

07cwin THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

UNITED STATES OF AMERICA)
)
) 07 CR 227
)
v.)
) Judge George W. Lindberg
JOHN TOMKINS)

MEMORANDUM OPINION AND ORDER

The government charged defendant with various crimes, in a fifteen-count indictment filed on September 18, 2007. Before the Court are defendant's pretrial motions.

I. Factual Background

The following facts are alleged in the indictment. Between January 2005 and September 2005, defendant bought common stock and call option contracts of 3Com Corporation. Between May 23, 2005 and October 25, 2005, defendant mailed letters to senior employees of several investment companies, threatening the recipients with violence if the price of 3Com's stock did not reach \$6.66 by October 31, 2005.

In addition, defendant bought common stock of Navarre Corporation between January and December 2006, and bought Navarre call option contracts between February 2006 and March 2007. Defendant mailed letters to individuals associated with various investment companies, in which he threatened the recipients with violence if Navarre's stock did not reach defendant's target price by certain dates.

Defendant also mailed a letter to Navarre's chief executive officer on March 13, 2006, directing him to increase the price of Navarre's stock to \$6.66 within sixty days by, among other actions, disseminating false information that the CEO was "taking the company private." The

letter threatened the CEO with violence if Navarre's stock price did not reach the target.

On June 9, 2006, defendant mailed letters to three individuals to whom he had previously sent threatening letters. The June 9 letters warned the recipients that "times up," and demanded that the price of Navarre's stock increase each day between June 13 and June 17, 2006. The letters also threatened to "ship a package" to targets such as relatives, friends, or neighbors, each day that the Navarre stock price did not "end green."

On January 26, 2007, defendant mailed packages to two individuals associated with investment companies. Each package contained a pipe bomb and a letter stating that "[t]he only reason you are still alive is because I did not attach one wire," and warning that "if you decide you want to keep the people around you safe, you will do as I say." The letters demanded "a rally in the stock price" of Navarre on certain dates, and specified target closing prices.

None of the recipients of the letters complied with defendant's demands, and no market activity resulted from his scheme.

The indictment charges defendant with ten counts of securities fraud, under 15 U.S.C. § 78j(b), 18 U.S.C. § 2, and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. 240.10b-

5. The indictment also charges defendant with two counts of mailing threatening communications, in violation of 18 U.S.C. § 876; two counts of possessing an unregistered destructive device, in violation of 26 U.S.C. § 5861(d); and possessing a destructive device in furtherance of a crime of violence, in violation of 18 U.S.C. § 924(c).

Before the Court is defendant's motion to dismiss the securities fraud counts of the indictment (Counts 1 through 10), his motion to suppress certain evidence, and four other pretrial motions.

II. Motion to Dismiss

Defendant moves to dismiss the first ten counts of the indictment, which charge him with securities fraud, on the basis that these counts fail to state an offense. Defendant is charged with violating Section 10(b) of the Securities Exchange Act, which provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, . . . —

. . . .
(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b). Rule 10b-5 states, in pertinent part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails

-
(a) To employ any device, scheme, or artifice to defraud,
. . . .
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

An indictment must allege facts which, if proven, constitute the crime charged. See

United States v. Gimbel, 830 F.2d 621, 624 (7th Cir. 1987). Defendant argues that the charged conduct does not constitute a violation of securities fraud laws because there are no allegations that defendant misled any stock market investors, or that there was any market activity based on defendant's misrepresentations. The government responds that defendant's conduct, combined with his intent to manipulate stock prices, is sufficient to violate Rule 10b-5, even though there was no actual market activity.

The Court starts with a basic principle of statutory construction, that “[g]enerally, courts strictly construe criminal statutes against the government and in the defendant’s favor.” United States v. Bhutani, 266 F.3d 661, 666 (7th Cir. 2001). When used in connection with securities markets, the word “manipulative” is “virtually a term of art,” and “connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.” Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976). Market manipulation generally refers to practices “such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.” Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476 (1977). The Supreme Court has cautioned that Section 10(b) “must not be construed so broadly as to convert every common-law fraud that happens to involve securities into a violation of § 10(b).” S.E.C. v. Zandford, 535 U.S. 813, 820 (2002).

Neither the government nor defendant cites any case that is factually similar to this one. For that reason, most of the authority cited by the parties provides little guidance in evaluating the facts presented here. For example, the parties’ debate over cases such as Markowski v. S.E.C., 274 F.3d 525 (D.C. Cir. 2001), and GFL Advantage Fund, Ltd. v. Colkit, 272 F.3d 189 (3rd Cir. 2001), is unhelpful, as both of those cases involved actual market activity.

Although United States v. Finnerty, 533 F.3d 143 (2d Cir. 2008), cited by defendant, also presents different facts than are presented here, it is instructive. In Finnerty, the defendant, a New York Stock Exchange specialist, was charged with securities fraud¹ under Section 10(b) and

¹ On appeal, the government abandoned any claim of market manipulation, and proceeded only on its claim of deceptive conduct. Finnerty, 533 F.3d at 148.

Rule 10b-5, for “interpositioning.”² See Finnerty, 533 F.3d at 145-46. The Second Circuit affirmed the district court’s judgment of acquittal, on the basis that the government offered no evidence that the defendant had conveyed a misleading impression to investors. Id. at 148-49. As the court stated: “The government has identified no way in which Finnerty communicated anything to his customers, let alone anything false.” Id. Nor had the government attributed anything to Finnerty “that deceived the public or affected the price of any stock: no material misrepresentation, no omission, no breach of a duty to disclose, and no creation of a false appearance of fact by any means.” Id. at 151. The court concluded that the government had undertaken to prove “no more than garden variety conversion.” Id. at 149.

The Finnerty court’s conclusion that the defendant’s conduct did not violate the securities laws because it did not involve the communication of deceptive information to investors suggests that defendant’s conduct here would similarly not support a prosecution for securities fraud. In this case, no communications were made to investors, and no action was taken in the market to manipulate stock prices.

The government argues that defendant’s scheme was designed to manipulate the market but was simply unsuccessful, and analogizes to mail and wire fraud cases to support its contention that such a scheme can support a prosecution. This argument is misplaced. In this case, no activity in the market occurred, whether the means were successful or unsuccessful. In

² Buyers and sellers of a security traded on the New York Stock Exchange must present their bids to buy and offers to sell to the Specialist Firm assigned to that security. Ordinarily, the specialists match the orders of the buyers and sellers to timely execute the trades at the best available price. “Interpositioning” occurs when a specialist prevents the normal trade between matching public orders, and instead takes a profit on the spread between the bid price and the ask price of customers’ orders. See In re NYSE Specialists Sec. Litig., 503 F.3d 89, 92-93 (2d Cir. 2007).

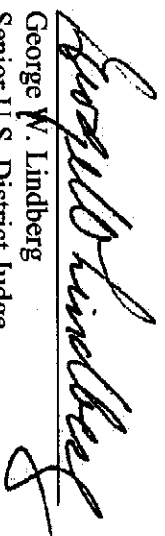
the mail fraud context, this would be more akin to a would-be defrauder placing a fraudulent document in a stamped envelope and then neglecting to mail it.

Here, while defendant may have wanted to manipulate the market through third parties, no information of any kind was actually communicated to investors, and no market activity of any kind actually took place. The Court concludes that the government's attempt to expand 15 U.S.C. § 78j(b) and Rule 10b-5 to encompass defendant's alleged conduct is unwarranted.

Although defendant may well have committed other violations, the facts as alleged do not support a prosecution for violations of 15 U.S.C. § 78j(b) and Rule 10b-5. Defendant's motion to dismiss Counts 1 through 10 of the indictment is granted.

ORDERED: Defendant's motion to dismiss [90] is granted. Counts 1 through 10 of the indictment are dismissed. Defendant's motion to suppress [95] is denied. Defendant's motion for disclosure of evidence [91]; motion for Santiago statement [92]; request for notice of other crimes, wrongs, or acts [93]; and motion for early return of trial subpoenas [94] are denied as moot.

ENTER:


George W. Lindberg
Senior U.S. District Judge

DATED: March 6, 2009