IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLORADO

Criminal Case No. 05-cr-00545-EWN

UNITED STATES OF AMERICA,

Plaintiff,

v.

1. JOSEPH P. NACCHIO,

Defendant.

GOVERNMENT'S RESPONSE TO DEFENDANT'S MOTION TO DISMISS THE INDICTMENT

The United States of America, by and through the undersigned government counsel, respectfully submits this response to the defendant's motion to dismiss the indictment.

INTRODUCTION

As set forth in more detail below, the indictment alleges all that is required of a securities fraud case, and more. The allegations in the indictment contain the essential elements of the offenses charged and sufficiently inform the defendant of what he must defend against. Accordingly, the indictment is legally sufficient. The defendant's motion seeks to challenge the sufficiency of the government's evidence. Such a challenge is improper in a Rule 12(b) motion. This response will address each of the following grounds that the defendant asserts for the dismissal of the indictment:

1. That the indictment is unconstitutionally vague. The indictment is constitutionally sufficient because it contains the essential elements of criminal insider trading, sufficiently informs the defendant of what he must be prepared to defend against, and enables the defendant to plead an acquittal or conviction under the indictment as a bar to any subsequent prosecution for the same offense.

2. That the indictment fails to charge that the inside information was material. The indictment expressly alleges that the information was material and alleges what inside information the defendant possessed. More is not required. The materiality of the alleged inside information is a question of fact for the jury and, as discussed below, is not immaterial as a matter of law. The *McDonald v. Kinder-Morgan* case heavily relied upon by the defendant is inapposite – it did not hold that non-public information about a company's future financial risks is immaterial as a matter of law where there is a duty to disclose.

3. That the defendant could not have possessed material non-public information if Qwest was not required to disclose that information. The defendant's argument is both wrong on the law and based upon an erroneous premise. Contrary to the defendant's contention, the government has never conceded, expressly or otherwise, that Qwest's financial reporting during the relevant period was fully accurate and complete.

4. That the indictment should be dismissed because the forfeiture allegation seeks gross proceeds. The majority rule in *criminal* forfeiture is that gross proceeds of

the illegal conduct are forfeitable upon conviction. Even if this Court were to adopt the minority rule which allows the defendant to offset the forfeiture amount by his direct costs, dismissal of the forfeiture allegations, let alone the indictment, is not the proper remedy and any such challenge is premature.

ARGUMENT

I. The Indictment Is Constitutionally Sufficient

On a motion to dismiss an indictment, the Court must presume that the allegations in the indictment are true. *United States v. Wood*, 6 F.3d 692, 694 (10th Cir. 1993). "Ordinarily the sufficiency of an indictment should be decided solely by the charges made in the indictment, without regard to the strength or weakness of the government's case." *United States v. Brown*, 925 F.2d 1301, 1304 (10th Cir. 1991). Where a defendant challenges the sufficiency of an indictment for failure to state an offense, the court is bound by the factual allegations contained in the four corners of the indictment. *United States v. Welch*, 327 F.3d 1081, 1090 (10th Cir. 2003).[1] An indictment is constitutionally sufficient if it contains the essential elements of the offense to be charged, sufficiently informs the defendant of what he must be prepared to defend against, and enables the accused to plead an acquittal or conviction under the indictment as a bar to any

[1] The only exception to this rule is where factual issues are undisputed and the government fails to object to the court's resort to evidence outside of the four corners of the indictment. *Welch*, 327 F.3d at 1090 n.11 (*citing Hall*, 20 F.3d at 1087). The government objects to all of the evidence outside of the four corners of the indictment proffered by the defendant in his motion to dismiss.

subsequent prosecution for the same offense. *United States v. Hall*, 20 F.3d 1084, 1087 (10th Cir. 1994) *(citing Russell v. United States*, 369 U.S. 749, 763-764 (1962)).

Generally the sufficiency of the government's evidence to support a charge may not be challenged by a pre-trial motion. *Id* at 1087. An indictment, if valid on its face, is enough to call for trial of the charge on the merits. *United States v. Meyers*, 95 F.3d 1475, 1484 (10th Cir. 1996).

In *United States v. Dunn*, 841 F.2d 1026 (10th Cir. 1988), the Tenth Circuit held that an indictment which quoted the language of the statute charged along with the dates of illegal activity and the place the offense was allegedly committed was sufficient. An indictment need not go further and allege in detail the factual proof that the government will offer to support the charges. *Id.* at 1029.

The indictment in this case precisely tracks the language of the statute and applicable rules and conforms to applicable case law setting forth the elements of a claim for insider trading. Paragraph 9 of the indictment alleges that the defendant "did knowingly and willfully.... use and employ...a manipulative and deceptive device, scheme, artifice or contrivance to defraud in contravention of" the Securities laws of the United States and Rules and Regulations of the Securities and Exchange Commission. *United States v. O'Hagan*, 521 U.S. 642 (1997) holds that "§10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, non-public information" because "trading on such information qualifies as a deceptive device under §10(b)...." *O'Hagan* at 652. SEC Rule 10b5-1 defines the term "on the basis of" to mean that "the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale." Here, paragraph 9 of the indictment explicitly alleges that the defendant sold Qwest securities "while aware of and on the basis of material nonpublic information." Contrary to the defendant's suggestion, nothing more is required of an insider trading indictment. There is no requirement to allege other schemes, misrepresentations, failures to disclose or frauds. Each element, as defined by statute, rule and Supreme Court decision has been alleged.

II. The Materiality Of The Inside Information Is Sufficiently Alleged

First, the indictment expressly alleges that the defendant was "aware of material, non-public information about Qwest's business" and goes on to describe the type of non-public information about Qwest that the defendant knew while he was selling over $100 million worth of Qwest stock. Indictment ¶ 6. The materiality of the non-public information is re-alleged in paragraphs 7, 8, and 9 of the indictment.

The defendant asserts that the type of inside information alleged in the indictment is immaterial as a matter of law. The defendant's argument is without merit for at least three reasons: materiality is a question of fact; most of the information is not contingent; and, contingent information such as a strong warning that business is deteriorating has been held to be the type of information that will support an insider trading claim.

Since the holding of the Supreme Court in *United States v. Gaudin*, 515 U.S. 506 (1995), the best practice in criminal cases is to submit all questions of materiality to the jury for resolution. *See United States v. DiRico*, 78 F.3d 732, 736 (1st Cir. 1996). *See also In re Adams Golf, Inc. Securities Litigation*, 381 F.3d 267, 274 (3d Cir. 2004) ("Materiality is ordinarily an issue left to the factfinder and is therefore not typically a matter for Rule 12(b)(6) dismissal."). "The determination of materiality 'requires delicate assessments of the inferences a reasonable shareholder would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact.'" *SEC v. Ginsburg*, 362 F.3d 1292, 1302 (11th Cir. 2004)(quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). "Only if the alleged misrepresentations or omissions are so obviously unimportant to an investor that reasonable minds cannot differ on the question of materiality is it appropriate for the district court to rule that the allegations are inactionable as a matter of law." *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 281 n.11 (3d Cir. 1992) (citing *TSC Indus.*, 426 U.S. at 450).

The defendant argues that undisclosed financial risks cannot constitute material information. The defendant is wrong. That assertion is contradicted by the reasoning of applicable Supreme Court authority and by its application by the Circuit Courts as set forth below. Materiality is proved by showing a substantial likelihood that a reasonable investor would have considered the information important in deciding to buy or sell

Qwest stock. *See TSC Indus., Inc.* at 449. The indictment alleges that the defendant was aware of material undisclosed information about the risks of an investment in Qwest stock in 2001 including that: Qwest's financial targets for 2001 were a "huge stretch" to begin with; that Qwest could not make its 2001 targets unless recurring revenue sources increased significantly and at a greater rate than Qwest had historically achieved; and without this unprecedented expansion Qwest would be unable to achieve its targets because there were insufficient non-recurring opportunities available and that Qwest's actual business results were consistently underperforming the rate necessary to achieve Qwest's 2001 targets from the inception of 2001.

In *Basic, Inc. v. Levinson*, the very case in which the Supreme Court announced the materiality standard for securities fraud cases, the alleged material information at issue was preliminary merger negotiations, events the Court dubbed "contingent or speculative in nature." 485 U.S. 224, 232 (1988). The Court expressly adopted a "fact-intensive inquiry" to govern the materiality of "contingent or speculative information or events." *Id.* at 238-40. With respect to forward-looking information, the Court held that materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." *Id.* at 238. Such a fact-specific approach fatally undermines the defendant's claim that contingent, forward-looking information cannot, as a matter of law, be material. *United States v. Smith*, 155 F.3d 1051, 1066 (9th Cir. 1998)

The defendant in *United States v. Smith*, a criminal insider trading case, argued that soft, forward-looking information like forecasts of future sales and revenue could not, as a matter of law, constitute material information within the meaning of Rule 10b-5 and, consequently, could not give rise to insider trading liability. *Id.* at 1064. The Ninth Circuit rejected the defendant's contention holding that "[t]here is, quite simply, no case law to support Smith's blanket assertion that forward-looking statements cannot, as a matter of law, constitute 'material' information within the meaning of Rule 10b-5." *Id.* at 1066. Citing an earlier Ninth Circuit case, the *Smith* court stated:

> Nor can there be any doubt that the forecast of earnings was a "material" fact. The applicable test of materiality is essentially objective: whether a reasonable man would attach importance (to the fact misrepresented) in determining his choice of action in the transaction in question. And generally earnings projections of a company constitute a prime factor in estimating the worth of its stock.

Id. (quoting *Marx v. Computer Sciences Corp.*, 507 F.2d 485, 489 (9th Cir. 1974) (internal quotations and citations omitted)).

Similarly, in *SEC v. Happ*, the defendant, a board member, argued that two voicemail messages he received from the CEO that the corporation was having "some difficulties during the quarter" did not amount to material inside information. 392 F.3d 12, 21 (1st Cir. 2004). Happ claimed that merely being told of corporate difficulties is too generic and too true of all public companies to be material in an of itself. *Id.* The First Circuit rejected Happ's contention and held that a rational jury could find that such messages constituted material, non-public information for insider trading.

The defendant's reliance on *McDonald v. Kinder-Morgan* is misplaced. The defendant asserts that "*McDonald* outlawed 10b-5 claims based upon non-disclosure of vague contingencies, that is, 'failure to disclose risks' in connection with earnings." Defendant's Motion at p.8. *McDonald* involved a claim by private plaintiffs that Kinder-Morgan's quarterly filing failed to disclose certain risks that could affect the future earnings of the company. 287 F.3d 992, 995-96 (10th Cir. 2002). The Tenth Circuit, upholding the District Court, held only 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). The court quoted with approval the District Court's ruling that "the accurate disclosure of purely historical results does not give rise to a duty to disclose the keep-whole contracts in order to make the disclosure of past financial data not misleading." *Id.* at 996. In short, the holding in *McDonald* was that the plaintiff's disclosure claim failed because the company had no duty to disclose the alleged missing information.

Contrary to the defendant's assertion, the holding in *McDonald* was <u>not</u> that future undisclosed risks to Kinder-Morgan's financial performance could not constitute material non-public information if an insider was selling Kinder-Morgan stock. The *McDonald* court did not even address the question that would be relevant to this case – if Kinder-Morgan insiders traded stock knowing that the existence of the "keep-whole" contracts created significant risks to the company's future financial performance, could that information constitute material non-public information. As is discussed below, a corporation is under no general duty disclose. However, if an insider is going to trade stock in his or her company and is in possession of material inside information, the insider must either disclose the information or abstain from trading.

Here, the information alleged in the indictment, on its face, easily presents a jury question on the issue of materiality. First, most of the alleged information is not forward looking or speculative. For example, paragraph 6(b) of the indictment does not allege simply that the defendant knew Qwest would not meet its targets in the future. Paragraphs 6(a) - 6(c) allege that the defendant knew something about the targets that the public did not. The defendant knew that the targets (which had already been issued and are historic facts) could not be reached unless Qwest's recurring revenue business increased significantly from its historic levels, and that Qwest's historic, not its projected, track record in growing recurring revenue was insufficient to achieve those targets. Paragraph 6(d) alleges that defendant knew something the public did not. The defendant knew, during the time period alleged, that Qwest's recurring revenue business was underperforming compared to the plan. The actual performance of Qwest's recurring revenue business during 2001 was neither speculative nor forward looking. The government will introduce evidence that Qwest's actual recurring revenue performance was far below the plan announced to the public while the defendant was selling his stock and that the defendant knew it. [2] Paragraph 6(e) alleges that the defendant knew that there were material undisclosed risks relating specifically to Qwest's recurring and non-recurring revenue streams. The indictment does not allege that there would or might be future risks or future events that posed these risks. It alleges that there was, then in existence, material undisclosed information that posed these risks. Risks to business are routinely disclosed and every 10K and 10Q filed by Qwest during the operative time period contains a section detailing material risks. There is nothing revolutionary in the government's allegation that material risks to a business can be the type of insider information that triggers a duty to abstain, and the defendant cannot argue that material risks do not constitute material information as a matter of law. Paragraph 6(f) alleges that the defendant knew something the public did not. The defendant knew that the actual gap, as measured from time to time by Qwest, between its actual (not projected) recurring revenue and its targets was increasing. The significance of that actual, not projected, development, was that Qwest's reliance on risky and unsustainable "one-time transactions" was increasing.

Finally, to the extent the indictment contains allegations that defendant was aware of material "contingent" information, as that term is defined in *Basic, Inc. v. Levinson,*

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[2] The defendant wisely sets aside the question of whether it matters whether Qwest was achieving its quarterly targets through recurring revenue or "one timers". The defendant sets the question aside because he knows that determination cannot be made as a matter of law. The materiality of how Qwest was making its numbers to investors is clearly a question of fact.

485 U.S. 224 (1988), it alleges information that a reasonable jury may find to be material. As set forth in the Circuit Court decisions above, a public company's ability to meet its publicly stated targets can be, and generally is, an extremely material fact. Paragraph 6(g) of the indictment specifically alleges that the defendant knew, at the time he was selling, that there would be insufficient non-recurring revenue sources to close the gap between Qwest's publicly stated financial targets and its actual performance. With respect to this allegation of the indictment, the jury will have to apply the two-pronged test of *Basic, Inc.* to determine (1) the probability that there would be insufficient non-recurring revenue to close the gap and (2) the magnitude of the consequences of an unfilled gap "in light of the totality of the company activity." *Basic, Inc.,* 485 U.S. at 238. A reasonable jury will be able to find that this forward looking information was material for insider trading purposes.

Efficient Market Theory. The defendant also argues that the efficient market theory demonstrates that the alleged non-public information was immaterial as a matter of law. The defendant claims that he disclosed the alleged non-public information asserted in the indictment and when he did the market did not react negatively rendering the alleged inside information immaterial as a matter of law.[3] Def. Motion at p.18. The inference that the defendant suggests is completely invalid for many reasons.

The "efficient market theory" has been used by some courts in private investor class actions to allow plaintiffs to establish a rebuttable presumption of reliance without needing to show that they actually knew of the communication that allegedly contained the misrepresentation or omission. *See Basic, Inc.*, 485 U.S. at 241-42. Unlike private investors, however, the government does not have to prove reliance in securities fraud cases. *See, e.g.*, *SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1363-64 (9th Cir. 1993); *SEC v. Rind*, 991 F.2d 1486 (9th Cir. 1993); *United States v. Haddy*, 134 F.3d 542, 549 (3d Cir. 1998); *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 206 n.6 (3d Cir. 2001); *Graham v. SEC*, 222 F.3d 994, 1001 (D.C. Cir. 2000); *SEC v. North American Research & Development Corp.*, 424 F.2d 63, 84 (2d Cir. 1970); *SEC v. Blavin*, 760 F.2d 706, 711 (6th Cir. 1985). The efficient market theory has also been used as a predicate for damage estimates in civil cases where an expert might testify that the price of a company's stock was artificially inflated by a certain amount based on observations of stock price movements following disclosure of information that was either previously undisclosed or that contradicted earlier false information. In addition, the defendant cites

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[3] It is interesting to note that the defendant argues that the indictment is unconstitutionally vague because it fails to apprise him of the nature of the accusations against him. At the same time, however, he claims that disclosures he made after the charged insider trades sufficiently disclosed the alleged inside information to the public.

several private investor civil cases where the Third Circuit used an efficient market analysis to determine that certain alleged misrepresentations or omissions were not material. Use of this methodology is not essential to proof of materiality, and the government presently intends to establish materiality in other ways including through testimony concerning admissions of the defendant and first-hand observations of market professionals who witnessed the defendant in his communications with investors.

However, in all of these cases, use of the efficient market presumption to draw inferences about damages or materiality requires that certain elements be met. These elements are frequently the subject of extensive *Daubert* hearings designed to determine whether the expert has correctly applied known and accepted methods. *See, e.g., RMED International, Inc., v. Sloan's Supermarkets, Inc.*, 2000 WL 310352 (S.D.N.Y.) (Not reported in F. Supp. 2d.), aff'd by District Court at 2000 WL 420548 (S.D.N.Y.). (Copies attached as Exhibits 1 and 2). These required elements are: (1) a discrete event, (2) careful observation of stock price fluctuations following the discrete event, (3) use of a statistically and analytically valid model for filtering out extraneous events from the one being measured to ensure that the price movement can be attributed to the event, and (4) there is no reason to believe that the market anticipated the news. *See, e.g.,* David Tabak and Frederick Dunbar, "Materiality and Magnitude: Event Studies in the Courtroom," *Litigation Services Handbook* 3d 19.1 (2001) (Copy attached as Exhibit 3). In order to use market reaction as evidence of materiality in an insider trading case, it seems logical that the defendant would have to meet the added burden of showing what the market would have done had the information been disclosed during the time frame of his trades.[4]

In the cases cited by the defendant, it was unnecessary for the court to employ a rigorous analysis of the efficient market theory because the plaintiff in these cases stipulated to the necessary elements. For example, in *Oran v. Stafford*, 226 F. 3d 275 (3d Cir. 2000), the plaintiff stipulated that there was a discrete announcement of the very information that was alleged in the complaint and that the stock price did not move. Similarly, in *In Re Burlington Coat Factory*, 114 F. 3d 1410 (3d Cir. 1997), the court dismissed only a tiny part of the complaint that alleged a failure to disclose, and then a subsequent discrete disclosure of $23 million item against over $1 billion in revenues. The court again noted that the plaintiff had alleged in the complaint that the stock price increased after revelation of this comparatively small item.

Here, the defendant does not even attempt to address the requirements of the efficient market theory in order to support an inference that the alleged material inside information was not material. In fact, every element of the efficient market theory, to the extent it is being used to support an inference about materiality, is unmet in this case on

[4] This element is not usually present in a securities class action and is not present or discussed in the cases cited by the defendant. In a class action, the class period is normally defined by the public disclosure of the corrective or omitted information. Here, the period of the scheme is defined by the sales and period of coverup.

the record before the Court and its application will be the focus of an intense factual dispute.

First, the defendant points to no discrete disclosure of the alleged inside information that would permit its evaluation using an event study. Instead the defendant identifies one unrelated disclosure and one incomplete disclosure that occurred months after the defendant stopped trading.

The August disclosure, even if the Court could consider it at this stage, was simply a disclosure of the amount of IRU revenue that Qwest had earned. The indictment does not allege that the defendant's knowledge of the amount of IRU revenue was the material inside information that precluded him from trading. The circumstances surrounding the August disclosure may be relevant to the defendant's scienter because the government believes that the evidence would show that the defendant personally directed the timing of the August disclosure so that he could, in his words, "spin it" to the market. However, the defendant points to nothing in the August disclosure which would allow an event analysis for the specific information alleged in the indictment.

The September 10 disclosure did include a disclosure to the effect that Qwest would not have sufficient revenue, including recurring and non-recurring sources, to meet its targets for 2001. Even if the market's reaction to that event could be measured accurately in light of September 11th, it would not tell us anything about the materiality of the disclosure had it occurred in the January-May time frame when the defendant was selling. The defendant presents no analysis as to whether the "efficient market" for financial information continued to function effectively in the weeks following September 11th when all eyes and all media was focused on the tragedy itself, nor is there any statistically valid attempt to filter out those events as required by the theory. As with the August disclosure, the circumstances surrounding the September disclosure may be relevant to the defendant's scienter because the defendant, in an effort to explain the sudden lowering of Qwest's targets, after he had reaffirmed those same targets only three weeks earlier, made statements that were a pretext about the reasons for reducing the targets.[5] However, the reaction of the market to the disclosure itself is not dispositive of materiality.

Second, the defendant has made no effort to employ any accepted statistical means to filter out other events such as market movement in evaluating the markets reaction to the alleged disclosures. Application of the efficient market theory to this case would involve critical factual disputes. For example, the government disputes that either one of the defendant's claimed disclosures adequately disclosed the inside information alleged in the indictment. Therefore, the efficient market theory cannot be applied because there is not a sufficiently direct correlation between the alleged inside information and the defendant's claimed disclosures.

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[5] Among other things he attributed the reduction in targets to recent housing start data rather than the collapse of the IRU market which had been under discussion at Qwest for months.

Finally, the fourth element of the efficient market theory is not met because the government contends, and will present evidence at trial, that the price of Qwest's stock was negatively impacted by events in the market prior to either of the defendant's claimed disclosures by which the market began to anticipate the material information. In June, July, and August, the market began adjusting Qwest's stock price due to skepticism in the analyst community as to the health of Qwest's business and concerns about its future performance. On June 20, 2001, Morgan Stanley issued an analyst report that was severely critical of Qwest and questioned how Qwest was calculating its revenues and earnings. On July 24, 2001, the defendant conducted an earnings release call with analysts and investors. Although the evidence will show that the defendant explicitly refused to disclose information about non-recurring revenue during this call so that he could "spin it" at a later conference, his performance on the call, including false statements about Qwest's financial guidance, so badly damaged his and Qwest's credibility that Qwest's share price began to fall.[6] Again, the circumstances surrounding the July call may be relevant to the defendant's scienter.

The price of Qwest stock also dropped after the Morgan Stanley report was issued in June. On May 29th, the date of last trade charged in the indictment, the defendant sold 5,000 shares of Qwest stock at $38.25 per share. On August 6th, the date before his first

[6] Between July 23rd and August 8th, Qwest's share price fell from $29.50 to $23.50, a decline of over 20%.

claimed disclosure, Qwest stock opened at $24.55 per share. By September 10th, the date of his second claimed disclosure, Qwest stock opened at $16.34 per share – a 57% drop in the price of Qwest stock since the defendant sold his stock on May 29th.

These are precisely the type of factual disputes that are inappropriate for consideration in a pretrial motion to dismiss. The government proffers these facts only for the purpose of advising the court that there are factual issues not properly resolved on this motion. As stated above, the government objects to consideration of evidence extrinsic to the allegations in the indictment in deciding the defendant's motion to dismiss. *See United States v. Hall*, at 1087. The efficient market theory may or may not assist the trier of fact in understanding materiality, but it does not compel dismissal of the indictment.

III. Defendant Could Possess Material Non-Public Information Even if Qwest Had No Duty To Disclose Such Information

The defendant asserts that "[i]t cannot . . . 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." Def. Mot. at p.4. The defendant then argues that the indictment must be dismissed because the government has conceded that there was no obligation to disclose the nonpublic information. This argument is simply wrong in every respect.

The defendant made **exactly the opposite argument** in *SEC v. Nacchio*, Civ. Action No. 05-CV-0480-MSK-CBS. In his Reply Memorandum in Support of his Motion to Dismiss, the defendant correctly stated an important basic principle of the securities laws that is central to this case when he stated unequivocally that "possession of material nonpublic information alone does not create a duty to disclose it." Reply Memorandum of Defendant Joseph P. Nacchio in Support of His Motion to Dismiss (Docket No. 67), Document No. 105-1 at 4. (Copy attached as Exhibit 4). The defendant goes on to explain several circumstances in which a defendant might have a legal justification for not disclosing otherwise material information. The circumstances of greatest application here include: (1) a right to keep material proprietary information secret if its disclosure to competitors would damage the company, and (2) the absence of any duty to update or correct information believed to be accurate at the time of its disclosure. *Id.* at 2. If the defendant was aware of material inside information and it was not disclosed for either reason, he is not relieved of his duty to abstain from trading.

For example, a company might issue an earnings forecast in good faith and later learn that market conditions had changed such that the forecast was no longer achievable. It is conceivable that the company would not be required to update its forecast publicly. In fact, Qwest publicly disclaims any duty to update in its filings. However, that does not mean that company executives can freely sell their stock after learning of significant problems with the forecast before the general public learns the unhappy truth. That is precisely the type of fraud that insider trading principles are designed to prevent.

In addition to the fact that the defendant has made the opposite argument in a related case, there are at least two things wrong with the defendant's argument. First, the government's evidence will show that the defendant himself gave, as an excuse for not disclosing some of the inside information, that it was proprietary and that it was of such importance that its revelation might help Qwest's competitors. Under the theory of this case, it does not matter whether the defendant's excuse is genuine or a fiction. If it is genuine, the defendant cannot trade while aware of nonpublic information. If it is a fiction, and the defendant's true motive for not disclosing it was to prevent the market from learning the truth while he sold his stock, the information is still material and the defendant has lied about his reason for not disclosing it. Applied to this case, the government will have to prove that the defendant was aware of material nonpublic information, but will not have to prove that Qwest had a duty to disclose it,[7] nor will it be a defense that the defendant had a good reason not to disclose the material information. In fact, the defendant's stated contemporaneous justification for not revealing some of the inside information may be relevant to his scienter and to materiality.

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[7] Of course, a defendant who is aware of material nonpublic information has the option of disclosing it prior to trading. However, the "duty to disclose," more appropriately called the "option to disclose or abstain" is different from the broad duty of disclosure called for by the Securities laws.

Second, the defendant repeatedly asserts throughout his motion that the government has "explicitly" conceded that Qwest's financial reporting during the relevant period was fully accurate and complete. The government has never made such a concession and the defendant's contention to the contrary is, at best, disingenuous. The defendant relies on the following statement in the Government's Status Report Regarding Discovery for his assertion:

> The defendant asserts that the government will have to prove that Qwest falsely and deliberately reported its financial results with the defendant's knowledge. That is not true. Unlike the SEC case, this case does not involve proof of accounting irregularities or fraud. Nor will it require that defense counsel be given the same period of time to prepare for trial that they might if this was the SEC case. **Even if** Qwest accurately reported its financial results, disclosed every fact required to be disclosed by law, and 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, the defendant 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.

Doc. 26 at p.2 (emphasis added). The sentence that the defendant relies on starts with "[e]ven if Qwest accurately reported its financial results . . . ." Such a qualified statement cannot reasonably be interpreted as a concession that Qwest did in fact accurately report its financial results. Of course, the defendant's statements to investors and analysts, including those that were in response to questions, all of which have been produced in discovery, will shed light on his awareness that the information in his possession was material and that it was nonpublic.

The defendant's argument in his civil papers is not just an admission. It is also supported by case law. The fact that a corporation is in possession of material nonpublic information does not, in itself, support a securities fraud claim. "A failure to disclose is actionable as fraud under § 10(b) of the Securities Exchange Act of 1934 only if 'one party has information that the other party is entitled to know because of a fiduciary duty or other similar relation of trust and confidence between them.'" *SEC v. Cochran*, 214 F.3d 1261, 1264 (10th Cir. 2000) (quoting *Chiarella v. United States*, 445 U.S. 222, 228 (1980) (internal quotation and citation omitted)). *See also Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 179 (2d Cir. 2001) ("A failure to disclose material information is actionable only when the defendant had an affirmative duty to disclose these facts.") "No matter how 'material' undisclosed information might be, the securities laws are not implicated unless there was first a duty to disclose this information." *Simon v. American Power Conversion Corp.*, 945 F.Supp. 416, 424 (D.R.I. 1996) (citing *Gross v. Summa Four, Inc.*, 93 F.3d 987, 992 (1st Cir. 1996)).

"One instance where such a duty to disclose arises is where a corporate insider trades on confidential information." *Id.* (citing *Chiarella,* 445 U.S. at 225-30). "Any insider 'in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed" *Castellano*, at

179 (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc)). The primary rationale for the disclose or abstain rule is to prohibit inside traders from exploiting their informational advantage to profit at the expense of investors. *See Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1203-04 (1st Cir. 1996).

This indictment properly alleges the crime of insider trading and the government has made no concession at all, much less one that would warrant dismissal.

IV. The Forfeiture Allegation Is Proper

The defendant asserts that the indictment, or at least the forfeiture allegation, should be dismissed because it is "demonstrably, and fatally, deficient." Def. Mot. at p.23. Without citation to any criminal forfeiture case law, the defendant asserts that "[t]he 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." *Id.* (emphasis in original).[8] The defendant argues essentially that dismissal of the forfeiture allegation is required because upon conviction it seeks forfeiture of the gross proceeds that the defendant obtained as the result of his illegal sales of Qwest stock. The defendant's motion is premature and without substantial basis in law.

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[8] This broad statement is contradicted by footnote 23 on the same page of the defendant's motion which cites to the definition of "proceeds" in the civil forfeiture statute defining proceeds in cases involving unlawful activities "is not limited to the net gain or profit realized from the offense." Def. Mot. at p.23 (quoting 18 U.S.C. § 981(a)(2)).

In a criminal case such as this, "[f]orfeiture is an element of the sentence imposed following conviction...". *Libretto v. United States*, 516 U.S.29, 38-39 (1995) (emphasis original). *Accord United States v. Ferrario-Pozzi*, 365 F.3d 5, 8 (1st Cir. 2004); *United States v. Cabeza*, 258 F.3d 1256, 1257 (11th Cir. 2001); Fed. R. Crim. P 32.2(b). *See also* Fed. R. Crim. P 11(b)(1)(J). The procedure for determining what property is subject to forfeiture is governed by Fed. R. Crim. P 32.2, which provides that the Court or the jury determines "what property is subject to forfeiture under the applicable statute," Fed. R. Crim. P 32.2(b)(1), or "the requisite nexus between the property and the offense committed by the defendant," Fed. R. Crim. P 32.2(b)(4). However, these determinations are not made until after the guilty plea, verdict, or finding of guilt. Fed. R. Crim. P 32.2(b)(1). Therefore, the questions of whether defendant should forfeit gross or net proceeds, and how these forfeited proceeds are to be calculated, are issue to be established by evidence after conviction, not to be decided now before trial based on arguments of counsel. Therefore, the defendant's argument should be denied as premature.

Should the Court wish to consider the issue now, the majority of courts that have considered the issue have held that gross proceeds of the offense, not net profits, are forfeitable in criminal forfeiture cases. For example, in *United States v. Boulware*, the Ninth Circuit held that a defendant who obtained a fraudulent loan was required to forfeit the full amount of the loan proceeds with no deduction for the amount of the loan that the defendant repaid. 384 F.3d 794, 813 (9th Cir. 2004). *See also United States v. Huber*, 404 F.3d 1047, 1058 (8th Cir. 2005) (defendant must forfeit the amount of money that he conspired to launder; that he incurred legitimate expenses in acquiring the untainted funds that were forfeitable as part of the money laundering offense does not mean he is entitled to any reduction in the forfeiture); *United States v. Keeling*, 235 F.3d 533 (10th Cir. 2000) (gross proceeds forfeitable in drug case); *United States v. Simmons*, 154 F.3d 765 (8th Cir. 1998) (collecting cases and holding that "the better view is the one that defines proceeds as the gross receipts of the illegal activity"; forfeiture is intended to punish all those who receive income from illegal activity, not just those whose criminal activity turns a profit); *United States v. Schlesinger*, 396 F. Supp. 2d 267, 278-79 (E.D.N.Y. 2005) (holding that defendant who submits inflated insurance claims must forfeit gross amount received from insurance company, not just the increment corresponding to the inflated portion of the claim). The *Boulware* court held that the proceeds definition in the civil forfeiture statute that allows for an offset of amount repaid in fraudulent loan cases, 18 U.S.C. § 981(a)(2)(C), does not apply to criminal forfeiture. 384 F.3d at 813.

The Seventh Circuit, on the other hand, defines proceeds as net profits. *See United States v. Jarrett*, 133 F.3d 519 (7th Cir. 1998) (affirming calculation that gave defendants credit for the cost of the heroin sold). *See also, United States v. Elliott*, 727 F.Supp. 1126, 1129 (holding that defendant was entitled to offset the forfeiture amount by costs incurred in purchasing and selling stock including brokerage commissions and interest on a margin account under the RICO forfeiture statute). Thus, even if this Court were to disregard the majority view, followed by the Tenth Circuit in *United States v. Keeling*, *supra*, that the gross proceeds should be forfeited, the remedy would be to forfeit the net proceeds as was done in *Jarrett* and *Elliott*, *supra*, not to dismiss the forfeiture allegations entirely. The defendant can show no authority for such a wholesale elimination of a forfeiture count.

In any event, whether this Court adopts the "gross proceeds" rational or the "net profits" rationale, the dismissal of the forfeiture allegation is not the appropriate remedy and the defendant's motion is premature. The amount of forfeiture is not an issue unless a jury convicts the defendant of the criminal charges. *See United States v. Myers*, 21 F.3d 826, 828 (8th Cir. 1994) (*dicta*). Therefore, the amount of forfeiture is a question that must await trial. *United States v. Messino*, 871 F.Supp. 1027, 1033 (N.D. Ill 1994). The defendant cites no authority for the relief he requests – that is, dismissal of forfeiture allegations because the defendant thinks the amount of forfeiture alleged is excessive.

CONCLUSION

For the foregoing reasons, the defendant's motion to dismiss should be denied. The allegations in the indictment contain the essential elements of the offenses charged and sufficiently inform the defendant of what he must defend against. Moreover, this Court cannot find the alleged inside information immaterial as a matter of law.

Dated: February 24, 2006

Respectfully submitted,

WILLIAM J. LEONE
UNITED STATES ATTORNEY

s/William J. Leone

William J. Leone
United States Attorney
James O. Hearty
Assistant U.S. Attorney
United States Attorney's Office
1225 17th Street, Suite 700
Denver, Colorado 80202
Telephone: (303) 454-0100
Fax: (303) 454-0400
E-mail: william.leone@usdoj.gov
james.hearty@usdoj.gov
Attorneys for the Government

CERTIFICATE OF SERVICE

I hereby certify that on this 24th day of February, 2006, I electronically filed the foregoing **GOVERNMENT'S RESPONSE TO DEFENDANT'S MOTION TO DISMISS THE INDICTMENT** with the Clerk of the Court using the CM/ECF system which will send notification of such filing to the following e-mail addresses:

Marci A. Gilligan
mgilligan@rglawoffice.net gmiller@rglawoffice.net

Edward S. Nathan
enathan@sgklaw.com lspector@sgklaw.com

John M. Richilano
jmr@rglawoffice.net gmiller@rglawoffice.net

Joel M. Silverstein
jsilverstein@sgklaw.com

Jeffrey Speiser
jspeiser@sgklaw.com

Herbert J. Stern
dpenna@sgklaw.com

s/Dorothy Burwell
DOROTHY BURWELL
Legal Assistant to William J. Leone
United States Attorney's Office
1225 17th Street, Suite 700
Denver, Colorado 80202
Telephone: 303-454-0100
Fax: 303-454-0400
E-mail: dorothy.burwell@usdoj.gov