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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SENECA GAMING CORPORATION, Plaintiff, v. MERRILL LYNCH, PIERCE, FENNER & SMITH, INCORPORATED, Defendant.	CIVIL ACTION NO. 1:09-cv-6969 (LAP) ECF Case

MEMORANDUM OF LAW IN SUPPORT OF DEFENDANT'S MOTION TO DISMISS PLAINTIFF'S COMPLAINT

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Defendant Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") respectfully submits this memorandum in support of its motion to dismiss the Complaint in its entirety and with prejudice pursuant to Federal Rules of Civil Procedure 9(b) and 12(b)(6).[1]

PRELIMINARY STATEMENT

Like many sectors of the economy, the market for auction rate securities ("ARS") has not escaped the effects of the recent credit crisis. A once robust market has nearly ground to a halt after a series of unprecedented auction failures. Many investors in ARS, including Plaintiff Seneca Gaming Corporation ("Seneca Gaming"), have been unable to liquidate their investments at par value and must retain their ARS until maturity or the market rebounds. Seneca Gaming holds ARS issued by Lakeside CDO I, Ltd. ("Lakeside"), which it purchased through Merrill Lynch. Seneca Gaming seeks to escape the current illiquidity of its investment through a host of claims, all premised on the allegation that, unbeknownst to Seneca Gaming, Merrill Lynch was manipulating the ARS market by submitting bids on its own behalf in auctions for ARS. The primary flaw in this argument is that the clandestine behavior it accuses Merrill Lynch of was not secretive. Merrill Lynch expressly disclosed its active role in the ARS market and the potential impact on investors. These ample disclosures are fatal to Seneca Gaming's claims.[2]

FACTUAL ALLEGATIONS[3]

[1] Merrill Lynch adopts and incorporates the arguments made by Lead Counsel for Merrill Lynch in its Memorandum of Law in Support of Defendants' Motion to Dismiss (Doc. 12) and its Reply Memorandum (Doc. 19) in *In re Auction Rate Securities Litigation*, No. 09-md-2030.

[2] Merrill Lynch provided Seneca Gaming with a letter discussing the deficiencies in the Complaint. Seneca Gaming chose not to amend its Complaint to address these defects.

[3] In ruling on a motion to dismiss, the Court "may consider any written instrument attached to the complaint, statements or documents incorporated into the complaint by reference, legally required public disclosure documents filed with the SEC, and documents possessed by or known to the plaintiff and upon which it relied in bringing the suit." *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 98 (2d Cir. 2007). The Court may also take judicial notice of facts that are "capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned." FED. R. EVID. 201(b)(2).

ARS are securities that have long-term maturities and pay varied interest rates based on periodic "Dutch auctions." (Compl. ¶¶ 2, 28). Publicly-traded ARS consisted mainly of debt instruments, including corporate bonds, municipal bonds, and preferred shares issued by closed-end funds. (*Id.* ¶ 30). The ARS market also included private offerings, including Lakeside ARS, which were backed by collateralized debt obligations ("CDO"). (*Id.* ¶ 30). Under the auction system, current and prospective investors submitted bids through a broker-dealer, such as Merrill Lynch, and based on the bids, the auction agent set the interest rate for the next period at the lowest rate of return at which all of the available securities would be purchased or held. (*See id.* ¶ 28). If insufficient bids existed, then the auction "failed," and the current holders of the securities retained ownership of the ARS until a subsequent, successful auction. (*Id.*). During this holding period, owners of the ARS continue to earn a default rate of interest, as outlined in the Private Placement Memorandum ("PPM") for the ARS purchased by Seneca Gaming. (*See, e.g.*, Lakeside CDO I, Ltd. PPM & Supplement (Exh. A)).

As a part of the successful auction market, Merrill Lynch, and other broker-dealers, routinely submitted bids for its own account in ARS auctions. The SEC investigated the ARS market and, in 2006, issued a publicly-available order concluding that broker-dealers, including Merrill Lynch, had "intervened in auctions by bidding for their proprietary account" to prevent auction failures and set clearing rates without adequate disclosures. ("2006 SEC Order") (Exh. B at 6). The order expressly stated that it did "*not* prohibit broker-dealers from bidding for their proprietary accounts when properly disclosed." (*Id.* at 6 n.6 (emphasis added)).

In December 2005, Seneca Gaming purchased $10 million in ARS issued by Lakeside CDO I, Ltd. and backed by asset-backed securities and related synthetic securities through a private placement. (*See* December 15, 2005 Trade Confirmation (Exh. C)). Seneca Gaming sold

the Lakeside ARS in May 2006 and then purchased $5 million in Lakeside ARS several months later in September 2006. (May 9, 2006 Trade Confirmation (Exh. D); (September 8, 2006 Trade Confirmation (Exh. E); (Compl. ¶ 46). The PPM for the Lakeside ARS, including the Supplement related to the Class A-2 ARS,[4] explained in detail the nature of the investment, disclosing, *inter alia*, how the auction process worked, the possibility of auction failure, the illiquidity of the investment, and the risks associated with the ARS based on the volatility of the underlying collateral. (*See* Exh. A).

In October 2006, in response to the 2006 SEC Order, Merrill Lynch detailed the features of the auction market in a document titled *Description of Merrill Lynch's Auction Rate Securities Practices and Procedures* ("ARS Practices and Procedures") that was posted on the Merrill Lynch website. (Exh. F). The ARS Practices and Procedures contained the following disclosures:

- "Merrill Lynch receives underwriting fees for underwriting issuances of auction rate securities."
- Merrill Lynch entered broker-dealer agreements with issuers and received fees for operating auctions.
- "Merrill Lynch plays multiple roles in the auction rate securities market, including providing services to issuers of auction rate securities, acting as an agent for investors . . . and purchasing and selling as principal for Merrill Lynch's own account."
- "Merrill Lynch's interest in participating in [the ARS] market may differ from yours."
- "Merrill Lynch is permitted, but not obligated, to submit orders in auctions for its own account either as a bidder or a seller, or both, and routinely does so in its sole discretion."
- "Merrill Lynch may routinely place one or more bids in an auction for its own account to acquire auction rate securities for its inventory, to prevent auction failure . . . or an auction from clearing at a rate that Merrill Lynch believes does not reflect the market for the securities."
- "Bids by Merrill Lynch or by those it may encourage to place bids are likely to affect the clearing rate, including preventing the clearing rate from being set at the maximum rate

[4] Seneca Gaming purchased Lakeside CDO I Class A-2 ARS on both occasions.

or otherwise causing bidders to receive a higher or lower rate than they might have received had Merrill Lynch not bid or not encouraged others to bid."

- "Because of these practices, the fact that an auction clears successfully does not mean that an investment involves no significant liquidity or credit risk."
- "Investors should not assume that Merrill Lynch will [continue to place support bids] or that auction failures will not occur."

(Exh. F) (emphasis added).

The Complaint recites the history of the growing credit crisis in early 2007, including distress in the subprime mortgage market and the downgrading of CDOs by credit rating agencies. (Compl. ¶ 47). On August 2, 2007, several auctions for CDO-backed ARS began to fail. (*Id.* ¶ 47-49). After the initial failures, Merrill Lynch, and other broker-dealers, stopped placing support bids in auctions. (*Id.* ¶ 48-49). Those auctions began to fail, including the Lakeside ARS auction on August 7, 2007, and then the entire ARS market, engulfed in a crisis of confidence, collapsed. (*Id.*). Seneca Gaming still owns $5 million in Lakeside ARS, which continue to pay the maximum interest rate pursuant to the PPM. (*Id.* ¶ 52); (*See* Exh. A). Unsatisfied with this arrangement, Seneca Gaming sought to escape the consequences of the deal to which it originally agreed and filed this action on August 6, 2009.

ARGUMENT

"To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.' " *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949 (2009) (quoting *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570 (2007)). Where a plaintiff "ha[s] not nudged [its] claims across the line from conceivable to plausible, the[] complaint must be dismissed." *Twombly*, 550 U.S. at 570. But claims that sound in fraud must be pleaded with greater specificity under Federal Rule of Civil Procedure 9(b), which "is applied assiduously to securities fraud." *Lentell v. Merrill Lynch & Co., Inc.*, 396 F.3d 161, 168

(2d Cir. 2005). Under the PSLRA and Rule 9(b), the circumstances constituting fraud must be pleaded with particularity and "supported by specific factual allegations." *Id.*

I. THE COMPLAINT FAILS TO STATE A CLAIM UNDER SECTION 10(B) AND RULE 10-B(5).

A. The Complaint Fails To Allege a Disclosure Claim.

"To state a claim for relief under § 10(b) and Rule 10b-5, plaintiff[] must allege that Merrill Lynch (1) made misstatements or omissions of material fact; (2) with scienter; (3) in connection with the purchase or sale of securities; (4) upon which plaintiff[] relied; and (5) that plaintiff['s] reliance was the proximate cause of [its] injury." *Lentell*, 396 F.3d at 172; *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 128 S. Ct. 761, 768 (2008). Because Seneca Gaming failed to sufficiently plead these elements, its claim should be dismissed.

1. Seneca Gaming Has Failed To Allege a Misrepresentation or Omission.

a. The Allegations in the Complaint Are Not Sufficiently Specific.

The Complaint fails to "(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent," as required by Rule 9(b) and the PSLRA. *Novak v. Kasaks*, 216 F.3d 300, 306 (2d Cir. 2000); 15 U.S.C. § 78u-4(b)(1). Instead, Seneca Gaming levels vague accusations about the nature of ARS generally and the auction market. (Compl. ¶¶ 5-6, 27). For instance, the Complaint alleges that Merrill Lynch made statements "[a]fter [Seneca Gaming] opened its Merrill brokerage account," but fails to state with specificity when and where such statements were made. (*Id.* ¶ 34). Such opaque statements make it difficult, if not impossible, for Merrill Lynch or the Court to determine the context or falsity of the statement and fail to meet the requirements of the PSLRA or Rule 9(b).

b. Seneca Gaming Has Not Identified a Misrepresentation That Was False When Made.

Even if the allegations are sufficiently specific, Seneca Gaming has still failed to identify a material misrepresentation. Seneca Gaming alleges that Merrill Lynch misrepresented the "nature, structure, and risks" of ARS, (Compl. ¶ 40), but the statements Seneca Gaming alleges were misrepresentations were truthful when made. "Where a complaint alleges a false statement, the complaint must 'state with particularity the specific facts in support of [plaintiffs'] belief that [defendants'] statements were false *when made*.'" *In re IPO Sec. Litig.*, 544 F. Supp. 2d 277, 285 (S.D.N.Y. 2008) (quoting *Rombach v. Chang*, 355 F.3d 164, 172 (2d Cir. 2004)) (emphasis added). The Complaint alleges that general statements, allegedly made by an agent of Merrill Lynch at some point in 2004 and 2006, that investments in ARS were "'safe,' 'highly liquid' 'cash equivalents'" and that "Merrill had never had a 'failed' auction" were misleading. (Compl. ¶¶ 33-36). However, Seneca Gaming fails to offer any factual support for the contention that these statements were false when made: Nothing in the Complaint suggests that, in 2004 and 2006, ARS were not liquid, safe, short-term investments. By Seneca Gaming's own allegations, the auction market was liquid until August 2007 when the auctions began to fail. (*Id.* ¶ 48). Seneca Gaming has failed to explain how it was fraudulent to describe ARS as liquid when – as of that point in time – they were in fact liquid. "Mere allegations that defendants should have anticipated future events and made certain disclosures earlier than they actually did do not suffice to make out a claim of securities fraud." *In re IPO Sec. Litig.*, 544 F. Supp. 2d at 287.

Seneca Gaming also alleges that statements about the nature of ARS were misleading, (Compl. ¶ 36), but again fails to identify a statement that was false when made. The Complaint asserts that at some point "[a]fter [Seneca Gaming] opened its Merrill brokerage account" in 2004, Merrill Lynch "recommended . . . that [Seneca Gaming] purchase ARS that were

'collateralized by mortgages.'" (Compl. ¶ 34). First, the statements identified in the Complaint do not purport to describe the Lakeside ARS or any other particular security. (Compl. ¶¶ 34, 36). Moreover, the alleged misstatements do not speak of exclusivity and suggest, at most, that some ARS sold by Merrill Lynch were collateralized in part by mortgages. (Compl. ¶ 34). This statement is not false or misleading because, as the Complaint implicitly admits, many of the ARS were backed by mortgages along with other assets and collateral. (*See* Compl. ¶ 38 (stating that the ARS were "tied to high-risk, subprime mortgages") (emphasis added)). Even if the statements were related to the Lakeside ARS, they are not misleading: As the PPM for Lakeside ARS explains, the collateral for the ARS includes "a pool of commercial and industrial bank loans," which can encompass mortgages. (Exh. A at 66).

c. Seneca Gaming Has Not Identified An Actionable Omission Because the Risks of ARS Were Extensively Disclosed.

Seneca Gaming also fails to allege an omission of material fact. The exact information that Seneca Gaming alleges Merrill Lynch concealed from the investors was fully disclosed in the 2006 SEC Order, the ARS Practices and Procedures, and media reports. Seneca Gaming cannot now claim ignorance of facts and risks about which it was repeatedly warned. Seneca Gaming alleges that Merrill Lynch failed to disclose that the Merrill Lynch placed bids for its own account in auctions, which affected the liquidity of the investment and prevented auction failures. (Compl. ¶¶ 40, 41). But Merrill Lynch specifically disclosed in the ARS Practices and Procedures that "Merrill Lynch is permitted, but not obligated, to submit orders in auctions for its own account either as a bidder or a seller, or both, and routinely does so in its sole discretion." (Exh. F at 15) (emphasis added). The ARS Practices and Procedures clearly informed investors that Merrill Lynch's practice of placing support bids was often used to "prevent auction

failures[s]" and "[b]ecause of these practices, the fact that an auction clears successfully does not mean that an investment involves no significant liquidity or credit risk." (*Id.* at 16).

Seneca Gaming also asserts that Merrill Lynch failed to disclose "Merrill's numerous and conflicting roles in the ARS market." (Compl. ¶ 42). However, the ARS Practices and Procedures expressly informed Seneca Gaming and other investors that "Merrill Lynch plays multiple roles in the auction rate securities market, including providing services to issuers of auction rate securities, acting as an agent for investors . . . and purchasing and selling as principal for Merrill Lynch's own account." (Exh. F at 4). Merrill Lynch also warned investors that its "interest . . . in [the ARS] market may differ from yours." (*Id.*). The investing public was well-aware of the role Merrill Lynch and other broker dealers played in the auction market. *See* 2006 SEC Order (Exh. B); (Exhs. G-L).

d. Any Alleged Misrepresentations or Omissions Are Immaterial.

To the extent that the Complaint identifies any alleged misstatements, such statements fall within a safe harbor and are immaterial and non-actionable. The following are immaterial as a matter of law: (1) general statements of optimism; (2) statements of future performance; and (3) statements accompanied by sufficient cautionary language. *Kemp v. Universal Am. Fin. Corp.*, No. 05 Civ. 9883, 2007 U.S. Dist. LEXIS 2162, at * 29-32 (S.D.N.Y. Jan. 10, 2007). The alleged misrepresentations identified by Seneca Gaming fall within the last two safe-harbors.

Many of the alleged misrepresentations are statements of future performance, which are "actionable only if 'they are worded as guarantees or are supported by specific statements of fact, or if the speaker does not genuinely or reasonably believe them.'" *In re Bristol-Meyers Squibb Sec. Litig.*, 312 F. Supp. 2d at 557 (quoting *In re IBM Corp. Sec. Litig.*, 163 F.3d 102, 107 (2d Cir. 1998)). Seneca Gaming alleges that Merrill Lynch touted ARS as "safe" and "highly-liquid"

investments, (Compl. ¶ 34), but fails to aver sufficiently that the statements were anything other than honestly-held opinions about the future performance of ARS.

Any misstatements are also rendered immaterial under the "bespeaks caution" doctrine. "[U]nder the well-established 'bespeaks caution' doctrine, an alleged misstatement is not actionable where investors were adequately warned of the relevant investment risks." *Ladmen Partners, Inc. v. Globalstar, Inc.*, No. 07 Civ. 0976, 2008 U.S. Dist. LEXIS 76670, at * 40 (S.D.N.Y. Sept. 30, 2008) (Preska, J.).[5] Seneca Gaming was warned of the risks of investing in the auction market, including the routine practice of submitting support bids. *See supra* pp. 3-4.

Additionally, the nature and risks associated with the collateral underlying the Lakeside ARS were widely disclosed. Seneca Gaming suggests that it was unaware that the Lakeside ARS were backed by CDOs, which it describes as "risky, liquid, complex derivatives," (Compl. ¶¶ 30, 33). However, the Lakeside ARS PPM discloses that the underlying collateral consisted of asset-backed securities and synthetic securities that encompassed a portfolio of investments including "pool[s] of receivable, debt obligations, debt securities, [and] finance leases" and "pool[s] of commercial and industrial bank loans, obligations and debt securities." (Exh. A at 3, 16, 66). The PPM cautioned that the investment was "speculative" and subject to the liquidity and risks of the underlying collateral, which "will fluctuate with, among other things, the financial condition of the obligors on or issuers of the Collateral Debt Securities or . . . general economic conditions, the condition of certain financial markets, political events, developments or trends in any particular industry and changes in prevailing interest rates." (*Id.* at 15). These extensive disclosures rendered any misstatements immaterial.

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[5] "The cautionary information need not be in the same document that contains the forward-looking statement, but must instead be reasonably available to investors and affect the total mix of information." *Kemp*, 2007 U.S. Dist. LEXIS 2162, at *30-31.

Moreover, absent any safe harbors, any misrepresentation about the collateral underlying the Lakeside ARS is still immaterial because the "true" facts were publicly disclosed. The name of the Lakeside ARS, which appeared on the trade confirmation received by Seneca Gaming, identifies the ARS as a CDO. (Exh. E). The definition and risks of CDOs in general were publicly available, and publicly-available information renders a misrepresentation immaterial. *See Ganino v. Citizens Util. Co.*, 228 F.3d 154, 167 (2d Cir. 2000).

2. Seneca Gaming Has Failed To Sufficiently Plead Scienter.

The PSLRA heightened pleading standard requires the Complaint to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). To satisfy this stringent standard, a plaintiff must allege "facts '(1) showing that the defendants had both motive and opportunity to commit the fraud or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness.'" *In re Citigroup Auction Rate Sec. Litig.*, 2009 WL 2914370, * 5 (S.D.N.Y. Sept. 11, 2009) (quoting *ASTI*, 493 F.3d at 99). When evaluating whether the facts alleged give rise to a strong inference of scienter, "a court must consider plausible nonculpable explanations for the defendant's conduct." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 323 (2007). "A complaint will survive . . . only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." *Id.* at 324.

a. The Non-Fraudulent Inferences Are More Compelling than Any Inference of Scienter.

Far from suggesting the requisite intent, Merrill Lynch's actions refute any inference of scienter. Merrill Lynch expressly disclosed that it "routinely" submitted support bids on its own account to prevent auction failures and to affect the clearing rate, but that investors should not assume that Merrill Lynch would continue to enter support bids or that a successful auction

reflected liquidity or low risk. *See supra* pp. 3-4. This full disclosure by Merrill Lynch negates any inference that Merrill Lynch was acting with an intent to defraud investors regarding its support for the ARS market. *See In re WOW Sec. Litig.*, 35 F.3d 1407, 1425 (9th Cir. 1994) ("detailed risk disclosure[s] negate[] an inference of scienter"); *In re Loral Space & Comm'ns Ltd. Sec. Litig.*, No. 01 Civ. 4388, 2004 WL 376442, at *15 (S.D.N.Y. Feb. 27, 2004).

Additionally, Merrill Lynch's own purchases of ARS preclude an inference of scienter. As the Complaint acknowledges, Merrill Lynch regularly purchased ARS in auctions for its own account. (Compl. ¶ 40). These investments belie any intent to defraud. Because "it would have made no economic sense for defendants to invest literally billions of dollars in a venture that they knew would fail," "[t]hese facts . . . compel the conclusion that defendants did not act with the scienter that is required under the securities laws." *Davidoff v. Farina*, No. 04 Civ. 7617, 2005 WL 2030501, at *11 n.19 (S.D.N.Y. Aug. 22, 2005).

Considering all nonculpable explanations, the compelling inference arises that Merrill Lynch believed ARS to be a sound financial investment for its own accounts and those of its customers. The eventual collapse of the entire ARS market suggests, at most, that Merrill Lynch "engaged in bad (in hindsight) business judgments in connection with ARS." *In re Citigroup*, 2009 WL 2914370, at *6. It is an impermissible leap from bad business judgment to fraud.

b. The Mere Receipt of Fees and a General Desire for Profitability Do Not Permit a Compelling Inference of Scienter.

Seneca Gaming unsuccessfully attempts to plead an inference of scienter with conclusory allegations about Merrill Lynch's desire to earn fees. (Compl. ¶¶ 29, 42). However, a generalized motive to show or increase profitability is insufficient to allege scienter. *See Kalnit v. Eichler*, 264 F.3d 131, 140 (2d Cir. 2001). Similarly, a "motivation to earn unspecified fees as a basis for inferring scienter" has been routinely rejected. *See In re Citigroup*, 2009 WL 2914370, at *6.

Accepting Seneca Gaming's vague allegations of intent "as adequate . . . would essentially read the scienter element out of existence." *In re Merrill Lynch & Co., Inc. Res. Rpts. Sec. Litig.*, 289 F. Supp. 2d 416, 428 (S.D.N.Y. 2003) (Preska, J.). As this Court has recognized:

> All firms in the securities industry want to increase profits and all individuals are assumed to desire to increase their compensation. Allegations such as these are inadequate to plead motive to commit a fraud on the market or the public under the securities laws and the Reform Act and will not be endorsed by this Court.

Id. Based on the scant allegations in the Complaint, a reasonable person could not "deem the inference of scienter cogent and at least as compelling as [the] opposing inference" that Merrill Lynch simply made a poor business decision. *See Tellabs*, 551 U.S. at 324.

3. Seneca Gaming Has Failed To Sufficiently Plead Reliance.

To survive a motion to dismiss, the Complaint must allege reliance or transaction causation. *Lentell*, 396 F.3d at 172. A plaintiff usually satisfies this requirement with an "allegation that but for the claimed misrepresentations or omissions, the plaintiff would not have entered into the detrimental securities transaction." *Id.* However, "[t]he general rule" is that reliance must be reasonable. *Harsco Corp. v. Segui*, 91 F.3d 337, 343 (2d Cir. 1996). Seneca Gaming attempts to allege that it relied on statements made by a Merrill Lynch broker, (Compl. ¶¶ 46, 71), but any reliance on such statements in the face of the extensive disclosures about the auction market would be patently unreasonable. *See In re Citigroup*, 2009 WL 2914370, at *7-8. "An investor may not justifiably rely on a misrepresentation if, through minimal diligence, the investor should have discovered the truth." *Starr ex rel. Estate of Sampson v. Georgeson Shareholder, Inc.*, 412 F.3d 103, 109 (2d Cir. 2005). Because Seneca Gaming could have discovered the exact information it now claims was undisclosed simply by reading the 2006 SEC Order, the ARS Practices and Procedures, the Lakeside ARS PPM, or various media reports, Seneca Gaming cannot establish direct reliance.

The extensive disclosures about the auction market also are fatal to any allegations of presumptive reliance. Seneca Gaming has not, and cannot, take advantage of the fraud-on-the-market presumption of reliance because the Complaint disavows that the ARS market was efficient when it alleges that the ARS market was only successful because "Merrill had continuously stepped in and purchased the ARS to conceal what would otherwise have been [auction] failures." (Compl. ¶¶ 40-42). When a plaintiff's "own allegations and evidence demonstrate that an efficient market cannot be established[,]" the fraud-on-the-market presumption is not applicable. *In re IPO Sec. Litig.*, 471 F.3d at 42-43. Merrill Lynch's disclosure of its involvement in the ARS market also negates a fraud-on-the-market theory of reliance: "In a fraud-on-the-market case, an omission is actionable under section 10(b) and Rule 10b-5 only if the [allegedly undisclosed] information has not already entered the market." *See Heliotrope Gen., Inc. v. Ford Motor Co.*, 189 F.3d 971, 975 (9th Cir. 1999). Nor may Seneca Gaming rely on the *Affiliated Ute* presumption, where reliance is presumed if the claim rests on an omission of material fact, because Seneca Gaming has failed to identify an actionable, undisclosed material fact. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972).

4. Seneca Gaming Has Failed To Sufficiently Plead Loss Causation.

"It is long settled that a securities-fraud plaintiff 'must prove . . . loss causation.'" *Lentell*, 396 F.3d at 172. "Loss causation 'is the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff.'" *Id.* (quoting *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 197 (2d Cir. 2003)). To establish loss causation, the loss must have been foreseeable and "caused by the materialization of the concealed risk." *Id.* at 173. For the loss to be foreseeable, "a plaintiff must allege . . . that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the

security." *Id.* A plaintiff also must properly allege that the "misrepresentation was the cause of the actual loss suffered." *Citibank, N.A. v. K-H Corp.*, 968 F.2d 1489, 1495 (2d Cir. 1992).

Seneca Gaming has not plausibly alleged that any economic loss it suffered resulted from the disclosure of misrepresentations by Merrill Lynch. Instead, the Complaint acknowledges that the actual cause of the loss was the decision to stop entering support bids: "Merrill and others chose to stop buying those securities . . . . As an immediate result, beginning August 2, 2007, financial institutions allowed at least 96 auctions for ARS tied to RMBS, CDOs and other derivatives to fail, leaving institutional and corporate investors stuck with nearly $9 billion of illiquid securities." (Compl. ¶ 48). That is, it was (allegedly) the failure to bid itself, and not any disclosure of a previously-suppressed fact, that caused Seneca Gaming's loss.

Any loss of liquidity of the ARS is likewise attributable to the marketwide collapse, not any disclosures of fraud. A plaintiff fails to sufficiently plead loss causation when the loss is not attributable to an earlier misrepresentation, but reflects "changed economic circumstances, changed investor expectations, new industry-specific or firm specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price." *Dura Pharm. Inc. v. Broudo*, 544 U.S. 336, 343 (2005). When, as here, the loss "coincides with a marketwide phenomenon causing comparable losses to other investors, . . . a plaintiff's claim fails when 'it has not adequately ple[]d facts which, if proven, would show that its loss was caused by the alleged misstatements as opposed to intervening events." *Lentell*, 396 F.3d at 174. Seneca Gaming's failure to sufficiently allege that any misrepresentation by Merrill Lynch, rather than the decision to stop entering support bids and the collapse of the market, caused its loss is fatal to its disclosure claim.

B. The Complaint Fails To State a Market Manipulation Claim.

"Market manipulation requires . . . (1) manipulative acts; (2) damage (3) caused by reliance on an assumption of an efficient market free of manipulation; (4) scienter; (5) in connection with the purchase or sale of securities; (6) furthered by the defendant's use of the mails or any facility of a national securities exchange." *ATSI*, 493 F.3d at 101. Seneca Gaming has not pleaded a claim for market manipulation with the requisite specificity. Rule 9(b) requires plaintiffs to aver "specific allegations as to which Defendants performed what manipulative acts at what times and with what effect." *In re Citigroup*, 2009 WL 2914370, at * 5. Seneca Gaming's vague references to "a series of fraudulent and deceitful acts or practices," (Compl. ¶ 70), are insufficient to allege market manipulation. *See id.* Moreover, Merrill Lynch's extensive disclosures are fatal to any claim of market manipulation.

1. Seneca Gaming Has Failed To Identify Any Manipulative Acts.

Market manipulation requires a manipulative or deceptive act that is *prohibited*, "such as wash sales, matched orders, or rigged prices." *See Santa Fe Indus., Inc. v. Green*, 97 S. Ct. 1292, 1301-02 (1977). Seneca Gaming does not, and cannot, identify any prohibited conduct by Merrill Lynch. In fact, the only conduct that Seneca Gaming even references– the submission of support bids – is completely legal and permitted by the SEC. (Exh. B). Practices that are permitted by the SEC cannot form the basis of a market manipulation claim.

Not only are Merrill Lynch's auction policies lawful activities, they were fully disclosed to Seneca Gaming, other investors, and the ARS market in general. While a market manipulation claim is premised on "the fact that investors are misled to believe 'that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators,'" *ATSI*, 493 F.3d at 100, full disclosure of the conduct in question is fatal to a claim of market manipulation. *Santa Fe*, 97 S. Ct. at 1303. In addition to repeatedly

informing investors about the practice of placing support bids, Merrill Lynch warned Seneca Gaming and other investors of the exact risk that befell it: "[A]uction failures are possible, especially if the issuer's credit were to deteriorate, if a market disruption were to occur or if, for any reason, Merrill Lynch were unable or unwilling to bid." (Exh. F at 18). Seneca Gaming's claim of market manipulation evaporates in the light of these disclosures.

2. Seneca Gaming Has Failed To Plead Adequately the Remaining Elements.

For the same reasons the misrepresentation claim should be dismissed for failing to plead particularized facts giving rise to a strong inference of fraudulent intent or for failing to plead that the economic loss was caused by fraudulent actions, Seneca Gaming's market manipulation claim likewise should be dismissed. *See supra* pp. 10, 13. Seneca Gaming has also failed to plead reliance. Reasonable reliance "on an (ultimately incorrect) assumption of an efficient market free of manipulation" is a necessary element of market manipulation. *In re Citigroup*, 2009 WL 2914370, * 6. Disclosure, however, precludes a finding of reliance. Recently, Judge Swain concluded that disclosures about the ARS market that were nearly identical to those received by Seneca Gaming from Merrill Lynch were fatal to a market manipulation claim. *Id.* at *7. As in *In re Citigroup*, these extensive disclosures are "fatal to [a] claim for market manipulation." *Id.*[6]

C. Seneca Gaming's Section 10(b) Claims Are Time-Barred.

"[T]he statute of limitations period applicable to section 10(b) and Rule 10b-5 [is] the earlier of '(1) two years after the discovery of the facts constituting the violation; or (2) 5 years after such violation.'" *In re GlaxoSmithkline PLC*, No. 05 Civ. 3751, 2006 WL 2871968, at * 7 (S.D.N.Y. Oct. 6, 2006). The limitations period begins upon inquiry notice: "when circumstances

[6] Seneca Gaming is also unable to rely on the theory of fraud-on-the-market in the context of a claim for market manipulation for the same reasons the theory is unavailable in its claim of misrepresentation. *See supra* p. 13.

would suggest to an investor of ordinary intelligence the probability that she has been defrauded." *LC Cap. Partners, LP v. Frontier Ins. Group Inc.*, 318 F.3d 148, 154 (2d Cir. 2003). When inquiry notice is apparent from the complaint and papers "integral to the complaint," the court "can readily resolve the issue on a motion to dismiss." *Lentell*, 396 F.3d at 168.

As early as 2004, information about the practice of submitting support bids in ARS auctions was publicly available. (Exhs. G-L). The May 2006 SEC Order, which was released to the public, further disclosed the role brokers played in connection with the auction market. (Exh. B). In October 2006, Merrill Lynch put Seneca Gaming on inquiry notice when it publicly released the ARS Practices and Procedures. (Exh. F). Additionally, as the Complaint points out, "auctions for ARS tied to RMBS, CDOs and other derivatives" similar to the Lakeside CDO, began to fail on August 2, 2007. (Compl. ¶ 48). All of the information about which Seneca Gaming now complains was available to the general public, investors, and Seneca Gaming by August 2, 2007, more than two years before Seneca Gaming filed this action on August 6, 2009. Because Seneca Gaming was on inquiry notice by August 2, 2007, at the latest, Seneca Gaming's claims under Section 10(b) and Rule 10b-5 are barred by the two-year statute of limitations.

II. THE COMPLAINT FAILS TO ALLEGE A SECURITIES CLAIM UNDER SECTION 12(A)(1).

Seneca Gaming purports to allege a violation of "Section 12(b)(1) of the Securities Act." (Compl., p. 19). Merrill Lynch interprets this claim as being pleaded under Section 12(a)(1) of the 1933 Securities Act, 15 U.S.C. § 77*l*(a)(1), which governs the registration of securities. Seneca Gaming's claim under this section is due to be dismissed for two independent reasons: Seneca Gaming is a Qualified Institutional Buyer exempted from Section 12(a)(1); and the claim is barred by the applicable statutes of limitations and repose.

A. Seneca Gaming Is a Qualified Institutional Buyer Under Rule 144A.

Section 12(a)(1) of the Securities Act makes it unlawful to sell an unregistered security. 15 U.S.C. § 77*l*(a)(1). However, SEC Rule 144A exempts the sale of certain unregistered securities to Qualified Institutional Buyers ("QIB") through private placements. 17 C.F.R. § 230.144A; *In re REFCO, Inc. Sec. Litig.*, 503 F. Supp. 2d 611, 620 (S.D.N.Y. 2007). A QIB includes a corporation "that owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity." 17 C.F.R. § 230.144A(a)(1)(i)(H). As the Complaint acknowledges, Seneca Gaming is a corporation that invested more than $300 million in securities. (Compl. ¶¶ 11, 19, 44). As such, Seneca Gaming is a QIB eligible to purchase unregistered securities, like Lakeside ARS, through private placements and the sale of ARS was exempted from liability under Sections 12(a)(1) and 5 of the Securities Act.

B. Seneca Gaming's Claim Is Time-Barred.

Even if Seneca Gaming was not a QIB and the sale of the unregistered ARS violated the securities laws, any claim by Seneca Gaming is barred by the one-year statute of limitations and the three-year statute of repose under Section 13. The Securities Act provides that "[n]o action shall be maintained . . . to enforce a liability created under section 77*l*(a)(1) . . . unless brought within one year after the violation upon which it is based." 15 U.S.C. § 77m. Because the violation occurs when the unregistered security is sold, *McLernon v. Source Intern., Inc.*, 701 F. Supp. 1422, 1427 (E.D. Wis. 1988), the cause of action arose, at the latest, on September 8, 2006, when Seneca Gaming purchased the Lakeside ARS. (Compl. ¶ 46). Because the instant action was filed on August 6, 2009, almost three years after the purchase of ARS, the claim is barred by the one-year statute of limitations.

Seneca Gaming's claim under Section 12(a)(1) is also barred by a statute of repose. The Securities Act imposes an unconditional, three-year statute of repose on claims of unregistered

securities. 15 U.S.C. § 77m ("In no event shall any such action be brought to enforce a liability created under section 77k or 77*l*(a)(1) of this title more than three years after the security was bona fide offered to the public."); *P. Stolz Family P'ship L.P. v. Daum*, 355 F.3d 92, 98-99 (2d Cir. 2004). The time for the statute of repose begins to run "when the security is first bona fide offered to the public." *P. Stolz*, 355 F.3d at 106. Here, the Lakeside ARS were first offered to the public on December 9, 2003, and the PPM placed investors, including Seneca Gaming, on notice that the securities were not registered and could only be purchased by QIBs. (*See* Exh. A). Because Seneca Gaming's claim under Section 12(a)(1) was filed in August 2009, well beyond three years after the security was bona fide offered to the public, it is barred by the statute of repose. *See id.*

III. SENECA GAMING'S CLAIM FOR COMMON LAW FRAUD FAILS.

Under New York law, a plaintiff must sufficiently allege the following elements of fraud to survive a motion to dismiss: (1) a false representation; (2) of material fact; (3) with intent to defraud; (4) reasonable reliance on the representation; (5) causing damages to the plaintiff. *Lama Holding Co. v. Smith Barney, Inc.*, 668 N.E.2d 1370, 1374 (N.Y. 1996). Because Seneca Gaming has not sufficiently alleged the common elements of misrepresentation, scienter, and reliance, the common law fraud claim is fatally deficient. *See supra* pp. 5, 10-13; *Fezzani v. Bear, Stearns & Co. Inc.*, 592 F. Supp. 2d 410, 423 (S.D.N.Y. 2008).

IV. SENECA GAMING'S CLAIM FOR BREACH OF CONTRACT FAILS.

Under New York law, "[t]he elements of a breach of contract claim are formation of a contract between the parties, performance by the plaintiff, the defendant's failure to perform, and resulting damage." *Flomenbaum v. NYU*, 2009 WL 4350604, at * 7 (N.Y. App. Div. Dec. 3, 2009). To survive a motion to dismiss, the plaintiffs must "set forth the contract provisions they

allege the defendant breached." *Peters v. Accurate Bldg. Inspectors Div. of Ubell Ent., Inc.*, 29 A.D.3d 972, 973 (N.Y. App. Div. 2006). Seneca Gaming's claim for breach of contract fails to meet this standard. The Complaint summarily alleges that the "Account Agreement constitutes a . . . contract" that "Merrill materially breached . . . by . . . selling unsuitable securities," (Compl. ¶¶ 74, 76), but fails to identify any contractual provision regarding suitability that Merrill Lynch allegedly breached. These bare and conclusory allegations are patently insufficient and merit dismissal. *See Iqbal*, 129 S. Ct. at 1949; *Owens v. Gaffken & Barriger Fund, LLC*, No. 08-Civ-8414, 2009 WL 3073338, at *14 (S.D.N.Y. Sept. 21, 2009).

CONCLUSION

For the reasons set forth above, Merrill Lynch respectfully requests that the Court dismiss the Complaint in its entirety and with prejudice.

Dated: January 4, 2010

Respectfully submitted,

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