NO. 07-1311

IN THE UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

UNITED STATES OF AMERICA,

Plaintiff-Appellee,

v.

JOSEPH P. NACCHIO,

Defendant-Appellant.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLORADO
THE HONORABLE JUDGE NOTTINGHAM
DISTRICT COURT NO. 1:05-cr-00545-EWN

APPELLANT'S REPLY BRIEF

Herbert J. Stern
Jeffrey Speiser
STERN & KILCULLEN
75 Livingston Avenue
Roseland, New Jersey 07068
(973) 535-1900 (telephone)
(973) 535-9664 (facsimile)

Maureen E. Mahoney
Alexandra A.E. Shapiro
J. Scott Ballenger
Nathan H. Seltzer
LATHAM & WATKINS LLP
555 11th Street, N.W.
Suite 1000
Washington, DC 20004
(202) 637-2200 (telephone)
(202) 637-2201 (facsimile)
Maureen.Mahoney@lw.com

Counsel for Defendant-Appellant

Dated: November 20, 2007

Oral Argument Scheduled For December 18, 2007

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INTRODUCTION

The undisputed facts establish *at least* a reasonable doubt that Nacchio sold these shares because he had inside information he knew was material:

- Nacchio announced his decision to sell these shares six months before he obtained the supposedly material information, and sold *less* than he said he would because he refused to sell below $38 per share. BR-11-12.[1]

- Nacchio knew his team had met challenging targets for 17 consecutive quarters, APP-2341–42, and shortly before his trades they reaffirmed that even "*with all of the debates* … the internal current view of Qwest was that they would reach $21.5 billion by December 31st, 2001"—substantially exceeding the guidance. APP-2323, 3276–77.

- Qwest reaffirmed its year-end projections two days before the first trade at issue and *no one* advised Nacchio those projections had to be reduced until months after his last sale. *Infra* 7.

- Qwest's audit committee and outside auditors specifically considered whether the percentage of revenues made up by IRUs was material—and concluded throughout the relevant period that it was not. *Infra* 10-11.

- Nacchio disclosed the revenue mix and reduced year-end guidance shortly after the executives with responsibility for these decisions first advised him to do so. *Infra* 5. The stock price did not drop. APP-4763.

- Nacchio knew Qwest's General Counsel was aware of the same information, *infra* 10-11, and that the GC was required to close the trading window and deny approval of 10b5-1 trading plans if this information was material, APP-2076–77. The GC did not close the window, and "warrant[ed]" in May that Nacchio could trade under a 10b5-1 plan. APP-5157, 5172.

[1] "BR-" and "APP-" reference Nacchio's opening brief and appendix; "USBR" references the government's brief; "DX" references audio and video exhibits in the supplemental appendix; "A-" and "GX" reference trial exhibits from Nacchio and the government, respectively.

The government's efforts to evade the import of these incontestable facts rests on three central errors.

First, it consistently misrepresents testimony about Qwest's higher *internal* goals as testimony about the *public* projections, and stitches together quotes from unrelated conversations to transform their meaning. We urge this Court to scrutinize the government's citations with care.

Second, it asserts without reasoning that the settled law governing the materiality of forward-looking predictions applies only in false-statements cases. But many such cases involved stock sales without disclosing allegedly material information, including *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509 (7th Cir. 1989). The government offers no plausible reason to analyze sales *by the company* and sales *by individual managers* differently and, tellingly, addresses *Wielgos* only in a footnote.

Third, it disregards the case it charged and tries to suggest that three bits of information—the percentage of IRUs in Qwest's Q1 revenue, a shortfall in new subscribers by April, and Casey's supposed report that there were no IRUs "in the funnel"—could be material *independent of the projections*. If such matters were material then no corporation or corporate manager could buy or sell stock, ever.

I. A REASONABLE JURY COULD NOT CONVICT

A. The Inference That Nacchio Sold These Shares Because Of Any Inside Information Is Baseless

1. Stock trades are not suspicious unless "'dramatically out of line with prior trading practices.'" *Nursing Home Pension Fund v. Oracle Corp.*, 380 F.3d 1226, 1232

(9th Cir. 2004) (citation omitted). If the defendant "provided credible and wholly innocent explanations for [his] stock sales" then that "conclusively rebut[s]" any inference of scienter. *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1427–28 (9th Cir. 1994); *McNamara v. Pre-Paid Legal Servs., Inc.*, 189 Fed. Appx. 702, 715 (10th Cir. 2006).

There is more than a "credible" explanation for these sales. The Board could not accommodate Nacchio's request to extend the June 2003 expiration date of his $5.50 options and wanted him to spread the sales over the period. APP-1930-31, 1855, 1925. Nacchio accordingly announced in October 2000, six months before these trades and months before he learned the information at issue, that he would begin exercising and selling these options—"about a million" per quarter. DX1560; APP-1929. Despite his announcement *and* "wave[s] of bad news" he was allegedly learning in early 2001 (USBR-8), he suspended his sales plan in March rather than sell below $38 a share. BR-12.

The government had to prove that Nacchio would not have resumed his preannounced sales plan, once the trading windows reopened, but for his acquisition of inside information.[2] That is illogical speculation. Nacchio's May 10b5-1 plan included a $38 floor—hardly consistent with a belief Qwest was doomed. The government struggles to fabricate a nefarious inference out of Nacchio's trading patterns. But it is not

[2] Its assertion that "aware[ness]" is sufficient was waived by proffering an instruction that the information must be "a factor." APP-260-61. *United States v. Williams*, 376 F.3d 1048, 1051 (10th Cir. 2004) (government cannot "argu[e] on appeal a position which it abandoned below").

meaningful to compare Nacchio's sales volume in the April-May 2001 trading window to average sales over the prior two years, before his October 2000 announcement. During the October-November 2000 window, Nacchio exercised an average of 103,571 options per trading day, APP-4764—hardly a "dramatic" difference from the 105,000 the government cites (USBR-13) for April-May. *Compare United States v. Larrabee*, 240 F.3d 18, 23–24 (1st Cir. 2001) (tippee placed unusually large order for stock in merger-target immediately after speaking to defendant, one of several people who knew of merger).

Having abandoned the nonsensical theory that Nacchio canceled the February automatic sales plan to sell shares even faster in April, USBR-23, 36, the government infers guilt because Nacchio exercised 860,000 options "in the first four days after the window opened." *Id*. But Nacchio sold 300,000 options on the first day of the October 2000 window and another 200,000 within the next four days. APP-4764; GX206. And there was no evidence that negative information might be disclosed later in the trading window. What possible illicit motive could be inferred from the fact that the trades occurred over five days instead of ten? The prosecution offers none.[3]

2. The prosecution criticizes Nacchio for selling rather than holding. But that is precisely what he announced he would do (DX1560), and it is exceedingly rare for executives to exercise options and hold the stock. *See* Ofek & Yermack, *Taking Stock: Equity-Based Compensation and the Evolution of Managerial Ownership*, 55 Journal of

[3] Nacchio's $5.50 options were not "underwater" (USBR-25) until *eleven months* after his last trade.

Finance 1367, 1376 (2000) ("executives retain approximately none of the shares acquired on the exercise of options"). Nacchio exercised Qwest options 69 times and only held shares *twice*. A-1979, A-1980, APP-4764–65. And Nacchio's sales only represented about 20% of his stock and vested options. *See* APP-4765; A-2006; *Ronconi v. Larkin*, 253 F.3d 423, 435 (9th Cir. 2001) (sales of 17% of holdings not suspicious).

3. Allegations of "deceptive conduct," USBR-24, cannot supply the missing proof. *First*, the prosecution's reliance on Nacchio's displeasure in April is misleading.[4] Mohebbi explained Nacchio was "disappointed" because the company was on track to miss *its stretch targets*, not the projections. APP-3260.

Second, Nacchio's statement that Qwest saw "nothing to dissuade" it did *not* pertain to the 2001 public revenue-projections but to "the plan [Qwest] announced *almost 18 months ago*"—the 5-year projected growth rates. GX593, at 31; GX594a.

Third, Nacchio did not delay releasing information in April. Nacchio announced the disappointing Q1 subscriber growth on April 24. APP-4807, 3636. The public guidance was reduced on September 10, GX646, approximately three weeks after that reduction was first recommended by Qwest's CFO. APP-2255–56. And the IRU revenue percentages were disclosed less than two weeks after the auditors concluded such disclosures should be made (and ten days after analyst Khemka's letter, USBR-14). A-23 at 1–2, 32–35; APP-4738. The discussion between Nacchio and Tempest about the

[4] The prosecution cites APP-2921 to suggest Nacchio hid his displeasure from investors. But this language is from the April 24 conference call when Nacchio told *investors*, "we are not pleased with the performance of [the national mass markets] unit." GX593, at 5; *compare* USBR-8–9. Casey's testimony, APP-2493, refers to a meeting in "late January or early February." APP-2491.

appropriate time to lower guidance sheds no light on what Nacchio knew in April-May. APP-1678. It followed Szeliga's August 15 recommendation that the guidance be reduced, and pertained to the risks to Qwest of lowering the guidance shortly after it was reaffirmed *on August 7*. *Id.*

B. The Conviction Cannot Be Sustained Based On Undisclosed Risks To The Public Projections

The only theory of materiality charged in the indictment or argued below was that Nacchio knew, "from early in 2001 through September 2001, that the business units were underperforming with regard to their specific internal budgets, and that *such under-performance would inhibit Qwest's ability to meet its 2001 financial guidance issued on September 7, 2000*." Bill of Particulars, 8 [Doc. No. 47]; APP-1396 ("what [Nacchio] knew is that Qwest was not growing at a rate that was sufficient to hit the yearly targets" disclosed to investors); APP-65-66.

That claim fails as a matter of law. Nothing Nacchio knew in April made failure so certain that he could no longer have a good-faith belief that the projections were reasonable or that disclosures were not required. Nor was the "magnitude" of any realistically perceived shortfall large enough to be material. BR-15–19; 17 C.F.R. §240.3b-6; *Wielgos*, 892 F.2d at 513, 515; *Shaw v. Digital Equipment Corp.,* 82 F.3d 1194, 1210 (1st Cir. 1996) (interim results cannot be "material" *because of what they portend for future events* unless they suggest an "extreme departure" from public

expectations in the very near future).[5] Those principles are not an improper "rigid formula." USBR-26. They just recognize that careful scrutiny is required when charges of fraud are based on projections that do not pan out.

1. The prosecution contends that "Nacchio's senior executives … told him that the $21.3 to $21.7 billion public target was unrealistic," USBR-5, but *no one* advised Nacchio that the public numbers were unrealistic and should be reduced before August 2001. The government cites huge ranges of testimony relating entirely to the higher *internal* targets. It points to "gaps" between the submissions prepared by the business units and their assigned internal targets without acknowledging that the combined submissions *never* produced a total 2001 revenue figure below $21.3 billion. APP-4967. The prosecution's reliance on Casey's "bullshit" email, USBR-5, is mainly for show: Casey's internal target was taken back down long before the April estimate. GX825; APP-4974, 4980; APP-5036, 5046.

2. The fact that Szeliga identified "risk" in the budget does not negate her unequivocal testimony that she determined, in good faith, that the current estimate at the

[5] *Shaw* did not merely accept an *allegation* of an imminent "extreme departure" from expectations. USBR-31. It explained: "In many circumstances, the relationship between the nonpublic information that plaintiffs claim should have been disclosed and the actual results or events that the undisclosed information supposedly would have presaged will be so attenuated that the undisclosed information may be deemed immaterial as a matter of law," citing several cases dismissing claims predicated on events 4-6 months in the future. 82 F.3d at 1210-11. Later courts have understood *Shaw*'s imminence and "extreme departure" analysis as the standard when interim results supposedly portend future collapse. *E.g., Glassman v. Computervision Corp.*, 90 F.3d 617, 631-32 & n.24 (1st Cir. 1996); *In re Seachange Int'l, Inc.*, 2004 WL 240317, *8 (D. Mass. 2004); *In re N2K Inc. Sec. Litig.*, 82 F. Supp. 2d 204, 208 (S.D.N.Y. 1999).

time of Nacchio's trades exceeded the public guidance by $200 million. APP-2323. There is always "risk" in a forecast and companies do not have to explain or quantify those risks when making projections. *Weilgos*, 892 F.2d at 514 ("Everyone understands that point estimates are almost certainly wrong" but firms need not "give ranges and identify the variables that will lead to departure" when making projections). Nor is it true that "Szeliga warned Nacchio that when she 'aggregated' the gaps, she expected Qwest to book no more than $20.4 billion of revenue in 2001." USBR-6. Szeliga told Nacchio that after "aggregat[ing] all the *risk*" identified by the business units, "we were still at this time coming to a billion dollars of risk *as it related to the target that we had set*." APP-2134.[6] She confirmed that she was referring to the *internal* target (APP-2211), which at that time (late December/early January, not "April 9" as the prosecution incorrectly states, USBR-15–16; APP-2132–33) was $22 billion. APP-2268. Szeliga's statement implied $300 million of "risk" (or 1.4%) in the $21.3 billion public projection, not 4.2% (*compare* USBR-30 n.14).[7] Even if that risk were treated as a certainty (and companies *cannot* deliberately err on the side of caution in forecasting) it was immaterial. *See* BR-24; *cf.* SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150, 45,151 (Aug. 19, 1999) (numerical threshold, "such as 5%," may serve as a preliminary assumption that an item is "unlikely to be material"). This case does not involve the "qualitative factors"

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[6] Emphases added unless noted.

[7] The prosecution relies on a memorandum prepared for Szeliga by the finance team on September 5, 2000, which evaluated risk in the $22 billion internal budget. Szeliga testified she *never* shared that memo with Nacchio. APP-2132. Nacchio knew only what Szeliga *told* him—*i.e.*, that she saw "a billion dollars of risk as it related to the target that we had set." APP-2134.

supporting a finding that the *fraudulently reported* revenues in *Ganino v. Citizens Utilities Co.*, 228 F.3d 154, 163 (2d Cir. 2000), were potentially material despite totaling only 1.7% of revenues.

3. The first two lines of the April 9 product update state that the "Current View of 2001" is a "$21.5B current estimate versus BOD plan of $21.8B." APP-5000. *That* was the "bottom line" (*compare* USBR-9) of the April estimate and Nacchio was entitled to rely on it.

Government witnesses Szeliga and Mohebbi testified without contradiction that the April 9 current estimate was the "internal current view of Qwest." APP-2323, 3277. The government argues the estimate was unreliable because it increased forecasted IRU revenues at a time when Casey told Nacchio that additional IRU revenues could not be generated. USBR-27. But *all* the projected increase in IRU sales was in the booming global-business unit, *not* Casey's wholesale unit. APP-5008, 5061 (global-business IRUs 61% *greater* than forecast in first quarter).[8] Its claim that the current estimate "remained $21.56 billion because only Nacchio had authority to reduce Qwest's targets" is unsupported. USBR-27 n.12. This was the "current estimate" not the "target." And Qwest's managers obviously *did* feel free to advise Nacchio when they concluded the public guidance had become unrealistic—in August 2001. APP-2255–56.

Finally, although Casey identified $675 million of "risk" (not "gap," USBR-9) in his April estimate, only $350 million stemmed from his prediction that the "[m]arket for

[8] IRUs were not an accounting trick, just another way of selling network capacity. Casey himself told Nacchio IRUs were "invaluable to Qwest" and the product of a "genius strategy." APP-2578.

IRUs [was] tightening." APP-5037. Even if Nacchio had no reasonable basis for disagreeing (Casey had been wrong before, BR-23) and those revenues were discounted completely, it would have portended a 0.4% miss.

4. The government cannot deny that when Qwest reduced the projections the stock *went up*. BR-27. It asserts without any evidentiary basis or citation that it had already gone down because Nacchio "trickled out" disclosures. USBR-33. The evidence shows the entire telecommunications sector declined that summer because investors already understood the adverse economic and demand trends. APP-3634–35 (analyst acknowledging sector-wide decline, and that shares of several Qwest competitors fell 72–100% from May-October 2001). The market's reaction to Qwest's preannouncement shows investors fully understood (indeed, overestimated) the challenges Qwest faced.

5. The government points to no sufficient evidence that Nacchio *knew* he had material information about the projections. Even just a "strong inference" of *civil recklessness* is inappropriate unless the information "was so obviously material that the defendant must have been aware both of its materiality and that its non-disclosure would likely mislead investors." *City of Philadephia v. Fleming Cos.*, 264 F.3d 1245, 1261 (10th Cir. 2001).

This Court recognized in *United States v. Lake* that the GC's failure to "t[ake] action when others failed to report" information necessarily informed other executives' understanding of whether their omissions were material. 472 F.3d 1247, 1261 (10th Cir. 2007). Qwest's senior managers, audit committee, and lawyers all knew the facts about Qwest's budget and performance in April-May. If the public projections were

unattainable, it was securities fraud for Qwest to reaffirm them. The GC also would have had an affirmative obligation to close the trading windows and not approve 10b5-1 plans. BR-29-30.

The prosecution asserts that Tempest's approval of Nacchio's trades was a "rubber stamp," USBR-36, but cites no evidence reasonably supporting that inference. It claims Tempest "did not have all the information Nacchio did," *id.*, but its citations recount immaterial differences. It does not challenge Nacchio's showing that Tempest attended the April meeting with Casey on which the government's argument hangs, APP-2575–76, and that Tempest knew everything the government now points to as material information, BR-29 & n.7.

C. This Conviction Cannot Be Sustained On The Theory That Nacchio Failed to Disclose Hard Facts That Were Material *Without Regard To The Projections*

In a footnote (tellingly, without a single record citation), the government asserts that "Qwest's public targets and statements may have been relevant, but by no means were they the 'sole' evidence of materiality." USBR-39 n.22. It suggests the rules governing forward-looking statements do not apply to three pieces of "hard" current information: (1) the failure to meet internal targets for new subscribers by April, (2) Casey's supposed report that there were no IRUs in the funnel, and (3) the percentage of IRUs in Qwest's Q1 revenue. This has nothing to do with the case the government charged and tried. Regardless, no reasonable jury could conclude that any of those items was independently material and that Nacchio *knew it*. Data this granular has never been thought to substantially alter the "total mix" of information available about a large

publicly-traded company. Attempting to continuously disclose matters like these would be both impossible and more confusing than useful to investors.

1. The government points out that information "viewed through two different lenses, can at once be both 'soft' and 'hard.'" BR-26 (citation omitted). But "reasonable basis" and "probability and magnitude" principles also govern liability in cases where "hard" current information is alleged to be material because it "strongly implies an important future outcome." *Shaw*, 82 F.3d at 1210; *Basic Inc. v. Levinson*, 485 U.S. 224, 238–39 (1988). To avoid those principles the government would have to refrain from imploring the jury (and this Court) to assess materiality through the "lens" of the projections.

2. All its arguments for why disappointing Q1 subscriber growth could have been material relate to "compounding" consequences for the year-end projections. At the time of the trades, the current estimate had already been revised to reflect the fact that "this shift is not occurring at the rate expected." APP-5000. And Nacchio did inform investors of that fact. APP-4807, 3636. Johnstone's analyst report recognized that Qwest's Q1 disclosures indicated Qwest would not achieve its objective of "doubling wireless subscribers" in 2001. APP-3629, 4935.

3. The prosecution strains mightily to recharacterize Casey's *prediction* into a present fact, repeatedly intoning that "there were no IRUs in the funnel for the third and fourth quarters." USBR-15. That was not how the government presented it below. APP-5179 (closing slide contending Casey's warning was material as a "[p]rojections of future earnings"). It also misstates the evidence. *First*, there were *two* IRU funnels: the

wholesale funnel, APP-5039, and the global business initiative summary, APP-5063. *Second*, neither funnel identified sales opportunities *by quarter*. APP-2506. *Third*, even disregarding the packed global funnel, Casey's wholesale funnel was *not* empty, but included $900 million in opportunities. APP-5039. *Fourth*, unexpected opportunities could *and did* arise. Just weeks later, Qwest considered a new wholesale IRU opportunity worth $200 million. APP-2572–73, 2700–03. *Fifth*, Casey's statements that the IRU market was "drying up" and that he did not have "visibility," APP-2496, were *predictions*—and ones that Szeliga said Nacchio challenged, APP-2230.

This Court held in *Garcia v. Cordova* that materiality is "more legal than factual in nature and thus review[ed] … *de novo*" when the case involves "soft information" such as opinions or predictions that are arguably "too speculative and unreliable to require disclosure under Rule 10b-5 as 'material fact.'" 930 F.2d 826, 828–30 (10th Cir. 1991). The government hangs its case on Casey's internal report that 0.4% of Qwest's revenue was "at risk" because the "market for IRUs [was] tightening as capital spending among carriers has slowed." APP-5037. But Casey's "funnel" could have changed in an instant. Predictions "'of a fickle and changeable character'" like these are immaterial, *Garcia*, 930 F.2d at 830 (citation omitted), and requiring their disclosure "would be equivalent to a bar on the use of [internal] projections if the firm wants to raise new capital." *Wielgos*, 892 F.2d at 516. Certainly there is no evidence that Nacchio *knew* Casey's IRU funnel was material.

4. The government's new theory that the percentage of revenues composed of IRUs was material, apart from what it portended for the projections, was not charged and cannot be right.

First, investors knew that Qwest sold IRUs. APP-2390–91; BR-26. *Glassman* held that disclosure that backlog orders were "*usually* low" rendered the "*specific* backlog numbers" immaterial, even though backlog levels had recently decreased 32%. 90 F.3d at 632–33 & n.26 (emphasis in original). Nacchio had no reason to believe the difference between 5% (IRU percentage in 2000, APP-3699) and 8% (first quarter of 2001, APP-2753–54) was material in itself.

Second, SEC rules do not require such revenue breakdowns. Item 101 of Regulation S-K provides that issuers must disclose "the amount or percentage of total revenue contributed by any class of similar products or services which accounted for *10 percent or more* of consolidated revenue." 17 C.F.R. §229.101(c)(i) (2001). Although not dispositive, "SEC regulations which mandate certain corporate disclosures are persuasive authority as to the materiality of those disclosures." *Andropolis v. Red Robin Gourmet Burgers, Inc.*, 505 F. Supp. 2d 662, 684 (D. Colo. 2007). In *Fleming*, this Court relied on a related provision of Regulation S-K requiring disclosure of litigation where damage claims exceed "10% of current assets" to dismiss a complaint that litigation was material. 264 F.3d at 1266. The Court used Item 103 as a "guidepost" to conclude the defendants had no reason to believe that litigation involving 3.5% of assets was material. *Id.* at 1267–68. Similarly in *Lake* this Court considered Regulation S-K thresholds for

disclosure of personal use of corporate aircraft when evaluating defendants' claim that their use was immaterial. 472 F.3d at 1258–60.

Third, disclosure of the IRU percentages did not negatively affect Qwest's stock price. On August 7, in a presentation *filed publicly with the SEC*, Nacchio told investors IRUs would be approximately 8% of Qwest's 2001 revenues. APP-4738.[9] That day, the stock closed virtually unchanged at $24. *Nine* trading days later it was at $24.10. Such evidence has been held "dispositive of the question of materiality." *Oran v. Stafford*, 226 F.3d 275, 283 (3d Cir. 2000) (Alito, J.) (no negative effect on stock price *four* days after disclosure); *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1124 (10th Cir. 1997) (plaintiffs failed to demonstrate "an adverse impact on [company's] stock price"). And again there is *zero* evidence that Nacchio pre-disclosed these numbers. The government's own witnesses testified that the "magnitude" of the IRUs "only came out in August." APP-3662.

Finally, Nacchio had no reason to know the IRU percentages were material apart from the projections.

The government says Qwest "executives made clear" to Nacchio that the IRU revenue mix was material, based on the views of Wolfe and the controller. USBR-35. Wolfe's "concern" related to the evaluation of the "projections." APP-1632. And the controller testified unequivocally that the CFO was responsible for this decision (APP-2774, 2789) and that by April 20, six days before Nacchio began trading, she and the

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[9] The numbers, disclosed several days later, were an easy computation from the percentages. *See In re Merck & Co. Sec. Litig.*, 432 F.3d 261, 269-71 (3d Cir. 2005).

outside auditors concluded the percentage of IRUs for Q1 was not material. APP-2774; 2795–96, 2389, 4672, 4682.

The government wrongly suggests that the auditors and audit committee only considered the IRU revenues in light of GAAP and GAAS, not their materiality. They were considering disclosure in management's discussion and analysis (MD&A), APP-4622, 4682, which is all about *materiality*. *See* SEC Release Nos. 33-8056, 34-45321, 67 Fed. Reg. 3,746, 3,747 (Jan. 22, 2002) (disclosure required where item is "reasonably likely to have a material effect on the registrant's financial condition or results of operations"). Wolfe testified that IRU disclosure "was a corporate issue" and involved "applying the SEC ground rules, definition of materiality." APP-1798.

The government implies that Nacchio admitted to knowledge in April that the stock would go down if the first-quarter revenue mix had been disclosed then. USBR-36. Its citation (APP-1653) shows only that Wolfe "discussed" with Nacchio that "the stock price would go down somewhat" after auditors determined *in late July* that the revenue mix should be disclosed. But Wolfe did not testify that *Nacchio said* the stock would decline due to this disclosure. Wolfe repeatedly testified that Nacchio would "*ask* [Wolfe] what will happen if we were to disclose" which belies an inference of knowledge. APP-1653. When Wolfe was directly asked what "Nacchio sa[id] he thought the effect of disclosure would be on the stock price," Wolfe recounted his own views—not Nacchio's. APP-1657.

II. THE INSTRUCTIONS WERE INADEQUATE

1. The defense consistently argued Nacchio had reasonable grounds to believe his team would meet its public projections, and that there is no obligation to disclose "data, assumptions, and methods" or "internal projections" so long as that was true. *E.g.*, APP-4417, 4410–18, 4424–25; BR-32. Nacchio's defense was "dependent on an understanding of applicable law" governing forward-looking projections, and "the court ha[d] a duty to instruct the jury on that law." *Lake*, 472 F.3d at 1263; *United States v. LaVallee*, 439 F.3d 670, 684 (10th Cir. 2006) (instructions must convey "an intelligent, meaningful understanding" of law governing the defense); *United States v. Butler*, 485 F.3d 569, 571 (10th Cir. 2007) ("defendant is entitled to jury instructions concerning his theory of defense").

The prosecution's answer—that "Nacchio was charged with *trading* on *inside information* … not … with making misstatements or failing to correct past misstatements," USBR-39 (emphasis in original)—simply refuses to engage with its own theory. Instead of charging Nacchio with defrauding the public with unattainable projections, the prosecution accused him of trading on "inside" knowledge that the projections were unattainable. The heart of either charge is an accusation that Nacchio knew the public projections had become materially misleading. "Reasonable basis" principles apply to "all of the bases of liability" under the securities laws. *Wielgos*, 892 F.2d at 513. The government argues that *Wielgos* involved registration statements, not insider trading. But the issuer's duty to disclose material information before selling

corporate stock, and an insider's duty to disclose material information before selling personal stock, are exactly the same. BR-17–18; *Shaw*, 82 F.3d at 1203–04.

The government says Rule 3b-6 "only protect[s] certain forward-looking statements filed with the SEC," USBR-40, but these projections were. APP-4781; 8-K filed April 25, 2001, *available at* http://www.sec.gov/Archives/edgar/data/1037949/000101905601500080/file001.txt. And the core purpose of the Rule (a safe harbor to encourage companies to issue projections) is obviously implicated by prosecutions like this one.

The government argues that reasonable basis "bears … on whether [projections are] misleading" rather than on materiality, USBR-40 n. 23, but here those inquiries merge. When the claim is that interim corporate results or debates are material because they undermine the attainability of projections, the critical issue is whether the projection has become *materially* misleading without additional disclosures. If not, the undisclosed data, assumptions, or internal debates are, by definition, immaterial. And the point of this doctrine is that projections *do not* become *materially* misleading unless they lack a reasonable basis.

2. The prosecution now claims the projections were not the only evidence of materiality. But the instructions certainly permitted the jury to convict on the theory the government actually charged and argued: that Nacchio's knowledge was material *because of what it portended for year-end*. The government cannot invite the jury to convict on that theory, procure instructions that fail to give the jury the guidance

necessary to evaluate it, and then defend the resulting conviction by arguing that it might have presented some of the same evidence through a different "lens."

3. Nacchio objected to the instructions, correctly identified the problem, and proposed curative instructions. The government's complaints about Nacchio's phrasing (USBR-39–40) are thus irrelevant. *See United States v. Laughlin*, 26 F.3d 1523, 1527–29 (10th Cir. 1994) (recognizing instructional error, even where defendant's proffered alternative was "disfavored" and "confusing"); *United States v. Jones*, 909 F.2d 533, 538–39 (D.C. Cir. 1990) (Ginsburg, R., J.) (same).

The government cites *United States v. Davis*, 953 F.2d 1482, 1492 (10th Cir. 1992), but it reviewed the instructions to ensure they "encompass[ed] [the defendant's] defenses" even while rejecting defendant's requested instruction as tendentious. Similarly, *United States v. Quarrell*, 310 F.3d 664, 676 (10th Cir. 2002), held the defendant was not entitled to *any* mistake-of-law instruction.

4. The government argues the good faith instruction rendered these defects harmless beyond a reasonable doubt. USBR-41. But it erroneously told the jury Nacchio could lack good faith "*even though* he honestly holds a certain opinion or a belief." APP-4561. It also permitted the jury to find that any scrap of information was material solely because of what it augured for the projections, *even though it did not strip those projections of a reasonable basis.*

5. The cautionary language accompanying Qwest's projections was also relevant to whether any inside information rendered those projections materially misleading. Juries are regularly instructed on the relevance of such language, s*ee* 4 Modern Federal

Jury Instructions-Civil § 82.02, and this Court has held it "cannot be ignored in construing the materiality of optimistic predictions." *Grossman*, 120 F.3d at 1121. The prosecution's claim (USBR-42) that "bespeaks caution" is inapplicable to "then-present factual conditions" is irrelevant. These instructions certainly permitted conviction for the ample speculative and predictive information the prosecution argued was material. And the doctrine *does* apply when present facts are alleged to render projections materially misleading. *Shaw*, 82 F.3d at 1213 ("forward-looking aspect" of present facts was immaterial under bespeaks caution). Finally, whether the warnings were "too generalized" was clearly a matter for the jury. The prosecution built its case around economic risks identified repeatedly in Qwest's filings. BR-25–26.

6. Since "probability and magnitude" or "total mix" would have addressed (albeit only in a limited fashion) the omissions Nacchio objected to, plain error review is inappropriate. A defendant who correctly identifies an instructional defect and proposes a solution need not propose every possible alternative. Regardless, this Court reviews *de novo* whether the instructions adequately explained the law. Here that truly required "reasonable basis" and "bespeaks caution" instructions, but "total mix" and "probability and magnitude" should be beyond dispute.

While the Supreme Court endorsed "probability and magnitude" in the merger discussions context, the footnote the government cites plainly implies that *even more extensive* guidance might be necessary for "other kinds of contingent or speculative information, such as earnings forecasts or projections." *Basic*, 485 U.S. at 232 n.9. This Court has applied that test outside the merger context. *Fleming*, 264 F.3d at 1265. And

courts have not treated "total mix" as another phrasing of "importance." *Id.* at 1268 ("'[A] statement or omission is only material if a reasonable investor would consider it important in determining whether to buy or sell stock,' *and* if it would have 'significantly altered the total mix of information available ….'" (quoting *Grossman*, 120 F.3d 1119)); *Ganino*, 228 F.3d at 162 (citing "total mix" standard and stating "[i]t is not sufficient to allege that the investor might have considered the misrepresentation or omission important").

7. The government offers no reason why the definition of "nonpublic" needed to discuss Qwest's duty to disclose. The court inserted this language, at the government's urging (APP-740), into the pattern instruction. *Compare* APP-4559 *with* Modern Federal Jury Instructions-Civil § 82.02. The only explanation is damning. The defense elicited substantial evidence that Nacchio was aware that Qwest's auditors and lawyers had decided the information at issue was not material as of April or May. BR-28–31. The court's instruction invited the jury to disregard that critical evidence of scienter by wrongly suggesting that these professionals were addressing a different question—whether Qwest had a duty to disclose.

8. The government cannot cite *any* case endorsing the problematic good faith instruction. The leading treatise contains *different* language, designed to convey that if a defendant makes false statements to deprive a person of property, believing he would eventually repay the victim is no defense. Kevin F. O'Malley et al., 1A *Federal Jury Practice and Instructions* §19.06; *see United States v. Bailey*, 327 F.3d 1131, 1143 (10th Cir. 2003) ("honest belief" "that everything would work out does not establish a good

faith defense"). Nacchio did not rely on any "honest belief about some collateral matter" (USBR-48), and the instruction was not even phrased to avoid such confusion. It directed a finding of bad faith "even though he honestly holds a certain opinion or belief" if "he *also* knowingly employs a device, scheme or artifice to defraud." APP-4561–63.

None of the cases the government claims "have affirmed instructions using virtually the same language" (USBR-46) even considers a challenge to a good faith instruction. None involves insider trading, or a government argument that conviction is appropriate based on *unrelated* acts of dishonesty.

In closing, the government focused the jury on this sentence—emphasizing that the defense "left out" the disputed language in its discussion of the good faith instruction—and then invited a finding of bad faith based on misconduct completely unrelated to the charged insider trading. APP-4514–15 (citing Weinstein testimony regarding prior "dishonest act involving Qwest").[10] Having obtained the conviction by urging the jury to apply the language in isolation, the government cannot preserve it by relying on other, unobjectionable language in the charge. *Cf. Lake*, 472 F.3d at 1262–63 (relying in part on government's closing arguments to find instructional error required new trial).

III. EXCLUSION OF FISCHEL REQUIRES A NEW TRIAL

Having made the erroneous CIPA rulings, the district court knew that Fischel's testimony *was* Nacchio's defense. Fischel has never been excluded, is the nation's

[10] The defense never put Nacchio's character for truthfulness at issue in questioning Weinstein. Mot. to Strike Testimony of David Weinstein, at 1–5 [Doc. No. 328].

preeminent expert on the economics of corporate law and financial markets, and this testimony, which is routinely admitted in securities fraud cases, would have refuted materiality and intent. Fischel's exclusion without a hearing, voir dire, or defense argument was improper and violated Nacchio's right to a defense, requiring a new trial.

1. The government's conclusory assertions that the testimony would not "assist" the jury and was "irrelevant" (USBR-58, 61) are belied by its own defense of the sufficiency of the evidence, which rests entirely on assertions Fischel would have refuted.

Most importantly, it argues that Qwest's IRU disclosures negatively affected its stock price (USBR-31), that "[a] reasonable jury may consider a range of facts, including: the information's effect on the market value when disclosed" (USBR-26), that the information was material and "Nacchio knew these facts were important to investors" (USBR-17). Fischel would have testified that "the economic evidence does not establish that information concerning the magnitude of Qwest's IRU revenue would have been material to reasonable investors on the dates of the Questioned Sales," APP-431–32, and would have refuted the government's claim that materiality cannot be determined by looking to stock price immediately following disclosure. *Compare* USBR-32-33 *with* APP-797.

The government contends "analysts were 'very surprised by the magnitude' of the IRU revenue [disclosed]…" USBR-15. Fischel would have testified that it did not affect their assessment of Qwest—based on his study of *all* analyst reports, which would have helped the jury understand the "total mix" far better than the testimony of individual

analysts. APP-480–81. An expert may rely on "[r]eports prepared by third parties" and "[o]pinions of other experts." 4 *Weinstein's Federal Evidence* §703.04 (2d ed. 2006).

The government maintains that after the disclosures investors determined "Qwest had been growing by only 6% or 7%, not the 12% Qwest had reported." USBR-29. Fischel would have testified based on "an economic study comparing the revenue multiples of telecommunications companies that disclosed non-recurring revenues … with those that did not," that "investors collectively" *did not* discount IRU revenues or regard the mix as material. APP-480–81.

Finally, Fischel would have testified that Nacchio's trades reflected an economically consistent pattern, APP-428–30, not "suspicious timing" or an "unusual pattern." USBR-22.[11]

2. The government does not dispute that expert testimony of this sort is routinely admitted in securities cases and is extremely helpful to the jury. BR-42, 40 n.13, 49. And it cannot cite a single contrary authority. It frequently offers similar expert testimony on materiality in *criminal securities fraud cases*.[12]

Nor does it contest the relevance of Fischel's testimony to intent, or that a defendant is entitled to "wide latitude" to introduce evidence bearing on specific intent. BR-42–43.

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[11] Fischel was permitted to testify as a summary witness (USBR-55), but merely to list the options exercised and shares sold as a percentage of saleable holdings. The court did not permit him to explain these numbers' significance. APP-3988.

[12] *E.g.*, *United States v. Reyes*, No. CR 06-0556, U.S. Opp. To Def. Reyes' Motion in Limine No. 7 to Exclude Proposed Government Expert Testimony, at 2 (N.D. Cal. June 4, 2007); *United States v. Schlisser*, 168 Fed. Appx. 483, 485 (2d Cir. 2006).

3. The court excluded Fischel because "[t]he March 29, 2007 [Rule 16] disclosure contained no methodology or reliable application of methodology to the case." APP-4075. That is unprecedented. NACDL-BR-1—9; BR-44–45.

Nacchio's 10-page notice met Rule 16's requirements, and the government cites no contrary authority. It and the district court incorrectly assume that the requirements of Rule 16 and Fed. R. Civ. P. 26 are "pretty close." APP-2037; APP-4075 (excluding Fischel because his "*expert report*" did not disclose methodology); APP-419 (government argued notice was "far less informative than the typical expert report in a run-of-the-mill medical malpractice case").[13]

However, all Rule 16 requires is a "summary" of the testimony. *United States v. Jackson* approved a government Rule 16 notice stating only:

> [P]lease be advised that [several police officers] may testify at trial concerning the use of beepers, firearms, walkie-talkies and Western Union wire transfers in connection with the sale of narcotics. In addition, each of these officers may testify that narcotics traffickers often secure locations such as houses or apartments to serve as a base for dealing narcotics. Each of these police officers will base their testimony on their years of training and experience in the area of drug investigations.

51 F.3d 646, 650 (7th Cir. 1995). And *United States v. Finley* reversed a conviction based on erroneous exclusion of an expert, where the notice "supplied the government with sufficient notice of the *general nature* of [the expert's] testimony," even though it "may not have been as full and complete as it could have been or the government would

[13] Nacchio had no notice that he had to satisfy *Rule 702* in his March 29, 2007 disclosure. Rule 16 does not require it and the district court's order directed Nacchio *only* to "bring[] his submission into compliance with Rule 16." APP-352.

have liked." 301 F.3d 1000, 1017 (9th Cir. 2002). Nacchio's notice listed Fischel's proposed testimony on trading patterns and the materiality of IRU revenue, and the considerations his opinion "is based on," APP-427–30. It also explained that Fischel analyzed extensive information, including Qwest's "[p]ress releases and financial press reports concerning [its] guidance"; "SEC filings and press releases"; and "[a]nalysts' reports concerning Qwest and other telecommunications companies." APP-433–34.

Finally, "the sanction of exclusion of a witness's expert testimony 'is almost never imposed,'" "'absent bad faith.'" *United States v. Sarracino*, 340 F.3d 1148, 1170 (10th Cir. 2003) (citations omitted); NACDL-BR-4–7. "[C]ourts should use particular caution in applying the drastic remedy of excluding a witness altogether," especially, where, as here, the testimony has "decisive value" and is "essential to the defense." *Finley*, 301 F.3d at 1018.

4. The district court misapplied *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579 (1993), which is reviewed *de novo*, and abused its discretion by improperly failing to hold a hearing, conduct voir dire, or permit defense argument. *Dodge v. Cotter Corp.*, 328 F.3d 1212, 1225 (10th Cir. 2003).[14]

Although a hearing is not *always* required, excluding Fischel's testimony without one was reversible error. Expert testimony is presumed admissible, *e.g.*, 4 *Weinstein's Federal Evidence* §702.02, and should "be excluded only if it 'is so fundamentally unsupported that it can offer no assistance to the jury,'" *Archer Daniels Midland Co. v.*

[14] Nacchio did not waive the admissibility of Fischel's testimony under Rule 702. BR-39-50.

Aon Risk Servs., Inc., 356 F.3d 850, 858 (8th Cir. 2004) (citation omitted). Testimony like this is routine fare, and Fischel is the preeminent expert in this field.[15] The court could have *admitted* the testimony without a hearing,[16] but could not exclude it without one. "[W]hen the reliability" of expert testimony is disputed, "the district court 'must hold an evidentiary hearing unless the proffer on its face is insufficient to raise a material issue of fact.'" *United States v. Sandoval*, 390 F.3d 1294, 1301 (10th Cir. 2004) (citation omitted).

The government argues Nacchio did not request a hearing, but *the government did*, APP-421, and the district court *prevented* Nacchio's counsel from requesting a hearing, which he intended to do. APP-3921–22 (Mr. Speiser: "Your Honor, may I be heard?" The Court: "No."). Nacchio also explicitly requested a hearing when moving to rebut the analysts. APP-481 n.4. Regardless, "the court has an independent responsibility for the proper management of complex litigation" and to afford the proponent of expert testimony "an opportunity to be heard on the critical issues" before excluding it. *Padillas v. Stork-Gamco, Inc.*, 186 F.3d 412, 417–18 (3d Cir. 1999); *Oddi v. Ford Motor Co.*, 234 F.3d 135, 152–53 (3d Cir. 2000).

The government (USBR-56) misrepresents *United States v. Rodriguez-Felix*, 450 F.3d 1117 (10th Cir. 2006). The district court did schedule a hearing, directed the defendant to file a *Daubert* proffer for the hearing, No. 1:04-cr-00665-WJ (D.N.M.)

[15] The government even relies on three cases citing Fischel's articles: *Basic*, *Shaw*, and *In re Burlington Coat Factory*, 114 F.3d 1410 (3d Cir. 1997) (Alito, J.).

[16] *Kumho Tire Co. v. Carmichael*, 526 U.S. 137, 152 (1999) (district court has discretion to "avoid unnecessary 'reliability' proceedings … where the reliability of an expert's methods is properly taken for granted"); BR-40.

(Docket Nos. 75, 76, 83), and heard argument—just not from the expert, who chose not to attend, Appellant's Br., No. 05-2142, 2005 WL 3445754, *4.

5. It does not matter whether the analysts testified as experts, as they told the jury they were, APP-3563; APP-3652, or lay witnesses. They offered opinions and testified about materiality. Johnstone testified, "in the first quarter of 2001, Qwest published … that they grew revenue 12 percent. But investors … did not know that that figure included over $400 million of one-time optical capacity revenue, which if you look at recurring revenue, the company actually grew its revenue 7-1/2 percent year over year, not 12 percent." APP-3589. This testimony (and his report, admitted over objection) that investors completely discounted IRU revenues conveyed that the magnitude of those sales was important to reasonable investors. And Johnstone testified that Qwest's disclosures "warranted a change in rating and point of view on the company." APP-3590.[17] Khemka also opined that IRU revenues were "not meaningful" to investors, and disclosure of their magnitude would be important to reasonable investors. APP-3670, 3676–77.

The government introduced materiality testimony through its analysts, but neither it nor the court can dictate how *the defense* could rebut this evidence. USBR-62 ("defense could 'call its own analysts who disagree' with Johnstone and Khemka"); APP-4070 ("maybe it requires rebuttal, but it doesn't require an expert").

[17] The court only struck Johnstone's answer to the *following* question. APP-3590-91 (stating that disclosure caused him to change Qwest's rating from buy to sell).

6. The government cites no case upholding exclusion of materiality testimony (or testimony negating an element of the offense) under Rule 403, and does not respond to Nacchio's cases. BR-40–41 n.13, 49; *United States v. Forbes*, 2007 WL 2890232, *2 (2d Cir. 2007) ("[R]eferences to the decline in Cendant's stock price … were probative on … materiality and permissible under [Rule] 403.").

7. Rule 602 does not apply to expert opinion testimony. *Daubert*, 509 U.S. at 592; BR-48 n.18.

IV. CIPA ERRORS

See classified excerpt.

V. CUMULATIVE ERROR

Even if the district court's errors, in isolation, were harmless, their "'cumulative effect on the outcome,'" *United States v. Toles*, 297 F.3d 959, 972 (10th Cir. 2002) (citation omitted), was not, given the dearth of evidence on materiality and intent, "harmless beyond a reasonable doubt," *United States v. Barrett*, 496 F.3d 1079, 1121 (10th Cir. 2007).[18]

VI. THE SENTENCE IS INCORRECT

1. The government argues that "[h]ad Nacchio obeyed the law, he would have sold *no* stock and reaped *no* return." USBR-64. But the statute prohibits "any *manipulative or deceptive device or contrivance*" "in connection with the purchase or sale." The sale is not illegal; the offense is "*[d]eception* through nondisclosure." *United States v. O'Hagan*, 521 U.S. 642, 654 (1997).

[18] The *Chapman* standard applies to instructional errors (USBR-41), and thus to cumulative error under *Barrett*.

This Court and others have long held that "'gains of the[] wrongful conduct,'" *SEC v. Patel*, 61 F.3d 137, 139–40 (2d Cir. 1995) (citation omitted), are measured by "the difference between the value of the shares when the insider sold them while in possession of material, nonpublic information, and their market value 'a reasonable time after public dissemination of the inside information.'" *SEC v. Happ*, 392 F.3d 12, 31 (1st Cir. 2004) (citation omitted); *SEC v. Maxxon, Inc.*, 465 F.3d 1174, 1179 (10th Cir. 2006); *SEC v. MacDonald*, 699 F.2d 47, 54 (1st Cir. 1983); *SEC v. Shapiro*, 494 F.2d 1301, 1309 (2d Cir. 1974). Statutes "'are to be read with a presumption favoring the retention of long-established and familiar principles,'" absent "'a statutory purpose to the contrary.'" *United States v. Texas*, 507 U.S. 529, 534 (1993) (citation omitted). There is "no reason why considerations relevant to … a civil fraud case should not apply, at least as strongly, to a sentencing regime in which the amount of loss caused by a fraud is a critical determinant of the length of a defendant's sentence." *United States v. Rutkoske*, 2007 WL 3102187, *9 (2d Cir. Oct. 25, 2007). Nor is it too complicated to apply these principles, USBR-65; courts routinely do in civil cases.[19]

The government effectively concedes the fine should be vacated.

2. The government does not respond to Nacchio's (55–56) and NACDL's (9–12) forfeiture arguments and ignores that equating "specified unlawful activity" in §981(a)(1)(C) with "unlawful activities" in §981(a)(2)(A) (USBR-67) renders two subsections superfluous and another redundant, BR-55–56.

[19] The government supplied no alternative calculation below, and ignores other factors impacting stock price. *Supra* 10.

CONCLUSION

This Court should direct a judgment of acquittal or, alternatively, reverse and remand for a new trial before a different judge.

Respectfully submitted,

s/ Maureen E. Mahoney

Herbert J. Stern
Jeffrey Speiser
STERN & KILCULLEN
75 Livingston Avenue
Roseland, New Jersey 07068
(973) 535-1900 (telephone)
(973) 535-9664 (facsimile)

Maureen E. Mahoney
Alexandra A.E. Shapiro
J. Scott Ballenger
Nathan H. Seltzer
LATHAM & WATKINS LLP
555 11th Street, N.W., Suite 1000
Washington, DC 20004
(202) 637-2200 (telephone)
Maureen.Mahoney@lw.com

Counsel for Defendant-Appellant

Dated: November 20, 2007

CERTIFICATE OF COMPLIANCE WITH RULE 32

I hereby certify in accordance with Fed. R. App. P. 32(a)(7)(C) that this brief has been prepared with the type-volume limitations of Fed. R. App. P. 32(a)(7)(B), and, this brief contains 8,009 words (per this Court's order of August 30, 2007, authorizing 8,5000 words), excluding the parts of the brief exempted by Fed. R. App. P. 37(a)(7)(B)(iii).

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I hereby certify that this brief complies with the typeface requirements of 10th Circuit Rule 32(a) because this brief was prepared using Microsoft Word 2003 in 13-point Times New Roman font.

s/ Maureen E. Mahoney
Maureen E. Mahoney
Latham & Watkins LLP
555 11th Street, N.W., Suite 1000
Washington, DC 20004
(202) 637-2200 (telephone)
(202) 637-2201 (facsimile)
Maureen.Mahoney@lw.com

CERTIFICATE OF SERVICE

I hereby certify that on this 20th day of November, 2007, I caused the foregoing **APPELLANT'S REPLY BRIEF** to be sent via electronic mail to:

U.S. Court of Appeals for the 10th Circuit:
esubmission@ca10.uscourts.gov

Stephan E. Oestreicher
stephan.oestreicher@usdoj.gov

James O. Hearty
james.hearty@usdoj.gov

Troy A. Eid.
troy.eid@usdoj.gov

Leo J. Wise
leo.wise@usdoj.gov

Kevin Traskos
kevin.traskos@usdoj.gov

I further certify that on this 20th day of November, 2007, I caused two (2) paper copies of the foregoing **APPELLANT'S REPLY BRIEF** to be sent via U.S. mail postage prepaid to:

Stephan E. Oestreicher, Jr.
Criminal Division, Appellate Section
U.S. Department of Justice
P.O. Box 899
Ben Franklin Station
Washington, DC 20044-0089

Troy A. Eid
James O. Hearty
Kevin Traskos
U.S. Attorney's Office-Denver Colorado
District of Colorado
1225 17th Street

Suite 700
Denver, CO 80202
(303) 454-0100

Leo J. Wise
U.S. Department of Justice
Criminal Division-Fraud Section
1400 New York Ave., N.W.
3rd Fl.
Washington, DC 20530
(202) 514-9842

s/ Maureen E. Mahoney

Maureen E. Mahoney
Latham & Watkins LLP
555 11th Street, N.W., Suite 1000
Washington, DC 20004
(202) 637-2200 (telephone)
(202) 637-2201 (facsimile)
Maureen.Mahoney@lw.com

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I, Maureen E. Mahoney, hereby certify that:

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s/ Maureen E. Mahoney
Latham & Watkins LLP
555 11th Street, N.W.
Suite 1000
Washington, D.C. 20004
(202) 637-2200 (telephone)
(202) 637-2201
Maureen.Mahoney@lw.com