

Second Circuit Applies Morrison to Criminal Prosecution Under Section 10(b) and Rule 10b-5

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In [*United States v. Vilar*](#), Case Nos. 10-521(L), 10-580(CON), 10-4639(CON), 2013 WL 4608948 (2d Cir. Aug. 30, 2013), the [United States Court of Appeals for the Second Circuit](#) held that [Section 10\(b\)](#) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and [Securities & Exchange Commission](#) (“SEC”) [Rule 10b-5](#), 17 C.F.R. § 240.10b-5, promulgated thereunder, do not apply to extraterritorial conduct in both the civil and criminal context. In so holding, the Second Circuit made clear that the [United States Supreme Court](#)’s ruling in [*Morrison v. National Australia Bank Ltd.*](#), 130 S. Ct. 2869 (2010) [blog article [here](#)], that civil liability under Section 10(b) does not apply extraterritorially, extends to criminal conduct as well. In light of that ruling, a criminal conviction for securities fraud can only be found if the defendant “engaged in fraud in connection with (1) a security listed on a U.S. exchange, or (2) a security purchased or sold in the United States.” While this holding did not disturb the defendants’ convictions in this case, the ruling provides guidance for future prosecutions under Section 10(b), which now require proof of a domestic sale or listing as a necessary element for conviction.

From the mid-1980s through their arrest in 2005, defendants Alberto Vilar and Gary Alan Tanaka worked as investment managers and advisors using a number of domestic and off-shore companies as vehicles for the investments that they managed. Vilar and Tanaka’s troubles began after the technology bubble burst in late 2000. Over the prior decade, Vilar and Tanaka had been offering investors the opportunity to invest in “Guaranteed Fixed Rate Deposit Accounts” (“GFARDAs”), which purportedly consisted of high-quality, short-term deposits, such as U.S. Treasury bills, with no more than 25% of the accounts to be invested in emerging growth stocks. However, the GFARDAs were not, in fact, secure investments and were instead fully invested in highly volatile technology and biotechnology stocks.

After the precipitous decline in technology securities of the early 2000s, Vilar and Tanaka struggled to sustain their business. In June 2002, they approached a long-standing client, Lilly Cates, and sought to sell her on a new investment that would purportedly invest in small businesses and obtain matching funds from the federal government. However, Vilar and Tanaka had never been approved

for such matching funds, and the investment did not exist. Cates ultimately invested \$5 million in the fictitious fund.

Upon depositing Cates' money into a company bank account, Vilar and Tanaka began using the funds to satisfy their own personal and corporate obligations. By early 2005, Cates became suspicious of Vilar and Tanaka's activity and ultimately reported them to the SEC. On August 15, 2006, Vilar and Tanaka were indicted on twelve total counts including securities fraud, conspiracy to commit securities fraud, mail fraud, wire fraud, money laundering and making false statements to the SEC. After a nine-week jury trial in the [United States District Court for the Southern District of New York](#), Vilar was convicted on all counts and Tanaka was convicted of conspiracy and certain of the securities fraud counts.

On appeal, Vilar and Tanaka raised a number of challenges to their convictions and sentences. The Second Circuit focused primarily on the issue of whether defendants' convictions could be sustained in light of the Supreme Court's holding in *Morrison* that Section 10(b) does not apply extraterritorially. In doing so, the Court addressed whether the *Morrison* holding applied in the criminal context, and, if so, whether the government proved that Vilar and Tanaka engaged in fraud with respect to a security listed on an American exchange or a security purchased or sold in the United States. The Second Circuit held that *Morrison* clearly extended the limitation on Section 10(b) to criminal as well as civil liability.

Acknowledging that there was no allegation that the securities at issue were listed on a U.S. stock exchange, the Second Circuit next considered whether a jury would have found, beyond a reasonable doubt, that Vilar and Tanaka engaged in fraud in connection with a domestic purchase or sale of securities. In addressing this issue, the Court considered evidence presented at trial that Cates, as well as certain of the GFARDA investors, signed investment materials, received letters and met with Vilar and Tanaka in the United States. In light of these facts, the Second Circuit determined that the jury would have found that Vilar and Tanaka engaged in fraud in connection with securities while in the United States if the jury had been instructed to consider that question. While this conviction withstood that careful scrutiny, in the wake of *Morrison* and this case, juries and courts now must consider and make a factual finding as to whether the fraud at issue in a Section 10(b) case occurred domestically.

The Second Circuit also considered the extraterritoriality element in connection with the calculation of the loss sustained by Vilar and Tanaka's victims for the purposes of determining their sentences and restitution obligations. The Second Circuit held that the district court was required to consider whether the defendants' relevant criminal conduct with respect to each transaction involved domestic securities, before it could consider those transactions in calculating defendants' restitution obligations or sentences. Thus, the case was remanded to the district court to recalculate the defendants' sentences and restitution in light of the ruling that Section 10(b) cannot apply abroad.

The Second Circuit was also asked to consider a number of other alleged errors at trial. One of those issues was whether Section 10(b) required proof that the victims of a fraudulent scheme actually relied upon the alleged material misrepresentations or omissions at issue. The Court ultimately held that reliance is not a necessary element when the government seeks to subject a defendant to civil or criminal liability under Section 10(b). The Court similarly rejected Vilar and Tanaka's other challenges regarding the sufficiency of the evidence presented at trial and the propriety of certain search warrants and jury instructions. It also declined to consider Vilar's ineffective assistance of counsel argument.

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