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June 24, 2011

Catherine O'Hagan Wolfe, Esquire
Clerk of Court
United States Court of Appeals for the Second Circuit
Thurgood Marshall U.S. Courthouse
40 Foley Square
New York, New York 10007

Re: *Colin Wilson v. Merrill Lynch & Co., Inc., et al.,* No. 10-1528

Dear Ms. Wolfe:

The Securities and Exchange Commission submits this *amicus curiae* brief in response to the Court's March 1, 2011, letter inviting the Commission to address certain issues raised in this appeal. These issues concern the liability of defendants-appellees Merrill Lynch & Co., Inc. and Merrill Lynch, Pierce, Fenner & Smith Inc. (collectively, "Merrill") for allegedly engaging in market manipulation in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5(a) and (c) promulgated thereunder in its role as auction dealer of auction rate securities ("ARS"). The Court's letter asked the Commission to address five questions related to the adequacy of Merrill's disclosure of its practices in the ARS market and the effect of that disclosure on the claim of market manipulation and allegations of reliance made by the plaintiff, who purchased ARS securities in the market from a broker-dealer other than Merrill. As explained further below, the Commission takes the following positions on the Court's questions:

I. The disclosures made by Merrill Lynch concerning its conduct in the auction rate securities market were not sufficient, as a matter of law, to preclude the plaintiff from pleading a claim of market manipulation.

II. Plaintiff's allegations that Merrill Lynch manipulated auctions for auction rate securities do not preclude plaintiff from pleading an efficient market for purposes of the fraud-on-the-market presumption of reliance.

III. Assuming that plaintiff has properly pleaded market efficiency for the purposes of the fraud-on-the-market presumption, Merrill Lynch's disclosures of its conduct in the auction rate securities market do not, as a matter of law, rebut that presumption by establishing truth-on-the-market.

IV. The presumption of reliance in non-disclosure or omission cases set forth in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), is generally available in manipulation cases, and is potentially available for the particular claim pleaded here.

V. Merrill Lynch's disclosures of its practices in the auction rate securities market do not, as a matter of law, preclude plaintiff from pleading that he justifiably relied on the integrity of the auction rate securities market.

BACKGROUND

A. The ARS Market

ARS were first developed in 1984 (AA115) and, by February 2008, the ARS market had grown to over $330 billion (AA313).[1/] During the time period relevant to the claims in this case—2003 to 2008, ARS consisted primarily of long-term bonds issued by municipalities and student loan entities, as well as preferred stock issued by closed-end funds, that have variable interest rates or dividend yields periodically reset through auctions. AA312-13; *United States v. Tzolov*, __ F.3d

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[1/] "AA" refers to the Appendix to Brief of Plaintiff-Appellant. "Cmplt." refers to the First Amended Consolidated Class Action Complaint. "Def. Br." refers to the Brief for Defendants-Appellees Merrill Lynch & Co., Inc. and Merrill Lynch, Pierce, Fenner & Smith, Inc.

__, 2011 WL 2342629 at *1 (2d Cir. June 15, 2011). They were used by issuers as an alternative variable rate financing vehicle, and they were offered to investors as a highly liquid investment and an alternative to money market funds. AA115; *Tzolov*, 2011 WL 2342629 at *1. Initially, investors in ARS were mainly institutional investors; but, over time, smaller investors also began participating in the market. Typically, the minimum investment was $25,000. AA115; 313.

Because ARS were auctioned at par, the yield to the investor, and the cost of financing for the issuer, between auction dates was determined by the interest rate, or "clearing" rate, established through the periodic auctions, which were typically held every seven, twenty-eight, or thirty-five days. AA115; 312. In these auctions, buy bids with the lowest interest rate, and then successively higher rates, were accepted until all of the sell orders in that auction were filled. AA115. The "clearing rate" was the lowest rate bid sufficient to cover all of the securities for sale in the auction. AA115; 313. If there were not enough bids to cover the securities in the auction, then the auction failed and the issuer would pay a maximum or "penalty" rate, which is either a flat rate or a rate set based on a formula described in the offering documents. AA115; 313. In the event of an auction failure, all of the current holders would continue to hold the securities at the penalty rate until the next successful auction, if any. AA115; 313-14.

The issuer of each auction rate security selected one or more broker-dealers to underwrite the offering and/or manage the auction process. AA115. Investors could submit bids only through the selected broker-dealers, and the issuer paid an annualized fee to each broker-dealer to manage the auction process. *Id*. The issuer also selected an auction agent to collect the bids and determine the clearing rate for the auction. AA116. Merrill participated in the ARS market as both an underwriter for public and private issuers that wanted to raise cash through the use of auction rate securities and as an auction dealer, managing auctions for issuers. AA314.

In August and September of 2007, as the credit market deteriorated, a number of auctions for certain ARS failed, including some ARS for which Merrill was the auction dealer. AA322. Conditions continued to deteriorate throughout the fall of 2007 and early 2008. On February 13, 2008, all major auction dealers, including Merrill, stopped supporting auctions by bidding to prevent auction failure, and 87% of all ARS auctions failed. AA322-23. As a result, investors

were unable to sell their ARS at auction and were forced to hold the securities until either liquidity returned to the market or the underlying debt instrument matured. The resulting illiquidity of the ARS market has not abated. AA323.

B. Merrill's Alleged Role in the ARS Market

Plaintiff alleges that Merrill, in its role as auction dealer for ARS, "engaged in a scheme, practice or course of conduct to manipulate the market for [Merrill] ARS in order to create the appearance that the securities traded at arm's-length auctions, when in fact the available supply well-exceeded the demand for those securities." Cmplt. ¶ 4 (AA29-30). Specifically, it is alleged that, in order to "create the appearance of a functioning auction market in which auction rate securities traded in accordance with actual supply and demand," Merrill maintained a policy of intervening in every auction. Cmplt. ¶ 42 (AA37-38). Merrill allegedly did so by "routinely" placing "support" bids (Cmplt. ¶ 44 (AA38)), through which it acquired ARS for its own account in order to mask a lack of demand and prevent auction failure (¶ 45 (AA38)). According to the complaint, until August 2007 Merrill followed a "uniform policy" of placing support bids "if needed to prevent auction failures" in "every" auction for which it was sole or lead auction dealer. ¶ 46 (AA39). Merrill allegedly placed support bids to prevent more than 5,800 auctions from failing between January 3, 2006 and May 27, 2008. ¶ 47 (AA39).

According to the complaint, Merrill executives knew that the ARS market was unsustainable by the fall of 2007 (¶ 135 (AA55)), and it was only through the conduct of Merrill and other auction dealers in artificially supporting the auctions, acting as buyers of last resort, that the market for Merrill ARS was able to exist during the class period. ¶ 192 (AA67). Plaintiff alleges that the conduct of Merrill and other auction dealers created an illusory market that, unbeknownst to plaintiff, had a high risk of failing and leaving investors with illiquid ARS. ¶ 193 (AA67).

The complaint also alleges that Merrill failed to disclose to investors: that it "invariably" placed support bids in "every auction" for which it was the sole or lead auction dealer to prevent auction failures; that it did so pursuant to a tacit agreement with issuers that it would suppress auction failures; and that the impact of its "extensive and sustained" intervention created the outward appearance that

Merrill ARS were readily liquid investments and that the auction market functioned by the natural interplay of supply and demand. ¶ 49 (AA39).

Merrill is also alleged to have made false statements to its customers describing ARS as highly liquid, safe investments similar to money market funds and classifying them as "other cash" on client account statements. ¶ 53 (AA40). The complaint further alleges that Merrill issued research reports in August and December 2007, as well as February 2008, which downplayed the risks of ARS and the consequences of auction failure. ¶¶ 72-75 (AA44-45), 159 (AA60), 160-62 (AA60-61).

C. Merrill's Disclosures

Merrill disclosed its role in the ARS market to investors and potential investors primarily through two sources—the offering documents for the various securities with which it was involved, and its public website. The prospectus, which was issued in 1997, for the ARS product purchased by the plaintiff states among other things that:

- Under certain circumstances, holders * * * may be unable to sell their shares * * * in an Auction and thus may lack liquidity of investment. AA173.

- a Broker-Dealer * * * may hold [the ARS] for its own account as a Beneficial Owner. A Broker-Dealer thus may submit orders to the Auction Agent as a Beneficial Owner or a Potential Beneficial Owner and therefore participate in an Auction as an Existing Holder or Potential Holder on behalf of both itself and its customers. AA178.

- If sufficient clearing bids do not exist, * * *, Existing Holders that have submitted Sell Orders will not be able to sell in the Auction all, and may not be able to sell any, shares * * *. Thus, under ceratin circumstances, Existing Holders and, thus, the Beneficial owners they represent may not have liquidity of investment. AA179.

- neither Broker-Dealers nor the Fund are obligated to purchase shares * * * in an Auction or otherwise nor is the Fund required to redeem shares * * * in the event of a failed Auction. AA182.

In 2006, Merrill also posted additional disclosures on its website. As relevant here, those disclosures state the following:

- Merrill Lynch is permitted, but not obligated, to submit orders in auctions for its own account either as a bidder or a seller, or both, and routinely does so in its sole discretion. AA102.

- Merrill Lynch *may routinely place one or more bids* in an auction for its own account to acquire auction rate securities for its inventory, *to prevent an auction failure* * * * or an auction from clearing at a rate that Merrill Lynch believes does not reflect the market for the securities. AA103 (emphasis added).

- Bids by Merrill Lynch * * * are likely to affect the clearing rate * * *. AA103.

- the fact that an auction clears successfully does not mean that an investment in the securities involves no significant liquidity or credit risk. Merrill Lynch is not obligated to continue to place * * * bids or encourage other bidders to do so in any particular auction to prevent an auction from failing or clearing at a rate Merrill Lynch believes does not reflect the market for the securities. Investors should not assume that Merrill Lynch will do so or that auction failures will not occur. AA103.

- Merrill Lynch *may submit a bid in an auction to keep it from failing*, but it is not obligated to do so. There *may not always* be enough bidders to prevent an auction from failing in the absence of Merrill Lynch bidding in the auction for its own account or encouraging others to bid. Therefore, *auction failures are possible*, *especially if* the issuer's credit were to deteriorate, if a market disruption were to occur or if, *for any reason, Merrill Lynch were unable or unwilling to bid*. AA105 (emphasis added).

D. Prior Commission Actions Regarding Auction Rate Securities

In May 2006, the Commission instituted and settled an administrative proceeding against fifteen broker-dealers participating in the ARS market, including Merrill. The Commission found that each respondent violated Securities

Act Section 17(a)(2) from at least January 1, 2003, through June 30, 2004, by engaging in one or more of eight violative practices. *In re Bear, Stearns & Co., Inc.; CitiGroup Global Markets, Inc.; Goldman Sachs & Co.; J.P. Morgan Securities, Inc.; Lehman Bros. Inc.; Merrill Lynch Pierce, Fenner and Smith, Inc.; Morgan Stanley & Co. Inc. and Morgan Stanley DW Inc.; RBC Dain Rauscher Inc.; Banc of America Securities, LLC.; A.G. Edwards & Sons, Inc.; Morgan Keegan & Co., Inc.; Piper Jaffray & Co.; SunTrust Capital Markets, Inc.; and Wachovia Capital Markets LLC*, Rel. No. 34-53888 (May 31, 2006) ("2006 C&D Order") (AA112-122, at 114). One of the violative practices was intervention in auctions, which was described, in relevant part, in the 2006 C&D Order as follows:

> Certain Respondents intervened in auctions by bidding for their proprietary accounts or asking customers to make or change orders without adequate disclosure. In certain instances, the interventions affected the clearing rate. Certain Respondents intervened in one or more of the following three ways:
>
> b.1. Bids To Prevent Failed Auctions. Without adequate disclosure, certain Respondents bid to prevent auctions from failing. * * *. These Respondents submitted bids to ensure that all of the securities would be purchased to avoid failed auctions and thereby, in certain instances, affected the clearing rate;

2006 C&D Order at 6 (AA117). The order, however, specifically noted that broker-dealers were not prohibited from bidding for their proprietary accounts in the auctions they administer, so long as this participation was "properly disclosed." *Id.* at 6, n.6 (AA117).

Under the terms of the settlement, each respondent was required to, among other things:

> at all times make a description of its then-current material auction practices and procedures available to * * * the general public on * * * its website * * *.

Id. at 11 (AA122). The disclosures posted on Merrill's website in 2006 (*supra* pp.6-7) were made pursuant to this settlement.

On August 22, 2008, after the collapse of the ARS market, the Commission issued a press release announcing a potential action against, and preliminary settlement in principle with, Merrill regarding its conduct in the ARS market prior to the market's collapse. In that press release, the Commission described Merrill's alleged misconduct as follows:

> The proposed charges involve alleged misrepresentations by Merrill Lynch to thousands of its customers that ARS were safe, highly liquid investments equivalent to money market instruments and cash. Merrill Lynch did not make adequate disclosures that the liquidity of these securities was based on Merrill Lynch supporting the auctions it managed when there was not enough demand. Investors were left holding illiquid securities when Merrill Lynch stopped supporting auctions in February 2008. Furthermore, Merrill Lynch continued to tout the purported liquidity of ARS to customers despite its awareness of the escalating liquidity risks in the weeks and months preceding the collapse of the ARS market.

SEC Enforcement Division Announces Preliminary Settlement with Merrill Lynch to Help Auction Rate Securities Investors, August 22, 2008, http://www.sec.gov/news/press/2008/2008-181.htm (AA192-94, at 192).

Under the terms of the settlement in principle, Merrill would offer to repurchase ARS from certain individual, charitable, and small business customers, thereby restoring liquidity for those customers. AA192-93. Merrill ultimately repurchased a number of ARS from its customers. AA311.

E. Procedural History of This Case

The complaint in this case alleges market manipulation pursuant to Rule 10b-5(a) and (c), and is brought on behalf of "all persons or entities that, between March 25, 2003, and February 13, 2008, purchased auction rate securities for which Merrill served as the sole auction dealer, lead auction dealer, co-lead auction dealer, or joint lead auction dealer." Cmplt. ¶ 2 (AA29). The original

named plaintiffs were customers of Merrill. After those plaintiffs accepted an offer from Merrill to repurchase their ARS as part of the preliminary settlement in 2008, the complaint was amended to name plaintiffs who were not Merrill customers and were therefore not eligible for the repurchase offer. AA311-12. Because the plaintiff on appeal was not a Merrill customer, the allegedly misleading statements made by Merrill to its customers did not reach him (AA355-56), and the complaint does not allege that he read the allegedly false research reports (*id.*).

Merrill moved to dismiss the complaint for failure to state a claim. On March 31, 2010, the district court granted that motion, finding that plaintiff failed to allege manipulative conduct and that he failed to sufficiently plead reliance. *See In re Merrill Lynch ARS Litig.*, 704 F.Supp.2d 378 (2010) (AA309-363). These findings largely turned on the district court's determination that Merrill sufficiently disclosed its role in the ARS market.

With respect to plaintiff's allegations of market manipulation, the district court found that Merrill fully disclosed the alleged manipulative conduct—placing support bids in auctions. AA332-38. The district court noted that "[t]he fact that Merrill * * * could prevent failed auctions through the placement of support bids was disclosed in numerous publicly available documents," including the 2006 C&D Order and Merrill's website. AA334-35. And, according to the district court, any distinction between Merrill's disclosure that it "routinely" bid and plaintiff's assertion that Merrill "invariably" did so was "semantic." AA336. Thus, Merrill's disclosures prevented its conduct from sending "a false pricing signal to the market," (AA334) and plaintiff failed to sufficiently allege manipulation (AA338).

With respect to reliance, the district court first found that plaintiffs alleging market manipulation can show reliance through the fraud-on-the-market presumption, under which plaintiffs relying on the price of a security determined in an efficient market are presumed to have relied on the defendant's fraudulent conduct. AA340-41. And, while noting that plaintiff's allegation that there was, in fact, no actual market for ARS securities called the efficiency of the ARS market into question (AA343 & n. 10), the district court determined that plaintiff's allegations of an efficient market here sufficed to survive a motion to dismiss. AA344. The court went on to find, however, that the fraud-on-the-market

presumption was rebutted here as a matter of law because an efficient market would have incorporated the information in the 2006 C&D Order, Merrill's website disclosures, and the prospectuses for the ARS at issue. As a result, knowledge of Merrill's practices would have been incorporated into ARS pricing by the time the plaintiff purchased his securities. AA344-48.

The district court also rejected plaintiff's claim to the presumption of reliance articulated in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972), which applies when a claim involves "primarily a failure to disclose" and the facts withheld are material. AA349-52. The district court first noted that both the Ninth and the Tenth Circuits have held that the *Affiliated Ute* presumption does not apply to manipulation claims. AA350 (*citing Joseph v. Wiles*, 223 F.3d 1155 (10th Cir. 2000) and *Desai v. Deutsche Bank Sec. Ltd.*, 573 F.3d 931 (9th Cir. 2009)). The district court also determined that the complaint was based primarily upon alleged market activity, rather than a specific omission, and was therefore not "primarily" an omission claim eligible for the presumption. AA351. And, even if *Affiliated Ute* applied to manipulation claims, and plaintiff's claim was primarily one of omission, the district court found that the disclosures rebutted any presumption of reliance. AA351-52.

Finally, the district court found plaintiff's allegations of individualized reliance on the integrity of the ARS market insufficient. In the district court's opinion, plaintiff failed to plead facts sufficient to demonstrate that, as downstream investors, the putative class members heard or received any direct representations from Merrill regarding the liquidity or efficiency of the ARS market (AA355-56) or that they read the allegedly false research reports (AA355). In addition, the district court found that plaintiff could have discovered the disclosures of Merrill's conduct in the prospectus and the 2006 C&D Order through "minimal diligence" and, in light of those disclosures, could not have justifiably relied on the integrity of the ARS market. AA357-61.

Plaintiff appealed this decision, and a panel of this Court (Circuit Judges Kearse, Sack, and Katzmann) heard oral argument in the appeal on February 25, 2011.

DISCUSSION

I. The disclosures made by Merrill Lynch concerning its conduct in the auction rate securities market were not sufficient, as a matter of law, to preclude the plaintiff from pleading a claim of market manipulation.

In certain circumstances, disclosure can prevent a false signal from being sent to the market, thereby undermining a claim of manipulation. *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977) (manipulative practices are those that artificially affect market activity in order to mislead investors; "nondisclosure is usually essential to the success of a manipulative scheme"); *see also ATSI Communications, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 100-01 (2d Cir. 2007) (distinguishing lawful from manipulative conduct by assessing whether a false impression of supply and demand had been created). This Court has asked the Commission whether Merrill's disclosures here were sufficient, as a matter of law, to preclude plaintiff's claim of manipulation. In the Commission's view, they were not.

The district court concluded that Merrill's disclosures negated plaintiff's claim that Merrill misled the market into believing that the clearing rates set by the auctions of its ARS were "dictated by the natural interplay of supply and demand" (AA335) because "[t]he fact that Merrill Lynch could prevent failed actions through the placement of support bids was disclosed" (AA334). In the district court's view, it was sufficient for Merrill to disclose:

> that Merrill Lynch *might routinely* submit support bids to prevent auction failures, that Merrill Lynch's bidding *could* determine clearing rates, that auction failures *were possible* "especially if * * * Merrill Lynch were unable or unwilling to bid," and that failed auctions *could* result in investors' not being able to sell any of their securities.

AA338 (emphasis added).

Courts have long recognized, however, that disclosure of a potential risk is insufficient when, in fact, the risk is much greater and/or is a known certainty. *See, e.g., Rombach v. Chang*, 355 F.3d 164, 173 (2d Cir. 2004) (the bespeaks

caution doctrine "'provides no protection to someone who warns his hiking companion to walk slowly because there might be a ditch ahead when he knows with near certainty that the Grand Canyon lies one foot away.'") (*quoting In re Prudential Sec. Inc. P'ships Litig.*, 930 F. Supp. 68, 72 (S.D.N.Y. 1996)). *See also Dolphin & Bradbury, Inc. v. SEC*, 512 F.3d 634, 640 (D.C. Cir. 2008) (same); *Lormand v. US Unwired*, Inc., 565 F.3d 228, 247 (5th Cir. 2009) (finding inadequate "warnings about * * * future risk of *limited* magnitude that would be averted rather than certain dangers that had already begun to materialize") (emphasis in original); *In re Westinghouse Sec. Litig.*, 90 F.3d 696, 709 (3d Cir. 1996) ("a reasonable investor would be very interested in knowing, not merely that future economic developments might cause further losses, but that (as plaintiffs allege) current reserves were known to be insufficient under current economic conditions"); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 544 (5th Cir. 1981) ("To warn that the untoward may occur when the event is contingent is prudent; to caution that it is only possible for the unfavorable events to happen when they have already occurred is deceit."), *rev'd in part on other grounds*, 459 U.S. 375 (1983); *see also Slayton v. American Express Co*., 604 F.3d 758, 770 (2d Cir. 2010) ("cautionary language that is misleading in light of historical fact cannot be meaningful."). The Commission has taken this same approach in its administrative proceedings. *See, e.g.*, *In re Dolphin & Bradbury, Inc.*, Securities Act Release No. 8721, at 15 (July 13, 2006).

Here, by stating that, in the absence of its bidding, there "*may* not always" be enough bidders to prevent auction failure, and that therefore auction failure was "*possible*" if Merrill failed to bid (AA105), Merrill's disclosures imply that some auctions have sufficient independent demand to prevent failure. In light of plaintiff's allegations that Merrill knew there was no such demand, and concealed that fact through its practice of placing support bids in *every* auction with knowledge that its failure to do so would lead to *certain* auction failure and the collapse of the ARS market, Merrill's disclosures were not sufficient.

The district court's focus on what it viewed as the lack of a distinction between the disclosures' description of Merrill's placement of support bids as "routine" and plaintiff's allegation that Merrill "invariably" or "systematically" placed such bids was similarly flawed. AA336 (describing the distinction as "merely semantic"). The disclosures' description of the frequency with which Merrill bid cannot be separated from the description of the likelihood it would do

so. By disclosing that it "*may* routinely" bid, rather than that it actually *did* so, Merrill misleadingly described as contingent something that plaintiff alleges was a certainty. Moreover, Merrill's disclosure stated that it "may routinely" bid not only to prevent auction failure, but also to acquire ARS for its own inventory or to set the clearing rate at a level it feels more appropriately approximates the market. AA103. This does not accurately describe Merrill's alleged practice of placing bids in every auction specifically for the purpose of preventing failure.

Merrill argues that it did disclose that it "would 'routinely'" bid to prevent auction failure. Def. Br. 29. This argument, however, conflates separate disclosures. Merrill's disclosure that it was permitted to place orders for its own account and "routinely does so" refers not to the placement of support bids, but rather to the fact that Merrill may submit orders "either as a bidder or a seller." AA102. It therefore does not convey a routine practice of placing support bids. In addressing support bids specifically, Merrill's website stated not that it "would," but that it "may," routinely place bids. As already discussed, this was insufficient.

Merrill also argues that disclosure that it "may routinely" place support bids was accurate because the use of "may" reserved its right to decide not to bid in any given auction. Def. Br. 32-33. In Merrill's view, to disclose the certainty of bidding would be inaccurate in light of its ability to refrain from bidding. Def. Br. 33-34. There would be no inaccuracy, however, in disclosing that Merrill currently placed support bids in all of its auctions, that without such bids the auctions would fail, and that Merrill reserved the right not to bid in the future. Indeed, such a disclosure would be consistent with Merrill's undertaking in the 2006 C&D Order to disclose its "then current" practices and would accurately portray the liquidity risks in the market for Merrill's ARS. Thus, especially when viewed together with the incomplete disclosure that, without Merrill's bidding, auction failure was possible, rather than certain, Merrill's disclosure that it "may routinely" place support bids was insufficient to preclude plaintiff's claim of manipulation.

Finally, in finding that there was sufficient disclosure, the district court pointed to the 2006 C&D Order, stating that it "highlighted that auction dealers had placed support bids to prevent failed auctions and specifically noted that the Order did not prohibit such conduct as long as it was properly disclosed." AA335. That order, however, listed eight separate violative practices and noted that "each"

of the fifteen respondents engaged in "one or more" of those practices. 2006 C&D Order at 5 (AA116). Even assuming the order notified investors that Merrill engaged in support bids (one of the eight violative practices), there is no discussion in the order of the key allegation here that if Merrill did not engage in support bids, the auctions would fail and the market would collapse. To the contrary, the order states that "certain respondents" bid to prevent auctions from failing and that "[i]n certain instances" these actions affected the clearing rate. And, while the order states that the practice of bidding for a broker's proprietary account was permitted if properly disclosed (2006 C&D Order at 6, n.6 (AA117)), it then requires Merrill and others to post their "then-current" practices on their websites. *Id*. at 11 (AA122). The order therefore merely begs the question of whether the website disclosures constituted an accurate description of Merrill's then-current practices. As already discussed, if the allegations of the complaint are taken as true, in the Commission's view the disclosures did not.

II. Plaintiff's allegations that Merrill Lynch manipulated auctions for auction rate securities do not preclude plaintiff from pleading an efficient market for purposes of the fraud-on-the-market presumption of reliance.

In *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), the Supreme Court addressed the manner in which plaintiffs in private securities actions can prove reliance through evidence common among members of the class, thereby allowing class certification under Federal Rule of Civil Procedure 23. 485 U.S. at 241-48. The Court recognized that "[r]equiring proof of individualized reliance from each member of the proposed plaintiff class" often would "prevent[] [plaintiffs] from proceeding with a class action, since individual issues then would * * * overwhelm[] the common ones." *Id.* at 242. The Court held that plaintiffs may overcome that obstacle by invoking a rebuttable presumption of reliance based on the fraud-on-the-market theory. *Id.* at 242-47.

The Supreme Court noted that in market based transactions, unlike face-to-face transactions, the market is "interposed between seller and buyer" and transmits information to the investor in the processed form of a market price. 485 U.S. at 244. Under the fraud-on-the-market theory, the Court explained, "the market price of shares traded on well-developed markets reflects all publicly available information," including "any public material misrepresentations," and

"[an] investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price." *Basic*, 485 U.S. at 246-47. Thus, "an investor's reliance on any public material misrepresentations * * * may be presumed for purposes of a Rule 10b-5 action." *Id.* at 247. This presumption is rebuttable through "[a]ny showing [by a defendant] that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price." *Id.* at 248.

Plaintiff argues that he is entitled to the fraud-on-the-market presumption here, asserting that the complaint sufficiently alleges an efficient market by stating that ARS were held by a wide variety of investors (Cmplt. ¶ 154, AA59), the auction market had existed since 1984 (Cmplt. ¶ 156, AA59), material information "had a prompt and immediate effect on the market price" of ARS (Cmplt. ¶ 162, AA60-61), Merrill published research reports on ARS (Cmplt. ¶¶ 157-60, AA59-60) and ARS were continually traded at periodic auctions (Cmplt. ¶ 34, AA36). The district court found these allegations of efficiency sufficient to withstand a motion to dismiss. AA344. The Court has not asked the Commission to express a view on this question and we do not do so. Rather, we address only the Court's question of whether plaintiff's allegations of manipulation preclude a finding of an efficient market where one is otherwise sufficiently pled.

In the Commission's view, they do not. There is nothing inherent in an allegation of manipulation that alters the fraud-on-the-market inquiry. Just as a misstatement sends a false signal to the marketplace by inserting false information and therefore artificially altering supply or demand, manipulation sends a false signal through "market activity aimed at deceiving investors as to how other market participants have valued a security." *ATSI*, 493 F.3d at 100. For example, manipulative practices such as matched orders and wash sales create a false impression of demand. Thus, in the words of the district court, like misstatements, manipulations "result in the injection of a false premise into the marketplace" which, in an efficient market, "is then reflected in the price of the security." AA341. It is therefore just as appropriate in a manipulation case to presume that reliance on the price of the security constitutes reliance on the defendant's wrongdoing. *See Scone Invs, L.P. v. Am. Third Mkt. Corp.*, 1998 WL 205338 at *5 (S.D.N.Y. April 28, 1998) (fraud-on-the-market presumption is "especially applicable in the market manipulation context"); *In re UBS ARS Litig.*, 2010 WL 2541166, at *25 n.16 (S.D.N.Y. June 10, 2010) (fraud-on-the-market presumption

applicable in manipulation cases); *see also Black v. Finantra Capital Inc.*, 418 F.3d 203, 209 (2d Cir. 2005) (stating, without discussion, that the district court "correctly instructed" the jury on the fraud-on-the-market presumption in a market manipulation case); *cf Peil v. Speiser*, 806 F.2d 1154, 1163 (3d Cir. 1986) (fraud-on-the-market presumption applies to all 10b-5 claims, whether brought under clause (a), (b), or (c)); *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040, 1051 (9th Cir. 2006) (fraud-on-the-market presumption applies in cases brought under all three clauses of Rule 10b-5), *vacated on other grounds by Simpson v. Homestore.com, Inc.*, 519 F.3d 1041 (9th Cir. 2008); *but see In re IPO Sec. Litig.*, 471 F.3d 24, 43, (2d Cir. 2006) ("it is also doubtful whether the *Basic* presumption can be extended, beyond its original context * * *").

Merrill argues that the presumption should not apply here because, if ARS prices were in fact set by it, rather than by supply and demand, the market cannot be efficient for purposes of the fraud-on-the-market presumption. Def. Br. 49-50. The district court similarly noted that "[t]he lack of an actual market for ARS would raise questions as to how public information was incorporated into ARS pricing." AA344, n.10. These arguments, however, conflate the allegation of fraud with the question of an efficient market. The fraud-on-the-market theory is based on the assumption that a well-developed market efficiently incorporates public information into the pricing of securities and it is therefore appropriate to presume that, in relying on the price, investors are relying on any fraud. That manipulation, or any other fraud, skews the market's ultimate valuation of the security does not undermine this premise. Thus, the question of market efficiency for the purposes of the presumption is whether, absent the fraud, the market efficiently incorporates information and conveys that information to investors.

Here, absent fraud, the interest rate in the ARS market (akin to the price) is intended to reflect demand for the security. Where there is ample demand for a particular ARS, the clearing rate would presumably be lower. As demand weakens, higher clearing rates are required to match the number of securities for sale in that auction and, in the case of insufficient demand to meet the available supply, the auction fails and the interest rate is set at a penalty rate. Plaintiff's allegation, not unlike that in an ordinary manipulation case, is that unbeknownst to the market, Merrill used support bids to purchase any excess supply. By doing so, it ensured that there were no auction failures and created an appearance of demand where there was none. Like in misrepresentation cases and other manipulation

cases, then, investors in what is alleged to have been an otherwise efficient market rely on the integrity of a market price that has in actuality been corrupted by the defendant's wrongdoing. It is therefore appropriate to presume that the investors relied on the wrongdoing itself. To conclude, as Merrill asserts, that an allegation that the price of a security is secretly manipulated or controlled by the defendant precludes such reliance would have the perverse effect of precluding use of the fraud-on-the-market presumption in cases in which the fraud is the most fundamental to the operation of the market and allowing the defendant to use its own alleged fraud as a defense to liability.

III. Merrill Lynch's disclosure of its conduct in the auction rate securities market does not, as a matter of law, rebut the fraud-on-the-market presumption by establishing truth-on-the-market.

As mentioned above, the fraud-on-the-market presumption of reliance is rebuttable. One way in which it can be rebutted is a showing that information has "credibly entered the market and dissipated the effects of the misstatements" on the stock's price. *Basic*, 485 U.S. at 249. This is sometimes termed the "truth-on-the-market" defense. See *Ganino v. Citizens Utilities Co.*, 228 F.3d 154, 168 (2d Cir. 2000). The Court asks whether, assuming plaintiff sufficiently pled an efficient market, Merrill's disclosures counterbalanced any misinterpretations resulting from the alleged manipulation. The district court concluded that they did. AA344-49.

Given the Commission's view that the disclosures cannot be said to be complete as a matter of law, however, it follows that they do not, as a matter of law, entitle defendants to the truth-on-the-market defense. Although the disclosures informed the market that Merrill *may routinely* support auctions, they did not inform the market that Merrill *always did so*, and *did so in order to prevent certain auction failure*. The disclosures therefore did not inform the market that, as alleged, market liquidity was entirely dependent on Merrill's participation.[2/]

[2/] Moreover, the complaint alleges that Merrill made numerous false statements to the investing public and its retail investors about the liquidity and safety of ARS. *See* Cmplt., ¶¶ 53 (AA40), 65-90 (AA42-48), 72-75 (AA44-45), 145-147 (AA57-58), 159 (AA60), 160-62 (AA60-61). Although these false

(continued...)

IV. The presumption of reliance in non-disclosure or omission cases set forth in *Affiliated Ute Citizens, Inc. v. United States*, 406 U.S. 128 (1972), is generally available in manipulation cases, and is potentially available for the particular claim pleaded here.

In *Affiliated Ute*, the Supreme Court held that, in cases involving "primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery." 406 U.S. at 153. Instead, if the plaintiff proves that "the facts withheld [are] material in the sense that a reasonable investor might have considered them important," *id.* at 153-54, the "obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact," and reliance is presumed. Like the fraud-on-the-market presumption, the *Affiliated Ute* presumption is not conclusive. Rather, it shifts the burden to the defendant to establish that the plaintiff did not rely on the omission in making the investment. *Burke v. Jacoby*, 981 F.2d 1372, 1379 (2d Cir. 1992).

The Court asks the Commission whether this presumption is generally available for manipulation claims. As this Court has long recognized, "[w]hat is important" in determining the applicability of the presumption "is to understand the rationale for a presumption of causation in fact in cases like *Affiliated Ute*, in which no positive statements exist: reliance as a practical matter is impossible to prove." *Wilson v. Comtech Telecommun. Corp.*, 648 F.2d 88, 93 (2d Cir. 1981). Unlike with a misstatement, with an omission, there is no outward manifestation of the defendant's wrongdoing on which the plaintiff can prove reliance. *Titan Group, Inc. v. Faggen*, 513 F.2d 234, 239 (2d Cir. 1975) ("Unlike instances of affirmative misrepresentation where it can be demonstrated that the injured party

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[2/](...continued)
representations did not reach plaintiff (*see supra* 8), an analysis of the truth on the market defense would be incomplete without consideration of all of the information in the marketplace. Thus, if pled adequately (*see* AA327-29), plaintiff's allegations regarding false statements to customers and false research reports could create factual issues as to whether these misrepresentations permeated the market to such an extent that they counteracted the effect of the disclosures, changing the total mix of information available and precluding dismissal of the complaint based on truth on the market.

relied upon affirmative statements, in instances of total non-disclosure * * * it is of course impossible to demonstrate reliance* * *.”). In such a case, “burdening plaintiffs with having to prove the generally indeterminable fact of what would have happened but for the omission would reduce the protection against fraud afforded by Section 10(b).” *DuPont v. Brady*, 828 F.2d 75, 78 (2d Cir. 1987).

This rationale applies equally in manipulation cases, and therefore, in the Commission’s view, the *Affiliated Ute* presumption is applicable. Although, unlike a claim of failure to disclose, the defendant in most manipulation cases is alleged to have engaged in an affirmative act, there is no direct, tangible manifestation of that act on which the plaintiff can prove reliance as there would be in a misrepresentation case. Indeed, the very goal of a manipulative scheme is to mask its effect and create the appearance of normal market operation. Just as in omission cases, then, it is appropriate to presume reliance on material, undisclosed manipulation, thereby shifting the burden to defendant to show that the plaintiff did not so rely. This conclusion is bolstered by the fact that both the Commission and courts have recognized that the failure to disclose that market prices are being manipulated is, in and of itself, a material omission. *In re Pagel*, Rel. No. 34-22280 (August 1, 1985), 1985 WL 548387, *4 (1985) (failure to disclose manipulation is a material omission of fact in the offer and sale of securities), *aff’d Pagel, Inc. v. SEC*, 803 F.2d 942 (8th Cir. 1986); *In re Tager*, 1963 SEC LEXIS 2445 at *28-29 (Jan. 25, 1963) (“It is well settled that failure of brokers and dealers to disclose material facts relating to market manipulation by them operates as a fraud and constitutes a willful violation of * * * Section 10(b)”); *United States v. Regan*, 937 F.2d 823, 829 (2d Cir. 1991) (no showing of a fiduciary duty necessary for criminal liability based on failure to disclose market manipulation), *quoting United States v. Charnay*, 537 F.2d 341, 351 (9th Cir. 1976).

In arguing to the contrary, Merrill cites *Desai v. Deutsche Bank Sec. Ltd.*, 573 F.3d 931 (9th Cir. 2009), in which the Ninth Circuit refused to apply the *Affiliated Ute* presumption to a manipulation claim. Def. Br. at 57-58. The *Desai* court concluded that “[i]f such non-disclosure of a defendant’s fraud was an actionable omission, then every manipulative conduct case would become an omissions case.” 573 F.3d at 941. The court, however, did not acknowledge or discuss the precedent cited above holding that the failure to disclose manipulation is, in fact, a material omission. Nor would use of the *Affiliated Ute* presumption in manipulation cases render “the Supreme Court’s case law on manipulative conduct

as little more than an entertaining, but completely superfluous, intellectual exercise" as the court in *Desai* feared. 573 F.3d at 941. The inquiry into the applicability of the *Affiliated Ute* presumption goes only to the reliance element in private causes of action. Allowing the presumption in manipulation cases would therefore have no effect on the remainder of the elements of a manipulation claim in either private or Commission actions.

Merrill also relies on *Joseph v. Wiles*, 223 F.3d 1155 (10th Cir. 2000). Def. Br. 58-59. In *Joseph*, the Tenth Circuit addressed the application of the *Affiliated Ute* presumption to an alleged scheme involving manipulation of financial data, dissemination of false financial data, concealing the truth about the company's financial outlook, and hiding the existence of the scheme itself. 223 F.3d at 1162. The court determined that concealment of the company's true financial outlook, and of the scheme, cannot "transform the alleged malfeasance into an omission rather than an affirmative act." *Id.* at 1163. As the court explained, application of the presumption in such a case "would fail to serve [its] purpose since this is not a case where reliance would be difficult to prove because it was based on a negative." *Id.* As already discussed, the same cannot be said in manipulation cases since the alleged malfeasance has no direct manifestation on which a plaintiff can prove reliance.

The Court also asks whether the *Affiliated Ute* presumption is available for the claim pleaded here. In the Commission's view, should the court determine as the district court did (AA331-32, 351) that, as pled, plaintiff's claim is based primarily on Merrill's undisclosed conduct, reliance, as a practical matter, would be difficult to prove and the presumption would be appropriate in this case. And, as already discussed in response to question one, in the Commission's view, the district court erred in finding (AA351-52) that Merrill's disclosures rebutted the *Affiliated Ute* presumption.

V. Merrill Lynch's disclosures of its practices in the auction rate securities market do not, as a matter of law, preclude plaintiff from pleading that he justifiably relied on the integrity of the auction rate securities market.

In the absence of a presumption of reliance, plaintiff must prove that he directly, and reasonably, relied on an assumption of the efficiency of the ARS

market, free of manipulation. *ATSI*, 493 F.3d at 101. This Court has held that a plaintiff cannot show such reliance if, through minimal diligence, he could have discovered the truth. *See Starr ex rel. Estate of Sampson v. Georgeson Shareholder, Inc.*, 412 F.3d 103, 109 (2d Cir. 2005). The district court found that Merrill's disclosures could have been discovered by plaintiff with reasonable diligence and "highlighted that broker-dealers * * * could submit bids for their own accounts to prevent failed auctions and to determine clearing rates." AA362. Therefore that court found that any reliance by plaintiff on the integrity of the ARS market was unjustifiable as a matter of law. AA362. The Court asks, in essence, whether the Commission agrees with this conclusion.

For the reasons already discussed, the Commission is of the view that Merrill's disclosures failed to adequately inform plaintiff of its alleged role in "propping up" the ARS market. Those disclosures therefore do not preclude plaintiff from pleading justifiable reliance on the integrity of the ARS market.

Respectfully yours,

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CERTIFICATE OF SERVICE

I hereby certify that, on this 24th day of June, 2011, I electronically filed the *amicus curiae* brief of the Securities and Exchange Commission using the CM/ECF system. In addition, on the same day, I caused the original and six copies of the brief to be filed with the Court.

/s/ *Tracey A. Hardin*
Tracey A. Hardin