No. 08-2114

IN THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

PET QUARTERS, INC., an Arkansas corporation; CLYDE A. JUSTER, an individual; MICHAEL PARNELL, an individual; WALTER D. O'HEARN, JR. an individual; and DEMETRI BETZIOS, an individual,

Plaintiffs-Appellants,

v.

DEPOSITORY TRUST AND CLEARING CORPORATION; DEPOSITIORY TRUST COMPANY; AND NATIONAL SECURITIES CLEARING CORPORATION,

Defendants-Appellees.

On Appeal from the United States District Court
for the Eastern District of Arkansas (Western Division)

BRIEF OF *AMICUS CURIAE* NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., IN SUPPORT OF APPELLANTS AND IN SUPPORT OF REVERSAL

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1, *Amicus Curiae* North American Securities Administrators Association, Inc. ("NASAA") states that it has no parent corporation and that no publicly held corporation owns 10% or more of NASAA's stock.

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IDENTITY AND INTEREST OF THE *AMICUS CURIAE*

The North American Securities Administrators Association, Inc. ("NASAA"), is the non-profit association of state, provincial, and territorial securities regulators in the United States, Canada, and Mexico. It has 67 members, including the securities regulators in all 50 states and the District of Columbia. Formed in 1919, it is the oldest international organization devoted to protecting investors from fraud and abuse in connection with the offer and sale of securities.[1]

The members of NASAA include the state agencies responsible for regulating the securities markets under state law—a body of law that first emerged nearly 150 years ago. Their fundamental mission is two-fold: protecting investors from fraud and abuse, and protecting the integrity of the marketplace so that capital formation is fair and efficient. The principal activities of state securities regulators include registering certain types of securities, licensing securities firms and agents, and filing enforcement actions against those who have committed fraud against the investing public.

NASAA supports all of these regulatory functions. In addition, NASAA represents the membership's position, as *amicus curiae*, in significant cases involving financial services regulation. In its briefs, NASAA addresses legal issues arising not only in governmental enforcement actions but also in private

[1] All parties have consented to NASAA's filing an *amicus curiae* brief in this case.

actions in which wronged investors seek relief under the securities statutes or the common law. *See* NASAA *Amicus Curiae* Briefs, *available at* http://www.nasaa.org/issues___answers/enforcement___legal_activity/968.cfm.

NASAA and its members have a stake in the outcome of this case for three reasons. Of paramount importance is protecting the right of these appellants (hereinafter, “Investors”) and similarly-situated companies and individuals to seek redress under state law for any fraud or similar abuses they may have suffered at the hands of the nation’s clearing agencies. The Investors are alleging that they have been harmed as a direct consequence of the Appellees’ (hereinafter, “Clearing Agencies”) misrepresentations and market manipulations. Those claims are rooted in longstanding state-law prohibitions against fraud in the securities markets, and they deserve a fair hearing. In a rapidly changing marketplace where financial fraud is increasingly novel and sophisticated, plaintiffs who have suffered injury must be able to rely on these historic remedies to reach those who are responsible for their losses.

The Clearing Agencies’ defenses—cast in terms of preemption but amounting to a de facto claim of immunity—should not be permitted to overcome the Investors’ right to present their case. The Clearing Agencies contend in effect that their role in the clearing and settlement process is too important, that the national market system is too fragile, and that the disruption threatened by the

fraud claims at issue is too great to permit this case to go forward. These alarming scenarios are unfounded. The Investors are invoking traditional and uniform state causes of action that provide remedies for fraud and similar misconduct. They do not seek through this lawsuit to replace or restructure the nation's clearing agencies or any legitimate mechanisms that Congress and the SEC have established for clearing and settling securities transactions. Their claims, which must be taken as true on a motion to dismiss, are aimed at unlawful misrepresentations *about* the operation of those mechanisms, and they should not be extinguished in the name of preemption.

Stifling private actions in this manner also eliminates a vital deterrent against wrongdoing more generally. *See Basic Inc. v. Levinson*, 485 U.S. 224, 230-32 (1988) (the private cause of action is an "essential tool for enforcement of the 1934 Act's requirements," including fraud claims). Dismissal of this case may very well allow unlawful conduct to persist, to the detriment of other emerging companies, investors, and the marketplace as a whole.

Finally, NASAA and its members have a more general interest in resisting the preemption of state laws that protect the public. State statutes governing securities transactions and other financial services all play a vital role in protecting consumers. Congress can and does set limits on the scope of those laws, but those limits should be sparingly applied, not only because Congress and the courts have

said so, but because investors and consumers usually suffer when they are denied access to state courts to seek redress for unlawful conduct. Limiting the scope of preemption in accordance with a fair interpretation of federal law and Congressional intent is vital, not only in this case, but for the sake of other consumers whose best, and perhaps only, recourse is in state court under state law. Thus, if the preemption arguments advanced by the Clearing Agencies are validated, then other plaintiffs with legitimate claims regarding other types of securities fraud may also be denied redress. Especially today, as financial frauds of all kind continue to proliferate, barriers to the courts should be removed, not fortified.

ARGUMENT

I. State Law Has Applied to the Securities Markets for Over a Century, and Congress Has Repeatedly and Expressly Preserved the Role of State Law, Both as to Securities Generally and as to the Clearing and Settlement of Securities Transactions.

In any field where state law has traditionally applied, a strong presumption against preemption arises. *See*, *e.g.*, *Medtronic, Inc. v. Lohr*, 518 U.S. 470, 485 (1996). Overcoming that presumption is possible only where a Congressional intention to preempt state law is “clear and manifest.” *See Bates v. Dow AgroSciences LLC*, 544 U.S. 431, 449 (2005). Under these principles, the Investors’ fraud claims cannot reasonably be deemed preempted. State law has traditionally played a major role—at times an exclusive one—in the regulation of

securities transactions. Even in the more narrow realm of clearing and settlement on national exchanges, state law plays a significant role. Accordingly, the presumption against preemption undoubtedly arises in this case.

The Appellees cannot overcome this presumption. Congress has very clearly preserved the application of state law in numerous savings clauses found throughout the federal securities acts. Many of those clauses were written expressly to preserve fraud claims under state law. It is therefore impossible to find any evidence—let alone "clear and manifest" signs—of a Congressional intent to preempt state law as to the Investors' fraud claims. Accordingly, a finding of preemption cannot be made in this case.

A. State Law Has Occupied a Central Role in All Facets of Securities Regulation for 150 Years.

States began adopting statutory provisions regulating securities transactions in the mid-19th century, long before the federal securities laws were conceived. *See generally* LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 31-32 (3d ed. 1989). Among the earliest state securities laws was a Missouri statute passed in 1907 that regulated the operation of exchanges by outlawing "the keeping of places for dealing in stocks" unless trades were properly documented. *Id.* at 32. Kansas passed the first comprehensive securities law in 1911, *id.* at 34, and by 1929 and the Great Depression, "virtually all the states had some sort of securities act," 12 JOSEPH C. LONG, BLUE SKY LAW § 1.1 (2005).

In the modern era, state securities laws have been refined and unified in a series of model statutes—the Uniform Securities Acts of 1956, 1985, and 2002—and most states have adopted a version of those uniform laws. *See* UNIF. SEC. ACT § 101, U.L.A. 1 (1956) (table of adopting states); UNIF. SEC. ACT § 101, U.L.A. 1 (1985) (table of adopting states); UNIF. SEC. ACT § 101, U.L.A. 1 (2002) (table of adopting states). All three acts share fundamental similarities, in part because the drafters modeled their core provisions on corresponding language in the federal securities laws to promote uniformity and state-federal coordination. For example, the uniform act provisions imposing civil liability and prohibiting fraud reflect this approach. *See* SECURITIES REGULATION, *supra*, at 4134 (Section 410(a) of the 1956 uniform act, which imposes civil liability, tracks Section 12 of the Securities Act of 1933 ("1933 Act"); *id.* at 70 (Section 101 of the 1956 uniform act, which prohibits fraud, tracks Section 17(a) of the 1933 Act and Rule 10b-5 promulgated under the Securities Exchange Act of 1934 ("1934 Act")).

The end result of this evolution is a dual system of securities regulation in which state law continues to play a central role, alongside federal law, not only in the enforcement arena but also with respect to regulation. For example, the states now regulate broker-dealers and their agents in areas ranging from licensing and books and records requirements to a wide array of misconduct including sales fraud, churning, manipulation, conversion, and failure to supervise. *See generally*,

e.g., UNIF. SEC. ACT (1956) and annotations thereto. State law also plays a major role in the regulation of investment advisers and investment adviser representatives. *See generally* UNIF. SEC. ACT, Art. 4 (2002) (provisions on investment advisers). Under the 1996 amendments to the Investment Advisers Act of 1940, state securities regulators bear sole responsibility under state law for the licensing and regulation of all investment advisers with up to $25 million in assets under management, while the SEC regulates the larger investment advisers. *See* 15 U.S.C. § 80b-3a; 17 C.F.R. § 275.203A-1. Even so, Congress expressly preserved the application of state antifraud laws even to those larger, federally licensed investment advisers. *See* 15 U.S.C. § 80b-3a(b)(2). And state regulators are responsible for licensing and overseeing *all* of the individual representatives of investment advisers, regardless of the amount of money their firms have under management. *See* Unif. Sec. Act § 404(a) (2002) (requiring investment adviser representatives to be registered in the states in which they do business).[2]

The states, with the support of NASAA, also play a critical regulatory role in the testing and licensing of firms and individuals in the retail securities industry. Through a contractual relationship, NASAA and The National Association of Securities Dealers ("NASD") jointly operate the Central Registration Depository ("CRD"), a computerized database used to collect and house licensing information

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[2] Arkansas, of course, has its own comprehensive securities law, based on the Uniform Securities Act of 1956. *See generally* ARK. CODE ANN. § 23-42-101 *et seq.*

on broker-dealer firms and their agents. In addition, NASAA has contracted with the NASD as a vendor for the operation of the Investment Adviser Registration Depository ("IARD"), a system similar to the CRD. Industry participants obtain their licenses through the CRD and IARD systems. Information in these systems concerning testing results, disciplinary histories, and licensing status is available to the public via the web or from state securities regulators.

State law is also a powerful weapon used by regulators and private plaintiffs against all types of business entities and individuals who commit fraud, manipulation, and related abuses in connection with securities transactions. *See*, *e.g.*, UNIF. SEC. ACT §§ 101, 410 (1956) (anti-fraud and civil liability provisions). These egalitarian provisions apply regardless of licensing status, and they may be brought to bear with equal force against the unscrupulous boiler room operator, the large Wall Street brokerage firm, or any number of other market participants—including clearing agencies—who have deceived or exploited the investing public to advance their own economic interests. *See*, *e.g.*, *Goldstein v. DTC*, 717 A.2d 1063, 1064 (Pa. Super. Ct. 1998) (suit under state law for breach of fiduciary duty arising from depository's failure to segregate and account for interest owed on funds paid for IPO shares), *appeal denied*, 736 A.2d 605 (Pa. 1999).

State securities regulators bring an enormous number of enforcement actions each year under their securities codes, seeking remedies that include restitution,

injunctions, administrative orders, fines, licensing sanctions, and criminal penalties. *See* NASAA Enforcement Statistics, *available at* http://www.nasaa.org/issues___answers/enforcement___legal_activity/1002.cfm. Private plaintiffs also routinely invoke state securities statutes and state common law to obtain damages for misconduct in connection with securities transactions. For years, Congress and the courts have recognized the important role that private actions play not only as means of personal redress but also as an important complement to the enforcement efforts of governmental authorities. The Senate Report accompanying the Private Securities Litigation Reform Act of 1995 ("PSLRA") described the importance of private rights of action as follows:

> The SEC enforcement program and the availability of private rights of action together provide a means for defrauded investors to recover damages and a powerful deterrent against violations of the securities laws. As noted by SEC Chairman Levitt, "private rights of action are not only fundamental to the success of our securities markets, they are an essential complement to the SEC's own enforcement program." [citation omitted]

See S. REP. NO. 104-98, at 8 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 687; *see also Levinson*, 485 U.S. at 230-32 (private cause of action is an "essential tool for enforcement of the 1934 Act's requirements").

The foregoing summary demonstrates that state law traditionally has played, and continues to play, a vital role in regulating the securities markets in the United States.

B. Congress Has Expressly and Repeatedly Preserved State Law in the Area of Securities Regulation.

Congress has made clear in numerous savings clauses that state law continues to apply to securities transactions, notwithstanding the advent of federal regulation. The federal securities Acts of 1933 and 1934 each contain broad savings clauses that preserve state regulatory and state common law remedies in the securities field. Section 16 of the 1933 Act provides that "the rights and remedies provided by this subchapter shall be in addition to any and all other rights and remedies that may exist at law or in equity." 15 U.S.C. § 77p(a). Section 28 of the 1934 Act contains an identical provision, as well as a separate clause that expressly preserves the authority of state regulatory authorities: "[N]othing in this chapter shall affect the jurisdiction of the securities commission . . . of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder." 15 U.S.C. § 78bb(a). These savings provisions apply to state common law as well as statutory law, and they also preserve state laws that were enacted subsequent to 1933 and 1934. *See Rousseff v. Dean Witter & Co.*, 453 F. Supp. 774 (N.D. Ind. 1978).

These savings clauses are aptly cited for the proposition that *field preemption* cannot be found in the context of securities regulation. *See id.* at 780 (two savings clauses are "a clear and unequivocal congressional expression not to preempt state securities laws"); *see also Raul v. Am. Stock Exch., Inc.*, Nos. 95 Civ.

3154 (SAS) & 95 Civ. 8361 (SAS), 1996 WL 381781, at *5 (S.D.N.Y. May 2, 1996) (1934 Act savings clause "has consistently been interpreted by courts as a protection of state authority in the field of securities regulation, not as a limitation on that power"); 69A AM JUR. 2D SECURITIES REGULATION – FEDERAL § 1070 (two savings clauses "make it absolutely clear that Congress was not preempting the field"). By the same token, they signify a clear and manifest Congressional intent to preserve rather than preempt state laws, especially as to fraud claims.

It is true that Congress has occasionally enacted provisions expressly limiting the application of state securities law in discrete areas. However, none of those limitations effected a general repeal of the savings clauses discussed above. For example, during most of the 20th century, the states exercised the authority to register and regulate all securities offerings, whether the securities were nationally traded or strictly local in character. *See* 12 BLUE SKY LAW, *supra*, § 5.1 (states exercised plenary parallel authority with federal regulators after the 1933 and 1934 Acts). In the National Securities Markets Improvement Act of 1996 ("NSMIA"), Congress preempted the regulatory authority of state regulators to register nationally traded securities, to reduce what were seen as duplicative registration requirements. *See* 15 U.S.C. § 77r. Even as to federally registered securities, the states are entitled to receive notice filings, collect fees, and issue stop orders in the

event of non-compliance with these filing and fee requirements. *See* UNIF. SEC. ACT § 302 (2002).

In NSMIA, however, Congress did not otherwise disturb the general savings clauses from the 1930s, nor did it limit state common law fraud claims. *See*, *e.g.*, *Zuri-Invest AG v. Natwest Fin., Inc.*, 177 F. Supp. 2d 189, 193-95 (S.D.N.Y. 2001) (by virtue of savings clause, the NSMIA did not preempt state common law claims for fraud and conspiracy). Moreover, Congress clarified the scope of its preemption by expressly preserving the authority of state securities regulators to "bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer," in connection with all types of securities, including those traded on the national exchanges. *See* 15 U.S.C. § 77r(c)(1).

Similarly, in 1998, Congress passed the Securities Litigation Uniform Standards Act to restrict certain class actions under state law. *See* 15 U.S.C. § 77p(b) (preempting certain class actions alleging fraud under state law). But, as with NSMIA, Congress expressly preserved state jurisdiction both generally and with respect to specific types of class actions under state law. *See*, *e.g.*, 15 U.S.C. § 77p(a) (reiterating 1933 Act savings clause preserving state common law "except as provided" in the amendments); 15 U.S.C. § 77p(d)(1) (preserving certain class actions for fraud under law of state where issuer was incorporated). Thus, with

limited exceptions, Congress has left the field of securities regulation open to state statutory and state common law.

C. Congressional Intent to Preserve State Law Is Equally Apparent in the Specific Area of Clearing and Settlement.

A similar analysis based upon the history of state regulation and Congressional enactments shows that state law traditionally has played, and continues to play, a major role in the specific area of clearance and settlement of securities transactions.

Prior to the Securities Acts Amendments of 1975 ("1975 Amendments"), the clearing and settlement of securities transactions on the nation's exchanges was unquestionably regulated as a matter of state law. *See* SECURITIES REGULATION, *supra*, at 2897; *see also People v. Ruskay*, 152 N.E. 464 (N.Y. 1926) (under New York law and exchange's clearing and settlement procedures, broker's criminal conviction for cross-trading with customer could not be sustained). During that era, state common law and state statutes modeled after the Uniform Commercial Code ("UCC") defined the property rights and liabilities of parties to securities transactions.

Notwithstanding the increased prominence of federal law in the area of clearing and settlement as of 1975, the UCC, which has been adopted by virtually

every state, has continued to occupy this central role.[3] Part 5 of Article 8 of the UCC is headed "Security Entitlements," and it sets forth an extensive body of legal principles governing the transfer of securities. As stated in the commentary, "Article 8 deals with the settlement phase of securities transactions. It deals with the mechanisms by which interests in securities are transferred, and the rights and duties of those who are involved in the transfer process." *See* Prefatory Note to UCC, at 11. The topics include the acquisition of security entitlements from securities intermediaries, UCC § 8-501 (1994); the property interests of entitlement holders in financial interests held by intermediaries, UCC § 8-503 (1994); the duties of intermediaries with respect to payments and distributions, UCC § 8-505 (1994); and the priorities among security interests and entitlement holders, UCC § 8-511 (1994).

Revisions to the UCC over the years confirm the ongoing relevance of state law to the regulation of clearance and settlement in securities transactions. For example, the drafters made significant changes to the UCC in 1994, to ensure that state law kept pace with changes in the way securities were being owned and transferred. "[T]he prior version of Article 8 did not adequately deal with the system of securities holding through securities intermediaries that has developed in the past few decades." *See* Prefatory Note to UCC, at 3. Far from being outmoded

[3] Arkansas is among the many states that have adopted the UCC, including UCC Chapter 8 on investment securities. *See generally* ARK. CODE ANN. § 4-1-101 *et seq.*

or displaced, state law has kept pace with the modernization of the nation's clearing and settlement system.

Numerous cases illustrate the point that the UCC and other state laws govern disputes between exchanges and market participants over securities transfers. *See*, *e.g.*, *Delaware v. New York*, 507 U.S. 490, 504-05 (1993) (UCC and additional state law governed determination that depositories and other intermediaries holding securities were the "debtors" for purposes of interstate escheat claims); *Lucas v. Lucas*, 946 F.2d 1318, 1323-24 (8th Cir. 1991) (court applied state law to determine that stocks transferred by book entry at DTC rather than by paper certificate could be the subject of conversion); *Olde Monmouth Stock Transfer Co. v. Depository Trust & Clearing Corp.,* 485 F. Supp. 2d 387, 397-98 (S.D.N.Y. 2007) (action for tortuous interference under state law allowed to proceed against DTCC and DTC); *Dean Witter Reynolds, Inc. v. Selectronics, Inc.*, 594 N.Y.S.2d 174, 176-77 (N.Y. App. Div. 1993) (UCC § 8-204 applied so that broker had cause of action against clearing house, transfer agent, and others for their failure to note transfer restrictions on face of stock; federal private offering regulations dealing with transfer restrictions did not preempt state claim); *see also Carapico v. Philadelphia Stock Exch., Inc.*, 791 A.2d 787, 790-93 (Del. Ch. 2000) (request by member of exchange to examine books and records in relation to charges of mismanagement held proper under Delaware law).

The UCC and other state laws governing clearance and settlement on the nation's exchanges have been the subject of numerous savings clauses in the federal securities statutes. In the provisions specifically dealing with the establishment of the national clearing and settlement system, Congress actually instituted reverse preemption in favor of the states. It granted the states plenary authority to adopt laws that differ from the provisions of any SEC rule relating to the transfer of securities, provided that the states act within two years after the SEC adopts its rule. *See* 15 U.S.C. § 78q-1(f)(3). Congress further provided that even when states have not invoked their authority to override federal law, the SEC's rules and regulations take precedence over state law only if the SEC can make certain findings regarding the need for the rule and its impact on the rights of shareholders and other persons under state law. *See* 15 U.S.C. § 78q-1(f)(1), (2).

Finally, Congress added yet another savings clause preserving the authority of state regulators to enforce rules governing clearing agencies and transfer agents, provided those rules are not inconsistent with the 1975 Amendments. *See* 15 U.S.C. § 78q-1(d)(4); *see also Raul*, 1996 WL 381781, at *7 (although the 1975 Amendments expanded SEC's oversight of the SROs, they do not reveal a Congressional intent to "preclude previously established causes of action;" state law claim for exchange's failure to enforce own rules was not preempted). In light of these Congressional enactments that expressly preserve state law with respect to

clearing agencies and their activities, the Appellees cannot overcome the presumption against preemption.

II. The Investors'Claims Are Not Barred Under the Doctrine of Conflict Preemption, Because Actions for Fraud and Related Misconduct Under State Law Do Not Interfere with the Federal Regulation of Clearing and Settlement and They Advance Important Goals of Federal Law.

The lower court predicated its ruling on a finding of conflict preemption. Conflict preemption can occur in two forms: where it is "impossible for a private party to comply with both state and federal requirements, . . . or where state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *See Zuri-Invest*, 177 F. Supp. 2d at 195 (internal quotations and cited authorities omitted). The lower court's ruling should be reversed because the investors' state law claims do not conflict either with the obligations that federal law imposes upon the Clearing Agencies or with the policies and objectives that Congress intended to achieve through federal law.

A. It Is Not Impossible for the Clearing Agencies to Comply Simultaneously with the State Laws Underlying the Complaint and with Federal Laws and Regulations.

In this case, it is not impossible for the Clearing Agencies to comply with federal law and at the same time refrain from engaging in the fraudulent misconduct alleged in the Investors' Complaint.

In principle, of course, state laws prohibiting fraud are thoroughly compatible with federal law, insofar as state and federal securities laws parallel each other so closely and reflect a shared commitment to the eradication of securities fraud.

This general principle holds true in this case. While the stock borrow program ("SBP") may be inherently flawed, that is not the essence of the Investors' Complaint. They allege that the Clearing Agencies have engaged in a pattern of deceiving the public about the SBP and fostering its use as an instrument of market manipulation. For example, the alleged misrepresentations and omissions include false statements about the nature of the "loans" of stock made to satisfy delivery obligations through the SBP (first and fifth claims); false statements about the efficacy of the program as a prompt and accurate settlement mechanism (second and sixth claims); and false statements about the true number of shares that result from the so-called lending process (third and seventh claims).

Assuming the Complaint's allegations of fraud are true, it is difficult to see how Congress, the SEC, or any SRO could have shielded such misconduct from the application of state law. No federal law, SEC regulation, or SRO rule requires or authorizes the Clearing Agencies or anyone else to commit fraud. And nothing in those laws and rules prevents the Clearing Agencies from describing the SBP truthfully and accurately in their communications with the public.

In fact, the state law standards of conduct being applied in this lawsuit easily coexist with the federal standards of conduct that govern clearing agencies. The federal requirements applicable to clearing agencies are set forth in a variety of sources, including Section 17A of the 1934 Act, 15 U.S.C. § 78q-1; the SEC's release approving the registrations of the NSCC and the DTC, 48 Fed. Reg. 45,167 (Sept. 23, 1983); and the guidelines adopted by the SEC for registering clearing agencies, 45 Fed. Reg. 41,920 (June 23, 1980). Although the requirements generally concern operational capabilities and internal governance, some provisions relate, directly or indirectly, to standards of honesty and ethics. For example, Section 17A of the statute provides that clearing agency rules must be designed in part to "protect investors and the public interest." *See* 15 U.S.C. § 78q-1(b)(3)(F). In addition, the statute requires that clearing agencies be capable of complying with "the provisions of this chapter," a reference that encompasses the antifraud provisions of the 1934 Act. *See* 15 U.S.C. § 78q-1(b)(3)(A); *see also* 48 Fed. Reg. at 45,179 (with respect to safeguarding participant funds and securities, there will be no "unique federal standard of care for registered clearing agencies"); Standards for the Registration of Clearing Agencies, 45 Fed. Reg. at 41,930 (state standards of care apply to bailees for hire, such as clearing agencies).

Insofar as these provisions collectively require clearing agencies to protect investors, observe the federal prohibitions against fraud, and conform to state law

standards of care, they are compatible with the provisions of Arkansas law underlying the Complaint. There is no clash between the Investors' state law claims and federal law.

A number of cases highlight the distinction between prohibitions on misconduct that are compatible under state and federal law, and regulatory obligations that cannot be reconciled for purposes of a conflicts analysis. For example, in *Raul v. American Stock Exch., Inc.*, the court allowed claims for common law fraud and breach of fiduciary duty to proceed against an exchange. *See* 1996 WL 381781, at *6. It held that conflict preemption did not apply because the exchange was subject to essentially the same obligations under its own rules and under state law. *Id.*

In *Raul*, the court differentiated other cases in which the relief sought pursuant to state law was in direct conflict with the SEC's directives. *Id.* Those cases are typically ones in which the plaintiffs seek remedies under state law for practices that are expressly and specifically *permitted* under SEC regulations. *See*, *e.g.*, *Guice v. Charles Schwab & Co.*, 674 N.E.2d 282, 289 (N.Y. 1996) (state law challenge to order flow payments held preempted because SEC had promulgated detailed regulations addressing precise timing, form, and degree of disclosure required as to order flow payments).

This case is very different from *Guice*: there is no SEC regulation that creates an informational "safe harbor" for the Clearing Agencies; there can be no suggestion that the imposition of state antifraud provisions will imperil the existence of the nation's clearing and settlement system; and there is no conceivable Congressional policy that could justify allowing the Clearing Agencies to commit fraud and market manipulation unimpeded. Accordingly, even under *Guice* and similar cases, no conflict preemption arises. *Cf. In re NYSE Specialists Sec. Litig.*, 405 F. Supp. 2d 281, 298, 304-05 (S.D.N.Y. 2005) (finding that misrepresentations by exchange would not qualify as legitimate quasi-governmental activities and therefore would not fall within the ambit of the exchange's immunity), *aff'd in part, vacated in part and remanded*, 503 F.3d 89 (2d Cir. 2007), *cert. denied*, 128 S. Ct. 1707 (2008).

The SEC has taken strong issue with some of the Investors' allegations, but these challenges should not be confused with "conflicts" for preemption purposes. For example, the SEC has vehemently denied that the SBP creates "artificial securities." *See* Brief of the SEC, *Amicus Curiae,* on the Issue Addressed, in *Nanopierce Techs., Inc. v. DTCC*, 168 P.3d 73 (Nev. 2007), *cert. denied*, 128 S. Ct. 2428 (2008). Rather than supporting dismissal of the case, however, the SEC's point favors the Investors' contentions in two respects. First, it implicitly concedes the materiality of a factual issue at the heart of the Investors' claims—a factual

issue more appropriately addressed in discovery and at trial. Second, it obfuscates the distinction between issued and outstanding shares on the one hand, and artificial or phantom shares on the other. The SEC argues that the number of securities issued and outstanding is determined solely by the issuer, not by the SBP. *Id.* at 14. While perhaps true, this observation is beside the point. It does nothing to negate the fact that the operation of the SBP unquestionably creates phantom shares—shares that carry certain entitlements and cause dilution and price suppression. The SEC concedes as much in its footnote: "the aggregate number of positions reflected in customer accounts at broker-dealers may in fact be greater than the number of securities issued and outstanding." *Id.* at 16 n. 6. Such factual disputes warrant a trial on the merits, not dismissal on preemption grounds.

It is also true that the Nevada Supreme Court has recently held very similar fraud claims against the Clearing Agencies to be preempted on conflict grounds.[4] *See Nanopierce Techs., Inc. v. DTCC*, 168 P. 3d 73 (Nev. 2007), *cert. denied*, 128 S. Ct. 2428 (2008). But the majority opinion in *Nanopierce* reflects a basic confusion about the relationship between the actual provisions of the SBP and the Investors' fraud allegations. The Court asserted that the appellants' fraud claims

[4] Two other federal district courts have rejected similar claims against the Clearing Agencies. *See Capece v. DTCC*, No. 05-80498, 2005 WL 4050118 (S.D. Fla. Oct. 11, 2005) (focusing on field preemption, which the court below correctly rejected); *Whistler Invs., Inc. v. DTCC*, No. CV-S-05-0634, 2006 U.S. Dist. LEXIS 97548 (D. Nev. May 24, 2006) (summarily adopting *Capece* without extensive analysis), *appeal pending*, No. 06-16088 (9th Cir. argued Mar. 10, 2008).

were "in essence" challenging the very language of the rules governing the program. *Id.* at 83. As argued by the dissenting justices in *Nanopierce*, however, the majority's view was a "mischaracterization" of the plaintiffs' fraud claims. *Id.* at 86. In *Nanopierce,* as in this case, the allegations of the plaintiffs were not a direct challenge to any language in any approved rule, but rather a straightforward contention that the Clearing Agencies had made misrepresentations about the manner in which they actually operated the program. *Id.*

B. Allowing the Investors' Claims to Proceed Will Not Interfere with the Attainment of Congressional Objectives, and Will Actually Advance the Goals of Federal Securities Law.

Allowing this case or similar actions to be brought against the Clearing Agencies will not "create an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." On the contrary, this case actually advances some of the most fundamental policies underlying the federal securities laws—transparency and investor protection.

Congress had essentially three objectives in mind when it passed Section 17A: (1) to establish a national system, (2) for the prompt and accurate clearance and settlement of securities transactions, (3) that would be fair to investors. *See* 15 U.S.C. § 78q-1(a). The Investors' lawsuit does not interfere with the attainment of any of these goals.

First, it does not imperil the national nature of the current market system. As the Clearing Agencies have emphasized in previous cases, they are by far the most dominant clearing agencies in the country and they process the overwhelming majority of securities trades executed on our nation's exchanges. If the Investors prevail, this configuration will not change. The result will be that the Investors are made whole for any damages they can prove. If the lawsuit also reveals unacceptable flaws in the SBP and in the manner in which the Clearing Agencies have operated it, then it will be up to the federal authorities to institute any regulatory fix they deem appropriate. *Cf. Capital Research & Mgmt. Co. v. Brown,* 53 Cal. Rptr. 3d 770, 776 (Cal. Ct. App. 2007) (possible impact of fraud action on behavior of mutual fund does not limit application of NSMIA savings clause). None of these outcomes will make the system any less national or centralized.

The Investors' lawsuit also will not make the clearing and settlement system any less prompt or accurate. It will either have no effect whatsoever, or it will lead to improvements on both counts. If the Investors' allegations are true, then it is the Clearing Agencies' manipulative operation of the SBP that is undermining prompt and accurate settlement. Settlements are not prompt to the extent the SBP enables short sellers to shirk their delivery obligations for long periods, and settlements are not accurate to the extent the Clearing Agencies use the SBP to manipulate share

prices through the proliferation of phantom shares. Any changes in the system that address those problems—assuming they exist and are revealed in the litigation—will only enhance prompt clearing and settlement.

Any notion that unless this lawsuit is dismissed, the uniform regulatory scheme governing clearance and settlement will be destroyed is groundless. The Investors are invoking traditional state law provisions prohibiting fraud, manipulation, and related misconduct. Those provisions are simply not disparate among the states. On the contrary, they share a high degree of uniformity throughout the country. *See Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 529 (1992) ("[s]tate-law prohibitions on false statements of material fact do not create 'diverse, nonuniform, and confusing' standards," but instead "rely only on a single, uniform standard: falsity") (plurality op.). Furthermore, experience to date does not justify such fears. Neither state regulators nor private litigants have shown an inclination to superimpose myriad, conflicting regulatory demands upon the nation's clearing and settlement system. At issue in this case is abuse: lying about the true nature of the system to facilitate and perpetuate manipulation.

Specifically with respect to the SEC's own rule-making efforts aimed at abusive short selling, the Investors' claims generate no policy conflicts. *See*, *e.g.*, Regulation SHO, 17 C.F.R. § 242.203(b) (requiring only "reasonable grounds" to believe that a security can be borrowed prior to short sale). As a threshold matter,

Regulation SHO and its various amendments were not in effect during the time period relevant to the Complaint. Nor could Regulation SHO somehow be construed as a substitute for a private cause of action for fraud. Whatever merit Regulation SHO may have as a proscriptive rule, it could not possibly remediate the Investors' injuries from past fraud. The case law supports this analysis. *See New York v. Grasso,* 350 F. Supp. 2d 498, 507 (S.D.N.Y. 2004) (SEC's future intention to address problems revealed in litigation through rulemaking had no bearing on the case, not only because the proposals had not yet taken effect, but also because the suit was predicated on fundamentally distinct state law claims).

More to the point, though, Regulation SHO does not address either the SBP itself or the Clearing Agencies' representations about the program. Simply put, Regulation SHO embodies no policies and contains no standards of conduct at variance with the requirements of full and fair disclosure that the Investors' seek to invoke. On the contrary, to the extent the rule is designed to address some aspects of abusive short selling, then it is, at least broadly speaking, in harmony with the Investors' claims.

The SEC's most recent regulatory actions further confirm that the Investors' misrepresentation claims promote, rather than undermine, the policies embodied in federal law. On July 15, 2008, the SEC issued an emergency order restricting the practice of naked short selling in 19 specific stocks, representing

some of the nation's largest financial institutions deemed especially vulnerable to manipulation under current market conditions. *See* Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58166 (July 15, 2008) (requiring that seller at least "arrange to borrow" security prior to sale).

This dramatic action highlights three points. First, it confirms that serious abuses are occurring in the area of short selling, to the detriment of companies and investors alike. To the extent that the Clearing Agencies are contributing to the problem through fraudulent conduct, they should be held to account.

Second, the release demonstrates that the SEC and the Investors share a common objective: a fair marketplace in which corporate merit, not dishonest and manipulative schemes, determine a company's fate and an investor's returns. In the words of SEC Chairman Cox, the SEC's "most basic role is to ensure a continued flow of liquidity to the markets from participants who are confident the game isn't rigged against them." Christopher Cox, Editorial, *What the SEC Really Did on Short Selling*, WALL ST. J., July 24, 2008, at A15. Chairman Cox also made clear that purging the market of fraud and manipulation is just as important for small and emerging companies as it is for large and well-established firms: "The scope of last week's [emergency] action is based on the Fed's designation of those financial institutions to which our government and the taxpayers will now

temporarily provide liquidity, but its rationale extends to *all* public companies." *Id.* (emphasis added). In terms of policy objectives, then, the Investors' goals coincide with those of Congress and its designated federal regulator.

Finally, in his release, Chairman Cox alludes to the some of the profound misperceptions that surround short selling: "Many people think naked short selling is already illegal, but that isn't true. Shares are normally delivered to the buyers within three business days of the trade. But in most stocks, . . . that three-day period can be extended indefinitely." *Id.* These comments quite clearly suggest that the public has been misled or deprived of basic information regarding the true nature of short selling and the mechanisms used to deal with it, such as the SBP. If the Investors in this case can show that they were indeed misled by the Clearing Agencies, and that they suffered damages as a result, then they deserve a remedy in court.

For all of these reasons, rather than undermining Congressional objectives, this lawsuit will advance them. The overriding purpose of the securities laws is protecting investors and maintaining their confidence in our markets. When Congress enacted PSLRA, it made this point clear by opening the Conference Report with the following declaration: "The overriding purpose of our nation's securities laws is to protect investors and to maintain confidence in our capital markets . . . ." H.R. CONF. REP. NO. 104-369, at 31 (1995), *reprinted in* 1995

U.S.C.C.A.N. 730, 731 (emphasis added). The core postulate of all securities regulation is that investors are best served through transparency: give them the truth, either through a prospectus or an antifraud provision, and they will protect themselves. *See*, *e.g.*, *Rousseff*, 453 F. Supp. at 781 (primary purpose of federal securities laws is protecting investing public by insuring it receives full disclosure of information necessary to effect informed securities transactions; longer state statute of limitations enhances that purpose and therefore does not conflict with federal law); 12 BLUE SKY LAW, *supra*, § 1.44 (main focus of 1933 Act is full disclosure).

By holding the Clearing Agencies to a standard of full and honest disclosure, the Investors' claims promote the goals of the securities laws. The company and the individual investors before the Court seek the truth about an important mechanism used in the clearing and settlement process, a mechanism they believe is being used unlawfully to devalue their investments. Their claims should be put to the test at trial, not extinguished on grounds of preemption.

CONCLUSION

For the reasons set forth above, the *Amicus Curiae* respectfully suggests that this Court should reverse the lower court's decision to dismiss the Complaint.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE
PURSUANT TO FED. R. APP. P. 32(a)(7)(C)
AND CIRCUIT RULE 28A(c) FOR CASE NUMBER 08-2114

In accordance with Federal Rule of Appellate Procedure 32(a)(7)(C) and Eighth Circuit Rule 28A(c), the undersigned hereby certifies that this brief complies with the applicable type-volume limitations. Exclusive of the portions exempted by Federal Rule of Appellate Procedure 32(a)(7)(B)(iii), this brief contains 6,894 words. This certificate was prepared in reliance on the word-count function of the word processing system used to prepare this brief (Microsoft Office Word 2003).

The undersigned further certifies, in accordance with Eighth Circuit Rule 28A(d)(2), that the electronic PDF version of this brief copied onto CD-ROM and provided to the Court has been scanned for viruses and is virus-free.

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Stephen W. Hall

CERTIFICATE OF SERVICE

In accordance with Federal Rule of Appellate Procedure 25(d)(2) and Eighth Circuit Rule 28A(a) and (d), the undersigned hereby certifies that this brief was timely filed under Federal Rule of Appellate Procedure 25(a)(2)(B) by sending the original and ten paper copies of the brief, as well as an electronic PDF version of the brief, by overnight mail to the Clerk's office on July 28, 2008.

The undersigned hereby further certifies that, on July 28, 2008, two paper copies and an electronic PDF version of the brief were served by overnight mail on counsel for Appellants and counsel for Appellees at the following addresses:

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