FILED UNDER SEAL PURSUANT TO
CALIFORNIA RULE OF COURT 8.46

No. A135682

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA
FIRST APPELLATE DISTRICT, DIVISION ONE

OVERSTOCK.COM, INC., *et al.*,

Plaintiffs-Appellants,

v.

GOLDMAN, SACHS & CO., *et al.*,

Defendants-Respondents,

Appeal from a Judgment of the California Superior Court,
County of San Francisco
Case No. CGC-07-460147, Hon. John E. Munter

RESPONDENTS' BRIEF OF DEFENDANTS MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED AND MERRILL LYNCH PROFESSIONAL CLEARING CORP.

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CERTIFICATE OF INTERESTED ENTITIES OR PERSONS

Defendants-Respondents Merrill Lynch, Pierce, Fenner & Smith Incorporated and Merrill Lynch Professional Clearing Corp. file this Certificate of Interested Entities or Persons under Rule of Court 8.208.

The undersigned counsel certifies that the following entities or persons have an ownership interest of 10 percent or more in Merrill Lynch, Pierce, Fenner & Smith Incorporated: Bank of America Corporation. The undersigned counsel also certifies that the following entities or persons have an ownership interest of 10 percent or more in Merrill Lynch Professional Clearing Corp.: Bank of America Corporation. The Merrill Lynch entities are aware of no other person or entity with an interest required to be disclosed.

Dated: March 20, 2013

O'MELVENY & MYERS LLP

By
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Attorneys for Defendants-Respondents and Appellants Merrill Lynch, Pierce, Fenner & Smith Incorporated and Merrill Lynch Professional Clearing Corp.

TABLE OF CONTENTS

Page

PRELIMINARY STATEMENT 1
STATEMENT OF THE CASE 8
A. Overstock's History of Significant Losses 8
B. The Merrill Lynch Entities' Prime Brokerage and Clearing Businesses 9
C. The National Clearance and Settlement System 10
D. Federal Regulation of Short Selling 11
1. Reg SHO's "Locate" Requirement 11
2. Reg SHO's "Close-Out" Requirement 14
E. Merrill Pro's Policies and Procedures for Settling Market-Maker Short Sales 16
F. Plaintiffs' Theory of Liability 17
G. The Superior Court's Summary Judgment Decision 20
STANDARD OF REVIEW 22
ARGUMENT 22
I. Plaintiffs Submitted No Evidence of a Section 25400 Violation 22
A. Plaintiffs submitted no evidence that either Merrill Lynch entity engaged in transactions prohibited by Section 25400 24
1. The Merrill Lynch entities cannot be held liable under Section 25400 for transactions in which they were neither a purchaser nor a seller 24
2. The Section 10(b) cases Plaintiffs cite do not support their attempt to extend Section 25400 28
B. Plaintiffs submitted no evidence that Merrill Pro's clients engaged in transactions prohibited by Section 25400 31
II. Plaintiffs Submitted No Evidence of Market Manipulation in California 34
A. Plaintiffs submitted no evidence that the Merrill Lynch entities' allegedly manipulative conduct occurred in California 35
B. Plaintiffs submitted no evidence that any allegedly manipulative transactions occurred in California 37
1. Section 25400 requires offer or acceptance in California 38

TABLE OF CONTENTS
(continued)

Page

2. Stock transactions on the Pacific Exchange did not take place in California 40
3. Plaintiffs cannot show manipulative transactions in California by relying on Merrill Pro's clearing activity 43
4. Cooper's California location does not establish manipulative transactions in California 47
5. Plaintiffs submit no evidence showing that Merrill Pro's "X-Trade" platform was located in California during the relevant period 48
6. A single Merrill Pro client with a California address does not establish that manipulative Overstock transactions occurred in California 49

III. Plaintiffs Failed to Create a Triable Issue of Fact As to Whether Any Defendant Caused Their Alleged Injury 50

A. Defendants shifted the burden to Plaintiffs to create a triable issue of fact on causation 50

B. Dr. Shapiro's declaration lacks foundation and should not have been admitted into evidence 52

1. Dr. Shapiro's "signaling" theory lacks foundation 53

(a) Dr. Shapiro's Granger test cannot prove causation 54

(b) Dr. Shapiro does not opine that any additional short selling resulting from Defendants' failures-to-deliver caused Overstock to reach the 1% short-interest threshold 57

2. Dr. Shapiro's "quantity" theory is not supported by any analysis or calculations 57

C. Dr. Shapiro's declaration is insufficient to create a triable issue of fact regarding causation 59

1. Dr. Shapiro does not opine that manipulative conduct or transactions in California caused injury to Plaintiffs 60
2. Dr. Shapiro does not opine that any particular Defendant's conduct caused injury to Plaintiffs 61

IV. Plaintiffs Submitted No Evidence of Scienter 61

TABLE OF CONTENTS
(continued)

Page

V. California Courts Lack the Power to Provide a Remedy for Merrill Pro's Failure to Deliver Overstock Shares to CNS 64

A. The federal courts have exclusive jurisdiction over Plaintiffs' claims because Plaintiffs seek to enforce delivery obligations created by Regulation SHO..........................64

B. Plaintiffs' claims are preempted by Reg SHO, which specifically authorizes the conduct they label "market manipulation" under California law...67

1. Plaintiffs' interpretation of Section 25400 conflicts with Reg SHO's close-out requirement, market-maker exemption, and allocation provision...................................68

2. Plaintiffs cannot avoid preemption by asserting that federal law and California law share the goal of preventing market manipulation 70

VI. The Superior Court's Decision on the New Jersey RICO Claim Should Be Affirmed..72

CONCLUSION...72

TABLE OF AUTHORITIES

Page(s)

CASES

ABC Charters v. Bronson,
591 F. Supp. 2d 1272 (S.D. Fla. 2008) 71

Am. Ins. Ass'n v. Garamendi,
539 U.S. 396 (2003) 71

Anschutz Corp. v. Merrill Lynch & Co.,
690 F.3d 98 (2d Cir. 2012) 34, 39

Bell v. H.F. Cox, Inc.,
209 Cal. App. 4th 62 (2012) 22, 50

California Amplifier, Inc. v. RLI Ins. Co.,
94 Cal. App. 4th 102 (2001) .... *passim*

Capece v. Depository Trust & Clearing Corp.,
2005 WL 4050118 (S.D. Fla. Oct. 11, 2005) 66

Cohen v. Stevanovich,
722 F. Supp. 2d 416 (S.D.N.Y. 2010) 62

Cole v. Patricia A. Meyer & Assocs., APC,
206 Cal. App. 4th 1095 (2012) 61

Crosby v. Nat'l Foreign Trade Council,
530 U.S. 363 (2000) 70

D'Alessio v. N.Y. Stock Exch., Inc.,
258 F.3d 93 (2d Cir. 2001) 66

Diamond Multimedia Sys., Inc. v. Superior Court,
19 Cal. 4th 1036 (1999) .... *passim*

Dillon v. Militano,
731 F. Supp. 634 (S.D.N.Y. 1990) 26, 29

Fezzani v. Bear, Stearns & Co.,
384 F. Supp. 2d 618 (S.D.N.Y. 2004) 30

Geffcken v. D'Andrea,
137 Cal. App. 4th 1298 (2006) 58

TABLE OF AUTHORITIES
(continued)

Page

Great Am. Ins. Cos. v. Gordon Trucking, Inc.,
165 Cal. App. 4th 445 (2008) 51

Hawkins v. NASD,
149 F.3d 330 (5th Cir. 1998) 65, 66

Heit v. Weitzen,
402 F.2d 909 (2d Cir. 1968) 29

In re Blech Secs. Litig.,
928 F. Supp 1279 (S.D.N.Y. 1996) ("*Blech I*") 29

In re Blech Secs. Litig.,
961 F. Supp. 569 (S.D.N.Y. 1997) ("*Blech II*") 30

In re DVI, Inc. Secs. Litig.,
639 F.3d 623 (3d Cir. 2011) 56

In re Imperial Credit Indus. Secs. Litig.,
252 F. Supp. 2d 1005 (C.D. Cal. 2003) 57

In re Nvidia Corp. Secs. Litig.,
2010 WL 4117561 (N.D. Cal. Oct. 19, 2010) 56

In re Omnicom Grp., Inc. Secs. Litig.,
541 F. Supp. 2d 546 (S.D.N.Y. 2008),
aff'd, 597 F.3d 501 (2d Cir. 2010) 60

In re Sci. Atlanta, Inc. Sec. Litig.,
754 F. Supp. 2d 1339 (N.D. Ga. 2010), *aff'd sub nom. Phillips v. Sci.-Atlanta, Inc.*, 489 F. App'x 339 (11th Cir. Sept. 6, 2012) 60

In re Victor Techs. Secs. Litig.,
102 F.R.D. 53 (N.D. Cal. 1984) 39

In re Williams Secs. Litig.,
496 F. Supp. 2d 1195 (N.D. Okla. 2007),
aff'd, 558 F.3d 1130 (10th Cir. 2009) 57

Johnson v. City of Loma Linda,
24 Cal. 4th 61 (2000) 22

TABLE OF AUTHORITIES
(continued)

Page

Kamen v. Lindly,
94 Cal. App. 4th 197 (2001) 20, 26, 27, 28

Kight v. CashCall, Inc.,
200 Cal. App. 4th 1377 (2011) 22, 50

Korsak v. Atlas Hotels, Inc.,
2 Cal. App. 4th 1516 (1992) 52

La. Pac. Corp. v. Money Mkt. 1 Institutional Inv. Dealer,
2011 WL 1152568 (N.D. Cal. Mar. 28, 2011)...................................... 63

Laabs v. City of Victorville,
163 Cal. App. 4th 1242 (2008) 52

Levitt v. J.P. Morgan Secs, Inc.,
270 F.R.D. 127 (E.D.N.Y. 2010) 31

Levitt v. J.P. Morgan Secs, Inc.,
2013 WL 1007678 (2d Cir. Mar. 15, 2013)........................... 9, 25, 31, 43

Lopes v. Vieria,
2011 WL 1883157 (E.D. Cal. May 17, 2011) 28

Lowe v. NASD Regulation Inc.,
1999 WL 1680653 (D.D.C. Dec. 14, 1999)... 66

Lubin v. Sybedon Corp.,
688 F. Supp. 1425 (S.D. Cal. 1988).. 39

Mayo v. Dean Witter Reynolds, Inc.,
258 F. Supp. 2d 1097 (N.D. Cal 2003) 71

Mirkin v. Wasserman,
5 Cal. 4th 1082 (1993) 26

Nanopierce Techs., Inc. v. Depository Trust & Clearing Corp.,
123 Nev. 362 (Nev. 2007) 67, 70

Nardizzi v. Harbor Chrysler Plymouth Sales, Inc.,
136 Cal. App. 4th 1409 (2006) 58

TABLE OF AUTHORITIES
(continued)

Page

Openwave Sys. Inc. v. Fuld,
2009 WL 1622164 (N.D. Cal. June 6, 2009) 20, 27, 28

Opulent Fund, L.P. v. Nasdaq Stock Mkt., Inc.,
2007 WL 3010573 (N.D. Cal. Oct. 12, 2007) 66

People v. Bassett,
69 Cal. 2d 122 (1968) 58

People v. Prince,
40 Cal. 4th 1179 (2007) 22

Pet Quarters, Inc. v. Depository Trust & Clearing Corp.,
545 F. Supp. 2d 845 (E.D. Ark. 2008) 67, 70

Pickett v. IBP, Inc.,
2003 WL 24275809 (M.D. Ala. Apr. 10, 2003) 56

Pope Invs. II LLC v. Deheng Law Firm,
2011 WL 5837818 (S.D.N.Y. Nov. 21, 2011) 63

Sangster v. Paetkau,
68 Cal. App. 4th 151 (1998) 49

Sargon Enters., Inc. v. Univ. of So. Cal.,
55 Cal. 4th 747 (2012) 52

Sparta Surgical Corp. v. NASD,
159 F.3d 1209 (9th Cir. 1998) 66

Spicer v. Chicago Bd. Options Exch., Inc.,
1990 WL 172712 (N.D. Ill. Oct. 30, 1990) 23

Sullivan & Long v. Scattered Corp.,
47 F.3d 857 (7th Cir. 1995) 64

Union Bank v. Superior Court,
31 Cal. App. 4th 573 (1995) 51

United States v. Ferrarini,
9 F. Supp. 2d 284 (S.D.N.Y. 1998) 29

TABLE OF AUTHORITIES
(continued)

Page

Whistler Invs., Inc. v. Depository Trust & Clearing Corp.,
539 F.3d 1159 (9th Cir. 2008) 67, 68, 70

Whitehall Wellington Invs., Inc. v. NASD,
2000 WL 1846129 (S.D. Fla. Dec. 7, 2000) 66

Wright v. Bloom,
2012 WL 6000960 (N.D. Cal. Nov. 30, 2012) 28

Young v. Bates Valve Bag Corp.,
52 Cal. App. 2d 86 (1942) 58

STATUTES

Cal. Civ. Proc. Code § 437c(c) 52

Cal. Corp. Code § 25008 .... *passim*

Cal. Corp. Code § 25400 .... *passim*

Cal. Corp. Code § 25500 .... *passim*

Cal. Corp. Code § 25504 27

Cal. Evid. Code § 801 .... 46, 52

Securities Exchange Act of 1934, Section 9,
15 U.S.C. § 78i(a) 26

Securities Exchange Act of 1934, Section 10(b),
15 U.S.C. § 78j(b) .... *passim*

Securirites Exchange Acto of 1934, Section 17A,
15 U.S.C. § 78q-1(a) 10

Securities Exchange Act of 1934, Section 27,
15 U.S.C. § 78aa(a) 7, 64, 65, 66

TABLE OF AUTHORITIES
(continued)

Page

RULES AND REGULATIONS

17 C.F.R. § 242.203(b) .... *passim*

17 C.F.R. § 242.203(c)(6) 14

NASD Rule 11830 11

NYSE Rule 3370(b)(2) 11

NYSE Rule 440C.10 11

OTHER AUTHORITIES

C.W.J. Granger, *Testing for Causality: A Personal Viewpoint*, J. Econ. Dynamics & Control (1980) 55

Depository Trust & Clearing Corporation, *DTCC's Updated Critique of Section 4.1 of Prof. Finnerty's paper, "Short Selling, Death Spiral Convertibles and the Profitability of Stock Manipulation"* (Jan. 24, 2006) 58

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PRELIMINARY STATEMENT

Plaintiffs claim that New York-based Merrill Pierce and its wholly owned subsidiary Merrill Pro[1] manipulated the market for Overstock common stock in California. Plaintiffs originally sued only Merrill Pierce on the theory that it had done so by engaging in "naked" short selling of Overstock shares. But after discovery revealed that premise to be false, Plaintiffs added Merrill Pro as a defendant and recast their claims as a referendum on Merrill Pro's policies and procedures for settling its market-maker clients' short sales. To be clear, Plaintiffs no longer allege that any purchases or sales of Overstock by either Merrill Pierce or Merrill Pro—in California or elsewhere—were manipulative in any way. Instead, Plaintiffs now contend that between August 2005 and December 2006 Merrill Pro's procedures for settling ***its clients'*** transactions constituted market manipulation under California Corporations Code Section 25400. Specifically, Plaintiffs argue that Merrill Pro's longstanding policy of intentionally failing to borrow and deliver stock in connection with short sales by market makers was "manipulative" and intended to depress Overstock's share price—even though Merrill Pro's policy applied across the board to all securities.

The Superior Court properly rejected Plaintiffs' claims. First, Section 25400 prohibits manipulative ***transactions***, not post-transaction settlement procedures, and it is undisputed that neither Merrill Pro nor Merrill Pierce engaged in any manipulative Overstock transactions.

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[1] Defendant Merrill Lynch, Pierce, Fenner & Smith Incorporated is referred to herein as "Merrill Pierce." Defendant Merrill Lynch Professional Clearing Corp. is referred to as "Merrill Pro." The Goldman Sachs Defendants "GS&Co." and "GSEC" are referred to collectively as "Goldman Sachs." Merrill Pierce and Merrill Pro join in the arguments in the Respondents' Brief of Goldman Sachs to the extent such arguments are applicable here.

Second, Section 25400 prohibits only manipulative conduct ***in California***, and Plaintiffs presented no evidence that Merrill Pierce's or Merrill Pro's settlement procedures were designed, implemented, or carried out in California. On either basis—or on any of the three additional bases described below that the Superior Court did not reach—the judgment should be affirmed.

Merrill Pierce and Merrill Pro provide a diverse array of financial services, but this case concerns their conduct as "clearing brokers," providing "clearing" and "settlement" services to their clients. "Clearing" is the process of comparing both sides of a trade to identify and resolve any discrepancies between how buyer and seller reported its terms. It occurs after a trade is executed, usually that night. "Settlement" is the process of exchanging money and shares between buyers and sellers. It typically occurs three business days later (on a net basis). While Merrill Pierce and Merrill Pro both act as clearing brokers, their businesses are different—Merrill Pierce primarily serves retail clients and broker-dealers with retail clients, while Merrill Pro primarily serves broker-dealers that act as professional investors.

Merrill Pierce also provides securities lending services. Specifically, after a client executes a short sale, Merrill Pierce clears and settles the transaction and charges the client a fee to borrow the stock sold short until the client purchases the stock to close out its short position. Merrill Pierce provides this service not only to its own clients, but also to Merrill Pro's clients and other broker-dealers.

During the relevant period, 2005-2006, the federal regulations governing short sales contained certain exemptions governing activity by market makers, *i.e.*, specialized broker-dealers who maintain liquidity in the marketplace by standing ready to buy and sell securities at bid and ask prices. To encourage market liquidity, federal law permitted market

makers (unlike other short sellers) to avoid the cost of borrowing stock that they sold short. Merrill Pro therefore implemented a "do-not-flip" procedure ***in New York*** that isolated market-maker short sales and ensured that stock would not be borrowed, and consequently not delivered, when settling those exempt transactions. The resulting "failures-to-deliver" were not permanent; federal law required that they be "closed out" by a stock purchase within 13 days. Merrill Pro therefore instituted another system, also ***in New York***, to track its market-maker clients' failure-to-deliver positions and confirm that they were closed out within the requisite 13 days. In other words, Merrill Pro put in place procedures to ensure its compliance with federal short-selling regulations that would not undermine the SEC's goal of ensuring that market makers would continue to provide market liquidity. None of those procedures was designed, implemented, or carried out in California, and Plaintiffs do not allege that Merrill Pro failed to follow its own procedures.

Nevertheless, Plaintiffs contend that Merrill Pro's settlement procedures violated Section 25400, the scope of which is limited to market manipulation ***in California***. Plaintiffs argue that Merrill Pro was obligated to disregard the federal market-maker exemption when its market-maker clients traded in Overstock and instead was required to borrow and deliver Overstock shares. But Plaintiffs can cite no rule or regulation supporting their position. Plaintiffs' convoluted theory of market manipulation is that if Merrill Pro had borrowed Overstock shares from Merrill Pierce to deliver on behalf of Merrill Pro's market-maker clients, then Merrill Pierce would have had less stock to supply to other clients that wanted to sell Overstock short. That would have supposedly prevented those other clients from short selling Overstock shares and thus inflated their price. Notably, Plaintiffs have no complaint with Merrill Pierce's clearance or settlement procedures—it had no market-maker clients to be exempted from federal

delivery requirements and therefore few failures-to-deliver—but imply that it should be held liable as the "beneficiary" of Merrill Pro's do-not-flip policy because that policy permitted Merrill Pierce to lend more shares to other clients.

While Plaintiffs' theory is saddled with flaws, the most glaring is that even if Plaintiffs are correct that Merrill Pro misapplied the federal market-maker exemption, Merrill Pro's settlement activities do not constitute a violation of Section 25400. Section 25400 is not a catch-all enforcement mechanism for every possible violation of a securities regulation—it prohibits only specific forms of market manipulation, such as wash sales, matched orders, or a series of transactions conducted for the purpose of inducing others to trade. Plaintiffs have not suggested, let alone submitted evidence, that Merrill Pro or Merrill Pierce was ever the buyer or seller in these types of manipulative transactions. In fact, Plaintiffs do not even suggest that either Merrill Pierce or Merrill Pro ***ever purchased or sold*** Overstock shares. This is fatal to Plaintiffs' claims, because courts and commentators uniformly agree that Section 25400 prohibits only manipulative market activity (*i.e.*, buying and selling), not after-the-fact clearance and settlement activity. (*See* pp. 22-31.)

The Superior Court could have based its grant of summary judgment solely on the fact that the Merrill Lynch entities did not purchase or sell Overstock securities. But the court went further, finding that Plaintiffs failed to meet their burden of creating a triable issue of fact as to whether any allegedly manipulative conduct occurred in California. The record evidence categorically established that the failures-to-deliver, as well as Merrill Pro's decision to fail to deliver its market makers' short sales, occurred ***in New York***. The evidence also established that Merrill Pro did not conduct any settlement operations in California and that Merrill Pierce did not conduct any securities lending operations in California. Thus, the

Superior Court correctly found no evidence that any of the alleged misconduct took place in California. (*See* pp. 34-37.)

Plaintiffs do not dispute these facts on appeal. Instead, they attempt to manufacture a California connection, arguing that clearing trades qualifies as "effecting" trades under Section 25400 and that Merrill Pro can be held liable because it cleared ***some*** Overstock transactions in California. But as the Superior Court correctly observed, Plaintiffs have never even alleged that Defendants' clearance activities (which occur on the night of the trade) were manipulative; Plaintiffs have only challenged Defendants' settlement activities (which occur three days later). In any event, the Overstock transactions that Plaintiffs contend were cleared in California were processed through an electronic clearing platform ***that had no failures to deliver***. Indeed, Plaintiffs' damages and causation expert testified that he did not even consider the transactions on that platform. The trades allegedly cleared in California thus have no connection to Plaintiffs' Section 25400 claims, and whether those particular transactions might have been "effected" in California is thus irrelevant.

Even though the Merrill Lynch entities did not engage in relevant (much less manipulative) conduct in California, Plaintiffs contend that Section 25400 nonetheless applies to their claims because Merrill Pro's market-maker clients allegedly executed Overstock short sales in California. But the Superior Court properly rejected this argument as well. Merrill Pro cannot be held liable for merely clearing allegedly manipulative transactions executed ***by others***. And Plaintiffs likewise did not present any evidence supporting their allegation that the clients' allegedly manipulative transactions occurred in California. Plaintiffs' primary evidence on this point was that several New York-based market-making clients executed Overstock short sales on the Pacific Exchange, which was located in Illinois and merely overseen by a San Francisco-based regulator. Under

California Corporations Code Section 25008, however, a transaction occurs "in this state" for purposes of Section 25400 only when the offer to buy or sell is made or accepted here. Thus, transactions on the Pacific Exchange did not occur in California simply because a regulator resided here (and Plaintiffs submitted no evidence of offers or acceptances for such trades occurring here). The Superior Court also properly rejected Plaintiffs' secondary argument that manipulative transactions occurred in California simply because a San Francisco-based Merrill Pro employee communicated with a New York-based client about his trading. (*See* pp. 37-50.)

Either of those reasons, *i.e.*, no evidence of manipulative trades by Merrill Pro or Merrill Pierce and no evidence that alleged misconduct occurred in California, was sufficient for the Superior Court to grant summary judgment in Defendants' favor. Moreover, there are at least three additional grounds to dispose of the case that the Superior Court did not need to reach.

First, Plaintiffs did not create a triable issue that any Defendant caused their alleged injury (*i.e.*, artificially depressed Overstock's share price) because their causation expert was unable to attribute any decline in Overstock's share price to the conduct Plaintiffs claim was improper. Plaintiffs' sole evidence of causation and injury was a declaration from Dr. Robert Shapiro, who began by improperly relying on a ***correlation*** test to find ***causation***. He then aggregated ***all*** failures-to-deliver in Overstock, without distinguishing those that might be actionable against a particular Defendant under California law from the rest. His opinion is therefore only that Merrill Pro's settlement of ***all*** market-maker short sales that resulted in failures-to-deliver ***collectively*** (that is, those claimed by Plaintiffs to be manipulative together with lawful transactions), and ***combined*** with GSEC's own aggregate failures-to-deliver (again, lumping together both lawful and allegedly manipulative transactions), might have reached a

threshold that caused Overstock's share price to decline. He offered no opinion on whether the relevant subset of the transactions—*i.e.*, transactions that Plaintiffs say were manipulative, that involved Merrill Pro, and that occurred in California—would have reached such a threshold or otherwise had any effect on Overstock's stock price. Nor did Dr. Shapiro suggest any injury from Merrill Pierce's conduct at all. (*See* pp. 50-61.)

Second, Plaintiffs have no evidence of the scienter required by Section 25400. Indeed, Plaintiffs have never suggested, let alone submitted evidence, that Merrill Pro adopted its do-not-flip policy in order to deceive the market into driving down Overstock's stock price. Plaintiffs concede as much when they argue that Merrill Pro took advantage of the federal market-maker exemption (for all stocks, not just Overstock) in order to maximize Merrill Pierce's securities lending profits. To be clear, those alleged profits are from earned fees—Plaintiffs do not contend that Merrill Pierce or Merrill Pro ever bought, sold, or shorted Overstock shares. Scienter cannot be inferred from a company's own legitimate interest in earning client fees. (*See* pp. 61-63.)

Third, California courts lack the power to provide Plaintiffs a remedy for the conduct they complain of. Under Section 27 of the Securities Exchange Act of 1934, only the federal courts have jurisdiction to determine whether Merrill Pro properly made use of the federal market-maker exemption. And California law cannot impose a delivery obligation on Merrill Pro that the SEC explicitly chose not to levy. (*See* pp. 64-72.)

Accordingly, the decision below should be affirmed and Plaintiffs' misguided attack on Merrill Pro's settlement practices put to an end.

STATEMENT OF THE CASE[2]

A. Overstock's History of Significant Losses

Plaintiff Overstock.com, Inc., is a Utah-based online retailer that sells "brand name merchandise at heavily discounted prices." (1 AA A0095, ¶ 2; 1 AA A0098, ¶ 18.)[3] Overstock, which admits to "a history of significant losses," reported disappointing financial results throughout the relevant period. (3 DA D000447; 3 DA D000657.) Indeed, in 2005 and 2006—the two years in which Plaintiffs claim Defendants depressed Overstock's stock price—Overstock reported record losses of $25.2 million and $106.8 million, respectively. (3 DA D000657.)

Overstock was also repeatedly forced to restate its financial results and defend several regulatory investigations into its accounting practices. In February 2006, for example, Overstock admitted accounting errors and withdrew its financial reports for 2004 and 2005. (*See* 2 DA D000408.) Three months later, in May 2006, Overstock disclosed the first of a series of SEC investigations into its conduct. (2 DA D000337.) Nevertheless, Plaintiffs blame Defendants for Overstock's share-price decline between August 2005 and December 2006. (*See* 13 PA P3201-02, ¶ 7.)

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[2] Merrill Pierce and Merrill Pro also refer the Court to the more detailed procedural history set forth in Goldman Sachs' Brief.

[3] Plaintiffs' Opening Brief ("POB") cites three appendices from this and two earlier appeals. For consistency, this brief cites to the same record, along with Defendants' accompanying appendix, and uses the same citation format. Accordingly, the record consists of (i) the Appendix of Defendants-Respondents, cited as "[vol] DA [page]"; (ii) Plaintiffs' Appellants' Appendix, cited as "[vol] PA [page]"; (iii) Appellants' Appendix filed by Plaintiffs in No. A133487, cited as "[vol] AA [page]"; and (iv) the Consolidated Appendix filed by Defendants in Nos. A133487 and A135180, cited as "[vol] CA [page]." The Reporters' Transcript is cited as "[vol] RT [page]." Unless otherwise stated, all emphases in quotations are added and internal citations, footnotes, and quotation marks are omitted.

B. The Merrill Lynch Entities' Prime Brokerage and Clearing Businesses

Merrill Pierce is a full-service broker-dealer that engages in a variety of prime brokerage activities. (*See* 10 PA P2370, ¶ 4.) Merrill Pro acts principally as a clearing firm for other broker-dealers, allowing them to outsource back-office functions like cashiering, recordkeeping, and the clearing and settling of securities transactions. (9 PA P2159, ¶ 4.) Merrill Pro is one of the leading clearing firms for options market makers—independent SEC-registered broker-dealers that are accredited members of one or more of the nation's option exchanges. (9 PA P2159-60, ¶ 7.)

Unlike retail investors, options market makers generally execute their transactions themselves and engage a firm such as Merrill Pro to perform only the related clearing, settlement, and recordkeeping functions. (See 9 PA P2159-60, ¶¶ 5-7.) "Clearing" is the computerized process of comparing trade reports from thousands of buyers and sellers to ensure that they match. (91 CA C021532, n.5 (citing 3 DA D000676-91).)[4] It occurs after a trade is executed, usually that night. (91 CA C021532, n.5.) "Settlement" is the process, also automated, of exchanging money and shares. (*Id.*) It typically occurs three business days later. (*Id.*) Merrill Pierce and Merrill Pro earn fees for their services in clearing and settling securities transactions conducted by their clients but do not have a proprietary interest in their clients' transactions or the positions they create.

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[4] *See also Levitt v. J.P. Morgan Secs, Inc.*, ___ F. 3d ___, 2013 WL 1007678, at *1 (2d Cir. Mar. 15, 2013) ("Approximately ninety percent of the broker-dealers registered with the Securities and Exchange Commission hire a clearing broker to perform the back-office services associated with securities trading. Major clearing firms handle millions of trades daily on behalf of customers of hundreds of broker-dealers. A clearing broker's involvement in any given transaction typically begins after the execution of a trade, when the clearing firm processes, settles, and clears the transaction and prepares an appropriate trade confirmation to send to the customer.").

(*See* 10 PA P2371, ¶¶ 11-12; 9 PA P2162, ¶ 16.) The transactions are initiated by clients, the actual buyers and sellers of stock, who have sole exposure to the resulting profits and losses from those trades. (10 PA P2371, ¶¶ 8-11; 9 PA P2162, ¶ 14.)

C. The National Clearance and Settlement System

Federal authorities have established a national system for clearing and settling securities transactions. In 1975, Congress gave the SEC authority to establish that system. *See* 15 U.S.C. § 78q-1(a). The SEC thereafter approved the establishment of the National Securities Clearing Corporation ("NSCC") to facilitate the electronic clearance and settlement process for all stock trades among U.S. brokerage firms. In turn, the NSCC established the Continuous Net Settlement system ("CNS"), a computer system that accounts for the clearing and settlement of each member firm's daily trades on an aggregate basis. (*See* 4 DA D000867; *see also* 3 DA D000678, n.32) The SEC also approved the establishment of the Depository Trust Company ("DTC") to serve as a vault for virtually all of the nation's securities and maintain accounts for its members reflecting the ownership of those securities. (*See* 3 DA D000676; 3 DA D000690.) This system permits the transfer of securities with a simple book-entry adjustment to DTC accounts rather than a physical exchange of paper stock certificates. (3 DA D000679.)

Merrill Pierce and Merrill Pro, like all large U.S. brokerage firms, are members of the NSCC and DTC (9 PA P2159, ¶ 4; 10 PA P2370, ¶ 4), and clear and settle virtually all securities transactions, including virtually all transactions in Overstock stock, through CNS. (9 PA P2167, ¶ 31; 10 PA P2372, ¶ 14.) The CNS system nets all purchase and sale activity reported by member firms and provides each member with a single daily obligation to deliver or right to receive shares of each security, with a corresponding right to receive or obligation to make a single cash payment.

(*See* 3 DA D000678, n.32.) For example, if a member firm's clients altogether sell a total of 300 shares of Security A and buy a total of 200 shares of Security A, that firm would have a net "delivery obligation" to CNS of 100 shares of Security A three days later. If the firm fails to meet that delivery obligation, the firm has a "failure-to-deliver." Neither the delivery obligation nor the failure-to-deliver correlates to any specific transaction or client; it is based on the net obligation resulting from all client activity. (*See id.*; 9 PA P2081, ¶ 3.)[5]

D. Federal Regulation of Short Selling

Before 2005, short sales were regulated by various overlapping and potentially inconsistent rules.[6] In November 2003, the SEC proposed Regulation SHO ("Reg SHO") to establish a uniform regulation for short sales. It became effective January 3, 2005, and superseded earlier rules. (*See* 4 DA D000766 (Reg SHO Adopting Release).)

1. Reg SHO's "Locate" Requirement

Reg SHO provided uniform requirements for short sales. Its first significant feature is the "locate" requirement, which requires a broker-

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[5] For this reason, Plaintiffs' unsupported assertion that "[i]t is *trades* that fail" (POB at 42 (emphasis in original)) is simply wrong. With hundreds of clients buying and selling the same stock in a given day, it is generally impossible to associate the net delivery obligation with any particular trade. This is because many clients' short (and long) sales are cancelled out by other clients' purchases, resulting in a net delivery obligation that is smaller than the total number of shares clients sold that day. In the example above, the member's 100-share delivery obligation would not correspond to the 300 shares its client sold and could not be connected to any particular transaction.

[6] *See, e.g.*, 4 DA D000914 (NYSE Rule 440C.10, requiring "diligent effort" to borrow securities to make delivery on short sales); 4 DA D000923-24 (NASD Rule 3370(b)(2), requiring broker executing short sale to make "affirmative determination" that broker can deliver by settlement date); 4 DA D000928 (NASD Rule 11830, requiring close-out of certain failures to deliver).

dealer executing a short sale to first reasonably determine that the shares can be borrowed by the settlement date. *See* 17 C.F.R. § 242.203(b)(1) (2005) (submitted to the Superior Court as 4 DA D000901-03); (*see also* 4 DA D000772 (Reg SHO Adopting Release)). Reg SHO established several exceptions to the locate requirement that are relevant here. First, by its terms, the obligation to "locate" securities before entering a short-sale order applies only to the broker-dealer executing the short sale, not to a broker-dealer (such as Merrill Pro) clearing transactions that were executed by others. *See* 17 C.F.R. § 242.203(b)(1). Second, in the interest of promoting market liquidity, the SEC exempted broker-dealers that are registered market makers from the locate requirement for short sales executed in connection with bona fide market-making activity. *See* 17 C.F.R. § 242.203(b)(2)(iii). Thus, market makers are permitted to execute short sales in connection with their market-making activities without making any effort to determine whether the stock can be borrowed to make delivery on settlement date. (*See* 4 DA D000823 (SEC's "Naked" Short Selling Antifraud Rule); 4 DA D000839-40, n.6 (SEC's Key Points About Reg SHO).) The SEC has explained that it wanted market makers to be able to sell securities short without restriction so that they could appropriately hedge their positions and remain market neutral. (*See, e.g.*, 4 DA D000829 (SEC's Key Points About Reg SHO).)

By exempting market makers from the locate requirement, Reg SHO permits them to engage in "naked" short sales. *See* 17 C.F.R. § 242.203(b)(2)(iii). In fact, the SEC has expressly endorsed the practice:

> ***Naked short selling is not necessarily a violation of the federal securities laws or the Commission's rules.*** Indeed, in certain circumstances, ***naked short selling contributes to market liquidity***. For example, broker-dealers that make a market in a security generally stand ready to buy and sell the security on a regular

> and continuous basis at a publicly quoted price, even when there are no other buyers or sellers. Thus, market makers must sell a security to a buyer even when there are temporary shortages of that security available in the market.

(4 DA D000829 (SEC's Key Points About Reg SHO).)

The SEC has also recognized that a market maker "would not be making a representation at the time it submits an order to sell short that it can or intends to deliver securities on the date delivery is due. . . ." (4 DA D000823 (SEC's "Naked" Short Selling Antifraud Rule).) The adopting release for Regulation SHO explains that the rationale behind the market-maker exemption was to strike a balance between the costs associated with locating/borrowing stock and the benefit of market liquidity:

> The Commission recognizes that locate and delivery requirements may increase costs for some market participants who engage in short selling. . . . The rule includes certain exceptions from the locate requirement, which mitigate many associated cost burdens. The rule provides an exception for bona-fide market making. . . . ***Excepting bona-fide market making activity from the locate requirement will benefit investors and the market by preserving necessary market liquidity.***

(4 DA D000783 (Reg SHO Adopting Release).) The SEC thus recognized that permitting market makers to delay delivery until after the settlement date (and thus avoid borrowing costs) would incentivize them to continue providing liquidity in securities that were difficult or expensive to borrow. As the nation's options market regulators have explained, persistent failures-to-deliver—regardless of the negative connotations that phrase might invite—"are not indicative of abusive intent" precisely because they result from legitimate options market-making activity. (12 DA D003151.) In fact, options market makers generally have no possible interest in

manipulating the market because they do not profit from an increase or decline in stock price:

> Options market makers do not effect short selling of securities to engage in speculative or directional trading. Rather, they . . . buy calls or sell puts in response to customer demand to sell calls or buy puts. The resultant short sale hedges in threshold securities may involve extended fails to deliver, but the driving cause was the customer activity in the options which forced the market makers to sell short to hedge. Naked short selling to hedge by options market makers is not the type of abusive naked short selling that the threshold securities provisions in Regulation SHO are designed to address.

(*Id.*)

2. Reg SHO's "Close-Out" Requirement

Reg SHO's second significant feature was its requirements for when a broker-dealer must "close out" failures-to-deliver in "threshold" securities.[7] During the relevant period, Reg SHO required broker-dealers to close out each failure-to-deliver position in a threshold security that remained open for 13 consecutive settlement days (*i.e.*, for 16 business days after the transaction) by purchasing stock. *See* 17 C.F.R. § 242.203(b)(3). Where a clearing broker's failure-to-deliver position was attributable to the short positions of its broker-dealer clients, Reg SHO permitted the clearing broker to allocate to those clients its failure-to-deliver position. (*See id.*) After such an allocation, it became each client's sole responsibility to close out its allocated failure-to-deliver position in accordance with Reg SHO. (*See id.*) Merrill Pro therefore implemented a system for allocating its CNS fail-to-deliver position to its market-maker clients and making those clients

[7] A "threshold security" meets certain failure-to-deliver criteria. *See* 17 C.F.R. § 242.203(c)(6). Overstock was a threshold security throughout most of the relevant period. (12 PA P3134, ¶ 68.)

responsible under Reg SHO for purchasing stock to close out their allocated fail-to-deliver position. (*See* 9 PA P2163-65, ¶¶ 21-22.)

Because Reg SHO required only individual failure-to-deliver positions allocated to each client to be closed out within 13 days, Merrill Pro's ***overall*** CNS failure-to-deliver position in Overstock remained open for extended periods. The SEC has explained that such an extended failure-to-deliver does not suggest that individual failure-to-deliver allocations were not properly closed out in accordance with Reg SHO. (*See* 4 DA D000861-63 (SEC Reg SHO FAQ No. 5.8, providing example of broker-dealer remaining in fail-to-deliver position for 25 days in compliance with Reg SHO); 4 DA D000775, n.95 (Reg SHO Adopting Release providing similar examples).) For example, if Merrill Pro Client A sold short on Day 1 and was allocated a 500-share failure-to-deliver, Client A would have to purchase 500 shares to close out that fail by Day 17 (*i.e.*, 13 days after settlement). If Merrill Pro Client B sold the same stock short on Day 9 and was also allocated a 500-share failure-to-deliver on Day 12, Client B would not have to purchase those 500 shares until Day 25. Thus, even if Merrill Pro Client A complied with Reg SHO's close-out requirement by purchasing 500 shares of stock on Day 13, Merrill Pro could remain in a failure-to-deliver position at CNS until Client B closed out its fail on Day 25. Because of this fluid—and, for the market, beneficial—dynamic, the SEC has explicitly recognized that failures-to-deliver "can exist ***indefinitely*** in a continuous net settlement system" even when all rules are followed. (3 DA D000694.) While some critics of the SEC (including Overstock CEO Patrick Byrne) have argued that this system creates "counterfeit" shares and an unlimited supply of stock, the SEC has categorically rejected this notion. (*See* 4 DA D000864 (Reg SHO FAQ No. 7.1: "With regards to the contention that the U.S. clearance and settlement system, and specifically NSCC's CNS system, creates counterfeit shares, this is not the case.").)

E. Merrill Pro's Policies and Procedures for Settling Market-Maker Short Sales

Merrill Pro implemented settlement procedures to ensure that clients complied with Reg SHO's close-out requirement. First, because market makers were exempt from Reg SHO's "locate" requirement and not required to immediately borrow or deliver stock, Merrill Pro implemented an automated do-not-flip system that isolated market-maker short sales and ensured that Merrill Pro would not borrow and deliver stock on the settlement date for those transactions. (9 PA P2162-63, ¶¶ 17-18; 9 PA P2214-15, ¶ 10.)[8] Merrill Pro was able to do this because its market-maker clients had designated accounts that they represented would be used only for bona fide market-making activity. (9 PA P2159-61, ¶¶ 7-12; 9 PA P2214-15, ¶ 10.) As a consequence of the do-not-flip system, Merrill Pro had a failure-to-deliver position at CNS in those securities that its market-maker clients sold short. (9 PA P2163-64, ¶ 21.)

Second, Merrill Pro developed its "Threshold Fail Tracking System," which allocated Merrill Pro's failure-to-deliver position to its market-maker clients and individually tracked each client's fail-to-deliver position in accordance with Reg SHO. (*Id.*; 9 PA P2213-14, ¶¶ 8-9.)[9] That

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[8] Plaintiffs imply that Merrill Pro adopted this policy in "mid-2005." (*See* POB at 49.) The undisputed evidence, however, shows that Merrill Pro had implemented the do-not-flip policy approximately five years earlier, because pre-Reg SHO rules also did not require market makers to borrow and deliver stock they sold short. (*See* 9 PA P2162-63, ¶ 18.) Technically, the policy applied only to "negative-rebate securities," *i.e.*, securities for which the borrowing fee exceeded the interest earned on the proceeds from the short sale. (*Id.*) It is undisputed that Overstock had a high borrowing fee and therefore was a negative-rebate security throughout the relevant period. (*See* POB at 10.)

[9] Merrill Pierce also used the Threshold Fail Tracking System, but had few failures-to-deliver to track because it had no market-maker clients. (*See* 9 PA P2214, ¶ 9 (discussing Merrill Pierce's use of Threshold Fail Tracking

system enabled Merrill Pro to remind each client of its obligation to purchase stock to close out the allocated fail within 13 days. (9 PA P2164-65, ¶ 22; 9 PA P2213-14, ¶¶ 7-9.) Although Merrill Pro had no responsibility under Reg SHO to close out its clients' fails, on occasion Merrill Pro did purchase stock on the client's behalf to ensure the client's compliance with its close-out obligation. (9 PA P2164-65, ¶ 22.) Plaintiffs point to no evidence that Merrill Pro ever had to close out a client's Overstock fail, however, and never challenged any such "buy-in" transaction as manipulative. (*See* 13 PA 3400-15 (Plaintiffs' expert declaration identifying allegedly manipulative Overstock transactions without including such buy-ins); 3 CA C000663-9 CA C002060 (expert's worksheets).)

Given Merrill Pro's large base of market-maker clients, these policies and procedures resulted in significant failures-to-deliver in many different negative-rebate securities, including Overstock. (*See* 13 PA P3273-74, ¶¶ 43-44.) This is because market makers routinely hedged their long options positions by engaging in stock short sales in order to remain market neutral. These short sales were then part of the do-not-flip and threshold fail tracking systems.

F. Plaintiffs' Theory of Liability

In the operative Fourth Amended Complaint, Plaintiffs alleged that "[s]ince at least January 2005, large quantities of Overstock shares have been the subject of naked short selling." (2 PA P0452, ¶ 28.) According to Plaintiffs, Defendants' "persistent failures to locate and deliver" allegedly "created immense downward pressure on the price of Overstock's securities by creating an unlimited supply of stock for sale." (2 PA P0452, ¶ 29.)

System); *see also* 10 PA P2371, ¶ 6 (describing Merrill Pierce customer base); 5 DA D001112-11 DA D002945 (CNS Accounting Summaries for Merrill Pierce DTC account 161).)

Plaintiffs alleged that Defendants' failures-to-deliver were "intentional" and motivated by a desire to "remove[] a core cost from their securities lending business" and thus "earn more money through the charging of fees, commissions and/or interest." (2 PA P0452,¶ 30.) Plaintiffs also alleged that Defendants "engage[d] in naked short selling on their own account" and "intentionally fail[ed] to deliver stock to obtain the gains from a drop in price in Overstock stock for their own account." (*Id.*) Plaintiffs were allegedly injured by this conduct when they sold Overstock shares at depressed prices. (2 PA P0453, ¶ 35.)

Plaintiffs refined their allegations on summary judgment. They no longer contended that the Merrill Lynch entities engaged in naked short selling for their own accounts or somehow profited from a drop in Overstock share price, because there is no evidence to support such allegations. (*See* 45 CA C010792 (complaining only about settlement activities); *see also* POB at 10-14 (alleging that defendants "facilitate[d] trades by their customers" and failing to mention any proprietary short sales by Merrill Lynch entities).) Rather, Plaintiffs focused on Merrill Pro's procedures for settling market-maker short sales. Specifically, Plaintiffs allege that because Merrill Pro's policy was to not borrow shares that its market-maker clients had sold short and therefore "intentionally" failed to deliver those shares, Merrill Pro violated Section 25400. (POB at 12.) As Plaintiffs explained it to the Superior Court, their claim is that "Merrill Pro's policies and procedures were set up to encourage violations of Reg SHO and maintain fails to deliver for long periods of time." (11 PA P2707.)

Plaintiffs contend that Merrill Pro's policies and procedures constitute "market manipulation" of Overstock because by not borrowing shares from Merrill Pierce to make delivery for market-maker clients, Merrill Pro allowed Merrill Pierce to lend more shares to other clients. (*See*

POB at 12.) This allegedly allowed those other (unidentified) clients to sell more shares (including Overstock shares) short and, according to Plaintiffs, drove down Overstock's share price. (*See id.*) It also supposedly allowed Merrill Pierce to earn a greater profit from its securities lending operations because other clients would pay Merrill Pierce to borrow its shares while Merrill Pro's market-making clients would not (because, under federal law, they had no obligation to do so). (*See id.* at 10-11.)

Plaintiffs also contend that some of Merrill Pro's market-maker clients engaged in wash sales and matched orders in Overstock by purchasing stock and simultaneously entering into a short-term "FLEX" options contract that would reestablish their short position on the following day via an options exercise. (*See id.* at 39.) According to Plaintiffs, those transactions were intended to deceive regulators and "make it appear that the fails were not as persistent as they were." (*Id.* at 12-13.) As Plaintiffs note, several market makers were sanctioned by regulators (long after they left Merrill Pro) regarding their misuse of the market-maker exemption and conduct in closing out fails-to-deliver. (*See id.* at 21 n.13.) What Plaintiffs fail to note is that the conduct of these errant market makers ***was designed to deceive Merrill Pro***. For example, the SEC sanctions order against former Merrill Pro client Hazan Capital Management ("HCM"), and its owner Steven Hazan, explained that Merrill Pro had properly allocated a portion of its failure-to-deliver position to HCM and notified HCM of its close-out obligations. (82 CA C019447, ¶¶ 13-14.) HCM then executed transactions to deceive Merrill Pro into believing that HCM had satisfied this obligation:

> To avoid a forced close out [by Merrill Pro], Hazan, on behalf of HCM, entered into a series of sham reset transactions that circumvented HCM's obligation under Reg. SHO to close out its fail-to-deliver position. These complex

> sham transactions gave the appearance that HCM was closing out its fail-to-deliver position by purchasing securities of like kind and quantity.

(82 CA C019448, ¶ 16; *see* 82 CA C019448-49, ¶¶ 15, 19.) Another former Merrill Pro client, SBA Trading, and its owner Scott Arenstein engaged in similar conduct. (*See* 82 CA C019420 ¶ 14. ("In order to avoid being bought-in [by Merrill Pro, Arenstein] entered into series of transactions that circumvented [his] obligation to actually deliver securities to close out their short position pursuant to Reg SHO.").) Nevertheless, Plaintiffs contend that Merrill Pro should be held liable for clearing and settling those transactions under Section 25400. (*See* POB at 44-46.)

G. The Superior Court's Summary Judgment Decision

The Superior Court entered its Further and Final Order Granting Defendants' Motions for Summary Judgment on April 11, 2012. (91 CA C021523-36.) The court found that under *Kamen v. Lindly*, 94 Cal. App. 4th 197 (2001), and *Openwave Systems Inc. v. Fuld*, 2009 WL 1622164 (N.D. Cal. June 6, 2009), liability under Section 25400 may be imposed only on purchasers or sellers or those offering to purchase or sell securities. (*See* 91 CA C021526-28.) The court further found that even if liability could extend to parties other than purchasers or sellers, Section 25400 applies only to those who are direct and willful participants in effecting the allegedly manipulative transactions—and not to secondary actors. (91 CA C021527-28.) The court also recognized that under *Diamond Multimedia Systems, Inc. v. Superior Court*, 19 Cal. 4th 1036 (1999), Section 25400 regulates only manipulative conduct that takes place in California. (91 CA C021526-27.)

Applying these principles, the Superior Court found that the Merrill Lynch entities had successfully shifted the burden to Plaintiffs to create a triable issue of fact as to whether either Merrill Pro or Merrill Pierce

engaged in manipulative conduct in California that violated Section 25400. (91 CA C021528-29.) Specifically, Merrill Pro and Merrill Pierce submitted evidence that (i) their failures to deliver occurred in New York (9 PA P2167, ¶ 31; 10 PA P2372, ¶ 14); (ii) the decision to fail to deliver occurred in New York (9 PA P2163-64, ¶ 21; 9 PA P2167, ¶¶ 29-31; 10 PA P2370, ¶ 5; 10 PA P2372, ¶¶ 13-14); (iii) their settlement activities occurred in New York, New Jersey, and Florida (9 PA P2167, ¶¶ 29-31; 10 PA P2372, ¶ 13); and (iv) Merrill Pierce's securities lending activities occurred in New York and Illinois (8 PA P2079, ¶ 5).

The court held that Plaintiffs failed to satisfy their burden of creating a triable issue of fact for two reasons. First, the Superior Court found that none of the allegedly manipulative Overstock transactions at issue were "proprietary" purchases or sales by the Merrill Lynch entities (*i.e.*, trades for their own accounts). (91 CA C021533.) Second, the Superior Court found that Plaintiffs proffered no evidence that the Merrill Lynch entities' allegedly manipulative settlement activities occurred in California. In particular, the court found no evidence that: (i) any of the allegedly manipulative failures-to-deliver occurred in California; (ii) any of Merrill Pro's decisions to intentionally fail to deliver were made in California; (iii) either Merrill Lynch entity conducted settlement operations (the operations that led to failures-to-deliver) in California; or (iv) either Merrill Lynch entity conducted prime brokerage, proprietary trading, or securities lending operations in California. (91 CA C021529-30.) In addition, the court found that even if Merrill Pro could be held liable under Section 25400 for clearing and settling its clients' transactions, Plaintiffs presented no evidence that any of the allegedly manipulative client transactions occurred in California. (91 CA C021532-33.)

In light of its holding, the court found it "unnecessary to address" the other grounds on which the Merrill Lynch entities sought summary

judgment, including that (i) Plaintiffs did not introduce evidence showing that the allegedly manipulative Merrill Lynch conduct caused any decline in the price of Overstock shares; (ii) the Merrill Lynch entities did not act with the high degree of scienter required by Section 25400; and (iii) a California court cannot provide Plaintiffs a remedy given the federal nature of this issue. (91 CA C021534.)

STANDARD OF REVIEW

The Superior Court's summary judgment ruling is reviewed *de novo*, considering all of the evidence set forth in the moving and opposition papers except that to which objections were made and sustained. *See Johnson v. City of Loma Linda*, 24 Cal. 4th 61, 65-66 (2000). Summary judgment must be affirmed if it is correct "on any ground raised in the trial court proceedings." *Kight v. CashCall, Inc.*, 200 Cal. App. 4th 1377, 1387 (2011); *see also Bell v. H.F. Cox, Inc.*, 209 Cal. App. 4th 62, 71 (2012) ("We must affirm a summary adjudication if it is correct on any ground that the parties have had an adequate opportunity to address on appeal, regardless of the trial court's stated reasons."). The Superior Court's ruling on Defendants' objections to the testimony of Dr. Shapiro is reviewed for an abuse of discretion. *People v. Prince*, 40 Cal. 4th 1179, 1222 (2007) ("We apply an abuse of discretion standard in reviewing a trial court's decision to admit the testimony of an expert.").

ARGUMENT

I. Plaintiffs Submitted No Evidence of a Section 25400 Violation.

The Superior Court properly granted the Merrill Lynch entities' motions for summary judgment because Plaintiffs submitted no evidence that either of them violated Section 25400. Section 25400(a) prohibits "wash sales" or "matched orders," *i.e.*, "the entering of purchase and sale orders of equal amounts in order to create the appearance of active trading and raise or depress the price of a security." Harold W. Marsh & Robert H.

Volk, *Practice Under the California Securities Laws* § 14.05[2][c] (2012) ("Marsh & Volk"); *see also* Cal. Corp. Code § 25400(a). Section 25400(b) prohibits effecting "a series of transactions . . . creating actual or apparent active trading in [a] security or raising or depressing the price of such security, for the purpose of inducing" others to purchase or sell the securities. Cal. Corp. Code § 25400(b); *see also* Marsh & Volk § 14.05[2][d]. Section 25400 is thus directed only at specific types of market manipulation; it is not a general antifraud or securities statute. *See Spicer v. Chicago Bd. Options Exch., Inc.*, 1990 WL 172712, at *3 (N.D. Ill. Oct. 30, 1990) (explaining that Section 25400's federal analogue, Section 9 of the Exchange Act, "is not a catch-all" securities fraud provision like Section 10(b)).

Plaintiffs submitted no evidence that either Merrill Lynch entity engaged in the types of transactions prohibited by Sections 25400(a) and (b). First, as the Superior Court correctly found, Plaintiffs presented no evidence that either Merrill Lynch entity ***ever*** bought or sold Overstock securities for its own accounts, much less did so to create a false appearance in the market or induce others to trade. This fact alone is dispositive, as the Merrill Lynch entities cannot be held secondarily liable under Section 25400 for clearing and settling ***their clients'*** allegedly manipulative transactions. Second, even if Merrill Pro could be held liable for its clearing and settling of client trades, there is no evidence that it cleared or settled the types of manipulative transactions prohibited by Section 25400.

A. **Plaintiffs submitted no evidence that either Merrill Lynch entity engaged in transactions prohibited by Section 25400.**

1. **The Merrill Lynch entities cannot be held liable under Section 25400 for transactions in which they were neither a purchaser nor a seller.**

Every relevant authority agrees that Section 25400 does not permit secondary liability and that a defendant can be held primarily liable only if the defendant is itself the buyer or seller in a manipulative transaction. Here, Plaintiffs have presented no evidence that either Merrill Lynch entity was a buyer or seller of Overstock shares, much less a buyer or seller in a manipulative Overstock transaction. (*See* 13 PA 3400-15 (Plaintiffs' expert declaration identifying allegedly manipulative Overstock transactions); 3 CA C000663-9 CA C002060 (expert's worksheets); *see also* 91 CA C021533 (MSJ Order: "[T]he only arguably 'proprietary' trades by any defendant identified in the record were certain purchases by GS&Co.").) The Superior Court therefore did not err in dismissing Plaintiffs' claims against both Merrill Lynch entities.

Plaintiffs concede that Section 25400 does not impose secondary liability on those who merely provide assistance with transactions that violate the statute. (*See* POB at 35 ("[S]econdary liability was never at issue here.").) Plaintiffs argue instead that Merrill Pro can be liable as a primary actor because it "effected" its clients' manipulative transactions.[10] Specifically, Plaintiffs argue that the term "effect," as used in Sections 25400(a) and (b), means more than buying and selling and includes activities like "facilitating" or "guaranteeing" a transaction such that those

[10] Plaintiffs do not suggest that Merrill Pierce had any clients engaging in manipulative transactions, instead making the illogical claim that Merrill Pierce's inaction (because it was not asked to lend stock) rendered it a primary actor in the transactions. (*See* POB 10-12.)

activities can also be a basis for "primary" liability. (*Id.* at 27-30.) There is no support for this radical extension of Section 25400. Section 25400(a)(1) prohibits "effect[ing] any transaction" "[f]or the purpose of creating a false or misleading appearance of ***active trading*** or a false or misleading appearance with respect to ***the market*** for any security." Cal. Corp. Code § 25400(a)(1).[11] And Section 25400(b) prohibits "effect[ing] . . . a series of transactions in any security creating actual or apparent ***active trading*** in such security or raising or depressing ***the price*** of such security, for the purpose of inducing the purchase or sale of such security by others." Cal. Corp. Code § 25400(b). This statutory language makes clear that the conduct prohibited under Section 25400 involves ***market activity***—not ancillary conduct, such as clearing or settlement, that occurs ***after*** the "active trading" is complete and any "false or misleading appearance" or price movement has already occurred. *See California Amplifier, Inc. v. RLI Ins. Co.*, 94 Cal. App. 4th 102, 108 (2001) (holding that market manipulation within meaning of Section 25400 requires "artificially creating market activity in a security"). *See also Levitt*, ___ F. 3d ___, 2013 WL 1007678, at *1 (explaining that "clearing broker's involvement in any given transaction typically begins after the execution of a trade").

Plaintiffs' attempt to extend the scope of Section 25400 is inconsistent with every authority on the statute. For example, Marsh & Volk, the leading treatise on California securities law (written by the law's principal drafters), states unambiguously that "[Section 25400's] Subdivision (a), dealing with matched orders, and Subdivision (b), dealing with liability for a series of transactions manipulating the price of a security, by their very nature ***require that the defendant be a purchaser or***

[11] Subsections a(2) and a(3) prohibit only "entering an order," not "effecting" a transaction. *See* Cal. Corp. Code § 25400(a)(2), (3). Plaintiffs do not suggest that either provision applies here.

seller since the conduct prohibited is associated with a market transaction." Marsh & Volk § 14.05[4]); *see also Mirkin v. Wasserman*, 5 Cal. 4th 1082, 1103 (1993) (relying on Marsh & Volk as authoritative and noting that Professor Marsh and Commissioner Volk were "principal drafters" of California's securities laws).[12]

Moreover, Plaintiffs have not cited a single case in which a court has applied Section 25400 or Section 9 of the Securities Exchange Act of 1934 (on which Section 25400 is modeled[13]), 15 U.S.C. § 78i(a), to a defendant who did not engage in a purchase or sale. *See, e.g., Dillon v. Militano*, 731 F. Supp. 634, 636 (S.D.N.Y. 1990) (dismissing Section 9 claim against clearing broker because there was no allegation that it engaged in manipulative transactions). In fact, the California courts that have addressed the issue have uniformly followed Marsh & Volk and held that liability under Section 25400 is limited to buyers and sellers or persons offering to buy or sell. In *Kamen*, for example, the Court of Appeal held that "[c]ivil liability pursuant to Corporations Code section 25500 [which provides the private right of action for violations of Section 25400] applies only to a defendant who is either ***a person selling or offering to sell or***

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[12] Having no answer to Marsh & Volk, Plaintiffs relegate their discussion of it to a footnote. (*See* POB at 34 n.5) Plaintiffs contend that Marsh & Volk's unambiguous statement that Section 25400 "requires that the defendants be a purchaser or seller" should be ignored in favor of a general requirement that "the defendant must have been engaged in market activity." (*Id.*) But accepting this argument does not save Plaintiffs' claims, because they have presented no evidence that Merrill Pro engaged in "market activity." Merrill Pro's alleged misconduct occurred during the settlement process, which by definition took place after the market activity was complete.

[13] *See California Amplifier*, 94 Cal. App. 4th at 114-15 ("Corporations Code sections 25400 and 25500 are patterned after and virtually identical to section 9, subdivisions (a) and (e), of the Securities Exchange Act of 1934. California courts may look to federal statutes for guidance in interpreting a closely analogous state statute.").

buying or offering to buy a security." 94 Cal. App. 4th at 206. While Plaintiffs attempt to distinguish *Kamen* on the ground that it involved Section 25400(d) (*see* POB at 32), the Court of Appeal's decision was based on the language of Section 25500, which is the sole source of a private right of action for all subdivisions of Section 25400, *see* 94 Cal. App. 4th at 204-06. Contrasting Section 25500 with Section 25504 (which is not at issue here), the Court explained that "the Legislature knows how to establish secondary liability when it wants to do so, yet failed to do so with respect to Corporations Code section 25400." *Id.* at 204.

Similarly, in *California Amplifier*, the Court of Appeal found nothing permitting secondary liability in Section 25400:

> [S]ection 25504 imposes liability on a person who "materially aids" an act or transaction that violates section 25501 or 25503, and section 25504.1 imposes liability on persons who "materially assist" certain other violations. But, there is no such language in section 25400 or 25500. To impose liability on persons who do not directly participate in a section 25400 violation would be contrary to the legislative decision to exclude aiders and abettors from section 25500 liability.

94 Cal. App. 4th at 113. The Superior Court therefore correctly held that the Merrill Lynch entities cannot be held liable for merely assisting with transactions of others by providing clearing or other services after the market activity is complete. (*See* 91 CA C021527-28.)

Openwave Systems is also on point. There, a federal court applied *Kamen* and concluded that "plaintiff cannot state a claim under section [25400(b) if] defendants neither sold nor offered securities" for sale. *Openwave Sys.,* 2009 WL 1622164, at *9. While Plaintiffs urge this Court to reject *Openwave* (POB at 33-34), the federal court's reasoning is sound. Relying on *Kamen* and Marsh & Volk, the defendants in *Openwave* argued

that Section 25400(b) imposes liability only on a defendant who either sells or offers to sell or buys or offers to buy a security. *See Openwave Sys.*, 2009 WL 1622164, at *9. The plaintiff contended that *Kamen* was distinguishable because it interpreted subdivision (d), rather than subdivision (b), *id.*—the same argument Plaintiffs make here. The *Openwave* court rejected the plaintiff's argument, finding that "the language of *Kamen* strongly suggests that no theory of secondary liability is available under any subsection of Section 25400, with perhaps the exception of subsection (e)." *Id.*; *see also Wright v. Bloom*, 2012 WL 6000960, at *2 (N.D. Cal. Nov. 30, 2012) ("As a matter of law, however, plaintiffs cannot state a claim for relief against [defendant] under Sections 25400 and 25500 because [defendant] was not the seller (or buyer). . . . Section 25500 applies only to a person who either (1) sells or offers to sell, or (2) buys or offers to buy a security."); *Lopes v. Vieria*, 2011 WL 1883157, at *11 (E.D. Cal. May 17, 2011) ("[C]ivil liability pursuant to Corporations Code section 25500 applies only to a defendant who is either a person selling or offering to sell or buying or offering to buy a security.").

2. The Section 10(b) cases Plaintiffs cite do not support their attempt to extend Section 25400.

Section 25400 is not a broad, all-purpose securities fraud statute like Section 10(b) of the Exchange Act, which prohibits all manipulative or deceptive devices in connection with the purchase or sale of securities. *See* 15 U.S.C. § 78j(b). Plaintiffs nevertheless rely on two federal district court cases (one now reversed) holding that clearing brokers engaged in securities fraud may be held liable as primary violators under Section 10(b) of the Exchange Act as support for their unprecedented interpretation of Section 25400. (*See* POB at 36-37.) But unlike courts addressing Section 25400 claims, courts addressing Section 10(b) claims have repeatedly held that Section 10(b) does not require a defendant to have engaged in market

activity. *See, e.g.*, *Heit v. Weitzen*, 402 F.2d 909, 913 (2d Cir. 1968) ("There is no necessity [under Section 10(b)] for contemporaneous trading in securities by [the defendant]."); *United States v. Ferrarini*, 9 F. Supp. 2d 284, 297 (S.D.N.Y. 1998) ("There is no requirement [under Section 10(b)] that an individual defendant actually buy or sell securities."). Thus, whether Section 10(b) permits finding primary liability against brokers who do not purchase or sell the security says nothing about whether Section 25400 should be read to do so. In fact, Section 25400 drafters Marsh and Volk expressly acknowledge that Section 25400 is to be interpreted differently. *See* Marsh & Volk § 14.05[4] (distinguishing Section 25400's "market activity" requirement from Section 10(b)).

Moreover, the two Section 10(b) cases Plaintiffs rely upon do not suggest that clearing brokers can ever be held liable for merely clearing and settling their clients' manipulative transactions. First, in the *Blech* cases, the plaintiffs sued Blech & Co.'s clearing broker, Bear Stearns, under Section 10(b), and the court granted Bear Stearns's motion to dismiss because "the plaintiffs have failed to allege facts showing that Bear Stearns did anything more than act as Blech & Co.'s clearing broker." *In re Blech Secs. Litig.*, 928 F. Supp 1279, 1295. (S.D.N.Y. 1996) ("*Blech I*"). In particular, "the Complaint [did] not allege that Bear Stearns caused or directed trading by Blech & Co.'s customers or solicited or induced them to buy Blech Securities at inflated prices." *Id.*; *see also Dillon*, 731 F. Supp. at 636 (rejecting Section 10(b) manipulation claim against clearing broker because complaint did not "plead that [the clearing broker] was making decisions regarding the accounts").

The *Blech* plaintiffs then filed an amended complaint adding allegations that Bear Stearns was directly involved in Blech & Co.'s manipulative scheme because Bear Stearns had directed Blech & Co. to undertake the transactions and, in fact, executed the transactions for Blech

& Co. *See In re Blech Secs. Litig.*, 961 F. Supp. 569, 578-79 (S.D.N.Y. 1997) ("*Blech II*").[14] This time the court denied Bear Stearns's motion to dismiss because the plaintiffs had sufficiently alleged that Bear Stearns had undertaken more than mere clearance and settlement by directing the allegedly manipulative transactions. As the court explained:

> ***When Plaintiffs allege mere clearing conduct against Bear Stearns, such allegations amount to no more than a non-existent claim of aiding and abetting*** because, at most, they allege only that Bear Stearns knowingly and substantially assisted Blech by clearing the fraudulent trades. However, ***the Complaint crosses the line dividing secondary liability from primary liability when it claims that Bear Stearns "directed" or "contrived"*** certain allegedly fraudulent trades.

Id. at 584. Thus, *Blech II* held that primary liability could potentially be imposed on Bear Stearns only because Bear Stearns had allegedly ***gone beyond its role as a clearing broker*** and ***directed*** its clients' manipulative trades. Bear Stearns's "extra" conduct was a prerequisite to liability because "[t]he act of clearing sham trades alone, even with scienter, is not enough to show an attempt to unlawfully affect the price of such securities within the meaning of Section 10(b)." *Id.*; *see also Fezzani v. Bear, Stearns & Co.*, 384 F. Supp. 2d 618, 642 (S.D.N.Y. 2004) ("Knowledge of [] fraud and clearing fraudulent transactions are insufficient to make the Bear Stearns Defendants primary violators on the basis of market manipulation.").[15]

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[14] Apparently preferring to ignore the court's decision to dismiss the *Blech* plaintiffs' original complaint, Plaintiffs erroneously refer to this decision as *Blech I.* (*See* POB at 36.)

[15] While Plaintiffs assert that *Blech* is factually similar because Bear Stearns was allegedly "locking up" securities to prevent them from being loaned out (purportedly "the mirror image of what Defendants did here")

Second, Plaintiffs cite *Levitt v. J.P. Morgan Securities, Inc.*, 270 F.R.D. 127 (E.D.N.Y. 2010), where the district court granted class certification to investors asserting a Section 10(b) claim against Bear Stearns for its role in clearing its client's allegedly fraudulent trades. (*See* POB at 37.) But *Levitt* has been reversed, and in doing so the United States Court of Appeals for the Second Circuit explicitly recognized the distinction between a clearing broker that merely knows of a client's market manipulation and clears the manipulative trades anyway and a clearing broker that "shed its role as clearing broker and assumed direct control of the introducing firm's operations and its manipulative scheme." *See* ___ F. 3d ___, 2013 WL 1007678, at *10. As the Second Circuit made clear, the former cannot be held primarily liable, even under Section 10(b). *Id.*

Here, the Superior Court properly found that Plaintiffs presented no evidence that Merrill Pro went beyond its role as a clearing broker and controlled the operations of its market-maker client. (*See* 91 CA C021532.) In fact, the uncontroverted evidence establishes that Merrill Pro's market-maker clients initiated and directed their own trading, including their Overstock short sales. (*See, e.g.*, 9 PA P2162, ¶¶ 13-14.) Even Plaintiffs admitted below that Merrill Pro did not direct its clients' trading, but rather "instituted policies to accommodate" that trading. (45 CA C010819.) And Plaintiffs presented no evidence regarding Merrill Pierce's conduct at all.

B. Plaintiffs submitted no evidence that Merrill Pro's clients engaged in transactions prohibited by Section 25400.

Since it is undisputed that Merrill Pro cannot be liable under Section 25400 for the alleged manipulative transactions of its clients, the legality of

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(POB at 36), that fact pattern serves only to underscore the difference between Section 25400 and Section 10(b). Section 25400 refers to manipulative "transactions," and "locking up" securities—even if considered a manipulative "device" or "scheme" under Section 10(b)—is not a "transaction" in any sense of the word.

the underlying short sale transactions by those clients is not at issue. Indeed, Plaintiffs told the Superior Court in opposing summary judgment that "Plaintiffs['] claim here is not based on the transactions by Defendants' customers; rather it is Defendants' decision to intentionally fail to deliver to settle trades in Overstock securities . . . ." (45 CA C010826; *see* also 91 CA C021529 (MSJ order quoting this statement).) Similarly, Plaintiffs' proffered damages and causation expert Dr. Shapiro testified explicitly that he did not even consider client transactions; he based his analysis entirely on Merrill Pro's and GSEC's conduct in failing to deliver. (13 PA P3201-02, ¶¶ 6-7; 12 DA D003090:14-25 (deposition testimony that he limited his analysis of the Merrill Lynch entities to failures-to-deliver in two Merrill Pro DTC accounts).)

In any event, Plaintiffs have not even presented evidence that Merrill Pro's market-maker clients executed "naked" short sales for the purpose of creating a false appearance in the market or inducing additional short sales. *See* Cal. Corp. Code § 25400(a), (b). To the contrary, Plaintiffs' own experts conceded that Merrill Pro's market-maker clients executed the short sales at issue to hedge options transactions as part of "reverse conversions." (*See* 13 PA P3408-09, ¶ 27 (Plaintiffs' expert concluding that Merrill Pro market-maker clients HCM and SBA traded almost exclusively in reverse conversions).) A reverse conversion, which is the opposite of a "conversion," involves the sale of a put option, purchase of a call option, and sale of stock. (*See, e.g.*, 13 PA P3278, ¶ 58.) Reverse conversions are market-neutral trades in which the trader's profit equals the revenue from the sale of the put option less the cost of the call option and any borrowing or other transaction costs; as Plaintiffs' expert Robert Conner put it, they are designted to "result[] in [a] position insulated from market risk," *i.e.*, not susceptible to profit (or loss) from stock price movements. (*See* 13 PA P3278, ¶ 58 (describing mechanics and pricing of conversion trades).) In

other words, the traders do not care if the stock price subsequently goes up or down, giving them no reason to try to affect the market price.

Plaintiffs' suggestion that these trades are "manipulative" because they somehow sent "false information" to the market (*see* POB at 40) is illogical. Plaintiffs complain that the market makers priced their reverse-conversion trades to reflect the fact that the market makers would not have to pay borrowing costs—because Merrill Pro had a policy of not borrowing and delivering market-maker short sales. (*See id.* at 38-39.) But no "false signal" was sent to the market: The pricing signal was ***true***. Merrill Pro's policy was to not charge market-maker clients borrowing fees because under Reg SHO market makers had no obligation to borrow.

The same holds for Merrill Pro's clients' so-called "FLEX reset transactions," which Plaintiffs admit were used by market makers to maintain their hedging short positions and "make it appear that the fails were not as persistent as they were." (*Id.* at 12-13; *see also* 13 PA P3407-08, ¶ 24.)[16] The false impression that the market makers were trying to create was therefore a deceit to Merrill Pro's books and records (specifically its Threshold Fail Tracking System), where the age of the market makers' fails was improperly reset. But Plaintiffs do not, and cannot, suggest that this tracking information was public or otherwise available to the market. The resulting inaccurate tracking information did not deceive the market or induce additional purchases or sales of Overstock, as required by Section 25400. *See* Cal. Corp. Code § 25400(a),

[16] The SEC also concluded that this was the purpose of the reset transactions. (*See* 82 CA C019448, ¶ 16 ("These complex sham transactions gave the appearance that HCM was closing out its failure-to-deliver position. . . ."); 82 CA C019420, ¶ 14 (SBA "executed a series of complex transactions that appeared to close out [its] fail to deliver position. . . .").)

(b).[17] Plaintiffs simply have no evidence that Merrill Pro's clients engaged in transactions that did so.

II. Plaintiffs Submitted No Evidence of Market Manipulation in California.

The Superior Court's judgment should be affirmed for the additional reason that Plaintiffs failed to establish a triable issue of fact as to whether either Merrill Lynch entity engaged in manipulative conduct in California, as required by the California Supreme Court's seminal decision in *Diamond Multimedia*. *See* 19 Cal. 4th at 1063 ("[S]ection 25400 regulates only manipulative conduct in California."). *See also Anschutz Corp. v. Merrill Lynch & Co.*, 690 F.3d 98, 111-12 (2d Cir. 2012) (rejecting Section 25400 claim against Merrill Lynch because "[t]he alleged unlawful conduct at the crux of this case . . . is not alleged to have occurred, and did not occur, in California"). As the Superior Court correctly held, there is no evidence that Merrill Pro's allegedly manipulative settlement activities or Merrill Pierce's allegedly manipulative securities lending activities occurred in California. (*See* 91 CA C021529-34.) Moreover, Plaintiffs' attempt to shift the focus of their claims to the transactions of Merrill Pro clients does not change the analysis, because there is no evidence that they engaged in manipulative transactions in California either.

[17] This is also true of Plaintiffs' allegation that Merrill Pro clients were "selling into a buy-in," because there is no allegation that those sales injected false information into the market. (*See* POB at 39.) Rather, Plaintiffs allege only that those sales "allowed [the fails] to persist for long periods of time." (*Id.* at 40.) But more importantly, Plaintiffs have not identified a single instance in which Overstock securities were sold into buy-ins by a Merrill Pro client. (*See id.* (citing deposition testimony that does not mention Overstock).)

A. Plaintiffs submitted no evidence that the Merrill Lynch entities' allegedly manipulative conduct occurred in California.

Plaintiffs claim that (i) Merrill Pro intentionally failed to deliver millions of Overstock shares to CNS in connection with market-maker short sales, and (ii) Merrill Pierce failed to lend to Merrill Pro the shares Merrill Pro needed to deliver, thus enabling Merrill Pierce to lend those shares to other customers. (*See, e.g.*, POB at 12.) Plaintiffs were required to present evidence that those alleged wrongful actions occurred in California. But after "review[ing] all of the evidence plaintiffs submitted about defendants' alleged California conduct and hear[ing] extensive argument and question[ing] the parties about this issue at the January 5, 2012 hearing," the Superior Court correctly concluded that "the record evidence fails to give rise to a triable issue of material fact on the issue of whether any defendant, by reason of defendant's conduct occurring in California, was engaged in manipulative conduct in California." (91 CA C021534.) This holding should be affirmed.

First, Plaintiffs submitted no evidence that any of Merrill Pro's failures-to-deliver occurred in California. (*See, e.g.*, 11 PA P2648, ¶ 5.) The Superior Court therefore correctly held that "the record evidence categorically establishes that all [failures-to-deliver] occurred in New York, where the National Securities Clearing Corporation . . . and the Continuous Net Settlement system . . . are located." (91 CA C021529 (citing, *inter alia*, 9 PA P2167, ¶ 31).) Plaintiffs do not dispute these findings on appeal, nor do they point to any contradictory evidence.

Second, Plaintiffs submitted no evidence that any Merrill Pro employee located in California made a decision (or even had the authority to make a decision) about the settlement of Overstock transactions or the delivery of Overstock shares. As the Superior Court observed, any decision

to intentionally fail to deliver "would have necessarily occurred outside of California because the record evidence was uncontradicted that defendants' personnel having decisional authority were located outside of California and ***defendants did not conduct any settlement operations in California***." (91 CA C021530 (citing, *inter alia*, 9 PA P2158-67, ¶¶ 1, 21, 29, 31).) Plaintiffs do not dispute these findings on appeal either.

Nor could they. The evidence Plaintiffs proffered regarding the supposed genesis of the do-not-flip policy (*see* 11 PA P2678-79)[18] shows that it was developed and implemented entirely outside California: (i) a July 13, 2005 email from Merrill Pro's former President, Thomas Tranfaglia, ***who worked in New York*** (14 CA C003302); (ii) a February 10, 2005 email from Merrill Pro's former CEO, John Brown, ***who worked in New York*** (13 CA C003115);[19] (iii) a June 28, 2005 email from Merrill Pro employee Christine Ritchie indicating on its face that ***she worked in New York*** (14 CA C003306); (iv) a February 15, 2005 email from Merrill Pro managing director Curt Richmond, ***who worked in New York*** (13 CA C003125); and (v) an April 19, 2005 email between Tranfaglia, Brown, and other Merrill Pro executives, ***all of whom worked in New York*** (14 CA C003276).[20]

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[18] As explained earlier, Plaintiffs incorrectly claim that the do-not-flip policy was put in place in 2005. In truth it was installed years earlier, and the cited evidence concerns Merrill Pro's decision to maintain the policy and automate the process after Reg SHO became effective.

[19] Plaintiffs' separate statement (11 PA P2678-79, ¶ 37) incorrectly describes this as a February 11, 2005 email.

[20] The Superior Court properly rejected Plaintiffs' effort to rebut this evidence by claiming that communications to clients by San Francisco-based Merrill Pro employee Alan Cooper about the do-not-flip procedures somehow suggested that he had been involved in implementing the process. (*See* 91 CA C021533-34.) When asked about implementation of the do-not-flip policy, Cooper—who did not join Merrill Pro until 2004 (21 CA

Third, Plaintiffs presented no evidence that Merrill Pierce's alleged failure to lend Merrill Pro a sufficient number of Overstock shares to satisfy its delivery obligations to CNS occurred in California. Although Plaintiffs purported to dispute Merrill Pierce's statement—supported by sworn testimony from the securities lending chief—that its "Securities Lending Department . . . conducted its borrowing, lending, and related transactional activity entirely in New York and Illinois," the only evidence Plaintiffs cited was the fact that Merrill Pierce is registered as a broker-dealer in all 50 states, including California, and has what Plaintiffs termed "substantial operations in California." (12 PA P3088, ¶ 4.) Of course, the mere fact that Merrill Pierce is registered as a broker-dealer in California and has operations in California does not mean that it conducts securities lending activities in California. The Superior Court thus correctly concluded that "the record evidence also was undisputed that defendants' securities lending operations were conducted outside California." (91 CA C021530.) And once again, Plaintiffs do not dispute this finding on appeal.

B. Plaintiffs submitted no evidence that any allegedly manipulative transactions occurred in California.

Because the Merrill Lynch entities did not engage in relevant conduct (much less allegedly manipulative conduct) in California, Plaintiffs argue on appeal that they satisfied *Diamond Multimedia* by presenting evidence that the underlying manipulative transactions by Merrill Pro's ***clients*** occurred in California. (*See* POB at 40-42.) This is an about-face from Plaintiffs' position below, where they told the Superior Court explicitly that "Plaintiffs['] claim here is not based on the transactions by Defendants' customers; rather it is Defendants' decision to intentionally fail to deliver to settle trades in Overstock securities . . . ." (45 CA C010826.)

C004945:4-12)—testified explicitly: "I don't know. I was not involved in those decisions." (22 CA C005081:1-7.)

Plaintiffs had it right the first time. They cannot argue—as they must to establish primary liability—that they are "not trying to hold Defendants liable for their clients' manipulative transactions" (POB at 42), while simultaneously seeking to rely on those same transactions as proof that Merrill Pro's alleged manipulative conduct occurred in California. But in any event, as explained below, Plaintiffs did not present evidence that any of the allegedly manipulative transactions of Merrill Pro's clients occurred in California.[21]

1. Section 25400 requires offer or acceptance in California.

In *Diamond Multimedia*, the California Supreme Court held that "[t]o the extent that section 25400 prohibits stock transactions for market manipulation purposes in subdivisions (a) and (b), ***section 25008 applies to establish whether that conduct occurred in California***." 19 Cal. 4th at 1051; *see also id.* at 1051 ("Section 25008 . . . defines 'in this state' for the purpose of determining when a stock transaction takes place in California."). Yet despite devoting much of their brief to the argument that they submitted evidence of manipulative transactions in California, ***Plaintiffs do not once cite this controlling statute***. This is unsurprising, as Corporations Code Section 25008 is fatal to their claims.

Under Section 25008, a securities transaction occurs "in this state" only if: (i) the offer to buy or sell is made in California; (ii) the offer to buy or sell is accepted in California; or (iii) the security is delivered to the

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[21] Plaintiffs have never suggested, let alone presented admissible evidence, that Merrill Pierce or its clients engaged in manipulative transactions. (*See* 13 PA 3400-15 (Plaintiffs' expert declaration identifying allegedly manipulative transactions); 3 CA C000663-9 CA C002060 (expert's worksheets).) Thus, if Plaintiffs' claims are based on specific client transactions—as opposed to manipulative settlement or securities lending activity—summary judgment for Merrill Pierce must be affirmed on this basis alone.

purchaser in this state and both the seller and the purchaser are domiciled in this state. Cal. Corp. Code § 25008; *see also In re Victor Techs. Secs. Litig.*, 102 F.R.D. 53, 60 (N.D. Cal. 1984) ("The jurisdictional prerequisites of a claim filed under section 25500 are satisfied when offers of securities are made from California to persons outside the state, or when acceptance of the offer is directed to a person within California."). All of the transactions Plaintiffs claim as manipulative involve delivery of securities through CNS, which is located in New York. (*See* 13 PA 3400-15 (Plaintiffs' expert declaration identifying allegedly manipulative Overstock transactions); 3 CA C000663-9 CA C002060 (expert's worksheets); 9 PA P2167, ¶ 31.) Plaintiffs therefore can establish a manipulative transaction "in this state" under Section 25008 only if they show that the offer to buy or sell the Overstock securities was made or accepted in California.

Plaintiffs did not even try to satisfy this standard before the Superior Court. Instead, ignoring *Diamond Multimedia* and Section 25008, Plaintiffs asked the Superior Court to conduct something akin to a jurisdictional analysis and consider the parties' "California contacts" to determine whether California has a "sufficient nexus to this dispute." (*See* 45 CA C010809-11.) But Plaintiffs cannot prevail by pointing to some other connection or "nexus" between transactions in Overstock securities and California. *See* Marsh & Volk § 3.08[2] (state of incorporation and domicile of parties are irrelevant under Section 25008 unless securities are delivered in California); *Anschutz*, 690 F.3d at 111 (rejecting argument that Section 25400 claim had "sufficient nexus" to California because it "confuse[d] the requirements of personal jurisdiction with the availability of a state statutory remedy"); *Lubin v. Sybedon Corp.*, 688 F. Supp. 1425, 1460-61 (S.D. Cal. 1988) (location of issuer is irrelevant under Section 25008). The Superior Court therefore properly rejected that tactic and looked only to the location of the offer or acceptance. (*See* 91 CA

C021532-33 (looking to location of Pacific Exchange).) Plaintiffs pointed to no evidence that any Overstock transaction, let alone a manipulative transaction, satisfies that test.

2. Stock transactions on the Pacific Exchange did not take place in California.

Plaintiffs contend that Merrill Pro's clients executed Overstock short sales in California because they executed Overstock short sales on the Pacific Exchange. (*See* POB at 45-48; 45 CA C010817.) But despite its name, the Pacific Exchange's stock-trading facility, known as the Archipelago Exchange, was located 2,000 miles to the east—***in Illinois***—during the relevant period. (*See* 9 PA P2084, ¶ 16.) As the Superior Court correctly observed, "according to the undisputed evidence, (1) the Pacific Exchange's physical equities trading floor in San Francisco was closed before the start of the relevant period, and (2) all securities trades on the Pacific Exchange during the relevant period (except for options trades) were executed on an electronic trading platform [*i.e.*, the Archipelago Exchange] located in Chicago." (91 CA C021533.) Plaintiffs do not dispute these facts. Indeed, Plaintiffs' designated expert on the Pacific Exchange, Peter Chepucavage, testified that the Pacific Exchange's trading facility moved from a physical trading floor in California to computers in Illinois, and therefore he did not dispute that the "physical trades" on the Pacific Exchange after 2002 occurred in Illinois. (*See* 60 CA C014739:6-14; 60 CA C014745:18-20.) Plaintiffs instead contend that the Pacific Exchange should be treated as though it were located "in California" because the self-regulatory organization ("SRO") overseeing the Archipelago Exchange was headquartered here. Chepucavage described their position as follows:

> [T]he so-called "Archipelago Exchange" was a facility of the Pacific Exchange, and the Pacific Exchange was located in California through at

> least 2006, and continues to have a presence in San Francisco. In my opinion, and as I testified at my deposition, because the SRO was in San Francisco, trades on the Pacific Exchange occurred in California.

(10 CA C002184, ¶ 8.)[22]

There is no dispute that the Pacific Exchange had an office in San Francisco and was the SRO responsible for supervising the Archipelago Exchange in Chicago. But under Section 25008, where a regulator is located makes no difference. What matters is the location of the ***offer*** and ***acceptance***—which, for equity trades on the Pacific Exchange during the relevant period, was Illinois. (*See* 9 PA P2084, ¶ 16.) Plaintiffs offered no evidence of any offers to buy or sell Overstock securities that had been made or accepted in California. Thus the Superior Court properly held that Plaintiffs presented no basis to conclude that any of the Overstock short sales identified by Plaintiffs occurred in California.

Plaintiffs point to two purported errors in the Superior Court's decisions. First, Plaintiffs contend that the Superior Court erred by failing to address trading by Merrill Pro's clients in Overstock ***options***, some of which took place on the Pacific Exchange's options trading facility, which remained in California. (POB at 45-46.) But Plaintiffs do not claim that they were injured by any manipulative trades in Overstock options. In fact, Plaintiffs' damages expert, Dr. Shapiro, testified that he did not consider options trading data and instead focused exclusively on Merrill Pro's failures to deliver ***stock*** to CNS. (13 PA P3201-02, ¶¶ 6-7; *see also* 12 DA D003083:9-14.) And Plaintiffs have never claimed that there was market

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[22] Defendants objected to this testimony as lacking foundation and containing an improper legal conclusion. (57 CA C013889-94.) The Superior Court agreed that this legal opinion was improper and said that it "wouldn't receive the statement as to where trades on the Pacific Exchange occurred." (31 RT 1719:26-27.)

manipulation in the Overstock options market, much less that they were injured from having participated in that market. As explained above, Plaintiffs contend only that Merrill Pro's clients used Overstock options trades to "hide the scheme from regulators." (POB at 46.) But whether that alleged conduct occurred in California is irrelevant to whether any of the allegedly manipulative ***short sales*** resulting in failures-to-deliver and a supposedly manipulated ***stock*** market (and forming the basis of Plaintiffs' Section 25400 claims) occurred in California.[23] Moreover, Plaintiffs identified nothing about how Merrill Pro cleared and settled clients' options trades (to which the do-not-flip policy did not apply) that was supposedly manipulative.

Second, Plaintiffs contend that "[u]nder the trial court's reasoning, one might hold that all trades supposedly made on the New York Stock Exchange are not made in New York, but are in fact made . . . where the Exchange might find it least expensive to keep its computers." (POB at 47.) But unlike the Pacific Exchange, people still trade stock on the floor of the New York Stock Exchange in lower Manhattan. The Pacific Exchange did not merely "rely on remotely-located computer[s]," as Plaintiffs suggest. (*Id.* at 46.) It shut down its San Francisco-based stock trading floor in 2002 (it is now a health club) and transferred all stock trading to the Archipelago Exchange—where offers were made and accepted—in Illinois. (*See* 60 CA C014739:11-14; 60 CA C014745:18-20.) Thus, under Section 25008, stock trades on the Pacific Exchange did not occur in California.

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[23] The same goes for Plaintiffs' contention that in mid-2006 New York-based HCM switched from being an options market maker on the New York-based AMEX to being a remote market maker on the Pacific Exchange's San Francisco-based options trading facility. (*See* POB at 44-45.) That says nothing about HCM's allegedly manipulative Overstock short sales, which occurred outside California, as described above.

3. Plaintiffs cannot show manipulative transactions in California by relying on Merrill Pro's clearing activity.

Plaintiffs also suggest that they can show that manipulative Overstock transactions occurred in California because they have evidence that Merrill Pro cleared transactions in California. (*See* POB at 48.)[24] This argument fails for at least three reasons. First, as explained above, "clearing" refers to the process of comparing and matching both sides of a transaction after the trade has been completed. Clearing is thus irrelevant to determining whether a transaction takes place in California for purposes of Section 25400, because it takes place ***only after the offer and acceptance have occurred*** and the location of the trade has been established under Section 25008. (*See* 91 CA C021532, n.5 (MSJ Order)); *Levitt*, ___ F. 3d ___, 2013 WL 1007678, at *1.

Second, Plaintiffs have not alleged—much less submitted evidence—that Merrill Pro's clearing activities (regardless of location) were manipulative; Plaintiffs' complaint is about Merrill Pro's settlement activities, which occurred three days later. As the Superior Court observed, "plaintiffs' claims are based on failures to deliver shares to complete ***settlement***" and "concern the ***settlement*** process, rather than clearing." (*Id.*)

Third, and most fundamentally, Plaintiffs have not submitted any evidence that Merrill Pro cleared any ***manipulative*** Overstock transactions

[24] Plaintiffs contend, for example, that although New York-based HCM executed conversion trades with New York-based GS&Co. on the Chicago Board Options Exchange (*see* POB 38-39; *see also* 8 PA P2033, ¶ 17), those transactions were "effected" in California because Merrill Pro allegedly cleared them here. (POB at 48-51.)

in California.[25] While Plaintiffs contend that transactions in Merrill Pro's DTC trading account numbered 369 (*i.e.*, its "Sage" trading platform) were cleared in San Francisco (11 PA P2643-44, ¶ 3), ***those transactions did not result in any failures to deliver*** and thus have no connection to Plaintiffs' Section 25400 claims. (*See* 5-11 DA D001112-2945 (CNS Accounting Summaries showing no failures-to-deliver in Overstock for DTC account number 369).) As the Superior Court properly found:

> Plaintiffs' evidence that Merrill Pro conducted the clearing of some transactions in California for part of the relevant period on Merrill Pro's so-called "Sage" platform is unavailing for the additional reason that ***there is no evidence that any fails to deliver Overstock stock occurred in those transactions***. Plaintiffs . . . did not identify any fails to deliver Overstock stock through the "Sage" account (No. 369) that had been "cleared" in California.

(91 CA C021532, n.6 (citing 5 DA D001112-11 DA D002945).) The Superior Court's conclusion is confirmed by the fact that Plaintiffs claim no injury from transactions in Merrill Pro's 369 account; Dr. Shapiro testified that he did not even analyze data from that account. (13 PA P3201-02, ¶¶ 6-7 (omitting 369 from list of accounts analyzed); 12 DA D003091:7-14 (deposition testimony admitting that he did not analyze data in Merrill Pro's 369 account and had no opinion on "the activities in Merrill Pro account 369").)

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[25] In fact, Merrill Pro's San Francisco branch manager testified that any clearing activities were moved out of California over the course of "several months" after Merrill Pro acquired a large Chicago-based clearing firm in April 2005. (*See* 21 CA C004946:20-47:9.) This means that Merrill Pro's San Francisco office was not clearing any trades by the time Defendants began their alleged manipulation of Overstock's share price in August 2005.

Plaintiffs also assert that San Francisco-based Merrill Pro employee Alan Cooper "manually processed the trades to ensure no delivery of stock would be made" and "would also assist in these trades by manually enter[ing] the trades into the bookkeeping side of the clearance process." (POB at 49-50.) But of course "processing a trade" for "the clearance process" ***takes place after the offer and acceptance has already occurred*** and is therefore irrelevant under Section 25008. In any event, Plaintiffs misstate the record—there is no evidence that Cooper "manually processed trades." The only support Plaintiffs cite for this statement is Cooper's deposition testimony, but that testimony directly contradicts the proposition:

> Q. And why is [a client] asking you to [manually enter trades] as opposed to someone else at Merrill? Was that your job?
>
> A. ***I don't know why he was asking me. And no, it wasn't my job.***
>
> Q. How did it get accomplished that these were put in his position? Did you forward it to someone else? Did you do it yourself?
>
> A. I don't remember how this resolved itself.
>
> Q. Okay. Well, if you were going to put these in his position, how would you do that?
>
> A. ***I wouldn't do it. I wouldn't know how to do it.***
>
> Q. Who would have known how to do it?
>
> A. ***Floor personnel, you know, probably on the AMEX [which is in New York] or maybe somebody in our back office [which was in Illinois and New York].*** I'm not really sure who knew how to access the—if this was PAX at the time or—I'm not too sure where these positions were going.

> Probably with PAX [which was located in Illinois].

(22 CA C005201:8-25; Ex. A to March 20, 2013 Declaration of Matthew D. Powers in Support of Defendants Merrill Lynch, Pierce, Fenner & Smith Incorporated's and Merrill Lynch Professional Clearing Corp.'s Motion to Augment the Record on Appeal.) The other evidence Plaintiffs cite likewise does not support their allegation that Cooper "manually processed" the settlement of any ***Overstock*** trade, because it all concerns ***other securities***. (*See* 22 CA C005091:6-C005092:11 (deposition testimony concerning transaction in Fairfax Financial Holdings ("FFH")); 22 CA C05098:9-C05100:16 (deposition testimony regarding transaction in Martha Stewart Omnimedia ("MSO")); 14 CA C003274 (email concerning FFH transaction); 14 CA C003289-90 (email concerning MSO transaction); 14 CA C003292 (email concerning MSO transaction); 14 CA C003300 (email concerning unidentified security).)

Plaintiffs also contend that they can show manipulative transactions in California because they presented expert testimony that Merrill Pro sent clearing data to California. (*See* POB at 51-53.) But expert opinion is not a substitute for facts. Plaintiffs argue that the Superior Court erred in excluding for lack of foundation the "opinion" of their expert Robert Conner that "[a]s a matter of routine practice . . . Pacific Exchange trade data was submitted by clearing firms, including GSEC and Merrill Pro, to the Pacific Clearing Corp. in Los Angeles, California as part of the process of clearing trades." (*Id.*) The Superior Court's decision to exclude this testimony about Merrill Pro's "routine practice" for lack of foundation was proper under Evidence Code § 801(b). Conner did not claim to have ever worked for Merrill Pro (*see* 13 PA P3262-64, ¶¶ 5-11; 13 PA P3298) and therefore has no personal knowledge about Merrill Pro's clearing practices or where Merrill Pro sent clearing data. Despite dozens of depositions of

Merrill Lynch personnel and the receipt of millions of documents, Plaintiffs could not cite any evidence supporting Conner's contention about Merrill Pro. Indeed, Conner's only claimed basis for his testimony was his interpretation of a letter from Goldman Sachs's counsel and a conversation with a former GSEC employee, neither of which provided a foundation for him to give fact testimony about any Defendant's practices, let alone those of ***Merrill Pro***. (13 PA P3294-95, ¶ 110.) In any event, even if the objection had been overruled, the testimony about data submission after a trade was executed would not establish that any particular transaction occurred in California under Section 25008.

4. Cooper's California location does not establish manipulative transactions in California.

Apart from pointing to alleged clearing activities in California, Plaintiffs devote much of their brief to discussing Cooper's activities as a client service representative. Plaintiffs contend that Cooper: (i) acted as HCM's client service representative and jokingly referred to Hazan as his "boyfriend"; (ii) participated in a call between HCM and Merrill Pro's compliance officer (who was in New York); (iii) communicated with HCM about Merrill Pro's policies and procedures for market-maker trades, including its do-not-flip policy, Threshold Fail Tracking System, and Reg SHO close-out (or "buy-in") notices; (iv) communicated with HCM and others regarding their FLEX reset transactions; and (v) assisted HCM in becoming an options market maker on the Pacific Exchange. (*See* POB at 49-51.) These allegations misrepresent the record evidence. But even if they were all true, they do not establish that manipulative Overstock transactions occurred in California. It is undisputed that HCM's Overstock short sales were executed by HCM, not Cooper, and HCM was located ***in New York***. (*See* 10 PA P2581-83.) None of these facts suggests that the offer or acceptance in HCM's Overstock short sales took place in

California. *See Diamond Multimedia*, 19 Cal. 4th at 1051 (requiring § 25400 plaintiffs to satisfy § 25008); Cal. Corp. Code § 25008 (requiring offer, acceptance, or delivery in California). Plaintiffs' assertions that Cooper "was also involved in recruiting" Scott Arenstein's New York-based SBA Trading as a Merrill Pro client (POB at 51) is similarly irrelevant. That allegation says nothing about whether Arenstein or SBA made or accepted an offer to short sell Overstock shares in California.

5. Plaintiffs submit no evidence showing that Merrill Pro's "X-Trade" platform was located in California during the relevant period.

Plaintiffs contend that a Merrill Pierce employee ***in Chicago*** effected manipulative Overstock transactions using Merrill Pro's "X-Trade" platform (formerly known as Kawabunga), which Plaintiffs allege was "housed" in San Francisco. (POB at 51.) Plaintiffs submit no evidence, however, establishing that X-Trade was "housed" in San Francisco between August 2005 and December 2006; nor could they—X-Trade was a "front-end" software system (*i.e.*, a program installed on end users' desktop computers, like Windows or Word) ***that was not centrally located.*** (60 CA C014761:13-19; 60 CA C014767:3-6.)

Neither of the two pieces of evidence Plaintiffs cite (POB at 51 n.25) supports their claim of California "housing." First, Plaintiffs cite the testimony of former Merrill Pro and Sage employee Michael Andera. But Andera did not testify that X-Trade was located in California during the relevant period. (*See* 11 PA P2723 (citing multiple excerpts from Andera transcript, none of which supports Plaintiffs' allegation).) To the contrary, Andera repeatedly testified that X-Trade was a decentralized front-end system that allowed users to send orders to Merrill Pro's separate order-management system known as "SOMS" or "the Pipes" and that the actual order-management system was moved to New York soon after Merrill

Pro's April 2004 acquisition of Sage. (60 CA C014761-71.) Thus, Andera's testimony establishes that the relevant computer systems were not in fact "located in California" during the alleged period of market manipulation (August 2005 to December 2006). Plaintiffs also point to the testimony of a Chicago-based Merrill Pierce employee, Eugene McCambridge. But McCambridge testified only that he primarily used X-Trade to enter orders; he said nothing about where X-Trade was located. (24 CA C005630:2-31:3.) Plaintiffs failed to identify any evidence that anyone in California used X-Trade (or any other means) to make an offer or acceptance for an allegedly manipulative purchase or sale of Overstock securities.

6. A single Merrill Pro client with a California address does not establish that manipulative Overstock transactions occurred in California.

Out of the hundreds of Merrill Pro clients that traded Overstock securities, Plaintiffs identify a single client, Group One, that purportedly "was based in San Francisco" (POB at 55)—despite a sworn statement by that firm's CFO to the contrary (*see* 10 PA P2392-93 (swearing to SEC that Group One's "principal place of business" is in Illinois)). But the mere fact that this client had an office in San Francisco would not be evidence that Group One executed manipulative Overstock short sales "in this state"—particularly given that the client also had offices in other states, including its Illinois headquarters. To create a triable issue of fact as to whether a Group One manipulative Overstock transaction occurred in California, Plaintiffs were required to submit evidence that an offer or acceptance associated with that transaction occurred here. *See* Corp. Code § 25008. They did not. *See Sangster v. Paetkau*, 68 Cal. App. 4th 151, 163 (1998) ("[R]esponsive evidence that gives rise to no more than mere speculation

cannot be regarded as substantial, and is insufficient to establish a triable issue of material fact.").[26]

III. Plaintiffs Failed to Create a Triable Issue of Fact As to Whether Any Defendant Caused Their Alleged Injury.

While the Superior Court found it "unnecessary to address" causation given Plaintiffs' failure to submit evidence of allegedly manipulative conduct in California (91 CA C021534), this Court should affirm the Superior Court's decision on the additional ground that Plaintiffs submitted no admissible evidence that their alleged injuries were caused by any Defendant's conduct in California. *See* Cal. Corp. Code § 25500; *see also Bell*, 209 Cal. App. 4th at 71; *Kight*, 200 Cal. App. 4th at 1387.

A. Defendants shifted the burden to Plaintiffs to create a triable issue of fact on causation.

Defendants shifted the burden to Plaintiffs to present evidence of causation by submitting with their summary judgment motion Plaintiffs' interrogatory responses. (*See* 13 PA P3122, ¶ 38 (citing Plaintiffs' interrogatory responses, 9 PA P2225-368); 11 PA P2699-700, ¶ 47 (same).) Those interrogatories confirmed that Plaintiffs could not identify a single fact or document showing that they were injured by Defendants' conduct. (*See* 9 PA P2225-368.)[27] Plaintiffs therefore bore the burden to present

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[26] Plaintiffs also contend, without supporting evidence, that HCM's "account was based at Merrill Pro's San Francisco office." (POB at 56.) But HCM itself was based in New York and was a market maker on the AMEX in New York for most of the relevant period. (*See* 10 PA P2581-83; 19 CA C004494.) There is thus no basis to presume that any offer or acceptance of any of HCM's Overstock transactions occurred in California.

[27] Specifically, Plaintiffs provided no response to interrogatories asking them to state all facts and identify all documents supporting their contentions that (1) "As a proximate result of Defendants' acts and omissions occurring in California with regard to Overstock, as alleged, Overstock's stock price was manipulated downward, and Plaintiffs were injured by such downward manipulation," and (2) "persistent failures to

competent evidence raising a triable issue of fact regarding causation. *See Great Am. Ins. Cos. v. Gordon Trucking, Inc.*, 165 Cal. App. 4th 445, 451 (2008) ("A defendant moving for summary judgment may rely on 'factually devoid discovery responses' to show that the plaintiffs' cause of action has no merit and to shift the burden to the plaintiff . . . ."); *Union Bank v. Superior Court*, 31 Cal. App. 4th 573, 590 (1995) (same). To hold otherwise would effectively overrule *Union Bank* and sanction Plaintiffs' tactic of evading disclosure of their causation theory (not to mention the evidence that supposedly supported that theory) until after the statutory deadline for Defendants' summary judgment motions in order to protect those flawed theories from judicial scrutiny.

In any event, any possible defect in Defendants' initial showing was remedied by Plaintiffs' submission of the declaration of their expert, Dr. Robert Shapiro, which conclusively demonstrated that Plaintiffs had no admissible evidence that could possibly create a triable issue of fact on the issue of causation. (*See* 11 PA P2778-80, ¶¶ 263-69.) The parties thoroughly briefed both the evidentiary objections to Dr. Shapiro's declaration and the substantive defects in his theory of causation. (*See, e.g.*, 56 CA C013439 (Objections); 67 CA C016181 (Plaintiffs' Response); 68 CA C016345 (Plaintiffs' Additional Response); 45 CA C010858-63 (SJ Opp'n); 52 CA C012512-19 (SJ Reply).) As a result of these

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locate and deliver have created immense downward pressure on the prices of Overstock securities by creating an unlimited supply of stock for sale." (9 PA P2345-46; 9 PA P2348-55.) Although Plaintiffs claimed that they would do so later (*see, e.g.,* 9 PA P2345 (objecting on ground "it is premature to demand information that is the subject of expert analysis")), that empty response did not excuse their failure to provide the information necessary to permit Defendants to evaluate or rebut Plaintiffs' causation theory before the statutory summary judgment deadline. Defendants' interrogatories required Plaintiffs to identify facts, not expert opinions. Plaintiffs' failure to do so properly placed the burden squarely upon them to proffer such facts in opposition to summary judgment.

comprehensive submissions, the record on causation is complete, and it is appropriate to assess the failure of Plaintiffs' evidence to create a triable issue of fact. *See Laabs v. City of Victorville*, 163 Cal. App. 4th 1242, 1267 (2008) (plaintiff's expert declaration supplied "missing link" permitting summary judgment to defendant); *see also* Cal. Civ. Proc. Code § 437c(c) ("The motion for summary judgment shall be granted if ***all the papers submitted*** show that there is no triable issue as to any material fact . . . .").

B. Dr. Shapiro's declaration lacks foundation and should not have been admitted into evidence.

Dr. Shapiro offered two distinct theories of causation, which he called his "signaling" effect and "quantity" theories. Defendants objected to Dr. Shapiro's testimony on the ground that both of these novel theories lacked foundation. (*See* 56 CA C013439-658 (citing Cal. Evid. Code § 801 (opinion testimony must be "[b]ased on matter . . . that is of a type that reasonably may be relied upon by an expert in forming an opinion upon the subject to which his testimony relates") and *Korsak v. Atlas Hotels, Inc.*, 2 Cal. App. 4th 1516, 1523 (1992) (finding trial court abused its discretion in admitting expert testimony under Rule 801 because "courts have the obligation to . . . require adequate foundation for the opinion")).) While a trial court certainly has discretion in allowing or barring expert testimony, the Supreme Court recently confirmed that trial courts must also discharge their "substantial 'gatekeeping' function" to exclude speculative and unreliable expert opinions and "must," among other things, determine "whether, as a matter of logic, the studies and other information cited by experts adequately support the conclusion that the expert's general theory or technique is valid." *Sargon Enters., Inc. v. Univ. of So. Cal.*, 55 Cal. 4th 747, 769, 772 (2012); *see also id.* at 773 ("[T]he trial court's discretion in [regard to the admission of expert testimony] is circumscribed; it must be

exercised within the limits the law permits.").[28] Here, Dr. Shapiro's testimony was so bereft of foundation and logic as to make its admission an abuse of discretion.

1. Dr. Shapiro's "signaling" theory lacks foundation.

Dr. Shapiro's primary opinion is that Defendants' collective failures-to-deliver—or, more precisely, all fails-to-deliver of Merrill Pro and GSEC combined—caused Overstock's share price to be depressed between August 2005 and December 2006, based on the following reasoning: (i) Defendants' failures-to-deliver in Overstock caused more Overstock short selling in the market as a whole during that period, meaning they caused Overstock's "short interest" (*i.e.*, the ratio of the number of shares sold short to the total shares outstanding) to increase during that period; (ii) Overstock's marketwide short interest was in the top 1% of all Nasdaq-listed companies during that period; and (iii) companies in that 1% bracket tend to have a depressed share price. (13 PA P3201-03, ¶¶ 8-9; 13 PA P3240-41, ¶¶ 90-92.) There is no debate that Overstock was among the top 1% of Nasdaq companies measured by short interest. The foundation question is therefore whether there was any evidence on which an expert could reasonably rely to opine that any Defendant's conduct ***caused*** Overstock to be in that top 1%.

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[28] The Superior Court properly rejected the "opinion" of Plaintiffs' expert Conner that Defendants' conduct harmed Plaintiffs, because he did not perform any analysis of trading activity, failures-to-deliver, stock prices, or other data in support. (*See* 13 PA P3285-86, ¶ 78; *see also* 12 DA D003072:18-24 ("Since my role here is not to quantify, I'm not trying to do quantitative studies . . . .").) While the Superior Court did not strike this portion of Conner's declaration outright, the court essentially did so by finding that the statements were empty of evidentiary value. Specifically, the court agreed that "if the expert says it and it's not supported, it's not worth anything. In other words, standing alone, [Conner's] statement doesn't add anything." (32 RT 1769:4-8.)

There is none. First, Dr. Shapiro relied exclusively on a ***correlation*** test, not a causation test, to opine that Defendants' fails-to-deliver caused more Overstock short selling. This alone renders his opinion inadmissible. Second, Dr. Shapiro failed to opine that the additional short selling supposedly resulting from each Defendant's failures-to-deliver—or even from their collective failures-to-deliver—is what caused Overstock's short interest to be in the top 1%. He therefore lacked foundation for an opinion that Defendant's conduct was the ***reason*** Overstock had a depressed stock price.[29] These defects do not go to the weight of Dr. Shapiro's testimony. They are fundamental methodological errors that render his opinion nothing more than inadmissible junk science.

(a) Dr. Shapiro's Granger test cannot prove causation.

Dr. Shapiro's sole analytical support for his statement that Defendants' failures-to-deliver "caused" additional short selling of Overstock shares is his "Granger causality test." (13 PA P3233-35, ¶¶ 72-75.) But as Dr. Shapiro himself concedes, "Granger causality" means only correlation, not causation. (12 DA D003098:6–10 (Shapiro deposition testimony that "it is a correlation").) In other words, when Dr. Shapiro opines that the Granger test shows that phenomenon A "causes" phenomenon B, he is merely stating that phenomenon A is typically

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[29] Dr. Shapiro also has no foundation for his conclusion that Overstock's presence in the top 1% bracket ***caused*** Overstock's stock price to decline. The single academic paper he cites in support—which has nothing to do with market manipulation or fails-to-deliver—does not come close to supporting such a conclusion, instead suggesting that stocks in the top 1% bracket were in fact overvalued where short selling was constrained. (*See* 12 DA D003156-89 (Paul Asquith, Parag Pathak, & Jay Ritter, *Short Interest, Institutional Ownership, and Stock Returns*, 78 J. Fin. Econ. 243 (2005) (concluding that short-selling constraints cause lower returns because they cause stock to be overvalued)).)

observed earlier in time than phenomenon B and that phenomenon A ***might*** cause phenomenon B. But it is also possible that a third factor—phenomenon C—actually causes both A and B. In this case, the "phenomenon A" is Merrill Pro's and GSEC's combined fails-to-deliver. The "phenomenon B" is increased Overstock short sales in the market as a whole. The Granger test does nothing more than say that increased short selling in Overstock ***might*** have been caused by Defendants' fails-to-deliver, but it does not say, and Dr. Shapiro therefore could not opine, that Defendants' failures-to-deliver did in fact cause them—the premise for his opinion.

Clive Granger, the creator of the Granger test, recognized this inherent problem and illustrated it with a meteorological example:

> As the lightning is usually observed before the thunder, because light travels faster than sound, it might seem that lightning causes thunder. However, both are manifestations of what is essentially the same event, and if the observations are placed at the time of the original electrical discharge, the spurious causation disappears.

(12 DA D003204 (C.W.J. Granger, *Testing for Causality: A Personal Viewpoint*, J. Econ. Dynamics & Control, at 342 (1980)).)[30] Both academic literature and even the manual for the software Dr. Shapiro used to run his Granger test agree that the test cannot be used to infer that one event ***causes*** another.[31]

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[30] The notion that thunder is "caused" by lightning is a common misperception based on the fact that light travels faster than sound, so lightning is seen several seconds before thunder is heard. But both are caused at the same time by an electrical discharge.

[31] *See, e.g.*, 12 DA D003233 (James D. Hamilton, *Times Series Analysis*, 307 (1994) ("Granger-causality tests . . . should not be used to infer a direction of causation.")); 12 DA D003229 (Eviews 7 Manual, warning that

Courts have repeatedly recognized that mere correlation does not constitute legal evidence of causation. *See In re DVI, Inc. Secs. Litig.*, 639 F.3d 623, 636 (3d Cir. 2011) ("[P]laintiffs must go beyond a ***correlation*** between market movement and disclosure to demonstrate the injurious price impact was ***caused*** by the material misrepresentation at issue rather than by some other intervening cause or causes . . . ."); *see also In re Nvidia Corp. Secs. Litig.*, 2010 WL 4117561, at *12 (N.D. Cal. Oct. 19, 2010) (dismissing securities fraud complaint for failure to establish loss causation, where "[plaintiffs] point to a ***correlation*** and not a ***causation***" (emphases in original)). In fact, no reported decision has ever permitted an expert to rely on a Granger test alone as evidence of causation. In the only decision nationwide to significantly discuss Granger, the court declined to exclude the expert's opinion outright but strongly cautioned that ***"[t]he Granger causality test should not be used in isolation to determine causation."*** *Pickett v. IBP, Inc.*, 2003 WL 24275809, at *4 n.3 (M.D. Ala. Apr. 10, 2003). But that is exactly what Dr. Shapiro has done here. He did not take into account any other phenomena that could have caused both the failures-to-deliver and the short selling, such as Overstock's poor financial performance or SEC problems, or other market effects or industry trends. (*See* 12 DA D003143:10–D003144:19.)[32]

"Granger causality measures precedence and information content but does not by itself indicate causality. . . .").

[32] Plaintiffs might contend that Dr. Shapiro used an "event study" to validate his reliance on the Granger test. But that contention is foreclosed by Dr. Shapiro's concession that the market, industry, and company-specific factors from his so-called event study "were not something that [he] considered in any of [his] Granger causality test and applications." (12 DA D003143:10-20.)

(b) Dr. Shapiro does not opine that any additional short selling resulting from Defendants' failures-to-deliver caused Overstock to reach the 1% short-interest threshold.

Even assuming that Dr. Shapiro could have properly opined that an individual Defendant's failures-to-deliver caused increased Overstock short selling, he did not opine that such additional short selling caused Overstock to be in the top 1% of Nasdaq-listed companies measured by short interest. (13 PA P3240-41, ¶¶ 90-92.) Thus, even if those companies in the 1% bracket tend to trade at lower prices than other companies, there is nothing in the record to support the conclusion that Defendants' conduct was the "***but-for***" cause of Overstock trading at such lower prices. Indeed, Plaintiffs do not, and cannot, suggest that Overstock was outside the 1% bracket in other periods—*i.e.*, periods before August 2005 or after December 2006. To permit Dr. Shapiro's opinion into evidence as a substitute for but-for proof was error. *See In re Williams Secs. Litig.*, 496 F. Supp. 2d 1195, 1275 (N.D. Okla. 2007) (excluding expert opinion that was "connected to existing data only by the *ipse dixit* of the expert"), *aff'd*, 558 F.3d 1130 (10th Cir. 2009); *In re Imperial Credit Indus. Secs. Litig.*, 252 F. Supp. 2d 1005, 1015 (C.D. Cal. 2003) (excluding expert opinion for lack of foundation where expert failed to "distinguish between the fraud-related and non-fraud related influences of the stock's price behavior").

2. Dr. Shapiro's "quantity" theory is not supported by any analysis or calculations.

Recognizing these fundamental defects in his opinion, Dr. Shapiro set out an alternative causation theory—his "quantity" theory—opining that failures-to-deliver "increased the supply of shares available for sale" and therefore cause a price decline under what he called "basic laws of supply and demand." (13 PA P3244-45, ¶ 101.) But Dr. Shapiro cites no data, calculations, or academic literature supporting this opinion, because there is

none. (13 PA P3244-45, ¶¶ 100-02.) That precludes its admission. *See People v. Bassett*, 69 Cal. 2d 122, 146 (1968) (excluding expert and noting "the *ipse dixit* of the most profound expert proves nothing except [if] it finds support upon some adequate foundation"); *Geffcken v. D'Andrea*, 137 Cal. App. 4th 1298, 1311 (2006) ("[A]n expert opinion based on speculation or conjecture is inadmissible.").

Dr. Shapiro's "quantity" theory appears to be based on Plaintiffs' allegation that failures-to-deliver create "phantom" shares—*i.e.*, artificially inflate supply. (*See* 2 PA P0451-52, ¶¶ 26-29 (Fourth Amended Complaint).) That is not an appropriate foundation for expert opinion. *See Young v. Bates Valve Bag Corp.*, 52 Cal. App. 2d 86, 96 (1942) ("[It] is no doubt the law . . . that where an expert witness bases his opinion entirely upon incompetent matter, or where it is shown that such incompetent matter is the chief element upon which the opinion is predicated, such opinion should be rejected altogether."). Dr. Shapiro's inability to cite anything in support of his opinion is unsurprising, as the SEC and the Depository Trust & Clearing Corporation have both expressly rejected this "counterfiet shares" theory.[33]

In short, Dr. Shapiro's "quantity effect" is nothing more than a paid expert parroting the language of Plaintiffs' complaint without any examination of or even citation to evidence. The Superior Court abused its discretion in admitting this opinion. *See Nardizzi v. Harbor Chrysler Plymouth Sales, Inc.*, 136 Cal. App. 4th 1409, 1415 (2006) (affirming trial court opinion that expert declaration was insufficient to defeat summary

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[33] *See* 4 DA D000864 (SEC Reg SHO FAQ No. 7.1: "Naked short selling has no effect on an issuer's total shares outstanding," and CNS does not "create[] counterfeit shares."); 12 DA D003236-43 (The Depository Trust & Clearing Corporation, *DTCC's Updated Critique of Section 4.1 of Prof. Finnerty's paper, "Short Selling, Death Spiral Convertibles and the Profitability of Stock Manipulation"* (Jan. 24, 2006)).

judgment on issue of causation because "[p]laintiffs cannot manufacture a triable issue of fact through use of an expert opinion with self-serving conclusions devoid of any basis, explanation, or reasoning").

C. Dr. Shapiro's declaration is insufficient to create a triable issue of fact regarding causation.

Even if Dr. Shapiro's declaration were properly admitted into evidence, Plaintiffs still would not have satisfied their burden to present evidence creating a triable issue of fact on causation because Dr. Shapiro did not opine that any individual Defendant's ***manipulative*** conduct or transactions ***in California*** caused Plaintiffs' damages. As a threshold matter, Dr. Shapiro did not even analyze any data concerning Merrill Pierce or GS&Co. and offers no opinion that those entities caused any damage at all. (*See* 13 PA P3201-02, ¶¶ 6-7 (describing analysis of DTC accounts belonging to Merrill Pro and GSEC only).) The judgment dismissing Plaintiffs' claims against Merrill Pierce and GS&Co. should therefore be affirmed on this basis as well.

Dr. Shapiro's opinions as to Merrill Pro and GSEC are also irrelevant because he impermissibly lumped together (i) all failures-to-deliver, including both those that resulted from allegedly manipulative conduct in California, and (ii) Merrill Pro's conduct with that of GSEC. In other words, there is literally no evidence in the record to suggest that the alleged wrongful conduct covered by Section 25400—*e.g.*, Merrill Pro's allegedly ***manipulative*** conduct ***in California***—caused a decline in Overstock's share price. *See* Cal. Corp. Code § 25500 (limiting damages to "the difference between the price at which such other person purchased or sold securities and the market value which such securities would have had at the time of his purchase or sale" absent defendant's Section 25400 violation).

1. Dr. Shapiro does not opine that manipulative conduct or transactions in California caused injury to Plaintiffs.

As Dr. Shapiro admitted, his analysis did not distinguish between (i) failures-to-deliver that resulted from allegedly manipulative conduct or transactions in California and (ii) failures-to-deliver that resulted from non-manipulative conduct or had no connection to California (or both). (*See* 12 DA D003083:24-84:5 (admitting his analysis does not distinguish California transactions or conduct from non-California transactions or conduct); 12 DA D003092:14-24 (same); 12 DA D003083:9-14, (acknowledging failure to distinguish between allegedly manipulative versus non-manipulative conduct).) He simply took ***all*** of Merrill Pro's and GSEC's failures-to-deliver in Overstock, regardless of whether they were allegedly related to California or not, and regardless of whether Plaintiffs contended they were manipulative or not, and aggregated them to support his opinion. His testimony is therefore insufficient to create a triable issue of fact regarding Plaintiffs' ability to prove a compensable injury within Section 25500. *See, e.g., In re Omnicom Grp., Inc. Secs. Litig.*, 541 F. Supp. 2d 546, 554 (S.D.N.Y. 2008) (granting summary judgment on ground that there was "no way for a juror to determine whether the alleged fraud caused any portion of [p]laintiffs' loss" because plaintiffs' expert failed to disaggregate non-fraud factors), *aff'd*, 597 F.3d 501, 512 (2d Cir. 2010); *In re Sci. Atlanta, Inc. Sec. Litig.*, 754 F. Supp. 2d 1339, 1376 (N.D. Ga. 2010) ("[I]n order to defeat summary judgment, plaintiffs in a securities fraud case must present evidence disaggregating the fraud and non-fraud-related causes of the plaintiff's loss."), *aff'd sub nom. Phillips v. Sci.-Atlanta, Inc.*, 489 F. App'x 339, 343 (11th Cir. Sept. 6, 2012).

2. Dr. Shapiro does not opine that any particular Defendant's conduct caused injury to Plaintiffs.

Furthermore, Dr. Shapiro did not separate out Merrill Pro's fails-to-deliver from GSEC's, presumably because he needed to combine them in order to find any correlation between failures-to-deliver and increased short selling. Dr. Shapiro testified only that Plaintiffs' injuries were "caused by the ***combined*** fails of Merrill Lynch and Goldman Sachs." (12 DA D003093:5-12.) But this says nothing about whether Merrill Pro's conduct alone (as opposed to GSEC's conduct) supposedly pushed Overstock into the top 1% bracket that Dr. Shapiro claims leads to price depression. Thus, Dr. Shapiro's opinion does not constitute evidence that the conduct of any one Defendant caused injury to Plaintiffs, as required by Section 25500.

IV. Plaintiffs Submitted No Evidence of Scienter.

The Superior Court's summary judgment ruling should also be affirmed because Plaintiffs failed to present evidence that either Merrill Lynch entity acted with the "high level of scienter" that Section 25400 requires. *See Cal. Amplifier*, 94 Cal. App. 4th at 112; *see also Cole v. Patricia A. Meyer & Assocs., APC*, 206 Cal. App. 4th 1095, 1106 (2012) ("Scienter also is necessary for liability under Corporations Code sections 25400 and 25500 . . . ."). Plaintiffs have never even suggested that they have evidence that Merrill Pro adopted or implemented its do-not-flip policy "[f]or the purpose of creating a false or misleading appearance of active trading in" Overstock or "for the purpose of inducing the purchase or sale of such security by others." Cal. Corp. Code. § 25400 (a) & (b). Yet as Marsh and Volk explain, such a showing of purpose is essential:

> [T]he crucial question is the intent with which the market activity is conducted. If the transactions are effected for the purpose of inducing the purchase or sale of the security by others, then they are unlawful; on the other hand, ***if that purpose is lacking, there is no violation.***

Marsh & Volk, § 14.05[2][d] (2012).

Merrill Pro's policy was, of course, to ***intentionally*** fail to borrow negative-rebate securities for its market makers' short sales, causing ***intentional*** fails-to-deliver, as Plaintiffs repeatedly tell the Court. (*See, e.g.*, POB at 3-4, 12, 15.) But that is not evidence of manipulative intent—to create a misleading appearance of market activity or to induce purchases or sales by others—that Section 25400 requires. *See* Marsh & Volk, § 14.05[2][d] & [3][a] (2012) (noting that § 25500's willful-participation requirement is separate from § 25400's illicit-purpose requirement). An intent to take an action says nothing about the purpose of the action. One can clearly transact "intentionally" (*i.e.,* not accidentally) in a security without having any manipulative purpose in doing so. Failures-to-deliver, intentional or otherwise, are not *per se* manipulative; there must be a purpose to manipulate the market. *See, e.g.*, *Cohen v. Stevanovich*, 722 F. Supp. 2d 416, 424 (S.D.N.Y. 2010) ("[F]ailures to deliver, without more, are insufficient to state a claim for market manipulation . . . . [T]o be actionable as a manipulative act, short selling must be willfully combined with something more to create a false impression of how market participants value a security."); (*see also* 4 DA D000823 ("Naked" Short Selling Antifraud Rule explaining that market maker "would not be making a representation at the time it submits an order to sell short that it can or intends to deliver securities on the date delivery is due")).

Plaintiffs have submitted no evidence that Merrill Pro's ***purpose*** in adopting its do-not-flip (*i.e.*, intentional-fail) policy ***for all negative-rebate securities in 2000*** (9 PA P2162-63, ¶ 18) was to manipulate the market ***for Overstock securities in 2005***. The allegation is as implausible as it is unsupported, since Merrill Pro ***had no position in Overstock securities***. (*See* 91 CA C021533 ("[T]he only arguably 'proprietary' trades by any defendant identified in the record were certain purchases by GS&Co.").)

Simply put, Merrill Pro had no motive to affect the price of Overstock stock.[34]

Faced with this uncontested evidence, Plaintiffs argue that Merrill Pro adopted its do-not-flip policy so that Merrill Pierce could lend its scarce shares to other clients that would pay borrowing fees. (*See* POB at 12.) But that ***disproves*** Plaintiffs' Section 25400 claims, which require Merrill Pro's purpose to be "creating a false or misleading appearance of active trading in" Overstock or "inducing the purchase or sale of such security by others." Merrill Pro's purpose—as Plaintiffs themselves present it—was not to do either of these things, but rather to permit Merrill Pierce to charge securities lending fees. That is not the market-manipulation purpose Section 25400 requires. *See, e.g., La. Pac. Corp. v. Money Mkt. 1 Institutional Inv. Dealer*, 2011 WL 1152568, at *8-9 (N.D. Cal. Mar. 28, 2011) (dismissing § 25500 market-manipulation claims because "[t]he desire to earn commissions or fees is a common motive to all for profit enterprises, and that motive—without more—is insufficient to give rise to a strong inference of scienter"); *Pope Invs. II LLC v. Deheng Law Firm*, 2011 WL 5837818, at *7 (S.D.N.Y. Nov. 21, 2011) ("[A]llegations of the motivation to receive fees for services do not suffice to establish motive, as all firms in the securities industry want to increase profits and all individuals are assumed to desire to increase their compensation.").

[34] In an attempt to disguise their lack of evidence, Plaintiffs falsely assert on appeal that "[t]he trial court found that Plaintiffs presented 'lots' of evidence of Defendants' intentional market manipulation." (POB at 8.) In fact, the Superior Court was merely observing that one of Goldman Sachs's evidentiary objections was immaterial because it addressed evidence in a category where Plaintiffs had proffered voluminous materials; the court never suggested that any of those materials amounted to admissible evidence of improper intent by Goldman Sachs, much less by the Merrill Lynch entities. (*See* 33 RT 1857:19–26; 35 RT 2127:1–10.)

V. California Courts Lack the Power to Provide a Remedy for Merrill Pro's Failure to Deliver Overstock Shares to CNS.

Because Plaintiffs' claims are based on Defendants' failure to deliver Overstock securities to CNS, a California court can offer Plaintiffs no remedy. Under Section 27 of the Exchange Act, only a federal court can decide that Defendants' failures-to-deliver were improper because any duty to deliver Overstock shares is derived from Reg SHO, a regulation promulgated under the Exchange Act. Moreover, Reg SHO permitted Merrill Pro and GSEC to remain in a net failure-to-deliver position indefinitely, so long as they complied with Reg SHO's close-out requirements or allocated the close-out obligation to their broker-dealer customers. Both Merrill Pro and GSEC presented uncontested evidence that they complied with these requirements. (9 PA P2163-65, ¶¶ 21-22 (describing Merrill Pro's allocation procedures); 8 PA P1981-82, ¶ 22 (describing GSEC's Reg SHO close-out procedures).) California law cannot impose more stringent delivery obligations and punish conduct that federal law permits.

A. The federal courts have exclusive jurisdiction over Plaintiffs' claims because Plaintiffs seek to enforce delivery obligations created by Regulation SHO.

To state a claim based on Merrill Pro's or GSEC's failure to deliver Overstock shares to CNS, Plaintiffs must first establish that Merrill Pro and GSEC had a duty to deliver. *See Sullivan & Long v. Scattered Corp.*, 47 F.3d 857, 863 (7th Cir. 1995) (dismissing market-manipulation claim against broker-dealer who intentionally failed to deliver as means of generating trading profits, because "plaintiffs do not point us to, and we have not been able on our own to find, a law that requires . . . short sellers to borrow the stock that they are selling short"). And although Plaintiffs strain to avoid admitting it, the only possible source of that duty here is Reg SHO, which superseded all previous short-selling regulations and

provided an exclusive regime for the resolution of failures-to-deliver at registered clearing agencies—*i.e.*, the CNS failures-to-deliver at issue here. (*See* 4 DA D000772 (Reg SHO Adopting Release).)

Under Section 27 of the Exchange Act, "[t]he district courts of the United States . . . shall have ***exclusive*** jurisdiction of violations of this chapter or the rules and regulations thereunder, and of ***all suits*** in equity and actions at law ***brought to enforce any*** liability or ***duty created by this chapter*** or the rules and regulations thereunder." 15 U.S.C. § 78aa(a). Plaintiffs' claim here—that Merrill Pro and GSEC each failed to perform its duty under Reg SHO to borrow and deliver Overstock shares to CNS—falls squarely within this statutory language. Indeed, this Court need look no further than the first page of Plaintiffs' opening brief to see that they are attempting to recover for the alleged consequences of intentional CNS failures-to-deliver that "[t]he understaffed Securities and Exchange Commission is supposed to catch and stop." (POB at 1-2.) The SEC, of course, does not enforce the California Corporations Code; the delivery obligations that Plaintiffs seek to levy are within the exclusive purview of the SEC, and therefore of the federal courts.

The mere fact that Plaintiffs have chosen to assert their claims under the guise of California law does not strip the federal courts of exclusive jurisdiction. In *Hawkins v. NASD*, 149 F.3d 330 (5th Cir. 1998), for example, the plaintiff asserted state-law claims against the NASD for its alleged failure to properly administer an arbitration proceeding. Because the NASD's "duties arise from . . . a body of rules . . . promulgated under [the Exchange Act]," the Fifth Circuit affirmed a finding of exclusive federal jurisdiction. *See id.* at 331-32. The court observed that "[the plaintiff's] claims against the [defendant], though carefully articulated in terms of state law, are actions at law seeking to enforce liabilities or duties created by federal securities laws which are governed exclusively by

federal courts pursuant to [Section 27]." *Id.* Similarly, in *Sparta Surgical Corp. v. NASD*, 159 F.3d 1209, 1211 (9th Cir. 1998), the Ninth Circuit found exclusive federal jurisdiction over state-law claims that sought relief based on alleged violations of NASD rules.[35] Numerous other courts have reached the same result.[36]

While Plaintiffs might contend that they are relying on a duty arising under Section 25400's broader prohibition on manipulative transactions, their summary judgment opposition and accompanying evidence demonstrate otherwise. As shown by Dr. Shapiro's exclusive reliance on failures-to-deliver to opine that Defendants caused Plaintiffs an injury, Plaintiffs' claims rest entirely on failures-to-deliver. (13 PA P3201-02, ¶¶ 6-7.) Thus, Plaintiffs are attempting to enforce Merrill Pro's and GSEC's obligations to deliver Overstock securities to CNS. But only a federal court has jurisdiction to address such a claim.

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[35] It is no answer to say that these cases were against SROs, as opposed to private companies like Defendants. *See, e.g., Opulent Fund, L.P. v. Nasdaq Stock Mkt., Inc.*, 2007 WL 3010573, at *4 (N.D. Cal. Oct. 12, 2007) ("The text of Section 27 plainly confers exclusive subject matter on the federal courts in all cases, making no distinction between for-profit and regulatory activity."); *Capece v. Depository Trust & Clearing Corp.*, 2005 WL 4050118, at *8 (S.D. Fla. Oct. 11, 2005) (rejecting argument that Section 27 applies only to cases against SROs).

[36] *See, e.g., D'Alessio v. N.Y. Stock Exch., Inc.*, 258 F.3d 93, 101 (2d Cir. 2001) (finding exclusive federal jurisdiction because "gravamen of [plaintiff's] state law claims is that [defendant] . . . conspired to violate the federal securities laws and other rules promulgated by the NYSE"); *Whitehall Wellington Invs., Inc. v. NASD*, 2000 WL 1846129, at *3 (S.D. Fla. Dec. 7, 2000) (finding exclusive jurisdiction where plaintiff alleged that defendants' "interpretation and/or application" of NASD rule violated state law); *Lowe v. NASD Regulation Inc.*, 1999 WL 1680653, at *3 (D.D.C. Dec. 14, 1999) ("Although the Plaintiffs' complaint is careful to allege only state law claims . . ., the Plaintiffs are seeking to enforce . . . a duty imposed by the Exchange Act.").

B. Plaintiffs' claims are preempted by Reg SHO, which specifically authorizes the conduct they label "market manipulation" under California law.

More than five years ago, Defendants demurred to Plaintiffs' initial complaint as preempted by federal law. (11 DA D002961-67.) Plaintiffs avoided dismissal at that stage by framing their allegations as challenging "the intentional manipulation of the securities market through naked short selling," a characterization that allowed them to cast the California Corporations Code as a supplement, rather than an obstacle, to federal securities law. (11 DA D002993.) But since then, Plaintiffs have redefined their claims to focus on Merrill Pro's and GSEC's failures-to-deliver, which resulted exclusively from short sales by their market-maker clients.[37] As a result, Plaintiffs' claims conflict with Reg SHO and are clearly preempted by federal law. *See Whistler Invs., Inc. v. Depository Trust & Clearing Corp.*, 539 F.3d 1159, 1166 (9th Cir. 2008) (dismissing state-law market-manipulation claim on preemption grounds because imposing delivery requirements implicated by those claims would be inconsistent with federal regulations governing clearance and settlement system); *Pet Quarters, Inc. v. Depository Trust & Clearing Corp.*, 545 F. Supp. 2d 845, 853 (E.D. Ark. 2008) (dismissing state-law market-manipulation claim based on conflict preemption because forcing defendant to comply with both SEC regulations and Arkansas law would "completely frustrate Congress's intent to have one uniform system of settling and clearing security transactions"); *Nanopierce Techs., Inc. v. Depository Trust & Clearing Corp.*, 123 Nev. 362, 378 (Nev. 2007) (dismissing state-law

[37] Neither Merrill Pro nor GSEC was a defendant when the preemption issue was previously briefed. As explained above, Plaintiffs have no evidence to back their original claim that Merrill Pierce and GS&Co. engaged in naked short sales and therefore base their claim entirely on Merrill Pro's and GSEC's failures-to-deliver.

market-manipulation claims because any "negative market effects, artificial inflation of shares, or so-called phantom shares that result from respondents not clearing and settling securities transactions as expediently as [plaintiffs] would prefer, would, it appears, constitute an exploitable flaw inherent in the federally authorized system, preempting state law challenges to that flaw").

1. Plaintiffs' interpretation of Section 25400 conflicts with Reg SHO's close-out requirement, market-maker exemption, and allocation provision.

Conflict preemption occurs when a "party's compliance with both federal and state requirements is impossible or [when], in light of the federal statute's purpose and intended effects, state law poses an obstacle to the accomplishment of Congress's objectives." *Whistler Invs., Inc.*, 539 F.3d at 1166. Here, Plaintiffs' proposed application of Section 25400 to Merrill Pro's and GSEC's failures-to-deliver would conflict with Reg SHO in three ways.

First, Plaintiffs contend that Merrill Pro's and GSEC's failures-to-deliver were manipulative and illegal under California law because they lasted so long. (*See, e.g.*, 11 PA P2737, ¶ 154 ("Defendants' large, persistent fails-to-deliver created a significant, artificial increase in the supply of stock . . . ."); POB at 15 (labeling fails as "persistent"); 11 PA P2757, ¶ 207 ("fails to deliver were the lynchpin of Defendants' manipulation of supply and demand").) But the SEC has recognized that "[t]he short condition can exist ***indefinitely***," even when all rules are followed. (3 DA D000694 (SEC Release No. 34-24297); 4 DA D000861-63 (Reg SHO FAQ No. 5.8).) Thus, there is a clear conflict between Plaintiffs' interpretation of California law as requiring Merrill Pro and GSEC to close out their failure-to-deliver positions and Reg SHO's close-out requirement, which permitted overall failure-to-deliver positions to

exist indefinitely. (*See* 4 DA D000775 n.95 (Reg SHO Adopting Release); 4 DA D000861-63 (Reg SHO FAQ No. 5.8).)

Second, Plaintiffs contend that intentional failures-to-deliver are *per se* manipulative and illegal under California law. (*See* 11 PA P2679-80, ¶ 38 (asserting that under Section 25400 clearing brokers have "the obligation to borrow and make delivery ***on all trades***, including market maker negative rebate short sales").) But as discussed above, in adopting Reg SHO the SEC decided to permit market makers to intentionally fail to borrow and deliver securities in order to maintain market liquidity in stocks with high borrowing costs. (*See supra*, pp. 11-14.) There is thus a clear conflict between the SEC rule permitting market makers to intentionally fail to borrow/deliver securities and Plaintiffs' interpretation of California law as prohibiting that same conduct as manipulative.

Third, Plaintiffs contend that clearing brokers like Merrill Pro and GSEC had an obligation under California law to close out failures-to-deliver by purchasing or borrowing securities. (*See, e.g.*, 11 PA P2679-80, ¶ 38 ("Merrill Pro could not allocate the massive fails to its clients. . . . Merrill Pro retained ultimate responsibility to close out any persistent fails to deliver.").) But as also explained above, Reg SHO permitted clearing brokers to allocate their failure-to-deliver position to their broker-dealer clients and shift the close-out requirement to that client. (*See supra*, pp. 14-15.) To the extent the client failed to close out its allocated failure-to-deliver position within 13 days, it was the client that was in violation of Reg SHO, not the clearing broker. In fact, HCM and SBA were sanctioned by regulators for such conduct. (82 CA C019443-52 (HCM Sanctions Order), 82 CA C019412-26 (SBA Sanctions Order).) There is thus a clear conflict between the SEC rule permitting clearing brokers to shift the legal burden for closing out a failure-to-deliver position to its market-maker clients and Plaintiffs' interpretation of California law as requiring clearing

brokers to close out their failures-to-deliver despite an appropriate allocation.[38]

In light of these conflicts, Merrill Pro and GSEC cannot be held liable under California law. To hold otherwise would frustrate the SEC's policy judgment in adopting Reg SHO and make compliance with both California and federal law impossible. *See Whistler Invs., Inc.*, 539 F.3d at 1166; *Pet Quarters, Inc.*, 545 F. Supp. 2d at 853; *Nanopierce Techs., Inc.*, 123 Nev. at 378.

2. Plaintiffs cannot avoid preemption by asserting that federal law and California law share the goal of preventing market manipulation.

As they did five years ago, Plaintiffs will likely argue that state and federal laws share a common goal of preventing intentional market manipulation. (*See* 11 DA D002993.) But while state and federal laws often share broad common ***goals***, this says nothing about whether the ***means*** chosen by state and federal regulators can be reconciled—the sole inquiry when evaluating conflict preemption. As the U.S. Supreme Court has explained, "conflicts are not rendered irrelevant by the . . . argument that there is no real conflict between the statutes because they share the same goals. . . . ***The fact of a common end hardly neutralizes conflicting means*** . . . ." *Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 379-80 (2000) (finding preempted Massachusetts statute that shared same goal as federal statute because statutes employed conflicting means (penalties, procedures, sanctions) to achieve shared end).

[38] Likewise, where a clearing firm itself conducts "buy ins" on the open market to close out failures-to-deliver under Reg SHO (as GSEC did), rather than allocating the fails to broker-dealer clients for them to resolve (as Merrill Pro did), its obligations under Reg SHO are complete. California law cannot impose an additional obligation upon the clearing firm to police its clients' trading and prevent them from conducting new short sales, which may or may not have violated Reg SHO.

The means chosen by the SEC to regulate failures-to-deliver was to (i) permit "naked" short selling by market makers and (ii) require any resulting failures-to-deliver to be closed out in 13 days, either by the clearing broker or the broker-dealer client to whom the fail was allocated. *See* 17 C.F.R. § 242.203(b)(2)-(3). As explained above, this was an SEC policy decision meant to balance the desire for timely delivery with the costs this would impose on market participants who furnish the liquidity needed to ensure functioning markets. Specifically, the SEC explained that "prohibiting all fails[] might be impracticable or an overly-broad method of addressing any potential abuses, and could also disrupt the efficient functioning of the Continuous Net Settlement ('CNS') system operated by the National Securities Clearing Corporation." (4 DA D000774, n.85 (Reg SHO Adopting Release); *see also* 4 DA D000864 (Reg SHO FAQ No. 7.1, explaining that Reg SHO's "flexibility is necessary in order to ensure an orderly market and to facilitate liquidity").) While Plaintiffs have long asserted that the SEC should have done more to prevent failures-to-deliver, California cannot second-guess the SEC's policy judgment and impose liability on clearing brokers that complied with federal law. *See Am. Ins. Ass'n*, 539 U.S. 396, 427 (2003) (finding preemption where "California seeks to use an iron fist where the President has consistently chosen kid gloves").[39]

Finally, Plaintiffs might seek to argue that Merrill Pro's and GSEC's conduct in remaining in a failure-to-deliver position was manipulative

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[39] *See also ABC Charters v. Bronson*, 591 F. Supp. 2d 1272, 1302-03 (S.D. Fla. 2008) (finding preemption where "inconsistency of sanctions [between state and federal statutes] undermines the congressional calibration of force"); *Mayo v. Dean Witter Reynolds, Inc.*, 258 F. Supp. 2d 1097, 1109 (N.D. Cal 2003) (finding that California's ethics standards were preempted and observing that "[w]hile the two sets of rules indeed may share similar goals, this alone does not mean that the state rules are not at odds with the accomplishment of the federal regulatory objectives").

regardless of whether it violated Reg SHO because it was done with allegedly manipulative intent. Plaintiffs have no evidence of such an intent, as described above. But they are trafficking in an even greater fallacy, one highlighted by the SEC in its amicus brief in *Nanopierce*:

> Plaintiffs' assertion that no federal law authorizes defendants to engage in a manipulation, or impose illegal tie-ins, and so on, is merely question begging. ***Any state law that defined defendants' federally-approved conduct as falling into any of these forbidden categories of conduct would be prevented.***

(1 DA D000032.)

Here, federal law expressly permitted Merrill Pro and GSEC to allocate, age, and close out their fails on a rolling basis and remain in a net failure-to-deliver position ***indefinitely***. (3 DA D000694; 4 DA D000775, n.95 (Reg SHO Adopting Release).) Plaintiffs cannot avoid conflict preemption by merely labeling that conduct "manipulative."

VI. The Superior Court's Decision on the New Jersey RICO Claim Should Be Affirmed.

As explained in Goldman Sachs's brief, the Superior Court properly sustained Defendants' demurrer to the New Jersey RICO claim in the Fourth Amended Complaint, properly found futile Plaintiffs' attempt to restate that New Jersey RICO claim in the Fifth Amended Complaint, and properly exercised its discretion to preclude Plaintiffs from filing a Fifth Amended Complaint on the eve of trial.

CONCLUSION

It is time that this wasteful and expensive litigation come to an end. Plaintiffs' lack of evidence of intentional market manipulation must finally doom their claims. Plaintiffs do not contend that either Merrill Lynch entity engaged in ***any*** Overstock transactions for its own account, much less manipulative transactions in California. To the extent Plaintiffs' real

complaint is with Merrill Pro's settlement activities, including its intentional failure to deliver Overstock shares to CNS, the uncontroverted evidence establishes that those activities did not take place in California. Accordingly, the Superior Court's summary judgment ruling was correct, and the judgment should be affirmed.

Dated: March 20, 2013

Respectfully submitted,

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CERTIFICATE OF WORD COUNT

I certify that the text of this Respondents' Brief consists of 22,274 words as counted by the Microsoft Word 2010 word processing program used to prepare this brief.

Dated: March 20, 2013

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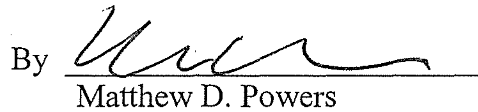
By 
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CERTIFICATE OF SERVICE

I, Linda A. Morris, declare:

I am a resident of the State of California and over the age of eighteen, and not a party to the within action; my business address is Two Embarcadero Center, 28th Floor, San Francisco, California, 94111-3823. On March 20, 2013, I served the following document(s):

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foregoing is true and correct.

Executed on March 20, 2013, at San Francisco, California.

Linda A. Morris

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