No. 07-1006

IN THE

Supreme Court of the United States

NANOPIERCE TECHNOLOGIES, INC. (N/K/A VYTA CORP.), KATHY-KNIGHT MCCONNELL, HELEN KOLADA, MAUREEN O'SULLIVAN, JANE SEITZ, STEPHEN SEITZ, AND JAMES STOCK,

Petitioners,

v.

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

Respondents.

On Petition for a Writ of Certiorari to the Supreme Court of Nevada

REPLY BRIEF FOR PETITIONERS

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Respondent clearing corporations' own website has long represented that they operate the stock borrow program only "to cover temporary shortfalls" in the delivery of shares sold by parties to securities transactions.[1] That is a false representation. There is nothing "temporary" about respondents' practice of permitting fails-to-deliver for tens of millions of shares to persist for months and even years. Nor do temporary shortfalls explain respondents' misrepresentations and failures to disclose their related practice of permitting the same shares in the stock borrow program to be re-lent electronically over and over, so that multiple persons are deemed to "own" the same shares.

State-law prohibitions against false statements like these are fundamental to ensuring the protection of investors and companies and ensuring the protection of the securities markets. But the court below effectively cast aside Congress's long-standing mandate of dual regulation of the securities markets, as declared in the savings clauses in both the 1933 and 1934 Acts, which Congress left fully intact in its 1975 amendments to the federal securities laws.

Both of respondents' practices – which substantially benefit the Wall Street investment banks and similar entities that own and control the respondent clearing corporations – have resulted in an artificial increase of shares in the electronic marketplace far beyond the number of shares that public companies have validly issued. According to petitioners' complaint, which the Court must accept as true, respondents misrepresented and concealed those and other material facts. Respondents are liable for any resulting

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[1] NSCC, http://www.nscc.com/clearance/.

damages under state common-law prohibitions against misrepresentation that are as old as the nation and that further the policy of full disclosure underlying federal securities law.

To allow preemption of petitioners' quintessential common-law claims would upset classic preemption principles that this Court has often explained, but that numerous lower courts, including the court below, have misapplied. That confusion has led to both specific conflict and general confusion among the lower courts. Review by this Court is therefore warranted, and this case presents an excellent vehicle for the Court to clarify proper conflict-preemption analysis for state securities claims.

I. PLENARY REVIEW IS WARRANTED BY THE CONFLICTS CREATED BY THE DECISION BELOW AND ITS IMPORTANCE TO THE NATIONAL SYSTEM OF SECURITIES REGULATION

A. The Decision Below Conflicts With Decisions Of Other State Courts Of Last Resort And Federal Courts Of Appeals

This Court has long protected the rights of injured persons to seek relief under state law against fraud and misrepresentations committed by entities whose actions federal agencies heavily regulate. *See, e.g.*, *Bates v. Dow AgroSciences LLC*, 544 U.S. 431, 451-53 (2005). Notwithstanding the parallel or overlapping applicability of federal law, the Court has held that state-law misrepresentation claims are often not preempted, in part because they typically parallel federal duties requiring regulated entities to tell the truth, *see id.*, and because they "rely only on a single, uniform standard: falsity." *Cipollone v. Liggett*

Group, Inc., 505 U.S. 504, 529 (1992) (plurality op.); *see* Pet. 29-30 & n.24. Such claims, therefore, can easily coexist with the federal securities laws that were enacted to ensure full disclosure and thus to protect both investors and the efficient and fair functioning of the securities markets. *See* Pet. 18-19; *Basic Inc. v. Levinson*, 485 U.S. 224, 230 (1988) ("fundamental purpose" of the 1934 Act was to implement a "philosophy of full disclosure") (internal quotation marks omitted).

1. The decision below directly conflicts with *O'Malley v. Boris*, 742 A.2d 845 (Del. 1999), in which the Delaware Supreme Court held that federal law did not preempt a state-law claim that a "negative response letter" from a broker to its customers, although permitted by the SEC-approved rules of the self-regulatory organization NASD, was nevertheless misleading for its failure to disclose the broker's interest. *See* Pet. 20-22

Respondents seek (at 16-17) to distinguish *O'Malley* on the ground that the state suit for misrepresentation did "'not interfere with the purpose or effectiveness of the NASD rule'" at issue, Opp. 17 (quoting *O'Malley*, 742 A.2d at 849), whereas here "the requested disclosures flatly contradict the fact of the SEC's approval as well as the actual language of the [stock borrow program]," *id.* To the contrary, *O'Malley*'s key holding was that federal approval of the NASD rule did not preempt a state-law claim that "additional disclosure requirements . . . [that] would be the same for all [of a broker's] customers" were necessary to avoid misleading investors who received the NASD-approved letters. 742 A.2d at 849. Just so here: there is no inconsistency between the SEC approval that allows the stock borrow program to operate and a state-law requirement that respondents make disclosures to investors about its operation – or avoid affirmative misrepresentations such as their statement that the program addresses only "temporary shortfalls." *See supra* p. 1.[2]

Respondents further incorrectly suggest that they are helped by *O'Malley*'s discussion of *Guice v. Charles Schwab & Co.*, 674 N.E.2d 282 (N.Y. 1996). They concede, however, that *O'Malley* distinguished *Guice* because "the NASD rule at issue in *O'Malley* did not purport to limit the disclosures which may be included in a 'negative action' letter." Opp. 17. Nothing in the three pages of stock borrow program rules approved in 1981 purports to limit, or even mentions, what disclosures respondents can or must make about the program. If anything, therefore, *O'Malley*'s treatment of *Guice* suggests that the New York court of last resort would agree with *O'Malley*. That does not resolve the conflict demonstrated in the petition, but merely places one more State on petitioners' side of the split. *See* Pet. 23 n.19.[3]

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[2] *See also* Resp. App. 2a (Compl. ¶ 1: ("The Stock Borrow Program . . . was purportedly created to address SHORT TERM delivery failures by sellers of securities in the stock market. However, the end result of the program has been to create tens of millions of unissued and unregistered shares to be traded in the public market. Further, in some instances, the Stock Borrow Program has resulted in two or more shareholders who purchase shares in separate transactions to own the same shares.").

[3] Respondents further argue (at 17) that *O'Malley* is distinguishable because it did not involve allegations that the NASD-approved letters "inherently operated as a fraud." As the petition makes clear (at 15-16), petitioners allege not that the stock borrow program is *inherently* a fraud, but rather that respondents have misrepresented to the public (affirmatively

2. The petition discusses (at 23-26) other cases in conflict with the decision below that respondents address barely, if at all. Those cases show that state-law claims for fraud or misrepresentation rarely conflict with the purpose of federal law because state law almost always furthers federal law by preventing falsehood. Respondents dismiss *Bronco Wine Co. v. Jolly*, 95 P.3d 422 (Cal. 2004) (as well as *Bates*, *see infra* pp. 7-8), as being premised on "Congress's intent in adopting the precise preemption language at issue." Opp. 18. But that distinction makes no difference when the relevant congressional intent is the same. In *Bronco Wine*, the court found that Congress's intent concerning wine labeling was "to protect consumers from misleading labeling, not to permit [such] labeling." 95 P.3d at 457. Similarly here, Congress charged the SEC with exercising its authority under § 78q-1, "having due regard for the public interest, the protection of investors, the safeguarding of securities and funds, and maintenance of fair competition among brokers and dealers, clearing agencies, and transfer agents." § 78q-1(a)(2)(A).[4]

3. Respondents cite (at 18-19) the Seventh Circuit's decision in *American Agriculture Movement, Inc. v. Board of Trade of Chicago*, 977 F.2d 1147 (7th Cir. 1992), as authority for their position on the

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and through omissions) its actual operations. And respondents' argument (at 16-17) that *O'Malley* was a suit against a broker rather than a clearing corporation is an exercise in irrelevancy: both cases involve the preemptive effect on state securities law of the SEC-approved rules of a self-regulatory organization.

[4] Respondents make no attempt to distinguish *Drake v. Laboratory Corp. of America Holdings*, 458 F.3d 48 (2d Cir. 2006), which, as we explain (Pet. 24, 26), also conflicts with the decision below.

merits. If correct, their argument would only deepen the conflict over federal preemption of state securities claims and heighten the need for review. In any event, the case supports petitioners' position (and thus conflicts with the Nevada Supreme Court's decision here) because it states that preemption is appropriate "'only when'" state law is used "'in a manner that would, in effect, regulate [federally regulated] markets'" at the state level. Opp. 19 (quoting 977 F.2d at 1157) (holding that state-law claims for breach of fiduciary duty and negligence were preempted; no mention of any misrepresentation claims). Here, by contrast, holding the clearing companies liable for misrepresenting their business practices to the public would not "directly affect [their] operations," *id.*, but would merely require them to describe those operations accurately to the public – consistent with the shared federal and state policy of full disclosure and candor.

Respondents also point (at 1 n.1, 18) to other district court decisions in their favor on claims involving the same conduct at issue here. Those decisions are of limited relevance to this Court's determination whether to grant review because they involve neither federal courts of appeals nor state courts of last resort, although the widespread litigation over respondents' representations concerning the stock borrow program does help to show that this case involves "an important question of federal law" that should be settled by this Court. Sup. Ct. R. 10(c). In any event, those decisions either followed the erroneous decision below, *see Pet Quarters, Inc. v. DTCC*, No. 4:04-cv-1528-RSW, 2008 U.S. Dist. LEXIS 15316 (E.D. Ark. Feb. 25, 2008), or contained a likewise flawed analysis of the conflict-preemption issues, *see, e.g.*, *Capece* *v. DTCC*, No. 05-80498-CIV-RYSKAMP, 2005 U.S. Dist. LEXIS 42039 (S.D. Fla. Oct. 11, 2005); *Whistler Investments, Inc. v. DTCC*, No. CV-S-05-0634-RJC (PAL) (D. Nev. June 1, 2006) (two-page decision adopting *Capece*), *appeal pending*, No. 06-16088 (9th Cir. argued Mar. 10, 2008). A handful of adverse district court decisions is no sure sign of correctness: as this Court noted in *Bates*, it may instead indicate only that "those courts too quickly concluded that [the relevant] claims were pre-empted." 544 U.S. at 446.[5]

B. The Decision Below Conflicts With *Bates*

In *Bates*, the Court made clear that state laws that rest on duties of care congruent with those in federal law are not preempted. *See* Pet. 26-27. *Bates* also compels the lower courts to examine whether state-law remedies would aid the purposes of federal law, and here petitioners' claims would further the fundamental purpose of full disclosure mandated by the securities laws. *See* Pet. 27-30. In addition, *Bates* makes clear that federal approval of regulated activities does not authorize later representations made by a regulated entity in connection with those activities – especially where, as here, the agency has not reviewed those statements. *See* Pet. 30.

In claiming *Bates* to be inapposite (at 18), respondents all but ignore the policy of full disclosure underlying the securities laws. Instead, respondents mistakenly suggest (*id.*) that state-law prohibitions

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[5] Although irrelevant to this case, the summary judgment issued in *Nanopierce Technologies, Inc. v. Southridge Capital Management*, No. 02-CV-0767, 2008 WL 250553 (S.D.N.Y. Jan. 29, 2008), *see* Opp. 4 n.4, in NanoPierce's view left viable breach-of-contract claims that NanoPierce may prosecute.

on misrepresentation are preempted by statutory language referring to "uniform standards and procedures for clearance and settlement." § 78q-1(a)(1)(D). In that very provision, however, Congress declared that "[t]he linking of all clearance and settlement facilities and the development of uniform standards and procedures for clearance and settlement will reduce unnecessary costs and *increase the protection of investors*." *Id.* (emphasis added). Congress could hardly have made clearer its view that § 78q-1(a)(1)(D) was fully consistent with the long-standing federal goal of investor protection, a goal also served by the state laws under which petitioners' claims arise. State laws against fraud and misrepresentation have coexisted with federal securities laws from the beginning, and Congress was careful to include savings clauses in the 1933 and 1934 Acts, as well as the 1975 Amendments. *See* Pet. 9-10.

C. The Petition Raises An Important Issue Meriting This Court's Review

The conflict presented here concerns the interplay of federal and state policies of full disclosure in the securities market, and the decision below interprets federal policy to bar state remedies serving the primary goal of the federal securities laws themselves. Holding the fraud- and misrepresentation-based claims at issue here to be preempted by federal law would be a huge encroachment on the States' long-standing role in adjudicating such claims on behalf of injured parties. *See* Pet. 31.

Respondents (at 20) claim that those policies are not implicated because granting relief to petitioners would subject the clearing companies "to purported state law disclosure obligations that contradict, and therefore obstruct, the federally approved system."

But this argument (which in any event lacks merit) goes to the merits of their case, not to its importance: if petitioners are correct, then the national importance of the federally approved system makes it all the more vital that respondents correctly represent their operations. Further, respondents' purported distinction (at 21) claiming that their clearance and settlement activities come into play only "*after* the trading decisions have been made" simply ignores that the alleged misrepresentations occurred *before* those trading decisions were made and thus affected those decisions.[6]

Further, respondents rely (at 4) on the fact that the alleged misrepresentations and omissions affected numerous companies and were not limited to petitioners here. But that makes the issue presented

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[6] Respondents incorrectly claim (at 3) that petitioners' position is "wholly contrary to the SEC's own characterizations and assessment [of the stock borrow program] in approving the program pursuant to its Congressional mandate." Respondents do not dispute that the SEC in the end *agrees* with petitioners' fundamental allegations regarding the existence of phantom shares in the market. *See* Pet. 18 n.16. The controversy in this case is whether they should be liable for misrepresenting the existence and extent of those phantom shares, including but not limited to respondents' statements that such conditions are merely "temporary" when in fact they are persistently long-standing. *See supra* pp. 1, 4; *see also* Helen Avery & Peter Koh, *The Curious Incident of the Shares That Didn't Exist*, *Euromoney*, Mar. 2005. Relatedly, respondents attempt to obscure, but do not dispute, that their mode of operation of the stock borrow program permits the DTC member broker for the buyer of loaned shares to re-lend those shares, which can result in numerous "owners" of the same shares and is not disclosed to the investing public. *Compare* Pet. 14-15 (explaining this) *with* Opp. 11 (stating only that the original lending broker cannot re-lend the same shares but not addressing the buying broker's ability to do so).

more important, not less. This Court should soon address the far-reaching harm caused by respondents' conduct, permit state law to provide a remedy for the numerous companies and investors that respondents have injured, and protect the integrity of the national securities markets.

II. IN THE ALTERNATIVE, THIS CASE SHOULD BE HELD PENDING THIS COURT'S DECISION IN *ALTRIA*

In the alternative, the Court should hold the petition pending its decision in *Altria Group, Inc. v. Good*, No. 07-562. *See* Pet. 32-33. Respondents suggest (at 21) that the issue there is limited to "express preemption." But the Court granted certiorari on questions of both express and implied preemption.[7] Moreover, the petitioners' brief in that case (at 45-57 (filed Mar. 31, 2008)) argues an implied preemption theory, claiming that a "state-law challenge to the use of FTC-authorized descriptors would substantially impede the FTC's low-tar policy." *Id.* at 46. It is therefore possible that the Court could address implied preemption in a way that will be instructive to the lower courts in this and similar cases. Accordingly, if the Court chooses not to grant review at this time, it should hold this case pending a decision in *Altria*.

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[7] *See* http://www.supremecourtus.gov/qp/07-00562qp.pdf. The Court has also granted certiorari on an implied preemption issue in *Wyeth v. Levine*, No. 06-1249. That case raises an issue of implied preemption by Food and Drug Administration actions of claims brought against a pharmaceutical maker. *See* http://www.supremecourtus.gov/qp/06-01249qp.pdf. In light of the possibility that the Court may not reach the implied preemption issue in *Altria*, the Court may consider it appropriate to hold this case for *Wyeth* as well.

CONCLUSION

For the foregoing reasons and those stated in the petition for a writ of certiorari, the petition should be granted.

Respectfully submitted,

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