Supreme Court, U.S.
FILED

No. 08-

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# Supreme Court of the United States

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ROBERT MORRISON, individually and on behalf of all others similarly situated, RUSSELL LESLIE OWEN, BRIAN SILVERLOCK and GERALDINE SILVERLOCK,

*Petitioners,*

*v.*

NATIONAL AUSTRALIA BANK LTD., HOMESIDE LENDING INC., FRANK CICUTTO, HUGH HARRIS, KEVIN RACE and W. BLAKE WILSON,

*Respondents.*

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

## PETITION FOR A WRIT OF CERTIORARI

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## QUESTIONS PRESENTED

I. Whether the antifraud provisions of the United States securities laws extend to transnational frauds where: (a) the foreign-based parent company conducted substantial business in the United States, its American Depository Receipts were traded on the New York Stock Exchange and its financial statements were filed with the Securities Exchange Commission ("SEC"); and (b) the claims arose from a massive accounting fraud perpetrated by American citizens at the parent company's Florida-based subsidiary and were merely reported from overseas in the parent company's financial statements.

II. Whether this Court, which has never addressed the issue of whether subject matter jurisdiction may extend to claims involving transnational securities fraud, should set forth a policy to resolve the three-way conflict among the circuits (*i.e.*, District of Columbia Circuit versus the Second, Fifth and Seventh Circuits versus the Third, Eighth and Ninth Circuits).

III. Whether the Second Circuit should have adopted the SEC's proposed standard for determining the proper exercise of subject matter jurisdiction in transnational securities fraud cases, as set forth in the SEC's amicus brief submitted at the request of the Second Circuit, and whether the Second Circuit should have adopted the SEC's finding that subject matter jurisdiction exists here due to the "material and substantial conduct in furtherance of" the securities fraud that occurred in the United States.

## RULE 29.6 STATEMENT

Pursuant to Supreme Court Rule 29.6, petitioners state that they have no parent companies or non wholly owned subsidiaries.

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## PETITION FOR A WRIT OF CERTIORARI

Petitioners respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit.

## OPINIONS BELOW

The panel opinion of the United States Court of Appeals for the Second Circuit (App. 1a) is published at 547 F.3d 167. The district court's order (App. 23a) is reported at 2006 WL 3844465.

## JURISDICTION

The judgment of the court of appeals was entered on October 23, 2008. On January 13, 2009, Justice Ginsburg granted an extension of time until March 23, 2009, in which to file a petition for a writ of certiorari. This Court has jurisdiction pursuant to 28 U.S.C. §1254(i).

The jurisdiction of the district court was invoked pursuant to 28 U.S.C. §§ 1331 and 1337 as well as Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa.

## RELEVANT STATUTORY PROVISIONS

The relevant provisions of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and

SEC Rule 10b-5 promulgated thereunder, are reproduced at App., 78a-79a.

## STATEMENT OF THE CASE

### A. Summary of the Argument

The text of the Securities Exchange Act of 1934 ("Exchange Act") is silent as to the transnational reach of the statute. *See, e.g., Itoba Ltd. v. LEP Group, LLC*, 54 F.3d 118, 121 (2d Cir. 1995). But since the enactment of the Exchange Act, courts in every circuit have recognized that "subject matter jurisdiction may extend to claims involving transnational securities fraud." *S.E.C. v. Berger*, 322 F.3d 187, 192 (2d Cir. 2003). As Judge Henry J. Friendly noted more than 30 years ago, "Congress [did not] intend to allow the United States to be used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners." *ITT v. Vencap, Ltd.*, 519 F.2d 1001, 1017 (2d Cir. 1975). Yet during the many years in which the Exchange Act has been on the books, this Court has never construed this central and often determinative issue of subject matter jurisdiction in the context of the federal securities laws.

Meanwhile, the Seventh Circuit has observed the disarray among the circuits, noting that the circuits have adopted divergent approaches to a widely-used test to determine the existence of subject matter jurisdiction in securities fraud cases: the so-called "conduct test." *Kauthar SDN BHD v. Sternberg*, 149 F.3d 659, 663-65

(7th Cir. 1998). The conduct test focuses "on the nature of [the] conduct within the United States as it relates to carrying out the alleged fraudulent scheme," *Psimenos v. E.F. Hutton & Co.*, 722 F.2d 1041, 1045 (2d Cir. 1983), on the theory, as first expressed by Judge Friendly, that "Congress would not want the United States to become a base for fraudulent activity harming foreign investors." *Europa & Overseas Commodity Traders, S.A. v. Banque Poriba London*, 147 F.3d 118, 125 (2d Cir. 1998). The Seventh Circuit, in observing the disarray among the circuits, stated "[a]lthough the Circuits that have confronted the matter seem to agree that there are some transnational situations to which the antifraud provisions of the securities laws are applicable, *agreement appears to end at that point*." *Kauthar SDN BHD*, 149 F.3d at 665 (emphasis added).

The District of Columbia Circuit has developed the most restrictive approach under the conduct test, and requires that the domestic conduct at issue must *itself* constitute a securities violation. The Third, Eighth and Ninth Circuits are at the opposite end, requiring only that at least *some* activity designed to further a fraudulent scheme occur within the United States. The Second, Fifth and Seventh Circuits have adopted a middle ground between these two positions, requiring that the domestic conduct in question be more than merely preparatory to

the fraud and that it be a direct cause of the loss in question.[1]

The SEC, in its amicus brief submitted to the Second Circuit panel, rejected the District of Columbia Circuit's restrictive approach and proposed the following standard to assess whether the antifraud provisions apply to transnational securities fraud cases:

> The antifraud provisions of the securities laws apply to transnational frauds that result exclusively or principally in overseas losses if the conduct in the United States is material to the fraud's success and forms a substantial component of the fraudulent scheme.

App. 48a. The SEC believed that, applying the standard to the allegations in petitioners' complaint, "material and substantial conduct in furtherance of the alleged fraud occurred in the United States so as to support application of the antifraud provisions . . . ." App. 49a-50a.

As the SEC noted in its amicus brief, "[t]hese type of suits have become more prevalent in recent years." App.

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[1] This disarray is shown by the fact that within days of the Second Circuit's decision in this case, a court in the Eleventh Circuit reached the opposite holding on virtually the same facts. *See In re CP Ships Ltd. Sec. Litig.*, No. 8:05-MD-1656-27T, 2008 WL 4663363, at *2 (M.D. Fla. Oct. 21, 2008) (court exercised jurisdiction over securities claims involving financial fraud at a Tampa, Florida-based subsidiary that were reported in financial statements of parent company in England).

at 51a (citing *Royal Dutch/Shell Transp. Sec. Litig.*, 380 F. Supp. 2d 509 (D.N.J. 2005); *In re Bayer AG Sec. Litig.*, No. 03 Civ. 1546, 2004 WL 2190357 (S.D.N.Y. Sept. 30, 2004); *Froese v. Staff*, No. 02 CV 5744, 2003 WL 21523979 (S.D.N.Y. July 7, 2003); *In re Gaming Lottery Sec. Litig.*, 58 F. Supp. 2d 62 (S.D.N.Y. 1999)). Indeed, the timeliness of the issue is underscored by the export to foreign jurisdictions of the Bernard Madoff Ponzi scheme, which has recently given rise to various class actions on behalf of foreign investors. *See, e.g.*, *Inversiones Mar Octava Limitada v. Banco Santander, S.A.*, No. 09 Civ. 20215 (S.D.N.Y. filed Jan. 26, 2009).

It is time for this Court to resolve the divergent conduct test approaches among the circuits. The Exchange Act and its role in transnational securities fraud is too important an issue in the current world-wide economic crisis to allow the lower courts to continue floundering in disarray with divergent standards. This case presents an ideal vehicle for bringing order to the conduct test standards since this case implicates the current split of authority and involves only this one issue.

### B. Summary of the Case

Respondent National Australia Bank ("NAB") is organized under the laws of Australia and, at all relevant times, was that country's largest bank. NAB's ordinary shares trade on the Australian securities exchanges, and

its American Depositary Receipts ("ADRs")[2] were intentionally created to trade on the New York Stock Exchange ("NYSE"). Respondent Frank Cicutto was Chief Executive officer of NAB until February 2004.

Respondent HomeSide Lending, Inc. ("HomeSide") was at one time the sixth largest mortgage servicer in the United States and at all relevant times was a wholly-owned subsidiary of NAB, and was located in Jacksonville, Florida.[3] HomeSide was a mortgage service provider, meaning it serviced mortgages in return for a fee. Respondents Harris, Race and Wilson served as HomeSide's Chief Executive Officer, Chief Operating Officer, and Chief Financial Officer, respectively, from April 1999 until each man "resigned" on September 4, 2001.

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[2] An "ADR" is a negotiable certificate issued by a United States depositary bank that represents a specified number of shares of a foreign security that have been deposited with a foreign branch or agent of the depositary. ADRs are registered with the SEC and are governed by the provisions of the federal securities laws. In particular, NAB was required to file with the SEC Forms 6 and 20, which are nearly analogous to Forms 10-Q and 10K filed with the SEC by United States corporations. It is not disputed that the ADRs were traded on the NYSE although they are not encompassed within the proposed plaintiff class.

[3] After the stunning revelation in September 2001 of the A$3.05 billion writedown that NAB was forced to book, NAB sold HomeSide to Washington Mutual, Inc. In September 2008, J.P. Morgan Chase & Co. purchased the banking assets of Washington Mutual, Inc.

Petitioners alleged that Harris, Race and Wilson, then residents of Florida, violated the federal securities laws by intentionally overvaluing HomeSide's portfolio with the selection of unduly aggressive mortgage prepayment speeds, in violation of Generally Accepted Accounting Principles, which respondents knew were incorrect and which were chosen solely in order to achieve over-inflated earnings targets. When the accounting fraud was uncovered and disclosed on September 3, 2001, NAB announced two massive writedowns totaling well over three billion Australian dollars.

While NAB claimed that the problems at HomeSide were caused by inadvertent errors or mere mistakes, the real reason for the writedown and restatement was fraud. Several employees and top executives at HomeSide had been cooking HomeSide's books since at least April 1999. Based, in part, on an analysis of HomeSide's internal computer data produced by former employees who acted as "whistleblowers", petitioners alleged that there was a consistent manipulation of key data in HomeSide's valuation models. HomeSide executives Harris, Race and Wilson, along with others, had deliberately overvalued HomeSide's mortgage portfolio – its only real asset. This overvaluation occurred in a declining interest rate environment in which customers were refinancing and paying off mortgages that were being serviced by HomeSide – by hundreds of millions of dollars – and HomeSide's only real asset, its mortgage servicing rights, was disappearing.

HomeSide's fraudulent financial information was then transmitted to NAB in Australia. NAB incorporated this fraudulent information into its annual reports, reprinting the fraudulent financial statements of HomeSide *line-by-line. Every false statement made by NAB concerning HomeSide's operations, results and value was a repetition of the false financial information that HomeSide concocted in Florida for the very purpose of misleading NAB's shareholders about HomeSide's value and financial results.*

### C. The Decisions Below

Notwithstanding uncontroverted proof of the perpetration of the fraud in Florida, documented and corroborated by the internal records of HomeSide provided to counsel by confidential witnesses, the district court, in an Opinion entered on October 26, 2004, dismissed the securities claims of Owen and the Silverlocks, on the grounds that the district court did not have subject matter jurisdiction over the foreign plaintiffs' claims. App. 42a.

The district court entered final judgment on January 16, 2007.

A three-judge panel of the Second Circuit heard oral argument on July 18, 2008. The panel invited the SEC to submit an amicus brief to offer "the view of the [SEC] on both the broader questions posed by this case and the case itself" as to whether the antifraud provisions of the United States securities laws apply to transnational fraud. App. 48a. As previously noted, the SEC believed the instant

case supported the application of the antifraud provisions of the Exchange Act.

The Second Circuit, without any analysis of the SEC's position, held that there was no subject matter jurisdiction. Instead, the panel explained that "[t]he issue for us to resolve here boils down to what conduct comprises the heart of the alleged fraud." App. 18a.

The Second Circuit panel summarized petitioners' position as follows:

> [Petitioners] assert that the alleged manipulation of the MSR by HomeSide in Florida made up the main part of the fraud since those false numbers constituted the misleading information passed on to investors through NAB's public statements. According to [petitioners], if HomeSide had not created and sent artificially inflated numbers up to its parent company, there would have been no fraud, no harm to purchasers, and no claims under Rule 10b-5.

App. 18a.

The panel, per an opinion authored by Judge Barrington D. Parker, Jr., unanimously affirmed the district court and held, contrary to Judge Friendly's admonition, that the locus of the statement determined whether subject matter jurisdiction existed, rather than the locus of the conduct that comprised the fraud. App. 19a.

## REASONS FOR GRANTING THE PETITION

### I. The Federal Courts of Appeals Are Deeply Fractured Over Subject Matter Jurisdiction Involving Transational Securities Fraud

#### A. The Exchange Act Does Not Address Jurisdiction Over Transnational Securities Fraud

While Congress may prescribe the extent of federal jurisdiction over actions to enforce the federal securities laws, so long as it does not violate the broad limits of the due process clause, *see, e.g., Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1334 (2d Cir. 1972), Congress, in the Exchange Act, said little that bears on the issue. As one court noted, the provisions of the Exchange Act "frame a fairly broad grant of jurisdiction, but they furnish no specific indications of when American federal courts have jurisdiction over securities law claims arising from [transnational] transactions." *Zoelsch v. Arthur Anderson & Co.*, 824 F.2d 27, 29-30 (D.C. Cir. 1987). In analyzing Congressional silence regarding transnational securities fraud in the Exchange Act, Judge Friendly observed that "[t]he Congress that passed these extraordinary pieces of legislation in the midst of the depression could hardly have been expected to foresee the development of offshore funds thirty years later . . . ." *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 993 (2d Cir. 1975).

However, the federal courts have not confined jurisdiction to securities transactions consummated in the

United States. "It is elementary that the anti-fraud provisions of the federal securities laws apply to many transactions which are neither within the registration requirements nor on organized American markets." *Europe & Overseas Commodity Traders*, 147 F.3d at 123. Indeed, the courts plainly recognize that "subject matter jurisdiction may extend to claims involving transnational securities frauds." *S.E.C. v. Berger*, 322 F.3d at 192.

### B. The Circuits Have Adopted Three Different Approaches To The "Conduct Test" At Issue

Two tests have emerged to determine the reach of the antifraud provisions of the Exchange Act: the "effects test" and the "conduct test." Subject matter jurisdiction may be obtained by satisfying either test alone or by an "admixture or combination of the two." *Itoba Ltd.*, 54 F.3d at 122. The effects test focuses on whether domestic investors or markets are affected as a result of actions occurring outside the United States. *Europe & Overseas Commodity Traders*, 147 F.3d at 125. Under the "conduct test," subject matter jurisdiction exists over "conduct occurring predominately in the United States that is related to a transaction in securities, even if the transaction takes place outside the United States." *Restatement (Second) of Foreign Relations of the United States* §416(1)(d) (1987). This is true "even as applied to securities sold outside the United States or to persons who are not United States nationals or residents." *Id.* cmt. a.

Several methodologies have been devised to determine when, under the conduct test, American courts have jurisdiction over domestic conduct that is alleged to

have played some part in the preparation of a transnational securities fraud. However, "[t]he chronic difficulty with [the conduct test] has been describing, in sufficiently precise terms, the sort of conduct occurring in the United States that ought to be adequate to trigger American regulation of the transaction." *Kauthar SDN BHD*, 149 F.3d at 665. "Indeed, the circuits that have confronted the matter have articulated a number of methodologies." *Id.*

The District of Columbia Court of Appeals has advanced the most restrictive approach under the conduct test, holding that the domestic conduct at issue must itself constitute a securities violation. *Zoelsch*, 824 F.2d at 31. ("[J]urisdiction will be in American courts where the domestic conduct comprises *all the elements of a defendant's conduct* necessary to establish a violation of Section 10(b) and Rule 10b-5")(emphasis added).

At the other end of the spectrum, the Third, Eighth and Ninth Circuits, while also focusing on whether the United States-based conduct causes the plaintiff's loss, "generally require *some lesser quantum of conduct.*" *Robinson v. TCI/US W. Commc'ns, Inc.*, 117 F.3d 900, 906 (emphasis added). The Third Circuit, in *S.E.C. v. Kasser*, 548 F.2d 109 (3d Cir. 1977), held that the conduct comes within the scope of the Exchange Act if "at least *some activity* designed to further a fraudulent scheme occurs within the country." *Id.* at 114 (emphasis added). The Eighth Circuit, in *Continental Grain (Austl.) Pty. Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409 (8th Cir. 1979), held that the Exchange Act provisions were applicable

when the domestic conduct "was in furtherance of a fraudulent scheme and was *significant with respect to its accomplishment.*" *Id.* at 421 (emphasis added). The Ninth Circuit adopted the Eighth Circuit's standard set forth in *Continental Grain (Austl.) Pty. Ltd.* in *Gruenthal GmbH v. Hotz*, 712 F.2d 421, 425 (9th Cir. 1983).

The Second, Fifth and Seventh Circuits have set a mid-course between the two extremes of the District of Columbia Circuit, on the one hand, and the Third, Eighth and Ninth Circuits, on the other hand. The Second Circuit, in this case, recently reiterated "that our 'conduct test' requires that 'the defendant's conduct in the United States [be] more than merely preparatory to the fraud, and [that] particular acts or culpable failures to act within the United States directly cause[ ] losses to foreign investors abroad' for subject matter jurisdiction to exist." *Morrison v. National Austl. Bank*, 547 F.3d 167, 173 n.6 (2d Cir. 2008).

Similarly, in *Robinson*, the Fifth Circuit held that the conduct test requires that the domestic conduct in question be: (1) more than merely preparatory to the fraud, and (2) a direct cause of the loss in question. *Robinson*, 117 F.3d at 906-07.

The Seventh Circuit, in *Kauthar SDN BHD*, aligned itself with the Second and Fifth Circuits' "conduct test" methodology and held that its approach:

> represents the same midground as that identified by the Second and Fifth Circuits. . . . [W]e would do serious violence to the

> policies of these statutes if we did not recognize our country's manifest interest in ensuring that the United States is not used as a "base of operations" from which to "defraud foreign securities purchasers or sellers." *Kasser*, 548 F.2d at 116. This interest is amplified by the fact that we live in an increasingly global financial community. The Second and Fifth Circuit's iterations of the test embody a satisfactory balance of these competing considerations.

*Kauthar SDN BHD*, 149 F.3d at 667.

### C. The Conflict Is Entrenched

The conflict between the circuits is entrenched, with different circuits choosing to follow different approaches and rejecting the approaches formulated by other circuits – and reaching differing results as a consequence. As the Seventh Circuit has observed, "[a]lthough the Circuits that have confronted the matter seem to agree that there are some transnational situations to which the antifraud provisions of the securities laws are applicable, agreement appears to end at that point." *Kauthar SDN BHD*, 149 F.3d at 665.

In view of such an entrenched conflict, resolution of the conflict by this Court is warranted.

## II. This Case Is An Excellent Vehicle For Addressing The "Conduct Test"

The context of this case afford an ideal opportunity to resolve the reach of the Exchange Act provisions to transnational securities fraud under the "conduct test". The issue is the sole ground upon which the Second Circuit's decision is based. Furthermore, although the Fifth and Seventh Circuits follow the Second Circuit's approach to the "conduct test," the result would have been different in other circuits.

As the *Kasser* case above demonstrates, petitioners would prevail under the test used in the Third Circuit because "at least some activity designed to further a fraudulent scheme occur[red] within the country." *Kasser*, 548 F.2d at 114. Petitioners also would prevail in the Eighth and Ninth Circuits because the domestic conduct alleged here "was in furtherance of a fraudulent scheme and was significant with respect to its accomplishment." *Continental Grain (Austl.) Pty. Ltd.*, 592 F.2d at 421. Indeed, all of the fraud alleged in the Complaint, except for publication, occurred in Florida.

## III. As Recognized By The SEC, Resolution Of The Split Among The Circuits Is Necessary Now

This Court should not allow uncertainty over how to implement the "conduct test" to persist in the federal circuits any longer.

First, the issue has already percolated in the federal appeals courts. As shown above, seven circuits have

addressed this issue, and three different tests have emerged. The issue has been laid out by the appellate courts below; it is time for this Court to rule.

Second, the extraterritorial application of the antifraud provisions of the federal securities laws is an important issue, implicating serious policy concerns. As the Third Circuit noted in adopting its "conduct" test standard, "it should be recognized that this case in a large measure calls for a policy decision" as to the extent the United States should police domestic conduct aimed at foreign investors. *Kasser*, 548 F.2d at 116.

Third, as shown above, the Exchange Act and its legislative history are silent on the issue of extraterritorial application. There is no language foreclosing it; nor is there any language defining its scope. This Court is the *only* vehicle for a definitive resolution of this important issue.

Fourth, as noted above, courts in different circuits are reaching different results on essentially identical facts. Indeed, within two days of the Second Circuit's decision in this case, a court in the Eleventh Circuit reached the opposite holding on virtually the same facts. *See In re CP Ships Ltd. Sec. Litig.*, 2008 WL 4663363, at *2 (court exercised jurisdiction over securities claims involving financial fraud at Tampa, Florida-based subsidiary that were reported in financial statements of parent company in England).

Finally, the incidence of transnational fraud has changed dramatically. Due to advances in electronic

communications and global financial liberalization, isolated financial markets have merged into an interconnected financial marketplace. Many corporations, including NAB, have become global citizens. Thus, any fraud, as most recently exemplified by the Madoff Ponzi scheme, affect investors and markets in multiple nations. As transnational fraud increases, guidance from the Court becomes even more crucial.

## IV. As The SEC Noted, The Second Circuit's Case-By-Case Application Of The "Conduct Test" Has Left "Uncertainty In The District Courts"

As the SEC noted in its *amicus brief*, the Second Circuit's case law on the "conduct test" can be read to set forth a series of 'diverse formulations' of the applicable legal standard. App. 49a (quoting *In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 346, 73-74 (S.D.N.Y. 2005)). The district court in *Alstom* noted that there has been an "apparent shift in emphasis from a test of strict causation" – one where the domestic conduct must be the immediate cause of the overseas investors' losses – "to one of materiality of the domestic acts." *Id.* This has created a "tension" in the case law, *id.*, and, as a result, courts have largely resorted to engaging in a case-by-case comparison of the specific fact patterns to those of existing Second Circuit precedent. The district court in this case similarly noted that "[t]he complexity of th[is] required analysis means that individual cases are decided on very fine distinctions." App. 32a.

As previously noted, the SEC proposed the following standard to assess whether the antifraud provisions apply to transnational securities fraud cases:

> The antifraud provisions of the securities laws apply to transnational frauds that result exclusively or principally in overseas losses if the conduct in the United States is material to the fraud's success and forms a substantial component of the fraudulent scheme.

App. 48a.

In support of its proposal, the SEC explained that:

> The Commission believes that this Court could bring greater clarity to this area by adopting the proposed formulation. Furthermore, because this jurisdictional test would also be applied to Commission actions, *see SEC v. Berger*, 322 F.3d 187, 193-94 (2d Cir. 2003), we believe that the proposed standard would help preserve the Commission's ability to bring an enforcement action involving future transnational frauds such as the one alleged in the case.

App. 49a.

In essence, the SEC recommended that the Second Circuit adopt a "conduct test" standard that was more

aligned with the Third, Eighth and Ninth Circuits. However, the Second Circuit, after inviting the views of the SEC, did not address, analyze or mention the SEC proposed standard in its opinion.

## CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted. The Court may also want to consider calling for the views of the SEC through the Soliciter General.

Respectfully submitted,

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