No. 03-932

IN THE

Supreme Court of the United States

DURA PHARMACEUTICALS, INC., *et al.*,
Petitioners,

v.

MICHAEL BROUDO, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court Appeals for the Ninth Circuit

BRIEF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS BROUDO *ET AL.*

REX A. STAPLES
General Counsel
STEPHEN W. HALL
Deputy General Counsel
MARK J. DAVIS *
Associate Counsel
NORTH AMERICAN
SECURITIES ADMINISTRATORS
ASSOCIATION, INC.
750 First Street, N.E., Suite 1140
Washington, D.C. 20002
(202) 737-0900

* Counsel of Record

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INTEREST OF THE *AMICUS CURIAE*

The North American Securities Administrators Association, Inc. ("NASAA"), is the nonprofit association of state, provincial, and territorial securities regulators in the United States, Canada, and Mexico. It has 66 members, including the securities regulators in all 50 states, the District of Columbia, and Puerto Rico. Formed in 1919, it is the oldest international organization devoted to protecting investors from fraud and abuse in the offer and sale of securities.[1]

[1] Pursuant to Sup. Ct. R. 37.6, NASAA represents that no counsel for any party authored this brief in whole or in part, and no person or entity, other than NASAA, its members, or its counsel, made any monetary

The U.S. members of NASAA are responsible for administering state securities laws and regulations. Their activities include licensing firms and their agents, investigating violations of state law, and filing enforcement actions when appropriate. State securities regulators often seek restitution from wrongdoers in enforcement actions to help make injured investors whole. They also promote the adoption and interpretation of state and federal laws that will advance the cause of investor protection.

NASAA supports the work of its members through training programs, investor education initiatives, enforcement support, legislative analysis, and advocacy in the courts. An important role of the association is representing the membership's position, as *amicus curiae*, in significant cases involving the interpretation of the securities laws and the rights of investors. NASAA and its members have a stake in the outcome of this appeal because it will have a widespread impact upon the ability of investors to seek redress in cases where unscrupulous issuers, promoters, or corporate executives have perpetrated a fraud on the market.

The Ninth Circuit correctly ruled that in an action under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), plaintiffs alleging fraud on the market meet their burden on loss causation if they plead and prove that the stock price on the date of purchase was inflated because of the defendants' misrepresentations. *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F. 3d 933, 938 (9th Cir. 2003). The court rightly rejected the unrealistic and onerous requirement that there be proof of a "stock price drop following a corrective disclosure" regarding the misrepresentations previously disseminated. *Id.* If this Court were to reverse the lower court

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contribution to the preparation or submission of the brief. Pursuant to Sup. Ct. R. 37.3, NASAA further represents that both parties to this appeal consented to the filing of this *amicus* brief. Copies of their written consents are being filed with this brief.

and establish the more burdensome standard as the federal rule on loss causation, many victims of securities fraud will lose the opportunity to recover their damages. Accordingly, on behalf of its members, NASAA has an interest in supporting the Respondents and advocating for affirmance.

SUMMARY OF THE ARGUMENT

The Ninth Circuit correctly held that plaintiffs seeking recovery under Section 10(b) of the 1934 Act for a fraud on the market can satisfy their pleading burden as to the element of loss causation by alleging that the stock price on the date of purchase was inflated because of the defendants' misrepresentations. The rule advanced by the Petitioners, suggesting that plaintiffs must instead allege a corrective disclosure followed by a price drop in order to survive a motion to dismiss, should be rejected. The federal statute at issue does not impose this requirement, the more burdensome standard is unnecessary to protect wrongdoers from baseless claims, and application of the Petitioners' restrictive rule thwarts the goals of the federal securities laws by depriving injured investors of a judicial remedy for fraudulent misconduct.

ARGUMENT

I. THE NINTH CIRCUIT'S FORMULATION OF THE LOSS CAUSATION STANDARD SERVES THE PURPOSES OF THE FEDERAL SECURITIES LAWS WITHOUT COMPROMISING THE AIMS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT

The Ninth Circuit ruled that the burden of pleading loss causation is met where the complaint (1) alleges that the stock price at the time of purchase was overstated, and (2) sufficiently identifies the cause of the overvaluation. *Broudo*, 339 F.3d at 939. This formulation of the loss causation standard is correct because it is supported by the plain language of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Congressional intent as expressed in the legislative history, and most importantly, the policies underlying the federal securities laws. The Ninth Circuit's ruling should therefore be affirmed.

In PSLRA, Congress codified the loss causation standard in simple terms: "[T]he plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." *See* Section 21D(b)(4) of PSLRA, 15 U.S.C. § 78u-4(b)(4). Congress thus adopted the common law element of loss causation, but it did not require the plaintiff to prove that element according to any particular formula. The language of the statute offers no support for the Petitioners' contention that causation can only be established through the often unattainable evidence of a corrective disclosure followed by a price drop. Under PSLRA, it is quite sufficient for plaintiffs to plead and prove that "the price on the date of purchase was inflated because of the misrepresentation." *See Broudo*, 339 F.3d at 938, quoting *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996), *cert. denied*, 519 U.S. 1112 (1997).

The legislative history of PSLRA supports this reading of the statute. In explaining the causation requirement set forth in Section 21D(b)(4) of PSLRA, 15 U.S.C. § 78u-4(b)(4), the Conference Report states: "For example, the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission." H.R. Conf. Rep. No. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740. The Ninth Circuit's ruling conforms precisely to this expression of legislative intent. Exactly how a plaintiff satisfies this burden of proof is a matter that Congress left to be determined at trial, not at the pleading stage and not pursuant to the rigid formula advocated by the Petitioners. While proof of a corrective disclosure followed by a drop in the stock price might serve in a particular case as evidence of the degree of price inflation, it is not, and should not be, the exclusive road to recovery. *See Blackie v. Barrack*, 524 F.2d 891, 909 n.25 (9th Cir. 1975) (post-disclosure drop in price is circumstantial evidence of inflation at the time of purchase, but it is not the exclusive measure of inflation), *cert. denied*, 429 U.S. 816 (1976); Michael J. Kaufman, *Loss Causation: Exposing a Fraud on Securities Law Jurisprudence*, 24 Ind. L. Rev. 357, 389 (1991) ("post transaction declines . . . may at most provide the evidentiary starting point for an analysis of the amount by which the fraud altered the transaction price").

The Petitioners counter by arguing that in PSLRA, Congress intended to adopt the rule of loss causation set forth in case law existing at the time of the statute's enactment. *See* Petitioners' Opening Brief at 22-26. Assuming this claim is true, it does not support the Petitioners' analysis of loss causation. The two cases they cite that predate enactment of PSLRA *do* stand for the proposition that plaintiffs must establish loss causation, but they *do not* stand for the proposition that plaintiffs must do so only through an analysis of the market's reaction to corrective disclosures. For example, in *Huddleston v. Herman & MacLean*, 640 F.2d 534 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983), the court formulated the out-of-pocket measure of damages in terms of "the difference between the price paid and the 'real' value of the security, i.e., the fair market value absent the misrepresentation, *at the time of the initial purchase by the defrauded buyer.*" *Id.* at 556 (emphasis added). The court acknowledged the formidable "valuation problems" flowing from this rule, but nowhere indicated that the answer necessarily lies in post-disclosure price movements. *Id.*

In *Bastien v. Petren Resources Corp*., 892 F.2d 680 (7th Cir.), *cert. denied*, 496 U.S. 906 (1990), also cited by the Petitioners, the Seventh Circuit held that loss causation was a required allegation, but did not prescribe the corrective disclosure and price deflation formula that the Petitioners urge upon this Court. On the contrary, the court in *Bastien* suggested that industry surveys establishing the general success of oil and gas ventures during the relevant time period would have supported an inference and an allegation that the failure of the defendants' operation must have been due to managerial incompetence. *Id.* at 685. Under *Bastien*, this would have satisfied at least the pleading burden on loss causation, insofar as the subject of the alleged deceit in that case was managerial skill and integrity. *Id.* at 682. Viewed in this light, the *Bastien* decision actually supports the Respondents in this case: it leaves them free to ignore specific disclosures and price movements and to base their pleadings on the general proposition that when a pharmaceutical company's leading drug delivery system is rejected by the FDA, the value and price of the company's shares will fall. In short, neither *Huddleston* nor *Bastien* undercuts the legal foundation for the Ninth Circuit's loss causation rule.[2]

[2] The Petitioners also argue that the Ninth Circuit's ruling on loss causation cannot be reconciled with the "look back" damages provision that Congress adopted in Section 21D(e)(1) of PSLRA, 15 U.S.C. § 78u-4(e)(1). *See* Petitioners' Opening Brief at 15-17. This is incorrect. That provision is an arbitrary cap on the amount of damages that a plaintiff may recover *if* the plaintiff chooses to calculate damages based upon the market price of a stock after the dissemination of corrective information. It does not require causation to be determined according to that formula. Of course, as the Ninth Circuit acknowledged, *see Broudo*, 339 F.3d at 938 n.4, other appellate courts have held that plaintiffs *are* required to demonstrate a corrective disclosure followed by a price drop in order to satisfy the element of loss causation. *See, e.g., Semerenko v. Cendant Corp*., 223 F.3d 165 (3d Cir. 2000), *cert. denied*, 531 U.S. 1149 (2001). In the view of this *amicus*, the rule in those cases is incorrect and should be rejected on the legal and policy grounds discussed above.

The Ninth Circuit's ruling is conceptually sound as well as legally correct. The court was absolutely right in stating that injury occurs at the time the investor pays the inflated price for the stock. *See Broudo*, 339 F.3d at 938. At that point, the investor has been unlawfully deprived of the funds required to pay the fraud-induced component of the stock price. Furthermore, that loss is a direct consequence of the inflationary impact of the defendants' fraudulent misrepresentations. Whether or not the investor is able to recover some portion of that loss is a separate matter of calculating damages. Moreover, investors who are defrauded in this manner suffer an immediate injury that stands entirely apart from whether or not they ultimately recoup some portion of their investment: loss of the use of their money from the moment they invest in the overpriced shares.

The greatest virtue of the Ninth Circuit's ruling is that it serves the underlying purposes of the federal securities laws, whereas the Petitioners' formula undermines those purposes. For decades, this Court has repeatedly declared that the federal securities laws are to be interpreted broadly to effectuate their remedial purposes and to protect investors. *See Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299, 301 (1946). This principle has been applied not only in governmental enforcement actions but in the context of private suits as well. In *Basic Inc. v. Levinson*, for example, the Court held that a presumption of reliance may be applied in fraud-on-the-market cases brought by private litigants, in part because an interpretation of the law "facilitating Rule 10b-5 litigation" supports the Congressional policy embodied in the 1934 Act. *See Basic Inc. v. Levinson*, 485 U.S. 224, 245 (1988). While PSLRA imposed special requirements on private claimants to address certain perceived abuses in class actions, it did not replace investor protection as the preeminent objective of the federal securities laws. When Congress enacted PSLRA, it made this point clear by opening the Conference Report with the following declaration: "The *overriding* purpose of our nation's securities laws is to protect investors and to maintain confidence in our capital markets . . . ." (emphasis added). *See* H.R. Conf. Rep. No. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 731.

The Court reaffirmed this guiding principle last year in *SEC v. Edwards,* 540 U.S. 389, 124 S. Ct. 892 (2003). There the Court held that a pay phone sale and leaseback program was an "investment contract" under federal securities law, notwithstanding the respondent's contention that the program offered investors a fixed, as opposed to a variable, rate of return. The Court unanimously rejected the respondent's technical distinction based on rates of investment return, stating that "We will not read into the securities laws a limitation not compelled by the language that would so undermine the laws' purposes." *SEC v. Edwards*, 124 S. Ct. at 897.

Similarly here, the technical formula advocated by Petitioners will seriously undermine investor protection. Meritorious claims involving frauds on the market will be barred in instances where a discrete disclosure followed by a corresponding price correction cannot be identified because of the defendants' ongoing concealment of their misconduct, a confluence of events that mask price correction, or a host of other factors. In those cases, plaintiffs will be unjustly deprived of the right to receive damages for fraudulent conduct that unquestionably caused them injury. Because the Petitioners' interpretation of the loss causation element will "so undermine" the purposes of the securities laws, and because it is neither "compelled" nor warranted by the applicable statutory language, it should be rejected.

The Ninth Circuit's rule avoids this unfairness to investors, and it does so without compromising the goals of PSLRA. Dispensing with the requirement of a corrective disclosure and a correlated price drop will not cause a flood of abusive class action litigation. The Ninth Circuit rule does not give plaintiffs a free pass on any element of a Section 10(b) fraud claim: it holds them to proof of loss causation by requiring them to establish that the misrepresentations and concealments at issue actually distorted the price paid for the stock. Nor does the rule lead to windfall recoveries. The process of calculating damages accounts for the amount of artificial price inflation, if any, that should fairly be offset against the plaintiffs' claims. *See Blackie v. Barrack,* 524 F.2d 891, 908-09 (9th Cir. 1975) (recovery is limited to actual damages, reflecting any price inflation recouped upon sale), *cert. denied,* 429 U.S. 816 (1976).

II. IF THE NINTH CIRCUIT'S RULING ON LOSS CAUSATION IS REVERSED, AN INCREASING NUMBER OF INVESTORS WILL SUFFER IRRETRIEVABLE LOSSES AT THE HANDS OF THOSE COMMITTING FRAUD

Private actions by defrauded investors are an enormously important complement to regulatory enforcements actions as a means of deterring and remediating securities fraud. State and federal securities regulators work tirelessly to detect, enjoin, and punish financial fraud, and wherever possible, they seek restitution to help make injured investors whole. However, private actions are the principal means of redress for victims of securities fraud, and such actions play a vital role in protecting the integrity of the marketplace. Congress and the courts alike have recognized this fact. The Senate Report accompanying PSLRA described the importance of private rights of action as follows:

> The SEC enforcement program and the availability of private rights of action together provide a means for defrauded investors to recover damages and a powerful deterrent against violations of the securities laws. As noted by SEC Chairman Levitt, "private rights of action

> are not only fundamental to the success of our securities markets, they are an essential complement to the SEC's own enforcement program." [citation omitted]

See S. Rep. No. 104-98, at 8 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 687; *see also Basic Inc. v. Levinson*, 485 U.S. at 230-31 (observing that the private cause of action for violations of Section 10(b) and Rule 10b-5 constitutes an "essential tool for enforcement of the 1934 Act's requirements"). To the extent that courts erect unwarranted barriers to recovery in private actions, such as the loss causation rule advanced by the Petitioners, investors will suffer.

Ensuring the availability of meaningful private remedies in federal court has become especially important for two reasons: financial crime is on the increase and redress through the state courts is limited. Over the last several years, there has been a marked rise in the incidence of corporate accounting fraud and securities law violations affecting large classes of investors. *See, e.g.*, Press Release, No. 2002-179, *SEC, NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices* (SEC, Dec. 20, 2002), *available at* http://www.sec.gov/news/press/2002-179.htm; *see also* Press Release, *State Investigation Reveals Mutual Fund Fraud* (Office of New York Attorney General, Sept. 3, 2003), *available at* http://www.oag.state.ny.us/press/2003/sep/sep03a_03.html. Those violations have harmed millions of investors nationwide, and the trend has not abated. *See* Brooke A. Masters, *Spitzer Targets Insurance Brokers*, Washingtonpost.com, Oct. 14, 2004 (describing the New York Attorney General's recently announced investigation of widespread corruption in the insurance industry), *available at* http://www.washingtonpost.com/ac2/wp-dyn/A34083-2004Oct14?language=printer. These developments illustrate the need for more access to the courts for injured investors, not less.

Congress recognized the seriousness of the problem, and the need for a legislative response, when it enacted the Sarbanes-Oxley Act of 2002. The House Report accompanying the House bill aptly describes the problem of deceptive corporate practices that harm investors:

> The collapse of the Enron Corporation provided irrefutable evidence of serious, systemic problems in our financial reporting system and our capital markets. Far from being an isolated instance, Enron was only the most spectacular example of what has become a common phenomenon—earnings manipulation and deceptive accounting by our largest companies. Before Enron, company after company—Waste Management, Sunbeam, Cendant, W.R. Grace, and many others—were found to have manipulated their accounting to present a picture to investors that did not match reality. As evidenced by the record number of investigations opened by the SEC thus far this year [2002], the problem has only become more acute.

See H.R. Rep. No. 107-414 (2002), 2002 WL 661614, *47 (Minority Views).

The stated purpose of the Sarbanes-Oxley Act is "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws." *See* Pub. Law 107-204, at 1, 116 Stat. 745 (2002) (codified at 15 U.S.C. § 7201 *et seq*.). In one provision aimed directly at improving the plight of wronged investors, Congress extended the statute of limitations applicable to private actions for securities fraud. *See* 28 U.S.C. § 1658. Congress thus recognized the need to "reduce procedural barriers to meritorious suits." *See Small v. Fritz Cos., Inc.*, 65 P.3d 1255, 1261 (Cal. 2003) (deciding that shareholders induced to hold stock rather than sell it may bring common law action for fraud). For the most part however, the laudable provisions of Sarbanes-Oxley are focused on enhancing the regulatory oversight of corporate accounting practices and toughening the penalties for violations of the securities laws. *See, e.g.*, Title I, 15 U.S.C. §§ 7211-19 (establishing an accounting oversight board for public companies); Title VIII, Section 807, 18 U.S.C. § 1348 (increasing criminal penalties for defrauding shareholders of publicly traded companies). It remains for the courts to interpret the securities laws in a manner that affords investors an adequate means of redress for corporate malfeasance.

A second factor weighing in favor of the Ninth Circuit's rule is the limited availability of alternative recourse in the state courts. This Court has observed that the disadvantages posed by a restrictive interpretation of federal securities law can be "attenuated" where adequate remedies are available under state law. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 738 n.9 (1975) (standing to bring private cause of action under Rule 10b-5 limited to actual purchasers or sellers). Conversely, where state law does not offer a significant alternative forum for plaintiffs' claims, there is a correspondingly greater justification for the federal courts to afford relief.

In this case, state law offers limited recourse for investors in the Respondents' position. Congress has expressly limited the use of class action suits seeking recovery for securities fraud under state law. In 1998, Congress enacted the Securities Litigation Uniform Standards Act ("SLUSA") to address the concern that "securities class action lawsuits [had] shifted from Federal to state courts" as a means of circumventing PSLRA. *See* 15 U.S.C.A. § 78a (Notes (2) and (5)). With certain exceptions, SLUSA provides that no class action based upon state law may be maintained in any state court on behalf of more than 50 class members. *See* 15 U.S.C. § 77p(b). Moreover, state common law generally does not recognize the doctrine of fraud-on-the-market, further limiting the state courts as an alternative forum for investors aggrieved by large-scale market manipulation of the sort alleged in this case. *See, e.g., Kaufman v. i-Stat Corp*., 754 A.2d 1188, 1193-94 (N.J. 2000) (reliance may not be satisfied through a fraud-on-the-market theory); *Mirkin v. Wasserman*, 858 P.2d 568, 584 (Cal. 1993) (same).[3]

Precisely because of the massive corporate frauds that have surfaced in recent years, some state courts have recognized the need to reevaluate barriers to civil actions alleging securities fraud. The California Supreme Court, for example, has cited the troubling increase in corporate fraud as a reason to recalibrate the balance between the interests of investors and the interests of corporations, in favor of providing greater judicial recourse to victims of fraud:

> When Congress enacted the Private Securities Litigation Reform Act of 1995 and the Uniform Standards Act of 1998, it was almost entirely concerned with preventing nonmeritorious suits. (Stout, supra, 38 Ariz. L. Rev. 711). But events since 1998 have changed the perspective. The last few years have seen repeated reports of false financial statements and accounting fraud, demonstrating that many charges of corporate fraud were neither speculative nor attempts to extort settlement money, but were based on actual misconduct. "To open the newspaper today is to receive a daily dose of

[3] The Uniform Securities Act, as adopted and revised in 1956, 1985, and 2002, has served as the model for the majority of state securities laws. It imposes statutory civil liability for securities fraud, but specifically targets those who offer or sell securities. *See* Unif. Sec. Act of 1956, § 410; Unif. Sec. Act of 1985, § 605; Unif. Sec. Act of 2002, § 509. The measure of damages under the Uniform Securities Act, as under several provisions of the federal securities laws, is essentially a rescissionary formula. *Id.* In the relatively few instances where state courts have had occasion to address the element of loss causation, they have done so in connection with claims brought under state statutory provisions, not the common law, and they have readily held that loss causation is not a required element of the plaintiff's case. *See Duperier v. Texas State Bank*, 28 S.W.3d 740, 753-54 (Tex. Ct. App. 2000); *Hines v. Data Line Systems, Inc*., 787 P.2d 8, 12-13 (Wash. 1990).

> scandal, from Adelphia to Enron and beyond. Sadly, each of us knows that these newly publicized instances of accounting-related securities fraud are no longer out of the ordinary, save perhaps in scale alone." (Schulman, et al., The Sarbanes-Oxley Act: The Impact on Civil Litigation under the Federal Securities Laws from the Plaintiff's Perspective (2002 ALI-ABA Cont. Legal Ed.) p.1.) The victims of the reported frauds, moreover, are often persons who were induced to hold corporate stock by rosy but false financial reports, while others who knew the true state of affairs exercised stock options and sold at inflated prices. (See Purcell, The Enron Bankruptcy and Employer Stock in Retirement Plans, Congressional Research Service (Mar. 11, 2002).) Eliminating barriers that deny redress to actual victims of fraud now assumes an importance equal to that of deterring nonmeritorious suits.

See Small v. Fritz Companies, Inc., 65 P. 3d 1255, 1263-64 (Cal. 2003) (a person wrongfully induced to hold stock may bring an action for fraud under state common law); *see also Murphy v. BDO Seidman, LLP*, 6 Cal. Rptr. 3d 770, 782 n.12 (Cal. Ct. App. 2003) (noting that recent scandals "support revisiting the fraud-on-the-market doctrine").

As long as limitations on recovery persist under state law, investors must depend upon the federal courts to afford complete relief where corporate executives and others have perpetrated a fraud on the market. As financial crimes abound and as alternative forums for aggrieved investors remain limited, it is especially important that the federal courts interpret federal law in a way that affords meaningful remedies to victims of securities fraud.

CONCLUSION

For the reasons set forth above, the decision of the Ninth Circuit should be affirmed.

Respectfully submitted,

REX A. STAPLES
General Counsel
STEPHEN W. HALL
Deputy General Counsel
MARK J. DAVIS *
Associate Counsel
NORTH AMERICAN
SECURITIES ADMINISTRATORS
ASSOCIATION, INC.
750 First Street, N.E., Suite 1140
Washington, D.C. 20002
(202) 737-0900

* Counsel of Record

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