No. 08-1172

In the Supreme Court of the United States

JOSEPH P. NACCHIO,
PETITIONER,
v.
UNITED STATES OF AMERICA,
RESPONDENT.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY BRIEF OF PETITIONER

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The petition and *amicus* briefs explained that if the internal debates and predictions underlying this prosecution count as "material inside information" then no company or executive can buy or sell stock, ever, without risking capricious criminal prosecution. The government does not deny the truth of that observation, the importance of the issue, or the tremendous confusion in the lower courts.

On the *Daubert* issues, the opposition stresses the factual disagreements between the *en banc* majority and dissent while ignoring the fundamental legal dispute (and circuit split) over whether a motion *in limine* puts the defendant on notice that the court may exclude his expert on an undeveloped record and without a hearing.

Like a narrow majority of the Tenth Circuit, the government "chooses expediency over due process," App.93a (Kelly, J., dissenting), and is willing to drive corporate America and basic fairness off a cliff to preserve its conviction in a case that should never have been brought. Certiorari should be granted.

1. The opposition does not deny the key facts that make this prosecution extraordinary. The allegedly material inside information consists solely of internal debates and predictions about far-off future events, and Q1 operating information alleged to be material *only* because of what it supposedly portended for year-end results.[1] Such risks can be material only if large and highly probable. The opposition pretends that

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[1] The government cannot change its materiality theory now, *Cola v. Reardon*, 787 F.2d 681, 688 (1st Cir. 1986), and argues that small potential shortfalls were material *because the market would punish Qwest for missing its projections.*

Nacchio could see eight months into the future with great certainty only by misrepresenting the facts.

The government asserts that Qwest analysts "calculated" a year-end 2001 revenue shortfall of "almost $1 billion" or 4.2% below the public projection. Opp.2. But it cites a document from September 5, 2000—*sixteen months before year-end 2001*, and before the budget process began. Nacchio was *acquitted* for trades from January-March, and *nobody* recommended reducing the projections until August. CAJA-2255-56.

The government notes that by April Qwest had not made the budgeted "shift" toward "recurring" revenues, but ignores the tremendous surge (61% above budget) in IRU revenues in Graham's unit. Pet.5. The revised April 9 budget accounted for the "recurring" revenue shortfall, and still showed Qwest exceeding year-end expectations. App.276a-77a. These were not "plug in" numbers. Casey saw $350 million of "risk" in *his* budget but *no IRUs were added to his budget.* Pet.6. All additional projected IRU sales were in *Graham*'s booming unit, and Graham testified that the budget "provid[ed] our best belief of what things were going to happen." CAJA-2702. The government's own witnesses uniformly testified that in April even "with all of the debates ... the internal current view of Qwest was that they would reach $21.5 billion by December 31st, 2001" *exceeding* the projections. App.236a; CAJA-3276-77.

The opposition makes Casey's prediction that "Qwest was 'draining the pond'" of demand for IRUs its centerpiece, even though the Tenth Circuit did not view Casey's potential shortfall (0.4%) as material. The government pretends that the subjective (and disputed) predictions of the most pessimistic person in the company were omniscient and infallible, and should have been disclosed to investors as gospel truth. That approach would permit conviction of *any* executive, and is inconsistent with precedent that tentative or uncertain predictions *cannot* be disclosed. Pet.23-24.

Nacchio also fully *disclosed* the "recurring" revenue shortfall (and thus disclosed that Qwest made its Q1 projections another way) two days before his first trade. Pet.7. Nacchio announced that revenues in Consumer and Small Business—"the largest recurring revenue business at the company," CAJA-1415—were *21%* off target and would fall similarly short of budgeted year-end projections, App.295a, but that "when something goes wrong[,] you come up with something new. ... So if one product is not as good, you go pump another product," App.290a.

The government pretends that Qwest's stock decline was obviously attributable to Nacchio "'trickl[ing] out'" information. Opp.6, 24 (citation omitted). Fischel's event study would have refuted this. Pet.3. That summer's market "meltdown of historic proportions" "largely obliterated the value of publicly traded securities throughout the telecommunications sector." *In re Williams Sec. Litig.*, 496 F. Supp. 2d 1195, 1201, 1264 (N.D. Okla. 2007), *aff'd*, 558 F.3d 1130 (10th Cir. 2009).

2. The opposition barely engages with the materiality issues, and does not deny their importance.

The government argues that the materiality definition from *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976), is sufficient for all contexts. In *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), this Court held that the generic *TSC* test *is not* sufficient for assessing merger discussions, and that "other kinds of contingent or speculative information, such as earnings forecasts or projections" might require additional refinements. *Id.* at 232 n.9.

The government never denies that this is the first time an executive has *ever* been prosecuted on the basis of undisclosed "risks" about *future* quarters, or that Nacchio was convicted for failing to disclose information that other circuits would have punished him *for disclosing.* It also never denies that these are unsettled and frequently litigated questions of great national importance. Pet.24-25. As the Chamber explains, the court's standard is "illogical, unsupported, and—in the litigious world in which businesses operate—impractical," Br.8, and it "portends serious consequences for American business interests," Br.1, because "[t]he variety and volume of data that would meet such a low [materiality] threshold—particularly in larger corporations—is staggering," Br.18.

The government never disagrees. Instead it brushes aside such concerns as a "policy-driven ... challenge to the wisdom of the rule subjecting corporations or insiders to liability." Opp.19. Insider trading law is largely a judicial creation, and this Court is certainly entitled to consider the profoundly dangerous "policy" implications of this unprecedented prosecution.

The government effectively concedes that companies have the same insider-trading duties as insiders, and will be liable whenever they buy or sell company stock without disclosing their internal debates, predictions, and interim operating data. That position "mean[s] that once the annual cycle of estimation begins, a firm must cease selling stock until it has resolved internal disputes" and is "equivalent to a bar on the use of projections if the firm wants to raise new capital." *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 516 (7th Cir. 1989).[2]

3. The government's effort to deny the circuit split is unpersuasive. It argues that the "extreme departure" standard from *Shaw v. Digital Equipment Corp.*, 82 F.3d 1194 (1st Cir. 1996), was describing the plaintiff's allegations, not the court's holding. The First Circuit disagrees. *Glassman v. Computervision Corp.*, 90 F.3d 617 (1st Cir. 1996), dismissed a complaint because "the undisclosed hard information pled did not indicate a 'substantial likelihood that the quarter would turn out to be an extreme departure from publicly known trends and uncertainties.' *Thus, the alleged nondisclosures [did not] f[a]ll within the ambit of ... Shaw.*" *Id.* at 631 (quoting *Shaw*, 82 F.3d at 1211).

The government suggests *Glassman* was not a materiality holding but "interpret[s] ... the applicable regulatory duties of disclosure." Opp.20. Realistically there is no space between disclosures required by SEC regulations and insider-trading law when the company is selling stock. Regardless, the government does not deny that insider-trading law applies to companies.

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[2] The government's suggestion that the "reasonable-basis" regulations will save companies from that catch-22 (Opp.19) is baffling, since it contends (Opp.17 n.6) that those rules do not apply in trading cases. 10b5-1 plans are no panacea for executives, particularly because under the government's theory they will never be able to initiate such plans.

Pet.21-23. The First Circuit does not recognize any distinction. *Shaw* "conceptualiz[ed]" the company "as an individual insider transacting in the company's securities" and explained that whether "[p]resent, known information that strongly implies an important future outcome ... must be disclosed (assuming the existence of a duty) poses a classic materiality issue." 82 F.3d at 1203, 1210.

Subsequent First Circuit decisions are consistent. In *SEC v. Happ*, Happ dumped stock after receiving an "unusual" voice-mail from the CEO, *two days* before the end of the quarter. 392 F.3d 12, 22 (1st Cir. 2004). In *ACA Financial Guaranty Corp. v. Advest, Inc.*, the defendant released a statement that it was reducing its financial aid budget when the truth was opposite. 512 F.3d 46, 64 (1st Cir. 2008).

The opposition asserts that *Walker v. Action Industries, Inc.*, 802 F.2d 703 (4th Cir. 1986), is outdated but does not explain. *Walker* was decided *after* the SEC's policy shift toward encouraging disclosure of projections. *Id.* at 707. The suggestion that *Krim v. BancTexas Group, Inc.*, 989 F.2d 1435, 1449 (5th Cir. 1993), concerned scienter not materiality is misdirection. There, as here, the defendant's degree of certainty about future events influenced both issues.[3]

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[3] In *United States v. Anderson*, 533 F.3d 623 (8th Cir.), *cert. denied*, 129 S. Ct. 518 (2008), Anderson dumped his stock before announcing a major shortfall in the quarter-in-progress. In *United States v. Smith*, 155 F.3d 1051 (9th Cir. 1998), *cert. denied*, 525 U.S. 1071 (1999) Smith argued only for a *per se* rule that forward-looking information can *never* be material. In *Rothberg v. Rosenbloom*, 771 F.2d 818, 820-21 (3d Cir. 1985), the material

The government just ignores the petition's explanation (Pet.19, 22-23) of why *Wielgos* is relevant and Nacchio's proposed "reasonable basis" instruction was appropriate. In the Seventh Circuit internal projections are categorically immaterial, except where a projection has been released and "the internal estimates are so certain that they reveal the published figures as materially misleading." *Wielgos*, 892 F.2d at 515-16. Contrary to the Opposition (17 n.6), that rule is not inconsistent with the petition. In the First Circuit, like the Seventh, "soft" internal predictions are always immaterial. *Shaw*, 82 F.3d at 1211 n.21. The *Shaw* standard relied on in the petition governs when *hard* current information can be material *because of what it portends for the future*. The limited "hard" information here makes this case a *better* vehicle for review. Opp.23-24.

Nacchio clearly would be acquitted in the First Circuit. *Glassman* dismissed the claim when the company knew five weeks before quarter-end that sales were only 24% of projections, and the stock fell 30% when the information was released. 90 F.3d at 630, 621. In April Qwest was ahead of budget, Nacchio was aware of only some "risk" that it would fall short at year end *eight months later*, and when the information was later disclosed Qwest's stock *went up*. The government's suggestion that Nacchio knew a year-end miss was "highly likely, if not certain" just contends that Nacchio should have believed Casey in April rather than the rest of his management team. (And the jury was never told it needed to make such a finding.)

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information was not "a guess or prediction" but rather "hard information about orders [already] on the books."

The government emphasizes Nacchio's comment, in a January 2001 motivational speech to Qwest salespersons, that the market would punish Qwest for missing its projections even by a miniscule amount. Opp.2. Surely the government cannot evade the settled law governing the materiality of small risks and send an innocent man to prison because he once exaggerated for effect in a purely internal pep talk.

4. The Tenth Circuit acknowledged that the instructions were "not particularly informative" (indeed, the jury asked for "precise" materiality guidance on the fourth day of deliberations, Trial Tr. 3216 (D. Colo. Docket No. 484, Apr. 17, 2007) but found no error because they did not "misstate the law" and Nacchio's proposal was flawed. Pet.26-28. Those are insufficient reasons for affirming instructions that give inadequate guidance, as other circuits hold and the government essentially concedes. (Its proposed Questions Presented wrongly omit this issue.)

The government notes that Nacchio objected to its proposed probability/magnitude instruction. Opp.10. But Nacchio proffered instructions applying a more detailed standard based on Seventh Circuit law, and his position (consistent with the question reserved in *Basic*, 485 U.S. at 232 n.9) was that probability/magnitude alone did not provide *enough* guidance. Fed. R. Crim. P. 30(d); *Arthur Andersen LLP v. United States*, 544 U.S. 696, 707 n.10 (2005).

5. The government mischaracterizes the *Daubert* dispute as "concern[ing] the principal facts, not the governing law," Opp.26-27, and wrongly asserts that the dissent "agreed with the basic legal principles announced in the majority decision," Opp.14. The

dissenters did believe that the majority egregiously mischaracterized the record, but considered the majority's "unprecedented [legal] holding that will apply in all future cases, until ... the Supreme Court intercedes" "[f]ar more troubling." App.74a.

The *en banc* decision rests on the fundamental *legal* premise that a motion to exclude that merely argues the necessary foundation has not been laid puts the proponent on notice that he must establish the evidentiary foundation for admissibility in response to the motion, or face exclusion. To the contrary, the *movant* bears at least a *prima facie* burden to demonstrate that the necessary foundation cannot be laid. The majority's holding is inconsistent with *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999), and decisions of other circuits—which have recognized that a court *cannot* exercise its *Daubert* gatekeeping without developing a sufficient record. Pet.28-31. These are important and recurring issues confronting district courts. NACDL/NYCDL Br.4. The newly assigned district judge recently denied continued bail but acknowledged that these are "unsettled" issues that "have given rise to much confusion." *United States v. Nacchio*, No. 05-cr-00545-MSK, 2009 WL 961483, at *12 (D. Colo. Apr. 7, 2009).

The government wrongly pretends the majority held that Judge Nottingham independently put Nacchio on notice of an intent to resolve the *Daubert* issues by competing written submissions. When discussing the source of Nacchio's supposed "notice" that *Daubert* was "at issue," the majority forthrightly asserted that "[t]he only notice to which Mr. Nacchio was entitled was notice of the fact that the admissibility of his expert witness's testimony had been challenged by a government motion which asked the district court to exclude the testimony." App.22a n.11. It forcefully rejected the dissent's "suggest[ion] that the district court had some [further] obligation to provide specific notice to Mr. Nacchio concerning '*when* and *how* the *Daubert* issue was to be addressed.'" App.21a n.10 (citation omitted). The only "notice" Nacchio got was the government's motion, and the judge's directive to bring his Rule 16 notice into compliance *with that Rule.*

The government disingenuously characterizes its Rule 16 motion as a *Daubert* motion, but it never argued that Fischel's methodology was unreliable. How could it, without knowing what Fischel's methodology was?[4] The government did argue that Fischel's testimony was not based on "specialized knowledge." Nacchio responded that a Rule 16 notice need not establish admissibility under *Daubert*, and to the Rule 702 arguments the government *actually made*, by demonstrating that Fischel's testimony was "specialized knowledge ... under Rule 702." App.333a. The opposition's suggestion that Nacchio's response invited the court to exercise its gatekeeper function on a totally inadequate record is wholly unfair. The government's motion acknowledged that if the court did not disqualify Fischel under Rule 16 it "would likely need to hold an evidentiary hearing." CAJA-420.

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[4] Judge Nottingham said "[t]he March 29, 2007[] disclosure [Nacchio's Rule 16 notice] contained no methodology," and "[a]ny suggestion that *the Government* was *in possession* of Fischel's ... methodology is simply disingenuous," App.269a. *See also* CAJA-3930 ("[I] just don't know what [Fischel's methodology] is."); App.269a (citing "*non-disclosure* of the methodology" as basis for exclusion).

Nacchio's failure to second that concession did not waive anything.[5]

6. Summary reversal is warranted.

a. Even if the district court was entitled to exclude Fischel on "independent and adequate" *Daubert* grounds, Opp.27-28, the procedure is *discretionary*, and Judge Nottingham's discretion was clearly influenced by errors of law. Pet.32-33. The *en banc* court egregiously ducked that issue.

b. The opposition's attempted rehabilitation of the majority's misreading of *Sprint/United Management Co. v. Mendelsohn*, 128 S. Ct. 1140 (2008), is unpersuasive. The majority invoked *Sprint* to presume the judge's decision "rested on *Daubert* grounds," Pet.14, notwithstanding Judge Nottingham's statement that *Daubert* was *not* "the main bas[i]s on which the Court rested its decision." App.350a.

c. The government cannot dispute that Nacchio argued "probability" and "magnitude" in his brief, and suggests only that "the panel specifically noted that it did 'not disregard [the probability] component of [the] materiality analysis.'" Opp.31 (quoting App.144a n.10) (first alteration in original). The government strategically omits the next sentence: "But in this case the parties have focused solely on the magnitude of the shortfall, should it occur." The court's holding demonstrates that it did not weigh probability in the balance, because it held that it was "a close question" whether Nacchio's information—concerning a *risk* of a

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[5] The opposition's reliance on the court's chambers rule is a red herring. The government did not rely on it in the district court and neither did Judge Nottingham.

4.2% shortfall nearly a year away—could be material by comparing it to the SEC's 5% guideline for the materiality of *known* errors in *already reported* financials.

d. The opposition's vague defense of Judge Nottingham and the *en banc* majority will not survive even cursory engagement with the record. Judge Nottingham *did not* exclude two government witnesses; he let them testify that the information was important to investors and then barred Fischel from rebutting. Pet.11. The judge's treatment of Nacchio led the panel to replace him for retrial, App.155a-56a; *see also* App.92a, for what appears to be only the second time ever in the Tenth Circuit.

The district court excluded Nacchio's entire substantive defense without warning because counsel had not submitted a civil expert report in a criminal case, refused to let counsel lay the foundation for testimony from the nation's leading expert *even though he was sitting in the witness chair*, and then triumphantly gave the jury four days off because "we're moving much faster than ever anticipated." App.269a-70a. Judge McConnell's conclusion that an egregious injustice was done here is correct, and summary reversal is warranted.

CONCLUSION

The petition should be granted.

Respectfully submitted,

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