UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

STANDARD INVESTMENT CHARTERED, INC., on behalf of itself and all those similarly situated,

Plaintiff,

vs.

FINANCIAL INDUSTRY REGULATORY AUTHORITY, INC.; NYSE GROUP, INC.; MARY L. SCHAPIRO; RICHARD F. BRUECKNER; T. GRANT CALLERY; TODD DIGANCI; and HOWARD M. SCHLOSS,

Defendants.

07 Civ. 2014 (JSR) [ECF Case]

PLAINTIFF'S MEMORANDUM OF LAW IN OPPOSITION TO MOTIONS TO DISMISS SECOND AMENDED COMPLAINT

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STATEMENT OF FACTS

Plaintiff Standard Investment Chartered, Inc. ("Standard" or "Plaintiff") seeks a money judgment under state law against Defendant Financial Industry Regulatory Authority, Inc. ("FINRA"); certain of its current or former officers (the "Officer Defendants"); its former managing director (collectively with the Officer Defendants the "FINRA Defendants"); and NYSE Group, Inc. ("NYSE") (collectively "Defendants"). The focus of the litigation involves the financial terms of the transaction (the "Transaction") between the NYSE and the National Association of Securities Dealers ("NASD"), which led to the creation of FINRA.[1] Standard alleges that the FINRA Defendants misrepresented key facts to Plaintiff and other NASD Members to obtain their votes in favor of the proposed Transaction. Plaintiff alleges that, as a consequence of their misconduct, the Officer Defendants pocketed huge raises and bonuses immediately following the consummation of the Transaction. Standard alleges that NYSE aided and abetted the FINRA Defendants and was unjustly enriched.

At the core of the case is the FINRA Defendants' issuance of a proxy statement on December 14, 2006 (the "Proxy Statement"), which contained out-and-out material falsehoods and omitted essential facts bearing on the Transaction and on a proposed "Special Member Payment" that was to be made upon its completion. The most important false representation was that federal tax authorities limited a payment to NASD Members to $35,000. Second Amended Complaint ("SAC" or the "Complaint") ¶ 13. The FINRA Defendants magnified the falsehood that the Internal Revenue Service ("IRS") limited NASD Member payments to $35,000 in many

[1] Through this merger, FINRA, a private Delaware corporation, became the "sole private-sector provider of member regulation for securities firms that do business with the public." (*See* Memorandum of Law in Support of Motion to Dismiss By Defendants Financial Industry Regulatory Industry, Inc., Schapiro, Diganci, Callery and Schloss, filed Nov. 3, 2009 ("FINRA Mem.") at 3.

different forms, over and over, as if saying it enough times and wishing it to be true would somehow make it come true. Other falsehoods and omissions of material facts included:

- the source of the funds to be used to pay NASD Members was projected future savings from "efficiencies" created by the Transaction, when the source of the payments was the NASD "Members' Equity," derived principally from the proceeds of the sale of NASDAQ;
- the SEC was poised imminently and unilaterally to force changes in the organizational structure of NASD if the Transaction was not approved by NASD Members when there is no evidence of any such intention by the SEC;
- the changes likely to be forced by the SEC would be on terms less favorable to NASD Members when there is no evidence of any such intention by the SEC;
- omission of the material fact that dissolution of NASD could have resulted in payments of over $300,000 per NASD Member firm;
- omission of the material fact that the $35,000 was nothing more than a direct monetary inducement for Members to vote for the By-Law amendments;
- omission of the material fact that NYSE and its member firms stood to reap huge benefits from the Transaction, at the expense of NASD Members who were not concurrently NYSE members;
- omission of the material fact that the Officer Defendants planned to seek substantial and immediate salary increases and bonuses;
- omission of the material fact that, at the date of the Proxy Statement through the Member vote, the IRS had not yet issued a formal ruling concerning the Transaction or the proposed Special Member Payment; and

- omission of the material fact that at the time the Proxy Statement was issued and when the vote took place, the FINRA Defendants had not yet received an opinion as to the fairness of the proposed Transaction to Plaintiff and NASD Members. *See, e.g., Id.* at ¶ 16.

The basic facts concerning the Transaction are set forth in Judge Kram's prior decision dismissing, without prejudice, the Amended Complaint and the Second Circuit's opinion remanding the case for further proceedings. *Standard Investment Chartered, Inc. v. NASD, et al.*, 2007 WL 1296712 (S.D.N.Y. May 2, 2007) ("*Standard*"), *appeal dismissed and case remanded*, 560 F.3d 118 (2d Cir. 2009); SAC ¶ 64. Largely ignoring the serious and detailed allegations in the SAC, Defendants raise legal objections, many of which flow from their "red herring" contention that the SAC "challenges a rulemaking." FINRA Mem. at 1. This assertion simply ignores the fact that the Complaint seeks money damages only, would leave the Transaction and By-Law changes effectuated by the Member vote intact, and the clear distinctions in precedent, the SEC's determination and logic. *See also*, FINRA Mem. at 12, 19.

Defendants ask the Court to dismiss the SAC: (1) under Rule 12(b)(1), because Standard purportedly did not exhaust its administrative remedies through the Ninth Circuit, which they argue is required and exclusive; (2) under Rule 12(b)(6), because Defendants are absolutely immune from actions for damages in every circumstance; and (3) under Rule 12(b)(6), because the SAC fails to state a cause of action. By contrast: (1) Standard has gone as far to secure its rights administratively as it logically could have; (2) Standard does not challenge any quasi-governmental conduct of NASD, NYSE or FINRA; and (3) the SAC states undeniably valid claims under Delaware law. Alternatively, Standard contends that the Court cannot grant Defendants' motions on Rule 12(b)(1) or 12(b)(6) grounds based on the current record.

The Facts Undermine Defendants' Exhaustion Arguments Because Standard Exhausted Those Administrative Remedies Necessary for this Litigation to Proceed to Trial

Defendants disingenuously portray Standard's lawsuit without acknowledging the Plaintiff's ultimately successful efforts to meet Judge Kram's concerns. Defendants depict this suit as a head-on challenge to the SEC rulemaking proceeding even though the litigation focuses exclusively on Defendants' wrongful private business conduct. *See, e.g.,* FINRA Mem. at 1. The facts undermine Defendants' characterizations. Specifically:

- Standard was never "aggrieved" by any SEC action. Plaintiff presented its objections through letters to the SEC, which considered them only in a limited way, as necessary under the terms of its own statutory mandate, and resolved them in a manner that was consistent with the SEC's governmental concerns and harmless to Standard's lawsuit;
- The SEC's ultimate disposition of Plaintiff's challenge to certain language in its Order, after Standard's commencement of an appeal before the Ninth Circuit, explicitly contemplated that Plaintiff would pursue its state law claims in this Court;
- This Court's consideration of the motions to dismiss occurs after the Second Circuit's remand and may be guided by its invitation to full consideration of all relevant issues;
- The SAC does not seek to undo the Transaction or modify any FINRA By-Laws;
- Standard seeks to proceed under state and common law relating to intra-corporate issues rather than interfere with FINRA's quasi-governmental functions;
- Standard's claims are for money damages only; and
- The notice of the SEC's rulemaking proceeding in the Federal Register did not even mention the Proxy Statement or the fairness of the $35,000 Special Member Payment or the reasons for it.

The Distribution of Assets Did Not Involve a Quasi-Governmental Function that the SEC Would Otherwise Perform

Defendants repeatedly argue that business conduct of a self-regulatory organization ("SRO") is a governmental function and maintain that the SEC could even revise SRO arrangements relating purely to corporate business conduct. *See, e.g.,* FINRA Mem. at 5. Even Defendants do not maintain that the SEC properly could re-write the Delaware state and common law applicable to the FINRA Defendants' business conduct or redistribute away the Members' assets or the assets of the SRO under the SEC's statutory powers. In December 22, 2006, correspondence from NASD's tax counsel to the IRS, NASD implicitly recognizes the private corporate nature of the FINRA Defendants' decision to make the payment, writing, "[t]he payment will be made in compliance with Delaware corporate law…" without any reference to oversight or review of the payment by the SEC. *See* Exhibit A to Standard's Motion for Reconsideration, Letter from Mario J. Verdolini, Jr., to Carter C. Hull, December 22, 2006 at 7-8 ("Recon. Mot. Exh. A"). Standard's claims as set forth in the SAC invoke:

- No violation of the Exchange Act or any federal law or regulation;
- No challenge to NASD's By-Laws changes effectuated pursuant to the Member vote;
- No challenge to the consolidation of NASD and NYSE;
- No challenge to any SEC rulemaking; and
- No challenge to any matter within the SEC's jurisdiction.

If successful, Standard's claims will be satisfied entirely through a money judgment in a court of law (without resort to the Court's equitable powers) against the assets of the organizational and individual defendants, and without any change whatsoever in the legal status of the Transaction. Unlike the NASD:

- The SEC does not possess NASD Members' business property, invest that property, safeguard that property or redistribute that property;
- The SEC does not approve SRO proxy statements or even receive them and did not approve the Proxy Statement at issue;
- Neither §14(a) of the Securities Exchange Act of 1934 or SEC Rule 14a-9 are applicable to the Proxy Statement at issue;[2] and
- The SEC did not formally approve, ratify or opine upon the fairness of the $35,000 payment to NASD Members.

Defendants' position is that because the Transaction had a quasi-governmental aspect, all aspects of it were comprehensively governed by the SEC and therefore are immune from litigation. In fact, the Transaction involved a host of functions and considerations; some of these were of regulatory concern to various agencies, others were not. Even on the regulatory side, the SEC's review was not exclusive. The combination of the two entities required an antitrust filing under the federal Hart-Scott-Rodino pre-merger notification rules. SEC Release No. 34-56145 at n. 7 (July 26, 2007) ("SEC Approval Order"). The IRS reviewed the tax consequences of the Transaction. The central SEC concern was to examine the proposed By-Law revisions. The SEC proceeded by an informal notice and comment procedure.

The Transaction also involved a business deal between the NASD and NYSE. As Defendants have so forcefully argued in pressing their case for confidentiality, one aspect of the business deal was a contract between NYSE and NASD that had an allegedly proprietary nature. *See, e.g.,* Opposition of the FINRA Defendants to Requests to Overturn this Court's Protective

[2] This is not to say that the Court should not be guided by court decisions regarding, *e.g.* materiality, reliance and other issues that arise in the context of allegations that a proxy statement has been deceptive.

Order at 1-2 (Docket No. 180). Another business aspect of the Transaction involved a re-distribution of assets, allegedly due to savings. *See, e.g.,* SAC ¶ 20. In each case, the deals involved payments of money and rearrangement of assets, none of which bore upon the performance of FINRA's (or its predecessors') functions as an SRO or the SEC's oversight of them. Out of the NASD "Members' Equity" of approximately $1.6 billion as of December 31, 2005[3], the NASD paid $103 million to NYSE (*id.*), purportedly for the purchase of assets; upon completion, it distributed approximately $176 million ($35,000 per NASD member), *Standard*, 560 F.3d at 121, but advised its Members that the distribution of these funds did not violate IRS rules because NASD was only paying out future savings due to presumed efficiencies. *Id.* at 120. Essentially, the FINRA Defendants told NASD Members that it was "passing on" the anticipated future savings from the Transaction to NASD Members. The SAC alleges that these statements in the Proxy Statement misrepresented both the source of the funds and the amount of savings that NASD actually anticipated – in effect, that Defendants intentionally shortchanged Plaintiff and the proposed Class through deceit. SAC ¶ 16; *Standard*, 560 F.3d at 121. The SAC alleges that most or all of the $35,000 per Member was derived from their own Members' Equity. SAC ¶ 16.

Both the NASD payments to NYSE and NASD Members came from proceeds from the sale of NASDAQ, NASD's proprietary trading market developed by NASD. NASD recognized that both payments were necessary to secure assent. Recon. Mot. Exh. A at 7, 9 ("NASD believes it is necessary to make the payment in order to achieve the proposed governance reforms and effect the transaction with NYSE Regulation."). The FINRA Defendants attempted to justify the payment to Members by reference to supposed future business efficiencies. *Id.* at

[3] NASD's 2005 Annual Report was the most recent report at the time the Transaction was agreed to and when NASD promulgated the Proxy Statement.

13. These business aspects of the Transaction were not the SEC's concern, nor part of its rulemaking.

The Complaint makes detailed, legally sufficient assertions of Defendants' wrongdoing. *See, e.g., Id.* at ¶¶ 18, 20, 22, 47, 70, 72, 101, 107-109. The brief filed on behalf of The New York Times and Dow Jones, in which Bloomberg joined, synthesizes these facts. The FINRA Defendants paid NASD Members the equivalent of a "bribe" financed out of accumulated assets to entice them to vote in favor of By-Law amendments necessary to effectuate the Transaction. *See* Memorandum of Law in Support of News Organizations' Application to Modify Protective Order at 3 ("News Mem.") (Docket No. 188). The FINRA Defendants conspired to arrive at a payment amount sufficient to entice NASD Members (together with the Proxy Statement's representations) to vote as requested, while redirecting sufficient financial resources to pay huge salary increases and bonuses to the Officer Defendants. *Id.*; *see also*, SAC ¶ 14; Recon. Mot. Exh. E, PPA Member Voting Analysis, November 1, 2006. Finally, the FINRA Defendants repeatedly asserted in a variety of ways, including within the Proxy Statement, that the purported $35,000 limitation on the Special Member Payment was imposed by the IRS, when in fact a range of payments *higher* than $35,000 was permitted and the IRS did not even issue an order approving the tax aspects of the Transaction until approximately two months *after* the By-Law vote occurred. News Mem. at 3-4.

Most striking are the FINRA Defendants' claims of the absence of fiduciary duties, which position to be sure the SEC did not approve. Because it is now legally expedient, the FINRA Defendants deny they owe fiduciary duties to Members, but NASD Board Minutes from July 20, 2006 contradict this assertion. Specifically, the Report of the Investment Committee memorializes the following, "[t]he Committee believes that an Investment Office is well justified

due to asset size (in excess of $2 billion) and in order to carry out attendant fiduciary responsibilities for the best interests of the members and organization." Exhibit 1 to Declaration of Jonathan W. Cuneo Pursuant to F.R.C.P. 12(b)(1) & 56(f) ("Cuneo Decl.").[4] Furthermore, Defendants' motions to dismiss neither explain, nor deny that FINRA's annual reports for 2003, 2004 and 2005 refer repeatedly to assets as "Members' Equity."[5] *See, e.g.,* SAC ¶ 8. Even if there is not an "equity" interest in the traditional sense, there is clearly a financial interest of the Members as to the disposition of NASD's assets.

Prior Procedural History of the *Standard* Case

The SAC follows Standard's pre-Transaction challenge before Judge Kram. Judge Kram dismissed the Amended Complaint under the doctrine of exhaustion of administrative remedies, directing Standard to the SEC, which was conducting a notice-and-comment rulemaking proceeding as to the consolidation as SROs of NASD and NYSE. *Standard*, 2007 WL 1296712 at *9. "[P]laintiffs must initially challenge SRO rulemaking in front of the agency that administers the Exchange Act and in accordance with that agency's administrative scheme." *Id.* at *6. The Court held that Standard's damage claims were not yet ripe. As of the Court's ruling on May 2, 2007, the Transaction had not yet closed. *Id*.

The day after Judge Kram's ruling – in line with her directive – Standard presented its concerns to the SEC, even though the SEC's public notice did not invite comment on the

[4] Excerpt included in public pleading with permission of counsel for the FINRA Defendants.
[5] Those annual reports contained statements by the Investment Committee that directly acknowledged that the assets were being invested for the benefit of NASD Members. *See, e.g.,* NASD 2004 Annual Financial Report at 10, NASD 2005 Annual Financial Report at 10 (both available at http://www.finra.org/AboutFINRA/AnnualReports/index.htm) ("The goal of NASD's investment policy is to generate long-term returns to be used to support NASD operations for the benefit of investors and *members*." (emphasis added) (Defendants' internal communications are needed to see the extent to which they followed a fiduciary standard as to these business assets.). *See* Cuneo Decl. ¶19(c).

$35,000 payment or the disposition of the assets in NASD's possession, but only on the By-Law amendments. *See* SEC Release No. 34-55495 (Mar. 20, 2007) ("SEC By-Law Notice"); *see also* http://www.sec.gov/comments/sr-nasd-2007-023/nasd2007023.shtml ("By-Law Webpage"). That letter advised the SEC that documents NASD produced in the *Standard* litigation were directly relevant to the accuracy of the Proxy Statement. *See* Letter from Jonathan W. Cuneo and Richard D. Greenfield to SEC, May 4, 2006 at 1. On June 11, 2007, Standard again urged the SEC to review documents produced in discovery bearing upon the proposed Transaction. *See* Letter from Jonathan W. Cuneo and Richard D. Greenfield to SEC, June 11, 2007 at 3. Not having heard from the SEC, Standard's Counsel requested that Counsel for NASD permit Standard to share the discovery documents with the SEC…." This was followed by a letter from Jonathan W. Cuneo and Richard D. Greenfield to the SEC on July 26, 2007 which stated at 1: "Stunningly, they declined … We implore [the SEC] to obtain these documents from NASD…." The SEC never obtained or reviewed the documents.

The SEC's response to concerns about asset disposition was circumscribed by its limited role with respect to the Transaction. SEC Approval Order at 52. The SEC engaged in a number of private*, ex parte*, communications with NASD representatives and received NASD's "purported explanation." *Standard*, 560 F.3d at 122. The SEC did not publicly notice the Delaware corporate business issues, hold hearings, or appoint an administrative judge to find facts in an "on-the-record" hearing. Indeed, there was nothing in the SEC notice to inform other NASD Members or the public at large that the Special Member Payment was of interest to the SEC.[6] In approving the Transaction, the SEC made findings[7] that NASD had complied with the

[6] Standard made its submission to the SEC out of respect for Judge Kram's decision. It expressly reserved its position that proxy issues should be "adjudicated by a court of competent

terms of its Articles of Incorporation and By-Laws; these findings are not at issue in this case. Its views on this aspect of the matter were abbreviated and, as shown shortly thereafter, that initial statement later required revision to accord with the Commission's actual considered views. The SEC made dispositive findings only "under the Exchange Act," and only for that purpose it commented on the Proxy Statement:

> The Commission ordinarily does not make determinations regarding state law issues but, when required to do so because state law necessarily informs its findings under the Exchange Act, it relies on the conclusions of experts or other authorities . . . The Commission believes that NASD has made a *prima facie* showing that these representations [about the $35,000 payment] were not misleading and that NASD's explanation is uncontradicted by the commenters' submission regarding this matter.

SEC Approval Order at 75.[8]

Standard sought review of the SEC Approval Order in the Ninth Circuit for the sole purpose of clarifying that the SEC did not definitively dispose of Plaintiff's proxy fraud, breach of fiduciary duty and other state law claims. In its challenge of the SEC Approval Order, Standard did not seek to change FINRA's new governance regime, its By-Laws or any quasi-government role. *Standard Investment Chartered, Inc. v. SEC*, No. 07-73405 (9th Cir. 2007), Br. for Appellant, filed Nov. 30, 2007, at pgs. 10-11; *see Standard*, 560 F.3d at 123.

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jurisdiction." Letter from Jonathan W. Cuneo and Richard D. Greenfield to SEC, May 4, 2007 at 1.

[7] The SEC set forth the scope of its mandatory findings. The SRO must have "completed all action required to be taken under its constitution, articles of incorporation, bylaws, rules, or instruments corresponding thereto." SEC Approval Order at 67.

[8] Neither Standard nor any other NASD Member had knowledge of the FINRA Defendants' *ex parte* communications with the SEC, nor the substance thereof. Any "commenters" could hardly have "contradicted" NASD's explanation without knowing that it had been made or what the "explanation" was.

Following the SEC's traditional interpretation of its authority[9] and agreeing with Standard, the SEC joined with it and asked the Ninth Circuit to remand the SEC Approval Order to allow clarification. The joint motion explained that the SEC Approval Order did "not purport to decide a question of state law" and it "did not intend that" its proxy-related findings "would be binding on a court in a related action based upon state law." Joint Motion to Remand ¶ 8; *Standard*, 560 F.3d at 123 fn. 3. The joint motion made clear – as carefully traced by the Second Circuit – that granting the joint motion would afford Standard and, all Class Members, the relief sought from the exhaustion process. The Ninth Circuit granted the joint motion of the SEC and Standard for a remand.

After the Ninth Circuit issued its remand order, counsel for NASD lobbied the SEC not to issue that clarification.[10] The SEC nonetheless promptly clarified its Approval Order, stating that the SEC's finding on NASD's compliance and Members' approval:

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[9] Self-Regulatory Organizations; Chicago Board Options Exchange, Inc.; Order Setting Aside Earlier Order Issued by Delegated Authority and Granting Approval to a Proposed Rule Change and Amendment No. 1 Thereto Relating to an Interpretation of Paragraph (b) of Article Fifth of its Certificate of Incorporation and an Amendment to Rule 3.16(b), File No. SR-CBOE-2004-16, SEC Release No. 34-51252, 2005 SEC LEXIS 426, *17 (February 25, 2005) (noting SEC does not purport to decide questions of state law except to the extent that the SEC's analysis of state law informs its finding that, as a federal matter under the Exchange Act and/or Articles of Incorporation and by-laws, the Exchange Act was complied with).

[10] *See* Memorandum from the Office of General Counsel and the Division of Trading and Markets regarding an April 29, 2008 conference call with representatives of FINRA (May 5, 2008):

> On April 29, 2008, a conference call was initiated by counsel for FINRA to counsel for the Commission regarding the order of the Court of Appeals for the Ninth Circuit in *Standard Investment Chartered, Inc. v. SEC*, No. 07- 73405 (9th Cir.), which remanded to the Commission for clarification the Commission's July 26, 2007, order approving an NASD rule change to enable the consolidation of the member regulatory functions of NASD and NYSE Regulation, Inc., which resulted in the creation of FINRA (Release No. 34-56145). Representing FINRA in the call were Grant Callery, General Counsel for FINRA, and attorneys from FINRA's outside counsel, Gibson Dunn and Crutcher; representing the Commission were Jacob H. Stillman and Susan S. McDonald of Office of

> is not a definitive adjudication under state law, such as a trial court would make after an evidentiary hearing, regarding the claim that the proxy statement was misleading. Except to the extent that state law informs the Commission's finding that, as a federal matter under the Exchange Act, NASD complied with its Certificate of Incorporation and by-laws with respect to the proxy approval process and that the proposed amendments to its by-laws were properly approved by NASD members, the Commission is not purporting to decide a question of state law. The Commission does not intend that its determination regarding the NASD's uncontradicted *prima facie* showing before the Commission that the proxy statement was not misleading be binding on a court in a claim based on state law.

SEC Release No. 34-56145A, 1-2 (May 30, 2008) (the "SEC Clarification").

Meanwhile, Standard had appealed Judge Kram's dismissal of the Amended Complaint to the Second Circuit. The Second Circuit ruled on March 18, 2009. *See generally, Standard*, 560 F.3d 118. In the *Standard* appeal, Defendants argued, as they argue now, that Plaintiff still did not satisfy an exhaustion requirement, even after the sequence of presentation of views to the SEC, SEC ruling, appeal to the Ninth Circuit, joint motion to remand, Ninth Circuit remand order and SEC ruling on remand. The Second Circuit did not accept or agree with this NASD argument. Rather, the Second Circuit granted Standard what it asked – to be sent back to this Court for further proceedings.

> General Counsel and Nancy J. Burke-Sanow of the Division of Trading and Markets. Counsel for FINRA expressed concern that what the Commission would say in the clarification of the July 26, 2007, release (as proposed in the joint motion to remand filed by the Commission and petitioner Standard Investment Chartered, Inc.) could be harmful to FINRA and other SROs because of the adverse impact it would have on them in litigation brought under state law.

(available at http://www.sec.gov/comments/sr-nasd-2007-023/nasd2007023.shtml).

ARGUMENT

A. The Exhaustion Doctrine Poses No Barrier to the Claims Asserted In the SAC.

1. Standard Exhausted Its Remedies Before the SEC and Obtained Relief Sufficient for This Lawsuit to Proceed.

Laying aside any misgivings about Judge Kram's ruling, Standard submitted comments with the SEC on May 4, 2007, June 11, 2007, and July 26, 2007. *See* By-Law Webpage. Standard clearly followed Judge Kram's road sign and raised its issues before the SEC.[11]

Much water has flowed under the bridge since Judge Kram's May 2007 ruling in *Standard*. *See* pgs. 9-13, *supra***.** In approving the By-Law changes in the context of its rulemaking proceeding, the SEC considered submissions by Standard, other commenters and by NASD. The SEC held no public hearings, took no sworn testimony and made its determination on the basis of informal and unsworn submissions without the benefit of the documents produced in this case. As the Second Circuit stated, "[w]hile briefing was underway [in the original case in the District Court], Standard sought and obtained expedited discovery from all defendants. Standard obtained communications between NASD and the Internal Revenue Service ("IRS") regarding NASD's tax-exempt status and the special $35,000 member payment." *Standard*, 560 F.3d at 121. The discovery referenced by the Second Circuit would provide part of the basis for what the SEC described as "an evidentiary hearing" in a "trial court." The SEC's initial approval

[11] Three times, Judge Kram's opinion in *Standard* expressed her view that the obligation of exhaustion was an "initial" one that came "prior to" litigation in this Court, not that exhaustion was a permanent roadblock. *Standard*, 2007 WL 1296712 at *5 (the plaintiff may only proceed "by *initially* pressing its complaint before the NASD") (quoting *Bruan, Gordon & Co. v. Hellmers*, 502 F. Supp. 897, 906 (S.D.N.Y. 1980)); *id.* at *6 ("plaintiffs must *initially* challenge SRO rulemaking in front of the agency"); *id*. at *9 ("the exhaustion doctrine" applies "*prior* to [a party's] exhausting its claims before the appropriate administrative body") (italics added to each parenthetical).

of the By-Law changes took note of "NASD's explanation regarding the Proxy Statement's representations about the $35,000 payment" and found that NASD had made a "*prima facie*" showing that those representations were not misleading. SEC Approval Order at 75. Later, the SEC clarified that its finding "is not a definitive adjudication under state law, such as a trial court would make after an evidentiary hearing, regarding the claim that the proxy statement was misleading." SEC Clarification at 1.

Although the Second Circuit did not adopt Defendants' position, Defendants argue that this Court should view the SEC's language about a "*prima facie*" showing as a rationale to foreclose any case. Looking at the SEC's language most favorably to Defendants before the subsequent SEC Clarification, the Court should view the Commission's non-adjudicatory regulatory "*prima facie*" showing as *dictum*, far short of a conclusion that is legally binding on this Court, either as collateral estoppel or *res judicata*. *See Arizona Grocery Co., v. Atchison, Topeka & Santa Fe Ry.*, 284 U.S. 370, 389 (1932). "Administrative action other than adjudication cannot be *res judicata*. Even if an exercise of the rule-making power depends on a finding of facts, neither the rule nor the finding is regarded as *res judicata*." K. Davis, 2 Administrative Law Treatise §18.08, at 597 (1958).

The SEC drew a distinction between its proceeding and a proceeding in a "trial court" with "an evidentiary hearing" (when the SEC said that its finding "is not a definitive adjudication under state law, such as a trial court would make after an evidentiary hearing," SEC Clarification at 1). By this distinction, the SEC obviously referred to this case, because the SEC Clarification was negotiated between the SEC and Standard with an eye toward this case and its further litigation on the merits of Standard's claims. The Defendants would have this Court believe that the SEC cynically euchred Standard into accepting a meaningless stipulation and worthless

clarification, the obvious effect of which would be to foist an unnecessary controversy upon this Court. Moreover, Defendants effectively contend that the SEC knowingly violated its own established position against making such state law determinations.

Standard's rights were not harmed by the SEC determination, which did not create any binding collateral estoppel or *res judicata* effects vis-à-vis Plaintiff's damage claims, but left Standard to pursue state law claims in court. Having achieved this outcome, any further appeal by Standard would have been ridiculously unnecessary, and any further "exhaustion" would have been "pointless." Defendants' position that Standard was obligated to pursue an appeal to its conclusion, having received the relief it sought through settlement and joint motion with the SEC – and the Ninth Circuit's granting of that joint motion – is unsupported by any precedent and would represent a policy of forcing the courts to adjudicate controversies when the parties to the "controversy," both private and official, no longer differ on the outcome. *See* U.S. Const. art III, §2, cl. 1; *see also, ABKCO Music, Inc. v. Harrisongs Music, Ltd.*, 722 F.2d 988, 997 (2d Cir. 1983) (noting that "courts favor the policy of encouraging voluntary settlement of disputes…."). Defendants would compel a court of appeals to force the SEC to make determinations it believed unnecessary to its approval of the By-Laws, the opposite of the purpose of the exhaustion doctrine.[12] *See Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., et al.*, 467 U.S. 837, 844 (1984) ("*Chevron*") ("We have long recognized that considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer….").

[12] All three of the purposes of the exhaustion doctrine have been served already. The proceedings have allowed the SEC to apply its expertise. The SEC developed the record it wanted. There have not been repeated interruptions by returns to this Court until appropriate. *See, e.g., Jersey Shore Broadcasting Corp. v. FCC*, 37 F.3d 1531, 1535-1536 (D.C. Cir. 1994).

2. Standard's State Law Damage Claims Do Not Require Exhaustion.

The SAC seeks only one form of relief – monetary damages under state law. This contrasts with Standard's initial Complaint which sought additional forms of relief prior to consummation of the Transaction. The SEC is without authority to order monetary damages. *See Feins v. ASE*, 81 F.3d 1215, 1217 (2d Cir. 1996); *see generally*, *Fiero v. FINRA*, 606 F.Supp.2d 500 (S.D.N.Y. 2009) (FINRA invocation of the judicial process to collect fine from FINRA Member). Because monetary compensation is not available through SEC procedures, damage claims do not require exhaustion of remedies. *Barbara v. NYSE*, 99 F.3d 49, 57 (2d Cir. 1996); *see also Standard,* 2007 WL 1296712 at *7; *see also Shapira v. Charles Schwab & Co.*, 187 F.Supp.2d 188, 192 (S.D.N.Y. 2002).

Defendants' reliance on *Swirsky v. NASD* demonstrates how porous the exhaustion doctrine is: "Exhaustion of administrative remedies is required if explicitly mandated by Congress, … but courts may relax this requirement somewhat…." 124 F.3d 59, 63 (1st Cir. 1997). *Swirsky* directly states that the central "purpose," of the exhaustion requirement is "'the avoidance of premature interruption of the administrative process.'" *Id*. at 62 (quoting *McKart v. United States*, 395 U.S. 185, 193 (1969)). The opinion cites three exceptions, all of which are clearly applicable here: "when the requirement occasions undue prejudice to subsequent assertion of a court action" and "where the agency is not empowered to grant effective relief." *Id.* at 63. The third exception, "when there are clear indicia of agency bias or taint," is particularly applicable in any future SEC consideration of this issue so long as the leadership of the SEC strongly favors FINRA and its consolidation. *Id*.

Defendants would distinguish *Barbara*, arguing that the SEC could have prevented Standard from experiencing damage by disapproving the Transaction. FINRA Mem. at 2. But,

when the SEC considered the By-Laws, it did not attempt to resolve issues of damages under state law far beyond its proper role and legal authority. Instead it left the proxy fraud and related state law claims to the courts, consistent with its specific federal statutory mission. *See* SEC Clarification at 1-2. Under Section 19(b)(2) of the 1934 Act, the SEC "shall" approve SRO proposed By-Law changes if "such proposed rule change is consistent with the requirement of [the 1934 Act] and the rules and regulations thereunder . . ." 15 U.S.C. §78s(b)(2)(B).

The SEC promulgated its blueprint for its own consideration of the Transaction in its notice of proposed rulemaking (which came subsequent to the filing of the *Standard* Complaint). *See generally* SEC Release No. 34-55495 (Mar. 20, 2007). The SEC did not seek to perform a comprehensive review of all the issues having any connection under every body of law, state and federal, leading to the Transaction, which included both the By-Law changes, and the NASD's proxy solicitation process and corporate deal. Even after *Standard* was commenced, the SEC chose not to invite public comment on all issues, but focused solely on the SEC's real concern, the By-Law issues. This Court has every reason to join the SEC in that agency's concept of the proper boundary between its authority and the authority of the courts. *See Chevron*, 467 U.S. at 844.

Under Judge Kram's reasoning in *Standard*, Plaintiff was not damaged until the Transaction closed without receiving the compensation to which it was entitled. *Standard,* 2007 WL 1296712 at *7. The closing occurred only after, and apart from, federal-law regulatory approvals (including approval by the SEC, the IRS and the antitrust authorities) and its redistribution of assets involved purely private issues. While an SEC action disapproving the By-Laws would have perhaps lessened Standard's damages, it would not have eliminated

them.[13] Because the SEC did not itself close the Transaction, was not a party to the Transaction, did not issue the Proxy Statement, did not make any dispositive resolution of state law issues, and did not shortchange Standard and the Members of the Class, Plaintiff's grievance is not with the SEC,[14] it is with the proprietary actions[15] of Defendants.

3. The Exchange Act Does Not Require the SEC to Pass on State Law Fraud Claims.

Before the Court are Plaintiff's damage claims, which the SEC agreed are "cognizable only under state law." Joint Motion to Remand ¶ 5. The Exchange Act does not govern actions "for breach of state law fiduciary duties," and does not "cover allegations of garden-variety mismanagement, such as managers failing to maximize[e] value for . . . shareholders . . . or of managers acting in a generally self-entrenching fashion," as Standard alleges. *Field v. Trump*, 850 F.2d 938, 948 (2d Cir. 1988). State law governs the actions of a board of directors, whose duties are "created by state common law," not "created by federal law . . . even if breach of the fiduciary relationship is predicated on the directors' alleged violation of federal law."[16] Consistent with this dichotomy, courts have considered damage claims against SROs and their

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[13] Standard also contends, addressed in a different context in Judge Kram's prior holding in *Standard*, 2007 WL 1296712 at *7, that some damages accrued when the $35,000 figure was established by NASD's Board. *See* the initial Complaint ¶ 97; *see also* Recon. Mot. Exh. B, NASD Board Minutes, November 21, 2006. There is a market for the purchase and sale of broker-dealers and broker-dealers borrow money based upon their future revenue expectations. *See, e.g.,* www.bdexchange.com

[14] The SEC's decision to allow the Transaction to proceed is consonant with jurisprudence of ancient origin that prospective relief to prevent harm will not issue when an adequate remedy exists at law. *See, e.g., Moore v. Consol. Edison Co. of N.Y.,* 409 F.3d 506, 510 (2d Cir. 2005)

[15] FINRA believes that the financial aspects of the Transaction are so proprietary that it has repeatedly advocated in this Court and the Second Circuit that its "business secrets" need to be protected. *See, e.g.,* NASD Memorandum of Law in Support of Motion for a Protective Order at 1 (Docket No. 86).

[16] *Sung v. Wasserstein*, 415 F.Supp.2d 393, 405-06 (S.D.N.Y. 2006) (internal citations omitted); *Bove v. PBW Stock Exch., Inc.*, 382 So. 2d 450, 453 (Fla. Ct. App. 1980) ("officers and directors stand in fiduciary relationship to the shareholders (members) and are bound to exercise the highest degree of fidelity and fairness").

officers involving false proxy statements, corporate governance and breaches of fiduciary duty. *See* fns. 17, 28, *infra*.

4. The Exchange Act's Review Procedures Do Not Bar This Court's Jurisdiction Over State Law Proxy Fraud and Related Claims, When the SEC Has Said That Those Claims Can Be Considered in Court.

Without expressly saying so, Defendants appear to invoke the doctrine of "field pre-emption." FINRA Mem. at 11-17. Pre-emption may be inferred only when:

> Congress's intent to preempt state law may be inferred: (i) where federal statute creates scheme of federal regulation so pervasive as to make reasonable inference that Congress left no room for states to supplement it, (ii) where federal law is in irreconcilable conflict with state law, (iii) where compliance with both statutes is a physical impossibility, or (iv) where state law stands as obstacle to accomplishment and execution of full purposes and objectives of Congress.

NASDAQ Stock Market, Inc. v. Archipelago Holdings, LLC, 336 F.Supp.2d 294, 300 (S.D.N.Y. 2004) (internal citations, quotations, and emphasis omitted). The Defendants fail to satisfy any of these four criteria. SROs are chartered under state law and are governed by both state and federal law. *Fiero*, 606 F.Supp.2d at 517-518. There is no conflict between federal law and state law because no federal law countenances breaches of fiduciary duty; compliance with both state and federal law is required and there is no conflict with any Congressional purpose. *Id.* (citing *National Ass'n of Securities Dealers v. Securities and Exch. Comm'n,* 431 F.3d 803, 804 (D.C. Cir.2005)).

Defendants fail to demonstrate Congressional intent to occupy exclusively this field, and ignore the deference that courts (in addition to the SEC) show to state law when the circumstances so warrant. "[T]he purpose of Congress is the ultimate touchstone in every pre-emption case." *Wyeth v. Levine*, 129 S. Ct. 1187, 1194 (2009) (internal citations omitted). "[I]n all pre-emption cases, and particularly in those in which Congress has 'legislated … in a field which the States have traditionally occupied,' …we 'start with the assumption that the historic

police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress.'" *Id.* at 1194-95 (internal citations omitted).

Congressional intent contemplates that SROs may sue and be sued in state or federal district court for breaches of state law, federal law or their own rules. *Fiero*, 606 F.Supp.2d at 517-518; 15 U.S.C. §78aa; *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117, 133-40 (1973) (NYSE rule not given pre-emptive effect over state law). Defendants' reliance on *Feins* is misplaced because that case involved an attempt to imply a new private action under federal law, not enforce an existing right under state law. 81 F.3d 1215.

Because the SEC has already found that state law proxy fraud and internal corporate governance are matters for the courts in this very case, there is no regulatory jurisdiction that prevents this Court from exercising power over Standard's claims. Plainly, the sheer number of cases brought against SROs for breach of fiduciary duties debunks Defendants' contention.[17]

A court within this District rejected "pre-emption" contentions by NYSE that were similar to those made by Defendants here. In *New York v. Grasso*, 350 F. Supp.2d 498, 505 & n.6 (S.D.N.Y 2004), the New York Attorney General sued the former chief executive officer of the NYSE and the NYSE for state law corporate governance violations. The defendants contended that the case could not proceed in a state forum, but must proceed only in a federal securities law forum. Rejecting this contention, Judge Lynch explained:

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[17] *See, e.g.*, *Wey v. NYSE*, No. 602510/05, Slip Op. at 15-18 (N.Y. Sup. April 10, 2007); *Hyman v. NYSE*, 848 N.Y.S.2d 51 (N.Y. Sup. 2007); *Ginsburg v. Philadelphia Stock Exchange, Inc.*, 2007 WL 1703421 (Del. Ch. May 30, 2007); *Higgins v. NYSE*, 806 N.Y.S.2d 339, 347 (N.Y. Sup. 2005); *In re NYSE/Archipelago Merger Litig.*, 824 N.Y.S.2d 764, *5 (N.Y. Sup. 2005); *Bove,*, 382 So.2d at 453 ("officers and directors stand in a fiduciary relationship to the shareholders (members) and are bound to exercise the highest degree of fidelity and fairness in all their dealings with them").

> As thus summarized, it is not apparent that the complaint states any claim under federal law or implicates any question requiring the interpretation of federal law….No reference is made [in the complaint] to federal law, and it is difficult to see how federal law could play any role in deciding the case. No principle of federal law must be referred to in order to decide . . . . Nor is there any apparent reason to believe that federal law shields . . . [what was] voted by conflicted or uninformed directors of [the NYSE].

Grasso, 350 F. Supp.2d at 501; *see also*, n. 12, *supra*. The Court rejected defendants' arguments on the ground that "'even though the 'alleged misconduct overlaps with conduct that is likewise proscribed by NYSE rules,' the plaintiff 'seeks only to enforce state law.'" *Grasso*, 350 F.Supp.2d at 504 (citation omitted). Judge Lynch emphasized the significance of how organic federal law prescribed that NYSE and NASD shall organize under New York or Delaware (or other state) law, thereafter to have transgressions adjudicated by the courts – rather than exclusively by the SEC – pursuant to that state's law: "To the contrary, federal law, for now, leaves the NYSE to organize its governance in accordance with state law. *See* 15 U.S.C. §78c(a)(1) (defining 'exchange' as 'any organization, association or group of persons, whether incorporated or unincorporated')." *Grasso,* 350 F.Supp.2d at 505. The court then distinguished the cases Defendants cited here involving complaints relating to an Exchange's (including NASD) disciplinary actions, enforcement functions and the like. *Id.* at 507 (emphasizing that the "Second Circuit case law fully supports this conclusion.")[18]

The cases that FINRA relies upon are those in which its actions are quasi-governmental, and involve entirely different circumstances.[19] Defendants' reliance on the provisions that make

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[18] *Grasso* discusses *D'Alessio v. NYSE*, 258 F.3d 93 (2d Cir. 2001) ("The NYSE's actions in that case related directly to the interpretation and enforcement of federal securities regulations," not New York or Delaware state law) and *Barbara*, 99 F.3d at 59 ("the court found the NYSE immune for actions taken in disciplinary proceedings mandated by federal law," not as to New York or Delaware state corporate law issues).

[19] *Hayden v. NYSE*, 4 F.Supp.2d 335 (SDNY 1998) (disciplinary action); *Feins,* 81 F.3d 1215 (membership to stock exchange); *Desiderio v. NASD*, 191 F.3d 198 (2d Cir. 1999) (membership

court of appeals jurisdiction exclusive are inapposite, because Plaintiff and the members of the Class have sued about being damaged by*, inter alia*, acts of NASD and NYSE, not the SEC. There is no proceeding before the Ninth Circuit. *See* Order Dismissing Appeal, Case No. 07-73405 at 1 (9th Cir. June 16, 2008).

5. Standard and Other Class Members Cannot Be Required to Exhaust a Proceeding Which Gave No Notice that Their State Law Rights Might Be Extinguished.

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to NASD); *In re Series 7 Broker Qualification Exam Scoring Litigation*, 548 F.3d 110 (D.C. Cir. 2008) (testing of prospective brokers); *see also In re NYSE Specialists Securities Litigation*, 503 F.3d 89, 96 (2d Cir. 2007).

The Administrative Procedure Act ("APA") provides that "notice of proposed rule making shall be published in the Federal Register" and "shall include," among other things, "either the terms or substance of the proposed rule or a description of the subjects and issues involved." 5 U.S.C. §553(b). The Second Circuit points out that "[n]otice is said not only to improve the quality of rulemaking through exposure of a proposed rule to comment, but also to provide fairness to interested parties and to enhance judicial review by the development of a record through the commentary process." *Riverkeeper, Inc. v. U.S. E.P.A.,* 475 F.3d 83, 112-13 (2d Cir. 2007) *(quoting Nat'l Black Media Coalition v. FCC,* 791 F.2d 1016, 1022 (2d Cir. 1986), *rev'd and remanded on other grounds*, 129 S.Ct. 1498 (2009)). Accordingly, "the final rule [issued by an agency] must be a 'logical outgrowth' of the rule proposed." *Id.*; *accord Environmental Integrity Project v. E.P.A.*, 425 F.3d 992, 996 (D.C. Cir. 2005) ("Given the strictures of notice-and-comment rulemaking, an agency's proposed rule and its final rule may differ only insofar as the latter is a 'logical outgrowth' of the former.") The test is "whether the agency's notice would fairly apprise interested persons of the subjects and issues" of the rulemaking. *Riverkeeper*, 475 F.3d at 113.

The notice said that the SEC would be considering whether to approve NASD's proposed changes to its By-Laws. That notice did not provide any indication that the SEC would be considering the state corporate law issues of the adequacy of the Proxy Statement, the sufficiency of the Special Member Payment or the process through which NASD sought Member approval of the rule change. The notice gave no warning that the SEC would be considering whether the $35,000 payment was the maximum amount that the NASD could distribute to its Members or even that the amount to be paid was fair to them. Even assuming *arguendo* that the SEC did actually "approve" the Proxy Statement or the adequacy of the $35,000 payment (a

virtually impossible proposition at best, since the Order contained in the SEC Release merely approved the proposed By-Law changes), such an "action" was not only alien to the SEC's role, it would be well outside of the scope of the advance notice that was published, would fail to comply with the most elementary of notice requirements under the APA and could have no legal effect. Moreover, it is simply irrelevant that comments were received pertaining to other extraneous issues (including comments made on behalf of Standard) as is practically universal in the unbounded procedural format of a rulemaking. *Environmental Integrity Project,* 425 F.3d at 996-97; *see also Fertilizer Inst. v. EPA,* 935 F.2d 1303, 1312 (D.C. Cir.1991) (stating agency "cannot bootstrap notice from a comment").[20]

6. Defendants' Exhaustion Argument Represents a Fact-Dependent Motion Under F.R.C.P. 12(b)(1) that Cannot be Granted on the Current Record Without Discovery.

Plaintiff has demonstrated that the SEC's words contemplate no further exhaustion. Defendants would raise the possibility of a factual challenge to the Court's subject matter jurisdiction. Defendants argue that they can conjure out of the SEC's decision as to the amendments to NASD's By-Laws enough in the way of ambiguity as to argue the SEC intended to preclude this litigation. *See, e.g.,* FINRA Mem. at 19 (questions "inescapably intertwined").

Defendants would launch the Court into an inquiry concerning the SEC's intent and the surrounding circumstances at the time it issued its order; this approach would raise factual issues particularly about Defendants' role both in public and *ex parte*, that should be determined only

[20] Counsel notes that we have been retained by another client (an NASD/FINRA Member) that did not participate in the notice-and-comment process before the SEC and was not aware that the amount of the payment was being addressed by the SEC. To spare the Court and the parties the time, distraction, and expense of additional filings, we have not sought to intervene such client as an additional plaintiff, but are prepared to do so if necessary.

after discovery.[21] The Court is entitled to look beyond the pleadings (*sua sponte* or otherwise) in considering a motion to dismiss for lack of subject matter jurisdiction, regardless of whether the motion challenges the factual assertions in the complaint. *Transatlantic Marine Claims Agency, Inc. v. Ace Shipping Corp.*, 109 F.3d 105 (2d Cir. 1997). Within the Second Circuit a plaintiff opposing a Rule 12(b)(1) motion is entitled to discovery as to jurisdictional facts. *Id.* In seeking discovery, the plaintiff should follow procedures applicable under Rule 56(f), and the courts should be guided by decisions under that rule. *See Gualandi v. Adams*, 385 F.3d 236, 244 (2d Cir. 2004); *Kamen v. Am. Tel. & Tel. Co.*, 791 F.2d 1006, 1011 (2d Cir.1986); *Exch. Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1131 (2d Cir.1976).

Plaintiff proffers the Declaration of Jonathan W. Cuneo Pursuant to F.R.C.P. 12(b)(1) & 56(f). To the extent further clarification is necessary, that discovery would show, *inter alia*:

1. Defendants did not seriously seek SEC review of the $35,000 payment or NASD's proxy process before this litigation commenced.

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[21] The SEC's position is clear and carefully parsing the SEC's prior orders shows the distinctions to be made. While Standard certainly has no conceptual quarrel with following the Second Circuit's suggestion that the Court inquire of the SEC, *Standard*, 560 F.3d at 125, there are numerous practical problems with implementing this suggestion. A judicial request for a subsequent SEC order depends, in part, on the SEC's willingness to issue such an order. Moreover, a subsequent SEC clarification order may well give rise to an opportunity by Standard or others to petition for review in the United States Court of Appeals, as Defendants position in this litigation would apparently contemplate; or the United States District Court.

Moreover, two SEC Commissioners were NASD officials at the time of the Transaction. Indeed, November 21, 2006 NASD Board Minutes indicate that the SEC Chair (a Defendant in this action), and another SEC Commissioner were present when the $35,000 figure was established and that the SEC Chair discussed it with the NASD Board. *See* Recon. Mot. Exh. B at 1, 3, NASD Board Minutes, November 21, 2006. It is not clear that even recusal of these two Commissioners would solve any problem of objectivity, as the SEC Chair, by law, controls the hiring, promotion and firing of the staff. *See* Reorganization Plan No. 10 of 1950, 15 U.S.C. § 78d. Because of this dilemma, limited discovery from Defendants and the SEC would be far preferable if the Court were to determine that further fact-finding is necessary.

2. Defendants pressed the SEC to make findings on the issues in the lawsuit as a tactical attempt to defeat Plaintiff's claims.
3. Defendants refused to permit the SEC to review its IRS correspondence produced in discovery in this case.
4. Defendants understood that their conduct in redistributing assets was governed by state law considerations and that the SEC did not customarily review such determinations.
5. Defendants also understood that their conduct in disseminating the Proxy Statement was not quasi-governmental action that the SEC would perform or otherwise review.
6. The SEC had no reason to participate in any scheme by Defendants to trick Plaintiff's Counsel into a worthless stipulation or trap Plaintiff with meretricious SEC findings.

B. <u>Defendants Have Not Established Any Case for Immunity.</u>

1. Immunity Is of a Rare and Exceptional Character and the Burden Is On Defendants to Establish It.

"Because FINRA is a SRO, it straddles the line between a public and a private entity," *Fiero*, 606 F.Supp.2d at 505. As the D.C. Circuit has held, FINRA "has two institutional hats: it serves as a professional association, promoting the interests of its Members and it serves as a quasi-governmental agency." *National Ass'n of Securities Dealer,* 431 F.3d at 804.

The Supreme Court has been "quite sparing" in its recognition of claims to absolute official immunity, particularly as to functions not of narrow kinds that are governmental. *Forrester v. White*, 484 U.S. 219, 224 (1988) (judge found not to be absolutely immune when acting in administrative capacity); *Antoine v. Byers & Anderson*, 508 U.S. 429, 437 (1993) (court reporter not absolutely immune); *see also*, *Owen v. City of Independence, Mo.*, 445 U.S. 622, 644-645 (1980) (recognizing that municipal corporations act in "proprietary" and "governmental" capacities). When it comes to SROs, courts focus on "'the nature of the function

performed, not the identity of the actor who performed it.'" *In re NYSE Specialists Securities Litigation*, 503 F.3d 89, 96 (2d Cir. 2007) (Sotomayor J.) (quoting *Forrester v. White,* 484 U.S. at 229, differentiating between "judicial" and "administrative" activities of judges).[22] In *NYSE Specialists,* the Court cautioned that absolute immunity "is of a rare and exceptional character." *Id.* (internal citations and quotations omitted).

Further, the Eleventh Circuit *en banc* has held that SROs do not enjoy immunity for their proprietary activities. *Weissman v. National Association of Securities Dealers*, 500 F.3d 1293, 1294 (11th Cir. 2007) (*en banc*). That opinion explained, in denying NASD and its former subsidiary NASDAQ, immunity from suit: "At the same time, as a private corporation, NASDAQ may engage in a variety of non-governmental activities that serve its private business interests, … [including] daily administration and management of other business affairs." *Id.* at 1296. Conversely, "[w]hen a SRO is . . . acting in its own interest as a private entity, absolute immunity from suit ceases to obtain." *Id.* at 1297. In that case, NASD made alleged misrepresentations in advertisements, much like those made in the Proxy Statement and otherwise by the FINRA Defendants as alleged by Plaintiff in this case. "This conduct was private business activity, and '[w]hen conducting private business, [SROs] remain subject to liability.'" *Id.* at 1299 (quoting *Sparta Surgical Corp. v. Nat'l Ass'n of Sec. Dealers, Inc.*, 159

[22] FINRA relies upon an opinion of then Circuit Judge, now Justice Sotomayor. FINRA Mem. at 19-20. However, at oral argument in the *Standard* appeal of the dismissal of the Amended Complaint, Justice Sotomayor directly questioned counsel for NYSE about whether this case involved regulatory conduct. Audio Recording of January 26, 2009 Oral Argument in *Standard,* 560 F.3d 118 (2d 2009) ("How is that a regulatory question? The SEC doesn't say the amount is the right amount. It says it qualifies you for regulatory treatment, but it doesn't specify the amount. How are any of the acts relating to the disclosures related to the value to be given a regulatory function entitled to absolute immunity?"). If the Court requires a copy of the audio recording of the argument, Plaintiff's Counsel is available to furnish the recording upon request.

F.3d 1209, 1214 (9th Cir. 1998)); *see also Opulent Fund v. Nasdaq Stock Market, Inc.*, 2007 WL 3010573 at *4 (N.D. Cal. Oct 12, 2007).

2. NASD's Payment to Its Members Was Not Quasi-Governmental In Nature.

Defendants cannot show that their actions were "quasi-governmental," such that their alleged conduct would justify the "rare and exceptional character" of absolute immunity.[23] *In re NYSE Specialists Securities Litigation*, 503 F.3d at 96. The SAC and other Plaintiffs' submissions render well pled, and, for a case at this phase, exceptionally well supported, allegations as to Defendants' wrongful conduct. Those well pled and well supported allegations specify with particularity the FINRA Defendants' actions, including claims that the Proxy Statement was false and deceptive as an integral part of a process for convincing NASD Members to go along with a manipulative and highly adverse corporate business rearrangement which short-changed NASD Members.

Defendants argue that since the SEC is governmental and some of the Defendants' regulatory functions parallel those of the SEC, Defendants have immunity for their actions in this case. However, a comparison of the SEC with the NASD shows that Defendants' actions or features in this case do not parallel the SEC:

- The SEC does not have members.
- The SEC does not issue proxy statements or approve SRO proxy statements, SEC Approval Order at 69-70; and did not approve the Proxy Statement at issue here.

[23] The presumptuousness of Defendants' claims for absolute immunity is reflected by the fact that, in dealing with their own Members over the Proxy Statement, Defendants argue for a broader immunity than that enjoyed by the United States Attorney General and FBI Director in the war on terrorism. *See Ashcroft v. Iqbal*, 129 S.Ct. 1937, 1945 (2009) (qualified immunity).

- The SEC does not purport to possess the property or otherwise manage or re-distribute the property of NASD or its Members.
- The SEC did not formulate, approve or ratify $35,000 as a payment to NASD Members.
- The SEC did not participate in "roadshows" to promote the Transaction.
- The SEC did not answer questions with misrepresentations about the source or amount of the Special Member Payment.
- In general, the SEC does not govern SRO rebates to Members.[24]

Just these items establish as a matter of law, by reference to the public record alone, that Defendants, by reason of their wrongful conduct as alleged in the SAC, were not engaged in quasi-governmental activity entitled to immunity.

3. Defendants' Immunity Claim is Intensively Fact-Dependent and Should Not be Decided Against Plaintiff Without Discovery.

Defendants argue that because their conduct that has been challenged by Standard is "germane" to protected activities (FINRA Mem. at 23)**,** their non-quasi-governmental conduct cannot be "separated from its regulatory core." NYSE Mem. at 14. Such a position asks the Court to accept as true their assertion – both express and implied – of many facts about which there is nothing in the record.[25] As such, the argument and the fact-dependent claim which underlies it should be rejected out-of-hand. If, however, the Court is inclined to consider an issue on which Defendants take an "inseparability" position the Court should not do so in the

[24] NASD made outright payments to NASD Members in 2000 and 2006. NASD also made commitments each time for future Member rebates. NASD has been providing Member rebates annually, to "provide firms with regulatory fee rebates of more than $150 million since 2000." NASD: 2005 Year in Review at 3 (available at http://www.finra.org/Newsroom/NewsReleases/2005/P0157943).

[25] Plaintiff contends that a very substantial portion of Defendants' fact-based arguments would be revealed as implausible by a record of the kind developed for a summary judgment motion.

Rule 12(b)(6) context.[26] The Second Circuit's ruling on appeal in the *Standard* case declined to accept Defendants' effort to have this action dismissed on immunity grounds. After noting that "[t]he appellees suggested at oral argument that we should reach their immunity defense even though that issue has not yet been considered by the District Court," the Second Circuit instead ruled that "we think it advisable to have the District Court make the initial determination" on exhaustion and so "we do not reach the immunity defense . . . ." 560 F.3d at 126. Both by word and by action, the Second Circuit expressed its respect for a district court's fact-based consideration of the immunity issue. The Second Circuit would not have this Court consider even the possibility of entertaining Defendants' far-fetched notions on the immunity issue without aiding the appellate court with a fact-based position.

If the Court accepts Defendants' attempt to lead it beyond the distinctions set out in the SAC between the challenged non-governmental activities of the Defendants, and those unchallenged activities that are protected, it can only do so with a factual record before it. Since the present record (and the discovery conducted to date) is limited, the Court is constrained from what it can conclude factually. In a similar vein, Defendants would have the Court accept their fact-dependent position that the $35,000 Special Member Payment was integral to the quasi-governmental impact of the proposed By-Law changes and the Transaction. They then use this

[26] Plaintiff submits that if the Court were to consider the various quasi-governmental and non-quasi-governmental activities of FINRA as "inseparable" that would effectively be granting summary judgment as to an asserted defense without discovery. While Standard maintains that, given the allegations of the SAC, it is inappropriate to reach this fact-based argument, Plaintiff can only address it fully following discovery. Out of an abundance of caution, Plaintiff submits the attached Declaration of Jonathan W. Cuneo Pursuant to F.R.C.P. 12(b)(1) & 56(f).

position to bootstrap the Special Member Payment to an argument that Defendants are absolutely immune from suit. *See, e.g.,* FINRA Mem. at 21. [27]

On the present record, in light of the allegations of the SAC, the Court would have no justification to find the disputed facts asserted by Defendants in support of such an "inescapably intertwined" argument. If the Court is inclined to accept this argument, Plaintiff seeks discovery concerning, *inter alia*, facts concerning internal communications at the NASD relating to the actions described in the SAC. From the limited discovery that previously occurred in this case, Plaintiff may reasonably anticipate that those internal communications will reflect the fact that Defendants' conduct was focused on business considerations as described in the SAC; and that these completely overshadowed any quasi-governmental considerations, interactions, or activities, if they were considered at all.

Defendants argue that for a grant to them of immunity, the courts need no factual insight that would be derived from discovery. For Defendants to argue this is natural, albeit unpersuasive, particularly since certain of their arguments are fact-dependent. The Second Circuit's opinion remanding the case counsels against crediting the Defendants' pitch. The Second Circuit remanded for further consideration by this Court of the nuances of exhaustion, including any which might have a factual context.

Clearly Defendants are not immune from damage suits over the intra-corporate business aspects of the Transaction.[28] The cases upon which Defendants rely involve alleged failures in

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[27] In fact, the question was posed of whether the Special Member Payment was "a case of vote buying" following the issuance of the Proxy Statement. *See* Floyd Norris, *Let's Vote on Securities Rules. Oh, and Here's $35,000*, N.Y. Times, November 29, 2006 (available at http://www.nytimes.com/2006/11/29/business/29place.html)

[28] NASD, NYSE as well as other SROs have been sued for damages many times for their actions. *See, e.g.*, *Wey v. NYSE*, No. 602510/05, Slip Op. at 15-18 (N.Y. Sup. April 10, 2007); *Hyman*, 848 N.Y.S.2d at 51; *Ginsburg*, 2007 WL 1703421, *1 (Del. Ch. May 30, 2007);

core governmental functions that could be performed by the SEC itself.[29] None of these cases involved representations by the FINRA Defendants, or any other SRO, over the terms of an intra-corporate deal or the payment to be made out of the SRO's assets.

C. The SAC States Claims Upon Which Relief May Be Granted.

1. F.R.C.P. 9(b) Is Not a Barrier to the Complaint.

Plaintiff amply satisfies the particularity requirements of F.R.C.P. 9(b).[30] F.R.C.P. (9)(b) imposes a burden on Plaintiff to state with "particularity the circumstances constituting fraud or mistake." The SAC adequately provides the FINRA Defendants with "fair notice of [the] Plaintiff's claim." *See, e.g., Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124 (2d Cir. 1994); *see Lerner v. Fleet Bank N.A.*, 459 F.3d 273, 290 (2d Cir. 2006) (quoting *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1175 (2d Cir. 1993)); *compare* SAC ¶¶ 13-16, 96-98, 101-144 *with Ashcroft,* 129 S.Ct. at 1945 (allegations against Attorney General and FBI Director did not provide adequate specificity regarding their challenged conduct). "[T]he primary purpose of Rule 9(b) is to afford defendant fair notice of the plaintiff's claim and the factual ground upon

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Higgins, 806 N.Y.S.2d at 347; *In re NYSE/Archipelago Merger Litig.*, 824 N.Y.S.2d at *5; *Grasso*, 350 F. Supp.2d at 505 & n.6; *Moore v. NASD.*, 1981 U.S. Dist. LEXIS 16774 (D.D.C. Aug. 31, 1981); *Bove,* 382 So.2d at 453. Sometimes no immunity defense is even raised in these cases; the litigation proceeds directly on the merits. *See, e.g.*, *Higgins,* 806 N.Y.S.2d at 347; *Wey v. NYSE*, No. 602510/05, Slip Op. at 15-18 (N.Y. Sup. April 10, 2007); *Hyman*, 848 N.Y.S.2d at 51; *Ginsburg*, 2007 WL 1703421, *1; *In re NYSE/Archipelago Merger Litig.*, 824 N.Y.S.2d 764, *5.

[29] The cases dealt with disciplining brokers, *D'Alessio,* 258 F.3d 93, disciplining broker-dealers, *Barbara*, 99 F.3d 49, suspending trading in a security and making announcements to the marketplace, *DL Capital Group, LLC v. Nasdaq Stock Market Inc.*, 2004 WL 993109 (S.D.N.Y. 2004), regulating markets, *In re NYSE Specialists Securities Litigation*, 503 F.3d 89 (2d Cir. 2007), licensing brokers, *In re Series 7 Broker Qualification Exam Scoring Litigation*, 548 F.3d 110 (D.C. Cir. 2008). The case Defendants principally rely upon involves quasi-governmental regulation of the marketplace. *Am. Benefits Group v. NASD*, 1999 WL 605246, *7 (S.D.N.Y. 1999).

[30] The particularity requirements of F.R.C.P. 9(b) – although satisfied by the SAC – do not apply to all Plaintiff's claims, only those that are fraud-based. *See, e.g., Zucker v. Katz*, 708 F.Supp 525, 530 (S.D.N.Y. 1989).

which it is based." *Novak v. Kasaks*, 216 F.3d 300, 314 (2d Cir. 2000), *quoting Ross v. Bolton*, 904 F.2d 819, 823 (2d. Cir. 1990). To be sure, Defendants are abundantly aware of and informed about the highly particularized fraud-based allegations in the SAC, the opinion of the Second Circuit issued March 18, 2009, Judge Kram's opinion dated May 2, 2007, as well as the proceedings before the SEC, including Plaintiff's own submissions and NASD's responses thereto.[31]

2. The SAC States Claims Under Delaware Law Against the FINRA Defendants.

"The Courts of this state [Delaware] will not allow the wrongful subversion of corporate democracy by manipulation of the corporate machinery or by machinations under the cloak of Delaware law." *Giuricich v. Emtrol Corp.*, 449 A.2d 232, 239 (Del. 1982). "Careful judicial scrutiny will be given a situation in which the right to vote . . . has been effectively frustrated and denied" and/or there is board action designed to interfere with or impede the effective exercise of corporate democracy by shareholders. *Giuricich*, 449 A.2d at 239; *In re Gaylord Container Corp. Shareholders Litig*., 753 A.2d 462, 477 (Del. Ch. 2000). These principles apply with particular force when there is a change of control over the organization or its assets, as occurred with the creation of FINRA and which is alleged with particularity in the SAC. *See, e.g.,* SAC ¶ 16; *Oliver v. Boston Univ.*, 2006 WL 3742598, *2 (Del. Ch. Aug. 8, 2006).

Examining just two of the FINRA Defendants' statements made in the Proxy Statement in the context of contemporaneous internal documents and submissions to the IRS illustrates just how deceitful, under Delaware law, were their actions as alleged:

EXAMPLE #1:

[31] If the Court were to find that any of the counts in the SAC fall short as a result of any omissions, technical defects, or the like, Standard respectfully requests that the Court give it an opportunity to re-plead, balancing the respective requirements of F.R.C.P. Rules 8 and 9(b).

PROXY STATEMENT TELLS NASD MEMBERS	NASD TELLS IRS
The one-time special payment is capped at $35,000 – "a larger payment is not possible."	Requesting payment in excess of $35,000, NASD explains it is "uncertain" how much money could be paid to Members; "there is no authority directly addressing a payment in analogous circumstances."[32]

FINRA Defendants Conceal from NASD Members:

In violation of Delaware law, the FINRA Defendants concealed material facts from NASD Members such as:

- NASD asked the IRS to authorize more than $35,000 per Member and, as of the dates of the Proxy Statement and vote by NASD Members, the IRS had not yet issued any letter with respect thereto;
- NASD justified its request to the IRS for more than $35,000 citing to a case where a non-profit dissolved, wound-up, liquidated and then paid Members; the FINRA Defendants thus knew that a different structure to the Transaction with NYSE could generate more than $35,000 per NASD Member; [33] and

[32] *See* Recon. Mot. Exh. A, Letter from Mario J. Verdolini, Jr., to Carter C. Hull, October 26, 2006 at 12.
[33] *Mill Lane Club, Inc. v. Comm'r*, 23 T.C. 433, 436 (1954).

- NYSE proposed to structure the Transaction so that NASD would dissolve, wind up, and capitalize FINRA.[34]

EXAMPLE #2:

PROXY STATEMENT TELLS NASD MEMBERS	NASD TELLS IRS
The one-time special payment, which Board authorized, is capped at $35,000, and was limited under tax laws to "the expected value of the incremental cash flows that will be produced by the consolidation transaction"	The amount of the payment amount was determined solely by the Board (not tax law) and was intended to persuade small Member firms to relinquish their control over the NASD; an economic incentive to secure their favorable vote in "recognition of the reduction of the members' collective voting power."[35]

FINRA Defendants Conceal from NASD Members:

- The Members of the putative Class possessed more than 90% voting control over NASD;
- The FINRA Defendants believed that $35,000 would be sufficient to gain enough Class Members' votes and thus secure NASD's reorganization into what is now FINRA;[36]
- The NASD Board made the determination that the $35,000 proposed to be paid to NASD Members was not to be the subject of negotiation.[37]

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[34] *See* Recon. Mot. Exh. F, Email from James Duffy, Executive Vice President and General Counsel of NYSE Group, Inc., to Defendant Grant Callery, Executive Vice President and General Counsel of NASD, November 30, 2006 ("we were not expecting that 'newco' would simply be a continuation of the existing NASD entity, simply with a changed name and governance structure. The signed term sheet expressly states that NASD will 'transfer all its assets, liabilities, equity, revenues, expenses and employees into New SRO, net of any member distribution related to the consummation of this transaction.'")

[35] Recon. Mot. Exh. A at 7.

[36] SAC ¶ 115.

[37] *Id.*

- The NASD Board acted to fix the $35,000 Special Member Payment long before the IRS acted and without regard to what it might conclude.

Delaware imposes upon the FINRA Defendants a duty to disclose fully and fairly all material facts within their control that would be likely to affect a Member's deliberations and ultimate vote. *See*, *e.g., Stroud v. Grace*, 606 A.2d 75, 83 (Del. 1992); *Malone v. Brincat*, 722 A.2d 5, 9 (Del. Supr. 1998); *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985).

A fact is material in the context of a proxy statement:

> If there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote . . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available

Rosenblatt, 493 A.2d at 944 (*quoting TSC Indus, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *In re MONY Group Inc. Shareholder Litigation*, 852 A.2d 9, 25 (Del.Ch. 2004). This "materiality standard is an objective one…", *Zirn v. VLI Corp.*, 621 A.2d 773, 779 (Del. 1993), and requires disclosure, in neutral, non-pejorative terms, of all material facts bearing upon the issue upon which a vote is being sought.[38]

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[38] The cases Defendants cite in support of their contention that Plaintiff needed to plead individual reliance on Defendants' false statements are wholly inapposite because they involve claims in which the plaintiff did not lose anything due to the allegedly false proxy statements. *Grace v. Rosenstock*, 228 F.3d 40, 49-50 (2d Cir. 2000) (appraisal remedy only to individuals who voted "yes" and plaintiff voted "no"). That case expressly upheld and followed *Mills v. Electric Auto-Lite Co*., 396 U.S. 375, 385 (1970) (holding causation established when the challenged proxy statement is an "essential link" in the transaction."); s*ee also Grace,* 228 F.3d at 47.

The business judgment rule has no application because the SAC charges a miscarriage of the suffrage process, including a false and fundamentally deceptive Proxy Statement, in a major

Once a disclosure is made, that information must not be misleading. *MONY Group*, 852 A.2d at 24-25. Although "Delaware law does not require disclosure of inherently unreliable or speculative information which would tend to confuse stockholders or inundate them with an overload of information," once a company "travel[s] down the road of partial disclosure of the history leading up to the [Transaction]. . . [it has] an obligation to provide the stockholders with an accurate, full and fair characterization of those historic events." *Arnold v. Society for Savings Bancorp, Inc.*, 650 A.2d 1270, 1280 (Del. 1994); *Lynch v. Vickers Energy Corp.*, 383 A.2d 278, 281 (Del. 1977); *MONY Group*, 852 A.2d at 27; *see also Freedman v. Restaurant Assoc. Industries, Inc.*, 1990 Del. Ch. LEXIS 142 at *15, *24 (Del. Ch. Sept. 19, 1990) (in a proxy statement, "where management chooses to disclose its motives or the purposes of a transaction, it has an obligation to disclose those purposes honestly and candidly.").

The FINRA Defendants contend that because of NASD's status as an SRO, they have no fiduciary duties to Standard and the Members of the Class, all of whom were NASD Members at the time of their vote upon the proposed By-Law changes and the Transaction. Surely the FINRA Defendants' position cannot be that they have no obligation to tell the truth. The NASD Board minutes discuss fiduciary duties owed to the Members on financial matters. *See* Exhibit 1 to Cuneo Decl. Plainly, the sheer number of cases brought against SROs and their directors for breach of fiduciary obligations undermines its position now. *See e.g., Wey*, No. 602510/05, Slip. Op. at 15-18 (N.Y. Sup. April 10, 2007); *Hyman*, 848 N.Y.S.2d at *1; *Ginsburg*, 2007 WL 1703421, *1; *Higgins,* 806 N.Y.S.2d at 347; *In re NYSE/Archipelago Merger Litig.*, 824

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change-of-control transaction that damaged NASD Members, not the NASD itself. *See Unocal v. Mesa Petroleum Co.,* 493 A.2d 946, 954 (Del. 1985). To the extent the FINRA Defendants are saying that the NASD Board was responsible for the manipulation of the process, that assertion compounds, not lessens, their culpability. The business judgment rule generally protects the decision-making process vis-à-vis the corporation itself. *See In re Citigroup Shareholder Derivative Litigation* 964 A.2d 106, 124, n. 50-53 (Del. Ch. 2009).

N.Y.S.2d 764, *5. At minimum, Defendants' assertions regarding the extent of their fiduciary duties to Plaintiff and the Class, were they to be entertained, are fact-dependent.[39]

Indeed, the SEC correctly recognizes that state-chartered SROs (as well as their directors) owe fiduciary obligations to their members and that these obligations are derived from state law.[40] Delaware courts also recognize such claims when asserted against a not-for-profit corporation and its board.[41]

3. The SAC States a Valid Claim for Aiding and Abetting Against NYSE.

The SAC also states claims under Delaware law for aiding and abetting against NYSE. In order to state a claim for aiding and abetting a breach of fiduciary duty that will survive a Rule

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[39] The NASD Certificate of Incorporation gives a limited exemption for fiduciary claims by Members against governors, thus implying that such a fiduciary duty in fact exists. Since amended, this Certificate of Incorporation was in force at the time of the Transaction. *See* Restated Certificate of Incorporation of National Association of Securities Dealers, Inc. (available at http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=4589). Presumably, such an exemption would be superfluous if no fiduciary duty existed.

[40] The SEC has stated with respect to SROs that "directors have fiduciary obligations under state law." 69 FED. REG. at 71140.

[41] *Oberly v. Kirby*, 592 A.2d 445 (Del. 1991). It is simply not true, as the FINRA Defendants contend, that a fiduciary obligation would exist under the circumstances of this case only if the NASD were a for-profit corporation in which NASD Members were owner-shareholders. Numerous contrary examples abound that prove the FINRA Defendants wrong. One prominent example arises in the context of an insurance company's conversion from mutual to stock form. A number of courts have concluded that although an insurance company owes a policyholder no fiduciary duty with respect to the disposition of claims and related matters, it does owe policyholders a fiduciary duty with respect to the treatment of their equity in the company when it converts to for-profit status. The courts have reached this conclusion even though the policyholders' equity or ownership interest, like the NASD Members' Equity here, does not take the form of stock ownership. *See, e.g., Reiff v. Evans*, 630 N.W.2d 278, 291 (Iowa 2001); *Heritage Healthcare Serv., Inc. v. The Beacon Mut. Ins. Co.,* 2004 WL 253547, *11-13 (R.I. Sup. Ct. Jan. 21, 2004); *Silverman v. Liberty Mut. Ins. Co.*, 2001 WL 810157, *6 (Mass. Super. 2001). Even the case that Defendants rely upon, *Crosse v. BCBSD, Inc.*, 836 A.2d 492 (Del. Sup. 2003), employs a nuanced, interest-based analysis to the particular relationships involved in a non-profit health services corporation. Significantly, that case did not involve allegedly false promises to pass on savings that the plan received to the beneficiaries and certainly did not involve traditional proxy protections.

12(b)(6) motion, a plaintiff must allege: (1) the existence of a fiduciary relationship; (2) the fiduciary breached its duty; (3) a defendant, who is not a fiduciary, knowingly participated in a breach; and (4) damages to the plaintiff resulted from the concerted action of the fiduciary and the non-fiduciary. *In re General Motors (Hughes) S'holder Litig.*, 2005 WL 1089021, *23 (Del. Ch. May 4, 2005). "A claim of knowing participation need not be pled with particularity. However, there must be factual allegations in the complaint from which knowing participation can be reasonably inferred. If such facts are not pled, then in order to infer knowing participation, the plaintiff must have alleged that the fiduciary breached its duty in an inherently wrongful manner." *Id.* at *94 (citations omitted).

Plaintiff has pled facts that establish NYSE had "knowing participation" in the breaches of fiduciary duty discussed above. *See, e.g.* SAC ¶ 16. The NYSE, and its agents or employees, and especially those representatives who negotiated the terms of the Transaction would have an inherent sense, and a ready access to full knowledge, of the true value of the NASD, NYSE and the fiduciary duties owed by the FINRA Defendants to the Members of the Class.

The allegations of the SAC clearly specify NYSE's knowledgeable participation in the FINRA Defendants' breaches of fiduciary duty. Plainly, a sophisticated investor/business partner such as NYSE participated in the knowingly inadequate proposed $35,000 payment to NASD Members. This inadequacy would have been particularly obvious to NYSE when compared to the value of the consequent control of the merged entity being obtained by NYSE's own members and NASD Members' Equity of at least $1.6 billion, which, as alleged in the SAC, was well in excess of $35,000 per Member. Moreover, as alleged in the SAC, NYSE helped draft the By-Laws and negotiated the terms of the consolidation in addition to actively soliciting, directly and through its membership, NASD Members' votes in favor of the Transaction. Given

these facts, such a sophisticated entity demonstrates its "knowing participation" in the FINRA Defendants' breaches of fiduciary duty. Inferring such knowing conduct by elite Wall Street entities that have particular skills and understanding, and, in this case, direct access to information has been upheld under Delaware law in the context of a motion to dismiss a claim for aiding and abetting. *In Re eBay, Inc. Shareholders Litig.*, 2004 WL 253521, *5 (Del. Ch. Jan. 23, 2004); *In Re Shoe-Town, Inc. Stockholders Litig.*, 1990 WL 13475, *8 (Del. Ch. Feb. 12, 1990).

Even assuming for the moment that these allegations did not establish "knowing participation," the actions of the FINRA Defendants satisfy the standard for "inherently wrongful" breaches of fiduciary duty that allow inference of knowing conduct by NYSE for the allegations to be upheld at the motion to dismiss stage. *See, e.g.*, *In re General Motors (Hughes) Shareholder Litig.*, 2005 WL 1089021, *24 (Del. Ch. May 4, 2005). The SAC alleges that NYSE knew that Standard and other Class Members were receiving inadequate consideration to relinquish control of NASD and its assets. SAC ¶ 25. Without a control premium being paid to NASD Members, NYSE had to know that such conduct on the part of the FINRA Defendants was "inherently wrongful," particularly since NYSE undoubtedly knew that the IRS had not, as of the dates of the Proxy Statement and the NASD Members' vote, provided any limitation on the maximum that could be paid to NASD Members. It undoubtedly also knew that the FINRA Defendants' representations in the Proxy Statement with respect to the purported IRS position were false and misleading.

4. Plaintiff States a Valid Claim Against NYSE for Unjust Enrichment.

In the SAC, Plaintiff alleges sufficient facts to state a claim for unjust enrichment against NYSE. The elements of a claim for unjust enrichment are: (1) an enrichment; (2) an

impoverishment; (3) a relation between the enrichment and the impoverishment; (4) the absence of justification; and (5) the absence of a remedy provided by law. *B.A.S.S. Group, LLC v. Coastal Supply Co.*, 2009 WL 1743730, *6 (Del. Ch. June 19, 2009).

Defendant NYSE received substantial payments from NASD totaling over $118 million. For NYSE Member firms, on whose behalf NYSE negotiated with NASD and its senior officers, that payment was all excess and unjust compensation, as they also experienced significantly reduced operating and transaction costs by the elimination of dual NASD and NYSE regulatory responsibilities. *See, e.g.,* SAC ¶ 105. In contrast, the $118 million payment was a purely uncompensated loss to Standard and the other Class Members. These Class Members were not subject to any NYSE role before the Transaction and their equity interest in NASD was harmed by these payments of more than $118 million to NYSE. Effectively, those payments came from Standard and each NASD Member *pro rata* from Members' Equity. This injury flows directly to NASD Members who were not dual members and resulted in an unjust enrichment of NYSE. *See* SAC ¶ 36. There is no adequate remedy for Standard and the other Class Members against NYSE at law.

5. Defendants' Arguments About Fiduciary Obligations Should Not Be Considered on a 12(b)(6) Motion.

The Court should not even address Defendants' arguments about fiduciary obligations at this stage. Plaintiff has exceeded its notice pleading obligations by alleging that the FINRA Defendants acted as fiduciaries in the context of the Transaction and the dissemination of the Proxy Statement in connection therewith. *See*, *e.g.,* SAC ¶ 5.

Fiduciary status raises complex issues of fact, in addition to law, the resolution of which should generally await the development of an evidentiary record. They should not usually be decided at the summary judgment stage, let alone the motion to dismiss stage. *See*, *e.g., Liss v.*

Smith, 991 F. Supp. 278, 304 (S.D.N.Y. 1998). Defendants rely upon critical factual statements that flatly contradict their own documents – among them the statement that "NASD Members have no claim to NASD assets." FINRA Mem. at 27; *contra* NASD 2005 Annual Report (specifically referring to "Members Equity") (available at http://www.finra.org/AboutFINRA/AnnualReports/index.htm).

The FINRA Defendants contend here that they were never fiduciaries because NASD/FINRA stands, sometimes, in an adversarial relationship with specific Members with respect to specific disciplinary and related matters. *See* FINRA Mem. at 32. However, such matters are not even remotely the subject of Standard's claims. Moreover, fiduciary status is not an all-or-nothing proposition. A person can be – and often is – a fiduciary with respect to one action, but not another. *See*, *e.g., In re Polaroid ERISA Litig.*, 362 F. Supp.2d 461, 472 (S.D.N.Y. 2005). Plaintiff does not allege, contend or even imply in the SAC, contrary to Defendants' suggestion, that the FINRA Defendants acted in a fiduciary capacity in all their dealings with NASD Members. Plaintiff alleges only that the FINRA Defendants acted as fiduciaries with respect to the particular actions challenged in the SAC's fiduciary duty counts. Chief among those challenged actions was the dissemination of a deceptive Proxy Statement that misrepresented and failed to disclose critical aspects of the Transaction, none of them more important in this case than the treatment of what the NASD itself calls "Members Equity" and the Members' entitlement thereto in the form of the Special Members' Payment and otherwise. As to those matters at least, the FINRA Defendants owed fiduciary duties to Standard and other Members of the Class, all of whom were NASD Members as of the dates of the Proxy Statement and the Member vote thereafter.

6. The Unpublished NYMEX Opinion Clearly Supports Plaintiff's Position.

In re NYMEX Shareholder Litigation involves the acquisition by a publicly traded company of a post-demutualization holding company that owned NYMEX. *See generally*, 2009 WL 3206051 (Del. Ch. Sept. 30, 2009).[42] From 1872 to 2000, NYMEX Exchange operated as a New York not-for-profit membership organization. *Id.* at *2. In 2000, it was demutualized and converted into a Delaware not-for-profit entity with a subsidiary membership company. *Id.* As a result of the demutualization, seatholders became Class A members and received trading privileges and stock. *Id.* at *2-3. The plaintiffs challenged the reliability and fairness of the fairness opinion for Class A memberships. *Id.* at *4-5

The Court discusses when a fiduciary duty arises and finds that "'an existing property right or equitable interest supporting such a duty must exist.'" *Id.* at *19 (quoting *Simons v. Cogan*, 549 A.2d 300, 303 (Del. 1988). The Court specifically found that "[b]efore NYMEX's 2000 demutualization, such a fiduciary relationship existed. . . However, the demutualization severed Members' equity stake in the exchange and transferred it into an equity stake in NYMEX holdings." *In re NYMEX S'holder Litig.*, 2009 WL 3206051 at *19. Class A rights became contractual rights. *Id.*

The Court found that Plaintiff's assertion that members in a non-stock corporation are owed the same fiduciary duties by the corporations' governing body as a shareholder in a stock corporation to be "overbroad," but not "unfounded." *Id.* The inquiry does not turn on whether it is a stock or non-stock corporation. *Id.* Rather, the relevant question is whether there is a separation of legal control from beneficial ownership with respect to a valid property interest "necessary for the imposition of a trust relationship with concomitant fiduciary duties." *Id.* "For a fiduciary duty to be created, there must be both (1) a property or other equitable interest; and

[42] Under applicable Delaware Supreme Court and Chancery Court rules, citation to unreported opinions is permissible. *See* Del. Sup. Ct. R. 14(b)(vi)(4); Del. Ch. Ct. R. 171(h).

(2) the ceding of legal control over the property interest, such that the owner 'reposes a special trust in and reliance on the judgment of those in control.'" *Id.* at 20.

Until this case was commenced, NASD's Annual Reports repeatedly recognized Members' Equity of at least $1.6 billion. After suit was commenced, all references to Members' Equity curiously disappeared from the subsequent NASD and FINRA Annual Reports. Surely it cannot be the case that at the end of 2005, NASD Members were entitled to their equity interest – over $1.6 billion from the sale of NASDAQ – only to have that equity interest disappear in 2006 and later due to wording in an NASD or FINRA Annual Report. Any consideration of this about-face must necessarily juxtapose FINRA's current position against what Defendants told the proposed Class orally and in writing. Indeed, NASD's own internal memorandum indicates that when Defendant Schapiro was asked a pointed question about the source of the $35,000 payment to NASD Members she confessed, "Mary [Schapiro] said that this was cost savings, but upon further probing, said that yes, the money is coming from Nasdaq proceeds." Recon. Mot. Exh. E, Minutes of Boca Raton Member Meeting, December 12, 2006. Defendants are doing nothing more than playing a sophisticated shell game with their Members, and this Court should not countenance such behavior from the very individuals and entities charged with regulating the transparency of our financial system.

CONCLUSION

For all the foregoing reasons and any that may be raised at a hearing on Defendants' motions to dismiss, Plaintiff respectfully requests that the Court deny such motions and permit the litigation to proceed to trial.

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Respectfully submitted,

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