03-7499, 03-7458

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

SHADI DABIT, on behalf of himself and all others similarly situated,

Plaintiff-Appellant,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Defendant-Appellee.

IJG INVESTMENTS L.P. and IRLYS GUY, on behalf of themselves and all others similarly situated,

Plaintiffs-Appellants,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Defendant-Appellee.

On Appeal from the United States District Court
for the Southern District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE, ON ISSUES ADDRESSED

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BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE, ON ISSUES ADDRESSED

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

This brief is filed in response to the Court's request that the Securities and Exchange Commission, the agency principally responsible for administration and

enforcement of the federal securities laws, file an amicus curiae brief addressing the Court's questions about the scope of the preemption provisions codified as Section 28(f) of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb(f), and Section 16(b) of the Securities Act of 1933, 15 U.S.C. §78p(b), which were enacted as part of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA").

STATEMENT OF THE CASE

1. The Facts Alleged in the Complaints

These consolidated class actions arise from defendant Merrill Lynch's alleged failure to provide objective research and stock recommendations to its customers, contrary to its promises to do so in exchange for the payment of annual fees and higher commissions. Both complaints rely on and incorporate the allegations in the affidavit filed by the New York Attorney General in support of his application for injunctive relief against Merrill Lynch under New York law. See IJG J.A. 12-14; Dabit J.A. 4, 43-80. The plaintiffs allege that, to promote business for its investment banking division, Merrill Lynch issued false and misleading analyst reports concerning publicly traded securities, and failed to disclose this conflict of interest between its research and investment banking divisions. See IJG J.A. 7-8, 11-13; Dabit J.A. 28.

In IJG, the plaintiffs propose to represent a class of all Merrill Lynch customers who had retail brokerage accounts with Merrill Lynch and paid a commission or annual fees during the period covered by the state statute of limitations. IJG J.A. 15. The IJG plaintiffs assert common law claims for breach of contract and breach of the duty of good faith and fair dealing. Id. at 22. They contend that their contract claim does not depend on any allegation of misrepresentation, but alleges only that Merrill Lynch failed to deliver the unbiased research it promised, thereby breaching its contractual duty. IJG Br. at 41. They also assert claims under Minnesota's Consumer Fraud Act and Deceptive Trade Practices Act; in that context, they do allege that Merrill Lynch made misrepresentations about its research reports. See IJG J.A. 18-22.

In Dabit, the plaintiffs propose to represent two subclasses of Merrill Lynch employees. One subclass alleges that based on Merrill Lynch's biased research reports its members continued to hold securities in their personal portfolios that they otherwise would have sold; they seek unspecified damages for losses attributable to holding the securities. Dabit J.A. 25. The other proposed Dabit subclass consists of Merrill Lynch employees who, as a result of Merrill Lynch's biased research, lost clients and the commissions those clients would have paid in

future transactions. Id. The Dabit plaintiffs assert claims for breach of fiduciary duty and breach of the covenant of good faith and fair dealing. Id. at 37-38.

2. The District Court Decision

The IJG plaintiffs filed their complaint in Minnesota state court; the Dabit plaintiffs did so in Oklahoma state court. After Merrill Lynch removed the cases to federal court pursuant to SLUSA, the Judicial Panel for Multidistrict Litigation centralized these and a number of other cases "involv[ing] common questions of fact" in the United States District Court for the Southern District of New York. In re Merrill Lynch & Co. Research Reports Sec. Litig., 223 F. Supp. 2d 1388, 1389 (J.P.M.L. 2002). On April 10, 2003, the district court (Pollack, J.) dismissed the complaints in IJG and Dabit, and two other cases in which appeals were not taken, as preempted by SLUSA. See Dabit J.A. 213; IJG J.A. 34.

The district court's order did not address the specific arguments the plaintiffs made in asserting that their claims were not preempted by SLUSA. The court instead focused on the fact that the complaints referred to the same factual allegations of biased research reports relied on in the federal securities fraud actions with which they had been centralized. Id. For that reason, the court concluded, "[t]he claims alleged in the [two] actions fall squarely within SLUSA's ambit." Id.

ARGUMENT

In requesting a brief from the Commission, the Court posed four questions concerning the scope of SLUSA. First, the Court asked whether, in requiring that a preempted action allege wrongdoing "in connection with the purchase or sale" of covered securities under SLUSA, Congress intended the "in connection with" requirement to have the same meaning as the identical term used in the antifraud provision in Section 10(b) of the Exchange Act, 15 U.S.C. 78(j)(b). Second, the Court asked whether the "purchaser-seller rule of standing or otherwise enunciated in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), should be adopted for SLUSA." Third, the Court asked "[w]hether SLUSA preempts actions that could not have been brought pursuant to § 10(b) and Rule 10b-5." Finally, the Court asked whether four scenarios, based on various claims in these cases, satisfy the "in connection with" requirement.

A. SLUSA Was Adopted to Prevent the Use of State Law Actions to Avoid the Requirements of the Federal Private Securities Litigation Reform Act.

SLUSA represented a significant change in the relationship between the federal securities laws and state law. When Congress adopted the Securities Act in 1933 and the Exchange Act in 1934, it intended to supplement rather than supplant state "blue sky" laws, many of which predated the federal statutes by

more than twenty years. See Testimony of the U.S. Securities and Exchange Commission Concerning S. 1260, the Securities Litigation Uniform Standards Act of 1997 Before the Subcommittee on Securities Committee on Banking, Housing and Urban Affairs, 105th Cong. 2 (Oct. 29, 1997) (statement of the Commission). As originally enacted, neither statute preempted any state law and, to the contrary, specifically preserved all other remedies available under state or federal law. Id. at 2-3.

This was still true when, in 1995, Congress adopted the Private Securities Litigation Reform Act ("PSLRA"). That statute was enacted to filter out potential strike suits by, among other things, imposing more stringent pleading requirements and mandatory discovery stays for federal securities fraud actions. See Spielman v. Merrill Lynch, Pierce, Fenner & Smith Inc., 332 F.3d 116, 122 (2d Cir. 2003).

After it enacted the PSLRA, Congress became concerned that plaintiffs were evading PSLRA requirements, particularly the heightened scienter pleading standard and discovery stay, by filing suits under state law in state courts. See SLUSA, Pub. L. No. 105-353, § 2(2), 112 Stat. 3227. In 1998, therefore, Congress enacted SLUSA, and stated in the legislation that it was doing so to "prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the [PSLRA]." Id. Sec. 2(5). See also

Green v. Ameritrade, Inc., 279 F.3d 590, 595 (8th Cir. 2002) (SLUSA prevents plaintiffs from evading federal protections against "abuse litigation" by filing suit in state, rather than federal, courts).

SLUSA altered the federal-state relationship by largely preempting state law securities fraud class actions. 1/ Section 28(f) of the Exchange Act provides that "[n]o covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging * * * [either] a misrepresentation or omission of a material fact" or "that the defendant used or employed any manipulative or deceptive device or contrivance", "in connection with the purchase or sale of a covered security."

Although the PSLRA had not imposed a heightened pleading requirement on private actions under the Securities Act and there was no perceived "flight" of private actions under the Securities Act from federal to state courts, SLUSA nevertheless also amended the Securities Act to provide, in Section 16(b), that no class action based on state law may be maintained in state or federal court by any

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1/ Two years earlier, in the National Securities Markets Improvement Act of 1996 ("NSMIA"), Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in part at 15 U.S.C. § 77r, 80a), Congress for the first time preempted some state securities regulation and divided the responsibility for securities registration and investment adviser registration between the Commission and the states.

private party alleging "an untrue statement or omission of a material fact" or "that the defendant used or employed any manipulative or deceptive device or contrivance," "in connection with the purchase or sale of a covered security."

SLUSA has been held by this Court and others to be a statute of "complete preemption," meaning that for any claim that falls within its scope only a federal claim exists and the complaint must be dismissed if the action has been brought only under state law. See Spielman, 332 F.3d at 123-124; Green, 279 F.3d at 596.

B. The Phrase "In Connection With The Purchase Or Sale" Of Securities, as Used in SLUSA, Has The Same Broad Meaning as In Section 10(b) of the Exchange Act.

The Court's first question is whether decisions interpreting the phrase "in connection with the purchase or sale"of securities in Section 10(b) of the Exchange Act and Rule 10b-5 are applicable to the interpretation of that same phrase in SLUSA's preemption provisions. The Commission recently addressed this question in an amicus brief filed in Gray v. Seaboard Securities, Inc., No. 03-7184 (2d Cir.) (brief filed October 6, 2003) ("Gray Br."). As we discussed there, the phrase "in connection with the purchase or sale" found in SLUSA has been correctly construed by courts to mean the same thing as the identical phrase found

in Section 10(b) of the Exchange Act. As the Court of Appeals for the Eleventh Circuit has stated:

> In enacting SLUSA, . . . Congress was not writing on a blank slate; instead, it was legislating in an area that had engendered tremendous amounts of litigation and received substantial judicial attention. In using the phrase "in connection with the purchase or sale of a covered security," Congress was not creating language from a vacuum; instead, it was using language that, at the time of SLUSA's enactment, had acquired settled, and widely-acknowledged meaning in the field of securities law, through years of judicial construction in the context of § 10b-5 [sic] lawsuits. Under these circumstances, we must presume that Congress intended the phrase "in connection with the purchase or sale of a covered security" to have the same meaning in SLUSA that it has in Section 10b-5 [sic].

Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 292 F.3d 1334, 1342-43 (11th Cir.), cert. denied, 537 U.S. 950 (2002); accord Green, 279 F.3d at 597; Falkowski v. Imation Corp., 309 F.3d 1123, 1129 (9th Cir. 2002), opinion amended, 320 F.3d 905 (9th Cir. 2003). Moreover, the state law cases Congress wanted to preempt in SLUSA were those that were being brought in order to avoid the PSLRA requirements that, in turn, had been enacted largely because of abusive Section 10(b) actions. Adopting for SLUSA purposes a construction of the term that is more restrictive than the definition applied under Section 10(b) would mean that litigants could continue to bring some cases under state law rather than being forced to sue under Section 10(b) and its attendant constraints.

In general, courts have recognized that the meaning of the Section 10(b) phrase "in connection with the purchase or sale of any security" is "as broad and flexible as is necessary to accomplish the statute's purpose of protecting investors." See SEC v. Rana Research, Inc., 8 F.3d 1358, 1362 (9th Cir. 1993), and cases discussed therein. This Court has long recognized that the "in connection with" requirement in Section 10(b) is satisfied when a misrepresentation is made "in a manner reasonably calculated to influence the investing public." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968) (en banc). Accord, McGann v. Ernst & Young, 102 F.3d 390, 392-96 (9th Cir. 1996); Britt v. Cyril Bath Co., 417 F.2d 433, 435-36 (6th Cir. 1969).

By its plain terms the phrase "in connection with the purchase or sale" of a security requires only that there be a nexus or relationship between the fraud and a securities transaction. See Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971) (paraphrasing "in connection with" as "touching"); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476 (1977) (quoting "touching" language from Bankers Life with approval); SEC v. Clark, 915 F.2d 439, 449 (9th Cir. 1990) ("some nexus"); Abrams v. Oppenheimer Gov't Sec., Inc., 737 F.2d 582, 593 (7th Cir. 1984) ("some nexus but not necessarily a direct and close relationship"); Brown v. Ivie, 661 F.2d 62, 65 (5th Cir. 1981) ("a nexus"). The necessary

connection therefore exists when, among other situations, "the proscribed conduct and the sale are part of the same fraudulent scheme," Alley v. Miramon, 614 F.2d 1372, 1378 n.11 (5th Cir. 1980) (Wisdom, J.), such as when the fraud and the sale of securities "coincide," SEC v. Zandford, 535 U.S. 813, 822 (2002).

We believe that under these principles, the "in connection with the purchase or sale of" securities requirement is satisfied when a broker-dealer makes a misrepresentation or omission to a customer that relates to the customer's brokerage account regardless of whether the deception coincides with, or could be expected to influence, a securities transaction. This is so because any misrepresentation or omission relating to an account should ordinarily be regarded as inherently "in connection with the purchase or sale of any security." The very purpose of a brokerage account is to buy and sell securities. Thus, any deception that could affect the decision of the customer to open a brokerage account, and to do so on the terms specified in the account agreement, closely touches on securities transactions. See Gray Br. at 12 n.9; see also SEC Amicus Br. at 13-14, filed in 1996 in Bissell v. Merrill Lynch & Co., 157 F.3d 138 (2d Cir. 1998).

There is no merit to the plaintiffs' claim here (see IJG Br. at 28) that only misrepresentations about particular securities bought or sold by a plaintiff, or that induce a particular purchase or sale, meet the "in connection with" requirement,

while misrepresentations about the general character of research provided by a brokerage firm or that affect the commissions charged on securities trades are excluded. That argument no longer can be made after the Supreme Court's decision in Zandford, 535 U.S. at 821, which expressly rejected the contention that fraud must pertain to the value of a security or "manipulation of a particular security" in order to meet the "in connection with" requirement. This Court had earlier rejected such a limitation on the scope of the "in connection with" language when it held in Press v. Chemical Investment Services Corp., 166 F.3d 529, 537 (2d Cir. 1999), that the statutory language encompassed an alleged misrepresentation about when the proceeds of a securities sale would be available to the customer.

C. Three Of the Four Situations Identified By The Court Involve Misrepresentations "In Connection With The Purchase Or Sale" Of Securities.

Applying the foregoing view of the "in connection with" language in SLUSA, we believe that the first three scenarios identified by the Court in its request satisfy the in connection with requirement, while the fourth scenario does not. The Court asked:

> Where a brokerage allegedly issued intentionally false and biased research reports to garner investment banking business, whether the

> following state law claims arising from that activity meet SLUSA's 'in connection with' requirement:
>
> (a) claims brought by the brokerage's clients for annual flat fees paid to the brokerage for unbiased investment research, which fees are not triggered by any actual purchases or sales of securities;
>
> (b) claims brought by the brokerage's clients for commissions fees paid to the brokerage for investing in securities recommended by the biased research;
>
> (c) claims brought by the brokerage's broker-employees for investment losses suffered in retaining securities as a result of the brokerage's falsely touting the securities' values; and
>
> (d) claims brought by the brokerage's broker-employees for the loss of future commissions to be paid by their clients who left the brokerage as a result of the biased research?

As to hypothetical (a), it is reasonable to expect that Merrill Lynch customers would be influenced, both in deciding to open accounts at the firm and later in making securities transactions, by the firm's false statements that its recommendations were objective. The very reason that a customer decides to pay additional fees in exchange for objective stock recommendations is to obtain information on which to decide whether to buy and sell securities. Even if a customer does not in fact later engage in securities transactions in the account, the deception in causing the account to be opened is so inherently related to securities transactions that it satisfies the "in connection with the purchase or sale"

requirement in SLUSA. See, e.g., McCullagh v. Merrill Lynch & Co., 01-Civ-7322-DAB, 2002 WL 362774, at *4 (S.D.N.Y. Mar. 6, 2002) (similar allegations of biased research satisfy the "in connection with" language of SLUSA because the alleged misrepresentation concerns "the quality of investment advice"); cf. Rowinski v. Salomon Smith Barney, Inc., No. 3:02cv2014, 2003 WL 22740976, at *3 (M.D. Pa. Nov. 20, 2003) ("plaintiff would not be concerned with the accuracy of SSB's analyst reports unless he intended to, and did, in fact, rely on them in deciding to purchase or sell stock").

An even closer connection exists between the alleged fraud and securities transactions under hypothetical (b). Under that hypothetical the fees paid as a result of the deceptive research claims are triggered if and when the customer makes an actual purchase or sale of securities. It seems apparent that a fraudulently induced fee that is paid as part of a securities transaction is a fraud "in connection with" that transaction. See Rowinski, 2003 WL 22740976, at *3 (concluding on similar facts that alleged fraud was "in connection with the purchase or sale" of securities in part because "[a] commission is earned by SSB only when a customer purchases or sells securities").

The Commission also believes that hypothetical (c) would come within the "in connection with the purchase or sale" language in SLUSA. Even though the

first proposed Dabit subclass consists only of Merrill Lynch employees, their claim is no different than that of any investor who continued to hold securities based on misrepresentations – their status as employees is irrelevant.

The final claims, described in hypothetical (d), fall outside the "in connection with the purchase or sale" language, and therefore outside SLUSA's preemption provisions. The premise of this hypothetical is that the customers to which the misrepresentations were made stopped doing business with the broker after they learned of the biased research. Because the customers were made aware of the falseness of the misrepresentations, the continuing effect of the misrepresentations necessarily ended. The broker-employees' claims, therefore, are not based on misrepresentations that could be part of a fraudulent scheme in which the misrepresentations played a part; they did not coincide with, nor might they have influenced, any possible purchase or sale of securities. To the contrary, the employees' claims necessarily depend on the fact that the former customers have learned of the misrepresentations and will not in the future engage in securities transactions through Merrill Lynch, where the plaintiffs are employed. The claims in this hypothetical simply have no factual or logical link to the alleged deception.

That the first three hypotheticals satisfy the "in connection with" requirement does not, however, mean that private plaintiffs making these claims can sue under Section 10(b) and Rule 10b-5. A private plaintiff suing under these provisions only has standing to sue if they allege that they either purchased or sold securities as a result of the alleged falsehood. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) ("Blue Chip"). Thus, to the extent plaintiffs alleging claims under hypotheticals (a) and (c) did not buy or sell securities as a result of the alleged fraud, they could not sue under Section 10(b) and Rule 10b-5. This does not mean, however, that the claims do not satisfy the in connection with requirement. As this Court has recently held, it is error to "conflate the issue of standing" under Blue Chip "with the question of whether the 'in connection with' requirement has been met," since these are "two distinct inquiries." Ontario Public Serv. Employees Union Pension Trust Fund v. Nortel Networks Corp., 2004 WL 1110496, *6, 379 F.3d 27 (2d Cir. May 19, 2004).

D. SLUSA Applies to Preempt State Law Actions Even if the Actions Do Not Meet the Purchaser/Seller Standing Requirement of Blue Chip.

The next question is whether the purchaser-seller rule enunciated in Blue Chip (originally articulated in this Court's decision in Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952)), should be adopted under SLUSA. Some state

law actions for securities fraud do not contain this requirement. See, e.g., Small v. Fritz Cos., 65 P.3d 1255, 1260-1261, 1263 (Cal. 2003). If SLUSA contains a purchaser/seller limitation, those state law actions would not be preempted.

The courts that have considered the issue have held that SLUSA does not preempt actions that do not meet the purchaser/seller requirement. They reason that the purchaser/seller limitation under Section 10(b) is based on a construction of the phrase "in connection with the purchase or sale" of securities, and that the use of the same phrase in SLUSA carries with it the same construction. For example, in Riley, 292 F.3d at 1342-43 the Eleventh Circuit held:

> In using the phrase "in connection with the purchase or sale of a covered security," Congress was not creating language from a vacuum; instead, it was using language that, at the time of SLUSA's enactment, had acquired settled, and widely-acknowledged, meaning in the field of securities law, through years of judicial construction in the context of § 10b-5 lawsuits. Under these circumstances, we must presume that Congress intended the phrase "in connection with the purchase or sale of a covered security" to have the same meaning in SLUSA that it has in § 10b-5.

Id. (emphasis in original). Accord, Green, 279 F.3d at 598; Gutierrez v. Deloitte & Touche, L.L.P., 147 F. Supp. 2d 584, 595 (W.D. Tex. 2001). 2/

2/ See also Gordon v. Buntrock, 2000 WL 556763, at *4 (N.D. Ill. Apr. 28, 2000) (Mem. Op.); Simon v. Internet Wire, Inc., 2001 U.S. Dist. LEXIS 4086, Fed. Sec. L. Rep. (CCH) ¶91,408 (C.D. Cal. Apr. 3, 2001); Burns v. Prudential Sec., 116 F. Supp. 2d 917, 922-23 (N.D. Ohio 2000); Shaev v. Claflin, 2001 U.S. Dist. LEXIS 6677, Fed. Sec. L. Rep. (CCH) ¶91,452

These decisions misapprehend the relationship between the purchaser/seller requirement and the "in connection with" element in Section 10(b). The Blue Chip Court began its analysis by noting that when this Court articulated the purchaser/seller limitation in Birnbaum, it relied on the facts that

> both § 10(b) and Rule 10b-5 proscribed only fraud "in connection with the purchase or sale" of securities, and * * * the history of § 10(b) revealed no congressional intention to extend a private civil remedy for money damages to other than defrauded purchasers or sellers of securities, in contrast to the express civil remedy provided by § 16(b) of the 1934 Act

421 U.S. at 731, citing Birnbaum, 193 F. 2d at 463-464. The Supreme Court stated that "the wording of § 10 (b), making fraud in connection with the purchase or sale of a security a violation of the Act, is surely badly strained when construed to provide a cause of action, not to purchasers and sellers of securities, but to the world at large." 421 U.S. at 733 n.5. The Court also noted that Congress twice rejected Commission proposals to add language to Section 10(b) referring to "any attempt to purchase or sell, any security," id. at 732. The Court concluded (id. at 733):

(N.D. Cal. May 17 2001); Shaw v. Charles Schwab & Co., Inc., 128 F. Supp. 2d 1270, 1272 (C.D. Cal. 2001); Hines v. ESC Strategic Funds, Inc., 1999 U.S. Dist. LEXIS 15790, No. 3:99-0530, 1999 WL 1705503, at *6 (M.D. Tenn. Sept. 17, 1999); Lalondriz v. USA Networks, 54 F. Supp. 2d 352, 353-54 (S.D.N.Y.), adhered to on reconsideration by 68 F. Supp. 2d 285, 286 (S.D.N.Y. 1999).

> The longstanding acceptance by the courts, coupled with Congress' failure to reject Birnbaum's reasonable interpretation of the wording of § 10 (b), wording which is directed toward injury suffered "in connection with the purchase or sale" of securities, argues significantly in favor of acceptance of the Birnbaum rule by this Court. Blau v. Lehman, 368 U.S. 403, 413 (1962). 3/

The Blue Chip Court went on, however, to state: "[h]aving said all this, we would by no means be understood as suggesting that we are able to divine from the language of § 10 (b) the express 'intent of Congress' as to the contours of a private cause of action under Rule 10b-5." 421 U.S. at 738. The Supreme Court held, rather, that in construing a judicially inferred private right of action, it would be

> proper that we consider, in addition to the factors already discussed, what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance.

3/ The Court also noted that other portions of the securities laws suggested a purchaser/seller requirement. In contrast to Section 10(b), Section 17(a) applies to "offers" to sell securities, showing that "[w]hen Congress wished to provide a remedy to those who neither purchase nor sell securities, it had little trouble in doing so expressly." Id. at 734. It also observed that the requirement in Section 28(a) of the Exchange Act, which requires that a plaintiff prove "actual damages," would counsel against allowing suits where the alleged injury "largely conjectural and speculative." Id. at 734-735. And it noted that the express non-derivative remedies in the Securities Act (Sections 11(a) and 12) and Exchange Act (Sections 9 and 18) all contain a requirement that the plaintiff purchase or sell securities. Id. at 736.

Id. at 737. Turning to these policy considerations, the Court stated (id. at 743, emphasis added) that "[t]he Birnbaum rule undoubtedly excludes plaintiffs who have in fact been damaged by violations of Rule 10b-5, and to that extent it is undesirable." In concluded, however, that this disadvantage was outweighed by the benefits of the rule in the elimination of cases involving great difficulties of proof and potential for vexatiousness (id. at 739-744). In short, although the Court concluded that the purchaser/seller requirement was consonant with the statutory language and structure, it indicated that if there were no net policy advantage to the purchaser/seller rule, it would not have endorsed it. See 421 U.S. at 738-39.

Yet the policy concerns that led to the adoption of the rule under Section 10(b) do not appear to apply under SLUSA. 4/ As applied under Rule 10b-5, the purchaser/seller rule serves to eliminate lawsuits that involve difficult issues of proof and are vexatious. Were the same rule to apply under SLUSA it would have the opposite effect, in that it would allow lawsuits with precisely these vexatious characteristics to go forward. In addition, adopting a purchaser/seller rule would make preemption turn on whether a state had a purchaser/seller requirement for its

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4/ The Commission takes no position on whether the Court could adopt a purchaser/seller limitation under SLUSA as a matter of policy. In Blue Chip, the Court held that it could consider policy because it was construing the parameters of an implied cause of action that had been judicially created in the first place. See 421 U.S. at 737.

securities fraud actions. Rather than enforcing a uniform national standard, as SLUSA was intended to do, the application of the Act would turn on what standing rule a state happened to recognize.

Some courts that have applied a purchaser/seller limitation under SLUSA have nonetheless done so in part based on the view that to do so is consonant with one policy reason for the Blue Chip decision. The Blue Chip Court said that the disadvantage of denying relief to a victim of securities fraud "is attenuated to the extent that remedies are available to nonpurchasers and nonsellers under state law." Id. at 738 n.9. These courts have reasoned that to apply SLUSA to preempt such state law suits would undercut this rationale. See Riley, 292 F.3d at 1344-1345; Green, 279 F.3d at 598; Guttierez, 147 F. Supp. 2d at 595. It is hardly clear, however, that the Congress that adopted SLUSA, which radically altered the relationship between federal and state law concerning securities fraud, entertained a similarly benign view of state law actions. To believe that would require a conclusion that while Congress saw fit under SLUSA to preempt most state law causes of action as a vexatious end-run around federal limitations on private securities law suits, it nevertheless exempted from preemption one state law cause of action the Blue Chip Court saw as a particularly vexatious form of litigation.

Adoption of the purchaser/seller rule for SLUSA poses other potentially serious problems. If the purchaser/seller rule is incorporated into the "in connection with" language, that same limitation arguably would apply to the Commission and the United States in civil and criminal enforcement cases under Section 10(b), since those also must meet that statutory element. Yet the Court has been explicit, in Blue Chip and afterwards, that the purchaser/seller requirement applies only to private securities fraud actions seeking damages, and not to government enforcement actions. See Blue Chip, 421 U.S. at 751 n.14 ("the purchaser-seller rule imposes no limitation on the standing of the SEC to bring actions for injunctive relief under § 10(b) and Rule 10b-5"); United States v. Naftalin, 441 U.S. 768, 774 n.6 (1979) (Blue Chip is "inapplicable" to a criminal prosecution).

Application of a purchaser/seller limitation to government actions could have a damaging effect on the enforcement of the securities laws in cases where it could not be shown that some investor purchased or sold securities. Hypothetical (c), discussed above, presents such a scenario. For this reason, as noted, this Court has long required, to meet the "in connection with" requirement, only that it be shown that a fraudulent statement was made "in a manner reasonably calculated to

influence the investing public * * *." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968) (emphasis added).

Finally, the Blue Chip Court recognized that even in a private action, a violation of Section 10(b) could exist without a purchase or sale of securities. The Court stated that "[t]he Birnbaum rule undoubtedly excludes plaintiffs who have in fact been damaged by violations of Rule 10b-5, and to that extent it is undesirable." 421 U.S. at 743 (emphasis added). If, absent a purchase or sale, the "in connection with" requirement was not met, the Court could not have believed that violations of Section 10(b) could have occurred, since an essential element of Section 10(b) would be absent.

We note, finally, that were SLUSA to apply only where there is an allegation of a purchase or sale of securities, the preemption of class actions would become a complex question. Even if the action only alleges that it is brought on behalf of persons who held securities during the class period, some of those persons will in fact have bought or sold the securities during the period. Would the entire class action be excluded from SLUSA preemption because there is no allegation of a purchase or sale, or will the court have to go behind the pleadings to ascertain if any of the class members in fact have purchaser/seller standing? This potential problem does not exist under the construction of SLUSA we propose here.

E. SLUSA Preempts State Law Actions Even Under Certain Circumstances Where They Could Not Be Brought Under Section 10(b) And Rule 10b-5.

The Court also asks "[w]hether SLUSA preempts actions that could not have been brought pursuant to § 10(b) and Rule 10b-5." This question is broad because there are a number of reasons why an action might not be sustainable under Section 10(b). One would be that there is no misrepresentation or other deception. The clear language of SLUSA, however, requires that the action allege a misrepresentation or misleading omission or other deception. Thus, the Commission does not believe the defendants are correct that a pure breach-of-contract claim – with no allegation of misrepresentation – comes within the terms of the preemption provisions. It seems clear from the face of the statute that claims containing no allegations of misrepresentation, untrue statements or any other form of fraud, such as claims alleging only a breach of contract or breach of fiduciary duty – are not preempted by SLUSA.

Another reason a Section 10(b) claim might fail would be because the fraud was not "in connection with the purchase or sale of securities." Since, however, as discussed above, the "in connection with" requirement in SLUSA is co-extensive with that in Section 10(b), a claim that failed for this reason also would fail to meet the "in connection with" requirement in SLUSA, and would not be preempted. A

private Rule 10b-5 action might also fail because the plaintiff lacks Blue Chip standing; yet because SLUSA contains no such limitation, that fact would not preclude SLUSA preemption.

The plaintiffs take the position (see IJG Br. at 19-20, 33) that SLUSA preempts only "traditional" or "typical" securities fraud, and, thus, that SLUSA does not preempt claims that would not state a claim under Section 10(b) for lack of an allegation of scienter (that is, that the deception was either knowing or reckless), which is an element of an action under Section 10(b) of the Exchange Act and Rule 10b-5. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976); see also Aaron v. SEC, 446 U.S. 680, 696 (1980). See Dabit Reply Br. at 4-5 (relying on Lander v. Hartford Life & Annuity Ins. Co., 251 F.3d 101, 110 (2d Cir. 2001)).

We believe, however, that the statute's language makes clear that SLUSA preemption does not require an allegation of scienter. 5/ Section 28(f) of the

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5/ There is scant judicial authority on the issue. The only federal court of appeals to address the issue has held, after noting that Section 16(b) of the Securities Act preempts non-scienter-based causes of action, that scienter is not required for SLUSA preemption. See Riley v. Merrill Lynch Pierce, Fenner & Smith, Inc., 292 F.3d 1334, 1345-1346 (11th Cir.), cert. denied 537 U.S. 950 (2002); see also In re Worldcom, 263 F. Supp. 2d 745 (S.D.N.Y. 2003) (similar). Some district courts, with little analysis, have concluded that SLUSA preempts only allegations of fraud with scienter, apparently accepting the view that Congress intended to reach only claims analogous to Section 10(b) claims. See, e.g., Green v. Ameritrade, Inc., 120 F. Supp. 2d 795, 798 (D. Neb. 2000), aff'd on other grounds, 279 F.3d 590 (8th Cir.

Exchange Act preempts allegations that the defendant used a "manipulative or deceptive device or contrivance" or made a "misrepresentation or omission of a material fact," "in connection with the purchase or sale of a covered security." Section 16(b) of the Securities Act replaces the first clause with a requirement that the defendant made "an untrue statement or omission of a material fact" but otherwise is identical to Section 28(f).

These terms are drawn from essentially identical language contained in Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act. The Supreme Court has held that the term "manipulative or deceptive device or contrivance" requires scienter. See Ernst & Ernst v. Hochfelder, 425 U.S. at 199 ("the words 'manipulative,' 'device,' and 'contrivance' [terms used in Section 10(b) of the Exchange Act] [are] terms that make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence"). On the other hand, the term "untrue statement or omission to state a material fact" does not. See Aaron, 446 U.S. at 696 (holding that "untrue statement" or "omission of a material fact" language is "devoid of any suggestion whatsoever of a scienter requirement"). As

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2002); Burns v. Prudential Sec., 116 F. Supp. 2d 917, 923-24 (N.D. Oh. 2000).

to the term “misrepresentation * * * of a material fact,” the Aaron Court noted that in Hochfelder, it

> pointed out that the similar language of Rule 10b-5(b) "could be read as proscribing . . . any type of material misstatement or omission . . . that has the effect of defrauding investors, whether the wrongdoing was intentional or not."

Id., quoting Hochfelder, 425 U.S. at 212. 6/ Although Section 28(f) uses the term “misrepresentation” rather than “misstatement” (the word used in Rule 10b-5(b)), we do not think the terms are significantly different. The common understanding of the term “misrepresentation” is that it does not require intent. The common law recognizes, for example, that actionable “misrepresentation” may be the product of negligence. See, e.g., Restatement (Second) of Torts § 304 (2004). In short, since SLUSA applies where any of these forms of deception is alleged, the language of SLUSA does not on its face require that the plaintiff’s allegations state a scienter-based claim, as required under Rule 10b-5.

The imposition of a scienter requirement would also be inconsistent with SLUSA’s principal purpose. In adopting SLUSA, Congress stated, as part of the findings in the legislation itself, that

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6/ Although the Hochfelder Court conceded that the language in Rule 10b-5 could support liability for negligence, Rule 10b-5 requires a showing of scienter because it is constrained by the narrower langauge of Section 10(b). See 425 U.S. at 214.

> in order to prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the Private Securities Litigation Reform Act of 1995, it is appropriate to enact national standards for securities class action lawsuits involving nationally traded securities, while preserving the appropriate enforcement powers of State securities regulators and not changing the current treatment of individual lawsuits.

SLUSA, Pub. L. No. 105-353, § 2(5), 112 Stat. 3227. While part of Congress's concern was the procedural constraints on class action litigation, another concern was compelling compliance with the PSLRA's heightened scienter pleading standard, which requires plaintiffs in Rule 10b-5 cases to allege scienter with greater specificity than many courts had previously required. See 15 U.S.C 78u-4(b). To the extent that migration toward state courts had been fueled by this requirement, it would have been because plaintiffs found it difficult, after the PSLRA, to make an adequate claim of scienter in Rule 10b-5 cases. If it were to be held that SLUSA does not apply to a case which cannot, for lack of an allegation of scienter, be brought under Rule 10b-5, this objective of SLUSA would be largely undercut. SLUSA could not compel compliance with the PSLRA's scienter pleading standard, since it simply would not apply to any class action complaint that

could not comply with the PSLRA standard. Congress could not have intended such a self-defeating result. 7/

CONCLUSION

For the foregoing reasons, the Court should rule in accordance with the positions urged in this brief.

Respectfully submitted,

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7/ Nothing in the language of SLUSA suggests that any of the other requirements of a private Rule 10b-5 action – such as statute of limitations, reliance, loss causation – must be met before SLUSA preemption will apply.

CERTIFICATE OF COMPLIANCE WITH Fed. R. App. P. 32(a)(7)(B)

I certify that the foregoing brief was prepared in proportionally spaced 14-point type and according to the wordprocessing program with which it was prepared, Wordperfect 11, has 6,738 words, excluding those portions excluded under Fed. R. App. P. 32(a)(7)(B)(iii).

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Susan S. McDonald

CERTIFICATE OF SERVICE

I certify that on June 22, 2004, I caused a copy of the foregoing brief of the Securities and Exchange Commission, amicus curiae, to be served on the Clerk of the Court and on counsel for each of the parties by facsimile transmission, and also caused the requisite number of copies to be served on the Clerk of the Court and on counsel for each of the parties by Federal Express overnight courier, addressed as follows:

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