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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SENECA GAMING CORPORATION, Plaintiff, - against - MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, Defendant.	:	Case No. 09-cv-6969 (LAP) ECF Case Electronically Filed

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

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Plaintiff Seneca Gaming Corporation ("SGC") respectfully submits this memorandum of law in opposition to the motion of defendant Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill") to dismiss the complaint and in response to Merrill's memorandum of law in support of the motion ("Def. Mem.").[1]

PRELIMINARY STATEMENT

This securities fraud action arises from investment banker Merrill's fraudulent inducement of SGC, a gaming facility operator owned by the Seneca Nation of Indians, to purchase millions of dollars of unregistered auction rate securities ("ARS") -- debt securities whose interest rates were set at frequent periodic auctions -- that Merrill falsely represented to SGC were safe, highly liquid, and could be freely sold at those auctions.

In fact, notwithstanding that Merrill was intimately familiar with SGC's need to invest its cash in safe, liquid investments, Merrill fraudulently concealed from SGC that the ARS were, in truth, not liquid, and were collateralized not by high quality residential mortgages, but mortgage derivatives backed by subprime mortgages and exotic derivatives structured and underwritten by Merrill for other clients. Critically, Merrill also fraudulently concealed from SGC that, among other things, the very auction markets Merrill heralded as providing liquidity were not *bona fide* auction markets at all. Rather, they were dependent upon Merrill's continual -- and secret -- propping up of that market by purchasing ARS for its own account, and that if and when Merrill decided it was no longer in its interest to prop up the auctions, the liquidity would evaporate. That is exactly what happened in August and September 2007 -- Merrill stopped propping up the auctions -- and liquidity evaporated, leaving SGC's investment virtually worthless. Had SGC

[1] Submitted herewith in opposition to the motion is the affidavit of Charles M. Miller, sworn to February 22, 2010 ("Miller Aff."). A copy of the complaint ("Compl.") is annexed to the Miller Aff. as Exhibit A.

known the truth -- that the ARS were in fact risky, speculative, and dependent on Merrill's whims -- it would not have purchased them.

SGC, asserting claims against Merrill for selling unregistered securities in violation of Section 12(a)(1) of the Securities Act, common law fraud, fraud in violation of Section 10(b) of the Securities and Exchange Act of 1933, and breach of contract, brings this action to recover its losses caused by Merrill's egregious misconduct.

In moving to dismiss, Merrill submits no fewer than 12 exhibits and argues that its manipulation of the ARS auctions was not "secretive" and that it "expressly disclosed its active role in the ARS market and its potential impact on investors." (Def. Mem. 1.) Not only are Merrill's arguments entirely inappropriate on a motion to dismiss -- at a minimum, they raise issues of fact -- they are demonstrably false and irrelevant. For example, Merrill makes much of a document it claims it posted on its website in October 2006 purportedly describing its ARS "Practices and Procedures," which Merrill claims disclosed its involvement in the ARS auctions. (Def. Mem. 3-4, 7-8, 12, 17.) Even assuming *arguendo* that that document accurately and adequately disclosed Merrill's involvement -- which it did not -- and even if a document posted on Merrill's website constituted disclosure to SGC -- which it did not -- the document was posted *after* SGC purchased the ARS at issue. Contrary to Merrill's claim, therefore, that document could not have constituted *any* disclosure, let alone adequate disclosure, to SGC before Merrill fraudulently induced SGC to purchase the ARS.

In sum, Merrill's arguments amount to a request, in effect, that this Court find, as a matter of law, that: (1) it was not false or misleading for Merrill to represent to SGC that the ARS were "liquid," even where the ability to sell and recover value depended upon secret purchases by Merrill, the ARS's underwriter and broker -- not by *bona fide* market investors;

(2) Merrill, the ARS broker and underwriter, adequately disclosed the liquidity of the ARS, even though it concealed the frequency with which it purchased ARS for the purpose of creating the appearance of liquidity and the amount of each auction it needed to purchase and thereby concealed the amount of ARS unwanted by *bona fide* investors; (3) Merrill's private placement memorandum ("PPM") sufficiently disclosed the ARS risks, even though that document did not identify the types of assets -- much less the actual assets -- collateralizing the ARS; (4) Merrill, which acted as investment banker to raise capital for SGC and assisted SGC in the management of that capital, had only an arms-length broker's duty to SGC; and (4) it was a "marketwide collapse," not Merrill's conduct, that caused SGC's inability to sell its ARS through Merrill-managed auctions and the resulting loss in value of those ARS.

None of these arguments is supported by the law or the facts. In any event, all of them are subject, at a minimum, to genuine factual dispute; and they are impermissibly supported by documents -- whose contents Merrill distorts and misrepresents -- not properly considered on a motion to dismiss.

FACTS

A. Merrill Serves as SGC's Financial Advisor

The Seneca Nation of Indians established SGC in 2002 to construct, lease, and operate its gaming facilities. In 2002, Merrill provided SGC with a presentation regarding Merrill's services in the hopes of securing investment banking business. Based upon Merrill's presentation, SGC approved Merrill as a financial services provider, and in May 2004, SGC engaged Merrill as a lead underwriter on SGC's issuance of $300 million in bonds. SGC advised Merrill the capital would be used primarily to pay construction costs on facilities under construction or on which construction would commence imminently. Because SGC's

construction costs would come due over time, SGC would, for the first time, have significant cash on hand. (Compl. ¶¶ 15-17.)

SGC opened a brokerage account with Merrill and placed its cash into that account. (*Id.* ¶ 19.) Merrill knew that SGC did not have the resources to analyze the risks of complex securities and that SGC did not even have guidelines for cash management. (*Id.* ¶¶ 20, 24.) Merrill provided essential assistance to SGC in developing a "Corporate Domestic Investment Policy" (the "SGC Guidelines") to govern SGC's cash management. (*Id.* ¶ 20.) The SGC Guidelines were established to "ensur[e] the following (in order of importance): 1. Preservation of capital; 2. Maintain an acceptable degree of liquidity; 3. Maximize yield within the constraint of maximum safety." (*Id.*) The SGC Guidelines established that SGC could purchase only safe, liquid, cash management instruments, and left no room for investments exposed to the risks of derivatives or synthetic securities. (*Id.* ¶ 22.)

In May 2005, Merrill served SGC as lead underwriter for SGC's issuance of $200 million of bonds. Merrill knew SGC raised the funds primarily to pay construction costs. (*Id.* ¶ 44.) SGC placed proceeds from those bonds in its Merrill brokerage accounts. (*Id.* ¶ 45.)

B. Auction Rate Securities and Derivative ARS

Despite helping to develop and knowing the SGC Guidelines and SGC's need to keep its cash safe and liquid, Merrill solicited SGC to purchase illiquid, high-risk securities disguised as safe and highly liquid cash management instruments in the form of ARS. (*Id.* ¶ 27.)

ARS are long-term bonds and preferred stock with interest rates or dividend yields that reset at "Dutch" auctions typically every 7, 14, or 28 days. Borrowers issuing ARS were able to obtain long-term financing at lower, short-term rates. Because ARS could only be sold for their full face -- or "par" value -- at auctions, brokers represented that ARS were as safe and liquid as money market instruments, but with a slightly higher yield to compensate for the intervals

between auctions. In the event holders of ARS seeking to sell ARS at auction outnumbered investors bidding for those ARS, the auction would fail, and none of the ARS holders could sell their securities until the next scheduled auction. (*Id.* ¶ 28.)

Merrill earned fees from the ARS market through several different and conflicting roles. First, Merrill received fees from the issuers for underwriting ARS. Second, Merrill acted as manager of the auctions for which it would receive fees. Finally, Merrill, as broker, would receive brokerage commissions for selling ARS to clients. (*Id.* ¶ 29.)

Among the issuers of ARS were municipalities and student loan providers. (*Id.* ¶ 30.) In the case of the municipalities, repayment for ARS was supported by the municipalities' powers to raise revenue. (*Id.* ¶ 31.) In the case of student loan auction rate securities, student loans would be placed into a trust, the trust would issue ARS, and the trust would repay investors that purchased ARS from the income received from repayment of the student loans. (*Id.*) Approximately 5% of ARS ("Derivative ARS") were issued by various types of trusts and off-shore "special purpose vehicles" ("SPVs") into which financial institutions, including Merrill, deposited bundles of risky, illiquid, complex derivatives. The SPVs issued ARS, and repaid investors from the income from the risky, illiquid securities. (*Id.* ¶¶ 30, 32.)

C. Merrill Sells Derivative ARS to SGC

Merrill (through Kevin Nicklas) ("Nicklas") introduced SGC (through Joe D'Amato) ("D'Amato") to ARS that Nicklas represented were "collateralized by mortgages." (*Id.* ¶ 34.) Nicklas represented that the ARS were safe because each dollar of ARS was covered by two or three dollars of mortgages with low default rates. (*Id.*) Nicklas represented that the ARS were "highly liquid" because they could be sold through regular auctions, that these auctions had "constant liquidity," and that Merrill had never had a failed auction. (*Id.*)

Each of Merrill's representations and concealments was false or misleading. Contrary to Merrill:

- the ARS Merrill intended to sell SGC were not "collateralized by mortgages" at a two or three to one ratio (*id.* ¶¶ 36, 37);
- the ARS were collateralized by and exposed to the risks of high-risk derivatives (*id.* ¶ 39);
- to the extent the ARS were tied to mortgages, a substantial portion of that exposure was to subprime mortgages excluded by the SGC Guidelines (*id.* ¶ 38);
- the ARS were not liquid and there were insufficient bidders to prevent Merrill auctions from failing on a regular basis (*id.* ¶ 40);
- Merrill concealed the failed auctions by purchasing, for its own inventory, ARS unwanted by *bona fide* investors (*id.*);
- SGC would not be able to sell the ARS at auctions at par value and recover its cash if Merrill decided to stop purchasing ARS for its own inventory (*id.* ¶ 41); and
- if SGC could not sell the ARS at auction, it would suffer substantial losses because SGC would be able to sell those securities, if at all, only at a substantial discount in whatever secondary market might develop due to the poor quality of the underlying assets (*id.* ¶ 41).

Based upon Merrill's misrepresentations and omissions, SGC purchased ARS from Merrill. (*Id.* ¶ 43.) On September 8, 2006, SGC purchased from Merrill $5 million face value of Lakeside CDO I PVT, A-2 (the "Lakeside ARS") that Merrill represented to SGC to be "mortgage-backed" ARS of the type that Nicklas had described. In fact, those ARS were not liquid, were not over-collateralized by mortgages, and had substantial exposure to exotic derivatives and securities tied to subprime mortgages. (*Id.* ¶ 50.)

D. Merrill Stops Buying Lakeside ARS

In early summer 2007, the value of the risky asset types underlying the Lakeside ARS plummeted. (*Id.*) Prior to August 7, 2007, Merrill determined that the fees it earned from its ARS business no longer justified the risk of buying Derivative ARS, including the Lakeside

ARS. (*Id.* ¶ 48.) On or about August 7, 2007, Merrill did not purchase Lakeside ARS at auction. (*Id.* ¶ 49.) Because Merrill's purchases were necessary for those auctions to succeed, the auction failed, leaving SGC unable to sell those securities at auction. (*Id.*) Because the Lakeside ARS are supported by poor quality assets, those securities can be sold only at a substantial discount, if at all, in whatever secondary market might exist. (*Id.* ¶¶ 50, 53.) SGC has had to borrow money, at additional cost to SGC, to cover its losses and maintain its construction projects. (*Id.* ¶ 52.)

ARGUMENT

It is well established that on a motion to dismiss under Fed. R. Civ. P. 12(b)(6):

> In considering a motion to dismiss pursuant to Federal Rule of Civil Procedure 12(b)(6) ..., a court must accept all of the allegations set forth in the complaint as true, and must draw all reasonable inferences in favor of the plaintiff. … A court's function on a motion to dismiss is "not to weigh the evidence that might be presented at trial but merely to determine whether the complaint itself is legally sufficient."

Coronel v. Quanta Capital Holdings Ltd., No. 07 Civ. 1405, 2009 WL 174656, at *10 (S.D.N.Y. Jan. 26, 2009).

Moreover, under Fed. R. Civ. P. 9(b):

> *Twombly* "requir[es] a flexible 'plausibility standard,' which obligates a pleader to amplify a claim with some factual allegations in those contexts where such amplification is needed to render the claim plausible." The question is whether the pleading alleges "enough facts to state [a] claim for relief that is plausible on its face."

Coronel, 2009 WL 174656, at *10 (internal citations omitted).

Here, there can be no question that the complaint passes muster. Rather than argue the sufficiency of SGC's allegations, Merrill adduces purported evidence -- including excerpts from a 2003 private placement memorandum, a May 2006 SEC order, three trade confirmations, a Merrill ARS "Practices and Procedures" document, and six news articles -- to try to disprove

those allegations. None of these documents is in any way referenced by, or relied upon, in the complaint. Accordingly, the documents are not properly considered on this motion. *See Kramer v. Time Warner Inc.*, 937 F.2d 767, 773 (2d Cir. 1991)[2] ("[A] district court must limit itself to facts stated in the complaint or in documents attached to the complaint as exhibits or incorporated in the complaint by reference").

As shown below, SGC clearly and sufficiently has alleged all of the elements of its claims.

I. SGC STATES A CLAIM FOR SECURITIES FRAUD

On its securities fraud claim, SGC alleges that Merrill (i) made misrepresentations and omissions concerning the liquidity of the ARS Merrill sold SGC, and the assets underlying those ARS (Compl. ¶¶ 36-41); (ii) intentionally and/or recklessly and with motive and opportunity to commit fraud (*id.* ¶ 42); (iii) in connection with the purchase or sale of the ARS (*id.* ¶¶ 43, 46); (iv) upon which SGC reasonably relied (*id.* ¶¶ 43, 71); and (v) which misrepresentations caused SGC's losses (*id.* ¶ 49, 52).

A. SGC Has Pled Misrepresentations and Omissions Regarding Liquidity

[2] The language Merrill quotes from *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 98 (2d Cir. 2007) (Def. Mem. 1 n.3.) is in no way to the contrary. None of the documents Merrill relies on here fall within the limited scope of documents a court may, under *ATSI*, consider on a motion to dismiss. To the extent this Court does not exclude Merrill's documents -- as it should inasmuch as they are nowhere attached to or incorporated in the complaint -- the motion must be converted to a summary judgment motion in accordance with FED. R. CIV. P. 12(d), with SGC afforded the opportunity to adduce evidence and obtain discovery, *see id.*; FED. R. CIV. P. 56(f); *Global Network Commc'ns, Inc. v. City of N.Y.*, 458 F.3d 150, 155 (2d Cir. 2006) ("As indicated by the word 'shall,' the conversion of a Rule 12(b)(6) motion into one for summary judgment under Rule 56 when the court considers matters outside the pleadings is 'strictly enforce[d]' and 'mandatory.'"). Nor, contrary to Merrill's implication (Def. Mem. 1 n.3), are there any relevant facts of which the Court may take judicial notice. To say the least, purported facts in documents such as news articles or those produced by the defendants itself are not the kind of facts "whose accuracy cannot reasonably be questioned." FED. R. EVID. 201(b)(2).

SGC has alleged that Merrill misrepresented the liquidity of the auctions for Merrill-brokered ARS, including the Lakeside ARS. Specifically, SGC alleges that at all relevant times:

- "Merrill did not disclose to SGC that there were not enough bidders to prevent the auctions from failing on a regular basis, and the only reason investors had not become trapped with those ARS was because Merrill had continuously stepped in and purchased the ARS to conceal what would otherwise have been failures." (Compl. ¶ 40.)

- "Accordingly, Merrill did not disclose to SGC that SGC's ability to sell Merrill-brokered ARS would at all times be dependent on Merrill's continued willingness to place bids for its own inventory." (*Id.* ¶ 41.)

- "Moreover, Merrill did not disclose that SGC would not be able to sell Merrill-brokered ARS and recover its cash if Merrill ever determined to stop buying ARS for its own inventory." (*Id.*)

- "Accordingly, Merrill's representations that Merrill-brokered ARS were bought and sold through a 'highly-liquid' auction market were false and misleading because a 'market' that relies on one single investor is no market at all, and cannot be considered 'liquid' by any measure." (*Id.*)

Merrill argues that SGC's claims should be dismissed because Merrill's statements that ARS were liquid were accurate and, in any event, Merrill disclosed the information necessary for SGC to assess liquidity, as demonstrated by Merrill's documentary evidence. (Def. Mem. 7-8.) Merrill's arguments are without merit.

SGC has pled that Merrill intended, and SGC reasonably believed, that Merrill's statements that its ARS were "highly liquid," there was "continuous liquidity" for the auctions, and Merrill had never experienced a failed auction, meant that (1) trading of ARS was among *bona fide* investors -- not propped up by Merrill; (2) there was sufficient investor demand for ARS SGC purchased -- not that SGC would depend on Merrill's continuing purchases; and (3) the risk of auction failure was that numerous investors would decide that ARS were no longer desirable cash management instruments -- not that Merrill would determine that its fees no

longer justified the purchases needed to maintain the auctions.[3] (Compl. ¶ 34.) Whether it was false and misleading for Merrill to describe as "liquid" auctions that failed to draw sufficient investor bids but that Merrill prevented from failing through its own purchases is, at best, an issue of fact and not proper for determination on a motion to dismiss. *Goldman v. Belden*, 754 F.2d 1059, 1068 (2d Cir. 1985) (the adequacy of disclosures about dependence on another company is "an inappropriate judgment to make as a matter of law").

Moreover, even if Merrill's factual evidence were proper -- which it is not -- those documents do not provide the information Merrill claims. Merrill contends that "[t]he exact information that Seneca Gaming alleges Merrill Lynch concealed from the investors was fully disclosed in the 2006 SEC Order,[4] the ARS Practices and Procedures, and media reports." (Def. Mem. 7.) Specifically, Merrill represents that "[t]he ARS Practices and Procedures clearly informed investors that Merrill Lynch's practice of placing support bids was often used to 'prevent auction failure[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.* 7-8.) Even assuming *arguendo* that the document accurately and adequately disclosed Merrill's involvement -- and it did not -- and even if a document posted on Merrill's website constituted disclosure to SGC -- and it did not -- the document was posted *after* SGC purchased the ARS at issue here. That document therefore could not have constituted *any* disclosure, let

[3] Merrill argues that "the statements identified in the Complaint do not purport to describe the Lakeside ARS or any other particular security." (Def. Mem. 7.) In fact, SGC has alleged that Nicklas represented that ARS were securities that were over-collateralized by high-quality mortgages and bought and sold through an auction market with constant liquidity. (Compl. ¶¶ 34, 35.) Merrill intended that its representations at the time it sold the Lakeside ARS would induce D'Amato to conclude that the Lakeside ARS possessed these qualities; D'Amato did reach this conclusion based upon Merrill's representations. (*Id.* ¶ 46.)

[4] The SEC's order states that the broker's purchases are not prohibited if "properly disclosed." (Def. Mem. 2.) Whether Merrill's purchases were "properly disclosed" is an issue of fact.

alone adequate disclosure, to SGC before Merrill fraudulently induced SGC to purchase the ARS.

Moreover, Merrill has doctored the text of its disclosures; that document does not provide any indication that Merrill *ever* purchased a single ARS for its own account for *any reason*, nervermind that Merrill did so "often" for the purpose of preventing failed auctions.

Merrill has cobbled together two pieces of language from its ARS Practices and Procedures and then inserted the word "often", despite the fact that that word -- nor any other word indicating frequency -- never appears in the document. Removing Merrill's edits, its document discloses only that "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." (Nemirovsky Aff. Ex. F at 16.) A "bid" is *not* a purchase. A bid is an offer to purchase at a certain price. A Merrill bid trumped by a higher bid from a *bona fide* investor would not need to be filled. Accordingly, contrary to Merrill's representation, Merrill never disclosed: (1) whether it ever *purchased* an ARS at auction, or the frequency with which it made any such purchases; (2) whether any such purchases "were used to 'prevent auction failure[s]" or, by contrast, to "acquire auction rate securities for its [own] inventory, … or [to prevent] an auction from clearing at a [certain] rate"; or, to the extent such purchases were to prevent auction failures, (3) the amount of the ARS unwanted by investors that Merrill needed to purchase to prevent the failure.[5]

[5] Merrill itself distinguishes between bids and actual purchases in its ARS Practices and Procedures, stating that "Merrill Lynch acts as principal for its own account when it places *orders* [*i.e.* bids] for its own account in auctions and when it *buys and sells* for its own account in the secondary market." (Nemirovsky Aff. Ex. F at 4) (emphasis added). Notably, Merrill's

The materiality of the information Merrill omitted -- but seeks to claim to the Court it disclosed -- is beyond question. For example, even assuming Merrill submitted "support bids" in every Merrill ARS auction, an investor would view ARS auction liquidity one way if (1) Merrill bought ARS in only 10 of every 100 auctions; (2) for the purpose of investing its own cash in 9 auctions, and for the purpose of preventing 1 auction failure; and (3) was compelled to purchase only 1% of the ARS issuance to prevent the failure. An investor would view liquidity differently if (1) Merrill bought ARS in 99 of every 100 auctions; (2) did so to prevent an auction failure each time; and (3) was compelled to purchase 50% of each issuance to prevent the failure. Moreover, an investor observing a shift from the former to the latter over time would be on notice that demand was decreasing and auctions were becoming less liquid.

Merrill possessed this data but chose not to disclose it. Instead, Merrill stated only that "the fact that an auction clears successfully does not mean that an investment involves no significant liquidity or credit risk." (Def. Mem. 4.) This disclosure was inadequate, particularly given that Merrill knew the precise liquidity risk in each of its auctions. (Compl. ¶¶ 40, 41.) *See In re Prudential Sec. Inc. Ltd. P'ships Litig.*, 930 F. Supp. 68, 72 (S.D.N.Y. 1996) ("Cautionary language…must precisely address the substance of the specific statement or omission that is challenged"). Moreover, while Merrill withheld this information, it did not stay silent or refer SGC to Merrill's written disclosures. Instead, Merrill represented to SGC orally that Merrill-brokered ARS were "highly-liquid," that there was "constant liquidity" for the auctions, and that Merrill had never experienced a failed auction. (Compl. ¶ 34.) Merrill's written disclosures did not contradict Merrill's oral statements. Because those disclosures did not inform investors that Merrill had ever purchased ARS at auction for any reason, an investor could conclude that third

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disclosures of secondary market purchases provide no information to investors about auction liquidity.

party investors routinely trumped Merrill's "support bids", obviating the need for Merrill to fill them. Likewise, if an investor were aware that Merrill purchased ARS for its own inventory, an investor could have reasonably concluded that, consistent with Merrill's representations, Merrill did so because it believed ARS to be desirable investments for Merrill's own cash.

B. SGC Has Pled Misrepresentations And Omissions Regarding Suitability

Merrill argues that SGC's claims should be dismissed because "all [of SGC's claims are] 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." (Def. Mem. 1.) Merrill's statement not only misrepresents SGC's claims,[6] it ignores SGC's allegations that Merrill misrepresented the suitability of the Lakeside ARS for SGC.

An investor may assert claims for unsuitability under § 10(b). *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 600-01 (2d Cir. 1978). The investor must allege that: (i) the securities were unsuited to the investor, (ii) the defendant knew or reasonably believed the securities were unsuitable, (iii) the defendant recommended the unsuitable securities anyway, (iv) with scienter, the defendant made material misrepresentations (or, owing a duty to the buyer, failed to disclose material information) relating to suitability, and (v) the investor justifiably relied to its detriment. *See Louros v. Kreicas*, 367 F. Supp. 2d 572, 585 (S.D.N.Y. 2005). In an unsuitability claim, "[s]cienter may be inferred by finding that the defendant knew or reasonably believed that the securities were unsuited to the investor's needs, misrepresented or failed to disclose the unsuitability of the securities, and proceeded to recommend or purchase the securities anyway." *Id.* at 589 (internal citations and quotations omitted).

[6] SGC has alleged that Merrill's *purchases* -- not *bids* -- of ARS at auction concealed the lack of liquidity. (*See* Compl. ¶¶ 40, 41; *see supra* p. 6.) As discussed above (*see supra* pp. 11-12), it was Merrill's actual purchases, not its bids, that concealed the lack of liquidity for Merrill-brokered ARS.

SGC has pled that Merrill, as SGC's investment banker, knew SGC's money was for construction costs and to repay its bonds (Compl. ¶¶ 17, 26); participated in drafting the SGC Guidelines (*id.* ¶ 20); knew the SGC Guidelines did not permit credit derivatives tied to synthetic securities or subprime mortgages (*id.*); and knew SGC did not have the resources to analyze the risks of such securities (*id.* ¶ 24). SGC has pled that despite the foregoing, Merrill introduced and sold to SGC ARS Merrill knew were illiquid and tied to synthetic securities and subprime mortgages while misrepresenting their liquidity and collateral quality. (*Id.* ¶¶ 37, 39.)

Merrill argues that SGC's claim should be dismissed because "[t]he name of the Lakeside ARS, which appeared on the trade confirmation received by Seneca Gaming, identifies the ARS as a CDO [and t]he definition and risks of CDOs in general were publicly available." (Def. Mem. 10.) Merrill ignores that CDOs are comprised of numerous other assets. One CDO may hold only asset-backed securities, another only risky derivative contracts, and another a combination of asset types. Without disclosing a CDO's composition, the acronym provides no material information. Moreover, whether "publicly-available" information would have put SGC on notice of the specific risks of the Lakeside ARS is a question of fact, as is the question of whether the name "collateralized debt obligation" would have notified SGC that the Lakeside ARS was not a "debt obligation" "collateralized by mortgages" as Merrill represented.

Merrill's representation that "the Lakeside ARS PPM discloses that the underlying collateral consisted of asset-backed securities and synthetic securities" (Def. Mem. 9) is false. The Lakeside PPM could not identify the collateral underlying the Lakeside ARS because much of the collateral had not been purchased at the time the PPM was prepared. (*See* Nemirovsky Aff. Ex. A at 15.) Accordingly, investors needed to rely on broker disclosure of specific risks at the time of sale. Moreover, the PPM does not state that the Lakeside ARS *will* be collateralized

by synthetic securities or any other assets; the PPM states only that "a portion of the Collateral Debt Securities *may* consist of Synthetic Securities[.]" (*Id.* at 16) (emphasis added). Merrill did not stay silent on the issue of the ARS collateral or direct SGC to the PPM. Instead, Merrill represented falsely that the ARS were over-collateralized by high-quality mortgages. (Compl. ¶¶ 34, 37.)

The PPM highlights the materiality of Merrill's misrepresentations. With respect to synthetic securities, "[t]he Issuer will not directly benefit from any collateral supporting the Reference Obligation and will not have the benefit of the remedies that would normally be available to a holder of such Reference Obligation," and "in the event of the insolvency of the counterparty, the issuer ... will not have any claim of title with respect to the Reference Obligation [and] will be subject to the credit risk of the counterparty as well as that of the Reference Obligor." (Nemirovsky Aff. Ex. A at 16-17.) Because Merrill concealed from SGC the Lakeside ARS exposure to synthetic securities, SGC could not have known these risks.

C. SGC Has Alleged Oral Misrepresentations

SGC has properly alleged Merrill's oral misrepresentations. As this Court has noted, the PSLRA requires a plaintiff to allege facts "sufficient to support a reasonable belief as to the misleading nature of the statement or omission," not "every single fact upon which their beliefs concerning false or misleading statements are based." *Coronel*, 2009 WL 174656, at *24 (*quoting Novak v. Kasaks*, 26 F.3d 300, 313-14 n.1 (2d Cir. 2000)). SGC has identified the alleged fraud with sufficient particularity:

- **the misrepresentations**: *e.g.*, Merrill-brokered ARS were "highly liquid" (Compl. ¶ 34); auctions for Merrill-brokered ARS enjoyed "constant liquidity" (*id.*); Merrill had never experienced a failed auction (*id.*); the ARS were "collateralized by mortgages" (*id.*); the ARS were collateralized at a ratio of two or three dollars worth of assets to one dollar of ARS (*id.*);

- **the speaker**: Merrill, through Nicklas (*id.*);

- **the time**: during conversations in connection with opening SGC's brokerage account in May 2004 (*id.*) and in connection with Merrill's sale of the Lakeside ARS in September 2006 (*id.* ¶ 46);

- **the circumstances**: telephone conversations between D'Amato and Nicklas (*id.* ¶¶ 24, 25, 35, 46); and

- **the deceitful nature of the communications**: *e.g.*, Merrill stated falsely that Merrill-brokered ARS were "highly-liquid" (*id*. ¶ 34); Merrill stated falsely that there was "constant liquidity" for Merrill ARS auctions (*id*.); Merrill stated falsely that Merrill had never experienced a failed auction (*id*.); Merrill falsely claimed the ARS were "collateralized by mortgages" at a two or three to one ratio (*id.* ¶¶ 34, 37).

These allegations are detailed, specific, and not conclusory.

D. SGC Has Alleged Scienter

SGC's complaint satisfies the PSLRA's scienter standard. Courts considering whether a § 10(b) complaint gives rise to a sufficiently "strong inference" of scienter must: (i) "accept all factual allegations in the complaint as true"; (ii) "consider the complaint in its entirety" and determine whether all the facts alleged -- taken collectively -- give rise to a "strong inference of scienter"; and (iii) "take into account plausible opposing inferences" in evaluating whether the complaint meets the standard. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 322-23 (2007). Under this standard, "[s]cienter can be pled by 'alleging 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.'" *Coronel*, 2009 WL 174656, at *25 (*quoting ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 99 (2d Cir. 2007)).

"[S]ecurities fraud claims typically have sufficed to state a claim based on recklessness when they have specifically alleged defendants' knowledge of facts or access to information contradicting their public statements." *Novak*, 216 F.3d at 308 (upholding complaint where plaintiffs claimed that defendants knowingly failed to mark down inventory they knew was worth less than stated publicly); *see also Cosmas v. Hassett*, 886 F.2d 8, 12-13 (2d Cir. 1989)

(allegations sufficient where defendants stated that sales to China would be "an important new source of revenue" when they knew or should have known that the Chinese government severely restricted such sales). Thus, while Merrill need not have been "clairvoyant," it was "responsible for revealing those material facts reasonably available to [it]." *Novak*, 216 F.3d at 309. SGC has alleged both of the *Coronel* prongs.

First, there was motive and opportunity. Merrill's investment banking clients would not issue ARS or pay Merrill underwriting fees if they could not sell ARS to investors. (Compl. ¶¶ 29, 42.) Investors would not buy ARS if they did not believe they were "safe" and "liquid." If ARS auctions failed and investors lost faith, the ARS platform would be destroyed and Merrill would lose the package of underwriting, managing, and brokerage fees. (*Id.*) That is motive.[7] As the underwriter, manager and broker (*id.* ¶¶ 29, 42), Merrill controlled all material information as to auction liquidity. (*Id.* ¶¶ 32, 36-42.) That is opportunity.

Second, SGC has alleged evidence of "conscious misbehavior" -- specifically, Merrill's disregard of the falsity of its misrepresentations and omissions concerning the credit and liquidity risks of its ARS, including the following:

- Merrill represented the ARS as a "highly liquid" investment and ARS auctions as having "constant liquidity" in total disregard of the actual liquidity risks that those securities posed (*id.* ¶¶ 34, 40-41);

[7] Merrill states falsely that "Seneca Gaming unsuccessfully attempts to plead an inference of scienter with conclusory allegations about Merrill Lynch's desire to earn fees." (Def. Mem. 11.) SGC does not allege merely that Merrill sought to increase or maintain profit from brokering ARS, but to maintain an artificial securities trading platform to generate investment banking, management and brokerage fees from multiple sources. (Compl. ¶ 42.) Such allegations go beyond those alleged in Merrill's authorities. *See In re Citigroup Auction Rate Sec. Litig.*, No. 08 Civ. 3095, 2009 WL 2914370, at *5 (S.D.N.Y. Sept. 11, 2009) ("Defendants were motivated to offset possible losses from other business activities" and "to earn unspecified fees"); *Kalnit v. Eichler*, 264 F.3d 131, 140 (2d Cir. 2001) (defendants motivated to protect a "lucrative compensation provision"); *In re Merrill Lynch & Co., Inc. Rs. Rpts Sec. Litig.*, 289 F. Supp. 2d 416, 428 (S.D.N.Y. 2003) ("defendants sought to attract investment banking business [and increase] bonus compensation").

- Merrill represented the ARS as "collateralized by mortgages" at a 2 or 3 to 1 ratio in total disregard of the truth that those ARS were not collateralized by mortgages, were not collateralized at a ratio of 2 or 3 to 1, and were exposed to synthetic securities (*id.* ¶¶ 34, 37-39); and

- Merrill sold ARS it knew were risky and illiquid despite knowing SGC's need for liquidity to pay ongoing construction costs and debt obligations (*Id.* ¶¶ 17, 24).

SGC alleges that Merrill purchased Derivative ARS to prevent auction failures despite knowing the securities' risks because Merrill had determined that its fees as underwriter, manager, and broker justified those purchases. (*Id.* ¶¶ 7, 49.) SGC alleges that when Merrill determined that its fees no longer justified the risks, Merrill stopped buying those ARS and the auctions failed. (*Id.* ¶¶ 7, 48.) Taken as true and evaluated collectively, these allegations plainly establish a "strong inference" of Merrill's scienter. *See Tellabs*, 551 U.S. at 322.

In response, Merrill argues that "Merrill Lynch's own purchases of ARS preclude an inference of scienter." (Def. Mem. 11.)[8] Merrill argues that "[b]ecause '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.'" (Def. Mem. 11) (*quoting Davidoff v. Farina*, No. 04 Civ. 7617, 2005 WL 2030501, at *11 n.19 (S.D.N.Y. Aug. 22, 2005).)[9]

[8] Merrill's cases address extensive disclosures going to the heart of the allegations that the courts considered part of the totality of evidence. (Def. Mem. 11.) In *In re Loral Space & Commc'ns Ltd. Sec. Litig.*, No. 01 Civ. 4388, 2004 WL 376442, at *15 (S.D.N.Y. Feb. 27, 2004), plaintiff had claimed that defendant "materially misrepresented the differences between Iridium's bankruptcy and Globalstar's future prospects," but defendant's 10-K "disclose[d] the existence of Iridium's failures and indicate[d] that Globalstar could conceivably suffer the same fate." In *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1425 (9th Cir. 1994), the court observed that "if, as Plaintiffs allege, the Officers knew that WOW was heading for financial disaster, they probably would have bailed out of their substantial holdings." Here, Merrill sought to minimize its holdings of Derivative ARS by ending its purchases. (Compl. ¶¶ 7, 47-51.)

[9] *Davidoff* is inapposite because, there, plaintiff alleged conduct that indisputably made no economic sense. Here, SGC alleges that Merrill's purchases were part of an integrated business that included fees for underwriting, managing, and brokering that more than offset the potential

SGC's inference of fraudulent intent is "at least as compelling as any opposing inference of nonfraudulent intent" Merrill offers.

E. Merrill Is Not Protected By The "Bespeaks Caution" Doctrine

The bespeaks caution doctrine "only applies to forward-looking statements and not to misrepresentations of present or historical fact." *Heller v. Goldin Restructuring Fund, L.P.*, 590 F. Supp. 2d 603, 617 (S.D.N.Y. 2008) (general warnings insufficient to preclude claims based on specific misrepresentations). Further, "[t]he bespeaks caution doctrine does not apply where the specific risk is apparent and not disclosed. If a party is aware of an actual danger or cause for concern, the party may not rely on a generic disclaimer in order to avoid liability." *Edison Fund v. Cogent Inv. Strategies Fund, Ltd.*, 551 F. Supp. 2d 210, 226 (S.D.N.Y. 2008) (inapplicable where defendants allegedly did not disclose specific known risks that adversely affected represented liquidity); *In re Prudential Sec. Inc. Ltd. P'ships Litig.*, 930 F. Supp. 68, 72 (S.D.N.Y. 1996) ("[g]eneral risk disclosures in the face of specific known risks which border on certainties do not bespeak caution").[10]

SGC alleges that Merrill's representations that its ARS were liquid and over-collateralized by high-quality mortgages were false at the time of sale. (Compl. ¶¶ 36-41, 50.)

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economic costs of purchasing and holding the ARS. To the extent Merrill disputes that the economic benefit of these fees did not outweigh the potential costs of its purchases, such is a question of fact not to be determined on a motion to dismiss. *Id.* *See SEC v. Parnes*, No. 01 Civ. 0763, 2001 WL 1658275, at *6 (S.D.N.Y. Dec. 26, 2001) (scheme from which defendants "stood to gain" supported inference of fraudulent intent and did not "def[y] economic reason").

[10] *Ladmen Partners, Inc. v. Globalstar, Inc.*, No. 07 Civ. 0976, 2008 U.S. Dist. LEXIS 76670, at * 44 (S.D.N.Y. Sept. 30, 2008), is inapposite because the cautionary statements warned precisely of the risk that formed the basis of plaintiffs' suit. *Id.* Moreover, *Ladmen* recognizes that "[d]efendants cannot … insulate themselves from liability by casting dangers that have already come to pass as mere risks that may occur at some point in the future." *Id.* at *40. *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 167 (2d Cir. 2000) *vacated* the District Court's decision because it did not draw inferences in favor of the plaintiff.

SGC alleges that Merrill knew, but failed to disclose, that the ARS were illiquid and high-risk. (*Id.* ¶¶ 36-41.) Merrill's written disclosures address only Merrill's bids -- not purchases of -- ARS, do not inform investors whether Merrill has made purchases to prevent auction failures or for one of the other reasons cited therein (*see supra* pp. 11-12), and state only that the Lakeside ARS "*may*" hold synthetic securities (*see supra* pp. 14-15). Such disclosures do not bespeak caution because "[t]he doctrine of bespeaks caution provides no protection to someone who warns his hiking companion to walk slowly because there might be a ditch ahead when he knows with near certainty that the Grand Canyon lies one foot away." *Prudential*, 930 F. Supp. at 72.[11]

F. SGC Has Pled Reasonable Reliance

SGC has pled reasonable reliance. SGC engaged Merrill as its investment banker. (Compl. ¶ 16.) Merrill advised SGC in raising capital. (*Id.* ¶ 17.) Merrill assisted SGC in creating a brokerage account to manage its capital. (*Id.* ¶ 19.) Merrill knew SGC did not have resources to analyze complex securities. (*Id.* ¶ 24.) When SGC sought assistance to create investment guidelines, Merrill did not advise SGC that it was an arms-length counterparty and could not help; Merrill participated in creating the SGC Guidelines. (*Id*. ¶¶ 20, 23.) When SGC sought to manage its cash, Merrill did not advise SGC that Merrill was merely a broker; Merrill introduced SGC to ARS. (*Id.* ¶¶ 27, 34.) When Merrill introduced ARS, Merrill was not silent on risks and did not refer SGC to written disclosures; Merrill represented that ARS were suitable because they were over-collateralized and there was constant liquidity. (*Id.* ¶ 34.)

[11] Merrill's disclosure cases (Def. Mem. 9-10, 12-13) are inapposite because the disclosures addressed the exact risks alleged. *In re Worlds of Wonder*, 35 F.3d at 1420 (disclosures revealed poor stock quality); *In re Loral Space & Comm'ns Ltd. Sec. Litig.*, No. 01 Civ. 4388, 2004 WL 376442, at *8 (S.D.N.Y. Feb. 27, 2004) (disclosures revealed company's poor performance); *Heliotrope Gen., Inc. v. Ford Motor Co.*, 189 F.3d 971, 976-77 (9th Cir. 1999) (disclosures revealed complained of tax arrangement); *Starr ex rel. Estate of Sampson v. Georgeson Shareholder, Inc.*, 412 F.3d 103, 110 (2d Cir. 2005) (disclosures revealed no-fee exchange of pre-merger shares for post-merger shares).

Merrill argues that SGC's reliance "in the face of the extensive disclosures about the auction market would be patently unreasonable."[12] (Def. Mem. 12.) Because Merrill relies upon the disputed (*see supra* pp. 10-11) factual assertion that "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" (Def. Mem. 12), its argument is not suited for resolution on a motion to dismiss. *Nathel v. Siegal*, 592 F. Supp. 2d 452, 466 (S.D.N.Y. 2008) ("The question of whether Plaintiffs' reliance was reasonable is fact-intensive and not suited for resolution on a motion to dismiss").

Merrill also ignores the heightened duties created by the parties' relationship, the extent of which are "a factual determination not susceptible to resolution on a motion to dismiss." *Salomon Bros., Inc. v. Huitong Int'l Trust & Inv. Corp.*, No. 94 Civ. 8559, 1996 WL 675795, at *2 (S.D.N.Y. Nov. 21, 1996) (Preska, J.). *See also Minpeco, S.A. v. ContiCommodity Servs., Inc.*, 552 F. Supp. 327, 331 (S.D.N.Y. 1982) (denying motion to dismiss where plaintiff alleged brokers were more than order takers). New York recognizes that where a client has a

[12] *Starr*, 412 F.3d 103 (Def. Mem. 12) is inapposite because the disclosure went to the heart of the alleged omission, and the document with the alleged omission specifically "included instructions for acquiring additional information regarding the share exchange." Here, no amount of diligence would have exposed the risks because that information was not publicly available. (Compl. ¶¶ 36, 40-41; *see supra* pp. 12-13.) *In re Citigroup*, 2009 WL 2914370, (Def. Mem. 10, 11, 12, 15, 16) is inapposite because plaintiff did not allege that defendants sought, and did, win plaintiffs' trust and confidence. Further, in *Citigroup*, the "Complaint [did] not assert, and … specifically disavow[ed], any Section 10(b) claim based on material misrepresentations or omissions." Finally, in *Citigroup*, the Court found that "Plaintiff's failure to proffer specific factual allegations as to the basis for his alleged reliance on market 'integrity' is, in the face of such disclosures and his disclaimer of any contention that the ARS market was efficient, fatal to his claim for market manipulation." SGC does not allege reliance on "market integrity" and has no position on whether the market was "efficient." SGC alleges that Merrill made specific representations to SGC of the liquidity and quality of Merrill-brokered ARS, and SGC reasonably relied upon those representations. (*See* Compl. ¶¶ 34, 36-41, 43, 71.) For this reason, *In re IPO Sec. Litig.*, 471 F.3d 24, 42-43 (2d Cir. 2006) is also inapposite because "market efficiency" is not at issue. Further, *IPO* relates to the highly-regulated IPO market, not the Merrill-created market for its own ARS, and addresses only Rule 23 class certification.

relationship with a broker who also provides investment advice, a general fiduciary duty will arise. *See Flickinger v. Harold C. Brown & Co., Inc.*, 947 F.2d 595, 599 (2d Cir. 1991) (fiduciary relationship existed where broker and customer "had a long-standing relationship during which [broker] provided investment advice and services"). Likewise, a broker that advises a customer in connection with the purchase or sale of a security assumes a fiduciary duty to "offer honest and complete information" regarding that security. *Barnes v. Printron, Inc.*, No. 93 Civ. 5085, 1998 WL 778378, at *9-10 (S.D.N.Y. Nov. 5, 1998) (fiduciary duty despite non-discretionary account). Moreover, the broker has a duty "to update [its] opinions and projections" because "[a] duty to disclose arises whenever secret information renders prior public statements materially misleading, not merely when that information completely negates the public statements." *See In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 267, 268 (2d Cir. 1993).

Contrary to Merrill's characterization of SGC and Merrill as arms-length counterparties to a "deal" (Def. Mem. 4), Merrill sought and won SGC's confidence and secured investment banking and brokerage business. (Compl. ¶¶ 16, 19.) Merrill did not merely offer ARS, but described those securities as suitable for the proceeds of SGC's bonds because they were liquid and over-collateralized by high-quality mortgages. (*See id.* ¶¶ 34, 46, 71.) Merrill, through information not available to SGC, knew this was false and knew ARS were becoming less liquid over time. (*Id.* ¶¶ 40, 41.) Merrill cannot now walk away from the relationship it worked to develop, the duties accompanying that relationship, its representations to a client that reposed its confidence in Merrill as an investment banking advisor -- not a faceless "deal" counterparty -- and the damage Merrill caused. Merrill had a duty to provide full and accurate disclosure to SGC and to update that information if Merrill learned those representations were no longer true. Merrill failed in its duty to SGC in every respect, and its failure caused SGC's losses.

G. SGC Has Pled Economic Loss and Damages

SGC has alleged specific damages. First, the value of the Lakeside ARS has been virtually wiped out. (*Id.* ¶ 53.) Second, SGC has incurred the cost of financing necessary to replace that lost capital. (*Id.* ¶ 52) The loss in the ARS value is the difference between the amount paid and the current value. The cost of SGC's financing is the amounts paid by SGC to arrange and service debt. Both measures are appropriate under § 10(b) because they are provable and not speculative. *See Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 347 (2005) (securities plaintiff must "provide a defendant with some indication of the loss").

SGC also seeks rescission of its ARS transactions. *Randall v. Loftsgaarden*, 478 U.S. 647, 662 (1986) ("[T]here is authority for allowing the § 10(b) plaintiff, at least in some circumstances, to choose between 'undoing the bargain (when events since the transaction have not made rescission impossible) or holding the defendant to the bargain by requiring him to pay [out-of-pocket] damages.'") (citation omitted); *In re UBS Auction Rate Sec. Litig.*, Nos. 08-CV-2967, 09-CV-4352, 08-CV-5251, 2009 U.S. Dist. LEXIS 26385, at *13-14 (S.D.N.Y. Mar. 30, 2009). Rescission would not require calculation of damages; it would involve SGC tendering the ARS to Merrill in exchange for their par value of $5 million. Rescission would transfer the risk of illiquidity and losses to Merrill and force Merrill to bear the consequences of its fraud.

H. SGC Has Pled Transaction and Loss Causation

SGC has pled that it would not have purchased the Lakeside ARS had it known the auctions for those securities were not liquid; its ability to recover its cash depended upon Merrill's purchases; and the ARS were not over-collateralized by high-quality mortgages but, instead, were supported by derivative contracts tied to synthetic securities and subprime mortgages. (Compl. ¶¶ 37, 40-41.) SGC has pled that the "materialization" of Merrill's misrepresentations and omissions caused SGC's loss because Merrill's cessation of purchases

caused SGC to be unable to sell those securities at auction (*id.* ¶ 49) and, as a result of the risky underlying assets, SGC could sell those securities only at a substantial loss, if at all, in whatever secondary market might exist. (*Id.* ¶ 53.) SGC has pled that it relied upon Merrill's misrepresentations whenever it decided to purchase and/or retain the ARS, and Merrill knew this if not intended it.

In light of the foregoing, SGC has pled that its losses were "foreseeable ... and caused by the materialization of [Merrill's] concealed risk." *See Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt., LLC*, 376 F. Supp. 2d 385, 403 (S.D.N.Y. 2005); *see also Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 96-98 (2d. Cir. 2001).[13] Accordingly, SGC has satisfied the standard for pleading transaction and loss causation. *See Lentell v. Merrill Lynch & Co. Inc.*, 396 F.3d 161, 173, 175 (2d Cir. 2005) (stating the standard; affirming dismissal where plaintiffs did not allege direct causation other than market forces); *Suez Equity*, 250 F.3d at 96 ("in order for the plaintiff to recover it must prove the damages it suffered were a foreseeable consequence of the misrepresentation"; reversing dismissal based on loss causation).

To challenge loss causation, Merrill relies on the fallacy that "Any loss of liquidity of the ARS is ... attributable to the marketwide collapse," arguing that SGC has "fail[ed] to sufficiently plead loss causation [because] 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.'" (Def. Mem. 14.) Merrill's argument ignores the complaint.

[13] In the common law fraud context, SGC losses incurred in connection with retaining ARS in reliance on Merrill's misstatements are just as actionable as losses incurred as a result of SGC's purchase/sale of those securities. *See, e.g., Fraternity Fund*, 376 F. Supp. 2d at 407.

At all relevant times prior to August 2, 2007, auctions for Merrill's CDO-backed ARS regularly failed to draw sufficient bidders. (Compl. ¶ 40.) To conceal the lack of bidders, Merrill purchased ARS for its own inventory. (*Id.* ¶ 40.) Merrill would only continue to make such purchases as long as Merrill determined that the fees from its ARS business justified its purchases. (*Id.* ¶¶ 7, 48.) Prior to August 7, 2007, Merrill determined that its fees no longer justified its purchases. (*Id.* ¶¶ 7, 48.) Merrill possessed, controlled, and concealed the foregoing information.[14] (*Id.* ¶¶ 40, 41, 48; *see supra* p. 6.) On August 7, 2007, Merrill did not buy Lakeside ARS at auction, causing SGC to be unable to sell its ARS. (*Id.* ¶ 49.) Merrill never resumed buying Lakeside ARS at auction, which caused SGC to be able to sell those ARS only at a substantial discount, if at all. (*Id.* ¶ 53.)[15] Accordingly, Merrill's conduct -- not a "marketwide collapse" -- caused SGC's losses. To the extent Merrill argues otherwise, its position is an affirmative defense not properly raised on a motion to dismiss. *See E. Gluck Corp. v. Rothenhaus*, 585 F. Supp. 2d 505, 512 (S.D.N.Y. 2008) ("a motion to dismiss is not the proper mechanism to raise defenses that are necessarily fact-intensive").

Even if Merrill's conduct were aggregated with that of other financial institutions to conjure a "marketwide collapse," such an event is not an automatic bar to loss causation because

[14] Merrill points to its disclosure that "Merrill Lynch plays multiple roles in the auction rate securities market, including providing services to issuers of auction rate securities, acting as agent for investors ... and purchasing and selling as principal for Merrill Lynch's own account." (Def. Mem. 8.) However, Merrill does not inform investors that it manages auctions for virtually every one of the ARS it underwrites; auction liquidity for those ARS depends almost entirely on Merrill's ability to sell those ARS to its own brokerage clients, or Merrill's own purchases; and Merrill would not broker ARS if it was not also earning fees from underwriting.

[15] Merrill efforts to demonstrate that its activity was legal and disclosed are misleading. (Def. Mem. 15-16). For example, *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977), expressly held that "nondisclosure is usually essential to the success of a manipulative scheme." SGC pleads non-disclosure. Further, the SEC did not condone Merrill's conduct and numerous attorney generals and the SEC have investigated and sued Merrill in connection with its conduct.

whether a "general fall in the price of" a class of securities caused a plaintiff's loss "is a matter of proof at trial and not to be decided on a Rule 12(b)(6) motion to dismiss." *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 197 (2d Cir. 2003) (allegations sufficient where defendants failed to disclose target company's principals' prior poor performing ventures).

Having established loss causation, SGC is entitled to consequential damages. *See In re Crazy Eddie Sec. Litig.*, 948 F. Supp. 1154, 1165-66 (E.D.N.Y. 1996) (consequential damages because plaintiff demonstrated "a causal nexus [between the violation and injury] with a good deal of certainty") (citations omitted).

II. SGC'S COMMON LAW FRAUD CLAIM IS SUFFICIENTLY PLED

For the reasons provided in its § 10(b) analysis (*see supra* pp. 8-26), SGC has sufficiently pled that Merrill perpetrated common law fraud. *See Shahzad v. Meyers*, No. 95 Civ. 6196, 1997 WL 47817, at *10 (S.D.N.Y. Feb. 6, 1997) (upholding common law fraud claim where 10b-5 claim was established because "elements [for common law fraud] are substantially identical to those governing § 10(b), [and] the identical analysis applies") (citation omitted); *Fraternity Fund*, 376 F. Supp. 2d at 407 (same).

Further, SGC is entitled to punitive damages in connection with its common law claims, because such damages are "appropriate in cases involving gross, wanton, or willful fraud or other morally culpable conduct." *Fraternity Fund*, 376 F. Supp. 2d at 412. Defendant's interaction with SGC exemplified deliberate and willful fraud. Merrill sought assiduously to win SGC's trust and confidence, and then used that relationship to sell SGC Derivative ARS by misrepresenting their credit and liquidity risks while concealing information critical to SGC's ability to assess the suitability of those securities for itself. (Compl. ¶¶ 36-42.) This was a classic case of self-dealing at another's expense. *See Fraternity Fund*, 376 F. Supp. 2d at 412.

III. SGC'S CONTRACT CLAIM IS SUFFICIENTLY PLED

SGC alleges that it opened a brokerage account pursuant to an Account Agreement with Merrill (Compl. ¶ 19); pursuant to that agreement, Merrill participated in developing the SGC Guidelines (*id.* ¶¶ 20-23); and "Merrill materially breached the terms of the Account Agreement by, among other things, selling unsuitable securities contrary to SGC's stated needs and its investment guidelines." (*Id.* ¶ 76.) SGC has sufficiently pled a claim for breach of contract. *See Vladimir v. Cowperthwait*, No. 06 Civ. 5863, 2007 U.S. Dist. LEXIS 48524, at *5 (S.D.N.Y. July 2, 2007) ("the plaintiff has pleaded sufficient facts to establish a claim, plausible on its face, that these investment policies established contractual obligations that the defendants breached").

IV. SGC'S § 10(b) CLAIMS ARE TIMELY

Merrill argues that SGC's § 10(b) claims are time barred because various news articles, Merrill's ARS Practices and Procedures, and the 2006 SEC Order constitute inquiry notice to SGC. (Def. Mem. 16-17). Whether and when a plaintiff is placed on inquiry notice is a classic issue of fact inappropriate for resolution on a motion to dismiss. *See Staehr v. Hartford Fin. Servs. Group, Inc.*, 547 F.3d 406, 412 (2d Cir. 2008). Indeed, as discussed above, the documents upon which Merrill relies are not properly considered here for any purpose. (*See supra* pp. 10-11.) *Lentell*, cited by Merrill (Def. Mem. 17), is not to the contrary because that case states that a court "can readily resolve the issue on a motion to dismiss" only when inquiry notice is apparent from the complaint and documents "integral to the complaint." *Lentell*, 396 F.3d at 168. Inquiry notice cannot be determined from the complaint, and Merrill does not argue it can. Moreover, as discussed above (*see supra* n.8), the documents upon which Merrill relies are by no means "integral to the complaint."

Even if Merrill's documents were properly submitted -- which they are not -- those documents would not be sufficient to put SGC on inquiry notice of Merrill's fraud. SGC has pled that at all relevant times prior to August 2, 2007, auctions for Merrill's CDO-backed ARS regularly failed to draw sufficient bidders. (Compl. ¶ 40.) To conceal the lack of bidders, Merrill purchased ARS for its own inventory. (*Id.* ¶ 40.) SGC has also pled that Merrill represented that it was selling SGC ARS that were over-collateralized by high-quality mortgages when, in fact, those securities were not over-collateralized and were exposed to the risks of synthetic securities. (*Id.* ¶¶ 34, 36-39.) The documents upon which Merrill seeks to rely address only Merrill's bids -- not purchases -- of ARS, do not inform investors whether Merrill made purchases to prevent auction failures or for one of the other reasons cited therein (*see supra* p. 11), and state only that the Lakeside ARS "*may*" hold synthetic securities (*see supra* pp. 14-15).

An investor is on inquiry notice only "when the circumstances would suggest to an investor of ordinary intelligence the probability that she has been defrauded." *Dodds v. Cigna Sec., Inc.*, 12 F.3d 346, 350 (2d Cir. 1993). *See also Newman v. Warnaco Group, Inc.*, 335 F.3d 187, 193 (2d Cir. 2003) ("[t]he fraud must be probable, not merely possible"). In establishing such notice, "defendants bear a heavy burden." *Nivram Corp. v. Harcourt Brace Jovanovich, Inc.*, 840 F. Supp. 243, 249 (S.D.N.Y. 1993) ("Inquiry notice exists only when uncontroverted evidence irrefutably demonstrates when plaintiff discovered or should have discovered the fraudulent conduct.") (internal quotations and citations omitted). Merrill's documents, even if considered, fail to meet that burden.[16]

V. SGC HAS TIMELY PLED A CLAIM UNDER SECTION 12(a)(1)

[16] SGC can establish that it was not on inquiry notice of Merrill's fraud until July 2008, at the earliest.

Merrill's argument that SGC's § 12(a)(1)[17] claim must be dismissed because SGC is a Qualified Institutional Buyer ("QIB") raises an issue of fact not proper for resolution on a motion to dismiss. Moreover, Merrill misrepresents the rule by failing to advise the Court that the $100 million investment threshold for determining QIB status encompasses only certain types of "securities" that do not apply here. *See* 17 C.F.R. § 230.144A(a)(2) (excluding bank deposit notes, certificates of deposit, loan participations, repurchase agreements and securities subject to repurchase agreements, and currency, interest rate, and commodity swaps); S.E.C. Release No. 6862 (Apr. 23, 1990) (excluding U.S. treasury bills, notes, and bonds). Finally, to the extent Merrill asserts that SGC is a QIB due to the ARS Merrill sold SGC in violation of the rule, such a finding would be illogical and would vitiate the rule.

Merrill's argument that SGC's claim under § 12(a)(1) is untimely is without merit. The statute of limitations under 15 U.S.C. § 77m bars actions brought over one year after the sale as Merrill claims. (Def. Mem. 18). However, unlike the securities in *McLernon v. Source Int'l., Inc.*, 701 F. Supp. 1422, 1427 (E.D. Wis. 1988), cited by Merrill, ARS are sold and resold, and their interest rates reset, every 28 days. (Compl. ¶ 28.) Notably, even though not a single auction has cleared in 2 ½ years, Merrill still manages -- and is paid for -- operating those auctions every 28 days. Merrill should not be permitted to collect its fees from the auctions and then argue that those auctions are a nullity because Merrill no longer props them up.

Moreover, the statute of repose does not foreclose SGC's claim. The statute of repose begins to run "when the security is first *bona fide* offered to the public." 15 U.S.C. § 77m. The Lakeside ARS were *never* offered to the public. Those securities were sold pursuant to a Rule

[17] Merrill correctly concludes that SGC intended to allege a violation pursuant to Section 12(a)(1) of the 1933 Securities Act, 15 U.S.C. § 77*l*(a)(1), and not Section 12(b)(1) as identified in the complaint. (*See* Compl. ¶ 19.)

144A *private* placement memorandum which is, by definition, a non-public disclosure. *See Am. High-Income Trust v. AlliedSignal*, 329 F. Supp. 2d 534, 543 (S.D.N.Y. 2004) ("offerings under Rule 144A are by definition non-public"); *Vannest v. Sage, Rutty & Co., Inc.*, 960 F. Supp. 651, 655 (W.D.N.Y. 1997) (PPM by definition not a public offering); *In re JWP Inc. Sec. Litig.*, 928 F. Supp. 1239, 1259 (S.D.N.Y. 1996) (Section 12(a)(2) does not apply to a private placement memorandum).[18]

CONCLUSION

For the foregoing reasons, Merrill's motion to dismiss the complaint should be denied, or, in the alternative, SGC should be granted leave to amend.

Dated: New York, New York
February 22, 2010

Respectfully submitted,

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[18] *P. Stolz Family P'ship L.P. v. Daum*, 355 F.3d 92, 98-99 (2d Cir. 2004), cited by Merrill (Def. Mem. 19), relies on *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 570, 571 (1995), which acknowledges that "prospectus" should have a consistent meaning throughout the Securities Act, including with respect to Section 12, and that "a prospectus . . . is confined to documents related to *public* offerings." *Id.* at 570-71 (emphasis added).