IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA
SECOND APPELLATE DISTRICT, DIVISION ONE

CAPITAL RESEARCH AND MANAGEMENT COMPANY, and
AMERICAN FUNDS DISTRIBUTORS, INC.,
Plaintiffs and Respondents,

v.

BILL LOCKYER, ATTORNEY GENERAL
OF THE STATE OF CALIFORNIA,
Defendant and Appellant.

PEOPLE OF THE STATE OF CALIFORNIA,
Plaintiff and Appellant,

v.

AMERICAN FUNDS DISTRIBUTORS, INC., a Corporation;
CAPITAL RESEARCH AND MANAGEMENT COMPANY, a
Corporation; and
DOES 1 THROUGH 100, inclusive,
Defendants and Respondents.

Civil Appeal No. B189249
Trial Court No. BC 330770, Consolidated With Trial Court No. BC 330774
Appeal from the Superior Court for Los Angeles County
The Honorable Carl J. West, Judge

BRIEF OF *AMICUS CURIAE* NORTH AMERICAN SECURITIES
ADMINISTRATORS ASSOCIATION, INC., IN SUPPORT OF THE
ATTORNEY GENERAL OF THE STATE OF CALIFORNIA

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TABLE OF CONTENTS

TABLE OF CONTENTS i

TABLE OF AUTHORITIES iii

IDENTITY AND INTEREST OF *AMICUS CURIAE* 1

ISSUES PRESENTED FOR REVIEW 21

ARGUMENT 22

I. NSMIA Expressly Preserves California's Authority To Bring This Enforcement Action 22

A. This Case Falls Under The Plain Language Of The Savings Clause 22

B. California's Right To Seek An Injunction Against The Use Of Fraudulent Offering Documents Also Was Preserved, Because NSMIA's Preemption Language Is Subject To A State's Right To Bring Enforcement Actions 23

C. The States Unquestionably Had The Right To Bring This Action Prior To NSMIA, So It Is Equally Proper Today, Because In NSMIA Congress Intended To Preserve The States' Traditional Antifraud Authority 26

D. The Case Law Applying NSMIA Supports California's Right To Pursue This Fraud Action 31

II. California's Enforcement Action Creates No Actual Conflict With Federal Law, Nor Does It Thwart The Accomplishment Of Congressional Objectives 34

A. California's Antifraud Provisions Do Not Impose Any Standards Of Conduct That Conflict With Federal Laws Or Regulations Governing Offering Documents 35

B. The Application Of State Antifraud Laws In Cases Such As This Advances The Cause Of Investor Protection Without Interfering With Any Congressional Objectives 35

CONCLUSION 43

CERTIFICATE OF COMPLIANCE WITH WORD LIMIT 45

CERTIFICATE OF SERVICE 46

TABLE OF AUTHORITIES

Cases

Coughlin v. State Bank of Portland, 243 P. 78 (Or. 1926) 30

Curtis v. State, 118 S.E. 2d 264 (Ga. Ct. App. 1960) 30

Danzig v. Superior Court of Alameda County, 87 Cal. App. 3d 604 (Cal. Ct. App. First Dist. 1978)... 29

Estate of Wood v. Commissioner of Internal Revenue, 909 F.2d 1155 (8th Cir. 1990) 30

Forsythe v. Sun Life Financial, Inc., 417 F. Supp. 2d 100 (D. Mass. 2006) 14

Galvin v. The Gillette Co., No. 051453BLS, 2005 WL 1155253 (Mass. Super. Ct. Apr. 28, 2005) 31, 32, 41

Hines v. Data Line Systems, Inc., 787 P.2d 8 (Wash. 1990)....................... 29

IDS Bond Fund v. Gleacher Natwest Inc., No. CIV. 99-116 (MJDJGL), 2002 WL 373455 (D. Minn. 2002) 28, 33

In the Matter of American Express Financial Advisers, No. INV04-122, Preliminary Statement (Feb. 17, 2005) 14

In the Matter of Morgan Stanley DW Inc., SEC Exchange Act Release No. 48789 (Nov. 17, 2003).. 11

In the Matter of Oppenheimerfunds, Inc. & Oppenheimerfunds Distrib., Inc., 2005 WL 2233552 (SEC Sept. 14, 2005)... 10

In the Matter of Yorkshire Ventures, Inc., SE8800451, 1988 WL 281997 (Minn. Dept. of Commerce, Mar. 31, 1988) 29

Jevne v. Superior Court, 111 P.3d 954 (Cal. 2005) 34

Kaplan v. Ritter, 519 N.E. 2d 802 (N.Y. 1987) 29

Lane v. Fenn, 146 A.D. 205 (N.Y. App. Div. 1911).................................. 30

Patterman v. The Travelers, Inc., 11 F. Supp. 2d 1382 (S.D. Ga 1997)..... 33

People v. Kaufman & Broad Homes of Long Island, Inc., 378 N.Y.S. 2d 258 (County Ct., Rockland County 1975), *aff'd,* 393 N.Y.S. 2d 144 (N.Y. App. Div. 1977).. 29, 30

Rousseff v. Dean Witter & Co., 453 F. Supp. 774 (N.D. Ind. 1978) 28, 36

SEC v. W. J. Howey Co., 328 U.S. 293 (1946) 38

Siemers v. Wells Fargo & Co., No. C 05-04518, 2006 WL 2355411 (N.D. Cal. Aug. 14, 2006) 8, 14

State v. First Investors Corp., 592 N.Y.S. 2d 561 (Supr. Ct. N.Y. County 1992) 28

State v. Goodrich, 726 P.2d 215 (Ariz. Ct. App. 1986) 29

State v. Justin, 779 N.Y.S. 2d 717 (Sup. Ct. Erie County 2003) 32

State v. Moore, 802 P.2d 732 (Utah Ct. App. 1990) 29

State v. Whiteaker, 129 P. 534 (Or. 1913) 30

Target Oil & Gas Corp. v. Commonwealth of Kentucky, No. 2004-CA-001947-MR, 2006 WL 1443980 (Ky. Ct. App. May 26, 2006) 31

Zuri-Invest AG v. Natwest Finance, Inc., 177 F. Supp. 2d 189 (S.D.NY. 2001) 32, 33, 34, 36, 37, 38, 39

Statutes

15 U.S.C. § 77a(10)... 15

15 U.S.C. § 77p(a)... 3, 28

15 U.S.C. § 77p(b)... 28

15 U.S.C. § 77p(d)... 28

15 U.S.C. §§ 77p(e)... 3

15 U.S.C. § 77q(a)(2) 11

15 U.S.C. §§ 77r(a).......... 2, 22, 23

15 U.S.C. § 77r(c).......... 3, 22, 27, 41

15 U.S.C. § 77r(d)(1).......... 15, 26

15 U.S.C. § 78bb(a).......... 28

15 U.S.C. § 78q-1(d)(4).......... 24

15 U.S.C. § 78q-1(f)(3) 23

15 U.S.C. § 80b-3a(a).......... 25

15 U.S.C. § 80b-3a(b)(2).......... 25

CAL. CORP. CODE § 25401 11

Regulations

17 C.F.R. §§ 230.400 – 479; §§ 480 – 488; §§ 495 – 498; §§ 490 – 494 37

17 C.F.R. § 240.10b-10 38

17 C.F.R. § 240.408.......... 38

17 C.F.R. § 270.34b-1 38

17 C.F.R. § 274.11A.......... 37

Rules

NASD Conduct Rule 2830(a)(4) 11

Other Authorities

Brief of *Amicus Curiae* North American Securities Administrators Association, Inc., in Support Appellants, in *Nanopierce Technologies, Inc. v. The Depository Trust and Clearing Corp.*, Case No. 45364 (Nev. S. Ct. May 1, 2006) 5

Brief of the North American Securities Administrators Association, Inc., as *Amicus Curiae*, in Support of Respondents Broudo *et al.*, in *Dura Pharmaceuticals, Inc. v. Broudo,* Case No. 03-932 (U.S. Nov. 17, 2004) .. 5

Brief of the North American Securities Administrators Association, Inc., as *Amicus Curiae* in Support of the People of the State of California, in *People v. Innovative Financial Services, Inc.,* Case No. D045555 (Cal. Ct. App. Sept. 6, 2005) 4

Cal. Sen. Bill 434, Ch. 876 (approved Oct. 12, 2003) 1

Christopher Cox, Chairman, SEC, Remarks at the North American Securities Administrators Association's Spring Conference (May 9, 2006) 20

Hearing on S. 1815, The Securities Investment Promotion Act of 1996, Hearing Before the Sen. Comm. on Banking, Housing, and Urban Affairs, 104th Cong. (1996) (Statement of Dee R. Harris, Director, Division of Securities, Arizona Corporations Commission, and President, NASAA) 6, 9, 42

H.R. CONF. REP. NO. 104-864 (1996) 27, 36, 40

H.R. CONF. REP. NO. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 731 36

H.R. REP. NO. 104-622 (1996) 24, 25, 26, 36, 40

Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1601, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,872 (Dec. 20, 1996) 25, 26

Information on NASAA Coordination Registration Programs 3

Investment Company Institute, 2005 Investment Company Fact Book, Section Two (Recent Mutual Fund Trends) and Section Four (Who Owns Mutual Funds) 9

Joint Press Release, SEC, NASD, NYSE, and NASAA, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003) 18, 19

12 JOSEPH C. LONG, BLUE SKY LAW (2005) 2, 15, 27, 33, 42

LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION (3rd Ed. 1989) 1, 27, 39

NASAA Member Enforcement Statistics.. 2

News Release, NASD, NASD Fines Four ING Broker-Dealers $7 million For Directed Brokerage Violations (Aug. 9, 2006).................................... 12

News Release, NASD, NASD Hearing Panel Fines American Funds Distributors $5 Million for Directed Brokerage Violations (Aug. 30, 2006) 11, 12

Press Release, CA Office of the Attorney General, Attorney General Lockyer Announces $18 Million Settlement with Franklin Templeton Fund Distributor (Nov. 17, 2004).. 12

Press Release, CA Office of the Attorney General, Attorney Lockyer Files Major Securities Fraud Lawsuit Against Edward Jones (Dec. 20, 2004)... 13

Press Release, CA Office of the Attorney General, Attorney General Lockyer Launches Investigation of Fraudulent Sales Practices by Mutual Funds (Jan. 2, 2004) 40

Press Release, CA Office of the Attorney General, Attorney General Lockyer Announces $9 Million Settlement with PA Distributors in PIMCO Fund Case (Sept. 15, 2004)..13, 40

Press Release, CA Office of the Attorney General, Attorney General Lockyer Sues American Funds For Not Telling Investors Truth About Broker Payments, at 1 (Mar. 23, 2005).. 7, 13

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Press Release, NH Bureau of Securities Regulation, American Express Financial Advisors Reach Settlement with New Hampshire Bureau of Securities Regulation (July 12, 2005) 13

Press Release, Office of New York State Attorney General, Merrill Lynch Stock Rating System Found Biased by Undisclosed Conflicts of Interest (Apr. 8, 2002) 18

Press Release, Office of New York State Attorney General, State Investigation Reveals Mutual Fund Fraud (Sept. 3, 2003) 16, 18

Press Release, SEC, American Express Financial Advisors (Now known as Ameriprise Financial Services, Inc.) to Pay $30 Million to Settle Revenue Sharing Charges (Dec. 1, 2005) 10

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Press Release, SEC, Citigroup Pays $20 Million to Settle SEC Action Relating to Mutual Fund Sales Practices (Mar. 23, 2005) 10

Press Release, SEC, Edward Jones to Pay $75 Million to Settle Revenue Sharing Charges (Dec. 22, 2004) 10, 12

Press Release, SEC, Franklin Advisers and Franklin Templeton Distributors to Pay $20 Million to Settle Charges Related to Use of Brokerage Commissions to Pay for Shelf Space (Dec. 13, 2004) 10

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Press Release, SEC, Prudential to Pay $600 Million in Global Settlement of Fraud Charges in Connection with Deceptive Market Timing of Mutual Funds (Aug. 28, 2006)... 17

Press Release, SEC, SEC Charges Morgan Stanley with Inadequate Disclosure in Mutual Fund Sales, 2003-159 (Nov. 17, 2003)..................... 10

Prohibition on the Use of Brokerage Commissions to Finance Distribution, SEC Release No. IC - 26591, 2004 WL 1969665 (Sept. 2, 2004) 7, 8

Registration Form Used by Open-End Management Investment Companies, SEC Release, File No. S7-10-97, 1998 WL 107729 (Mar. 13, 1998)....... 8, 9

Richard B. Smith, *A New Uniform Securities Act*, 6 No. 9 GLWSLAW 8 (Westlaw database) (Feb. 2003) 20 21

Stephen M. Cutler, Director, Division of Enforcement, SEC, Remarks Before the National Regulatory Services Investment Adviser and Broker-Dealer Compliance/Risk Management Conference (Sept. 9, 2003) 17

State of New York v. Canary Capital Partners, LLC, Complaint (Sept. 3, 2003).. 16

Testimony Concerning Initiatives to Address Concerns in the Mutual Fund Industry, Hearing Before the Sen. Subcomm. On Financial Management, the Budget and International Security, Comm. on Governmental Affairs, at 2, 1456 PLI/Corp 679 (Westlaw database) (statement of Paul F. Roye, Director, SEC Division of Investment Management) (Nov. 3, 2003) 9

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Testimony Concerning Recent Commission Activity to Combat Misconduct Relating to Mutual Funds, Hearing Before the Sen. Comm. on Banking, Housing, and Urban Affairs (Nov. 20, 2003) (statement of Stephen M. Cutler, Director, Division of Enforcement, SEC) 17

The Role of State Securities Regulators in Protecting Investors, Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs (June 2, 2004) 42

UNIF. SEC. ACT § 101 (1956) 39

UNIF. SEC. ACT § 101 (1985) 39

UNIF. SEC. ACT § 101 (2002) 39

UNIF. SEC. ACT §§ 501, 603, 604 (2002) 27

UNIF. SEC. ACT (2002), Prefatory Note 42

Wall Street Analysts Conflicts of Interest Global Settlement, Hearing Before the Sen. Comm. on Banking, Housing, and Urban Affairs (May 7, 2003) (statement of Christine A. Bruenn, Maine Securities Administrator, and President, NASAA) 19-20

IDENTITY AND INTEREST OF *AMICUS CURIAE*

Introduction

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, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. Formed in 1919, NASAA is the oldest international organization devoted to protecting investors from fraud and abuse in connection with the offer and sale of securities. NASAA and its members have an interest in this case because the lower court's ruling substantially narrows the states' traditional antifraud authority in a way that Congress never intended. Unless reversed, the decision below will undermine the states' ability to protect investors from fraud and abuse in the national securities markets.

The Work Of State Securities Regulators

The U.S. members of NASAA are the state agencies responsible for administering state securities laws, a body of law that first emerged nearly 150 years ago. *See generally* LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 31-34 (3d ed. 1989).[1] Their principal responsibilities fall into two distinct categories: regulation and enforcement. Regulation encompasses policy-making and preventive measures such as adopting rules to guide industry participants; registering securities offerings before they are marketed to investors; and licensing broker-dealers, investment advisers, and their agents to help ensure that they have the integrity and competence to deal fairly with the public. Historically, the states'

[1] California is a member of NASAA through the California Department of Corporations, the state agency with primary regulatory responsibility over securities in California. In 2003, the California legislature granted the state Attorney General concurrent authority to enforce the state's securities laws, reflecting the legislature's commitment to maximizing investor protection. *See* Cal. Sen. Bill 434, Ch. 876 (approved Oct. 12, 2003).

regulatory jurisdiction extended to all types of securities – those traded on the national exchanges, intrastate offerings, and investment schemes sold entirely outside the legitimate marketplace. *See* 12 JOSEPH C. LONG, BLUE SKY LAW § 5.1 (2005) (the states exercised plenary parallel authority with federal regulators after the 1933 and 1934 Acts). In 1996, with the passage of the National Securities Markets Improvement Act of 1996 ("NSMIA"), Congress substantially limited the states' regulatory oversight of *national* securities offerings. *See* 15 U.S.C. § 77r(a). Consequently, with respect to rule-making and registration, the states' role is now limited to local and regional offerings that are not traded on the national exchanges. States continue to play an important role, however, in reviewing more local securities offerings, licensing firms and their agents, and educating investors.

Even more important than the states' regulatory function is their enforcement role: protecting the nation's investors by bringing enforcement actions against the firms and individuals who have committed – or are in the process of committing – fraud and abuse in the offer and sale of securities. For nearly a century, state securities regulators have tirelessly pursued those who commit securities fraud, from the con artist operating a local Ponzi scheme to the Wall Street brokerage firm engaged in dishonest practices on a national scale. Each year, state securities regulators file thousands of enforcement actions under their securities codes seeking a wide range of punitive and remedial sanctions, including fines, injunctions, restitution orders, license revocations, and criminal penalties. *See, e.g.*, NASAA Member Enforcement Statistics.[2] In contrast with the states' regulatory authority, the states' antifraud jurisdiction has not been restricted

[2]*Available at* http://www.nasaa.org/issues___answers/enforcement___legal_activity/1002.cfm (showing that state securities regulators brought nearly 3,000 enforcement actions during the 2002/2003 reporting year)

by Congress. On the contrary, in NSMIA and other federal securities laws, Congress has expressly made clear that the states should continue to exercise their antifraud authority unhindered and without regard to whether securities offerings are local or national in character. *See, e.g.*, 15 U.S.C. § 77r(c) (NSMIA savings clause); 15 U.S.C. § 77p(a) (savings clause in Securities Act of 1933, preserving "all other remedies that may exist at law or in equity"); 15 U.S.C. § 77p(e) (savings clause in Securities Litigation Uniform Standards Act, providing that state securities commissions retain jurisdiction to investigate and bring enforcement actions).

NASAA's Role In Supporting Its Members

Since 1919, NASAA has supported both the regulatory and the enforcement work of its members. For example, to promote efficient capital formation, NASAA has helped develop standardized registration procedures for small, regional securities offerings. These procedures, such as the "Small Company Offering Registration" program, assist issuers by designating a lead state to review the proposed offering, establishing uniform review criteria, and setting firm deadlines for response by state regulators. They reflect the states' modern approach to securities registration, one that alleviates regulatory burdens on industry while preserving a significant measure of protection for investors.[3]

With respect to licensing, NASAA and the National Association of Securities Dealers ("NASD") jointly operate the Central Registration Depository ("CRD"). The CRD system enables state and federal regulators to license broker-dealer firms and their agents electronically. It also enables members of the public to check the background information, disciplinary history, and licensing status of their brokers, via the web or through contact with state securities regulators. In the area of investor

[3] *See generally* http://www.nasaa.org/Industry___Regulatory_Resources/Corporation_Finance/ (NASAA webpage describing coordinated registration programs).

education, NASAA works with its members to develop programs that help citizens avoid becoming victims of fraud.

One of NASAA's most important functions is to represent the membership's position in the rulemaking and legislative process. When rules are proposed by the SEC or a Self Regulatory Organization ("SRO"), NASAA often submits comment letters identifying the strengths and weaknesses of the proposed rules from the standpoint of investor protection. Similarly, NASAA frequently offers testimony in Congress on proposed federal legislation in the securities field or in the wider realm of financial services.

In support of the states' enforcement mission, NASAA organizes training conferences for state investigators and attorneys and assists its members in coordinating multi-state enforcement actions. In those cases, some of which are described in more detail below, state securities regulators exercise their broad antifraud authority to help abolish dishonest practices originating not just in local communities but also on Wall Street.

Finally, NASAA offers its legal analysis and policy perspective to the courts as *amicus curiae* in significant enforcement actions and other cases involving the interpretation of the securities laws and the rights of investors. In its briefs, NASAA addresses legal issues ranging from the types of investments that constitute "securities" under state law to the elements that private plaintiffs must prove to recover damages for securities fraud. *See, e.g.,* Brief of North American Securities Administrators Associtation, Inc., as *Amicus Curiae* in Support of the People of the State of California, in *People v. Innovative Financial Services, Inc.,* Case No. D045555 (Cal. Ct. App. Sept. 6, 2005) (supporting the position of the California Department of Corporations that viatical settlements are securities and that full restitution of investor losses is an appropriate remedy for securities fraud under California law);[4] Brief of the North American Securities Administrators Association, Inc., as *Amicus Curiae*, in Support of Respondents Broudo *et al.*, in *Dura Pharmaceuticals, Inc. v. Broudo*, Case No. 03-932 (U.S. Nov. 17, 2004) (supporting investors' position on the pleading requirements for loss causation in a private action for securities fraud).[5] NASAA also frequently addresses the scope of federal preemption over state securities laws and other consumer protection statutes relating to financial services. *See, e.g.*, Brief of *Amicus Curiae* North American Securities Administrators Association, Inc., in Support Appellants, in *Nanopierce Technologies, Inc. v. The Depository Trust and Clearing Corp.*, Case No. 45364 (Nev. S. Ct. May 1, 2006) (arguing that federal securities law does not preempt a private action under state law alleging that the nation's clearing agencies have committed fraud by misrepresenting the true nature and effect of the stock borrow program).[6] Ultimately, NASAA's mission, and the mission of its members, is to protect investors from fraud and abuse.

<u>The Assistance That NASAA Can Offer To The Court</u>

By virtue of NASAA's knowledge and experience in the field of securities regulation and enforcement, the association can assist this Court in addressing the legal issues presented in this appeal and in weighing the impact of the case on investor protection. The Court will benefit from NASAA's experience in coordinating multi-state enforcement actions. NASAA's involvement in those cases has given the association a unique insight into the value of state enforcement work, not only in local venues but in the national markets as well.

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[4] *Available at* http://www.nasaa.org/content/Files/IFSbrief.pdf.
[5] *Available at* http://www.nasaa.org/content/Files/BroudoBrief.pdf.
[6] *Available at* http://www.nasaa.org/content/Files/Nanopierce.pdf.

NASAA can also assist the Court in understanding the intended scope of NSMIA and the impact of preemption on the interests of investors. NASAA actually played a role in the legislative process that lead to the passage of NSMIA in 1996. Dee Harris, then President of NASAA, testified before the Senate Banking, Housing, and Urban Affairs Committee about the implications of the bill on state securities regulators and investors. *See Hearing on S. 1815, The Securities Investment Promotion Act of 1996, Hearing Before the Sen. Comm. on Banking, Housing, and Urban Affairs,* 104th Cong. (1996) (Statement of Dee R. Harris, Director, Division of Securities, Arizona Corporations Commission, and President, NASAA). Mr. Harris emphasized two points: that exempting nationally listed securities from state registration and review was appropriate, but that preserving the states' full antifraud authority was vital, not just as to oral sales practice abuses but as to written marketing materials as well. *Id.* at 2, 5. NASAA is thus intimately familiar with the federal statute at issue in this case as well as the impact that it can have on the states' authority to protect investors through enforcement actions.

The Significance Of This Case

Protecting California's Authority To Address The Appellees' Fraudulent Conduct

This case has enormous significance for NASAA and its members for two reasons. The most immediate objective of this appeal is preserving the right of the California Attorney General to enjoin the Appellees' fraudulent marketing practices and to impose sanctions for the misconduct that has already occurred. The violations at issue are serious and widespread, affecting millions of citizens in California and elsewhere throughout the country, and the Attorney General should be allowed to address them.

Shelf-space arrangements inflict harm on investors in a variety of ways. Under these agreements, a mutual fund will compensate a broker-dealer for aggressive and preferential marketing of its mutual fund products. In the case of "directed brokerage," the compensation takes the form of commissions on a high volume of trades that the fund directs to the broker-dealer. In the case of revenue sharing, the compensation takes the form of cash payments. The mutual fund in turn benefits from the accumulation of new assets under management and from a commensurate increase in fees.

These agreements create a fundamental conflict of interest between what's best for investors and what's best for the advisors, distributors, and broker-dealers that are involved in marketing mutual funds. For example, shelf-space arrangements motivate broker-dealers to recommend funds not on the basis of fund performance or client needs, but instead on the basis of the benefits to the broker-dealers. Attorney General Lockyer aptly described the nature of the conduct in these terms when he announced the filing of this case: "[W]hen you look beneath the cloak of legitimacy, the payments are little more than kickbacks to buy preferential treatment. Investors deserve to know that." *See* Press Release, CA Office of the Attorney General, Attorney General Lockyer Sues American Funds For Not Telling Investors Truth About Broker Payments, at 1 (Mar. 23, 2005).[7]

With respect to directed brokerage, which is one form of shelf-space arrangement, the SEC has come to view these conflicts of interest as so "unmanageable" and so fraught with potential abuse that the agency has banned the practice altogether, regardless of whether it is disclosed. *See* Prohibition on the Use of Brokerage Commissions to Finance Distribution, SEC Release No. IC - 26591, 2004 WL 1969665, at *1 (Sept. 2, 2004).

[7] *Available at* http://ag.ca.gov/newsalerts/release.php?id=586.

The SEC's release observes that beginning in 1981, fund advisers were permitted to follow a "*disclosed policy* 'of considering sales of shares that the fund issues as a factor in the selection of broker-dealers to execute portfolio transactions.'" *Id.* at *2 (emphasis added). The release explains, however, that the shelf-space arrangements of today "are far from the benign practice that we approved in 1981," *id.*, and it describes the inherent conflict as follows: "These practices may corrupt the relationship between broker-dealers and their customers. Receipt of brokerage commissions by a broker-dealer for selling fund shares creates an incentive for the broker to recommend funds that best compensate the broker rather than funds that meet the customer's investment needs." *Id.* at *3.[8]

These abuses affect a huge number of investors. Over the last two decades, mutual funds in this country have experienced "explosive" growth. *See* Registration Form Used by Open-End Management

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[8] Shelf-space arrangements not only corrupt the advice given to investors, they also can result in the wrongful depletion of assets belonging to the fund and ultimately to fund investors. For example, such deals may induce an adviser to engage in excessive trading in the fund to ensure that broker-dealers receive satisfactory compensation for their marketing efforts. See SEC Release No. IC – 26591, cited *supra* in text, at 3-4; *Testimony Concerning Investor Protection Issues Regarding the Regulation of the Mutual Fund Industry, Hearing Before the Sen. Comm. on Banking, Housing and Urban Affairs*, 1456 PLI/Corp 679, 714-15 (Westlaw database) (Apr. 8, 2004) (statement of William H. Donaldson, Chairman, SEC) (directed brokerage potentially "compromises best execution of a fund's portfolio trades, increases portfolio turnover, and corrupts broker-dealers' recommendations to their customers"). And a fund adviser that has incentivized brokers with money out of its own pocket may seek to recoup that money by inflating the compensation it charges the fund. *Cf. Siemers v. Wells Fargo & Co.*, No. C 05-04518 WHA, 2006 WL 2355411, at *12 (Aug. 14, 2006 N.D. Cal.) (holding that plaintiffs had properly plead a fraud claim under the federal securities Acts for failure to disclose shelf-space agreements and explaining that "[t]he secret paybacks to the broker-dealers came out of the mutual funds assets . . . . [I]nvestors were unwittingly paying extra but getting nothing in return").

Investment Companies, SEC Release, File No. S7-10-97, 1998 WL 107729, at *5 (Mar. 13, 1998). As of 2004, 92 million Americans owned mutual funds, and total assets invested in mutual funds had reached a record level of $8.1 trillion. *See* Investment Company Institute, 2005 Investment Company Fact Book, Section Two (Recent Mutual Fund Trends), at 1-2, and Section Four (Who Owns Mutual Funds), at 1.[9] Regulators and enforcement authorities regard mutual fund abuses as especially serious because of the huge number of victims affected. *See* Testimony of Dee R. Harris, cited *supra*, at 6 (emphasizing the importance of mutual fund disclosure requirements given that mutual funds are the investment of choice for middle class Americans); *Testimony Concerning Initiatives to Address Concerns in the Mutual Fund Industry, Hearing Before the Sen. Subcomm. On Financial Management, the Budget and International Security, Comm. on Governmental Affairs*, 1456 PLI/Corp 679, 681 (Westlaw database) (Nov. 3, 2003) (statement of Paul F. Roye, Director, SEC Division of Investment Management) (explaining the SEC's regulatory and enforcement response to mutual fund abuses, including shelf-space agreements, and citing the huge investment in mutual funds as a measure of their importance to the U.S. financial system).

Given the serious nature and the widespread impact of these violations, it is not surprising that they have become the focus of an almost unprecedented enforcement effort at both the federal and state levels, resulting in millions of dollars in fines and disgorgement orders. The failure adequately to disclose shelf-space agreements has been universally condemned by the SEC, the NASD, the NYSE, and state securities regulators, in addition to California. Between November 2003 and December 2006, the SEC filed at least nine major enforcement actions against the nation's leading mutual funds and their advisers and distributors

[9] *Available at* http://www.ici.org/factbook/index.html.

based upon their failure adequately to disclose shelf-space agreements to investors in their offering documents.[10] In every instance, the SEC's core allegation was fraud. In many cases, as in this one, the SEC found that the firms had made disclosures about their compensation arrangements that were incomplete and therefore misleading.

For example, in Morgan Stanley, the Commission made the following findings regarding the firm's incomplete disclosures in their prospectuses and Statements of Additional Information ("SAI's"):

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[10] Press Release, SEC, SEC Charges Morgan Stanley with Inadequate Disclosure in Mutual Fund Sales (Nov. 17, 2003), *at* http://www.sec.gov/news/press/2003-159.htm;
Press Release, SEC, Mutual Fund Manager MFS Pays $50 Million Fine to Settle SEC Enforcement Action (Mar. 31, 2004), *at* http://www.sec.gov/news/press/2004-44.htm;
Press Release, SEC, SEC Charges Pimco Entities with Failing to Disclose Their Use of Directed Brokerage to Pay for Shelf Space at Brokerage Firms (Sept. 15, 2004), *at* http://www.sec.gov/news/press/2004-130.htm;
Press Release, SEC, Franklin Advisers and Franklin Templeton Distributors to Pay $20 Million to Settle Charges Related to Use of Brokerage Commissions to Pay for Shelf Space (Dec. 13, 2004), *at* http://www.sec.gov/news/press/2004-168.htm;
Press Release, SEC, Edward Jones to Pay $75 Million to Settle Revenue Sharing Charges (Dec. 22, 2004), *at* http://www.sec.gove/news/press/2004-168.htm;
Press Release, SEC, Mutual Fund Manager Putnam Pays $40 Million Fine to Settle SEC Enforcement Action (Mar. 23, 2005), *at* http://www.sec.gov/news/press/2005-40;
Press Release, SEC, Citigroup Pays $20 Million to Settle SEC Action Relating to Mutual Fund Sales Practices (Mar. 23, 2005), *at* http://www.sec.gov/news/press/2005-39;
In the Matter of Oppenheimerfunds, Inc. & Oppenheimerfunds Distrib., Inc., 2005 WL 2233552 (SEC Sept. 14, 2005), *available at* http://www.sec.gov/litigation/admin/34-52420.pdf;
Press Release, SEC, American Express Financial Advisors (Now known as Ameriprise Financial Services, Inc.) to Pay $30 Million to Settle Revenue Sharing Charges (Dec. 1, 2005), *at* http://www.sec.gov/news/press/2005-168.htm.

"Although . . . the prospectuses and SAI's contain various disclosures concerning payments to the broker-dealers distributing their funds, none adequately disclose the preferred programs as such, nor do most provide sufficient facts about the preferred programs for investors to appreciate the dimension of the potential conflicts of interest inherent in them." *See In the Matter of Morgan Stanley DW Inc.*, SEC Exchange Act Release No. 48789, at ¶ 25 (Nov. 17, 2003) (available via link in Press Release cited in footnote *supra*). The SEC accordingly found that Morgan Stanley had willfully violated the antifraud provision in Section 17(a)(2) of the 1933 Act, which, like California's securities law (CAL. CORP. CODE § 25401), prohibits the "omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." *See* 15 U.S.C. § 77q(a)(2). The SEC's nine enforcement actions resulted in fines and disgorgement orders totaling almost a third of a billion dollars, as well as cease and desist orders enjoining the firms from future violations.

The self regulatory organizations, specifically the NASD and the NYSE, have also taken these violations very seriously, bringing numerous enforcements actions against member firms engaged in directed brokerage.[11] Just last month, the NASD announced sanctions against American Funds Distributors, Inc., for the same underlying practices that the California Attorney General has challenged in this case. *See* News Release, NASD, NASD Hearing Panel Fines American Funds Distributors

[11] While both the SEC and the states regard this practice as fraud and deceit, the NASD applies its Conduct Rules because it does not have a general antifraud provision at its disposal. *See* NASD Conduct Rule 2830(a)(4) (requiring disclosure of cash compensation arrangements for distribution of mutual fund securities). The states' fraud theories are consistent with NASD Rule 2830, as they are with the federal antifraud laws.

$5 Million for Directed Brokerage Violations (Aug. 30, 2006).[12] The NASD's hearing panel declared that "[a] clearer use of directed brokerage to further reciprocal arrangements, contrary to the purpose of (the Anti-Reciprocal Rule), is difficult to imagine." *See id.* at 1. The panel censured the firm and imposed a $5 million fine, one of the largest assessed by an SRO against any company involved in the shelf space scandal. *Id.*; *see also* News Release, NASD, NASD Fines Four ING Broker-Dealers $7 million For Directed Brokerage Violations (Aug. 9, 2006) (announcing the NASD's imposition of fines totaling $7 million against four brokers affiliated with ING for directed brokerage violations).[13] Both the NASD and the NYSE have brought enforcement actions against Edward D. Jones & Co., in conjunction with the SEC's enforcement proceeding. *See* SEC Press Release, cited in footnote *supra*.

Invoking their antifraud authority as preserved by NSMIA, state securities regulators have also taken action against mutual funds and their affiliates that have used undisclosed shelf-space agreements to increase their profits at the expense of investors. This case stands as a prime example of the states' commitment to the eradication of shelf-space fraud. The California Attorney General has filed three other enforcement actions against major mutual fund distributors involved in similar violations. Two of those cases have settled and another is pending. *See* Press Release, Office of the Attorney General, Attorney General Lockyer Announces $18 Million Settlement With Franklin Templeton Fund Distributor (Nov. 17,

[12] *Available at* http://www.nasd.com/PressRoom/NewsReleases/2006NewsReleases/NASDW_017294.

[13] *Available at* http://www.nasd.com/PressRoom/NewsReleases/2006NewsReleases/NASDW_017110.

2004);[14] Press Release, CA Office of the Attorney General, Attorney General Lockyer Announces $9 Million Settlement With PA Distributors in PIMCO Fund Case (Sept. 15, 2004);[15] Press Release, CA Office of the Attorney General, Attorney General Lockyer Files Major Securities Fraud Lawsuit Against Edward Jones (Dec. 20, 2004).[16]

California's experience exemplifies not only the states' role in addressing the shelf-space abuses, but also the collaboration between state enforcement authorities and the SEC with respect to fraud on a large scale. When Attorney General Lockyer first announced the filing of this action, he confirmed that his office had been "working closely with the SEC" on the case and he acknowledged the SEC's "substantial assistance and cooperation." *See* Press Release, Office of the Attorney General, Attorney General Lockyer Sues American Funds For Not Telling Investors Truth About Broker Payments, at 2 (Mar. 23, 2005).[17]

Other NASAA members are pursuing the problem of shelf-space agreements through appropriate enforcement action. For example, in July 2005, the New Hampshire Bureau of Securities Regulation announced a settlement of its case against American Express Financial Advisors for breach of its duty to fully disclose shelf space agreements to investors. *See* Press Release, NH Bureau of Securities Regulation, American Express Financial Advisors Reach Settlement with New Hampshire Bureau of Securities Regulation (July 12, 2005).[18] The Bureau alleged that the firm had engaged in fraud and deceit because information in the prospectus was inadequate "to reveal the extensive nature of the conflicts of interest driving the sale of American Express mutual funds and other proprietary products,"

[14] *Available at* http://ag.ca.gov/newsalerts/release.php?id=838.
[15] *Available at* http://ag.ca.gov/newsalerts/release.php?id=796.
[16] *Available at* http://ag.ca.gov/newsalerts/release.php?id=853.
[17] *Available at* http://ag.ca.gov/newsalerts/release.php?id=586.
[18] *Available at* http://www.sos.nh.gov/securities/PRESSR07_12_2005.pdf.

many of which performed poorly relative to other mutual fund products. *See id.* at 2; *In the Matter of American Express Financial Advisors*, No. INV04-122, Preliminary Statement, at 2, 3 (Feb. 17, 2005).[19] To settle the charges, American Express agreed to pay $5 million in fines, $2 million in disgorgement to injured New Hampshire investors, and the costs of investigation. *See* Press Release, *supra*, at 1-2; *see also* Press Release, NH Bureau of Securities Regulation, NH Securities Bureau File Against ING (June 9, 2006) (announcing filing of similar allegations against ING Life Insurance and Annuity Company and its affiliate, ING Financial Advisers).[20]

The magnitude of this enforcement effort at both the state and federal levels, the frequent application of antifraud provisions in these cases, and the formidable sanctions imposed upon the firms all confirm the importance of this appeal. This enforcement history also demonstrates another key point: the application of state antifraud provisions does not

[19] *Available at* http://www.sos.nh.gov/securities/EnforceOrderINV04-122.pdf.

[20] *Available at* http://www.sos.nh.gov/securities/PRESSR06_09_2006.pdf.

Shelf-space agreements and the failure to disclose them adequately to investors have also triggered a wave of private lawsuits. For example, in *Siemers v. Wells Fargo & Co.*, No. C 05-04518, 2006 WL 2355411 (N.D. Cal. Aug. 14, 2006), the defendants' prospectus indicated that the adviser "*may* consider" fund sales in the selection of broker-dealers to execute the fund's portfolio transactions, when in fact, according to the plaintiffs, the advisor had "*already* entered into firm kickback arrangements." *Id.* at *5-6. The court ruled that for purposes of a motion to dismiss, the prospectus was materially misleading under the federal antifraud provisions: "A reasonable investor is more likely to view the broker-dealer's recommendation with skepticism if he or she knows for sure that the broker-dealer's objectivity has already been compromised." *Id.* at *6. These private actions have met with varying degrees of success, some counts being dismissed on procedural grounds and some on more substantive determinations about the materiality of the claims presented. *See, e.g., Forsythe v. Sun Life Financial, Inc.*, 417 F. Supp. 2d 100, 105, 113-15 (D. Mass. 2006) (striking some claims due to lack of private right of action and lack of standing, but sustaining claims for breach of fiduciary duty); *see also* cases reviewed in *Siemers v. Wells Fargo & Co.*, at *6-9. In none of these cases, however, has any court held that NSMIA preempts the plaintiffs' claims.

conflict with the federal laws and regulations applicable to shelf-space violations.[21]

Whatever aspects of revenue sharing are allowed to persist from a regulatory standpoint – a matter for the SEC to decide, not the states – there is no doubt that the conflict of interest that it creates must at a minimum be disclosed to investors under the basic principles of honest and full disclosure embodied in both state and federal securities laws. As the foregoing cases show, enforcing this standard of conduct calls for the joint efforts of both state and federal agencies. The California Attorney General has an important role to play in that effort and he should not be deprived of the jurisdiction that he needs to protect the citizens of California – a jurisdiction that states have always enjoyed and that Congress has expressly preserved for the benefit of investors.

Protecting The States' Antifraud Authority
Under NSMIA For Use Against A Wide Range Of Fraudulent Schemes

This case has important implications for state securities regulators and for investors on a broader level. The lower court did not confine its ruling to the specific facts of this case, but instead suggested that NSMIA preempts all "state regulation of offering documents." Ruling and Order at 20. Given the breadth of the term "offering document," *see* 15 U.S.C. §§ 77r(d)(1) and 77b(a)(10); 12 JOSEPH C. LONG, BLUE SKY LAW, § 5.4 (2006), this interpretation of NSMIA could be read to shield a wide variety of marketing materials from any state jurisdiction, including state antifraud authority.

As argued elsewhere in this brief, such a dramatic restriction on the states' historic role in policing securities fraud cannot be reconciled with Congress's language and intent. But in addition to its legal infirmities, the

[21] This huge commitment of enforcement resources also refutes the Appellees' attempt to trivialize California's allegations. *See* Appellees' Br. at 45.

lower court's interpretation has ominous implications from the standpoint of investor protection. Unless reversed, it will stifle the efforts of state regulators to protect the public from fraud and abuse. The states' prominent role in the shelf-space cases is not an unprecedented or isolated occurrence. The states have a proven track record of uncovering and remediating securities fraud not just at the local level, but in cases involving securities offered nationally by the country's most prominent brokers and advisers. The states' continued role in policing national securities offerings for fraud is at risk in this appeal.

Two examples, in addition to the shelf-space cases, illustrate the value of state enforcement work in addressing large scale misconduct by securities firms. In 2003, the New York Attorney General uncovered two illegal trading schemes that had become widespread in the mutual fund industry. Mutual funds were allowing favored companies and individuals to engage in practices known as "late trading" and "market timing," to the detriment of average citizens holding mutual fund shares, and in contravention of prospectus language disavowing such practices. *See* Press Release, Office of New York State Attorney General, State Investigation Reveals Mutual Fund Fraud (Sept. 3, 2003).[22]

New York brought the first enforcement action addressing these violations against a hedge fund known as Canary Capital Partners, LLC, and its affiliates. *Id.* The case was based upon New York's antifraud provisions and it resulted in a settlement that included restitution payments of $30 million for the benefit of injured investors and a fine of $10 million. S*ee State of New York v. Canary Capital Partners, LLC,* Complaint, at 41-43;[23] s*ee also* Press Release at 2. New York's investigation exposed similar

[22] http://www.oag.state.ny.us/press/2003/sep/sep03a_03.html.

[23] *Available at* http://www.oag.state.ny.us/press/2003/sep/canary_complaint.pdf.

misconduct at other mutual funds and it triggered a wave of enforcement actions by federal and state regulators much like the enforcement effort targeting shelf space abuses, described above. *See, e.g.*, Press Release, SEC, Prudential to Pay $600 Million in Global Settlement of Fraud Charges in Connection With Deceptive Market Timing of Mutual Funds (Aug. 28, 2006).[24]

The SEC and other experts in the securities field applauded New York for its aggressive work on behalf of the nation's investors. Stephen Cutler, then Director of the SEC's Division of enforcement, publicly acknowledged New York's contribution: "The most recent evidence of conflicts run amok is Attorney General Spitzer's action against Canary Capital Partners relating to its transactions in mutual funds . . . . Mr. Spitzer has taken an important step in bringing this action, and I commend him for it." *See* Stephen M. Cutler, Remarks Before the National Regulatory Services Investment Adviser and Broker-Dealer Compliance/Risk Management Conference, at 1 (Sept. 9, 2003).[25] In testimony before the Senate Committee on Banking, Housing, and Urban Affairs, Mr. Cutler emphasized that the SEC was aggressively pursuing wrongdoing in the mutual fund industry and would "continue to work closely and cooperatively with state officials who also are taking steps to protect investors." *See Testimony Concerning Recent Commission Activity to Combat Misconduct Relating to Mutual Funds, Hearing Before the Sen. Comm. on Banking, Housing, and Urban Affairs*, at 5, 9 (Nov. 20, 2003) (statement of Stephen M. Cutler, Director, Division of Enforcement, SEC).[26] Mercer Bullard, one of the nation's leading experts on mutual funds, declared that "[t]hese findings that prominent mutual fund managers

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[24] *Available at* http://www.sec.gov/newsw/press/2006/2006-145.htm.
[25] *Available at* http://www.sec.gov/news/speech/spch090903smc.htm.
[26] *Available at* www.sec.gov/news/testimony/ts11203smc.htm.

collude with hedge funds to pick the pockets of fund shareholders undermines the integrity of the fund industry and reminds us of the importance of state regulators' enforcement efforts in uncovering and fighting securities fraud." *See* Press Release, Office of New York State Attorney General, State Investigation Reveals Mutual Fund Fraud, at 2 (Sept. 3, 2003), cited *supra.*

Another stunning example of the states' contribution to investor protection arose in 2002. The states joined forces with the SEC and the SRO's to investigate and remediate some of the most unseemly fraud that has emerged on Wall Street in the modern era. The states and their federal counterparts discovered that research analysts at the country's leading investment banking firms were issuing false stock ratings in order to attract and keep lucrative underwriting business from the companies being rated by the analysts. Emails obtained in the investigation revealed instances of analysts internally deriding stocks as pieces of "junk," but brazenly assigning them high stock ratings for public consumption, all because the company being rated was an investment banking client. *See* Press Release, Office of New York State Attorney General, Merrill Lynch Stock Rating System Found Biased by Undisclosed Conflicts of Interest, at 1 (Apr. 8, 2002), and supporting documents.[27] In those cases, as in this one, a profound conflict of interest was hurting everyday investors.

After a coordinated state, federal, and SRO investigation, ten of the country's largest investment banks reached a global settlement, resolving claims for fraud and other misconduct in connection with their false and misleading analyst reports. *See* Joint Press Release, SEC, NASD, NYSE, and NASAA, Ten Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment

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[27] *Available at* http://www.oag.state.ny.us/press/2002/apr/apr08b_02.html (including links to affidivat in support of New York's allegations).

Banking (Apr. 28, 2003).[28] The firms agreed to pay a total of almost $1.4 billion in restitution, fines, and investor education support, and further agreed to institute reforms designed to eliminate conflicts of interest between their investment banking and research departments. *Id.* In their statements, officials from the agencies involved cited not only the benefits for investors, but also the extraordinary importance of collaboration between state regulators and the SEC and SRO's in tackling large scale frauds. The head of the NYSE stated that "[t]he partnership between the SEC, state regulators, and the SRO's and our lawmakers remains the best and most effective system of market regulation, and the global settlement reflects that." *Id.* at 5 (statement of Dick Grasso, CEO of the NYSE). In subsequent Congressional testimony, then President of NASAA, Christine Bruenn, highlighted the essential role of state regulators in the analyst cases, while also issuing a reminder that in cases involving the national markets, the states' role is one of enforcement, not rule-making:

> I believe it represents a model for state-federal cooperation that will serve the best interests of investors nationwide. As they did with penny stock fraud, microcap fraud, day trading and other areas, the states helped to spotlight a problem and worked with national regulators on market-wide solutions.[29] It bears repeating: the states, historically and in the current cases, investigate and bring enforcement actions – they do not engage in rulemaking for the national markets. That is rightly the purview of the SEC and the SRO's. None of the regulators who were involved in this global settlement could have done it on its own.

Wall Street Analysts Conflicts of Interest Global Settlement, Hearing Before the Sen. Comm. on Banking, Housing, and Urban Affairs, at 2 (May

[28] *Available at* http://www.sec.gov/newsw/press/2003-54.htm.
[29] Discuss chart attached to Bruenn testimony summarizing the large enforcement cases brought by states.

7, 2003) (statement of Christine A. Bruenn, Maine Securities Administrator, and President, NASAA).[30]

More recently, the SEC's Chairman, Christopher Cox, delivered a keynote speech at NASAA's Spring Conference in which he praised the collaborative enforcement efforts of the SEC and state securities regulators, citing the analyst settlement and a long list of other successes in large scale cases: "Partly as a result of our improved coordination in allocating enforcement resources, the SEC and state regulators have recently achieved some spectacular results in a number of high profile cases. The historic global analyst settlement is an excellent example of how much we can accomplish working together." *See* Christopher Cox, Chairman, SEC, Remarks to the North American Securities Administrators Association, at 2 (May 9, 2006).[31]

When Congress enacted the savings clause in NSMIA, it intended to preserve, not diminish, the robust – indeed indispensable – role that the states' have historically played with respect to national as well as local securities offerings. As stated by one commentator:

> Many schemes to defraud investors involve locally generated pyramid schemes, misrepresentations, and scams. Without state regulation accompanied by civil and criminal enforcement of the law in state courts, there would be little hope of redress for many victimized investors. State enforcement is also available when there are fraudulent schemes involving federal covered securities. In effect, Congress and the SEC have acknowledged that federal regulators are unable to cope with all the enforcement that needs to be done.

[30] *Available at* *http://www.nasaa.org/Issues___Answers/Legislative_Activity/Testimony/555.cfm*.
[31] *Available at* http://www.sec.gov/news/speech/2006/spch050906cc.htm.

Richard B. Smith, *A New Uniform Securities Act,* 6 No. 9 GLWSLAW 8, at 2 (Westlaw database) (Feb. 2003).

The ruling in the court below jeopardizes this critical state enforcement role. Especially at a time when fraudulent conduct is on the rise in all sectors of the financial services industry, state antifraud authority must be given the sway Congress intended. Preserving state jurisdiction is vital, not only in this case, but for the sake of other investors who depend upon the efforts of state enforcement authorities to protect them from fraud and abuse.

ISSUES PRESENTED FOR REVIEW

1. Whether the savings clause in NSMIA permits a state securities regulator to bring an enforcement alleging fraud and seeking to enjoin the use of offering documents for covered securities, where (a) the state action fits within the plain language of the savings clause, (b) the preemption provision that would arguably prohibit the state's action is subordinate to the savings clause, and (c) the state is exercising the same type of antifraud authority that states were exercising prior to NSMIA and that Congress intended to preserve in the savings clause.

2. Whether a state's enforcement action conflicts with federal law for preemption purposes, where (a) federal regulators have repeatedly found the misconduct at issue in the state action to constitute fraud under federal law, (b) where the state action does not intrude upon the federal government's exclusive regulatory role with respect to national securities offerings, and (c) where the state action actually promotes one of the central goals of federal securities law – full disclosure for the benefit of investors.

ARGUMENT

I. NSMIA Expressly Preserves California's Authority To Bring This Enforcement Action.

This action by the California Attorney General to enforce the antifraud provisions of California's securities law falls squarely within the plain language, as well as the intent, of the savings clause that Congress wrote into NSMIA. Contrary to the lower court's ruling, the savings clause is not ambiguous and it clearly encompasses this type of state enforcement action.

A. This Case Falls Under The Plain Language Of The Savings Clause

In NSMIA, Congress generally prohibited the states from engaging in the registration and merit review of nationally traded securities offerings. 15 U.S.C. §§ 77r(a)(1), (2), and (3). At the same time, Congress made very clear that, in contrast with the states' regulatory function, the states' enforcement authority was to be fully preserved, whether or not it was brought to bear on offering documents used to market "covered" securities. Congress included a broad savings clause in NSMIA that protected the states' antifraud authority in these terms:

> Consistent with this section, the securities commission (or agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud and deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions.

15 U.S.C. § 77r(c).

California's enforcement action has all of the attributes necessary to bring it squarely within the ambit of the savings clause: It is (1) an enforcement action (2) brought by a state agency, or office performing the functions of a securities commission, (3) under the laws of the state (4) with respect to fraud or deceit (5) in connection with securities or securities transactions. On its face, therefore, this case is an appropriate exercise of state jurisdiction that should be allowed to proceed, not dismissed on preemption grounds.

B. California's Right To Seek An Injunction Against The Use Of Fraudulent Offering Documents Also Was Preserved, Because NSMIA's Preemption Language Is Subject To A State's Right To Bring Enforcement Actions

The lower court's concern was that Congress might have intended to preclude a state enforcement action to the extent it had the practical effect of "prohibiting" or imposing "conditions upon" the use of an offering document – the regulatory actions that NSMIA ostensibly preempts. *See* 15 U.S.C. § 77r(a)(2); Ruling and Order, at 16. But the evidence is overwhelming that Congress intended the preemption provision to be *subject to* the savings clause. The most compelling authority for this proposition is the language of the statute itself. *All* of the provisions limiting state authority begin with the admonition that they apply "[e]xcept as otherwise provided in this section." 15 U.S.C. § 77r(a). The reference to "this section" includes the savings clause. Thus, NSMIA preserves the states' authority to prohibit or condition the use of an offering document *if* the state is taking an enforcement action under its antifraud laws to prevent fraud or deceit.[32]

[32] Equally important is what Congress did not say in the savings clause. The savings clause contains no language to the effect that the states' antifraud authority is preserved "except as to offering documents." Also conspicuously absent is language to the effect that states may exercise their authority only to the extent it does not conflict with other provisions in federal law. When Congress has intended this effect, it has not hesitated to include this language. For example, in the provisions aimed at establishing a national system for clearance and settlement for securities transactions, Congress was very clear in defining the scope of related state law. First, Congress established a precise, two-year window in which states could adopt laws that actually differed from certain rules adopted by the SEC. *See* 15 U.S.C. § 78q-1(f)(3). Elsewhere, Congress clearly articulated the

The legislative history is conclusive on this issue. The legislators repeatedly stated that the preemption language was "subject to" the savings clause. For example, the report of the House Committee on Commerce states that "Section 18(a) prohibits State governments from requiring the registration of, or otherwise imposing conditions on, offerings of "covered securities" as defined in Section 18(b), **subject to Section 18(d), which preserves State authority to investigate and bring enforcement actions with respect to fraud or deceit . . . ."** H.R. REP. NO. 104-622, at 29 (1996) ("House Report") (emphasis added).

Later, the House Report elaborates upon the types of documents that are immune from state *regulatory* review, and it further notes that states are precluded from exercising "indirect" authority to regulate the matters preempted. But here again, the House Report makes perfectly clear that "**in each case**, the prohibitions are **subject to the provisions of subsection (d),"** the savings clause. *Id.* at 30. (Emphasis added). The House Committee recognized the importance of the issue and therefore was very deliberate in making its intentions clear:

> The relationship between Section 18(d) [the savings clause] and Section 18(a) [the preemption clause] is especially important. The Committee intends to preserve the ability of the States to investigate and bring enforcement actions under the laws of their own State with respect to fraud and deceit (including broker-dealer sales practices) in connection with **any** securities or **any** securities transactions, **whether or not**

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permissible boundaries for state regulation, providing that nothing in the amending section would impair the authority of state regulatory authorities "to make and enforce rules governing such person which are not inconsistent with this chapter and the rules and regulations thereunder." *See* 15 U.S.C. § 78q-1(d)(4). The phrase "consistent with" as it appears in the savings clause does not equate with these clear enunciations of Congressional intent. Suggestions to the contrary are overcome by the phrase "except as otherwise provided" in the preemption clause, and by the legislative history discussed in text confirming that Congress intended the regulatory restrictions to be "subject to" the states' antifraud authority.

> **such securities or transactions are otherwise preempted from state regulation by Section 18.**

Id. at 34 (emphasis added.).

The House Report contains yet further proof in the form of examples establishing that under the savings clause, states may prohibit the use of a prospectus if it contains false information *or* omits material information.

> If, however, a State had undertaken an enforcement action that alleged, for example, that the prospectus contained fraudulent financial data or failed to disclose that principals in the offering had previously been convicted of securities fraud, it is conceivable that State laws regarding fraud and deceit could serve as the basis of a judgment or remedial order that could include a restriction or prohibition on the use of the prospectus or other offering document or advertisement within that State. The Committee does not intend Section 18 to be interpreted in a manner that would prohibit such judgments or remedial orders.

Id. at 34. The meaning of the examples is clear: if a state brings an enforcement action based upon claims of fraud or deceit, as the California Attorney General has done in this case, then it may seek remedial orders that ban the use of fraudulent offering documents, whether or not the securities at issue otherwise fall under the preemption provisions of NSMIA.[33]

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[33] NSMIA also reallocated the responsibility for regulating investment advisers (IA's), granting the states authority to register smaller IA's and granting the SEC authority to register larger IA's. *See* 15 U.S.C. § 80b-3a(a) (establishing a $25 million dividing line between state and federally licensed IA's). Once again, however, Congress emphasized the importance of state enforcement by preserving the states' antifraud authority as to all IA's, including federally licensed IA's. *See* 15 U.S.C. § 80b-3a(b)(2). The savings language used in this section of NSMIA is similar to the savings clause at issue in this appeal. The SEC's interpretation of that language supports the California Attorney General in this case. In its release proposing rules to implement the new regime for IA regulation, the SEC cautioned that states could not seek to regulate federally registered IA's

C. The States Unquestionably Had The Right To Bring This Action Prior To NSMIA, So It Is Equally Proper Today, Because In NSMIA Congress Intended To Preserve The States' Traditional Antifraud Authority

The scope of the states' antifraud authority prior to NSMIA lends further support to California's position in this case, given Congress' resolve not to alter that authority in any way. The statute, the House Report, and the Conference Committee Report demonstrate that Congress intended to preserve all of the fraud authority that the states had been exercising prior to the enactment of NSMIA.

The title of the savings clause is "Preservation of Authority," and the body of the clause specifies that states shall "retain" their jurisdiction to bring enforcement actions with respect to fraud or deceit. 15 U.S.C. § 77r(d)(1). The House Report repeatedly affirms this goal of the statute: "The Committee intends to **preserve** the ability of the States to investigate and bring enforcement actions under the laws of their own State with respect to fraud and deceit." House Report at 34 (emphasis added). Elsewhere the House Report states that "[i]t is also the Committee's intention **not to alter**, limit, expand, or otherwise affect in any way any State statutory or common law with respect to fraud and deceit . . . ." *Id.* at 34 (emphasis added). And the Report of the House Conference Committee observes that "[t]he Managers have preserved the authority of the states to protect investors through application of state antifraud laws. This

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indirectly by applying requirements governing dishonest and unethical business practices, "**unless** the prohibited practices would be fraudulent absent the requirements." *See* Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1601, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,872 (Dec. 20, 1996). In other words, the misconduct of even federally registered IA's is fair game for state enforcement authorities, provided that states are pursuing genuine fraud claims, not practices that, while dishonest and unethical, fall short of being fraudulent.

preservation of authority is intended to permit state securities regulators to **continue to exercise** their police power to prevent fraud and broker-dealer sales practice abuses . . . ." H.R. CONF. REP. NO. 104-864, at 40 (1996) ("Conference Report") (emphasis added);[34] s*ee also* LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION, at 64 (3rd Ed. 1989) (NSMIA "**does not diminish** state authority to investigate and bring enforcement actions generally with respect to securities transactions") (emphasis added).

There is no question that prior to NSMIA, the states were free to bring enforcement actions alleging fraud in any type of offering document, regardless of whether or not the document pertained to a nationally traded security. The states were also free to seek injunctive relief or administrative orders limiting or prohibiting the use of such fraudulent documents. At their inception, the federal securities laws expressly preserved state jurisdiction over all types of securities. *See* 12 JOSEPH C. LONG, BLUE SKY LAW § 5.1 (2005) (states exercised plenary parallel authority with federal regulators after passage of the 1933 and 1934 Acts). The federal securities Acts of 1933 and 1934 each contain broad savings clauses that preserve state statutory and 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

[34] In one of the more perplexing sections of its opinion, the lower court seems to suggest that California's claims do not enjoy the protections of the savings clause because they are distinct from the "common law fraud and deceit claims contemplated by Congress." Ruling and Order at 16. The court's premise is incorrect. The savings clause encompasses enforcement actions by state agencies alleging fraud and other misconduct, and those enforcement actions are invariably based upon statutory provisions. *See* 15 U.S.C. § 77r(c)(1); *see also, e.g.,* UNIF. SEC. ACT OF 2002, §§ 501 (general antifraud provision), 603 (right to seek injunctive relief), 604 (right to seek fines and other remedies). Moreover, the legislative history declares that Congress did not intend to alter any "State **statutory** or common law with respect to fraud or deceit." Conference Report at 34 (emphasis added). Thus, the savings clause obviously shields claims under the California Corporations Code from preemption, as well as claims under the common law.

other rights and remedies that may exist at law or in equity." 15 U.S.C. § 77p(a); *see also* 15 U.S.C. § 78bb(a) (savings clause in 1934 Act). These savings provisions apply to state common law as well as statutory law, and they also preserve state laws enacted subsequent to 1933 and 1934. *See Rousseff v. Dean Witter & Co.*, 453 F. Supp. 774, 780 (N.D. Ind. 1978); s*ee also IDS Bond Fund, Inc. v. Gleacher Natwest Inc.*, No. CIV. 99-116 (MJDJGL), 2002 WL 373455 (D. Minn. 2002) (further evidence that NSMIA does not preempt state fraud claims is that Congress did not amend the 1933 and 1934 Act savings clauses). In fact, Congress has never limited the authority of state securities regulators to bring actions for fraud and deceit in the offer and sale of securities.[35]

Prior to NSMIA, state securities regulators, criminal prosecutors, and private plaintiffs routinely sought remedies under state law for fraudulent misrepresentations and omissions in prospectuses and other offering documents. The case law is full of examples, some dating back almost a century. Many involved requests for injunctive relief or the administrative equivalent of a cease and desist order, and in some instances, they even involved what would presumably be classified as a "covered security" under NSMIA. For example, in *State v. First Investors Corp.*, 592 N.Y.S. 2d 561 (Sup. Ct. N.Y. County 1992), the New York Attorney General brought a securities fraud action for injunctive relief against a mutual fund and its affiliates specializing in junk bonds. Although the fraud was perpetrated through both oral and written materials, a core allegation was that principals of the operation declared massive dividends for themselves shortly after disseminating a misleading prospectus

[35] In 1998, Congress passed the Securities Litigation Uniform Standards Act to restrict class actions based on state antifraud law. 15 U.S.C. § 77p(b). But as with NSMIA, Congress expressly preserved the jurisdiction of state regulators to "investigate and bring enforcement actions." 15 U.S.C. § 77p(d).

suggesting that such dividends were unlikely in the near future. *Id.* at 564. The court found it probable that the State would prevail on its securities fraud claim under New York law. *Id.* at 566.

A sampling of the civil, administrative, and criminal case law at the state level includes these additional decisions: *State v. Moore,* 802 P.2d 732, 734 (Utah Ct. App. 1990) (criminal prosecution for fraud under state securities law for misrepresentations and omission in prospectus used to sell promissory notes for factoring business); *Hines v. Data Line Systems, Inc.,* 787 P.2d 8, 11-12 (Wash. 1990) (private action for fraud under state securities law where prospectus disclosed that success of company depended on key officer, but failed to disclose that key officer had recently experienced brain aneurysm); *In the Matter of Yorkshire Ventures, Inc.*, SE8800451, 1988 WL 281997, at *1, 2 (Minn. Dept. of Commerce, Mar. 31, 1988) (administrative enforcement action under state securities law for fraudulent misrepresentations and omissions in prospectus regarding use of funds being raised); *Kaplan v. Ritter,* 519 N.E. 2d 802, 804 (N.Y. 1987) (criminal prosecution under state securities law, in which court observed that "the securities fraud and larceny counts were predicated specifically on petitioner's failure to disclose the bribe transaction in the Citisource stock prospectus, resulting in defrauding of 'members of the public . . . ."); *State v. Goodrich*, 726 P.2d 215, 220 (Ariz. Ct. App. 1986) (enforcement action under state securities law for omissions of material fact in prospectuses and in oral representations concerning financial condition, business background, and prior disciplinary history); *Danzig v. Superior Court of Alameda County,* 87 Cal. App. 3d 604, 607 (Cal. Ct. App. First Dist. 1978) (class action under state law for securities fraud in prospectus); *People v. Kaufman & Broad Homes of Long Island, Inc.,* 378 N.Y.S. 2d 258, 261 (County Ct., Rockland County, NY 1975) (criminal prosecution under state securities law for fraudulent prospectus and other filings in sale of condominium units), *aff'd,* 393 N.Y.S. 2d 144 (N.Y. App. Div. 1977); *Curtis v. State,* 118 S.E. 2d 264, 798 (Ga. Ct. App. 1960) (criminal prosecution under state securities law for fraud in sale of stock, including false statements in prospectus that officers were bonded and false statements about investments the company would make); *Coughlin v. State Bank of Portland,* 243 P. 78, 83 (Or. 1926) (suit under state law for misrepresentations in reports of bank's financial condition, in which court observed the general rule that a "corporation and its officers and directors may be liable to persons who are induced to purchase stock by reason of false statements in stock certificates, or in prospectuses or reports, issued by them . . . ."); *State v. Whiteaker,* 129 P. 534, 535 (Or. 1913) (criminal prosecution under state law for fraud involving prospectus issued by oil company); *Lane v. Fenn,* 146 A.D. 205, 208 (N.Y. App. Div. 1911) (action for damages under state law for fraud and deceit in prospectuses for stocks and bonds issued by United States Independent Telephone Company).

Congress is presumed to have been familiar with this body of law when it enacted NSMIA and declared its intention to preserve – without any alteration – state statutory and common law with respect to fraud and deceit.[36] *See Estate of Wood v. Commissioner of Internal Revenue,* 909 F.2d 1155, 1160 (8th Cir. 1990) ("[I]t is proper to consider that Congress

[36] The long list of cases predating NSMIA, cited in text, highlights another error in the lower court's ruling. The lower court found that "the presumption against preemption does not apply under the facts of this case" because, in its view, "there is no authority for the proposition that the regulation of statements in prospectuses or offering documents has traditionally been governed by state law." Ruling and Order at 20. If by "regulation" the court meant registration and merit review, then the court was plainly wrong: the whole point of NSMIA was to end the states' traditional regulatory function with respect to covered securities and prospectuses and offering documents. If by "regulation" the court meant enforcement, then the cases cited in text prove the opposite of the court's statement: state statutory and state common law has frequently been applied to fraudulent prospectuses and offering documents for at least a century. Accordingly, the presumption against preemption does apply in this case, and, contrary to the lower court's finding, the Appellees have failed to overcome it.

acts with knowledge of existing law, and that 'absent a clear manifestation of contrary intent, a newly-enacted or revised statute is presumed to be harmonious with existing law and its judicial construction'") (quoted authority omitted). California's allegations in this case are fundamentally no different from the claims for securities fraud reflected in the case law predating NSMIA – omissions of material information in offering documents. Under NSMIA, therefore, California's claims are saved from preemption.

D. The Case Law Applying NSMIA Strongly Supports California's Right To Pursue This Fraud Action

Relatively few courts have had occasion to address the impact of NSMIA on enforcement actions or civil suits alleging securities fraud under state law, but the courts that have decided the issue have consistently ruled against preemption. For example, the Kentucky Court of Appeals recently rejected a claim that NSMIA preempted the authority of the Kentucky Division of Securities to enforce an investigative subpoena. *See Target Oil & Gas Corp. v. Commonwealth of Kentucky,* No. 2004-CA-001947-MR, 2006 WL 1443980 (Ky. Ct. App. May 26, 2006). The Division had issued the subpoena to investigate possible fraud in the marketing of an oil company stock. *Id.* at *1. The court held that even if the company's securities were deemed "covered" within the meaning of NSMIA and therefore exempt from registration under Kentucky law, the savings clause allowed the Division to investigate the possibility that the company had misled its investors. *2-3. The court drew no distinction between the Division's jurisdiction over fraudulent written materials and fraudulent oral solicitations. *3, 4.

In *Galvin v. The Gillette Co.,* No. 051453BLS, 2005 WL 1155253, (Mass. Super. Ct. Apr. 28, 2005), the Massachusetts Secretary of State, in his capacity as the state's securities regulator, was investigating whether two broker-dealers had issued fraudulent fairness opinions in connection with a proposed merger of Gillette and Procter & Gamble. While conceding that NSMIA may have preempted the Secretary's authority to review or take action with respect to the merger, *id.* at *7, the court upheld the Secretary's authority to investigate "whether fraud may be present where registered broker-dealers have issued 'fairness opinions' . . . ." *Id.* (quoting the Secretary's stated purpose for the investigation). The court based its ruling on the savings clause, which reflected an intent to preserve state authority: "Congress, rather clearly, intended that state regulators be free in their ability **to continue** to investigate for fraud in connection with securities and securities transactions." *Id.* (emphasis added); *see also State v. Justin*, 779 N.Y.S. 2d 717, 736, 738-39 (N.Y. Supreme Ct. 2003) (federal law did not preempt Attorney General's fraud claim based on broker-dealer's failure to supervise agents selling payphone investments, based on savings clauses in NSMIA and in the 1933 and 1934 federal securities acts).

Other cases involve defendants invoking NSMIA in an effort to preempt *private* actions for fraud and deceit, but those decisions also support California's right to proceed in this case. In *Zuri-Invest AG v. Natwest Finance, Inc.*, 177 F. Supp. 2d 189 (S.D.NY. 2001), the plaintiffs sued an adviser and various underwriters for securities fraud in connection with investments in a company operating an overseas steel mill. The federal district court emphatically rejected a preemption defense under NSMIA. First the court held that express preemption did not apply, relying on statements in the legislative history establishing that Congress did not intend to "alter, limit, expand, or *otherwise affect in any way* any State statutory or *common law with respect to fraud and deceit.*" *Id.* at 193-94, citing Conference Committee Report (emphasis supplied by court). The court observed that "[a] more clear cut statement against preemption would be hard to find." *Id.* The court also held that implied preemption did not apply, because state law fraud claims "easily coexist" with the regulatory requirements imposed by NSMIA. *Id.* at 196; *see also IDS Bond Fund, Inc. v. Gleacher Natwest Inc.*, No. CIV. 99-116 (MJDJGL), 2002 WL 373455 (D. Minn. 2002) (NSMIA did not impliedly preempt state law claims for fraud in Offering Memorandum; state law did not impede Congress's purpose because state law and federal law prohibited the same fraudulent conduct).

In *Patterman v. The Travelers, Inc.*, 11 F. Supp. 2d 1382 (S.D. Ga 1997), the plaintiffs alleged that the defendants had fraudulently induced them to convert whole life insurance policies into term policies and mutual fund shares. *Id.* at 1384-85. The defendants countered that NSMIA "completely pre-empted state regulation of mutual fund disclosure documents." *Id.* at 1386. The federal district court read NSMIA's preemption clause much more narrowly: "[n]either the text of the statute nor its legislative history manifest Congress' intent to completely pre-empt state law claims within NSMIA's scope." *Id.* at 1387. *Patterman* and *Zuri-Invest* are significant in part because the court sustained plaintiffs' mutual fund related fraud claims even without the benefit of a savings clause expressly preserving private lawsuits. NSMIA's silence on the issue of civil enforcement, the legislative history reflecting an intent to preserve both statutory and common law claims under state law, and the savings clauses found in other federal securities laws all warranted rejection of the defendants' preemption defense. *See also* 12 JOSEPH C. LONG, BLUE SKY LAW, § 5:24 (2006) (observing that state agencies "retain their ability to enforce antifraud provisions against exchange-listed and other covered securities, both in connection with initial offering of these securities or in the secondary trading therein"), and § 4:48 (NSMIA did not "restrict in any way the antifraud jurisdiction of the states").

The principles enunciated in these cases apply here as well and support the Attorney General's right to bring these fraud claims: Congress intended to preserve, not restrict, the states' antifraud authority in NSMIA, and prohibitions against fraud under state law do not interfere with the federal government's regulation of covered securities.

II. California's Enforcement Action Creates No Actual Conflict With Federal Law, Nor Does It Thwart The Accomplishment Of Congressional Objectives.

Even in the absence of express preemption, state law may be preempted to the extent it conflicts with federal law. *See Zuri-Invest AG v. Natwest Fin., Inc.,* 177 F. Supp. 2d 189, 195 (S.D.N.Y. 2001). 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." *Id.* (internal quotations and cited authorities omitted). In this case, neither form of conflict preemption applies.[37]

[37] The third type of preemption, known as "field preemption," is not at issue in this appeal. Field preemption requires the extraordinary showing that the federal scheme of regulation is "so pervasive as to make reasonable the inference that Congress left no room for the State to supplement it," or that the federal statute in question "touch[es] a field in which the federal interest is so dominant that the federal system will be assumed to preclude enforcement of state laws on the same subject." *See Zuri-Invest AG v. Natwest Fin., Inc.,* 177 F. Supp. 2d 189, 195 (S.D.N.Y. 2001) (quoting *Rice*, 331 U.S. at 219). Few statutes have been held to preempt state regulation entirely, and "[i]t is well-settled that federal law does not enjoy complete preemptive force in the field of securities." *Zuri-Invest AG,* 177 F. Supp. 2d at 195; *see also Jevne v. Superior Court,* 111 P.3d 954, 964 (Cal. 2005) (noting that because the 1934 Act contains two savings clauses, field preemption is not at issue, but holding that California ethics rules for arbitrators were preempted under a conflicts analysis).

A. California's Antifraud Provisions Do Not Impose Any Standards Of Conduct That Conflict With Federal Laws Or Regulations Governing Offering Documents.

The lower court correctly perceived that this case does not involve an actual conflict between state and federal requirements. The court acknowledged that "it may not be 'impossible' to comply with California's Corporate Securities Law and NSMIA, as it applies to disclosures in offering documents." Ruling and Order at 18. California's effort to prohibit fraud in this case obviously generates no conflict with the same prohibitions against fraud under federal law. Nor does California's enforcement action conflict with the federal laws or regulations governing prospectus disclosure. Nothing in any federal laws or regulations either *prevents* the Appellees' from making full and fair disclosure in accordance with California law or *excuses* their failure to do so. Put another way, federal law does not require or permit fraudulent misrepresentations or omissions in offering documents any more than California law does.

Far from being in conflict, the state and federal laws applicable in this case are strongly aligned. As demonstrated in the enforcement actions discussed above, all federal and state agencies view the conduct alleged in this action as unlawful and fraudulent. Under both federal and state law, the Appellees and similarly situated companies must disclose all material information that is necessary for investors to understand fully the costs and conflicts of interests arising from shelf-space agreements. There is no conflict between state law and federal law in this case.

B. The Application Of State Antifraud Law In Cases Such As This Advances The Cause Of Investor Protection Without Interfering With Any Congressional Objectives

This case is also devoid of the more abstract form of conflict recognized in the law of preemption. The application of state antifraud provisions to offering documents for covered securities does not "stand as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress," either in this case or as a general proposition. *See Zuri-Invest AG*, 177 F. Supp. 2d at 195. The lower court's ruling to the contrary was erroneous and should be reversed.

Congress's primary purpose in enacting NSMIA was to "further advance the development of national securities markets and eliminate the costs and burdens of duplicative and unnecessary regulation by, as a general rule, designating the federal government as the exclusive regulator of national offerings of securities." *See* Commerce Report at 16. At the same time, Congress sought to avoid compromising investor protection, which has always been and remains to this day one of the paramount objectives of the federal securities laws. *See* House Report at 16 (noting the legislation seeks to promote efficiency, competition, and capital formation "without compromising investor protection"); *see also* H.R. CONF. REP. NO. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 731 (emphasis added) ("The *overriding* purpose of our nation's securities laws is to protect investors and to maintain confidence in our capital markets"); *Rousseff v. Dean Witter & Co.*, 453 F. Supp. 774, 781 (N.D. Ind. 1978) (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).

Allowing states to apply their antifraud provisions to offering documents, as California has done in this case, serves both of these goals: it does not interfere with federal regulation of the national markets, yet it furthers the cause of investor protection. Accordingly, even under the second conflicts test, NSMIA does not preempt this or similar state enforcement actions.

The enforcement of state antifraud provisions does not undermine the federal government's role as the principal regulator of national securities offerings. The allocation of responsibility between the federal and state governments under NSMIA reflects two distinct but fundamentally compatible roles: regulation and enforcement. The federal government's regulatory role with respect to national securities offerings is one of adopting prescriptive rules to guide industry and registering securities offerings before they are marketed to ensure facial compliance with those rules. *Cf. Zuri-Invest AG,* 177 F. Supp. 2d at 197 (the term "regulation" most naturally refers to positive enactments by state legislatures and federal agencies, not common law damages actions). The role preserved for the states is one of initiating enforcement actions after securities are offered and sold, to address specific instances of fraud or deceit. The savings clause reflects Congress's recognition that it could preserve the states valuable enforcement role in policing fraud without impinging upon the federal government's regulatory role.

The federal regulations applicable to the registration of nationally offered securities reflect this distinction between regulatory requirements and general prohibitions against fraud. The regulations also confirm that these two legal standards are compatible and complementary. In hundreds of pages of regulations, along with the Form N-1A, the SEC has set forth extensive regulatory disclosure requirements that mutual funds must observe in their registration statements and prospectuses. *See* 17 C.F.R. §§ 230.400 – 479; §§ 480 – 488; §§ 495 – 498; 490 – 494; *see also* 17 C.F.R. § 274.11A (requiring the Form N-1A to be used as the registration statement for open-end investment companies). Those requirements specify categories of information to be addressed in the prospectus, as well as strict formatting standards governing everything from paper size to wording and sentence structure.

The regulations also make clear, however, that compliance with the regulatory mandate is separate and distinct from the additional obligation to comply with the general antifraud provisions in the federal securities laws. *See* 17 C.F.R. § 230.408 (in addition to information expressly required by the regulations, registration statements must include "such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they were made, not misleading"); *see also* 17 C.F.R. § 240.10b-10 (requirement that particular information be disclosed "is not determinative of a broker-dealer's obligation under the general antifraud provisions of the federal securities laws to disclose additional information to a customer at the time of the customer's investment decision"); 17 C.F.R. § 270.34b-1 (the fact that sales literature includes specified information does not relieve investment company, underwriter, or dealer of any obligations under antifraud provisions of the federal securities laws).

Thus, embedded in the regulatory scheme is an acknowledgement that rules and regulations are not sufficient to ensure honesty and fair dealing in the marketplace. The more general legal duty to refrain from fraud is essential because no amount of rulemaking "is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946).

State antifraud prohibitions coexist peacefully with the federal regulations, just as the federal antifraud prohibitions do. *Cf. Zuri-Invest AG*, 177 F. Supp. 2d at 196 (state law damages action "easily coexists" with the regulatory requirements under NSMIA). Requiring companies to tell the truth and the whole truth in their offering documents under state law does not intrude upon the SEC's regulatory authority. It merely enforces a general, preexisting obligation to be honest, which has been at the heart of federal and state securities laws since they were first enacted during the early 1900's. Moreover, state antifraud provisions are uniform in relation to the federal antifraud provisions, so the application of state antifraud law imposes no additional burdens upon the national markets. *See* LOSS, SECURITIES REGULATION, at 4134 (UNIF. SEC. ACT OF 1956 § 410(a), imposing civil fraud liability, tracks Section 12 of the Securities Act of 1933); *id.* at 70 (UNIF. SEC. ACT OF 1956 § 101, prohibiting fraud, tracks Section 17(a) of the Securities Act of 1933 and Rule 10b-5 promulgated under the Securities Exchange Act of 1934). State antifraud provisions are also uniform among the states, so the application of state antifraud law does not create a patchwork of inconsistent obligations that industry participants must satisfy.[38] As stated in *Zuri-Invest*, "'[s]tate law prohibitions on false statements of material fact do not create 'diverse, non-uniform, and confusing' standards.'" *Zuri-Invest AG,* 177 F. Supp. 2d at 197, quoting *Cippollone v. Liggett Group Inc.,* 505 U.S. 504, 528-29 (1992). In short, state antifraud law poses no threat either to the "development of national markets" or to the elimination of "unnecessary regulation." House Report at 16.

[38] 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. Most states have adopted a version of the 1956 Uniform Act. *See* UNIF. SEC. ACT § 101, U.L.A. 1 (1956) (table of adopting states). A number of states have adopted a version of the 1985 Uniform Act. *See* UNIF. SEC. ACT § 101, U.L.A. 1 (1985) (table of adopting states). The 2002 Uniform Act is in the relatively early stages of consideration in the state legislatures, but it too is gaining adherents. *See* UNIF. SEC. ACT § 101, U.L.A. 1 (2002) (table of adopting states). The three uniform acts are similar, in part because the drafters modeled many of the core provisions on corresponding language in the federal securities laws to promote uniformity and state-federal coordination. The result is significant uniformity among state securities laws, especially with respect to the antifraud provisions.

The legislative history of NSMIA reflects a concern that the states might abuse their antifraud authority by invoking state laws against fraud or deceit as the basis for imposing on covered securities the kind of regulatory requirements reserved to the federal government. See House Report at 34; Conference Report at 40. This concern about the possible misuse of state antifraud authority is unfounded. With respect to this enforcement action, the Attorney General's allegations are without question bona fide claims for fraud that fall within the letter and the spirit of the savings clause. The Complaint on its face stakes out a strong case for fraud and deceit, and the innumerable enforcement actions brought by the SEC for the same type of misconduct under the corresponding federal antifraud provisions remove any doubt. The Attorney General certainly is not seeking to conduct a merit review of the Appellees' mutual fund offerings, nor is he attempting to outlaw shelf-space agreements or otherwise interfere with federal regulatory requirements. His goal is simply to ensure that those agreements are fully and fairly disclosed. As he explained when he announced his office's investigations into the shelf-space abuses: "Our laws governing securities transactions rest on a simple principle: Investors must be told the truth, the whole truth . . . . when they make investment decisions that affect their lives and futures." *See* Press Release, CA Office of the Attorney General, Attorney General Lockyer Launches Investigation of Fraudulent Sales Practices by Mutual Funds (Jan. 2, 2004);[39] *see also* Press Release, CA Office of the Attorney General, Attorney General Lockyer Announces $9 Million Settlement with PA Distributors in PIMCO Fund Case, cited *supra* (Sept. 15, 2004) ("California workers and retirees deserve complete honesty and full disclosure when they make decisions to invest their hard-earned money . . . . Our securities laws rest on that foundation. To protect

[39] *Available at* http://ag.ca.gov/newsalerts/release.php?id=567.

investors, strong enforcement of these laws is crucial"). This case is an effort by the Attorney General to protect the citizens of his state from fraud and abuse as contemplated by NSMIA. It is not a threat to the federal government's regulatory authority.

There was also no justification for the court's more general prohibition on the states' right to allege fraud in offering documents. NSMIA establishes a clearly discernable boundary line between permissible exercise of state fraud authority and impermissible regulation. In order to apply its authority under the savings clause, a state must (a) initiate an enforcement action, and (b) allege fraud or deceit, or unlawful conduct by a broker-dealer. *See* 15 U.S.C. § 77r(c). State securities regulators have been bringing such enforcement actions for almost a century, and during that time the courts have been adjudicating those claims and developing an extensive jurisprudence on the law of fraud. The judicial system is well-equipped to determine if a state's enforcement action falls within the scope of the savings clause.

Concern about state encroachment upon the regulatory role reserved to the federal government is unfounded for other reasons as well. State securities regulators have neither the inclination nor the resources to venture across the jurisdictional divide that Congress has established.[40] Philosophically, states have accepted NSIMIA's allocation of regulatory and enforcement responsibility between the states and the federal government. When NASAA offered testimony on the bill leading to NSMIA, the association's president Dee Harris acknowledged "the

[40] Experience over the last decade since NSMIA was enacted proves the point. State regulators simply have not attempted to abuse their antifraud authority. The defendant in *Gillette,* 2005 WL 1155253, discussed in text *supra*, apparently raised the argument. The court rejected the defendants' attribution of improper motive for the investigation, *id.* at *8, and upheld the Secretary's right to subpoena documents, provided they fell within the parameters of a fraud investigation, *id.* at *9.

appropriateness of exempting, for purposes of State registration and review, those companies listed or eligible for listing" on the national exchanges. *See* Statement of Dee R. Harris, cited *supra*, at 5; *see also* 12 JOSEPH C. LONG, BLUE SKY LAW § 5.11 (2006) (most states exempted exchange-listed securities from registration well before NSMIA was enacted, as reflected in section 402(a)(8) of the UNIF. SEC. ACT OF 1956); UNIF. SEC. ACT OF 2002, Prefatory Note, at 3 (overarching purposes of the new uniform act are first, to articulate more clearly the objectives of uniformity and cooperation among state and federal governments, and second, to achieve consistency with the preemption provisions of NSMIA). State regulators are motivated not by an urge to reclaim lost regulatory jurisdiction, but rather by a genuine desire to abolish fraudulent practices that hurt everyday investors in their states and across the country.

Apart from motive, state securities regulators lack the resources to address technical defects in national securities offerings through the expensive process of initiating fraud actions. *See The Role of State Securities Regulators in Protecting Investors, Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, at 2 (June 2, 2004) (statement of Joseph P. Borg, Director, Alabama Securities Commission; Chairman, NASAA Enforcement Section) (citing national, multistate enforcement actions dating back to early 1990's, but also focusing on the "more routine caseload" involving sales practice abuses "at the local level day in and day out").[41] With respect to national offerings, states generally expend their resources only when a fraudulent practice – such as the one at issue in this case – has infected the securities industry so thoroughly that state and federal enforcement authorities must bring their combined

[41] *Available at* http://www.nasaa.org/Issues___Answers/Legislative_Activity/Testimony/1167.cfm.

resources to bear. The high profile cases discussed above illustrate the type of systemic fraud that prompts states to act. In short, NSMIA sets forth clearly defined prerequisites for state enforcement action and the states have neither the desire nor the resources to circumvent these limitations or to encroach upon the federal government's regulatory jurisdiction over covered securities. In light of these considerations, the lower court's ruling was an unnecessary and lamentable restraint on the states' historic authority to protect investors.

The real risk is this case is not that state securities regulators will invoke their fraud authority to pursue preempted regulation. Rather, it is just the opposite: that the nation's most powerful Wall Street firms will cry "preempted regulation" in an effort to shield genuinely fraudulent practices from the legitimate exercise of state enforcement authority. This Court should not allow the preemption doctrine to be used in this fashion, and it should reverse the lower court's ruling so that the Attorney General's claims can proceed on the merits.

CONCLUSION

For the reasons set forth above, the Court should reverse the Ruling and Order below.

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CERTIFICATE OF WORD COUNT

Pursuant to Rule 14(c)(1) of the California Rules of Court, the undersigned hereby certifies that this BRIEF OF *AMICUS CURIAE* NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., IN SUPPORT OF THE ATTORNEY GENERAL OF THE STATE OF CALIFORNIA, contains 13,252 words, including footnotes, but excluding the Table of Contents, the Table of Authorities, this certificate, and any attachments.

[Signed]

Amy Fan

CERTIFICATE OF SERVICE

I hereby certify that on the 13th of September, 2006, a copy of this BRIEF OF *AMICUS CURIAE* NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., IN SUPPORT OF THE ATTORNEY GENERAL OF THE STATE OF CALIFORNIA was served on the parties and the appropriate courts, in accordance with the rules of this Court, by sending it via Federal Express overnight delivery to the following persons at the following addresses:

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[Signed]

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