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OVERSTOCK.COM, INC., KEITH CARPENTER, OLIVIER CHENG, FERN BAILEY and WENDY MATHER, as Co-Personal Representatives of the Estate of MARY HELBURN, ELIZABETH FOSTER, HUGH D. BARRON, DAVID TRENT, and MARK MONTAG

SUPERIOR COURT OF THE STATE OF CALIFORNIA

COUNTY OF SAN FRANCISCO

OVERSTOCK.COM, INC., et al.,

Plaintiffs,

v.

MORGAN STANLEY & CO., et al.,

Defendants.

Case No. CGC-07-460147

PLAINTIFFS' MEMORANDUM OF POINTS AND AUTHORITIES IN OPPOSITION TO DEFENDANTS' MOTION FOR SUMMARY JUDGMENT OR, IN THE ALTERNATIVE, SUMMARY ADJUDICATION

Date: January 9, 2012
Time: 9:30 a.m.
Dept: 305
Judge: Honorable John E. Munter

Action Filed: February 2, 2007
Trial Date: March 5, 2012

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Plaintiffs Overstock.com, Inc. ("Overstock"); Keith Carpenter; Oliver Cheng; Fern Bailey and Wendy Mather, as Co-Personal Representatives of the Estate of Mary Helburn; Elizabeth Foster; Hugh D. Barron; David Trent; and Mark Montag (collectively, "Plaintiffs") respectfully submit this Memorandum of Points and authorities in Opposition to Defendants' Motion for Summary Judgment or, in the Alternative, Summary Adjudication (the "Motion").

I. **INTRODUCTION**

As set forth fully herein, Defendants intentionally manipulated the market for Overstock securities, which caused Plaintiffs harm. Defendants artificially [redacted] in Overstock stock through manipulative devices that were designed to perpetuate selling of the stock, increase short interest in the stock and drive down its price. This was no accident, but the product of calculated intent, as reflected in the fact that Defendants intentionally caused [redacted] of shares of Overstock trades not to settle to further their scheme. Defendants' manipulation of supply reached such heights that the manipulated amount reached roughly [redacted] of the entire "float" (tradable supply) of Overstock shares. The supply was manipulated in massive amounts from at least August 2005-December 2006.

In their brief, Defendants make five arguments in attacking Plaintiffs' California Corporation's Code Section 25400 claims: 1) the manipulation did not occur in California; 2) Defendants did not "effect" trades; 3) the transactions at issue were not manipulative; 4) Defendants did not have manipulative intent; and 5) Plaintiffs were not harmed by Defendants' conduct. As to issues 1 through 4, Defendants failed to shift the burden to Plaintiffs as required by *Aguilar v. Atlantic Richfield Co.*, 25 Cal. 4th 826, 850 (2001). As to issue 5, it is neither contained in any of Defendants' Notices of Motion and Motion for Summary Judgment or, in the Alternative, Summary Adjudication ("Notices"), nor do Defendants even purport to provide any material issues of undisputed facts on this point.

Whereas Plaintiffs' opposition is supported by documentary evidence and specific factual analysis from highly-qualified experts, Defendants fail to submit admissible evidence in support of what is supposed to be, under *Aguilar* and California law, an evidentiary motion. Instead, Defendants submit a federal-style, no-evidence motion. For example, Defendants' separate statements of facts are replete with legal conclusions followed by a statement that Plaintiffs have no evidence, such as: "[Defendant] did not willfully engage in any act or transaction in violation of Section 25400. Plaintiffs cannot produce evidence showing otherwise." Defendants' separate statements cite only to some declarations that are equally devoid of facts. In those declarations, Defendants declare their good faith and refer to records--none of which are submitted with the motion--which would purportedly show that Defendants did not effect trades that caused massive, persistent fails-to-deliver in Overstock securities that manipulated the market.

Plaintiffs hereby present over 400 documents and the testimony of 32 fact witnesses to establish that factual issues exist as to each of Defendants' five arguments. In sum, Plaintiffs have the facts on their side, as well as the testimony of securities experts, options experts, experienced traders and Wall Street veterans. There is simply no basis for denying Plaintiffs a right to trial on their claims.

When you file a "Motion for Summary Judgment, you are asking the Court to rule without the need for a jury. So you need evidence for all your statements. The reference to SS 102 and similar citations are citations to record evidence supporting the statement.

II. STATEMENT OF FACTS

A. Plaintiffs' Injuries Resulting from Defendants' Manipulation.

In 2006, Overstock issued stock twice—using W.R. Hambrecht in San Francisco, California to arrange securities offerings to purchasers in California and elsewhere—and suffered damage because the sales were at artificially-depressed prices. SS 102.[1] Individual Plaintiffs, including California residents Hugh Barron and David Trent, also suffered damage as a result of trading during the period when Overstock's stock price was artificially depressed. SS 101.

[1] There are four Separate Statements of Material Facts submitted in support of Defendants' Motion for Summary Judgment. As to the material facts in dispute added by Plaintiffs, Plaintiffs have numbered them such that each material fact Plaintiffs have provided bears the same number in all four Separate Statements. Thus, a reference to "SS 100" or any number greater than that is a reference to that fact in each of the four Separate Statements: Plaintiffs' Separate Statement of Disputed and Undisputed Material Facts in Opposition to Goldman, Sachs & Co.'s Motion for Summary Judgment or, in the Alternative, Summary Adjudication; Plaintiffs' Separate Statement of Disputed and Undisputed Material Facts in Opposition to Goldman, Sachs Execution & Clearings Motion for Summary Judgment or, in the Alternative, Summary Adjudication; Plaintiffs' Separate Statement of Disputed and Undisputed Material Facts in Opposition to Merrill Lynch Pierce Fenner & Smith's Motion for Summary Judgment or, in the Alternative, Summary Adjudication; Plaintiffs' Separate Statement of Disputed and Undisputed Material Facts in Opposition to Merrill Lynch Profession Clearing Corp.'s Motion for Summary Judgment or, in the Alternative, Summary Adjudication.

Defendants Merrill Lynch Pierce Fenner & Smith ("Merrill Lynch"), Merrill Lynch Professional Clearing Corp. ("Merrill Pro") (together "Merrill"), Goldman Sachs ("Goldman Sachs"), Goldman Sachs Execution & Clearing ("GSEC") (together "Goldman") (collectively "Defendants"), caused the artificial depression in Overstock's stock price by manipulatively increasing the supply of Overstock stock to perpetuate short selling in Overstock and drive down its price. SS 132-195, 263-269. Defendants are responsible for and control settlement of stock, including delivery of stock to settle short sales. In the normal course, delivery of stock occurs within three days of the date of the trade. SS 134. However, Defendants consciously opted not to settle trades at all—but instead to create massive fails-to-deliver in Overstock—in order to artificially increase the tradable supply of shares of Overstock available for short sales by as much as [redacted], thus artificially increasing short sales beyond their normal supply constraints. SS 137. Defendants were successful, as short-selling in Overstock was driven to manipulated volumes and its price correspondingly dropped, with massive amounts of short selling occurring [redacted]. SS 104, 113, 157, 163, 167. As shown *infra*, Defendants knowingly and intentionally decided to cause fails-to-deliver to increase their purported supply, knew such increase would drive down Overstock's stock price, knew that it was wrong to do so, [redacted]

If a fact you need to prove is not something a layperson would know, you must use an expert.

As testified to in a declaration by economist, Dr. Robert Shapiro, the former Undersecretary of Commerce for Economic Affairs in the President Clinton administration, Overstock's stock price was depressed by roughly [redacted] and depressed in other amounts when Individual Plaintiffs sold shares at various times. SS 167. The injuries were caused by abnormal and long-lasting increases in fails-to-deliver in Overstock securities, which artificially inflated the supply and short interest in Overstock (short interest refers to the number of shares of a stock sold short at a given time). SS 263-269. It is well-settled that heavy short selling, as reflected in increasing short interest, puts downward pressure on stock price. SS 164. More precisely, the increase in the short-interest ratio, which is calculated by dividing the total number of shares sold short by a stock's average daily trading volume during a one-month period, reflects the increase in downward pressure on the stock price. SS 163-164. Dr. Shapiro also testifies as to the dilutive effect on the stock price caused by artificially increasing the supply for a specific period of time. SS 165.

Alleging and proving actual knowledge or "willful blindness" (avoiding learning the truth, but you know what the truth likely is) is a required element of fraud based claims.

Defendants, as experienced market participants, understood that their intentional fails to deliver would drive down Overstock's stock price. SS 166. Joseph Mastrianni, a Merrill Managing Director, confirmed that it is "well understood in the industry" that naked short selling resulting in fails-to-deliver will artificially increase supply and drive down the price of a stock. Mastrianni stated that the fails would be correlated with additional selling and that naked short selling would put sell pressure on a security which would "ultimately drive the stock down." A person testifying on behalf of Deutsche Bank as the person most knowledgeable [redacted] Goldman Sachs expressed its [redacted] SS 138. As selling is perpetuated, the price effects inevitably follow, as Dr. Shapiro shows.

Here, Plaintiffs go beyond allegations of naked shorting-- this is intentional fraud on the market.

SS 264-66. Merrill Pro's Chief Compliance Officer, Linda Messinger, testified how naked short sales inject false information into the market and drive down the price of the stock: [redacted] SS 166.

Defendants inflated short interest in Overstock in 2005 and 2006 to extraordinary levels. SS 163. In addition to the short interest ratio analyzed by Dr. Shapiro, a GSEC executive referred to another measure of short interest in Overstock known as short-to-float[2] in exclaiming: [redacted] In other words, in this internal email written in May 2006, [redacted] Also in May 2006, Goldman Sachs' research department distributed to clients [redacted] *Id.*

[2] The float is the number of freely-tradable shares, and short-to-float is the float divided by the short interest.

B. Supply and Demand Places a Natural Limit on Short Selling in an Unmanipulated Market

Interesting we have not seen the borrowing rates for GME go up substantially, but it occurred in Overstock

Clearing firms' difficulty in borrowing Overstock stock placed a natural, market-based limit on short interest. The supply of shares in the market to borrow is limited, which is why, as that supply is lent out, shares become harder to borrow. "Hard-to-borrow" essentially means that the sources of supply are limited relative to the demand to borrow the stock in connection with short sales. Because Overstock was very hard-to-borrow, all of the brokers would scour the lending market to try to locate stock. As testified to in a declaration from Michael A. Manzino, who was second-in-command at Morgan Stanley in its securities lending department during the relevant time period, Overstock was one of a small number of hard-to-borrow securities that was the focus of day-to-day work in securities lending.[3] SS 135. Overstock was so hard to borrow that clearing brokers in 2006 charged high borrow fees, known as "negative rebates," to persons who wished to borrow the stock in order to sell short. Those fees, in the form of annual interest, were as high as [redacted] in Overstock in 2006. *Id.*

When a short-seller would contact a clearing firm to inquire about short-selling Overstock, the firm would sometimes have to tell the short-seller that no short sale could be executed because the firm had no inventory of the stock.[4] SS 135. Even if the clearing firm could locate some stock, it typically had to pay a large fee to borrow the stock from a lender (such as custodial banks like State Street or Bank of New York) which the firm would in turn pass to the short seller with an added fee tacked on. *Id.* The short seller then had to decide whether it was willing to risk shorting a stock knowing that the stock had to, for example, drop [redacted] just for the short seller to break even. *Id.* Thus, the ability to drive up short interest and drive down price was ordinarily limited by the natural functioning of supply and demand, as explained in more detail in the declarations of Robert Conner, Robert Shapiro and Michael Manzino.

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[3] Morgan Stanley is Goldman's longtime competitor in securities lending, and the two firms had the largest securities lending operations in 2006.

[4] [redacted] but, as shown below, they were able to approve additional shorts amounting to [redacted] of shares by manipulatively increasing their supply of Overstock by millions of shares.

Everyone on "the Street" constantly talked to other brokers looking for stock and therefore had a realistic, shared sense of how hard it was to locate stock and how expensive it was to borrow. SS 136. For example, if Goldman needed to borrow stock, it had a stock loan desk which would call Morgan Stanley, UBS, Banc of America, etc., to ask whether that firm could lend stock to Goldman. Merrill did likewise. All the prime brokers faced the same general supply-and-demand constraints when a stock, like Overstock, was hard-to-borrow. *Id.*

C. <u>**Defendants Decide to Fail Trades in Extraordinary Volume to Artificially Increase their Supply and Perpetuate Selling in Overstock.**</u>

This paragraph says Defendants intentionally caused FTDs, not accidentally

Facing the same supply constraints as all of the other brokers, Defendants decided to manipulate supply and demand. Specifically, in 2005, both Goldman Sachs and Merrill Lynch decided to create fails-to-deliver [redacted] so that they could correspondingly create "supply" in Goldman Sachs and Merrill Lynch. SS 137. The scheme worked roughly as follows: [redacted] of fails-to-deliver would be concentrated in [redacted] so that [redacted] of shares of corresponding "supply" could be artificially created in Goldman Sachs/Merrill Lynch. SS 139. This decision to intentionally fail trades provided both Merrill and Goldman [redacted] of additional shares to support new short sales. SS 154, 157. This artificial supply could exist for as long as the fails-to-deliver position at CNS existed. As shown below, Defendants managed to dramatically inflate supply in Overstock stock and the corresponding short interest volume for much of 2005 and all of 2006.

As Dr. Shapiro explains, large, persistent fails-to-deliver drive short interest by artificially increasing the supply of stock that is available to support short sales. Short interest does not drive fails; fails drive short interest.[5] SS 158. Specifically, by intentionally failing trades by the [redacted], Goldman and Merrill perpetuated short selling beyond its normal market levels and artificially drove up short interest, and correspondingly drove down Overstock's stock price. SS 154, 157, 167. In contrast, when brokers operate lawfully, short selling as reflected in

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[5] Defendants themselves argue that fails-to-deliver in equity securities decreased dramatically when new anti-fraud rules and regulations were enacted at the height of the financial crisis in 2008. Thus, it is quite clear that short selling need not result in fails-to-deliver, but, to the contrary, fails-to-deliver were entirely willful.

This paragraph, as applied to Gamestop, would mean Citadel is incentivized to the extent it can gouge brokerages.

short interest does not cause fails-to-deliver. SS 149-150. Clearing brokers routinely clear huge numbers of short sales in highly-shorted stocks without fails-to-deliver, but Goldman and Merrill, instead designed their trades to fail. SS 145. Overstock was a hot stock, and Goldman and Merrill could demand negative rebates fees for borrowing at rates that sometimes exceeded [redacted]. SS 159. Hedge fund clients were particularly interested in a stock that was "truly hard to borrow" and would [redacted] SS 162. Goldman and Merrill pumped up the short selling in Overstock with a massive, artificial supply of Overstock securities.

Discovery in this case has revealed that [redacted] of all fails-to-deliver in Overstock were caused by Goldman and Merrill. SS 146. Discovery has further revealed that defendant GSEC failed-to-deliver Overstock securities <u>for [redacted] straight</u> while defendant Merrill Pro failed to deliver Overstock securities to the CNS system[6] <u>for [redacted] on end</u>. At times, Goldman's and Merrill's combined fails to deliver exceeded [redacted] <u>shares</u> of Overstock when Overstock had only about ten million tradable shares total. SS 145. In other words, owing to Defendants' combined conduct, at times <u>the manipulated supply surpassed [redacted] of the float of Overstock</u> shares. SS 157. By failing [redacted] shares, Goldman and Merrill had an additional [redacted] shares to use to increase short selling and generate the downward price pressure described by Dr. Shapiro.

This shows there is historical examples of naked shorting resulting in over 100% extra shares being included in float

The fails-to-deliver in Overstock were so large and persistent that Overstock was on the "Threshold Securities List" for 667 consecutive trading days—nearly three straight years, every single trading day. SS 147. The "Threshold Securities List" is a list published daily identifying stocks that have high fails-to-deliver in the CNS system and the list is based on fails reported by all clearing brokers who are part of the CNS system, which includes all major clearing brokers such as Goldman, Merrill, Morgan Stanley, Bear Stearns, etc. While there are hundreds of brokers participating in the CNS system, it was Goldman and Merrill—and they

[6] Typically, a broker like Goldman or Merrill delivers stock to the Continuous Net Settlement ("CNS") system, not directly to the actual counterparty. CNS then makes delivery to the counterparty's broker. A fail-to-deliver occurs when a clearing broker does not deliver stock to CNS that it owes to CNS as part of settlement of a trade. SS 134. The CNS system is owned by the Depository Trust & Clearing Corporation ("DTCC"), which is owned in turn by Goldman, Merrill and other brokers.

Note here, that this implies DTCC would have actual knowledge, as would the counterparties of short sellers, that an FTD occurred. That, taken together with the volume of FTDs, suggests actual knowledge or willful blindness.

alone—who willfully failed to deliver stock to the CNS system and caused Overstock to be on the Threshold Securities List for years – for longer consecutive and total time periods than any other company was or ever has been.[7] SS 146, 147.

Short seller strategy includes trading to create disinformation. It is unfortunate the explanation of "how" was redacted.

Defendants' decisions to intentionally fail to deliver trades also required them to devise procedures and trading strategies that would cause the fails to persist for these long periods of time in such a way to divert regulatory attention. As described in more detail below, Defendants [redacted] and to disguise the fraud. SS 200-206.

Can someone get in touch with Allaire to settle the ongoing dispute over options and what is effective?

As testified to by Marc Allaire, an options trading expert who has written two books on the subject, has twice testified for the U.S. Attorney and teaches advanced options at the Chicago Board Options Exchange Institute, [redacted]

[7] Regulation SHO was a federal regulation that went into effect in January 2005 ("Reg SHO"). The stated purpose of Regulation SHO was to "simplify and update short sale regulation" and the regulation, among other things, "impose[d] additional requirements on securities that have a substantial amount of fails to deliver." Request for Judicial Notice ("RJN"), Ex. 127 at pp. 1, 23 (Final Rule, July 28, 2004, available at www.sec.gov/rules/final/34-50103.htm). The Threshold Securities List was authorized by the SEC as a means of tracking and disclosing whether, as the SEC originally expected, fails-to-deliver after the implementation of Regulation SHO would be unusual and short-lived. For almost all stocks, that was true, as less than one-half of one percent of stocks ended up on the Threshold List. 71 Fed. Reg. 41712 n.19. For Overstock, reality was the exact opposite of what the SEC had anticipated, as Defendants' manipulation caused it to be on the Threshold List every day, for years. SS 147.

The process of reviewing evidence to infer fraudulent intent is sometimes referred to as examining "indicia of fraud," or "the badges of fraud."

D. **Defendants Acted with Manipulative Intent.**

Fraudulent intent is rarely written on a piece of paper, but rather is inferred from the factual circumstances. The declaration of Robert Conner, a 30-year veteran of the securities industry who has testified as an expert recently in arbitrations resulting in a $20 million FINRA award against GSEC and a $79 million FINRA award against Merrill Pro, sets forth in detail facts showing manipulation and intent, some of which are set forth below.

Goldman and Merrill knew of their massive, ongoing fails-to-deliver in the CNS System because the information is readily available and tracked by them, and firms regularly monitor their fails-to-deliver to CNS. SS 148. The hundreds of other clearing firms, like Morgan Stanley, Bear Stearns, Fortis, UBS and others, did not have massive fails like Goldman or Merrill. The reason why is simple: Clearing firms routinely ensured that fails, to the extent they inadvertently occurred, were promptly resolved. SS 149-150. As described by the second-in-command of securities lending at Morgan Stanley, these clearing firms delivered stocks and promptly resolved any inadvertent failures-to-deliver, including for the very hard-to-borrow stocks.[8] SS 150. Overstock was one of the hardest stocks to borrow in 2005 and 2006, but Morgan Stanley still made delivery and did not have a long-lasting fail-to-deliver position at CNS in Overstock. *Id.* Morgan Stanley was certainly not alone in monitoring fails-to-deliver and making delivery to eliminate inadvertent fails. As testified to in deposition by the person most knowledgeable at former defendant Banc of America, [redacted] Consequently, the Banc of America representative testified [redacted] SS 145.[9]

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[8] The DTCC's website asserts that over 99.9% of trades at DTCC are settled within three days. SS 150. As shown in an SEC release, in May 2006, only 298 securities—38% of all equity securities—were on the threshold list for an average day. 71 Fed. Reg. 41712 n. 19. Goldman's and Merrill's fails in Overstock are an extraordinary deviation.

[9] Plaintiffs submit the declaration of Professor Leslie Boni, who is an Associate Professor of Finance and the Chair of the Department of Finance, International, Technology and Entrepreneurship at the Anderson School of Management of the University of New Mexico and who was a Visiting Academic Scholar at the U.S. Securities and Exchange Commission ("SEC"),

Not only does basic logic and industry experience show that the fails-to-deliver here were willful, [redacted] Both Goldman and Merrill *decided to intentionally* fail trades in order to manipulatively increase their supply. [redacted]

Office of Economic Analysis, Washington, D.C. Her work as a Visiting Scholar at the SEC included the analysis of failure to deliver data for U.S. securities markets. Since her work as a Visiting Scholar at the SEC, a substantial portion of her academic work and research has been devoted to studying failures to deliver in U.S. securities markets. Dr. Boni concluded that based on her work at the SEC and her academic research, the fails to deliver Overstock shares in Merrill's and Goldman's DTCC accounts [redacted] SS 219.

[10] "Threshold securities" are securities for which there are total fails to deliver at CNS in excess of one half of one percent of outstanding shares, which the SEC deemed to be a "significant" amount of fails. For Overstock, this would be approximately 100,000 shares. Overstock was a threshold security every day from August 2005 through December 2006. SS 147.

[redacted]

[redacted]

Both Goldman and Merrill knew they were doing something wrong, [redacted]

[redacted]

[redacted]

The evidence of Defendants' intent is also reflected in [redacted]

Defendants needed to roll the fails because the stock was generally needed to support short selling for a long period of time.

[11] Defendants needed to roll the fails because the stock was generally needed to support short selling for a long period of time.

[redacted]

[redacted]

[redacted]

[redacted]

A detailed discussion of the facts establishing a significant California nexus to the manipulation is set forth *infra* in Section III.B.1. Generally, all Defendants are California registered broker dealers, and as such, are by definition effecting transactions in California. SS 100. [redacted]

III. ARGUMENT

A. Standards on Summary Judgment.

"[S]ummary judgment may be granted only where it is shown that the entire 'action' 'has no merit.'" *Hypertouch, Inc. v. ValueClick, Inc.*, 192 Cal. App. 4th 805, 834 (Feb. 10, 2011) (quoting Cal. Civ. Proc. Code § 437c(a)). As the moving parties, Defendants bear the burden of persuasion that there is no triable issue of material fact and that they are entitled to judgment as a matter of law. *Aguilar v. Atlantic Richfield Co.*, 25 Cal. 4th 826, 850 (2001). "If there is one, single material fact in dispute, the motion must be denied." Hon. Robert I. Weil & Hon. Ira R. Brown, Jr., *California Practice Guide: Civil Procedure Before Trial* ¶ 10:28 (The Rutter Group 2011); *see also Nazir v. United Airlines, Inc.*, 178 Cal. App. 4th 243, 252 (2009).

Defendants also bear the "initial burden of production to make a prima facie showing of the nonexistence of any triable issue of material fact." *Aguilar*, 25 Cal. 4th at 850. To satisfy this burden, Defendants must "present evidence … and not simply point out that plaintiff does not possess, and cannot reasonably obtain, needed evidence." *Id.* at 854; *see also Hypertouch*, 192 Cal. App. 4th at 838-40. If Defendants meet their initial burden, the burden would then shift to Plaintiffs to make a prima facie showing that a triable issue of fact exists. *Aguilar*, 25 Cal. 4th at 850. If Defendants fail to meet their initial burden, summary judgment and adjudication must be denied. *Id.*; *Consumer Cause, Inc. v. SmileCare*, 91 Cal. App. 4th 454, 468 (2001).

All evidence and inferences must be viewed in the light most favorable to Plaintiffs. *Aguilar*, 25 Cal. 4th at 856. Defendants' affidavits should be strictly construed, while Plaintiffs' affidavits should be liberally construed. *Stationers Corp. v. Dun & Bradstreet, Inc.*, 62 Cal. 2d 412, 417 (1965). Any doubts as to the propriety of the motion should be resolved in favor of Plaintiffs. *Id.*

B. Defendants' Motion for Summary Adjudication of Plaintiffs' Section 25400 Claims Should be Denied.

Blue Sky laws, like Section 25400, are remedial statutes that are given a broad and flexible interpretation. 79A Corpus Juris Second Securities Regulation § 483; *People v. Cole*, 156 Cal. App. 4th 452, 480 (2007) (noting the "broad scope" of California's securities laws); *Hall v. Superior Court*, 150 Cal. App. 3d 411, 417 (1983) (California's securities laws were enacted to "protect the public from fraud and deception in securities transactions"); *see also Morillion v. Royal Packing Co.*, 22 Cal. 4th 575, 592 (2000) (remedial statutes are liberally construed).[12] The approach of California's securities laws "'is to sweep *all* transactions in securities within the regulatory net.'" *Cole*, 156 Cal. App. 4th at 480-81.

Sections 25400(a) and (b) prohibit Defendants from effecting manipulative

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[12] As Defendants acknowledge, Section 25400 was modeled after Section 9 of the Securities Exchange Act of 1934. *Kamen v. Lindly*, 94 Cal. App. 4th 197, 202-03 (2001). Congress passed federal securities fraud statutes to achieve broad remedial goals. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 589 n.30 (S.D. Tex. 2002); *see also Affiliated Ute Citizens of Utah v. U.S.*, 406 U.S. 128, 151 (1972) (securities statutes interpreted flexibly).

transactions, and series of transactions, in any security, including Overstock stock and options. Section 25400 applies to interstate transactions; a person need not be physically present in California to violate the statute. *Diamond Multimedia Sys., Inc. v. Superior Court*, 19 Cal. 4th 1036, 1051 (1999); *Anschutz Corp. v. Merrill Lynch & Co.*, 785 F. Supp. 2d 799, 818 (N.D. Cal. Mar. 27, 2011). Sections 25400(a) and (b) also apply to "any person" that "effect[s]" transactions in any security, so these sections may be violated by persons that are not purchasers or sellers. *See, e.g.*, Cal. Corp. Code § 25004(a). *U.S. v. Weisscredit Banka Commercial v. Divertimenti*, 325 F. Supp. 1384, 1394 (S.D.N.Y. 1971).[13] Section 25400(b) is particularly broad; transactions can be illegal under it solely because of the actor's intent. *Markowski v. SEC*, 274 F.3d 525, 529 (D.C. Cir. 2002). Whether Defendants had the requisite intent is inferred from all the facts and circumstances of the case and is generally a question of fact. *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 794 (2d Cir,. 1969); *Kunert v. Mission Fin. Serves. Corp.*, 110 Cal. App. 4th 242, 256 (2003); *SEC v. Masri*, 523 F. Supp. 2d 361, 373 (S.D.N.Y. 2007).

Section 25500 provides a remedy for Section 25400 violations:

> Any person who willfully participates in any act or transaction in violation of Section 25400 shall be liable to any other person who purchases or sells any security at a price which was affected by such act or transaction for the damages sustained by the latter as a result of such act or transaction. Such damages shall be the difference between the price at which such other person purchased or sold securities and the market value which such securities would have had at the time of his purchase or sale in the absence of such act or transaction, plus interest at the legal rate.

Cal. Corp. Code § 25500.

1. Defendants' Argument they are Entitled to Summary Adjudication of Plaintiffs' Section 25400 Claims because Plaintiffs Cannot Show that Allegedly Manipulative Transactions Occurred in California Fails.

In demurring to Plaintiffs' New Jersey RICO claim, Defendants emphasized this case's California contacts, arguing that California has an overriding interest in having its law applied. Now that the Court has sustained Defendants' demurrer to the New Jersey claim without

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[13] Because Section 25400 is modeled on Section 9(a) of the Securities Exchange Act of 1934, federal decisions interpreting that statute "are unusually strong persuasive precedent." *Kamen*, 94 Cal. App. 4th at 202-03.

leave to amend, Defendants' lead argument on summary judgment is that California law does not apply at all. Rejecting their own prior view that not applying California law would be "beyond fathom," Defendants now shamelessly claim that California lacks a sufficient nexus to this dispute because conduct at issue occurred in states like – you guessed it – New Jersey. Allowing Defendants to have it both ways would trample on every sound policy followed by California courts.[14]

Section 25400 makes it unlawful for "any person, directly or indirectly, in this state" to effect manipulative securities transactions. Cal. Corp. Code § 25400. "The definition of 'in this state' is not restrictive … ." *Diamond Multimedia*, 19 Cal. 4th at 1051 (emphasis added). It encompasses interstate transactions and applies to "California licensed stockbrokers and dealers whose intent is to affect the national market in a stock … ." *Id.* at 1050, 1051.

The term "indirectly" also is "quite broad and pervasive … ." *Nimitz v. Cunny*, 221 F. Supp. 571, 573 (N.D. Ill 1963). A single telephone will satisfy the analogous jurisdictional provision of federal securities statutes – which make it "unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce" to effect manipulative transactions – even if the call is intrastate and the "misrepresentations or words of fraud are not uttered over the telephone." *Starck v. DeWine*, 364 F. Supp. 466, 469 (N.D. Ill. 1973) (emphasis added).[15]

Section 25400 thus applies if Plaintiffs' 'injuries were caused at least in part by conduct within California.' *Anschutz* 785 F. Supp. 2d at 818 (emphasis added). As the Ninth Circuit has held, California's securities laws apply where "any statutory element" of a transaction "takes place in California." *Parvin v. Davis Oil Co.*, 524 F.2d 112, 117 (9th Cir. 1975) (emphasis

[14] In contrast to Defendants' whipsaw approach of receiving the dismissal of a New Jersey claim by emphasizing the California contacts, followed by an attempt to have a California claim dismissed by emphasizing the New Jersey contacts, Plaintiffs have consistently maintained that securities transactions may be interstate and that the laws of more than one state may concurrently apply. *See, e.g.*, *Lintz v. Carey Manor Ltd.*, 613 F. Supp. 543, 550-51 (W.D. Va. 1985).

[15] *See also Aquionics Acceptance Corp. v. Kollar*, 503 F.2d 1225, 1228 (6th Cir. 1974); *SEC v. Freeman*, 1978 WL 1068, at *2 (N.D. Ill. 1978) (noting "the extremely liberal interpretation" given to the jurisdictional provision of analogous federal securities statutes and stating that "[e]ven an incidental reliance on the means of interstate commerce – at any point in the process of offer and sale – is sufficient to activate their prohibitions").

added).[16] The California contacts need not be extensive: Sending an agreement to California and receiving a check sent from California are each sufficient for the application of California law. *Id.* at 117.[17]

A Defendant need not even be physically present in California to violate California's securities laws. *Parvin* involved a Colorado defendant and transactions with "extensive Colorado contacts." *Id.* at 114, 117. California law applied. *Id.* at 117. In *Anschutz*, neither the plaintiff nor the defendant was a California corporation; the only California contact was that the plaintiff's agent bought securities from its California office. *Anschutz*, 785 F. Supp. 2d at 818. Section 25400 applied. *Id.* As long as a manipulative transaction has some connection to California, Section 25400 applies, even if Defendants masterminded the scheme in other states. *See generally* Uniform Securities Act § 414 (1956), 2006 cmt ("It is quite clear that a person may violate the law of a given state, even criminally, without ever being within the state or performing within the state every act necessary to complete the offense.").

a. Defendants Fail to Shift the Burden on this Element of Plaintiffs' Claims.

Defendants claim as a material undisputed fact in regards to this element of Plaintiffs' claims, that the manipulative transactions were not conducted on any exchange located in California, stating either that [redacted]

[16] *See also Anschutz*, 785 F. Supp. 2d at 818; *id.* at n.18("[C]onduct in California that resulted in the alleged harm to plaintiff . . . is sufficient to allow plaintiff to bring claims under California's Corporation Code."); *Anschutz Corp. v. Deutsche Bank Securities, Inc.*, 2010 WL 1464375, at *4 (N.D. Cal. 2010) ("Plaintiff alleged that 'Deutsche Bank, directly or indirectly, induced TAC to purchase securities from an agent in the State of California.'"); 1 Harold Marsh, Jr. & Robert H. Volk, *Practice Under the California Securities Laws* § 3.08[5] (suggesting that Section 25400 applies "whenever any element of the transaction sufficient to invoke California jurisdiction . . . has occurred in California.") (hereinafter "Marsh & Volk").

[17] Numerous other authorities are in accord. *See, e.g.*, *Hall v. Superior Court*, 150 Cal. App. 3d 411, 417-18 (1983) (negotiations in California and telephone call to California sufficient for application of California securities laws); *Lintz.*, 613 F. Supp. at 550 (noting that Professor Loss – the draftsperson of the Uniform Securities Act – has "suggested that the only limitation on the reach of the statute is that the state have a real nexus to the transaction, i.e., that one or more of the prohibited actions occur in the state"); *Rio Grande Oil Co. v. State*, 539 S.W.2d 917, 921-22 (Tex. Ct. App. 1976) ("[W]e think it clear that the Texas Securities Act applies if any act in the selling process of securities covered by the Act occurs in Texas.").

[redacted] Defendants offer no competent, admissible evidence to support either claim. None of Defendants' purported "evidence" even states that Overstock was not traded on the Pacific Exchange, or that the Pacific Exchange was not located in California in 2004, 2005, 2006, or 2007. Because Defendants fail to make a prima facie showing on these issues, they fail to shift the burden and their motions must be denied. *Aguilar*, 25 Cal. 4th at 850.

(1) The McCarthy Declaration Fails to Shift the Burden.

Defendants rely on the Declaration of Thomas McCarthy ("McCarthy Dec."), an unqualified, undesignated expert who states that he is a Financial Services Industry Consultant who used to work for the Depository Trust & Clearing Corporation – not the Pacific Exchange, the SEC, or any self-regulatory organization ("SRO"). McCarthy Dec. ¶¶ 1-2. McCarthy does not state that Overstock was not traded on the Pacific Exchange during the Relevant Period. *See id.* ¶ 16. [redacted] SS 106-113. McCarthy also does not state that the Pacific Exchange was not located in California after 2002. *See* McCarthy Dec. ¶ 16; *Stationers Corp. v. Dun & Bradstreet, Inc.*, 62 Cal. 2d 412, 417 (1965) (affidavits of party moving for summary judgment must be strictly construed). Again, McCarthy could not make such a statement in good faith, because it is not true. *Id.*

Even if McCarthy had declared any of these matters (which he did not), such a declaration would lack foundation. Defendants did not designate McCarthy as an expert regarding either the Pacific Exchange or the transactions' California nexus.[19] Nothing in

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[18] Defendants expressly state that their Joint Compendium of Undisputed Material Facts ("Defendants' Joint Compendium" or "DJC") "is a reference to, but not a substitute for or a part of, the Separate Statements of Undisputed Material Facts filed by each moving Defendant." DJC, at 2 n.1. As such, Defendants' Joint Compendium should not be relied upon by the Court. Plaintiffs will accordingly address, and respond to, Defendants' actual Separate Statements. See, e.g., *Consumer Cause, Inc. v. SmileCare,* 91 Cal App. 4th 454, 472 (2001) ("'This is the Golden Rule of Summary Adjudication: if it is not set forth in the separate statement, it does not exist. Both the court and the opposing party are entitled to have all the facts upon which the moving party bases its motion plainly set forth in the separate statement.'") (citation omitted).

[19] Defendants instead designated Michael T. Bickford as a purported expert on "[t]he extent to which any allegedly manipulative activities involving Overstock.com ("OSTK") occurred in California." Declaration of Ellen Cirangle in Support of Opposition to Motion for Summary

McCarthy's resume suggests that he has any "expertise" on self-regulatory organizations or where the Pacific Exchange was located. *See* Cal. Civ. Proc. Code § 437c(d) (declarations "shall show affirmatively that the affiant is competent to testify to the matters stated … .").

McCarthy also fails to provide any basis for the inference that the Pacific Exchange was not located in California after 2002, which, again, is an inference that he does not state. *See* McCarthy Dec. ¶ 16.; Cal. Civ. Proc. Code § 437c(c), (d). McCarthy's suggestion that the Pacific Exchange was not located in California after 2002 relies solely on his review of SEC releases from 2001 and 2002 and Archipelago Holdings, Inc.'s 10-K for the year 2004. None of these documents states that Overstock was not traded on the Pacific Exchange, or that the Pacific Exchange was not located in California after 2002. All these documents do is describe Archipelago's operations and a proposed merger between Archipelago and the Pacific Exchange. Because McCarthy fails to provide a "reasoned explanation of why the underlying facts [purportedly] lead to the ultimate conclusion," his declaration is entitled to no weight on the material issues regarding the Pacific Exchange. *Powell v. Kleinman*, 151 Cal. App. 4th 112, 123 (2007) (citation omitted).

(2) The SEC Documents Fail to Shift the Burden.

Defendants also improperly rely on requests for judicial notice of the truth of matters stated in Archipelago Holding, Inc.'s ("Archipelago") 10-K for 2004 and an SEC release dated July 19, 2002.[20] As Defendants' own authority makes clear, the existence of SEC filings may be judicially noticed, but the purported truth of matters stated therein may not be. *Aquila v. Superior Court*, 148 Cal. App. 4th 556, 569, 575 (2007); *see also Arce v. Kaiser Found. Health Plan, Inc.*, 181 Cal. App. 4th 471, 482 (2010) (the court may take judicial notice of official acts, but "the truth of matters asserted in such documents is not subject to judicial notice"). These SEC

Judgment (Cirangle Dec.), Ex. 190 at 5. In moving for summary judgment, Defendants did not submit any declaration from Bickford. Relying on any additional evidence that Defendants may submit on reply, such as a declaration from Bickford, would violate Plaintiffs' due process rights. *San Diego Watercrafts, Inc. v. Wells Fargo Bank*, N.A., 102 Cal. App. 4th 308, 316 (2002).

[20] Merrill Lynch also seeks to support its purported points about the Pacific Exchange with an April 2, 2002 SEC notice regarding the American Exchange. *See* ML UF 48; Defs. RJN Ex. 27. This appears to be a typographical error on Merrill Lynch's part, as the notice has nothing to do with the Pacific Exchange and where it was located during the Relevant Period.

documents thus could not shift the burden.

These documents also would not shift the burden, even if the purported truth of the matters stated therein were subject to judicial notice (which it is not). Among other things, Archipelago's 10-K for the year 2004 discusses Archipelago's proposed acquisition of the Pacific Exchange and does not state where the Pacific Exchange was located in 2004 – much less where it was located in 2005, 2006, and 2007. Moreover, the SEC release dated July 19, 2002 describes Archipelago's operations and likewise has no bearing on where the Pacific Exchange was located in 2004, 2005, 2006, and 2007.

Defendants' citation to these documents in support of their argument appears to be that since the Pacific Exchange used a computer facility in Chicago for equity trading (known as Archipelago, or Arca), trades on the Pacific Exchange occurred entirely outside of the state of California. However, this ignores the fact that Arca itself was never an actual exchange during the relevant period; it merely subcontracted some computer work for the Pacific Exchange; the Pacific Exchange, not Arca, was in 2005 (and later) the SRO recognized by the SEC; the Pacific Exchange was headquartered at 115 Sansome Street in San Francisco during the relevant period; and all trades effected using Arca computers were considered Pacific Exchange trades (a computer system is not an exchange). SS 104. It also ignores the fact that the options floor of the Pacific Exchange has always been in San Francisco, and Arca never facilitated Pacific Exchange options trading that were integral to manipulative trades designed to extend the fails. SS 105. The Court cannot take judicial notice of Defendants' make-believe "facts" regarding the supposed location of the Pacific Exchange.

(3) The Ruth Declaration Fails to Shift the Burden.

GSEC relies on the Declaration of John Ruth ("Ruth Dec."), which makes only the conclusory assertion that "[t]he transactions in OSTK that GSEC executed, cleared, and/or settled were conducted on the New York Stock Exchange, Nasdaq, NYSE Arca, and other exchanges. None of these exchanges were located in California during the Relevant Period." Ruth Dec. ¶ 12. The Ruth Declaration does not mention the Pacific Exchange, state that the Pacific Exchange was not located in California during the Relevant Period, or provide any foundation for such a purported belief. As such, the Ruth Declaration fails to carry GSEC's initial burden. *See, e.g.*, Cal. Civ. Proc. Code § 437c(d); *Krantz v. BT Visual Images, Inc.*, 89 Cal. App. 4th 164, 173 (2001) (reversing grant of summary judgment where conclusory declarations did not shift burden); *Guthrey v. State*, 63 Cal. App. 4th 1108, 1119 (1998) (declaration containing no specific facts to support conclusory assertion was properly excluded); *Colby v. Schwarz*, 78 Cal. App. 3d 885, 889 (1978) ("The declarations are deficient in that they contain in part only conclusions."); *Stationers Corp.*, 62 Cal. 2d at 417 (1965) (affidavits of party moving for summary judgment must be strictly construed).[21]

Defendants are two of the largest prime brokers in the country. Yet, they cannot introduce any competent testimony or admissible evidence sufficient to make a prima facie showing that Overstock was not traded on the Pacific Exchange, or that the Pacific Exchange was not located in California after 2002. That is because neither statement is true. Since Defendants fail to shift the burden on material issues regarding the Pacific Exchange, summary judgment and adjudication must be denied as to this element of Plaintiffs' claims. *Aguilar*, 25 Cal. 4th at 850.

b. Triable Issues of Material Fact Exist as to Whether Conduct Occurred, at Least in Part, in California.

Even if Defendants had shifted the burden (which they have not), triable issues of material fact would still exist as to each of the following matters, any of which are sufficient to deny Defendants' motions, as actions by Defendants essential to the fraudulent scheme occurred in California. SS 100-131.

(1) The Parties Are in California.

In seeking dismissal of Plaintiff's New Jersey RICO claim, Defendants argued that California law should apply because two Plaintiffs are California residents and because

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[21] Goldman Sachs also suggests that it is relying on the Declarations of David Santina ("Santina Dec.") and Bryan Ghalioungui ("Ghalioungui Dec."). However, these declarations only purport to address where Goldman Sachs performed certain functions, engage in speculation as to where certain trades occurred and do not state whether Overstock was traded on the Pacific Exchange during the Relevant Period, or where the Pacific Exchange was then located. *See* Santina Dec. ¶ 17; Ghalioungui Dec. ¶ 10. These declarations therefore also do not shift the burden to Plaintiffs. *Stationers Corp.*, 62 Cal. 2d at 417 (affidavits of party moving for summary judgment must be strictly construed).

Overstock's stock sales that form the basis of their damages in this case took place in California. Request for Judicial Notice in Support of Opposition to Motion for Summary Judgment ("RJN"), Ex. 7 at 13:5-6; RJN Ex. 8 at 8 n.9. As Defendants argued, the situs of an injury is a relevant factor in determining whether a state's law applies. *Id.*,, Ex. 7 at 13:3-6; Ex. 8 at 8:12-14 and fn. 9 at 8:22-28; *Offshore Rental Co. v. Continental Oil Co.*, 22 Cal. 3d 157, 168 (1978).[22]

Defendants also present Plaintiffs' residences and the locations of Plaintiffs' Overstock stock sales as material facts. GS&Co. UF 37; GSEC UF 50; ML UF 11-12; MLPRO UF 11-12. Thus, where there are issues of material fact as to whether any Plaintiffs are California residents, or whether any Plaintiffs sold Overstock stock in California at prices that were artificially affected by Defendants' manipulative conduct, summary judgment and adjudication must be denied. *Nazir v. United Airlines, Inc.*, 178 Cal. App. 4th 243, 252 (2009).

Defendants fail to shift the burden as to at least Plaintiffs Hugh Barron, David Trent, and Overstock. Messrs. Barron and Trent are both California residents. SS 101. Messrs. Barron and Trent – as well as Mary Helburn – sold Overstock stock in California, through brokerages located in California, at prices that were artificially depressed as a result of Defendants' manipulative conduct. *Id.*

As for plaintiff Overstock, Overstock's lead manager for certain 2006 stock offerings was the investment bank of WR + Hambrecht & Co., located in San Francisco, California. SS 102. W.R. Hambrecht + Co., LLC accordingly maintained accounts in Overstock's name holding shares of common stock of Overstock. *Id.* These accounts were maintained in California, and the value of these offerings was diminished by Defendants' manipulative conduct in violation of Section 25400. *Id.* Thus, sales of securities by Overstock

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[22] California law is routinely applied where a Defendants' conduct has effects in this state. *See, e.g.*, *Knevelbaard Dairies v. Kraft Foods, Inc.*, 232 F.3d 979, 993-94 (9th Cir. 2000) (price-fixing that allegedly occurred in Wisconsin actionable under California's Cartwright Act because it allegedly led to higher prices being paid in California); *Panavision Int'l, L.P. v. Toeppen*, 141 F.3d 1316, 1318-19, 1327 (9th Cir. 1998) (California's anti-dilution statute applied to Illinois resident who registered PanaVision.com domain name in Illinois where the Illinois resident sought to obtain money from Panavision and caused Panavision to suffer injury in California); *Kearny v. Salomon Smith Barney, Inc.*, 39 Cal. 4th 95, 119-20 (2006) (California statute may be applied to out-of-state defendant who records, outside of California, telephone calls involving California residents).

occurred in California at prices that were artificially depressed by Defendants' conduct.

As for Defendants, they are all are California licensed broker-dealers with California offices. SS 100. Section 25400 applies to "California licensed stockbrokers and dealers whose intent is to affect the national market in a stock … ." *Diamond Multimedia*, 19 Cal. 4th at 1036.

(2) Manipulative Trading Occurred in California.

The Pacific Exchange was a California exchange located in California during the Relevant Period, with its principal place of business at 115 Sansome Street, San Francisco, CA. SS 104-105; *See also Bauman v. DaimlerChrysler Corp.*, 644 F.3d 909, 925 (9th Cir. 2008); *see also Bauman v. DaimerChrysler AG*, 2005 WL 3157472, at *8 (N.D. Cal. Nov. 22, 2005) (finding, in November 2005, that the Pacific Exchange was located in San Francisco). The Pacific Exchange was at that time "the fifth-biggest U.S. stock-options market" and, specifically, a "San Francisco-based stock market." RJN, Ex. 130 at 1 (July 1, 2005, Pacific Exchange Bulletin).

GSEC's records show that [redacted] Moreover, Overstock was listed on NASDAQ, and [redacted] of Merrill Lynch, who [redacted] SS 111. [redacted] further testified [redacted] *Id.* [redacted]

[23] GSEC's trade histories for its 690 DTC account contain no exchange codes, creating a triable issue of fact as to the exchange(s) on which these trades were conducted. SS 107.

[24] [redacted] SS 112.

[redacted] SS 110. In order to clear Pacific Exchange equity trades in 2005-2006, GSEC and Merrill Pro engaged in clearing functions in California with the Pacific Clearing Corp. SS 115.

The Merrill Defendants effected trades in Overstock that were part of the manipulative scheme using [redacted] SS 116.[25] [redacted] Merrill Lynch testified that [redacted]

Defendants used their artificial supply to support short sales in Overstock by California clients. [redacted]

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[25] These platforms were developed by Sage Clearing Corp. ("Sage") in San Francisco, whose assets Merrill Pro acquired in April 2004.

[26] Merrill Defendants do not even shift the burden on issues pertaining to XTrade. Merrill Pro submits a Declaration from Michael R. Andera (the "Andera Dec.") of Merrill Defendants' San Francisco office. [redacted]

[redacted] As testified to in the declaration by Stephen Seal, who was an options market maker for nearly 30 years, options market makers ordinarily factor in borrow cost as part of a short sale; [redacted]

[redacted]

Defendants' manipulative scheme had other market effects in California. For example, in manipulating the price of Overstock stock on a national market, Defendants caused manipulated pricing to be disseminated on the Pacific Exchange in California. *See generally Diamond Multimedia*, 19 Cal. 4th at 1052 (where a statement is "willfully disseminated in California, it is made 'in this state'" for purposes of Section 25400). Defendants' manipulative scheme also resulted in Overstock appearing on the "Threshold Securities List" – which was also disseminated in California – for over 668 days. SS 131. Defendants' manipulative conduct harmed every California resident who entered into securities transactions in a manipulated market in Overstock.

For all of the reasons set forth in this Section, summary judgment and adjudication must be denied on whether relevant conducted occurred, "directly or indirectly, in this state." Cal. Corp. Code § 25400.

2. Defendants' Argument they are Entitled to Summary Adjudication of Plaintiffs' Section 25400 Claims Because Section 25400 Does Not Impose Secondary Liability on Clearing Firms Fails

a. Sections 25400(a) and (b) Prohibit Effecting Manipulative Trades

Section 25400(a) and (b) provide:

It is unlawful for any person, directly or indirectly, in this state:

(a) For the purpose of creating a false or misleading appearance of

> active trading in any security or a false or misleading appearance with respect to the market for any security, (1) ***to effect*** any transaction in a security which involves no change in the beneficial ownership thereof, or (2) to enter an order or orders for the purchase of any security with the knowledge that an order or orders of substantially the same size, at substantially the same time and at substantially the same price, for the sale of any such security, has been or will be entered by or for the same or different parties, or (3) to enter an order or orders for the sale of any security with the knowledge that an order or orders of substantially the same size, at substantially the same time and at substantially the same price, for the purchase of any such security, has been or will be entered by or for the same or different parties.
>
> (b) ***To effect***, alone or with one or more other persons, a series of transactions in any security creating actual or apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others. (emphasis added)

b. "Effecting" Trades is Not Limited to Purchasing or Selling Stock

In arguing that Section 25400(a) and (b) are limited to purchasers and sellers, and therefore arguing they did not "effect" trades, Defendants ignore both the plain language of the statute and the Court's previous guidance on this identical issues. In denying Defendants' motion to strike, the Court noted:

> Without ruling on that issue, the Court nevertheless expresses its tentative view that Sections 25400(a) and (b) can apply, at least in some situations, to persons who are not actual "sellers" or "buyers" of securities. This view rests upon the conclusion that the words "to effect" a transaction, as used in subdivisions (a) and (b), are not necessarily limited, as a matter of law, to those who are actual sellers or buyers. That conclusion, in turn, rests upon a comparison of the statutory language of subdivisions (a) and (b) on the one hand, both of which use the words "to effect" a transaction, and the immediately following subdivisions (c) and (d), which refer to a "person selling or offering for sale or purchasing or offering to purchase" a security. That contrast leads this Court to hold the view, at least a tentative view I should say, that parties can "effect" prohibited transactions without being sellers or buyers in them. The Legislature used the words selling, offering for sale, purchasing, and offering for purchase when it was speaking of actual or hopeful sellers or buyers, and it did not use those words in subdivisions (a) and (b), which are the subdivisions under which the plaintiffs in this case rest their Section 25400 claim.
>
> This Court does not believe that defendants' references to Sections 25500, 25504, and 25504.1 of the Corporations Code change the essential analysis. Nor does the case law cited by defendants, to the Court's tentative thinking, answer the question in defendants' favor.

RJN, Ex. 6 (February 15, 2008 Transcript) at 22:10-23:13. While Defendants now attempt to revisit the issue, the Court's initial judgment was correct.

The Court's initial judgment is confirmed by the definitional section applicable to Section 25400. Section 25004(a) defines "broker-dealer" as "any person engaged in the business of effecting transactions in securities ... for the account of others or for his own account." Cal. Corp. § 25004(a) (emphasis added); *see also Cole*, 156 Cal. App. 4th at 480 (interpreting this and other statutes in light of "the broad scope of the Corporate Securities Law in protecting the public from unscrupulous practices in the sale of securities").[27] In recognizing that one can "effect[] transactions ... for the account of others," the Legislature necessarily acknowledged that one need not be a purchaser or a seller to be potentially liable under Sections 25400(a) or (b).[28]

The Court's initial judgment is further confirmed by the legislative history. Section 25400 was modeled on Section 9 of the federal Securities Exchange Act of 1934,[29] and "[t]he legislative history shows that the term 'effect' as used in Section 9 of the 1934 Act and other sections means 'to . . . (participate) in a transaction whether as principal, agent, or both'." *United States v. Weisscredit Banca Commerciale E D'Investimenti*, 325 F. Supp. 1384, 1394 (S.D.N.Y. 1971). In showing that one can "effect" a transaction by "participat[ing]" in it as an "agent," the legislative history also establishes that one can "effect" a transaction without being a purchaser or a seller.

Consistent with the Court's initial judgment, the statutory scheme, and the legislative history, the term "effecting securities transactions" has "been interpreted broadly," both by the courts and by the SEC. *Cornhusker Energy Lexington, LLC v. Prospect Street Ventures*, 2006 WL 2620985, at *6 (D. Neb. 2006); *DeHuff v. Digital Ally, Inc.*, 2009 WL

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[27] The Uniform Securities Act includes essentially the same definition. *See* Unif. Securities Act § 102(4) (2002). As stated in the comment to that Act, "[t]he recognized distinction is that a broker acts for the benefit of another while a dealer acts for itself in buying for or selling securities from its own inventory." *See id.* § 102 cmt. 6; *see also* 15 U.S.C. § 78c(a)(4) (defining "broker" as "any person engaged in the business of effecting transactions in securities for the account of others").

[28] The Court must, of course, read the statute "as a whole, seeking to harmonize all parts of the statutory scheme." *Breslin v. City and County of S.F.*, 146 Cal. App. 4th 1064, 1079 (2007).

[29] *Kamen*, 94 Cal. App. at 202-03.

4908581, at *3 (S.D. Miss. 2009). The SEC staff has expressly rejected the position asserted by Defendants, stating that, "[i]n our view, the term 'effect' should be construed broadly to encompass not only persons who are engaged in the offer or sale of securities, but also those person who perform other than purely ministerial or clerical functions .... Persons who hold customer funds or securities in connection with security transactions perform services which cannot be characterized as purely ministerial or clerical." RJN, Ex. 14 (*Financial Surveys, Inc.*, SEC No-Action Letter (July 30, 1973) (emphasis added), 1973 WL 8453, at *2.)[30]

The courts and the SEC have repeatedly held that "'[a] person effects transactions in securities if he or she participates 'at key points in the chain of distribution.'" *Indus Partners, LLC v. Intelligroup, Inc.*, 934 N.E.2d 264, 268 (Mass. Ct. App. 2010) (emphasis added) (quoting *BondGlobe, Inc.*, SEC No–Action Letter (2000–2001 Transfer Binder) Fed. Sec. L. Rep. (CCH) par. 78,056, at 77,518; 2001 SEC No–Act. Lexis 140, at *2 (Feb. 6, 2001)). The SEC has stated this definition in long line of releases and no action letters.[31] As two of the largest prime brokers in the country, Defendants are surely aware of the SEC's definition. [redacted]

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[30] *See also In re Wheat, First Securities*, SEC Release No. 34-48378 (August 20, 2003), available at 2003 WL 21990950, at n.49 (quoting this letter) (RJN, Ex. 24).

[31] *See, e.g., In re CentreInvest, Inc.*, SEC Release No. 34-60485 (Aug. 12, 2009), available at 2009 WL 2461149, at *3 ("A person 'effects transactions in securities' if he or she participates in such transactions 'at key points in the chain of distribution.'") (RJN, Ex. 34); *see also In re Driving Hawk*, SEC Release No. 399 (July 7, 2010), *available at* 2010 WL 2685821, at *3 (RJN Ex. 38); *In re Wheat, First Securities*, SEC Release No. 34-48378 (August 20, 2003), *available at* 2003 WL 21990950, at n.49 (RJN, Ex. 24); *BondGlobe*, SEC No-Action Letter (Feb. 6, 2001), *available at* 2001 WL 103418, at *1 (RJN, Ex. 20); *BD Advantage, Inc.*, SEC No-Action Letter (Oct. 11, 2000), *available at* 2000 WL 1742088, at *1 (RJN, Ex. 19); *Progressive Technology Inc.*, SEC No-Action Letter (Oct. 11, 2000), *available at* 2000 WL 1508655, at *1 (RJN, Ex. 18); *Oil-N-Gas, Inc.*, SEC No-Action Letter (June 8, 2000), *available at* 2000 WL 1119244, at *1 (RJN, Ex. 17); *Transfer Online, Inc.*, SEC No-Action Letter (May 13, 2000), *available at* 2000 WL 719802, at *1 (RJN, Ex. 16); *MuniAuction, Inc.*, SEC No-Action Letter (Mar. 13, 2000), *available at* 2000 WL 291007, at *1 (RJN, Ex. 15).

[redacted].[32]

The SEC considers various indicia in determining whether one "effects" securities transactions. "Actions indicating that a person is 'effecting' securities transactions include soliciting investors; handling customer funds and securities; participating in the order-taking or order-routing process; and extending or arranging for the extension of credit in connection with a securities transaction." *In re Warrior Fund, LLC*, S.E.C. Release No. 34-61625, 2010 WL 717795, at *3 (March 2, 2010) (emphasis added) (RJN, Ex. 36).[33] In stating that one can "effect" securities transactions by, *e.g*, "handling customer funds and securities," "participating in the order-taking or ordering routing process," or "extending or arranging for the extension of credit," the SEC makes it clear that one can "effect" transactions without being a purchaser or a seller. The Court's initial judgment is further confirmed by the security industry's usage of the term "effect." SS 100. There is simply no basis for interpreting the word "effect" to be limited to purchasing or selling securities.

c. Defendants Effected Trades in Overstock

It is undisputed that Defendants effected trades in Overstock. As broker-dealers, Defendants – by statutory definition – "effect[] transactions in securities." Cal. Corp. Code § 25004(a). Defendants also have indisputably effected transactions in Overstock stock [redacted]

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[32] The New York Stock Exchange ("NYSE") also has found that GSEC violated a NYSE Rule by "effecting … customers' short sales on minus and zero-minus ticks." *Goldman Sachs Execution & Clearing*, NYSE Hearing Board Decision 07-33 (Mar. 13, 2007), *available at* 2007 WL 784321, at *2 (RJN, Ex. 105). Thus, the NYSE also agrees that one need not be a purchaser or seller to "effect" securities transactions.

[33] The SEC has made the same, or similar, statements in *BondGlobe*, SEC No-Action Letter (Feb. 6, 2001), *available at* 2001 WL 103418, at *1 (RJN, Ex. 20); *BD Advantage, Inc.*, SEC No-Action Letter (Oct. 11, 2000), *available at* 2000 WL 1742088, at *1 (RJN, Ex. 19); *Progressive Technology Inc.*, SEC No-Action Letter (Oct. 11, 2000), *available at* 2000 WL 1508655, at *1 (RJN, Ex. 18); *Oil-N-Gas, Inc.*, SEC No-Action Letter (June 8, 2000), *available at* 2000 WL 1119244, at *1 (RJN, Ex. 17) *MuniAuction, Inc.*, SEC No-Action Letter (Mar. 13, 2000), *available at* 2000 WL 291007, at *1 (RJN, Ex. 15). *See also* ROBERT L. COLBY & LANNY A. SCHWARTZ, BROKER-DEALER REGULATION § 1A:2.2 (Practicing Law Institute 2011) (listing numerous instances of "participation" in securities transactions that, according to the SEC, constitutes "effecting securities transactions").

[redacted] GSEC UF 70-72; MLPRO UF 70, 78, 79. Such conduct constitutes "effecting" transactions. *See, e.g.*, *SEC v. Margolin*, 1992 WL 279735, *5 (S.D.N.Y. Sept. 30, 1992).

Strikingly, Defendants ignore this voluminous authority and custom and usage, instead relying on the definition from a single dictionary, which states that "effect" means "to bring about." Defs. Br., at 20:26. Yet even under their own definition, Defendants "effected" securities transactions. For example, in conceding that they "cleared" trades, Defendants cite *Levitt v. Bear Stearns & Co.*, 340 F.3d 94, 97 (2d Cir. 2003) for the proposition that "'[a] clearing firm … completes transactions by delivering securities to the purchasing broker-dealer and by making money payments to the selling broker-dealer.'" Defs. Br. at 21:24-27 (underline added); *see also SEC v. Margolin*, 1992 WL 279735, *5 (S.D.N.Y. Sept. 30, 1992) (providing clearing services constitutes "effecting transactions in securities"). By admitting that they "completed transactions," Defendants admit that they "brought" the transactions "about" and participated in them at "key points in the chain of distribution," *i.e.*, that they "effected" transactions.[35]

There is no question that under the well-established statutory and legal definition of "effect," Defendants effect trades. As broker-dealers – who are statutorily defined as those

[34] Admissions made in discovery are "entitled to and should receive a kind of deference not normally accorded evidentiary allegations in affidavits." *D'Amico v. Bd. of Med. Examiners*, 11 Cal. 3d 1, 22 (1974).

[35] In *Koruga v. Fiserv Correspondent Services, Inc.*, 183 F. Supp. 2d 1245 (D. Or. 2001), the court upheld an arbitration award against a clearing broker. *Id.* at 1248. The *Koruga* arbitration panel rejected the same argument that Defendants make here, stating that "[a]part from the fact that the argument flies in the face of the plain language of these statutes ('effecting' means to bring about, cause to happen, accomplish) there is absolutely no authority that a clearing broker or introducing broker does not engage in "effecting transactions in securities," particularly when it is the clearing broker who passes title and exchanges consideration therefor, and does so for financial gain." *In the Matter of the Arbitration Between Koruga et al.*, 2000 WL 33534559, at *18 (NASD 2000) (RJN, Ex. 104).

"engaged in the business of effecting transactions in securities – Defendants are within the category of actors who can be potentially liable for violating Section 25400. Cal. Corp. Code §§ 25004(a), 25400(a), (b).

d. Plaintiffs Do Not Seek to Impose Secondary Liability on Defendants for their Clients' Actions

Defendants argue that they cannot be liable because they only performed "ministerial tasks of executing and/or clearing their clients' transactions after the orders were placed and/or market activity was complete" and did not direct, control, solicit or participate in the manipulative transactions, and therefore Plaintiffs are improperly attempting to impose "secondary liability" on Defendants for their clients' manipulative actions. Defs. Br. 21:20-22:2, 22:24-23:2.

Defendants' argument fails because Plaintiffs claim here is not based on the transactions by Defendants' customers; rather, it is Defendants' decisions to intentionally fail to deliver to settle trades in Overstock securities in order for Defendants to [redacted]" which drove down the price of Overstock stock and benefitted Defendants themselves. SS 132-195.

Defendants alone control and are responsible for settlement and delivery, not their clients. Defendants alone had the power and ability to intentionally fail to deliver [redacted] of shares of Overstock for long periods of time. Defendants alone had the power and ability to effect naked short selling on such a global scale by failing trades systematically. SS 134. [redacted]

[redacted] The net result of Defendants' direct actions was that the manipulation of supply and demand drove up short interest in Overstock and drove down its stock price, causing [redacted] losses to Plaintiffs. SS 263-269.

These allegations and the supporting facts are a far cry from Defendants' characterization of Plaintiffs' Complaint as seeking to hold Defendants secondarily liable for their clients' fraud. Plaintiffs' claims in this action are, and always have been, that the scheme at issue was created and carried out by Defendants.

Defendants do not argue, nor could they, that clearing firms cannot be primarily liable for market manipulation. Courts have found clearing firms primarily liable <u>even where it was their clients' market manipulation schemes and the clearing firms simply participated in those schemes.</u> For example, in *In re Blech Securities Litigation*, 961 F. Supp. 569 (S.D.N.Y. 1997), the court ruled that a purported "clearing broker" can incur primary liability for its participation in a manipulative scheme. *Id.* at 577-578, 584-85. There, the court refused to dismiss a Section 10(b) claim against the clearing broker, Bear Stearns, where the complaint alleged that Bear Stearns essentially contrived, or helped instigate, the scheme. *Id.* at 576, 584-85. As the court stated,

> Plaintiffs allege that Bear Stearns "directed" Blech & Co. to sell Blech Securities by demanding that Blech reduce its debit balance with knowledge of Blech's history of sham trading, and that Blech, in response to Bear Stearns' pressure, engaged in manipulative parking transactions, which Bear Stearns cleared. <u>This course of conduct by Bear Stearns - the instigation of trading that Bear Stearns knew or should have known would result in fraudulent trades that would artificially inflate the price of the Blech Securities, and the subsequent clearing of the resultant fraudulent trades for its own pecuniary benefit - constitutes an attempt to affect the price of the Blech Securities. As a result, by participating at both the initiation and clearing stages of the allegedly fraudulent transactions, Bear Stearns knowingly engaged in a manipulative</u>

scheme to defraud under Section 10(b), which affected the market upon which Plaintiffs relied in purchasing the Blech Securities.

Id. (citation omitted); *see also id.* at 585 (noting that plaintiffs stated a claim by alleging that Bear Stearns "knowingly contrived and funded sham transactions"). In *Koruga v. Fiserv Correspondent Services, Inc.*, 183 F. Supp. 2d 1245 (D. Or. 2001), although the claim against the clearing firm was brought under Section 25504, the court upheld an arbitration award against a clearing broker, stating that the arbitration panel found facts to support its ruling that the firm was liable under the "California Securities Acts as a direct participant in the wrongdoing.'" *Id.* at 1248 (emphasis added); *see also Cox v. Eichler*, 765 F. Supp. 601, 603, 610 (N.D. Cal. 1990) (brokerage firm may be liable for violating Section 25400).

Here, Defendants instigated the scheme and directed, solicited, controlled, executed, cleared and/or purchased what Defendants knew to be sham transactions. *See* SS 132-195. Defendants therefore are subject to liability under Section 25400(a) and (b) for their roles in effecting the transactions at issue.

e. Defendants Rely on Inapplicable Authorities that Do Not Interpret "Effect" and Instead Address Attempts to Impose Secondary Liability on Non-Broker-Dealers.

Defendants rely on cases that do not interpret the term "effect" and that instead addressed attempts to impose secondary liability on persons who were not broker-dealers – *i.e.*, persons who were not statutorily defined as persons "engaged in the business of effecting transactions in securities." These authorities are inapposite.

In stating this Court's tentative view that potential liability for Section 25400 violations is not confined to "purchasers" and "sellers," this Court correctly rejected Defendants' reliance on *Kamen v. Lindly*, 94 Cal. App. 4th 197 (2002). *See* RJN, Ex. 6 (2/15/08 Trans.), at 23:8-10; *see also* RJN, Ex. 5 (Mot. to Strike First Am. Complaint at 9:16-25). *Kamen* involved alleged violations of Section 25400(d), not violations of Section 25400(a) and (b), which are the sections at issue here. *Id.* at 202. Moreover, the *Kamen* court declined to impose secondary liability against an auditor and a corporate officer. *See id.* at 203-05. There is no indication that either the auditor or the officer was a broker-dealer – *i.e.*, one statutorily defined as "engaged in the business of effecting transactions in securities in this state for the account of others or for his own account." Cal. Corp. Code § 25004(a). Nor did the Court state that broker-dealers could not be directly liable for effecting the transactions, and series of transactions, prohibited by Section 25400(a) and (b). Indeed, *Kamen* recognized that those who were "engaged in market activity" may face liability. *Kamen*, 94 Cal. App. 4th at 204-05. As broker-dealers who effected transactions in Overstock securities, Defendants "engaged in market activity" here.

Openwave Systems, Inc. v. Fuld, 2009 WL 1622164 (N.D. Cal. June 6, 2009) also involved claims against directors and officers who did not effect transactions– not claims against broker-dealers. *Id.* at *1. Like *Kamen*, *Openwave* was decided on grounds of secondary liability. *Id.* at *9. The *Openwave* court did not consider or resolve the issue of whether broker-dealers – who by definition "effect[] transactions in securities" – could be directly liable for their role in "effecting" the transactions prohibited by Sections 25400(a) and (b). There also is no indication that the *Openwave* court was presented with the voluminous authority regarding the meaning of the term "effect" that the Court has been presented with here or did anything other than resolve the simple factual scenario before it. *Openwave* thus is not authority for the result that Defendants seek. *Styne v. Stevens*, 26 Cal. 4th 42, 57 (2001).

In stating its tentative views on the potential applicability of Section 25400(a) and (b), this Court implicitly rejected Defendants' misapplication of Marsh & Volk, who also do not state that broker-dealers cannot be liable for effecting manipulative transactions in violation of Sections 25400(a) and (b). *See* RJN, Ex. 6 (2/15/08 Trans.), at 23:8-10; *see also* RJN, Ex. 5 (Mot. to Strike First Am. Compl.) at 10:4-12.) Marsh & Volk preface their discussion with the point that "the defendant must have engaged in market activity in order to be liable." Marsh & Volk § 14.05(4). Again, Defendants are statutorily defined as being in "the business of effecting transactions in securities" and "engaged in market activity" here. Cal. Corp. Code § 25004(a).[36]

The Court also expressly rejected Defendants' reliance on Section 25504, which

[36] To the extent that Defendants read Marsh & Volk to suggest that only purchasers and sellers may "effect" transactions, such an interpretation is inconsistent with the plain language of Section 25004(a) and should not be considered by the Court. *See, e.g.*, *Diamond Multimedia*, 19 Cal. 4th at 1055.

imposes secondary liability on those who aid and abet violations of Sections 25501 and 25503. *See* RJN, Ex. 6 (2/15/08 Trans.), at 23:6-8; Cal. Corp. Code § 25504. Again, Defendants are directly liable for their roles in effecting the manipulative transactions at issue here. Moreover, Section 25501 expressly confines primary liability to purchasers and sellers, demonstrating that the Legislature knew how to do so when the Legislature intended. *See* Cal. Corp. Code § 25501 ("Any person who violates Section 25401 shall be liable to the person who purchases a security from him or sells a security to him, who may sue either for rescission or for damages … .") (emphasis added). The Legislature did not do so in Section 25400, instead extending potential liability to "any person" that "effect[s]" the manipulative transactions and series of transactions, as Defendants did here.

Finally, Defendants' argument is inconsistent with cases such as *Blech* which found clearing firms that were neither purchasers nor sellers directly liable under market manipulation statutes.

In the end, Defendants' argument is that even if they did effect manipulative transactions, and even if they did effect those manipulative transactions with manipulative intent, they still could never be liable because of some "purchaser/seller loophole" that is not expressed in the plain language of the statute, and is inconsistent with statutory language and case law. Defendants apparently believe that only Defendants' clients could be liable for Defendants' conduct – even though Defendants masterminded the scheme, effected the manipulative transactions, were necessary participants in the scheme, and profited quite handsomely from it (and, in the case of Goldman Sachs, [redacted]). This could not be what the Legislature intended in passing a broad, remedial statute like Section 25400. Summary judgment and adjudication must be denied.

3. Defendants' Argument they are Entitled to Summary Adjudication of Plaintiffs' Section 25400 Claims Because they Did Not Engage in any Manipulative Transactions Fails.

Defendants next claim that the transactions at issue are not encompassed by Section 25400. The approach of California securities laws, however, "is to sweep all transactions in securities within the regulatory net.'" *People v. Cole*, 156 Cal. App. 4th 452, 480-81 (2007).

It is well-established that "[m]anipulative schemes may not be allowed to succeed solely because they are novel." *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 793 (2d Cir. 1969). "To insure the multitude of investors the maintenance of fair and honest markets, manipulative practices of all kinds . . . are banned." *Id.* at 794 (discussing the federal analogue of Section 25400, quoting H.R. Rep. No. 1383, 73d Cong., 2d Sess., at 11 (1934)). Plaintiffs bring claims under two subsections of 25400: (a) and (b).

Section 25400(a), the narrower of the two sections, generally prohibits certain types of transactions, such as what are commonly know as "wash sales," "matched orders" or "prearranged trades" for a manipulative purpose. Section 25400(b), the broader of the two sections, makes it illegal "[t]o effect, alone or with one or more other persons, a series of transactions in any security or creating actual or apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others." Cal. Corp. Code § 25400(b).

Section 25400(b) has a broad application. It applies where the activity in a stock that the public sees is "'a mirage' rather than 'the reflection of genuine demand.'" *Crane*, 419 F.2d at 794 (quoting the legislative history); *see also SEC v. Resch-Cassin & Co.*, 362 F. Supp. 964, 975 (S.D.N.Y. 1973) (prohibition with respect to manipulative activity "is necessarily designed to outlaw every device 'used to persuade the public that activity in a security is the reflection of genuine demand rather than a mirage'") (citation omitted) (emphasis added). The purpose of this broader Section (b) "***is to prevent rigging of the market and to permit operation of the natural law of supply and demand***." *U.S. v. Stein*, 456 F.2d 844, 850 (1972) (emphasis added) (affirming criminal conviction under federal statute upon which Section 25400(b) was modeled).

Significantly, conduct "can be illegal" under Section 25400(b) "solely because of the actor's purpose." *Markowski v. SEC*, 274 F.3d 525, 529 (D.C. Cir. 2001) (emphasis added) (discussing the federal analogue of Section 25400(b)). Contrary to Defendants' suggestion, even "real" transactions can be manipulative and illegal under this broad statute. *Id.* at 528-29 (rejecting argument, made by Defendants here, that trades cannot be illegal where they were "real" – *i.e.*, they involved "real customers, real transactions, and real money").

Section 25400(b) applies where a defendant has caused <u>either</u> actual or apparent activity in the market for a security <u>or</u> a change in the security's price. *Stein*, 456 F.2d at 850; *Resch-Cassin*, 362 F. Supp. at 975-76.

a. Defendants Do Not Even Attempt to Shift the Burden.

Defendants fail to shift the burden as to whether they effected a series of transactions that created actual or apparent trading activity in Overstock securities or that depressed such the price of such securities. While Defendants' Joint Compendium states that Defendants did not engage in wash sales or other transactions prohibited by Section 25400(a) <u>or</u> a deceptive series of transactions prohibited by Section 25400(b), Defendants' own separate statements themselves address <u>only</u> wash sales – *i.e.*, conduct prohibited under Section 25400(a). Compare DJC ¶ 33 with GS SS ¶¶ 21, 60; GSEC SS ¶¶ 16, 52; ML SS ¶¶ 34, 44; MPRO SS ¶ 51. Because Defendants do not even attempt to assert as a purportedly undisputed material fact that they did not effect a series of transactions in Overstock securities that created actual or apparent or trading activity or that depressed the price as prohibited by Section (b), Defendants failed to shift the burden, so summary judgment and adjudication must be denied. *Aguilar*, 25 Cal. 4th at 850.

"Summary adjudication must completely dispose of the cause of action to which it is directed." *Nazir*, 178 Cal. App. 4th at 251. Here, Plaintiffs have alleged one Section 25400 cause of action. As such, summary adjudication cannot be granted based upon Defendants' arguments and evidence pertaining solely to Section 25400(a). *Hood v. Superior Court*, 33 Cal. App. 4th 319, 324 (1995) (trial court abused its discretion in not denying motion for summary adjudication that did not dispose of entire claim). Accordingly, the Court need not even consider the analysis of whether trades were manipulative as contained in subsections (b) and (c) below.

b. At the Very Least, Triable Issues of Fact Exist.

Defendants argue facts as to Section 25400(a), but offer zero facts to support any argument that their trades cannot violate 25400(b). While the Court need read no further given Defendants' failure to argue the complete statutory claim at issue, Defendants also try to ignore the facts showing their manipulation of the supply and demand in Overstock stock.

Section 25400(b) is not limited to trades without a change in beneficial ownership – to the contrary, even "real trades" can be manipulative under 25400(b). Defendants' activity here goes to the core of market manipulation – artificially interfering with supply and demand. Defendants intentionally failed trades to manipulate the supply of Overstock securities, driving up short interest in and driving down the price of Overstock stock. *See* SS 132-195. Rather than allow the natural forces of supply and demand to operate in the market for Overstock securities, Defendants took steps to interfere with natural forces by untethering short sales from delivery, thereby creating additional, artificial supply. Goldman Sachs even stated in writing, its intentions to [redacted]—rather than let selling take its normal course. SS 138. [redacted] By consistently failing trades amounting to [redacted] of shares in Merrill Pro and GSEC's CNS accounts, Defendants inflated the short interest in Overstock from August 2005-December 2006, even beyond the entire tradable supply of Overstock. SS 163.

Defendants' compliance manuals recognize that manipulation of supply and demand is one of the most basic forms of stock manipulation. Merrill Lynch's compliance manual states that [redacted] SS 193.

All of the fails in Merrill Pro's and GSEC's CNS accounts reflect the result of Defendants' decisions to intentionally fail Overstock shorts sales in those accounts and to cut off the necessary supply of stock to settle those trades. SS 137, 139-140, 144. By effecting short sales with no intent to settle the trades, Defendants increased short selling and short interest in Overstock beyond what would have otherwise existed had Defendants not altered normal market supply constraints, hence the manipulation of the supply. SS 154, 157, 161, 163. By failing trades, Defendants could then allocate the artificially-increased supply as a basis for supporting additional shorts—before the first shorts were settled . SS 139, 161. That was a basic point of the scheme – to pump up the shorting of Overstock stock as the price of Overstock declined, a vicious cycle described in the Manzino declaration. SS 154-155.

In addition to the direct price pressure of additional shorts caused by the manipulation, a manipulated level of extremely high short selling injects false information into the market. Selling "short" is a means by which market participants—beyond existing shareholders—may express negative sentiment, or expected price change, regarding a specific stock. SS 159. Consequently, the degree to which such "short sales" become a measurable percentage of the shares outstanding or, even more importantly, the "float" of shares available for trading (referred to as "short interest"), has come to be widely regarded as a statistical indicator of negative market sentiment. *Id.*

Defendants' actions injected false information into the marketplace for Overstock securities in the form of artificially high short interest figures for Overstock stock so that market participants would be induced to view the stock more negatively, creating downward price pressure on the stock. SS 152, 153, 159. With high negative rebate stocks such as Overstock, the short interest is additionally signaling not only a negative sentiment, but one that is so strong the short seller is wiling to bet against the stock at a cost of whatever the negative rebate is. SS 159. For example, where Overstock's negative rebate was [redacted], a legitimate short seller was betting the stock will drop enough to cover his [redacted] cost and then make an additional profit after that. Here, millions of shares of reported short interest in Overstock was created by the naked short sales that Defendants decided in advance to fail to deliver (such as [redacted]s shorts), and therefore the short seller had no negative rebate cost to factor into its short selling decision. In other words, the naked short sales by [redacted] and others were not a genuine expression of negative sentiment. However, the market nonetheless perceived those [redacted] of shares as short positions held by short sellers who were incurring that cost and thus had particularly strong negative sentiment. SS 159.

(1) Defendants have failed to establish that their intentional and persistent fails-to-deliver did not manipulate the market in Overstock securities.

Defendants argue their fails to deliver cannot fall under Section 25400(a) because there is a change in beneficial ownership when a short sale occurs, even though delivery does not. Defs. Br. 26:10-26. This argument fails for multiple reasons.

First, the most basic flaw in Defendants' argument is that, even assuming *arguendo* that beneficial ownership is created merely by the recording of a long position on a broker-dealer's books and records (which it is not, as discussed below), the fails to deliver by definition cannot and did not result in any "***change***" in beneficial ownership from one party to another. SS 196. Because Defendants never borrowed or had any intent to borrow the stock and its corresponding ownership rights from an actual owner of stock (a long holder) to make delivery, there never was any actual or even intended "***change***" in ownership. Despite the fact that Plaintiffs have addressed this argument multiple times, including successfully resisting Defendants' very first demurrer on the same issue in this case in 2007, Defendants continue to ignore this fatal flaw in their argument.[37]

Second, even if Plaintiffs' previously successful argument were completely ignored, Defendants' argument fails for the additional reason that "beneficial ownership" does not arise merely from the recording of a long position on a broker dealer's books that occurs when a buyer purchases shares. To the contrary, beneficial ownership can only be acquired by the delivery of stock. As stated by Goldman Sachs' counsel in a letter to the SEC on December 30, 2008, "[w]e believe it is important to stress that, when GS & Co. meets a <u>delivery</u> obligation to the market, it ceases to exercise voting and investment power over those securities upon

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[37] In Plaintiffs' Opposition to Defendants' Demurrer (May 10, 2007) at 12:17-13:4, RJN Ex. 2, Plaintiffs argued: "[A]s Plaintiffs allege, although the buyer's account may be credited with a book entry reflecting a sale, the Defendants intentionally never locate and deliver the stock to the buyer. Thus, Defendants do not "change" the beneficial ownership from one owner to another. Rather, the book entry, while it may create rights for the buyer, is not accompanied by the obtaining of those ownership rights from a holder of the stock. Thus, Defendants create a false or misleading appearance in the market for the stock because they allow the buyer's account to reflect a purchase, but never actually obtain and transfer the rights to the stock that has been purchased."

delivery." *Id.* at 5 (emphasis added). "Upon delivery, the purchaser of the shares acquires voting and investment power over the shares… ." *Id.* (emphasis added). Here, under Goldman's own definition, the massive fails-to-deliver resulted in a lack of change of beneficial ownership. The recording of a long position may give the holder a right to money vis-à-vis the broker dealer, but beneficial ownership is not a mere right to money. Beneficial ownership requires either voting power over securities or investment power to dispose of securities. SS 197, RJN, Ex. 45. As noted in Goldman's letter to the SEC: "[P]ositions that do not give GS & Co. and voting or dispositive rights over the subject securities should be excluded from the calculation [of beneficial ownership]." RJN, Ex. 45 at 4.

Taking an inconsistent position with Goldman's position to the SEC, Defendants here claim that trade execution, not delivery, is when beneficial ownership changes. Defendants cite the California Commercial Code, relying on the same argument Defendants unsuccessfully made in their first demurrer. The Commercial Code concerns a purchaser's rights against a securities intermediary like Goldman or Merrill, and provides that a purchaser obtains "a pro rata property interest in all interests in that financial asset held by the securities intermediary… ." Cal. Comm. Code § 8503(b). That security entitlement (a right to money from the broker-dealer) is not the same as beneficial ownership which is governed by securities law; for example, the Commercial Code does not determine voting rights. Even under the Commercial Code, a purchaser has "control" of an uncertificated security only if "the uncertificated security is delivered to the purchaser." *Id.* § 8106(c)(1). Absent delivery, there is no change in control.

In sum, Defendants created a false or misleading appearance in the market for the Overstock stock because trades were executed without any corresponding change in beneficial ownership, all as a result of the fraudulent scheme to effect securities transactions without any intent to own, borrow or deliver the stock and the corresponding rights. *See also* RJN, Ex. 48 at p. 4 (SEC's Chairman Cox notes that "fails to deliver can deprive shareholders of the benefits of ownership").

Defendants also argue, without any support, that because the fails to deliver resulted from purportedly "real sales to real buyers," they cannot be the basis for a manipulation claim. Defs. Br. 27:3-4. Again, this ignores the actual law. Significantly, conduct "can be illegal" under Section 25400(b) "solely because of the actor's purpose." *Markowski v. SEC*, 274 F.3d 525, 529 (D.C. Cir. 2001) (emphasis added) (discussing the federal analogue of Section 25400(b)). Contrary to Defendants' suggestion, even "real" transactions can be manipulative and illegal under this broad statute. *Id.* at 528-29 (rejecting argument, made by Defendants here, that trades cannot be illegal where they were "real" – *i.e.*, they involved "real customers, real transactions, and real money").

Defendants only other argument regarding their intentional fails to deliver is to argue that *Cohen v. Stevanovich,* 722 F. Supp. 2d 416 (S.D.N.Y. 2010) bars Plaintiffs' claims as a matter of law. *Cohen* decided on demurrer that the plaintiffs had failed to state a claim. Here, in contrast, Plaintiffs have already survived demurrer, and this Court has already held that Plaintiffs have stated a claim. That is because here, unlike in *Cohen*, more than mere fails to deliver are alleged. In *Cohen*, the court applied the heightened pleading standards of federal securities law and stated that "allegations of fails to deliver, <u>without more</u>, are insufficient to state a claim for market manipulation." *Id.* at 424 (emphasis added). The *Cohen* plaintiffs had relied "entirely on Exhibits A and B to the Complaint, which purport merely to show the price of SulphCo stock over time and the days on which SulphCo appeared on the Threshold list." *Id.* at 426. The *Cohen* plaintiffs had not attempted to identify a single short sale effected by any defendant, but instead relied on the mere existence of fails-to-deliver." *Id.* at 424 n.3. Of course, that is not the case here. Plaintiffs have alleged a detailed, massive market manipulation scheme to create artificial supply and [redacted] short sales in Overstock, which bears no resemblance to the bare reliance on the mere existence of fails to deliver at issue in *Cohen*. *See* Section II, *supra*.

In fact, Defendants made this identical argument to the *Cohen* court and the court agreed, even expressly finding: "[t]he Overstock.com case involved different claims under California state law and different allegations … and thus has no relevance to this motion." *Id.* at 426 n.5. This finding was pulled verbatim from the Reply Brief filed and signed by the same lead attorneys on behalf of the same Defendants in this litigation. RJN, Ex. 13. Thus, the *Cohen* defendants, represented by the same lawyers here, argued that this case had completely different facts than *Cohen*. After using this distinction to help secure dismissal in *Cohen*, Defendants now shamelessly argue to this Court that the cases are identical. Defendants' position before the *Cohen* court judicially estops them from using *Cohen* and arguing the opposite in this Court. *Jackson v. County of L.A.*, 60 Cal. App. 4th 171, 183 (1997). Defendants continue to ignore this fact, despite it being raised in prior briefs. Even if no estoppel applies, *Cohen* is irrelevant.

Defendants also cite to a quote from *ATSI Communications, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 101 (2nd Cir. 2007), whereby the court stated "[t]o be actionable as a manipulative act, short selling must be willfully combined with something more to create a false impression of how market participants value a security." Defs. Br. pp. 22:27-28:2. Defendants make no argument regarding the actual application of *ASTI* to the facts of this case. To the extent Defendants are arguing manipulative acts must send a false signal to the market, such argument does not help them here. All trades executed for a manipulative purpose are actionable, and no additional, "false" signal requirement exists. *Markowski v. SEC*, 274 F.3d 525, 528-29 (D.C. Cir. 2001); *SEC v. Masri*, 523 F. Supp.2d 361, 371-72 (S.D.N.Y. 2007) (rejecting finding additional requirement of alleging deceptive practices that "injected inaccurate information into the market.")

Moreover, as described above, intentionally failing trades to drive up short interest does send a false signal into the market. Market participants perceive short interest as a genuine statement of negative sentiment; the market cannot distinguish short interest that consists of genuine short sales versus naked short sales with no borrow cost or delivery. As short interest is manipulatively inflated, market participants will have an inflated perception of how negative the sentiment is towards Overstock securities, unaware of the behind-the-scenes upward manipulation of short interest. Thus, even if a "false signal" requirement existed under the law, the alleged trading in and of itself sends a false signal into the market. See *Masri*, 523 F. Supp.2d at 371-72 (noting that an open-market transaction with a manipulative intent in and of itself "distorts the functioning of the market and sends a false message to its participants."); *SEC v. Kwak*, 2008 WL 410427 *1 (D.Conn. 2008) ("[F]ailure to disclose a manipulation operates as a fraud or deceit on other investors.").

(2) Defendants fail to establish the flex "sham" transactions and sales into the buy-in cannot be manipulative transactions

As part of the manipulative scheme, Defendants also effected wash sales and matched orders and trades to extend the duration of the fails to deliver. Maintaining the fails to deliver in Overstock for significant periods of time was problematic for Defendants in light of federal regulations that required fails to deliver in threshold securities like Overstock to be closed out if the fail persisted for more than 13 days. The clearing firm, not CNS (nor the client), was responsible for tracking the duration of the fail-to-deliver and ensuring that it did not last more than thirteen days.

Section 25400(a) prohibits "wash sales" and "matched orders." Defendants contest that they effected wash trades, but fail to contest that they effected matched orders.

As to wash sales, Defendants argue that the [redacted]o not qualify as "wash sales." Defs. Br. 28:14-16. This is false. [redacted]

These transactions had all the hallmarks of what is understood to be "wash sales" in the industry – the trades are done for no economic purpose; rather, they are done to create a false impression that a change in position has occurred when in fact it has not. SS 207. [redacted]

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[38] More specifically, the phony "purchase" of stock was paired with a one-day, deep-in-the-money flex option that would automatically unwind the purchase without any trade settlement.

[redacted] *Id.*

As to matched orders, Defendants fail to even address whether certain trades were "matched orders," despite acknowledging such transactions are prohibited under 25400(a). Specifically, Defendants would from time-to-time [redacted]

Indeed, Merrill Pro even put down in writing [redacted]

Likewise, GSEC would [redacted]

[redacted]

These trades have the characteristics of wash trades or matched orders because each of these trades is designed at the inception to simply maintain an existing position. The surrounding trades are done for no economic purpose; rather they are done to create a false impression that a change in position has occurred when in fact it has not. SS 206.

Finally, Defendants argue they did not intend to create a false or misleading appearance in the market; rather, they just sought to create false internal records to avoid federal regulations. Defs. Br. 30:5-14. Such an argument ignores the fact that the false and misleading appearance in the market included the manipulation of supply and demand to artificially inflate short interest, and these sham trades were a part of the scheme to maintain fails and drive up short interest. SS 207-210. Moreover, as Messinger herself admitted, i[redacted]

[redacted] In Defendants' world, Overstock's stock should only go down.

(3) Defendants fail to establish the conversion trades cannot be manipulative transactions

[redacted]

[redacted] Under Section 25400(a), [redacted] acquired "beneficial ownership" of Overstock stock despite the fact that there was no actual stock being sold and no intent to deliver. Again, this argument fails for the same reasons it failed before, namely that no change in beneficial ownership occurred absent delivery. *See*, *supra*, Section III.B.3(b)(1). These trades were not legitimate trades intended to transfer or "change" beneficial ownership from one party to the next as in a bona fide short sale, as there was never any intent to deliver stock to settle the trade.

In addition, Defendants are liable under Section 25400(b) regardless of whether beneficial ownership changed. Defendants argue that they should not be liable because the conversion trades themselves are "market neutral," "meaning that the party engaging in the transaction does not stand to profit from any increase or decrease in the stock price, instead any profit or loss on the transaction itself is fixed immediately when the position is established." Defs. Br. 32:19-20. That is missing the forest for the trees. The conversion trades manipulatively created an artificial supply, and manipulation of supply and demand is the essence of market manipulation. [redacted] driving up the short interest and driving down the price. [redacted]. SS 132-195. Because there was no borrowing and delivery of stock in connection with these trades, [redacted]

[redacted] SS 230.

Finally, Defendants simply state, "Plaintiffs must prove that the transactions were effected for the purpose of inducing others to sell Overstock stock, which they cannot do." Defs. Br. 32:9-11. Defendants cite no evidence supporting their conclusory statement of fact, and therefore again fail to shift the burden. And, as set forth above, the reason [redacted] hort selling in Overstock. There is ample evidence that the entire scheme was created for the purpose of inducing both the initial naked short sales and the additional short sales in Overstock, sufficient to state a claim under Section 25400(b). *See* SS 132-258.

As previously discussed in response to the argument that fails to deliver cannot be manipulative because they do not inject false information into the marketplace, all trades executed for a manipulative purpose are actionable, and no additional, "false" signal is required. *Markowski v. SEC*, 274 F.3d 525, 528-29 (D.C. Cir. 2001); *SEC v. Masri*, 523 F. Supp.2d 361, 371-72 (2nd Cir. 2007) (rejecting finding additional requirement of alleging deceptive practices that "injected inaccurate information into the market"). Moreover, even if such a "false signal" requirement existed, the manipulative conversion trading in and of itself sends a false signal into the market. See *Masri*, 523 F. Supp.2d at 371-72 (noting that an open-market transaction with a manipulative intent in and of itself "distorts the functioning of the market and sends a false message to its participants."); *SEC v. Kwak*, 2008 WL 410427 *1 (D.Conn. 2008) ("[F]ailure to disclose a manipulation operates as a fraud or deceit on other investors."). The conversion trades induced more short selling by injecting false information into the market, *i.e.*, market participants would not know that the short sales were not a genuine expression of negative sentiment (such that the short seller was willing to pay a [redacted]% borrow fee to short the stock), but rather was a rigged, market-neutral trade that would unwind later without any borrow cost being paid. SS 159. Thus, Defendants' citation to *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 207 (3rd Cir. 2001) has little significance because Plaintiffs can show, though not required, that there is evidence that "the short sales at issue had 'inject[ed] false inaccurate information into the marketplace or creat[ed] a false impression of supply and demand." Defs. Br. at 32:13-16.

Accordingly, even if Defendants had in fact shifted the burden on this element, triable issues of fact exist as to whether the transactions Defendants effected at issue in this case were manipulative under Section 25400 (a) or (b).

4. Defendants' Argument that they are Entitled to Summary Adjudication of Plaintiffs' Section 25400 Claims Because there is No Issue of Fact as to their Manipulative Intent Fails.

Whether Defendants had manipulative intent is to be inferred from all the facts and circumstances of the case. *See, e.g.*, 1 Marsh & Volk § 14.05(2)(d), at 14-63; *see also Crane Co.*, 419 F.2d at 794 ("The requisite purpose . . . is normally inferred from the circumstances of the case."); *In re The Federal Corp.*, 25 S.E.C. 227, 230 (1947) ("Since it is impossible to probe into the depths of a man's mind, it is necessary in the usual case . . . that the finding of manipulative purpose be based on inferences drawn from circumstantial evidence."); *Filip v. Bucurenciu*, 129 Cal. App. 4th 825, 834 (2005) ("Whether a conveyance was made with fraudulent intent is a question of fact, and proof often consists of inferences from the circumstances surrounding the transfer.").

Questions pertaining to Defendants' intent therefore are questions of fact that should be resolved by the jury. *See, e.g., Kunert v. Mission Financial Servs. Corp.*, 110 Cal. App. 4th 242, 255 (2003) ("'The existence of the requisite intent is always a question of fact.'"); *Securities & Exchange Comm'n v. Masri*, 523 F. Supp. 2d 361, 373 (S.D.N.Y. 2007) (whether a defendant has manipulative intent "is a factual question, 'appropriate for resolution by the trier of fact'"); *U.S. v. Swink*, 21 F.3d 852, 855 (8th Cir. 1994) (willfulness is a question for the jury).

Where, as here, Defendants have effected a series of manipulative transactions, "intent may be inferred from the conduct itself." *Masri*, 523 F. Supp. 2d 3 at 367; *see also* Lewis D. Lowenfels, "Sections 9(A)(1) and 9(A)(2) of the Securities Exchange Act of 1934: An Analysis of Two Important Anti-Manipulative Provisions Under the Federal Securities Laws," 85 Nw. U. L. Rev. 698, 699 (1991) ("'[T]he only likely 'purpose' of engaging in wash sales and matched orders is to falsify the market.'") (citation omitted).

The courts and the SEC have long held that "[w]hen a person who has a 'substantial, direct pecuniary interest'" in the price of a security takes "active steps" to affect that price, "a finding of manipulative purpose is prima facie established." *Crane Co.* 419 F.2d at 795; *In re Halsey, Stuart & Co.*, 30 S.E.C. 106, 124 n.28 (1949), *available at* 1949 WL 36458; *see also SEC v. Resch-Cassin & Co.*, 362 F. Supp. 964, 978 (S.D.N.Y. 1973) (requisite purpose established where a defendant "had a profit motive in causing the price of the stock to rise . . . through its interest in closing the issue to assure its commissions as a member of the selling group"); 4 Bromberg & Lowenfels on Securities Fraud § 7.87 (2d Ed.) ("Decisions like [*Crane Co.*] make it clear that any substantial economic interest in the price level of a security gives some basis for inference of manipulative purpose when the holder of the interest acts or trades in a manner likely to affect that price level in a way that favors him.") A clearing firm which does not hold a direct position in a security can have the requisite intent to manipulate the market where circumstantial evidence shows that the firm would otherwise financially benefit from an artificial movement in the price of the securities. *In re Blech*, 961 F.Supp. 569, 583 (S.D.N.Y. 1997).

a. Triable issues of Material Fact Exist as to Whether Defendants had Manipulative Intent.

Here, Defendants effected a series of transactions to manipulatively increase the supply of Overstock securities and inflate short interest, effected "wash trades," effected "matched orders" and effected manipulative conversion trades. SS 196-206. The jury may infer manipulative intent from such manipulative conduct alone, so the Court need go no further in this analysis. *Masri*, 523 F. Supp. 2d at 367.

However, many additional facts and circumstances exist from which the jury could also infer that Defendants had manipulative intent. *See*, SS 207-258. Defendants' actions show that they were not just passively clearing client trades; indeed, ordinary clearing and settling of trades can be done automatically by computer without any human involvement. As shown in the background facts above, i[redacted] *See*, SS 132-195. Defendants' manipulation resulted in fails to deliver Overstock that at times exceeded [redacted] of the float in Overstock stock, which represented [redacted] dollars of Overstock stock. SS 157.

The fails to deliver in Overstock occurred as a result of conscious decisions on the part of both Goldman and Merrill to stop making delivery to settle trades in certain CNS accounts at the DTCC. [redacted]

[redacted]

[redacted]

[redacted]

Defendants had powerful incentives to manipulate the market for Overstock securities because it was a hard-to-borrow security and [redacted]).[39] SS 230.

[39] Defendants' cases involving conclusory, generalized allegations of a profit motive, such as a motive to obtain unspecified fees, are inapposite. *See* Defs.' Br. at 35:5-15. [redacted] Moreover, as discussed *infra*, under the workings of a federal mark-to-market regulation, Defendants would profit on a daily basis if the price of Overstock stock declined and would lose money if it rose. SS 235-236. [redacted]

As explained by

Supply is the lifeblood of securities lending because the basic function of securities lending is to borrow stock at one rate and lend it to short-selling clients at a higher rate, thereby capturing a spread and making a profit. To the extent it can artificially increase its supply of a hard-to-borrow securities and perpetuate selling in those securities, a clearing firm's profits will dramatically increase.[40] SS 231-232.

Defendants, as experienced market participants, understood that artificially increasing the supply of Overstock stock to perpetuate short selling would drive down the price of Overstock stock. SS 233. Defendants also would have understood given their day-to-day interactions with their hedge fund clients that, as the price of Overstock declined, the volume of short sellers would typically increase, resulting in increased profits to Goldman and Merrill from the additional volume of short selling. SS 232.[41] Defendants understood that through the

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Manzino, with excess artificial supply, Defendants would benefit from price declines as more and more stock was shorted that should not have been shorted. *Id.* Because Defendants had "a 'substantial, direct pecuniary interest'" in the price of Overstock and took "active steps" to affect that price, manipulative intent may be inferred. *Crane Co.* 419 F.2d at 795.

[40] Having decided to embark on a plan to intentionally fail to deliver [redacted] of dollars worth of hard to borrow stock in order to [redacted] short selling, Defendants had an additional motive to ensure that the price of the stocks they were intentionally failing to deliver did not increase. SS 235-36. When participants such as Defendants fail to deliver securities to CNS, the dollar value of that fail is "marked to market" every day. *Id.* The DTCC does this in order to match the parties financial obligations to the price of the stock on the original trade date. Thus, if on the trade date, stock was purchased for $100 per share, the firm that failed to receive the stock has collected $100 dollars from its customer. The firm that is failing to deliver owes one share of stock to DTCC. If the price of the stock declines, the firm failing to deliver gets cash from the DTCC equal to the amount of the decline. If the price of the stock <u>increases</u>, now the firm failing to deliver has to provide cash to the DTCC equal to the amount of the increase. *Id.*

Defendants, as experienced clearing firms, would have understood this financial tie to stock price of stocks they were failing to deliver. [redacted]

[41] [redacted] This is false and ignores the fact that the securities lending business is a volume business that, as to a particular stock, increases as the short sellers pile on to a stock that is declining in values, and as to the overall business depends upon the clients making profits through price declines in short selling such that they continue to

creation of artificial supply to [redacted]e short selling, Defendants could artificially increase the natural phenomenon of short interest sending a negative signal to the market, which led to price declines, which led to more short selling, more price declines, and more profits to Defendants. SS 226, 228, 231-233.

All clearing firms know that delivery is the very essence of a clearing firm's obligation in effecting trades, so [redacted] There simply is no substitute for allowing the jury to see the witnesses testify, with all of their contradictions, and draw their own judgment as to the parties' intent.

[redacted]

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short sell. SS 231-233. *See Nanopierce Techs. v. Southridge Capital Mgmt. LLC*, 2002 WL 31819207, at *4 (S.D.N.Y. Oct. 10, 2002)(("[D]efendants' contention that they stood to profit from an increase in the stock price of ITIS shares ... does not foreclose the possibility that they stood to gain even more from a decline in the price of ITIS stock.").

[42] [redacted]

[redacted] Defendants effected various types of sham transactions, including "wash" sales and "matched orders," in order to [redacted] Defendants were members of SIFMA, an industry lobbying group that expressly referred to [redacted] Overstock had been actively lobbying for legislation to curb Defendants' abusive activities, and Overstock's CEO, Patrick Byrne, has been outspoken regarding problems on Wall Street, something Defendants repeatedly complain about in this case, even going so far as to request judicial notice of some of these activities in support of this Motion. *See* Powers Declaration in Support of Defendants' Motion for Summary Judgment. When

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[redacted]

Overstock obtained passage of a law that would require disclosure of clearing firms' fails-to-deliver (which are kept secret from the public), [redacted]

Any and all of these facts provide a basis for the jury to infer that Defendants acted with manipulative intent.

b. Defendants' Arguments Regarding Reg SHO do Not Establish there are No Issues of Material Fact Regarding Defendants' Intent

As an affirmative defense to Plaintiffs' claims,[43] Defendants argue their conduct was legal. First, these arguments fail on their face because, as has been repeatedly briefed in this case, and found by this Court, intentional market manipulation is never legal. *See* Section III.D, *infra.* Defendants have never cited, nor could they, any basis for an argument that Reg SHO provides a safe harbor for intentional market manipulation. Accordingly, the Court need not even consider the further discussion set forth below.

Second, Defendants did not properly notice any motion to move for summary judgment on an affirmative defense that their conduct was purportedly lawful. Again, summary judgment cannot be granted, and the Court need read no further.

Third, Defendants' arguments also fail for the additional reasons set forth below.

(1) Defendants' Fails to Deliver had Nothing to do with Bona Fide Market Making

As an initial matter, all of Defendants' arguments under this section are premised on Defendants' assertion that the trades Defendants intentionally failed to deliver and corresponding naked short sales were bona fide market making trades. This premise is false. The fails to deliver and naked short selling here were not caused by bona fide market making. SS 250. Rather, as the facts set forth throughout this brief reflect, Defendants decided to

[43] Plaintiffs' claims do not require them to prove violations of Reg SHO, nor do they intend to. Plaintiffs will establish violations of Section 25400.

intentionally fail to make delivery on short sales in Overstock and other hard to borrow securities in order to artificially increase their supply of lendable stock to [redacted] selling in the stock.[44] Accordingly, this is a separate, independent reason the Court need not do any further analysis of Defendants' arguments in this Section.

(2) Defendants' Decision in Advance of Trades to Intentionally Fail to Deliver Short Sales of Overstock was Not Anticipated By or a "Forseeable Consequence" of Reg SHO

Ignoring all of the evidence of the manipulative scheme and the indicia of intent discussed throughout this brief, Defendants argue that, as a matter of law, they cannot have intended to manipulate the market in Overstock securities because intentionally failing to deliver stock and naked short sales is lawful. This argument is a red herring, as intentional market manipulation is never lawful, including when that market manipulation involves naked short selling and fails-to-deliver. In fact, as set forth *infra*, the SEC has repeatedly stressed that naked short selling may constitute illegal market manipulation and issued a number of emergency orders in 2008 because of such manipulation.

Defendants take out-of-context comments by the SEC that concern inadvertent, short-lived fails to deliver in limited circumstances and frivolously attempt to extend those comments to their intentional manipulation that resulted in [redacted] of fails-to-deliver in Overstock for [redacted]. The SEC has expressly recognized that "selling stock short and failing to

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[44] Additionally, as Marc Allaire testifies, [redacted]

deliver shares at the time of settlement with the purpose of driving down the security's price" is "manipulative activity" that, "in general, would violate various securities laws … ." RJN, Ex. 43, at 7 (Key Points About Reg SHO (Apr. 11, 2005)). Then-Chairman Christopher Cox of the SEC has stated that:

> Selling short stock without having stock available for delivery, and intentionally failing to deliver stock within the three-day settlement period, is market manipulation that is clearly violative of the federal securities laws.

RJN, Ex. 48 (Opening Statements at the Commission Open Meeting (July 12, 2006)).

In enacting emergency legislations in 2008 that banned short selling of the securities of nineteen financial institutions – including The Goldman Sachs Group, Inc. and Merrill Lynch & Co., Inc. – the SEC found:

> In an ordinary short sale, the short seller borrows a stock and sells it, with the understanding that the loan must be repaid by buying the stock in the market … . But in an abusive naked short transaction, the seller doesn't actually borrow the stock and fails to deliver it to the buyer. For this reason, naked shorting can allow manipulators to force prices down far lower than would be possible in legitimate short-selling conditions.

RJN , Ex. 33 (September 17, 2008 release); see also RJN, Ex. 32 (SEC Release 2008-143 (Jul 15, 2008)) Then-Chairman Cox also has stated that when fails to deliver lead a stock "to be chronically listed on Reg SHO's Threshold Security List for months and years at a time [there] is ample evidence that there is also fraud that needs to be arrested." RJN, Ex. 41 (March 4, 2008 hearing.)

The citation Defendants rely upon from the SEC Key Points expressly makes it clear the SEC envisioned only narrow, limited circumstances where marker makers, who must sell short a "thinly traded, illiquid stock" in response to customer demand, would not be able settle trades by T + 3 because they encounter "difficulty in obtaining securities when the time for delivery arises" due to a "temporary shortage." Defs. RJN, Ex. 39, at 2. In such circumstances, the SEC recognizes that it may take the market maker more than three days to purchase or arrange to borrow the security. *Id.* Thus, it is clear the SEC is referring to a situation where the market maker is both selling in a market with temporary shortages of stock, <u>and</u> making efforts to arrange to purchase or borrow the stock for settlement. [redacted] and no one intended to make any efforts to get delivery of the stock.

Defendants also refer to an SEC response to a Frequently Asked Question whereby the SEC noted that a fail to deliver position at DTCC can exist for more than 13 days, because new fails to deliver can occur before previously arising fails to deliver are closed out, "even though such newly arising fails are properly resolved in accordance with federal regulations." Defs. Br. 38:17-20. This citation does not help Defendants for multiple reasons.

First, the actual FAQ being answered is:

> Question 5.8: If a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security at the end of each day for 13 consecutive settlement days, but during the 13-day period the participant experiences a reduction in its end of day fail to deliver position at NSCC, how should the participant apply that reduction to its open fail position(s)?

Defs. RJN, Ex. 40, at 18. In the example provided by the SEC in response to this question, the SEC shows a fail to deliver of 4700 to 10,000 shares of stock that lasts 25 days, and explains how to allocate increased or decreases in the fail to deliver positions from the previous day. Nothing in this FAQ answer could possibly be used to establish that SEC was condoning an advance agreement by a clearing firm to intentionally and manipulatively fail to deliver millions of shares of Overstock for years.[45] Indeed, then-SEC Chairman Cox testified that when fails to deliver lead a stock "to be chronically listed on Reg SHO's Threshold Security List for months and years at a time [there] is ample evidence that there is also fraud that needs to be arrested." RJN, Ex. 41 (March 4, 2008 hearing). A Banc of America executive testified [redacted]

Finally, Defendants argue that because they clear for a lot of market maker clients,

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45 [redacted]

SEC rules would have allowed and expected Defendants to have massive intentional fails to deliver. Again, Defendants' arguments are misplaced.[46] Defendants point to the fact that Reg SHO has an exemption from its "locate" requirement for market makers.[47] Defendants then seek to justify their conduct through a statement by the SEC that "the SEC expressly recognized that permitting market makers to intentionally fail to deliver for up to 13 settlement days would enable market makers to continue providing liquidity in securities that were difficult or expensive to borrow." Defs. Br. 39:7-18.

Defendants point to no actual language by the SEC or in Reg SHO that says any thing about "intentionally" failing to deliver. To the contrary, as set forth above, the SEC anticipated temporary situations in thinly traded, illiquid stocks where, <u>after making efforts to borrow and make delivery by T + 3</u>, the stock cannot be found. [redacted]

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46 [redacted]

47 Defendants also cite a rule that was not even in effect during the time period at issue. Defs. Br. At 38:27-35:7, citing SEC Release No. 34-58774 dated October 17, 2008. This rule was meant to curb broker to broker fraud, where a broker dealer was deceiving another broker dealer regarding having a locate. Defs. RJN, Ex. 35 at 61667. Since market makers are exempt from the locate requirement, the SEC notes they would not be covered under this rule. *Id.* at 61672. The SEC's discussion refers back to the original Reg SHO Release, which as discussed above, noted that the times a market maker may have to naked short stock would be limited to temporary situations in illiquid, thinly traded stocks.

In that same release, the SEC reiterates: "[A]s we have stated on several prior occasions, we are concerned about the negative effect that fails to deliver may have on the markets and shareholders" and notes fails to deliver "unilaterally converts a securities contract [which is expected to settle within the standard three-day settlement period] into an undated futures-type contract, to which the buyer might not have agreed, or that might have been priced differently." *Id.* at 61669.

[redacted]

Plaintiffs' expert Stephen Seal, who worked as an options trader and market maker for 29 years, including as a market maker from 2004-2007, testifies in his declaration that his clearing firms, O'Conner and Fortis, charged him a borrow fee at settlement time because they were settling his trades. SS 256. Likewise, Michael Manzino, an executive on Morgan Stanley's stock loan desk, testifies in his declaration that Morgan Stanley did not intentionally fail market maker trades after Reg SHO was implemented. *Id.* Finally, it is utterly illogical for the "close-out rule," which was intended as a backstop to clean up any inadvertent fails at settlement time, would be interpreted as a license to intentionally fail all trades. SS 254.

Moreover, Defendants' argument is also inconsistent in that Defendants did not fail [redacted] Defendants fail to cite any language in Reg SHO or any SEC guidance that suggests, even remotely, that clearing firms should make delivery [redacted] the very documents cited by Defendants refer to discussions of short periods of time where stock might be "difficult" to borrow due to liquidity problems. If stock is expensive to borrow, the market maker properly prices that cost into his market making trades – the delivery requirement is not simply removed because there is a cost to deliver.

The bona fide market-making provisions in Reg SHO contain no exemption from delivery and were never intended to legalize a manipulative scheme to create [redacted] of dollars of massive, persistent fails to deliver in hard-to-borrow stocks. Reg SHO was intended to limit, not expand, fails-to-deliver while providing only a narrow, irrelevant exception that allowed market makers not to locate stock in advance of a trade in a fast-moving market. *See., e.g.*, 17 CFR Parts 240 and 242 at 62977 ("Short Sales; Proposed Rule") (referring to "narrow exception" from locate requirement for market makers "engaged in bona fide market making activities" "because they may need to facilitate customer orders in a fast moving market without complying with the proposed 'locate' requirement"; and discussing market makers would not be given an exemption from Reg SHO's mandatory close out provision because "extended failures to deliver appear characteristic of an investment or trading strategy, rather than being related to market making"; "[w]e believe it is questionable whether a market maker carrying a short position in a heavily shorted security for an extended period of time is providing liquidity for customers or rather is engaged in speculative trading strategies.") (RJN Ex. 22 at 62977).

In sum, the SEC regulations were designed to limit Defendants' ability to manipulate the market, not provide a safe harbor for fraud. Defendants simply invented new way to circumvent the federal regulations. Intentional market manipulation is never legal under federal law, and Defendants, as experienced market participants know that. As experienced clearing firms, Defendants also know that intentionally failing market maker trades is inconsistent with industry custom and practice. SS 254. [redacted]

Ultimately, Defendants' arguments do not establish any affirmative defense as a matter of law; to the contrary, they only highlight further evidence in support of Plaintiffs' claims.

5. Defendants' Argument that they are Entitled to Summary Adjudication of Plaintiffs' Section 25400 Claims Because Plaintiffs Suffered No Injury Caused by Defendants Fails.

a. Defendants did not Notice this as a Basis for Summary Adjudication nor did they Provide any Factual Evidence on this Point

As Defendants note in their argument on this point, Section 25500 is the statute that provides that if Defendants' actions caused a decline in Overstock's stock price and Plaintiffs sold stock at the depressed price, Plaintiffs are entitled to recovery. Defendants' Notices of Motion and Motion for Summary Judgment, or in the Alternative, Summary Adjudication ("Notices") fail to notice any motion relating to causation, damages or Section 25500. Accordingly, such issue is not before the Court.

Likewise, Defendants' Separate Statements are void of any material issues of fact as to causation and damages so even if Defendants had noticed these issues they failed to shift the burden.[48] Their issues mirror the issues in their Notices, which do not include causation or

[48] To satisfy their initial burden of production, Defendants must "present evidence ... and not

damages. Finally, Defendants' Brief itself likewise cites nothing. Accordingly, the Court need not do any further analysis of these issues. However, given that Defendants improperly placed this in their brief, Plaintiffs feel compelled to set forth their evidence below. All of this could have been avoided if Defendants, consistent with their Notice and Separate Statements, had simply not argued this point in their brief.

b. Defendants' Market Manipulation Caused Plaintiffs Harm

Defendants' market manipulation caused Plaintiffs harm. All Plaintiffs sold stock at prices that were artificially depressed due to Defendants' conduct. SS 268. [redacted] SS 166.

Robert Conner testifies in his declaration as to the causal effects of Defendants' conduct in this case that:

> Defendants' actions caused an artificial price decline in Overstock's stock price. The undertaking of the naked short selling which contemplates no delivery of shares in the settlement of those transactions effectively increases supply beyond its natural limits. The effect is to increase supply of shares for sale over demand and exert a downward pressure on the price of the stock over time. Additionally, the reported artificially inflated short interest, inflated meaning in excess of what would have been achieved in absence of the naked short selling, negatively impacts the investor perceptions of the likely price movement of the stock, independent of the fundamentals of the company, which leads to additional short selling and a lack of confidence in the stock, and less willingness of buyers to support a price, making it more vulnerable on the downside. Each of Defendant's actions were essential to

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simply point out that plaintiff does not possess, and cannot reasonably obtain, needed evidence." *Aguilar*, 25 Cal. 4th at 850. "The defendant may satisfy this requirement in one of two ways: First, it may 'present evidence that conclusively negates an element of the plaintiff's cause of action.' In the alternative, defendant 'may ... present evidence that the plaintiff does not possess, and cannot reasonably obtain, needed evidence—as through admissions by the plaintiff following extensive discovery to the effect that he has discovered nothing.'" *Hypertouch*, 192 Cal. App. 4th at 838 (quoting *Aguilar*, 24 Cal. 4th at 855). Defendants fail to do either here. What Defendants should have done to attempt to shift the burden is provide their own expert analysis of how the decline in Overstock's stock price purportedly was not caused by Defendants' manipulative conduct. Defendants failed to do so, even though they have designated at least one purported expert on the subject. To consider an analysis submitted for the first time on reply (which is what Defendants obviously, and improperly, plan to ask the Court to do) would violate Plaintiffs' due process rights. *San Diego Watercrafts, Inc.*, 102 Cal. App. 4th at 316. By failing to submit any evidence on causation of damages with their opening papers, Defendants failed to shift the burden on the issue and summary judgment and adjudication must be denied.

manipulating the supply and causing the artificial price decline. [redacted]

SS 263. Each of Defendants' actions was essential to causing the fails, manipulatively increasing the supply and causing the artificial price decline. *Id.*

In the concurrently submitted declaration of Dr. Robert Shapiro in Opposition to Defendants' Motion for Summary Judgment (the "Shapiro Declaration"), Dr. Shapiro confirms that Defendants' conduct caused a decline in the price of Overstock's shares, which damaged Plaintiffs when they sold or issued shares of Overstock. SS 264-269. Dr. Shapiro also quantifies the amount of damages that Plaintiffs suffered as a result of Defendants' conduct.[49]

Defendants' fails to deliver, and specifically Merrill Pro's fails to deliver in CNS accounts [redacted], and GSEC's fails to deliver in CNS accounts [redacted], caused the price of Overstock's shares to be lower than they would otherwise have been during the damage period (that is August 1, 2005 through December 31, 2006). Fails to deliver in these CNS accounts caused the price of Overstock shares to decline during the damage period in two ways, and Defendants deliberately caused those fails to occur and persist in massive volume.

Defendants' fails to deliver in Overstock stock drove up the short interest in the stock and drove down prices under the most basic principles of pricing theory in at least two

[49] Dr. Shapiro is an eminent, internationally known economist. He holds graduate degrees form Harvard University and the London School of Economics. He formerly served an as Under Secretary of Commerce for Economic Affairs in the Clinton Administration. His duties included oversight of the United States Bureau of Economic Analysis, and the conduct of the 2000 Census. He was ultimately responsible for the preparation of critical measures of the nation's economic performance, including the publication of GDP figures. For at least the past nine years, he has studied and performed extensive analysis of the impact of naked short selling on securities markets. He has advised a number of United States Senators (including Senator Harry Reid and former Senator Arlen Specter), and the current chairwoman of the SEC (Mary Schapiro) regarding the impact of naked short selling on U.S. securities markets. He is currently a Senior Fellow of the McDonough School of Business at Georgetown University in Washington D.C., on the Advisory Board of the International Monetary Fund, and acts as an economic adviser and consultant to numerous for profit and non-profit entities and organizations.

ways. SS 264. First, because shares were sold without being borrowed and delivered, the fails to deliver increased the supply of shares offered for sale. Since supply and demand determine price, a change in one without a corresponding change in the other will alter prices. In this case, Defendants' fails to deliver in the above referenced CNS accounts increased the supply of both the Overstock without affecting the demand, causing a decline in Overstock's share price in the damage period. SS 265.

Dr. Shapiro also identified a second, independent way in which Defendants' fails to deliver damaged Plaintiffs and reduced Overstock's share price. [redacted]

Dr. Shapiro found extremely high levels of persistent short sales in Overstock during the damage period. Based on his review of the academic literature, statements by representatives of Defendants, statements by SEC officials, and his own knowledge and understanding of the impact of short sales on securities markets, Dr. Shapiro found that high and persistent levels of short sales in Overstock, caused by Defendants' fails to deliver, caused the price of Overstock shares to decline during the damage period. SS 267. Thus, when Overstock and the other plaintiffs sold or issued shares during the damage period they received less than they would otherwise have received in the absence of Defendants' fails to deliver, and thus were harmed by Defendants' conduct.[50] *Id.*

Dr. Shapiro also quantified Plaintiffs' damages caused by Defendants' manipulation. As the Court stated in *GHK Associates v. Mayer Group, Inc.*, 224 Cal. App. 3d 856, 873-874 (1990):

> Where the *fact* of damages is certain, the amount of damages need not be calculated with absolute certainty. (*Channell v. Anthony* (1976) 58 Cal.App.3d 290, 317 (129 Cal.Rptr. 704); *Noble v. Tweedy* (1949) 90 Cal.App.2d 738, 745-746 (203 P.2d 778).) The law requires only that some reasonable basis of computation of damages be used, and the damages may be computed even if the result reached is an approximation. (*Allen v. Gardner* (1954) 126 Cal.App.2d 335, 340 (272 P.2d 99).) This is especially true where, as here, it is the wrongful acts of the defendant that have created the difficulty in proving the amount of loss of profits (*Ramona Manor Convalescent Hospital v. Care Enterprises* (1986) 177 Cal.App.3d 1120, 1140 (225 Cal.Rptr. 120)) or where it is the wrongful acts of the defendant that have caused the other party to not realize a profit to which that party is entitled. (*Mann v. Jackson* (1956) 141 Cal.App.2d 6, 12 (296 P.2d 120). (Italics in original.)

Dr. Shapiro's method of calculating damages, summarized above and set forth in detail in the Shapiro Declaration, more than satisfies the requirements set forth in *GHK Associates v. Mayer Group, Inc.*, and any uncertainty as to the exact amount of damages is attributable to Defendants.

Dr. Shapiro found that all of Defendants' fails to deliver Overstock shares caused harm.[51] SS 265-267. [redacted]

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[50] Dr. Shapiro also analyzed other factors that impacted Overstock's share price during the damage period, including the performance of the Nasdaq market, the performance of comparable companies and events (including Overstock's earning reports). Dr. Shapiro found that Overstock's share price declined in the damage period notwithstanding the fact that his analysis of the Nasdaq market and comparable companies demonstrated that Overstock's share price should have increased during the damage period. Dr. Shapiro found that events impacting Overstock (including Overstock's earnings announcements) explained some but not all of the decline in Overstock's share price during the damage period. The fact that his Nasdaq market analysis, his comparable company analysis, and his event study did not explain the substantial drop in Overstock's share price during the damage period reinforced Dr. Shapiro's opinion that Defendants' fails to deliver caused a substantial portion of the decline in Overstock's share price during the damage period. SS 269.

[51] Because all fails cause harm, if the trier of fact finds that some but not all of the fails in Defendants' DTCC accounts are actionable, Plaintiffs would still be entitled to recover damages based on a subset of fails in Defendants' DTCC accounts.

[redacted]

C. **Triable Issues Of Material Fact Exist as to Plaintiffs' UCL Claim.**

1. **As the Court has Already Ruled, Section 17200 may Apply to Defendants' Conduct.**

As Defendants implicitly acknowledge, the Court already has ruled that Section 17200 may apply to conduct alleged. In overruling Defendants' demurrer to Plaintiffs' UCL claim, the Court stated that:

> Turning to the demurrer to the fifth cause of action brought under Business & Professions Code Section 17200, et seq. and 17500, et seq., the Court overrules the demurrer. Support for this ruling is found in the recent case of Overstock.Com, Inc. versus Gradient Analytics, Inc., 151 Cal. App. 4th 688, First District, May 30, 2007. That opinion stands for the following propositions. First, whether or not one agrees with the decision in the case of Bowen versus Ziasun Technologies, Inc. 116 Cal. App. 4th 777, the Bowen court's holding that securities transactions are not covered under the UCL bars lawsuits based on deceptive conduct in the sale and purchase of securities, nothing more. In other words, as made clear by the Analytics court in italicized language of that opinion, the Bowen case does not hold that claims are barred where they do not arise from stock transactions between the parties. Second, as further said by the Analytics court, the conclusion reached by the court in the case of Roskind versus Morgan Stanley Dean Witter, 80 Cal. App. 4th 345, that the UCL potentially could provide a remedy for the securities violations there at issue if not preempted by federal law in that context was integral to the Roskind's determination that federal securities law did not preempt the plaintiff's UCL claim. In short, that conclusion of the Roskind court was not mere dictum. Third, at least as applied to non-preempted lawsuits not based on deceptive conduct in the sale and purchase of securities, the UCL may reach conduct occurring in the context of securities transactions. It is further worthy of mention that Overstock versus Gradient appellate opinion includes a reminder of the words of the California Supreme Court in the leading case of Cel-Tech Communications versus Los Angeles Cellular Telephone Co., that the sweeping language of the UCL is intended to permit tribunals to enjoin on-going wrongful business conduct in whatever context such activity might occur.

RJN, Ex. 4 (September 20, 2007 Order), at 60:10-61:14.

Gradient is more recent than *Bowen*, and Court of Appeal stated in *Gradient* that

Overstock's claims were not barred where they did "*not arise from any stock transactions between the parties.*" *Overstock.com, Inc. v. Gradient Analytics*, 15 Cal. App. 4th 688, 715 (2007) (emphasis in original).[52] No transactions between the parties are at issue here.

Defendants present the Court with no reason to reconsider the Court's prior ruling. The correctness of that ruling is even established by the "subsequent authority" on which Defendants rely. *See* Defs. Br. at 44:9-10. In *In re Charles Schwab Corporation Securities Litigation*, 257 F.R.D. 534, 553 (N.D. Cal. 2009), the court stated that "[t]he reach of [*Bowen*] … is far from certain" and that "California decisions have since interpreted *Bowen* narrowly." *Id.* at 553. The court refused to dismiss the Section 17200 claim. Similarly, in *Benson v. JPMorgan Chase Bank*, N.A., 2010 WL 1526394 (N.D. Cal. Apr. 15, 2010), the court contrasted *Bowen* with "a line of authorities that have rejected Bowen's narrow reading of the UCL," including *Roskind v. Morgan Stanley Dean Witter & Co.*, 80 Cal.App. 4th 345 (2000), and *Gradient*. *Benson*, 2010 WL 1526394, at *7. The court noted that *Gradient* "constitutes the most recent authority on the issue" and stated that *Roskind* and *Gradient* were "persuasive." *Id.* at *9. After finding that the facts of *Benson* "arguably fall closer to *Bowen* than those in [*Gradient*] and *Roskind*," the court declined to dismiss the UCL claim. *Id.*

The UCL's "sweeping language" is intended "to permit tribunals to enjoin on-going wrongful business conduct in *whatever context* such activity might occur." *Cel-Tech Communications, Inc. v. L.A. Cellular Tel. Co.*, 20 Cal. 4th 163, 181 (1999) (emphasis added). The Court should again rule that the UCL may apply to Defendants' conduct here.

2. Triable Issues Exist as to Whether Plaintiffs are Entitled to Injunctive Relief.

Under Defendants' own authority, injunctive relief may be awarded where Defendants claim that they will act lawfully in the future. *Cal. Serv. Station & Automotive Repair Ass'n v. Union Oil Co. of Cal.*, 232 Cal. App. 3d 44, 57 (1991). Here, Defendants fail to shift the

[52] The *Gradient* court further noted that "[t]he Attorney General has filed an amicus brief on this issue arguing, among other things that Bowen was wrongly decided." *Gradient*, 151 Cal. App. 4th at 715 n.20.

burden on whether Plaintiffs are entitled to injunctive relief. While Defendants' brief claims that "the challenged activities ended years ago," Defendants fail to provide any citation for that purported "fact." Defs. Br., at 45:10. Defendants' separate statements themselves do not claim that the challenged activity has ceased – only that the reported fails in to deliver in Overstock have decreased. *See*, *e.g.*, GS&CO. SS 91; GSEC SS 94; ML SS 60; MLPRO SS 86; *see also generally Nelson v. Pearson Ford Co.*, 186 Cal. App. 4th 983, 1021 (2010) (affirming award of injunctive relief where Defendant continued engaging in conduct after purported change in policy). Defendants therefore do not make a prima facie showing that their manipulative conduct is not ongoing, or that there is no reasonable possibility that such conduct will recur. Because Defendants failed to shift the burden, summary judgment and adjudication must be denied. *Aguilar*, 25 Cal. 4th at 850.

At the very least, there are triable issues of material fact. For example, Merrill Defendants' former Chief Compliance Officer testified that Merrill Defendants [redacted] triable issues of material fact exist as to whether Defendants should be enjoined from failing to deliver those securities.

a. Abstention is Not Appropriate.

Defendants argue that even if their conduct is illegal, and even if their illegal conduct is on-going, the Court still should not enter an injunction. In doing so, Defendants rely on *Shamsian v. Department of Conservation*, 136 Cal. App. 4th 621 (2006), which involved a beverage container recycling statute that imposed no mandatory duty on the defendant beverage manufacturers and that created no private right of action for the plaintiff. *Id.* at 632-39, 641. The *Shamsian* plaintiff nonetheless sought an injunction under the UCL that apparently would require the defendants to provide sufficient, convenient, efficient, and economical redemption opportunities. *Id.* at 626, 641. The court affirmed dismissal of the claim, stating that "[w]here

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[53] ETFs are investment funds that are traded on stock exchanges. ETFs hold assets that may include stocks, bonds, and commodities.

[an unfair competition law] action would drag a court of equity into an area of complex economic [or similar] policy, equitable abstention is appropriate. In such cases, it is primarily a legislative and not a judicial function to determine the best economic policy.'" *Id.* at 641-42 (brackets in original).

Here, Section 25400 <u>does</u> impose a mandatory duty on Defendants to not engage in manipulative transactions, and Section 25500 gives Plaintiffs a private right of action. Plaintiffs seek an injunction that would require Defendants to comply with the law, which would not require the Court to assume a legislative function or determine complicated matters of economic policy: The Court could order only that Defendants comply with Sections 25400.[54]

Again, the "sweeping language" of the UCL permits the Court "to enjoin on-going wrongful business conduct in whatever context such activity might occur." *Cel-Tech*, 20 Cal. 4th at 181. At the very least, the Court should make the determination as to whether to enter an injunction in the context of a full evidentiary record. Summary judgment and adjudication should be denied.

3. Summary Judgment may Not be Granted Based on Defendants' Arguments Pertaining to California.

After receiving dismissal of Plaintiffs' New Jersey RICO claim by emphasizing this case's California contacts and California's interest in this dispute, Defendants now attempt to receive dismissal of claim under California's UCL by arguing that the conduct at issue occurred in New Jersey. Defs. Br., at 47:1-3. The Court should reject this shameless attempt.

a. Triable Issues of Fact Exist as to the California Nexus.

As established above, Defendants fail to shift the burden regarding whether manipulative conduct occurred in California. For example, Defendants fail to shift the burden regarding whether they effected manipulative transactions in Overstock stock on the Pacific Exchange in California. *See* Section III.B.1.a, *supra*. Triable issues of material fact also exist as

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[54] *Electronic Trading Group, LLC v. Banc of America Securities LLC*, 588 F.3d 128 (2d Cir. 2009), is also inapposite. That case involved federal case law on the implied preclusion of federal antitrust claims (in particular, the Sherman Act) by federal securities law. *See id.* at 131. Plaintiffs have not asserted a Sherman Act claim here.

to, among other things, whether: Defendants effected manipulative transactions in Overstock from Defendants' California offices, Defendants effected manipulative transactions in Overstock in California for California clients, and Defendants' developed and furthered the manipulative scheme in California. *See supra* Section III.B.1.b, *supra*..

b. Defendants Authorities are Inapposite.

Defendants rely on cases involving UCL claims brought by non-California plaintiffs based on conduct and injuries that occurred <u>entirely</u> outside of California.[55] These authorities are inapposite. Among other things, there are – at the very least – triable issues of fact as to whether manipulative conduct occurred in California.

Defendants also ignore that Plaintiffs Hugh Barron and David Trent are California residents, and that Messrs. Barron and Trent, Mary Helburn, and Overstock each sold stock in California at prices that were artificially depressed as a result of Defendants' manipulative conduct. SS 268. Defendants' authorities – all of which involve nonresident plaintiffs and/or injuries that were suffered outside of California – are entirely inapplicable to Mr. Barron, Mr. Trent, the Estate of Ms. Helburn, and Overstock.

Defendants' suggestion that their status as nonresidents weighs against application of California law is flatly contradicted by an argument that Defendants made in receiving the dismissal of Plaintiffs' New Jersey RICO claim. In arguing for the "application" of California's non-existent civil RICO provisions, Defendants argued that California had an interest in "[p]rotecting businesses, such as Defendants, that do business in California and may be subject to suit here." RJN, Ex. 9 (July 8, 2011 Brief), at 19:12-15. The Court agreed. RJN, Ex. 10

[55] *See Sullivan v. Oracle Co.*, 51 Cal. 4th 1191, 1207, 1209 (June 30, 2011) (UCL claims based on overtime work performed outside California by out-of-state plaintiffs); *Jones-Boyle v. Wash. Mut. Bank*, 2010 WL 2724287, at *10 (N.D. Cal. July 8, 2010) (Maryland resident brought claim against non-California defendant based on loan entered into in Maryland that secured property located in Maryland); *Standfacts Credit Servs., Inc. v. Experian Information Solutions, Inc.*, 405 F. Supp. 2d 1141, 1148 (C.D. Cal. 2005) (nonresident plaintiffs brought UCL claim against nonresident defendants without alleging that nonresident defendants were directly liable for any conduct occurring in California); *Churchill Village, L.L.C. v. Gen. Elec. Co.*, 169 F. Supp. 2d 1119 (N.D. Cal. 2000) (addressing UCL claims brought by nonresident plaintiffs against nonresident defendants where the conduct and injuries occurred outside California); *Norwest Mortgage, Inc. v. Superior Court*, 72 Cal. App. 4th 214, 226-227 (1999) (addressing UCL claims brought by nonresident plaintiffs based on conduct and injuries that occurred outside of California).

(August 1, 2011 Transcript), at 14:2-3 ("California also has an interest in having its law applied to the instant case because each of the defendants does business in California … ."). It would be highly incongruous if doing of business in California enables Defendants to receive the benefits of a non-existent California law, but does not subject them to at least potential liability under an existing California statute.

It is well-established that "'[a] court with personal jurisdiction over a defendant may enjoin him from doing an act elsewhere … .'" *People ex rel. Mosk v. Nat'l Research Co. of Cal.*, 201 Cal. App. 2d 765, 776 (1962) (upholding injunction that asserted control over actions that "extend[ed] beyond the boundaries of California) (citation omitted). Defendants do not and cannot dispute that they are subject to the personal jurisdiction of the Court. The Court may therefore enter a UCL injunction even if Defendants are headquartered in states like New Jersey and some conduct at issue occurred outside California.

D. As the Court has Already Ruled, Plaintiffs' Claims are Not Preempted.

Defendants' final argument for summary judgment is a rehash of their previous preemption argument, which the Court already has considered and rejected. As the Court ruled:

> [I]t is this Court's view that, contrary to defendants' contention, the application of pertinent California law to defendants' alleged short selling activities would not stand as an obstacle to the accomplishment or the execution of the full purposes or objectives of federal law. ***Plaintiffs' claims do not conflict with federal law in that federal law does not sanction or otherwise protect intentional market manipulation such as that alleged here*** and there is room for state law remedies relating to such conduct that do not obstruct or otherwise impede federal law. In short, the allegations of plaintiffs' complaint are consistent with federal law. Therefore, the Court holds that plaintiffs' claims are not preempted by federal law, noting parenthetically that defendants do not claim, nor could they persuasively contend, that there is either express preemption or field preemption in the circumstances of this case.

RJN, Ex. 4 (Sept. 20, 2007 Order) at 59:22-60:9 (emphasis added).

Defendants petitioned for a writ of mandate on the Court's preemption ruling, which the Court of Appeal denied. RJN, Ex. 11 (Petition); RJN, Ex. 12 (Order). Defendants now ignore both the Court's prior ruling and the Court of Appeal's denial of their writ petition.

The Court should again reject Defendants' preemption argument. First, Section

25400 does not conflict with federal law or undermine congressional objectives. Second, neither Reg SHO nor any federal law allows the conduct at issue. Simply put, intentional market manipulation is not allowed or condoned under federal law, and thus no issue of preemption exists here, where Plaintiffs bring intentional market manipulation claims. SS 261.

1. Section 25400 does Not Conflict with Federal Law or Undermine Congressional Objectives.

Defendants again appear to concede that neither express nor field preemption applies. "Congress, the courts, and the SEC have made explicit that federal [securities] regulation was not designed to displace state blue sky laws that regulate interstate securities transactions." *A.S. Goldmen & Co. v. N.J. Bureau of Securities*, 163 F.3d 780, 781 (3d Cir. 1999) (emphasis added). Indeed, Reg SHO itself was promulgated by the SEC pursuant to the Securities Exchange Act of 1934 (the "Exchange Act") and, as the California Supreme Court has stated, "[t]he Securities Exchange Act of 1934 makes it clear that … federal law in this arena supplements, but does not displace state regulation and remedies." *Diamond Multimedia*, 19 Cal. 4th at 1057; *see also SEC v. Nat'l Securities, Inc.*, 393 U.S. 453, 461 (1969) ("Of course, under the securities laws state regulation may co-exist with that offered under the federal securities laws.").

While Defendants' preemption argument is again unclear, Defendants appear to take the position that Section 25400 conflicts with federal law or undermines congressional objectives. In doing so, Defendants again ignore that Plaintiffs' claims are not an attack on naked short selling *per se*, but are instead claims for intentional market manipulation.

Sections 25400(a) and (b) were modeled after Sections 9(a)(1) and (2) of the Exchange Act. *Kamen*, 94 Cal. App. at 202-03. The two statutes use identical language. *Compare* Cal. Corp. Code § 25400(a), (b) *with* 15 U.S.C. § 78i(a)(1), (2); *see also* 1 Marsh & Volk § 14.05(2)(a) ("The five subdivisions of Corp. Code § 25400 specifying the conduct made actionable by these sections are copied from clauses (1) through (5) of Subsection (a) of Section 9 of the 1934 Act.") If conduct violates Section 25400(a) and (b), it also would violate Sections 9(a)(1) and (2) – provided, of course, that the conduct used instrumentalities of interstate commerce. It is ludicrous to suggest that Section 25400 somehow "conflicts" with federal law.

It also is absurd to suggest that application of Section 25400 would somehow "undermine" congressional objectives. In enacting the Exchange Act, Congress made it clear that "federal law in this arena … does not displace state regulation and remedies." *Diamond Multimedia*, 19 Cal. 4th at 1057. Allowing California to regulate the same sort of manipulative transactions prohibited by Section 9(a)(1) and (2) of the Exchange Act would <u>further</u> the congressional goal of preventing and redressing market manipulation.

As such, Defendants authorities are all inapposite, because they all involve situations where there was a "clear," "direct," or "irreconcilable" conflict between state and federal law, or where allowing state law claims would "frustrate" or "destroy" a congressionally-mandated uniform system.[56] *See generally A&M Records, Inc. v. Heilman*, 75 Cal. App. 3d 554, 568 (1977) ("There is also no basis for concern over disrupting national uniformity, where, in this area of unfair business practices, the similarity of federal and state law itself indicates both a common purpose and the lack of any conflict with national policy."). Moreover, as Defendants' own authority makes clear, "[t]here is a presumption <u>against</u> federal preemption" and "state laws should be followed unless 'the clear and manifest purpose of Congress' was preemptive." *Churchill Village, L.L.C. v. Gen. Elec. Co.*, 169 F. Supp. 2d 1119, 1127 (N.D. Cal. 2000) (emphasis added) (citations omitted). Defendants fail to demonstrate a clear and manifest preemptive purpose here.

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[56] *See Levitin v. PaineWebber, Inc.*, 977 F.2d 698, 706, 707 (2d Cir. 1998) (state law claims would be in irreconcilable conflict with federal regulation and "undermine congressional objectives in creating an effective, uniform federal system"); *See Am. Agric. Movement v. Board of Trade of City of Chicago*, 977 F.2d 1147, 1156 (7th Cir. 1992) (allowing state law claims against the Chicago Board of Trade "would frustrate Congress' intent to bring the markets under a uniform set of regulations"); *Capece v. Depositorty Trust & Clearing Corp.*, 2005 WL 4050118, at *9 (S.D. Fla. Oct. 11, 2005) (allowing state law claims against DTCC would "would destroy the Congressionally-mandated uniform system"); *Whistler Invs., Inc v. Depository Trust & Clearing Corp.*, 539 F.3d 1159, 1166-68 (9th Cir. 2008) (state law claims against DTCC constituted a "direct challenge to the operation of" a congressionally-authorized national system); *DGM Invs., Inc. v. N.Y. Futures Exch., Inc.*, 2002 WL 31356362, at *5 (S.D.N.Y. 2002) (allowing state law claims against exchange and other entities would "stand as an obstacle" to accomplishment of congressional objective of bringing market under uniform regulation); *Nanopierce Techs., Inc. v. Depository Trust & Clearing Corp.*, 168 P.3d 73, 85-86 (Nev. 2007) (purpose of federal act's creation of national system would be frustrated if state law claims were allowed against DTCC).

2. Neither Reg SHO nor Any Federal Law or Regulation Provides a Safe Harbor for Defendants' Conduct.

In disingenuously claiming that their conduct is "expressly allowed" under Reg SHO, *see* Defs. Br., at 47:10, [redacted]

Indeed, the SEC has repeatedly made it clear that the conduct at issue here is manipulative and illegal. *See*, *e.g.*, RJN, Ex. 43 at 7 (Key Points About Regulation SHO (April 11, 2005)) ("Fraudsters may use naked short selling as a tool to manipulate the market. Market manipulation is illegal."); RJN, Ex. 35 at 1 (SEC Release 2010-26 (Feb. 24, 2010)) ("Short selling … may be used improperly to drive down the price of a security or to accelerate a declining market in a security."); *see also* RJN, Ex. 48 at 4 (Opening Statements at the Commission Open Meeting (July 12, 2006)) (remarks of then-Chairman Cox stating that "[s]elling short without having stock available for delivery, and intentionally failing to deliver stock within the standard three-day settlement period, is market manipulation that is clearly violative of the federal securities laws"); *see also* Section III.B.4(b), *supra*.

In sum, there is no conflict between Section 25400 and the federal statute on which it is modeled. Defendants' conduct is <u>not</u> allowed under Reg SHO, and Plaintiffs' Section 25400 in no way frustrates or destroys congressional goals. The SEC itself has subpoenaed Overstock seeking to receive documents that Defendants have produced in this action, which Plaintiffs have produced to the SEC. Thus, Plaintiffs' pursuit of a Section 25400 claim has not frustrated any federal purpose – it has instead furthered federal goals by enabling the SEC to obtain additional documents regarding Defendants' market manipulation. The Court should again reject Defendants' preemption argument.

IV. CONCLUSION

For the foregoing reasons, Defendants' motions for summary judgment, or, in the alternative, summary adjudication should be denied. After almost five years, and uncovering detailed facts to support their market manipulation claims, Plaintiffs are entitled to finally have a jury hear the merits of their claims.

Dated: November 10, 2011

STEIN & LUBIN LLP

By: ______________________________

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