SUPREME COURT OF THE STATE OF NEVADA

NANOPIERCE TECHNOLOGIES, INC., a Nevada Corporation; STEPHEN SEITZ, an individual; JANE SEITZ, an individual; KATHY KNIGHT-MCCONNELL, an individual; JAMES STOCK, an individual; MAUREEN O'SULLIVAN, an individual; and HELEN KOLADA, an individual,	SUPREME COURT CASE NO. 45364 DISTRICT COURT CASE NO. CV04-01079

Appellants,

vs.

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

Respondents.
_____/

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

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INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The national clearance and settlement system for securities plays a crucial role in our nation's capital markets. National Securities Clearing Corporation (NSCC), one of the defendants in this case, provides clearing services for virtually all broker-to-broker equity and corporate debt trades in the United States, clearing over 20 million equity transactions on an average trading day. Because of the importance of the effective performance of this system, Congress requires clearing agencies to be registered with the Securities and Exchange Commission and subject to the Commission's comprehensive oversight under Section 17A of the Securities Exchange Act of 1934, 15 U.S.C. 78q-1.

Plaintiffs' lawsuit threatens to disrupt or to impose substantial and unwarranted costs on this system by seeking damages against registered clearing agencies for operation of the NSCC stock borrow program pursuant to Commission-approved rules. The gravamen of plaintiffs' complaint is that they have been injured by a stock manipulation carried out by naked short sellers – those who sell shares they do not own without borrowing the shares necessary to make delivery. Yet plaintiffs sue here, not the short sellers, but these defendants, despite plaintiffs' concession that defendants are acting in compliance with applicable rules.

Some of plaintiffs' claims for relief allege that operation of the stock borrow program itself gives rise to damage claims, while others are characterized as "misrepresentation" claims, but both sets of claims are in actuality challenges to the correctness of the Commission's decision to approve the stock borrow program. Thus, a state court award of damages under plaintiffs' allegations would create a direct conflict with that decision, and plaintiffs' case is therefore preempted by the Exchange Act. As the regulator charged by Congress with ensuring that the national clearance and settlement system functions efficiently, in the public interest and for the protection of investors, the Commission has a strong and direct interest in seeing that the threats created by plaintiffs' lawsuit are ended by the affirmance of the district court's dismissal.

ISSUE ADDRESSED BY THE COMMISSION

Whether the Exchange Act preempts state law claims against registered clearing agencies either for operating the stock borrow program in accordance with Commission-approved rules, or for failing to disclose alleged "defects" in that program, the existence of which would be contrary to the factual basis on which the Commission approved the program.

BACKGROUND

A. Section 17A of the Exchange Act charges the Commission with overseeing the national clearance and settlement system in accordance with the public interest and the protection of investors.

Congress enacted Section 17A of the Exchange Act as part of the legislative response to the paperwork crisis of the late 1960s and early 1970s. See generally In the Matter of the Full Registration as Clearing Agencies of The Depository Trust Co. et al., SEC Rel. No. 34-20221, 48 Fed. Reg. 45167, 45168 (Oct. 3, 1983) ("Final Approval Order"); Bradford National Clearing Corp. v. SEC, 590 F.2d 1085, 1090-94 (D.C. Cir. 1978).

Section 17A opens with Congressional findings and a general direction to the Commission to be followed in administering the statute. Congress found that

> (A) The prompt and accurate clearance and settlement of securities transactions, including the transfer of record ownership and the safeguarding of securities and funds related thereto, are necessary for the protection of investors and persons facilitating transactions by and acting on behalf of investors.
>
> (B) Inefficient procedures for clearance and settlement impose unnecessary costs on investors and persons facilitating transactions by and acting on behalf of investors.
>
> (C) New data processing and communications techniques create the opportunity for more efficient, effective, and safe procedures for clearance and settlement.

> (D) The 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 and persons facilitating transactions by and acting on behalf of investors.

Section 17A(a)(1), 15 U.S.C. 78q-1(a)(1).

Congress directed the Commission, "having due regard for the public interest, the protection of investors, and the safeguarding of securities," to "facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities * * * in accordance with the findings and to carry out the objectives set forth" above. Section 17A(a)(2), 15 U.S.C. 78q-1(a)(2).

To achieve these statutory objectives, Section 17A makes it unlawful for a clearing agency to do business in interstate commerce unless it is registered with the Commission. Section 17A(b), 15 U.S.C. 78q-1(b). [1] Registration may not be

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[1] The term "clearing agency" means

> any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities or who provides facilities for comparison of data respecting the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions, or for the allocation of securities settlement responsibilities. Such term also means any person, such as a securities depository, who (i) acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a

granted unless the Commission finds that both the clearing agency itself and the clearing agency's rules meet specified statutory requirements (the "Requirements"), which implement the broad objectives of the statute. Section 17A(b)(1), 15 U.S.C. 78q-1(b)(1). A clearing agency's application for registration must contain the rules of the clearing agency, and such other information as the Commission requires "as necessary or appropriate in the public interest or for the prompt and accurate clearance and settlement of securities transactions." Section 17A(b)(2), 15 U.S.C. 78q-1(b)(2).

A clearing agency is required, among other things, to be so organized, and have the capacity, to be able to: facilitate the prompt and accurate clearance and settlement of securities transactions, safeguard securities and funds in its custody or control or for which it is responsible, comply with the provisions of the federal securities laws, enforce compliance by its participants with the rules of the

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> particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned, or pledged by bookkeeping entry without physical delivery of securities certificates, or (ii) otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates.

Section 3(a)(23)(A) of the Exchange Act, 15 U.S.C. 78c(a)(23)(A).

clearing agency, and carry out the purposes of Section 17A. Section 17A(b)(3)(A), 15 U.S.C. 78q-1(b)(3)(A).

The statute imposes both affirmative and negative requirements on clearing agency rules. Affirmatively, Section 17A requires that those rules be designed to

> – promote the prompt and accurate clearance and settlement of securities transactions,
>
> – assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible,
>
> – foster cooperation and coordination with persons engaged in the clearance and settlement of securities transactions,
>
> – remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, and
>
> – in general, to protect investors and the public interest.

Section 17A(b)(3)(F), 15 U.S.C. 78q-1(b)(3)(F).

Negatively, the rules must not be designed to permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency, or to regulate by virtue of any authority conferred by the Exchange Act matters not related to the purposes of Section 17A or the administration of the clearing agency. Id. Also, the rules must not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Section 17A(b)(3)(I), 15 U.S.C. 78q-1(b)(3)(I).

Registered clearing agencies are self-regulatory organizations (SROs) under the Exchange Act. Section 3(a)(26), 15 U.S.C. 78c(a)(26). Therefore, changes to a clearing agency's rules after registration may only be made pursuant to Section 19(b) of the Exchange Act, 15 U.S.C. 78s(b). That section provides that no change may take effect unless approved by the Commission under Section 19(b)(2), 15 U.S.C. 78s(b)(2), as being consistent with the Exchange Act, or unless permitted to take effect without prior approval pursuant to Section 19(b)(3), 15 U.S.C. 78s(b)(3).

The Commission also has plenary rulemaking authority with respect to clearing agency conduct. No registered clearing agency may engage in any activity as a clearing agency "in contravention of such rules and regulations * * * as the Commission may prescribe as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of" the Exchange Act. Section 17A(d)(1), 15 U.S.C. 78q-1(d)(1).

B. The Stock Borrow Program is designed to improve the efficiency of the Continuous Net Settlement system by increasing the likelihood that purchasers will receive their securities on settlement date.

In this section, we describe the relevant aspects of the continuous net settlement system, the procedures for buying-in securities for delivery to purchasers when sellers fail to deliver securities, and the stock borrow program.

Also, we correct some of the fundamental errors in plaintiffs' descriptions of the continuous net settlement system and the stock borrow program.

1. The Continuous Net Settlement system

The securities that are the subject of the complaint were deposited at defendant The Depository Trust Corporation (DTC). DTC accepts deposits of securities from participants or issuers, credits those securities to participants' accounts, and transfers securities among those accounts by computerized book-entry movements pursuant to the participants' instructions. The securities deposited at DTC are registered on the books of the security's issuer in the name of DTC's nominee, Cede & Co.

Trades in these securities clear through NSCC's continuous net settlement system. See generally NSCC Rule 11, Sec. 1(a); Final Approval Order, 48 Fed. Reg. at 45170 n.32; Bradford, 590 F.2d at 1091 n.2. [2] Under that system, NSCC becomes the contra-party to each purchase or sale of securities. NSCC assumes the obligation of each member that is receiving securities to receive and pay for those securities, and it assumes the obligation of each member that is delivering

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[2] Relevant excerpts of NSCC Rules and Procedures are contained in the Joint Appendix. The relevant rules can be found at JA Volume 6, pp. 905-11, and the relevant procedures, including Addendum C, can be found at JA Volume 2, pp. 347-88.

securities to make the delivery. Rule 11, Secs. 1(b), (c), (e); Procedure VII(A). NSCC is also assigned the receiving party's right to receive securities and the delivering party's right to receive payment. Id. The assumption of these obligations and the assignment of these rights place NSCC between the delivering member and the receiving member – the delivering member is obligated to deliver securities to NSCC; the receiving member is obligated to pay for securities delivered by NSCC; and NSCC is obligated to receive and pay for securities from the delivering member, and to deliver securities to the receiving member. Id.

All member transactions in a given security are netted daily, based on trade date, so that each member is required to deliver to NSCC or receive from NSCC only the difference between the total amount of each security that it bought and the total amount that it sold during the trading period (i.e., purchases are netted against sales). Procedure VII(C)(1). NSCC rules provide that a member that owes NSCC securities is described as having a short position, a member that is entitled to receive securities from NSCC has a long position, and a member that is neither obligated to deliver nor entitled to receive securities has a flat position. Rule 11, Secs. 1(a), 2. [3]

[3] "Short position" in this context means only that the member has an obligation to deliver securities to NSCC. It does not mean that the securities were sold short in the market.

For each member with a short position in a security on settlement date, NSCC instructs the securities depository designated by the member (i.e., defendant Depository Trust Company) to deliver securities from the member's account at the depository to NSCC's account there. Rule 11, Secs. 3, 4; Procedure VII(C)(2). NSCC then instructs the depository to deliver those securities from NSCC's account to members with long positions in the security. Rule 11, Secs. 3, 4; Procedure VII(C)(3). [4]

2. Buy-ins to satisfy delivery obligations when members fail to deliver securities

Sometimes, members fail to deliver to NSCC the total number of securities that they are obligated to deliver on a particular settlement date, i.e., they do not have sufficient securities on deposit at their designated depository to eliminate their short position. Procedure VII(C)(3). [5] In that situation, NSCC uses an algorithm to allocate the fails to deliver to members who are due to receive securities. Procedure VII(E). A member's failure to deliver may cause the

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[4] Details of the procedures for establishing each member's position on settlement date are set forth in Rule 11-5.

[5] Fails-to-deliver may be caused by reasons other than naked short selling. For example, human or mechanical errors or processing delays can result from transferring securities in physical certificate rather than book-entry form, thus causing a failure to deliver on a long sale within the normal three-day settlement period.

receiving member to whom the fail is allocated to have a long position, i.e., to be entitled to receive securities from NSCC.

A member that has failed to receive securities has two options: it may either maintain that position and wait for delivery to be made to it as securities are delivered to NSCC, or it may file a Notice of Intention to Buy-in with NSCC. Rule 11, Sec. 7(a), Procedure VII(J). In response to the filing of such a Notice, NSCC takes a series of steps to facilitate the buy-in, including, if necessary, executing the buy-in in the marketplace of its choice, through the agents of its choosing. Procedure X(A)(1). When a buy-in is executed, any loss incurred in the purchase is allocated in accordance with NSCC procedures to members with short positions in the security. Id.

The fact that a broker-dealer that is an NSCC member fails to receive securities that it purchased on behalf of a retail customer does not mean that the customer's purchase is not completed until the member's failure to receive is cured. Under Article 8 of the Uniform Commercial Code, a securities broker-dealer may credit a customer's account with a security even though that security has not yet been delivered to the broker-dealer's account by NSCC. In that event, the customer receives what is defined under the Uniform Commercial Code as a "securities entitlement," which requires the broker-dealer to treat the person for

whom the account is maintained as entitled to exercise the rights that comprise the security. See UCC Sections 8-104, 8-501.

3. The Stock Borrow Program

The stock borrow program is intended to improve the efficiency of the clearance and settlement system by increasing the likelihood that purchasers will receive delivery of their securities on settlement date even though insufficient securities have been delivered to NSCC. NSCC Rules, Addendum C. Under the applicable Rules, the program is automated and operates without the exercise of discretion by NSCC.

Members wishing to participate in the program as lenders notify NSCC each day of securities that they have on deposit with DTC that are available to be borrowed for delivery to receiving members. Id. If NSCC has unsatisfied delivery obligations on a particular settlement date, it will borrow available securities according to a formula that allocates the borrowing among members who are willing to lend. Id. Borrowed securities are entered in a special continuous net settlement sub-account, and are used to satisfy delivery obligations to members with long positions who would otherwise fail to receive. The lending member is credited the market value of the securities borrowed, and the long position in the member's account will reflect the borrowing of the shares until those shares are

returned. Id. Borrowed stock is returned to the lender through normal allocation in the continuous net settlement system as securities become available. Id. Alternatively, the lender, as any other member with a long position, may initiate buy-in procedures by submitting a Notice of Intention to Buy-in. Until the securities are returned, the lending member no longer has ownership rights in them, and therefore cannot sell or re-lend them.

4. Plaintiffs' incorrect descriptions of important aspects of the Continuous Net Settlement system and the Stock Borrow Program

This summary of the applicable NSCC rules makes clear that plaintiffs' descriptions of the continuous net settlement system and the stock borrow program are flawed in important respects. Among their erroneous allegations are that (1) the stock borrow program is the only way that fails to deliver can be cured, (2) NSCC is at fault for not requiring buy-ins, and (3) the stock borrow program results in the creation of phantom securities.

First, a receiving member that has failed to receive securities can obtain those securities through a buy-in that does not involve the stock borrow program at all.

Second, NSCC does not have the authority to require buy-ins. As noted, its role in the stock borrow program is automated and non-discretionary -- the only

entity authorized by the rules to require a buy-in is the receiving member. If a long position remains open for an extended period of time, that is because the receiving member has not initiated a buy-in, presumably because that member is willing to rely on the fact that it will eventually be allocated securities pursuant to NSCC's procedures. These statements are true whether the entity that is owed securities is the original purchaser who did not receive delivery, or a firm that has loaned securities to the stock borrow program.

Furthermore, NSCC has no mechanism for determining whether particular fails to deliver have occurred because of illegal naked short selling or for some legitimate reason. Nor are there any standards or rules that would guide its discretion in deciding whether to make a buy-in, if it were to undertake do so. In short, the assertion that NSCC is in some way culpable for failing to initiate buy-ins is contrary to the clear terms of the Rules.

Third and finally, neither the continuous net settlement system nor the stock borrow program creates artificial securities. The number of securities issued and outstanding is determined by the security issuer and is reflected in the issuer's records of registered ownership; nothing that happens in the course of clearing and settling trades, including any action taken by NSCC, can change that number.

As explained above, the continuous net settlement system is essentially an accounting system that records delivery and receive obligations among NSCC members. These obligations do not reflect *ownership positions*. Ownership positions, as opposed to the deliver and receive obligations recorded by NSCC, are reflected on the records of DTC.

The security's issuer maintains its own record of all of the registered ownership positions of its securities. All shares deposited at DTC are recorded on the issuer's records in the name of DTC's nominee, Cede & Co., and constitute some or all of the issuer's securities issued and outstanding. The fact that securities settle through the continuous net settlement system, or that they are deposited at DTC, does not increase the number of the issuer's shares.

As to the stock borrow program, as noted above and as further explained by the Commission's staff in guidance on the Commission's website, the securities loaned by NSCC members for use in the program must be on deposit at DTC, and are debited from members' accounts when the securities are used to make delivery. See Responses to Frequently Asked Questions Regarding SHO (Jan. 3, 2005), http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm. Once a member's securities are used for delivery to another member, the lending member no longer

has ownership rights in those securities, which means that it cannot sell or re-lend them until such time as the securities are returned to its DTC account.

When securities are not available to be loaned through the the stock borrow program, the buyer is required to either wait for delivery or initiate a buy-in. Neither waiting nor buying-in increases the number of issued and outstanding securities. All that the stock borrow program does is shift the *consequences* of the failure to deliver from a buyer that has not affirmatively indicated a willingness to wait for delivery of its securities to a lender that *has* indicated that it is willing to wait. This shift cannot possibly increase the number of securities issued, any more than the buyer's decision to either wait or initiate a buy-in can do so. Therefore, plaintiffs' assertion that the stock borrow program creates securities is incorrect. [6]

[6] While the number of securities outstanding does not change because of the clearance and settlement system, the aggregate number of positions reflected in customer accounts at broker-dealers may in fact be greater than the number of securities issued and outstanding. This is due in part to the fact that, as noted above, broker-dealers may credit customer accounts with securities entitlements in anticipation of delivery of the security to the broker-dealer.

C. The Commission has approved the Stock Borrow Program as being in compliance with the Requirements of the Exchange Act.

Defendants NSCC, DTC, and a number of other clearing agencies filed applications for registration with the Commission in 1976. Final Approval Order, 48 Fed. Reg. at 45168-69. The Commission granted each of these agencies conditional registration. Id. It then undertook a thorough review of each clearing agency's operations and rules to ensure that they met the statutory Requirements before granting full registration. Id. The Commission also published standards (the "Standards") to be used by its Division of Market Regulation in reviewing and making recommendations concerning whether each clearing agency should be granted full registration. Id. at 45169.

NSCC adopted the stock borrow program by rule changes that took effect pursuant to Section 19(b)(3) during the time when it was operating under the conditional registration. SEC Rel. No. 34-16514, 45 Fed. Reg. 5867 (Jan. 24, 1980) (notice of filing of NSCC proposed rule change adopting as a one year pilot program procedures for borrowing securities to meet system needs); SEC Rel. No. 34-17422, 46 Fed. Reg. 3104 (Jan. 13, 1981) (notice of filing of NSCC proposed rule change making pilot program permanent).

The Commission granted NSCC's application for full registration in 1983, nearly three years after the stock borrow program rules took effect. 48 Fed. Reg.

at 45178. After describing its review of NSCC's application and the extensive oversight it had exercised over NSCC during the pendency of that application, the Commission stated that it had determined "that NSCC's by-laws, rules, procedures, and systems, as amended, are consistent with the Requirements and the Standards," and that accordingly, it "believe[d] that NSCC should be granted full registration." Id. [7]

ARGUMENT

Plaintiffs are suing defendants for alleged manipulations committed by naked short sellers. Whether based on direct allegations that operation of the stock borrow program caused them compensable harm, or on allegations that defendants made actionable "misrepresentations" by failing to disclose asserted

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[7] The Commission relied on each clearing agency's application, as well as on the Commission's continuous monitoring and oversight of the agencies, including its review of each proposed rule change filed with it. 48 Fed. Reg. at 45170-71. Specifically,

> in carrying out the Commission's general oversight responsibilities, the Commission has reviewed, pursuant to Section 19(b) of the Act, each of the many proposed rule changes filed by the clearing agencies. Those rule changes have concerned most of the major services and systems of each clearing agency, all of the recent enhancements to clearing agency services, and all schedules of fees.

48 Fed. Reg. at 45171.

defects in the program, plaintiffs' claims conflict with the Exchange Act's regulatory regime for registered clearing agencies and with the Commission's approval of the rules governing the program. We therefore believe that the district court was correct in ruling that:

> Federal law explicitly permits the [stock borrow program] to operate. Plaintiffs have not alleged that the NSCC violated any rules governing [the stock borrow program]. Therefore, state law may not be applied as to impose damages on Defendants. To do so would be to forbid the Defendants from doing what the SEC authorized them to do.

Order, JA 1743.

The balance of this brief explains the basis for our conclusion.

A. State laws that conflict with federal regulatory regimes are preempted.

State laws are "naturally preempted to the extent of any conflict with a federal statute." Crosby v. National Foreign Trade Council, 530 U.S. 363, 372 (2000). [8] A court will find conflict preemption "where it is impossible for a private party to comply with both state and federal law, and where under the

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[8] In addition to conflict preemption, preemption can also arise when Congress has expressly preempted state law, and also when Congress has occupied the field in such a way as to exclude state law. Defendants have not argued that there is express preemption here, and because we believe that plaintiffs' claims are preempted under a conflict analysis, we do not discuss whether field preemption applies.

circumstances of a particular case, the challenged state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." Id. (internal citations, quotation marks, and brackets omitted). "What is a sufficient obstacle is a matter of judgment, to be informed by examining the federal statute as a whole and identifying its purpose and intended effects." Id. at 373. In Crosby (530 U.S. at 373), the Court quoted Savage v. Jones, 225 U.S. 501, 533 (1912):

> For when the question is whether a Federal act overrides a state law, the entire scheme of the statute must of course be considered and that which needs must be implied is of no less force than that which is expressed. If the purpose of the act cannot otherwise be accomplished – if its operation within its chosen field else must be frustrated and its provisions be refused their natural effect – the state law must yield to the regulation of Congress within the sphere of its delegated power.

SRO rules that are approved by the Commission preempt conflicting state law. Credit Suisse First Boston Corp. v. Grunwald, 400 F.3d 1119, 1128 (9th Cir. 2005), citing Merrill Lynch, Pierce, Fenner & Smith v. Ware, 414 U.S. 117, 127 (1973).

B. Permitting state law liability for the conduct alleged in the complaint would conflict with the Exchange Act regulatory regime.

1. Plaintiffs' direct challenges to the Stock Borrow Program are preempted.

Plaintiffs directly challenge the stock borrow program by alleging that operation of the program in conformity with the applicable rules gives rise to claims for manipulation (Claim 5), illegal tie-ins (Claim 6), conversion (Claim 19), intentional interference with contractual relationship (Claim 20), breach of duty of good faith and fair dealing (Claim 21), and conspiracy (Claim 22). These claims warrant little discussion, and they are scarcely mentioned in plaintiffs' brief – plaintiffs explicitly ask a state court to hold that damages may be awarded against registered clearing agencies for performing their roles in the national clearance and settlement system in accordance with Commission-approved rules. The conflict could not be clearer. Plaintiffs' assertion that no federal law authorizes defendants to engage in a manipulation, or impose illegal tie-ins, and so on, is merely question begging. Any state law that defined defendants' federally-approved conduct as falling into any of these forbidden categories of conduct would be preempted.

2. Plaintiffs' so-called "misrepresentation" claims are also preempted.

Perhaps recognizing that a state-law based frontal assault on the stock borrow program is doomed to failure, defendants seek to dress up their claims by alleging various forms of "misrepresentations." [9] But this tactic must fail because, in reality, plaintiffs' so-called misrepresentation claims, no less than their other claims, seek to attack the Commission's approval of the stock borrow program by holding defendants liable for conducting business in accordance with Commission-approved rules.

Plaintiffs' appellate brief concedes that plaintiffs are not alleging that defendants failed to comply with the relevant NSCC rules in conducting the stock borrow program (Pltf. Br. at 16). Furthermore, their complaint does not allege that defendants ever misrepresented the content of those rules, or that they falsely claimed that they were complying with the rules when they were not. Rather, plaintiffs in essence argue that defendants are liable for failing to disclose what

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[9] Plaintiffs allege that defendants made four misrepresentations about defects in the way the stock borrow program operates. Each of these alleged misrepresentations is the basis for four claims for relief, so that there are a total of sixteen misrepresentation claims: each of the four misrepresentations is alleged to be a violation of Nevada statutory law (Claims 1, 2, 3, 4), a negligent misrepresentation (Claims 7,8,9,10), an intentional misrepresentation (Claims 11,12,13,14) and a fraudulent misrepresentation (15, 16, 17, 18).

plaintiffs consider to be defects in those rules, or what plaintiffs allege are undesirable consequences of the rules.

The true nature of plaintiffs' allegations is made clear in their appellate brief, when they urge that there can be no conflict preemption here because:

> The SEC authorized the creation of the SBP [stock borrow program] only as that program was proposed and explained by the NSCC. It did not approve the defects in the SBP – and could not have done so – because the NSCC did not disclose those defects. Moreover, the SBP was touted by the NSCC as a mechanism for dealing with temporary, short-term fails-to-deliver. But as everyone in the financial world but the defendants now acknowledges, it has become in practice just the opposite in many cases – fails to deliver frequently remain open for long periods, even indefinitely.

Pltf. Br. at 30 (emphasis in original). In a footnote, plaintiffs further assert that defendants "vociferously deny that the SBP has the defects alleged in the" complaint, and that defendants therefore "could not have disclosed those defects to the SEC during the process by which creation of the SBP was approved, and the SEC could not – and did not – approve or authorize the program's defects that are alleged in the" complaint. Id. at n.16. Plaintiffs go on to claim that the Commission "did not authorize misstatements about the effect of the SBP, or approve of failing to disclose those effects to sellers and purchasers of securities" and that "[a]uthority to implement and operate a program is simply not co-extensive with a license to misspeak about the nature and effects of the program." Pltf. Br. 31.

According to plaintiffs, in other words, it is the failure to disclose these alleged "defects" in how the program functions that is the basis for plaintiffs' misrepresentation claims. Yet when the Commission approved the rules as being consistent with the statutory Requirements and the Commission-issued Standards, it thereby found that, among other things, the rules were designed to promote the prompt and accurate clearance and settlement of securities transactions, remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, and, in general, to protect investors and the public interest. See Section 17A(b)(3)(F).

To establish their fraud claims, plaintiffs would first have to prove either that the Commission erred when it originally approved the rules governing the program because the program was defective at that time, or that the program had become defective at some point during the past twenty years, so that the Commission erred in not putting a stop to it. Only after the premise that the program is defective had been established could plaintiffs go to the second step in their case, which is proving that the defendants committed actionable misrepresentations by failing to disclose the supposed defects.

Thus, plaintiffs seek to challenge the Exchange Act regulatory regime by asking a state court, applying state law, to determine that a Commission-approved

program does not work as the Commission understands it to work, and then to determine that defendants' failure to disclose the defects in the program is a form of fraud, compensable in damages. If accepted, plaintiffs' theory of liability would open up any Commission-approved SRO rule to challenges under similar theories, namely that the Commission erred in approving the rule because it misapprehended the rule's consequences, and that the SRO then committed state-law fraud by failing to disclose the facts that establish the Commission's error. Of course, any state law that created this result would make uniform regulation impossible, and would impermissibly stand as an obstacle to the accomplishment and execution of the full purpose and objectives of Congress in creating the Exchange Act's self-regulatory regime, including the portion of that regime applicable to registered clearing agencies under Section 17A.

Finally, plaintiffs argue that there can be no conflict preemption in this case because, in contrast to rules adopted by other SROs, the Commission does not have the authority to abrogate or amend the rules of registered clearing agencies once they have taken effect pursuant to Section 19(b). See Exchange Act Section 19(c), 15 U.S.C. 78s(c). They contend that therefore the Commission's "'approval' of the [stock borrow program] was not a true regulatory decision in any meaningful respect" because the Commission lacks the authority "to alter the

program proposed by the defendants, and therefore *cannot* remedy the defects" in the stock borrow program. Pltf. Br. at 30 (emphasis in the original).

It is important to appreciate the full consequences of this argument. Because the Commission cannot abrogate or amend *any* clearing agency rule, plaintiffs' assertion, if correct, would mean that *no* clearing agency rule has any preemptive effect, so that any state law in conflict with a clearing agency rule would prevail over the rule. That result would obviously have far-reaching and potentially seriously disruptive effects on the nation's system of securities clearance. It is therefore perhaps not surprising that plaintiffs cite no authority for the proposition that a regulator's authority to approve rules, but not to abrogate or amend them, means that the rules do not have preemptive effect.

In any case, plaintiffs' assertion that clearing agency rules cannot preempt state law because the Commission cannot abrogate or amend them is erroneous for at least two reasons. First, even prior to 1975, when Congress amended Section 19 of the Exchange Act to give the Commission authority to pass upon the validity of all SRO rules, the Supreme Court had recognized that properly adopted SRO rules could preempt conflicting state law, even though the rules had not been reviewed by the Commission. See Ware, 414 U.S. at 127, 129-31. Given that SRO rules adopted without Commission approval had preemptive effect prior to

1975, it is clear that Commission-approved rules have preemptive effect even though the Commission does not have authority to abrogate or amend those rules.

More fundamentally, even though the Commission cannot abrogate or amend clearing agency rules, Section 17A gives it plenary rulemaking authority of its own that would permit it to remedy any defects in the stock borrow program, or any other clearing agency operation within the Commission's regulatory purview. As explained above, Section 17A(d)(1) prohibits a registered clearing agency from directly or indirectly engaging in "any activity as clearing agency * * * in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of" the Exchange Act. Indeed, when the Commission gave final approval to NSCC's registration as a clearing agency, it observed that in the future, "as necessary," it would use "its rulemaking authority under Section[]17A(d)(1) * * * to ensure continued development of the" national clearance and settlement system. If the Commission were to conclude that the stock borrow program is contrary to the public interest or the protection of investors, it could adopt a corrective rule, with which NSCC would have to comply, even though the rule would not be a rule of the clearing agency.

C. There are remedies for manipulations perpetrated by naked short sellers.

It should be borne in mind that the fact that plaintiffs' claims are preempted does not mean that there are no remedies for manipulation by naked short sellers. These remedies include law enforcement actions against the wrongdoers by the government and private actions against the wrongdoers for damages. If the alleged problem is systemic rather than arising from isolated unlawful conduct, the appropriate remedy is to amend the regulatory regime. The Commission has not been unaware of allegations similar to those made by plaintiffs. See Order Granting Approval of a Proposed Rule Change Concerning Requests for Withdrawal of Certificates by Issuers, SEC Rel. No. 34-47978, 68 Fed. Reg. 35037, 35042 (June 11, 2003), Short Sales, SEC Rel. No. 34-50103, 69 Fed. Reg. 48008, 48016 n.85 (Aug. 6, 2004); Issuer Restrictions or Prohibitions on Ownership by Securities Intermediaries, 69 Fed. Reg. 70852, 70856 n.53 (Dec. 7, 2004).

Moreover, the Commission recently adopted Regulation SHO, which took effect a little over a year ago, to address its concern that naked short selling could cause an excessive number of extended fails-to-deliver. See Regulation SHO Proposing Release, SEC Rel. No. 34-48709, 68 Fed. Reg. 62972, 62975-78 (Nov. 6, 2003) (discussing problems potentially caused by naked short selling); Short

Sales, 69 Fed. Reg. at 48009 (explaining that certain provisions of Regulation SHO are designed to reduce short selling abuses); 48013 n.53 (noting that most commenters welcomed the regulation as a means to address naked short selling manipulation).

Among other requirements, Regulation SHO (1) requires broker-dealers to locate securities that are available for borrowing prior to effecting a short sale in any equity security, and (2) requires clearing agency participants to close out fail to deliver positions by purchasing securities of like kind and quantity for securities that are identified by a formula established by the regulation as having a substantial amount of fails. Short Sales, 69 Fed. Reg. at 48014, 48016-17.

The Commission also stated that it "intend[ed] to pay close attention to the operation and efficacy of the provisions we are adopting * * *, and will consider whether any further action is warranted." Short Sales, 69 Fed. Reg. at 48018; see id. at 48017 ("if the Commission believes that the rules as adopted are not having the intended effects of reducing potentially manipulative behavior, we may consider additional rulemaking"). The Commission has every intention of following through on that statement and taking any steps that it finds are necessary or appropriate in the future.

CONCLUSION

For the foregoing reasons, the ruling of the district court should be affirmed.

Respectfully submitted,

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February 2006

CERTIFICATE OF COUNSEL

I hereby certify that I have read this brief amicus curiae, and to the best of my knowledge, information and belief, it is not frivolous or interposed for any improper purpose. I further certify that this brief complies with all applicable Nevada Rules of Appellate Procedure, in particular, Nev. R. App. P. 28(e), which requires every assertion in the brief regarding matters in the record to be supported by appropriate references to the record on appeal. I understand that I may be subject to sanctions in the event that the accompanying brief is not in conformity with the requirements of the Nevada Rules of Appellate Procedure.

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