IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLORADO

Criminal Action No. 05-cr-00545-EWN

UNITED STATES OF AMERICA

Plaintiff,

v.

JOSEPH P. NACCHIO,

Defendant.

MOTION FOR DISMISSAL OF INDICTMENT

Comes now Defendant Joseph P. Nacchio, by and through undersigned counsel, and pursuant to Fed. R. Crim. P. 12(b)(2) and (3), and 7(c)(2), respectfully requests that the Court dismiss the indictment because, on its face, it: (i) fails to charge an essential element of all 42 counts against Mr. Nacchio -- the "materiality" of his alleged "inside information;" (ii) is so vague as to lack the constitutional sufficiency needed to allow Mr. Nacchio to mount a defense and to protect his due process rights; and (iii) contains facially deficient forfeiture allegations.

I. STATEMENT OF THE CASE

On December 20, 2005, Mr. Nacchio was indicted in a six-page indictment on 42 counts of insider trading. (Doc. 1 ¶ 9) The indictment alleges that Mr. Nacchio, while employed as the CEO and a board member at Qwest Communications International, Inc. ("Qwest"), sold stock with a gross sales price totaling $100,812,582.02. (*Id.* ¶ 9) The indictment further alleges that such sales occurred between January 2 - May 29, 2001 (*id.*), during which period Mr. Nacchio:

> [W]as aware of material, non-public information about Qwest's business, including, but not limited to: (a) that Qwest's publicly stated financial targets,

> including its targets for 2001, were extremely *aggressive* and a "*huge stretch*"; (b) that in order to achieve its publicly stated financial targets for 2001, Qwest would be required to significantly increase its recurring revenue business during the first few months of 2001; (c) that Qwest's past experience or "track record" in growing recurring revenue at a sufficient rate to meet its publicly stated financial targets was poor; (d) that Qwest's recurring revenue business was underperforming from early 2001 and was not growing at a sufficient rate to meet Qwest's publicly stated financial targets; (e) that there were material undisclosed risks relating specifically to Qwest's recurring and non-recurring revenue streams that put achievement of Qwest's 2001 publicly stated financial targets in *jeopardy*; (f) that the gap between Qwest's publicly stated financial targets and Qwest's recurring revenue was increasing, thus increasing Qwest's reliance on *risky* and unsustainable one-time transactions; and (g) that there would be insufficient non-recurring revenue sources to close the gap between Qwest's publicly stated financial targets and its actual performance.

(*Id.* ¶ 6) (emphasis added)

The heart of the Government's case is that Mr. Nacchio was told of a concern that Qwest *might not* be able to meet its publicly stated financial targets or, in the common parlance, "make its numbers." As a matter of law, this is insufficient to charge the crime of insider trading, especially given the government's explicit concession that Qwest's financial reporting during the relevant period was fully accurate and complete.

It is not alleged that Mr. Nacchio *knew* Qwest *could not* make its numbers, or even that he *believed* Qwest *would not* make its numbers, but merely that he had been told that Qwest *might not* be able to make its numbers. This Court has previously held that a failure to disclose financial "risks" is not the concealment of *material* information. *See McDonald v. Kinder-Morgan, Inc.*, 287 F.3d 992, 998 (10th Cir. 2002) (*aff'g* Nottingham, J.). As Mr. Nacchio is not charged with possessing any material information that would restrain him from exercising and then selling his stock options, the indictment does not charge an offense and should be dismissed.

Alleging that Mr. Nacchio was told that Qwest's publicly stated financial targets were "extremely aggressive" and "a 'huge stretch' " (Doc. 1 ¶ 6) also fails to allege the requisite materiality. What does a "huge stretch" or "extremely aggressive" mean -- especially when Qwest undisputedly *did* make its numbers from January 2 - May 29, 2001, the period during which Mr. Nacchio made the stock sales alleged in the indictment? What was he told prior to May 29, 2001 (the date alleged in the last count)?[1] Of what was Mr. Nacchio allegedly aware on the date specified in each of the remaining 41 counts?[2]

Additionally, the Government has asserted in a filing with this Court, that Mr. Nacchio is "criminally responsible for insider trading if he was aware of material inside information at the time of his trades and acted with the requisite scienter," and, most importantly, that this is true "*[e]ven if Qwest accurately reported its financial results, [and] disclosed every fact required to be disclosed by law*…." (Doc. 26 at 2, Government's Status Report Regarding Discovery," January 19, 2006) (emphasis added) The prosecution has put forth an impossible proposition.

[1] Paragraph 6 alleges that Mr. Nacchio learned everything described in the Paragraph "[n]o later than December 4, 2000, through and including September 10, 2001," yet the allegedly insider trades stopped on May 29, 2001. (*cf.* Doc. 1 ¶ 6 *with id.* ¶ 9) It is axiomatic that whatever was allegedly told to Mr. Nacchio *after* May 29, 2001 cannot *possibly* constitute a "material" non-public fact of which he was aware while trading.

[2] Paragraph 6 alleges that Mr. Nacchio was in possession of information "[n]o later than December 4, 2000." The Government is, therefore, alleging that *each and every* fact in ¶ 6 was known to Mr. Nacchio on December 4, 2000. But this is inconsistent with other portions of the same paragraph inasmuch as the very nature of many of the individual allegations suggests that Mr. Nacchio was being given additional information as the year 2001 unfolded. *See, e.g.*, ¶ 6(d) (emphasis added) ("Qwest's recurring revenue business was underperforming from *early 2001* and was not growing at a sufficient rate…."). If the Government really means *beginning* on December 4, 2000, and *continuing* through and including September 10, 2001, then the indictment lacks the constitutionally requisite sufficiency to allow Mr. Nacchio to defend, for we are left to guess which of these vague and contingent facts were allegedly known to him at *each* of the 42 different times he is alleged to have traded and, if it does not mean what it says, then we are left to guess at what it *does* mean.

As will be shown, under the circumstances here, the federal common law under Section 10b-5 is clear that there is but a single definition of "material information," applicable equally to the company and its officers. Indeed, the law tells us that knowledge by an officer is necessarily imputed to the company. It cannot, therefore, simultaneously be alleged that (1) Mr. Nacchio is guilty of insider trading because things he had been told before he sold his stock -- that the stated financial targets were "a huge stretch" and "extremely aggressive"-- were material information, and (2) that Qwest was *not* required to disclose this identical, supposedly "material" information. On the contrary, no insider can be guilty of a crime for trading in his company's stock if the company has accurately disclosed all that the law requires it and him to disclose. Any other standard would bring the marketplace into chaos.

In short, since the Government has charged Mr. Nacchio with nothing more than a failure to disclose financial risks, and has explicitly admitted that Qwest's disclosures as to its financial targets for 2001 were accurate and complete throughout the relevant period, it necessarily follows that the indictment fails to allege the "materiality" of Mr. Nacchio's "inside information" -- an essential element of all 42 counts against Mr. Nacchio. This failure renders the indictment facially deficient.

Further, the indictment is so vague as to lack constitutionally requisite sufficiency. The law is clear that the sufficiency of an indictment must be measured by the document's four corners and that a deficient indictment may not be saved by extraneous facts. Indeed, a court should refrain from considering evidence outside the indictment when testing its legal sufficiency. In other words, an indictment so vague as to lack constitutionally requisite sufficiency cannot be cured by a bill of particulars. That is to say, the answers to the bill of particulars which we have demanded will not save the indictment if it is constitutionally deficient. *See Russell v. United States*, 369 U.S. 749, 770 (1962) ("But it is a settled rule that a bill of particulars cannot save an invalid indictment."); *accord, United States v. Neal,* 692 F.2d 1296, 1302 (10th Cir. 1982) (citing *Russell*).[3] The answers to the bill cannot substitute for words the grand jury did not charge, and did not have in mind when it made the charges that it did.[4] Inasmuch as the words that this grand jury chose to adopt are insufficient as a matter of law, the indictment should be dismissed.

The indictment should also be dismissed for failure to allege materiality as a matter of law under the "efficient market test." The judicially noticeable facts, as more fully set forth below, are dispositive that the allegedly insider information could not have been material.

Finally, the indictment makes a demonstrably deficient forfeiture allegation. Even though the Government recognized the statutory restriction on the face of the indictment by stating that it was seeking proceeds obtained "as a result of the offense,"[5] it then ignored this restriction by demanding forfeiture of the *entire* gross sales price. (Doc. 1 Forfeiture Allegations at 6) The law is clear that arriving at the proceeds requires some type of calculation of *profit deriving from the charged offense*. Here, the Government has failed to deduct from the gross

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[3] The demand for a bill of particulars was filed in compliance with the Order of the Court to do so in the same time period that was allowed to file the facial challenge to the indictment. That is the only reason this demand is being made at this time.

[4] "To allow the prosecutor, or the court, to make a subsequent guess as to what was in the minds of the grand jury at the time they returned the indictment would deprive the defendant of a basic protection which the guaranty of the intervention of a grand jury was designed to secure. For a defendant could then be convicted on the basis of facts not found by, and perhaps not even presented to, the grand jury which indicted him." *Russell*, 369 U.S. at 770. The *Russell* Court, 369 U.S. at 770, cited to the decision in *United States v. Lattimore*, 215 F.2d 847 (D.C. Cir. 1954). The *Lattimore* court similarly explained: "The prosecutor, in supplying the particulars, cannot guess at what was in the grand jury's mind or ascribe a meaning to a charge by the grand jury if that meaning is not apparent upon the face of the indictment." 215 F.2d at 850.

[5] *See* 18 U.S.C. § 981(a)(1)(c) (statute limited to proceeds *traceable to a violation*.)

sale price the amount of the monies paid by Mr. Nacchio for the shares. Furthermore, the proper amount of forfeiture is the difference between the value of the shares before disclosure of the material, non-public information, and the market value of the shares after the marketplace assimilated the alleged material information.[6]

For each one of these reasons, it is respectfully submitted, the indictment should be dismissed.[7]

II. ARGUMENT

A. The Elements Of The Charged Offense

The indictment alleges insider trading in violation of 15 U.S.C. § 78j, 17 C.F.R. § 240.10b-5 and 17 C.F.R. § 240.10b5-1. (Doc. 1 at 1) Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and SEC Rule 10b-5 which is promulgated thereunder, 17 C.F.R. § 240.10b-5, prohibit fraudulent acts done in connection with securities transactions. *See Dura Pharmaceuticals, Inc. v. Broudo*, -- U.S. --, 125 S.Ct. 1627, 1630-31 (2005); *see also Basic Inc. v. Levinson*, 485 U.S. 224, 230 (1988). Although § 10b does not use the term "insider trading," "§ 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information." *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997).

[6] As we will show in discussing the "efficient market" test for materiality, *infra*, there was *no* change to the share price after the market absorbed *either* disclosure of allegedly inside information and, consequently, there was *no* "profit deriving from the charged offense."

[7] During the January 20, 2006 pre-trial conference, the Court observed that multiplicity was an area where the defense had previously suggested the possibility of attacking the face of the indictment, noting that "the Government even offered a bill of particulars." (Transcript of Proceedings, 12:2, January 20, 2006). We believe a motion addressing multiplicity is premature until after the Government provides that bill of particulars, in the event the indictment is not dismissed.

In this District:

> [T]he following are the elements … to establish a misrepresentation violating Rule 10b-5: "(1) a material misrepresentation, (2) in connection with the purchase or sale of a security, (3) scienter, [and] (4) use of the jurisdictional means." … Depending on the circumstances, the first element may be satisfied in alternative ways, such as by showing an omission where there is a duty to speak.

Geman v. S.E.C., 334 F.3d 1183, 1192 (10th Cir. 2003) (citations omitted); *accord*, *City of Philadelphia v. Fleming Companies, Inc.*, 264 F.3d 1245, 1257-58 (10th Cir. 2001), citing *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1118 (10th Cir. 1997); *see also Anixter v. Home-Stake Products*, 77 F.3d 1215, 1225 (10th Cir. 1996) (similar definition); *and see Shriners Hospitals For Children v. QWEST Communications Int'l Inc.*, 2005 WL 2350569, at *6 (D. Colo. 2005) (Blackburn, J.) (citing *Anixter), and S.E.C. v. C. Jones & Co.*, 312 F.Supp.2d 1375, 1379 (D. Colo. 2004) (Miller, J.) (citing *Geman*).[8]

Thus, to prove insider trading, the Government must allege the existence of a material representation or omission and Mr. Nacchio's *knowing use* of that information while trading. Having failed to make the requisite allegations on the face of the indictment, the indictment should be dismissed.

[8] Although this is a criminal matter, the civil common law of securities is applicable. "It is … settled that the same standards apply to civil and criminal liability under the securities law." *United States v. Gleason*, 616 F.2d 2, 28 (2d Cir. 1979); *accord*, *United States v. Causey*, 2005 WL 2647976, at *2 (S.D. Tex. 2005) (citing *Gleason*). Indeed, in *Chiarella v. United States*, 445 U.S. 222, 226 (1980), an appeal from a criminal 10b-5 conviction, Justice Stevens repeatedly cited to civil 10b-5 cases, beginning with *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). *See also United States v. Dowlin*, 408 F.3d 647, 658 (10th Cir. 2005) (in a criminal appeal, citing to 10th Circuit civil securities opinions for elements of securities fraud).

B. As A Matter Of Law, The Allegations Of The Indictment Fail To Allege The Requisite Materiality

As a matter of law, "[a] statement is material only if 'a reasonable investor would consider it important in determining whether to buy or sell stock.' " *McDonald*, 287 F.3d at 998, quoting *Grossman*, 120 F.3d at 1119.[9] In *McDonald*, the plaintiff alleged that the company had made materially misleading statements because "they do not disclose the existence of the significant *risks* associated with the Bushton-related 'keep whole' contracts while reporting the incremental operating revenue and operating income attributable to the operation of the Bushton plant." 287 F.3d at 996 (emphasis added). This Court dismissed the *McDonald* complaint on its face under Rule 12(b)(6), for failure even to state a claim. The Tenth Circuit then upheld this Court's conclusion that "the accurate reporting of historic successes does not give rise to a duty to further disclose *contingencies* that might alter the revenue picture in the future." *Id.* at 998 (emphasis added).

This indictment suffers from the *identical* lethal disability.

There is no allegation in the indictment that Qwest's historical reporting was anything but accurate and complete. *McDonald* outlawed 10b-5 claims based upon non disclosure of vague contingencies, that is, "failure to disclose risks" in connection with earnings, yet it is *precisely* these *vague contingencies* -- "extremely aggressive," "a huge stretch," "risky," and "jeopardy" -- which the prosecution had the grand jury specify as the "material" information known to Mr. Nacchio. (Doc. 1 ¶ 6) Claiming that Mr. Nacchio had been told that Qwest's "publicly stated financial targets, including its targets for 2001, were extremely aggressive and a 'huge stretch' " is just a different way of saying that Mr. Nacchio was aware that there were "contingencies that

[9] *Grossman*, in turn, cites *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) and *Basic Inc.*, 485 U.S. at 231-32.

might alter the revenue picture in the future," which is exactly what this Court, and the Tenth Circuit sitting in review of this Court, have held to be immaterial, *as a matter of law*.

Consequently, *McDonald* instructs that these types of contingencies do not give rise to a duty to disclose. The indictment is not saved by the other vague and conclusory allegations of Paragraph 6. Whether taken individually or as a whole, they merely establish the reality faced by every public company when future earnings are projected based on past history: not all expectations may be met and the actual sources of revenue often do not precisely line up, either with those of the past or with those expected in the future. *See, e.g., Stevelman v. Alias Research Inc.*, 174 F.3d 79, 85 (2d Cir. 1999) ("Management's optimism that is shown only after the fact to have been unwarranted does not, by itself, give rise to an inference of fraud."); *see also In re Ikon Office Solutions, Inc. Securities Lit.*, 131 F.Supp.2d 680, 702 (E.D. Pa. 2001) ("The fact that a future prediction turns out to be wrong does not mean it was fraudulent when made."), *aff'd*, 277 F.3d 658 (3d Cir. 2002).

For example, ¶ 6(b) alleges that Mr. Nacchio was told, "[n]o later than December 4, 2000," "that in order to achieve its publicly stated financial targets for 2001, Qwest would be required to significantly increase its recurring revenue business during the first few months of 2001."[10] Putting aside the factual issue that there is no difference between making the target via non-recurring rather than recurring income, such an allegation is insufficient to establish that the

[10] The vague contingent nature of these allegations increases the earlier in time Mr. Nacchio was allegedly told these things, because the earlier they were communicated to him, the more speculative they necessarily must have been. Paragraph 6 of the indictment charges that he knew all of the allegations of ¶ 6(a) - (g) "[n]o later than December 4, 2000." It is hard to imagine a more speculative occasion than thirteen months in advance of the close of the period covered by the target numbers. To be sure, the alleged material non-public information would still have represented entirely speculative contingencies even if they had been told to Mr. Nacchio on May 29, 2005, the date of his last alleged insider trade. But, of course, that is not what has been charged.

earnings guidance had to be changed to render it not misleading. *See Kushner v. Beverly Enterprises, Inc.*, 317 F.3d 820, 831 (8th Cir. 2003) ("[T]here is no duty to disclose 'soft information,' such as a matter of opinion [or] predictions …. 'Soft information must be disclosed only if virtually as certain as hard facts.' ") (quoting *In re Sofamor Danek Group, Inc.*, 123 F.3d 394, 402 (6th Cir. 1997), *cert. denied*, 523 U.S. 1106 (1998)). In any event, as we show in Point C, *infra*, the Government admits that the guidance was materially sufficient.

The same circumstance holds true of Paragraph 6(d), which alleges that "[n]o later than December 4, 2000," "Qwest's *recurring revenue business* [which was not its only source of income] was underperforming from early 2001 and was not growing at a sufficient rate to meet Qwest's publicly stated financial targets" (emphasis added).[11] In plain English, the indictment alleges that between December 4, 2000 and September 10, 2001, the rate of growth of the recurring revenue business imperiled the achievement of the target.[12] It alleges no more than a contingency, a mere possibility which was always subject to change and which might well have evolved at any point during or after the period from December 4, 2000 through May 29, 2001. And May 29, 2001 is the last date which should matter for this indictment since that is the last date of any crime charged. This bare allegation of a contingency is so far different from the accusation of *knowledge* that more recurring revenue *could not* or *would not* be realized, let

[11] It does not seem possible that results from "early 2001" could have been known to Mr. Nacchio on December 4, 2000. Nevertheless, that is what the indictment says.

[12] The indictment repeatedly stresses the importance of September 10, 2001, the date of the second public disclosure of allegedly material information. (Doc. 1 ¶ 3 ("This guidance was repeatedly reaffirmed by NACCHIO prior to September 10, 2001."); *id.* ¶ 6 ("No later than December 4, 2000, through and including September 10, 2001…."); and *id.* ¶ 9 ("Beginning on or about January 2, 2001, and continuing through and including September 10, 2001….")).

alone that any shortfall in expected recurring revenue *could not* be made up from other revenue sources, that it is directly forbidden by *McDonald*.

Paragraph 6(c) alleges that, "[n]o later than December 4, 2000," "Qwest's past experience or 'track record' in growing recurring revenue at a sufficient rate to meet its publicly stated financial targets was poor." Whatever "poor" means, and that is anyone's guess, the prosecution does not allege that Qwest's historical disclosures were in any manner deficient or false or misleading, or that Mr. Nacchio *knew* or even *believed* that Qwest could not make its numbers. And this allegation is made notwithstanding that this Court has specifically held, as affirmed by the Tenth Circuit, that accurate reporting of historic financial results does *not* give rise to a duty "to further disclose *contingencies* that might alter the revenue picture." 287 F.3d at 998 (emphasis added). It simply cannot be denied that these allegations impermissibly attempt to convert such historical information into "material" statements.

Paragraph 6(e) alleges "that there were material undisclosed *risks* relating specifically to Qwest's recurring and non-recurring revenue streams that put achievement of Qwest's 2001 publicly stated financial targets in *jeopardy*" (emphases added). The prosecution's deliberate use of these inherent uncertainties, alleging that achieving the revenue target was "risky" or "in jeopardy," is directly prohibited by *McDonald*.

Paragraph 6(f) alleges that "[n]o later than December 4, 2000, through and including September 10, 2001," "the gap between Qwest's publicly stated financial targets and Qwest's recurring revenue was increasing, thus increasing Qwest's reliance on *risky* and unsustainable one-time transactions" (emphasis added).[13] Again, we are presented with an indictment that fails

[13] The nature of this statement also makes it unlikely to have been made "[n]o later than December 4, 2000." Here, too, the earlier the date Nacchio was "told" something (continued)

to charge a crime and instead contains language which this Court has ruled requires dismissal on its face. What is this, if not a *contingency*, something that may or may not come to pass and that may or may not prove relevant *in hindsight* after all other sources of revenue are taken into account?[14]

As no other allegations of materiality have been made, the indictment fails to allege this requisite element of the offense and the indictment should, therefore, be dismissed. *See United States v. Coia*, 719 F.2d 1120, 1123 (11th Cir. 1983), *cert. denied*, 466 U.S. 973 (1984) ("It is perfectly proper, and in fact mandated, that the district court dismiss an indictment if the indictment fails to allege facts which constitute a prosecutable offense.").

C. The Government's Judicial Admission Renders The Allegations Against Mr. Nacchio Immaterial

Putting aside the strictures of *McDonald*, this indictment should be dismissed because the Government has taken the position in a filing with the Court that Qwest's financial guidance and disclosures were accurate and complete, even as it alleges in the indictment that Mr. Nacchio had a duty to disclose that same information. The information cannot logically or legally be both material and immaterial at the same time. Because the Government concedes that Qwest's filings were accurate and complete it follows, *a fortiori*, that Mr. Nacchio cannot have acted inappropriately in trading on the same information and that the indictment, therefore, fails to allege materiality, a necessary requisite of the offense.

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the more hopelessly contingent it was and, after May 29, 2001, anything told to Nacchio is necessarily immaterial.

[14] The same is true of the allegations of Paragraph 6(g), where it is alleged "that there would be insufficient non-recurring revenue sources to close the gap between Qwest's publicly stated financial targets and its actual performance."

The prosecution has stated to this Court that Mr. Nacchio "is still criminally responsible for insider trading if he was aware of material inside information at the time of his trades and acted with the requisite scienter," "[e]ven if Qwest accurately reported its financial results, [and] disclosed every fact required to be disclosed by law…." (Doc. 26 at 2) To the extent the Government is conceding that, during the operative time in question, Qwest accurately reported its financial results and disclosed every fact required to be disclosed by law, this Court may deem this a judicial admission, having "the effect of withdrawing a fact from issue and dispensing wholly with the need for proof of the fact." *Guidry v. Sheet Metal Workers Int'l Ass'n, Local No. 9*, 10 F.3d 700, 716 (10th Cir. 1993), *cert. denied*, 514 U.S. 1063 (1995); *accord*, *United States v. Alvarez-Becerra*, 33 Fed.Appx. 403, 406-07 (10th Cir.), *cert. denied*, 536 U.S. 931 (2002) (citing *Towerridge, Inc. v. T.A.O., Inc.*, 111 F.3d 758, 769 (10th Cir. 1997) and *Guidry*);[15] *see also Plastic Container Corp. v. Continental Plastics of Oklahoma, Inc.*, 607 F.2d 885, 906 (10th Cir. 1979), *cert. denied*, 444 U.S. 1018 (1980) (same doctrine, drawn from Second and Fifth Circuit authority).

As a matter of law, Mr. Nacchio's knowledge is imputed to the company. *See, e.g., S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 860-62 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). Qwest's knowledge cannot, therefore, be less than Mr. Nacchio's. Accordingly, the Government's concession that, throughout the period that Mr. Nacchio was trading his stock, Qwest had "accurately reported it's financial results, [and] disclosed every fact required to be disclosed by law" compels the conclusion that Mr. Nacchio had *no* undisclosed material information about Qwest when he made the trades that are the subject of the 42 count indictment.

[15] Although *Alvarez-Becerra* was not selected for publication in the Federal Reporter, it may assist the Court in its disposition of the matter *sub judice* because, there, the doctrine of "judicial admission" was applied in a criminal matter. 10th Cir. Rule 36.3 (B)(2).

Accordingly, by the government's own admission, whatever possible contingencies Mr. Nacchio was told about were not material and he was free to sell his stock. *See, e.g., Grossman*, 120 F.3d at 1119 ("unless the statement 'significantly altered the "total mix" of information' available, it will not be considered material"), quoting *TSC Indus.*, 426 U.S. at 449; *and see Garcia*, 930 F.2d at 829 ("The [Supreme] Court has explained that it deliberately did not set the materiality standard too low because of concern that a minimal standard would result in avalanches of information that would bury stockholders in trivia…."), citing *Basic*, 485 U.S. at 231.

The Government seems to be suggesting in the alternative that the knowledge Mr. Nacchio (and Qwest) had was material, but nevertheless did not have to be disclosed. (*see* Doc. 26 at 2-3 ("Qwest … had a good faith belief or a recognized legal right to withhold material information under one of the exceptions to disclosure under the securities laws…. In fact, it is the essence of at least one type of insider trading that the defendant is in possession of material inside information that is *not* legally required to be disclosed.")) An example of this exception would be undisclosed news about a pending merger. *See*, *e.g.*, *Garcia v. Cordova*, 930 F.2d 826, 828-29 (10^{th} Cir. 1991), citing *Chiarella*, 445 U.S. at 226-29. This, however, is *not* the allegation in Paragraph 6 of the indictment. This is not a charge concerning withheld news as to a subject which is not released because of a legal right to be silent, this is a charge that Mr. Nacchio heard that there was something wrong with Qwest's publicly stated financial targets to the effect that they were "extremely aggressive and a 'huge stretch.' " If this were material as to Mr. Nacchio, it would have had to be disclosed by Qwest as well, since it would not fall under any "exceptions to disclosure under the securities law."

D. The Indictment Fails To Allege An Offense

The Paragraph 6 laundry list of things Mr. Nacchio was allegedly told is not only nothing more than a list of contingencies, the words themselves are too vague to state a crime. Words like "stretch," "aggressive," "risky" and "jeopardy" are accordion-type language that in reality say *nothing* definite enough to be understood and, certainly, nothing definite enough to be defended against. The language connotes nothing meaningful. This, in the final analysis, is why such language cannot be "material."

Accordingly, the indictment fails to apprise Mr. Nacchio with reasonable certainty of the nature of the accusation against him. That is, the prosecution has failed to allege the operative facts of the crime of insider trading with the constitutional sufficiency that would allow Mr. Nacchio to mount a defense and comport with his due process rights. This omission is a facial deficiency that, respectfully, requires dismissal of the indictment.

The Tenth Circuit has consistently held that a vague indictment does not pass constitutional muster. In *United States v. Hall*, 20 F.3d 1084, 1087 (10th Cir. 1994) (some citations omitted), the Court affirmed the district court's dismissal of an indictment, stating:

> An indictment is deemed constitutionally sufficient if it (1) contains the essential elements of the offense intended to be charged, (2) sufficiently apprises the accused of what he must be prepared to defend against, and (3) enables the accused to plead an acquittal or conviction under the indictment as a bar to any subsequent prosecution for the same offense. *Russell v. United States,* 369 U.S. 749, 763-64 … (1962); *United States v. Walker*, 947 F.2d 1439, 1441 (10th Cir. 1991). … An indictment should be tested solely on the basis of the allegations made on its face, and such allegations are to be taken as true. *United States v. Sampson*, 371 U.S. 75, 78-79 … (1962). Courts should refrain from considering evidence outside the indictment when testing its legal sufficiency.

Accord, United States v. Welch, 327 F.3d 1081, 1090 (10th Cir. 2003) (citing *Hall*).

Constitutional sufficiency does not merely require that the allegations of an indictment be detailed enough to provide for mounting a defense, it also safeguards the due process protection that a grand jury affords as a check on an over zealous prosecutor. A grand jury may *not* give a prosecutor a blank check. *See United States v. Kilpatrick,* 821 F.2d 1456, 1464-65 (10th Cir. 1987).

In *United States v. Curtis*, 506 F.2d 985, 990 (10th Cir. 1974) (emphases added), the Court explained that an indictment requires:

> [S]ome substantial indication of the nature or character of any scheme or artifice to defraud, or to obtain money or property by means of false pretenses, representations or promises is requisite. *And it is not sufficient in this regard to merely plead the statutory language*. *Cf. Russell v. United States*, 369 U.S. 749 … (1962); *Lowenburg v. United States*, 156 F.2d 22 (10th Cir. 1946). A reference to the cases cited first above will disclose that in each instance the nature of the schemes or artifices is identified or described, *including the particular pretenses, representations or promises claimed to have been false*.

The *Curtis* Court was confronted with a mail fraud indictment in which "the[] salient facts vital to the government's claim of an unlawful scheme or artifice are masked, if not concealed, by the conclusionary language of the indictment as framed." *Id.* at 987. Similarly, here, the wholly vague contingencies of Paragraph 6 mask the salient facts vital to the prosecution's claim. When the contingencies are stripped away -- that is, when words like "extremely aggressive," "huge stretch," "risky" and "jeopardy" are removed from the indictment, as they must be under *McDonald* as well as for vagueness -- *all that is left is the bare language of the statute*. Such charging language, using only the words of the statute (*e.g.*, willfully sold on the basis of inside information), is what *Curtis* prohibits. As the *Curtis* Court observed:

> What the 'scheme and artifice to defraud', or the 'false and fraudulent pretenses, representations and promises' referred to in the indictment were, is left to speculation. And by the curious commingement of references to the scheme with

> allegations of various means utilized to carry it out, the indictment is confusing as well as vague.

Id. at 989. The *Curtis* Court reversed and remanded, because:

> In sum, the indictment here, after all has been said and done, pleads little more than the statutory language without any fair indication of the nature or character of the scheme or artifice relied upon, or the false pretenses, misrepresentations or promises forming a part of it. …

Id. at 992.

In addition to violating the legal requirements for pleading securities fraud as announced in *McDonald*, this indictment is confused, confusing and internally inconsistent. It uses terminology which no one can define and time segments which are impossible to assess.[16] It was obviously brought in a hurry, notwithstanding a three year investigation, on the very eve of the discharge of the grand jury which had been investigating a case of fraud but which was left only with this product instead. It was not brought in this form to simplify the case, as the Government has repeatedly represented to this Court, but because the Government had no case at all. The prosecution is attempting, by its incorrect and inconsistent declarations of what it must prove, to avoid the accounting issues which cannot be sidestepped in determining the accuracy of the public guidance as to Qwest's future income and earnings. Thus, if the Court permits the case to go forward -- which we respectfully submit it should not do -- all of Qwest's accounting during the relevant period will be material to the accuracy of its public guidance, as will be the

[16] If the Government is asserting that on December 4, 2000 Mr. Nacchio did not know *each and every* one of the allegations in Paragraph 6, then in order for Mr. Nacchio to prepare a defense he must first know what and when it is alleged he knew with respect to *each* of the 42 counts. Alternatively, if the Government really *is* asserting that Mr. Nacchio knew all these things on December 4, 2000, the allegations are still vague and contingent. Further, as has been noted, *anything* which Mr. Nacchio is alleged to have been told after his last trade on May 29, 2001 can *never* satisfy a requisite element of the charged offenses, so that to the extent the allegations concern information given to him after May 29, 2001 they should be stricken.

reasonableness of the views of that guidance's internal critics, and the reasonableness of Mr. Nacchio's rejection of those views.

Because the Government failed to satisfy the requisites of the Constitution in seeking the instant indictment, the indictment should, we respectfully submit, be dismissed.

E. The Allegations Of The Indictment Are Also Immaterial, As A Matter Of Law, Under The "Efficient Market Test" Of Materiality

A court may find non-public information to be immaterial as a matter of law by employing the "efficient market" test. *See Texas Gulf Sulphur Co.*, 401 F.2d at 858-59 ("The disclosure of information materially important to investors may not instantaneously be reflected in market value, but despite the intricacies of security values *truth does find relatively quick acceptance on the market* ") (emphasis added). Similarly, the SEC has itself argued that "market reaction" reflects materiality. *See, e.g., S.E.C. v. Hoover*, 903 F.Supp. 1135, 1146-47 (S.D. Tex. 1995).

In a series of cases beginning with *Burlington Coat Factory Securities Litigation*, 114 F.3d 1410 (3d Cir. 1997), then Circuit Judge Alito championed the "efficient market" test as a method of determining those times when, as a matter of law, an alleged failure to disclose was *not* material and, consequently, could not support an insider trading or 10b-5 claim. This is just such a situation. As will be discussed, the reality is that the market failed to react negatively to Mr. Nacchio's disclosures of the allegedly material non-public information asserted in the indictment, rendering that information immaterial as a matter of law.

In *Burlington Coat Factory*, the Third Circuit explained:

> Because the market for BCF stock was "efficient" and because the July 29 disclosure had no effect on BCF's price, it follows that the information disclosed on September 20 was immaterial as a matter of law. Ordinarily, the law defines "material" information as information that would be important to a reasonable

> investor in making his or her investment decision. … In the context of an "efficient" market, the concept of materiality translates into information that alters the price of the firm's stock. … This is so because efficient markets are those in which information important to reasonable investors (in effect, the market,) … is immediately incorporated into stock prices. … Therefore, to the extent that information is not important to reasonable investors, it follows that its release will have a negligible effect on the stock price. In this case, plaintiffs have represented to us that the July 29 release of information had no effect on BCF's stock price. This is, in effect, a representation that the information was not material.

114 F.3d at 1425 (multiple citations omitted).

This is precisely the fact pattern presented in the present matter. The Court may take judicial notice that the material information Mr. Nacchio is alleged to have traded on was conveyed to the marketplace in two disclosures, one on August 7, 2001,[17] and the second on September 10, 2001.[18] The Court may also take judicial notice as to the market's "immediate" reaction to each disclosure, as the daily trading price of Qwest shares is certainly not in dispute.[19] Fed. R. Evid. 201(f) ("Judicial notice may be taken at any stage of the proceeding."); *see also*

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[17] On this date, Mr. Nacchio spoke at a conference hosted by US Bancorp Piper Jaffrey Inc. *See* Exhibit A, Qwest's filed SEC Form 8K (August 7, (2001)). Mr. Nacchio's slide presentation included a discussion of the company's "non-recurring" income and charted how "Non-recurring Broadband Capacity Sales as [a] Percentage of Qwest Revenue," had dropped from "about 80%" in 1997 to "about 5%" in 2000 and was "estimated" at "about 8%" in 2001. *Id.*, Slides 10-11. This disclosure relates directly to the "non-recurring" income allegations in Paragraph 6 of the indictment.

[18] It was on September 10, 2001 that Mr. Nacchio announced that Qwest "currently expected optical capacity sales to generate less revenue for the second half of 2001 than previously announced," and the company was updating its financial guidance by reducing its annual revenue estimate to $20.5 billion. *See* Exhibit B, Qwest's filed SEC Form 8K at *2, *5 (September 10, 2001). *Cf.* Exhibit C, Qwest's filed Form 8K at *1 (January 24, 2001) (initial Qwest 2001 revenue estimate was $21.3 - 21.7 billion). In other words, the September 10, 2001 8K reduced estimated 2001 revenue by $ .8 - 1.2 billion. It is again worth noting that Qwest *did* achieve its financial targets during the first two quarters of 2001, the period in which Mr. Nacchio actually traded.

[19] *See* Exhibit D, Charts generated on the Yahoo Finance internet site, of Qwest stock prices for the five days of trading from: (1) August 7 - 13, 2001, and (2) September 10 - 20, 2001.

United States v. Gordon, 634 F.2d 639, 642 (1st Cir. 1980) ("The district judge was free to dispose of the motion [to dismiss the indictment] … by taking judicial notice…."); *and see United States v. Briddle*, 212 F.Supp. 584, 589 (S.D. Cal. 1962) ("This Court has the power to receive evidence -- including evidence adduced by means of judicial notice -- upon the hearing of the defendants' motions to dismiss the indictment at bar."). Indeed, in *Hall*, the Tenth Circuit observed that:

> [I]t is permissible and may be desirable where the facts are essentially undisputed, for the district court to examine the factual predicate for an indictment to determine whether the elements of the criminal charge can be shown sufficiently for a submissible case.

Hall, 20 F.3d at 1087 (quoting *United States v. Brown*, 925 F.2d 1301, 1304 (10th Cir. 1991)).

The *Hall* Court found additional support in another Tenth Circuit decision for "the proposition that under certain circumstances a trial court is within its jurisdiction in ordering a pretrial dismissal based on the insufficiency of the evidence," concluding that "our affirmance of the district court's dismissals in *Wood* is an implicit recognition of a district court's authority, under certain limited circumstances, to go beyond the allegations of the indictment and make predicate findings of fact." 20 F.3d at 1087-88 (discussing *United States v. Wood*, 6 F.3d 692 (10th Cir. 1993)).

What will be seen is that after the first disclosure, not only did the price of Qwest stock not drop, it actually *rose*. Similarly, Qwest shares rose over three dollars per share on the day of the second disclosure and, despite the events of September 11, 2001 (which came only a day later), despite that the financial markets were then shut down for a week, and despite the fact that the general market suffered a significant downturn when trading resumed, the price of Qwest stock *retained* its gain, then remained virtually *unchanged* for the next week of trading. In other words, there was *no immediate* negative reaction to the news, which is dispositive, as a matter of law, that the disclosures were not material.

Judge Alito's subsequent opinion in *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000), is an even more dramatic demonstration that the indictment against Mr. Nacchio should be dismissed due to the non-materiality of the disclosures at issue, because the market's reaction to disclosures there was virtually identical to those in the matter *sub judice* and that court held that the disclosure was therefore not material as a matter of law. In *Oran*, after the disclosure took place, not only did the stock not drop, it actually "rose by $3.00 during the four days after the … disclosure." 226 F.3d at 283. Here, Qwest was trading at $24.29 when the market opened on August 7, 2001, the date of the first alleged disclosure. Over the next week the price of Qwest stock actually rose, closing at $24.66 on August 13 (the fifth day of trading). *See* Exhibit D. The second alleged disclosure was on September 10, 2001. On that day, Qwest stock opened at $16.34 and *immediately rose*, closing at $19.90, a gain of more than three dollars a share, or *more than 21%*. Once the markets reopened on September 17 the Qwest stock bucked the huge general downward trend,[20] preserved the September 10 gain, then held steady for the next 5 days.[21] *Id.* "Under *Burlington's* market test, this price stability is dispositive of the question of materiality." *Oran*, 226 F.3d at 283. Subsequently, in *In re NAHC, Inc. Securities Litigation*, 306 F.3d 1314, 1330 (3d Cir. 2002), the court concluded that "no negative effect" on a company's stock price immediately following the date of disclosure *rendered the disclosed*

[20] By the close of trading on September 17, 2001, the Dow Jones Industrial Average had dropped *nearly 700 points*, or 7.1%, to its lowest level since December 1998. The NASDAQ composite index lost 6.8%. *See* Exhibit E (Gretchen Morgenson, *A Nation Challenged: The Overview*, N.Y. TIMES, September 18, 2001, at A1 (electronic version).

[21] Qwest shares opened at $19.63 on September 17, 2001. Over the next five days of trading the shares went as high as $20.34 on September 20 and closed at $19.56 that same day. (Exhibit D)

information immaterial as a matter of law. This, notwithstanding that the company's stock price plunged 75% just three weeks after the disclosure was made. *Id.* at 1321.

In re Merck & Co., Inc. Securities Litigation, 432 F.3d 261 (3d Cir. 2005) is the most recent Third Circuit "efficient market" opinion. There, "the disclosure occurred on April 17, and there was no negative effect on Merck's stock" until a *Wall Street Journal* article was published two months later. *Id.* at 269. Finding the facts similar to those found in *In re NAHC Inc.*, the court again deemed the initial disclosure immaterial as a matter of law. *Id.*

Although the Tenth Circuit has never addressed the "efficient market" test of materiality, courts throughout the country have employed the test. In *Basic Inc.*, the Supreme Court observed that "[r]ecent empirical studies have tended to confirm Congress' premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." 485 U.S. at 246. *See also, e.g., Grimes v. Navigant Consulting, Inc.*, 185 F.Supp.2d 906, 914 (N.D. Ill. 2002) (the court deemed a disclosure immaterial when the stock rose that same day, instead of falling as expected).[22]

Here, where it is undisputed that the price of Qwest stock rose following each of the two disclosures, and there was *no* negative reaction by the end of a week of trading, this Court should, respectfully, find as a matter of law that these disclosures were immaterial. Because these disclosures are alleged to be the material non-public information Mr. Nacchio traded on and they are immaterial as a matter of law, the indictment should be dismissed for failure to allege a requisite element of the offense.

[22] Other decisions besides *Texas Gulf Sulphur* and *Hoover, supra*, have looked to the initial reaction of the marketplace when assessing the materiality of a disclosure. *See, e.g., In re Verifone Securities Litigation*, 784 F.Supp. 1471 (N.D. Cal. 1992); *Crowell v. Ionics, Inc.*, 343 F.Supp.2d 1, 22 (D. Mass. 2004); *S.E.C. v. Penthouse Intern., Inc.*, 390 F.Supp.2d 344, 353-54 (S.D.N.Y. 2005).

F. **The Forfeiture Allegations Of The Indictment Are Demonstrably Deficient**

The indictment makes a forfeiture allegation that the $100,812,582 gross sales price of Mr. Nacchio's sales "represent[s] the amount of proceeds obtained as a result of the offenses." (Doc. 1, Forfeiture Allegations at 6) This is demonstrably, and fatally, deficient. The Federal Rules of Criminal Procedure, the forfeiture statute itself and the applicable federal common law are unequivocal that the words "proceeds obtained as a result of the offense" necessitate a *"profits" calculation* and can *never* consist solely of the gross sales price. Because the indictment fails to employ a profit calculation and instead demands forfeiture of the gross sale price, the forfeiture allegations of the indictment are facially defective and should be dismissed.

Fed. R. Crim. Pro. 7(c)(2) states:

> Criminal Forfeiture. No judgment of forfeiture may be entered in a criminal proceeding unless the indictment … provides notice that the defendant has an interest in property that is subject to forfeiture in accordance with the applicable statute.

The forfeiture statute asserted in the indictment (Doc. 1, Forfeiture Allegations at 6), 18 U.S.C. § 981(a)(1)(C), defines property subject to forfeiture as "[a]ny property … which … is derived from proceeds traceable to a violation."[23] Thus, the starting point -- as mandated by the statute and conceded on the very face of the indictment -- is that there must be a causal relationship between the property sought by forfeiture and the charged offense.

One of the deficiencies in the indictment's forfeiture demand is the failure to credit Mr. Nacchio with the price he paid for the shares. How can any conceivable definition of "proceeds

[23] 18 U.S.C. § 981(a)(2) states, in relevant part (emphasis added): "For purposes of paragraph (1), the term "proceeds" is defined as follows: (A) In cases involving … unlawful activities … the term 'proceeds' means property of any kind *obtained … as the result of the commission of the offense giving rise to forfeiture*, and any property traceable thereto, and is not limited to the net gain or profit realized from the offense."

gained" from the sale of stock ignore his costs of purchasing the stock in the first place? As fatal as this deficiency is alone, equally serious deficiencies exist from claiming the entire gross sale price as the "proceeds obtained as a result of the offenses. " Unlike most situations where insider trading is alleged, Mr. Nacchio did not purchase the shares in question on the open market. Rather, he executed options which were granted to him as part of his compensation. The only accusation in the indictment is that he *sold* these shares while in possession of certain information. (Doc. 1 ¶ 9 at 4) Consequently, it would be demonstrably false to suggest that the proceeds could be derived *solely* by subtracting the purchase price from the gross sales price. This is because Mr. Nacchio's profit from buying at an option price and selling at the market price was at least partly attributable to his compensation, not the alleged offense of insider trading. Clearly, a different formula must be employed, a formula which has found wide acceptance.

The First, Second and D.C. Circuits have concluded that:

> In an insider trading case, the proper amount of disgorgement is generally the difference between the value of the shares when the insider sold them while in possession of the material, nonpublic information, and their market value "a reasonable time after public dissemination of the inside information." *SEC v. MacDonald*, 699 F.2d 47, 54-55 (1st Cir. 1983); *see also SEC v. Patel*, 61 F.3d 137, 139 (2d Cir. 1995); *SEC v. Shapiro*, 494 F.2d 1301, 1309 (2d Cir.1974).

S.E.C. v. Happ, 392 F.3d 12, 31 (1st Cir. 2004); *accord*, *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1231 (D.C. Cir. 1989).

When this analysis is applied to the instant facts, the amount subject to forfeiture would not be the gross sales price, or even the net sales price (the gross sales price minus the amount paid) but, rather, the difference between (i) the value of the shares just before Mr. Nacchio disclosed the allegedly material non-public information, and (ii) the value of the shares "a reasonable time after that disclosure." As shown in the discussion of the "efficient market" test for materiality, *supra*, the market *failed* to react negatively to *either* of the two disclosures. Thus, even if the charged offense is proven beyond a reasonable doubt, for purposes of forfeiture there were *no* "proceeds obtained as a result of the offenses." Critically, while the Government might quibble over just what starting value should be applied to the formula, it is clear that under *any* permissible methodology *some amount* must be deducted from the *net* -- not gross -- sales price. This double factual infirmity is fatal to the indictment.

It is, therefore, necessary to employ the method of valuing the profits, or proceeds, from alleged insider trading as adopted by most Circuits, which defines "profits" as the difference between the value of the shares prior to disclosure of the insider information, and the value of the shares after the market assimilated that information. Only in this manner can the "proceeds obtained as a result of the offenses" be separated from the proceeds to which Mr. Nacchio was legitimately -- and uncontestedly -- entitled as part of his compensation as the CEO of Qwest.

Because the Government lists the full gross sales price as the proceeds obtained as a result of the offense, not even crediting the cost of purchasing the shares let alone tying the amount sought in forfeiture to the *offense* charged, the forfeiture allegations of the indictment are facially deficient.

III. CONCLUSION

For the foregoing reasons Defendant, Joseph P. Nacchio, respectfully asks for entry of an Order dismissing the indictment.

Respectfully submitted this 10th day of February, 2006.

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CERTIFICATE OF SERVICE

I hereby certify that on this 10th day of February, 2006, a true and correct copy of the foregoing **MOTION FOR DISMISSAL OF INDICMENT** was served on the following via the USDC CM/ECF system:

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I hereby certify that the foregoing will be served by U.S. Mail, postage prepaid, to the following:

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