged in the Hwang case can be entirely lawful, as the government apparently acknowledged in pretrial briefing. But the indictment does not explain clearly how or why Archegos' trading was manipulative aside from allegations about the traders' intent.

Consider, for example, the allegations about end-of-day trading and purchases of large volumes of shares in a short period of time. There are entirely legitimate reasons why traders may place such trades in the manner alleged in the Hwang case: Large-volume or market-on-close trades necessarily affect the forces of supply and demand, and thus the stock price, yet there is nothing inherently manipulative about them.

The government disclaims any obligation to prove that the defendant's conduct deceived, misled or omitted information from any market participant. But if all that distinguishes lawful from unlawful trading is the intent of the trader, then financial institutions and trading firms are left without guidance about the scope of permissible trading activity or how to train employees to stay on the right side of the law.

At bottom, the government's intent-based theory of liability creates ambiguity and fails to provide clear rules for market participants. Broad allegations of manipulation, as in the Hwang case, leave trading firms in a state of uncertainty, have a chilling effect on legitimate market activity and risk criminalizing lawful conduct. Ambiguity in the case law underscores the need for courts to clarify the definition of manipulation and establish an objective standard.

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[1] U.S. v. Hwang, 22 Cr. 240 (AKH) (S.D.N.Y.), Indictment, Dkt. 1, at 35, 37.

[2] U.S. v. Hwang, Gov't Mem. of Law in Opp. To Def. Pretrial Mot., Dkt. 53, at 31.

[3] See id. at 25-26, 28, 31.

[4] U.S. v. Hwang, Gov't Requests to Charge, Dkt. 127, at 33.

[5] 938 F.2d 364 (2d Cir. 1991).

[6] Id. at 368.

[7] Id. at 369.

[8] U.S. v. Hwang, Gov't Opp to Def. Pretrial Mot., Dkt. 53, at 27-28.

[9] 15 Cr. 536 (PGG) (S.D.N.Y. 2018). For a discussion of an alternative standard of intent recently adopted by the Honorable Lewis J. Liman in U.S. v. Phillips, 22 Cr. 138 (LJL) (S.D.N.Y.), a market manipulation case, see Michael Longyear, John Siffert, and Zachary Shemtob, A Closer Look at Novel Jury Instruction in Forex Rigging Case, Law360 (Feb. 12, 2024).

[10] Set Capital v. Credit Suisse Grp., 996 F.3d 64, 76-77 (2d Cir. 2021).

[11] Id. at 77 (internal quotation marks omitted).

[12] U.S. v. Hwang, Gov't Mem. of Law in Opp. To Def. Pretrial Mot., Dkt. 53, at 25.