12-1707-cv

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

NEW JERSEY CARPENTERS HEALTH FUND,
on Behalf of Itself and All Others Similarly Situated,
Plaintiff-Appellant,

v.

THE ROYAL BANK OF SCOTLAND GROUP, PLC, GREENWICH CAPITAL HOLDINGS, INC., GREENWICH CAPITAL MARKETS, INC., DBA RBS Greenwich Capital, WACHOVIA CAPITAL MARKETS, LLC, sued herein as Wachovia Securities, LLC, DEUTSCHE BANK SECURITIES, INC.,
(For Continuation of Caption See Inside Cover)

On Appeal from the United States District Court
for the Southern District of New York

BRIEF FOR *AMICUS CURIAE* SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION IN SUPPORT OF DEFENDANTS-APPELLEES AND AFFIRMANCE

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NOVASTAR MORTGAGE FUNDING TRUST, SERIES 2006-3, NOVASTAR MORTGAGE FUNDING TRUST, SERIES 2006-4, NOVASTAR MORTGAGE FUNDING TRUST, SERIES 2006-5, NOVASTAR MORTGAGE FUNDING TRUST, SERIES 2006-6, NOVASTAR MORTGAGE FUNDING TRUST, SERIES 2007-1, NOVASTAR MORTGAGE FUNDING TRUST, SERIES 2007-2, NOVASTAR MORTGAGE FUNDING CORPORATION, SCOTT F. HARTMAN, GREGORY S. METZ, W. LANCE ANDERSON, MARK A. HERPICH, SCOTT F. HARTMAN, NOVASTAR MORTGAGE INC., NOVASTAR MORTGAGE FUNDING CORPORATION, GREGORY S. METZ, RBS SECURITIES, INC., WELLS FARGO ADVISORS, LLC, FKA WACHOVIA SECURITIES LLC,

Defendants-Appellees,

MOODYS INVESTORS SERVICE, INC.,
THE MCGRAW-HILL COMPANIES, INC.,

Defendants.

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1, *Amicus Curiae* Securities Industry and Financial Markets Association hereby certifies that it is a non-profit corporation. It has no parent corporation and no publicly held corporation owns 10% or more of its stock.

INTEREST OF AMICUS CURIAE

The Securities Industry and Financial Markets Association ("SIFMA") is a securities industry trade association representing the interests of hundreds of securities firms, banks, and asset managers. SIFMA's mission is to support a strong financial industry while promoting investor opportunity, capital formation, job creation, economic growth, and trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the United States regional member of the Global Financial Markets Association.

SIFMA regularly files amicus curiae briefs in cases that raise legal issues of vital concern to securities industry participants. SIFMA has appeared as amicus curiae in many cases involving issues arising under the federal securities laws, including *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011); *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011); *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010); *Merck & Co. v. Reynolds*, 130 S. Ct. 1784 (2010); *Jones v. Harris Associates L.P.*, 130 S. Ct. 1418 (2010); and *Willow Creek Capital Partners v. UBS Securities LLC*, No. 11-122 (2d Cir.) (pending).[1]

[1] No counsel for a party authored this brief in whole or in part; and no such counsel or any party made a monetary contribution intended to fund the preparation or

This case involves significant issues regarding the standing and pleading requirements that apply to a plaintiff alleging securities law violations. Although distinct, the legal standards that require a plaintiff to (1) demonstrate standing to pursue its claims and (2) plead those claims with sufficient facts to state a plausible ground for relief serve a common purpose: to reduce the burden and unnecessary costs of vexatious litigation. Plaintiff-Appellant's approach would allow general allegations of industry-wide misconduct – untethered to the actual securities offerings at issue and, worse, regarding securities offerings in which Plaintiffs did not themselves participate – to proceed to discovery. This would open the floodgates to claims by plaintiffs whose alleged injuries bear no relation to the issues in a particular case, and are instead based on after-the-fact, one-size-fits-all allegations of misconduct. Such suits would impose unwarranted costs on SIFMA members and ultimately harm the United States capital markets.

Judges in this Circuit and others agree that increasing the uncertainty of litigation costs and risks – the inevitable result of Plaintiff's approach – harms the U.S. capital markets. As Second Circuit Judge Ralph K. Winter writes: "[w]hen a rule of liability is not efficient, the payment by firms of damages or fines unnecessarily increases the cost of doing business in the United States." Ralph K.

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submission of this brief. No person or entity, other than amicus and its counsel, made a monetary contribution intended to fund its preparation or submission.

Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 948 (1993). While investors may diversify against those risks, "the entrepreneurs whose companies purchase capital cannot diversify against unnecessary liability; they will not, at the margin, purchase capital, at least not in the country in question." *Id.* Judges Boudin and Lynch of the First Circuit recently made the same point. *S.E.C. v. Tambone*, 597 F.3d 436, 452-53 (1st Cir. 2010) (citations omitted) (noting in concurrence: "No one sophisticated about markets believes that multiplying liability is free of cost. And the cost, initially borne by those who raise capital or provide audit or other services to companies, gets passed along to the public"); *see also Pac. Inv. Mgmt. Co. LLC v. Mayer Brown LLP*, 603 F.3d 144, 157 (2d Cir. 2010) (2011) (noting that "[u]ncertainty also increases the costs of doing business and raising capital"), *cert. denied*, 131 S. Ct. 3021 (2011).

The issues before this Court are particularly critical in the context of securities class actions, which are "the 800-pound gorilla that dominates and overshadows other forms of class actions." John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1539 (2006). As the Supreme Court has recognized, private securities class actions "can be employed abusively to impose substantial costs on

companies and individuals whose conduct conforms to the law." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007). Further implications include allowing "plaintiffs with weak claims to extort settlements from innocent companies." *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 163 (2008).

It is especially troubling to allow meritless claims to move forward where, as here and in the numerous similar cases pending across the country, the plaintiff is a sophisticated institutional investor. As Dean Robert C. Clark of Harvard Law School observed, institutional investors tend to be sophisticated and powerful enough to demand and obtain the information they need before investing. "The legal system does not have to protect them with a superimposed mandatory disclosure system." *Cf.* C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1153-54 (1988) (noting that courts seem inclined to consider institutional investors at least *prima facie* sophisticated) (collecting cases) (citations omitted)). Here, the sophisticated Plaintiff also had access to extensive disclosures and publicly-available information regarding the risks associated with its investment. *See also* Order and Mem. at 15, *New Jersey Carpenters Health Fund v. NovaStar Mortg., Inc.*, 08-CV-5310 (S.D.N.Y. Mar. 29, 2012) (discussing the well-known and widely available information about the

subprime mortgage market that was available to Plaintiff at the time of its investment).

Professor Bradley J. Bondi's research further reinforces the threat that meritless securities litigation poses to U.S. capital markets. According to Professor Bondi, the "risk of an expensive class action lawsuit likely to result in a corporation paying millions of dollars to settle claims with questionable merit" is a "significant deterrent to capital formation in the United States." Bradley J. Bondi, *Facilitating Economic Recovery and Sustainable Growth Through Reform of the Securities Class Action System: Exploring Arbitration as an Alternative to Litigation*, 33 HARV. J.L. & PUB. POL'Y 2, 607, 638 (2010). In the same vein, the Financial Services Roundtable has opined that "[e]xcessive litigation and the threat of litigation are the most significant impediments to the competitiveness of U.S. businesses" and that "the growth in class action lawsuits, especially securities class-action cases, imposes substantial uncertainties and costs and presents a major competitive challenge to U.S. financial services firms in comparison to foreign firms that are not subject to a similar risk." Richard M. Kovachevic, *et al.*, *Fin. Servs. Roundtable, The Blueprint for U.S. Financial Competitiveness*, at 63 (2007).

Cases involving the subprime mortgage crisis or mortgage-backed securities ("MBS") heighten these concerns. As one study noted, "the breadth of industries

affected [by MBS litigation] is unprecedented." *Subprime-Related Securities Litigation: Early Trends*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (2009) (available at http://blogs.law.harvard.edu/corpgov/2009/04/05/subprime-related-securities-litigation-early-trends/#twentysix); *see also* Jennifer E. Bethel *et al.*, *Law and Economics Issues in Subprime Litigation*, HARVARD LAW SCHOOL'S JOHN M. OLIN CENTER FOR LAW, ECONOMICS, AND BUSINESS (2008) (available at http://www.law.harvard.edu/programs/olin_center/papers/612_Ferrell_Bethel_Hu.php) (predicting that litigation arising out of the subprime mortgage crisis will be "substantial, perhaps unprecedented" and noting that "[t]he facts so far have been sobering. The percentage of securities class action suit filings has increased by almost 50 percent year over year.").

Moreover, this Court's ruling is likely to impact securities litigation well beyond MBS cases. In fact, "as Circuit Courts of Appeals begin to weigh in, the issues arising out of subprime securities suits may ultimately shape the contours of the private 10b-5 action as it continues to evolve from its origins in the Great Depression." Christopher J. Miller, *Don't Blame Me, Blame the Financial Crisis: A Survey of Dismissal Rulings in 10b-5 Suits for Subprime Securities Losses*, 80 FORDHAM L. REV. 1, 273, 291 (2011-2012). At bottom, this Court's decision is

significant to numerous pending MBS cases, SIFMA's members, and the broader U.S. capital markets, and SIFMA has an interest in expressing its views on its members' behalf.

SUMMARY OF ARGUMENT

There are two issues before this Court, the resolution of which could have a profound effect on SIFMA's members. First, the Court must determine whether a plaintiff has standing to pursue claims under Sections 11 and 12 of the Securities Act of 1933 based on MBS offerings in which it did not purchase any securities. Well-established precedent answers no.

Constitutional and statutory standing requirements allow only those who suffer a sufficient injury to sue. Plaintiff's theory, which would expand standing to allow claims related to MBS offerings in which the plaintiffs did not themselves purchase securities, flies in the face of this longstanding doctrine, and could result in a wave of new litigation on behalf of plaintiffs who suffered no actual injury caused by the alleged wrongdoing in the case. In reaching its decision, this Court should follow the overwhelming majority of courts that have held that a "plaintiff was not harmed by, and thus has no standing to sue for, alleged misrepresentations contained in other prospectuses or registration statements offering other securities that it did not purchase." *Emps.' Ret. Sys. of the Gov't of the V.I. v. J.P. Morgan*

Chase & Co., 804 F. Supp. 2d 141, 151 (S.D.N.Y. 2011); *see also Me. State Ret. Sys. v. Countrywide Fin. Corp.* ("*Countrywide*"), No. 2:10-CV-302, 2011 WL 4389689, at *6 (C.D. Cal. May 5, 2011) ("Plaintiffs lack standing to sue on Certificates they did not purchase because they have suffered no injury from those investments they did not make.").

The second issue presented here is whether a plaintiff may base its claims on general allegations of industry-wide misconduct in the MBS market, without pleading any specific facts regarding the actual underlying loans at issue. Well-established precedent again says no.

The plausibility standard established in *Iqbal* and *Twombly* "demands more than an unadorned, the-defendant-unlawfully-harmed-me accusation." *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009). When applying this pleading standard in the MBS context, the District Court properly held that a plaintiff must do more than allege "the subprime market melted down and Defendants were market participants, so they must be liable for my losses in my risky investment." Order and Mem. at 15, *New Jersey Carpenters Health Fund v. NovaStar Mortg., Inc.*, 08-CV-5310 (S.D.N.Y. Mar. 29, 2012) (citing Order and Mem. at 15, *New Jersey Carpenters Health Fund v. NovaStar Mortg., Inc.*, 08-CV-5310 (S.D.N.Y. Mar. 31, 2011)).

Adopting the Plaintiff's loosened standard by reversing the District Court could expose SIFMA members and other market participants to meritless litigation based solely on a defendant's involvement in a securities transaction, regardless of its role or actual culpability. In addition to the increased burden on SIFMA members and other defendants, weakening the pleading requirement will result in increased costs for the courts.

For these reasons, SIFMA respectfully requests that the Court affirm the judgment below, which is strongly supported by existing U.S. Supreme Court and Circuit Court case law and establishes a practical and workable approach to the issues presented.

I. PLAINTIFFS LACK STANDING TO PURSUE CLAIMS BASED ON OFFERINGS IN WHICH THEY DID NOT PURCHASE SECURITIES

A. A Securities Lawsuit Plaintiff Must Establish Both Constitutional and Statutory Standing to Bring Suit

A plaintiff's standing under Article III of the Constitution is a threshold question that goes to subject-matter jurisdiction—i.e., a federal court's power to entertain an action. *Warth v. Seldin*, 442 U.S. 490, 498 (1975). In the MBS context, courts analyze standing under both the Constitution and the applicable statute upon which a plaintiff's claims are based. Here, where plaintiff alleges

violations of Sections 11 and 12 of the Securities Act, a court looks to the specific statutory language of those provisions.

1. Standing under Article III of the U.S. Constitution

Article III of the U.S. Constitution requires a plaintiff to allege "(1) injury in fact, a 'concrete and particularized harm to a legally protected interest;' (2) causation, a 'fairly traceable connection between the asserted injury-in-fact and the alleged actions of the defendants,' and; (3) redressability – 'a nonspeculative likelihood that the injury can be remedied by the requested relief.'" *New Jersey Carpenters Health Fund v. Residential Capital, LLC*, No. 08 CV 8781 (HB), 2010 WL 1257528, at *3 (S.D.N.Y. Mar. 31, 2010) (quoting *W.R. Huff Asset Mgmt. Co. v. Deloitte & Touche LLP*, 549 F.3d 100, 106-07 (2d Cir. 2008)). As applied in the class action context, the named plaintiffs must "show that they personally have been injured, not that the injury has been suffered by other, unidentified members of the class . . . they purport to represent." *W.R. Huff Asset Mgmt. Co.*, 549 F.3d at 106 n.5. Critically, as discussed below, this analysis relates to standing to bring suit, which may be addressed in a motion to dismiss, not suitability to act as lead plaintiff.

2. Standing under Sections 11 and 12 of the Securities Act

Section 11(a) provides that where a material fact is misstated or omitted from an effective registration statement filed with the SEC, "any person acquiring such security" may bring an action for losses that the misstatement or omission caused. 15 U.S.C. § 77k(a). Section 12(a)(2) is similar except that it applies to misstated or omitted material facts in prospectuses. 15 U.S.C. § 77l(a)(2). A Section 12(a)(2) claim can be asserted only by "the person purchasing such security." *Id.* Federal courts have consistently construed these phrases to mean that to have standing to bring a claim, a plaintiff must actually have purchased the security upon which it seeks to sue. *See, e.g., In re Lehman Bros. Sec. & ERISA Litig.*, 684 F. Supp. 2d 485, 491 (S.D.N.Y. 2010), *aff'd*, 650 F.3d 167 (2d Cir. 2011); *In re Salomon Smith Barney Mut. Fund Fees Litig.*, 441 F. Supp. 2d 579, 607 (S.D.N.Y. 2006).

B. Standing Must Be Determined Separate From, and Prior to, Class Certification

Standing is the "key to the courthouse door." *In re Merrill Lynch & Co., Inc. Sec., Derivative & ERISA Litig.*, 597 F. Supp. 2d 427, 431 (S.D.N.Y. 2009) (citation omitted). Accordingly, it must be analyzed separate from, and prior to, the issue of class certification. This is the case with respect to Article III standing. *See Steel Co. v. Citizens for a Better Env't*, 523 U.S. 83 (1998) (Article III

jurisdiction is generally an antecedent question). It also applies to questions of statutory standing under the securities laws. *Emps.' Ret. Sys. of the Gov't of the V.I.*, 804 F. Supp. 2d at 150-151 (analyzing statutory standing in an MBS case on a motion to dismiss).

Indeed, courts frequently address standing at the motion to dismiss stage in securities class actions, and dismiss complaints where plaintiffs lack standing. *See, e.g., In re Salomon Smith Barney*, 441 F. Supp. 2d at 606 (granting defendants' motion to dismiss for lack of standing, and stating "Article III standing is determined first, before proceeding to the issue of determining the class.").

New Jersey Carpenters Vacation Fund v. The Royal Bank of Scotland Group, PLC, 720 F. Supp. 2d 254 (S.D.N.Y. 2010) is instructive. There, like here, plaintiffs asserted claims under Sections 11, 12 and 15 of the Securities Act based on alleged misrepresentations in MBS offering documents. Certain defendants moved to dismiss, arguing that plaintiffs lacked standing to pursue claims related to offerings in which they did not purchase securities. In granting defendants' motion, Judge Baer stated that "Plaintiffs' argument that this should be held in abeyance until class certification is not persuasive." *Id.* at 264. As Judge Baer held, that a suit is a class action "adds nothing to the question of standing, for even named plaintiffs who represent a class must allege and show that they personally

have been injured." *Id.* at 264-65 (quoting *Lewis v. Casey*, 518 U.S. 343, 357 (1996)).

C. Plaintiffs Lack Standing to Pursue Claims Based on Offerings in Which They Did Not Purchase Securities

It is well-settled that a plaintiff who did not purchase securities in a specific offering lacks standing to sue on behalf of other investors who purchased securities in that offering. Indeed, "[e]very court to address the issue in a MBS class action has concluded that a plaintiff lacks standing under both Article III of the U.S. Constitution and under Sections 11 and 12(a)(2) of the 1933 Act to represent the interests of investors in MBS offerings in which the plaintiffs did not themselves buy." *Me. State Ret. Sys. v. Countrywide Fin. Corp.*, 722 F. Supp. 2d 1157, 1163 (C.D. Cal. 2010) (collecting cases); *see also Emps.' Ret. Sys. of the Gov't of the V.I.*, 804 F. Supp. 2d at 151 (holding that "plaintiff was not harmed by, and thus has no standing to sue for, alleged misrepresentations contained in other prospectuses or registration statements offering other securities that it did not purchase.").

This fundamental principle is especially important where, as here, each MBS offering is comprised of separate and distinct securities. A plaintiff who has not purchased securities from a specific offering, therefore, does not – and cannot – suffer any alleged injury arising from that offering.

1. Each MBS offering is comprised of separate and distinct securities

MBS differ from traditional corporate securities in many respects, each of which weighs against conferring standing upon a plaintiff to sue without having purchased securities in the specific offering it seeks to challenge.

First, each MBS offering[2] is backed by a distinct mortgage pool that is often further subdivided into smaller loan groups. The loans in the pool may be "originated by different companies, by different underwriting officers, and valued by different appraisers. Moreover, the loan groups could be comprised of different types of loan products, *e.g.*, first lien loans, second lien loans, fixed rate loans, and adjustable rate loans. The term length of the loans could also differ." *Countrywide Fin. Corp.*, 2011 WL 4389689, at *7.

Second, each offering is structured to address different risk appetites and is comprised of multiple distinct tranches of mortgage pass-through certificates that each represents a different investment opportunity. "The very point of pooling mortgages and creating tranches is to create different securities whose credit and

[2] In addition to each offering being backed by a different mortgage pool, some courts have stated that different tranches of MBS within the same offering are backed by different loans in different loan groups. *See, e.g., Countrywide*, 2011 WL 4389689, at *5 (explaining that mortgage pass-through certificate tranches are "often backed by different loans than other tranches in the same MBS offering").

risk profiles attract different purchasers." *In re Washington Mut. Mortgage-Backed Sec. Litig.*, 276 F.R.D. 658, 663 (W.D. Wash. 2011).

Third, each offering of MBS has its own unique prospectus supplement containing distinct disclosures about the different tranches and the particular loans backing the different tranches. *Countrywide*, 2011 WL 4389689, at *7. Indeed, the SEC's regulations specifically treat prospectus supplements as a new registration statement, providing that "for the purpose of determining any liability under the [Securities Act], each . . . post-effective amendment [to a shelf registration statement, such as a prospectus supplement,] shall be deemed to be a *new registration statement* relating to the securities offered therein . . . ." 17 C.F.R. § 229.512(a)(2) (emphasis added).

2. A plaintiff does not suffer any personal injury from an offering in which it did not purchase securities

Because each MBS offering consists of separate and distinct securities, a plaintiff does not suffer any personal injury from an offering in which it did not purchase securities. *In re Lehman Bros. Sec.*, 684 F. Supp. 2d at 490 (holding that plaintiffs cannot allege that they have "suffered any injury stemming from the offerings in which they did not purchase and thus have no standing."); *see also Me. State Ret. Sys.*, 722 F. Supp. 2d at 1163 ("Plaintiffs lack standing because they have no personal stake in the outcome and have suffered no injury from offerings

which they did not purchase."). Thus, it is no surprise that Judge Baer recently dismissed claims with regard to offerings in which the plaintiffs did not purchase securities, holding

> the harm Plaintiffs may have suffered based on misstatements in the Offering Documents for the Certificates they purchased has no bearing on any harm suffered by other investors based on alleged misstatements in other offering documents with details about other offerings that Plaintiffs did not purchase.

New Jersey Carpenters Vacation Fund, 720 F. Supp. 2d at 265.

D. Allowing Plaintiffs to Sue Based on Offerings in Which They Did Not Purchase Securities Would Have Broad Implications for Securities Litigation Generally and SIFMA Members

The Supreme Court of the United States has cautioned that private securities class actions "can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law." *Tellabs, Inc.*, 551 U.S. at 313. Further implications include allowing "plaintiffs with weak claims to extort settlements from innocent companies." *Stoneridge,* 552 U.S. at 163. Indeed, shareholders of issuers and other market participants facing large securities class action claims ultimately shoulder the cost of issuers paying to settle meritless claims.

This Court does not need to look beyond the allegations in Plaintiff's Consolidated First Amended Securities Class Action Complaint (Dkt. 56) ("FAC")

and Corrected Second Amended Class action Complaint (Dkt. 120) ("SAC") to see the detrimental impact of allowing a plaintiff to bring claims based on offerings in which it did not purchase securities.

In the FAC, Plaintiff asserted claims based on MBS that were issued in six different offerings, even though Plaintiff only purchased securities in one of those offerings. When including the securities issued in all six offerings, Plaintiff alleged that the defendants "underwrote and sold to Plaintiff and the Class *$7.75 billion* of Home Equity Loan Asset-Backed Certificates." FAC ¶ 2 (emphasis added). Judge Batts held that Plaintiff lacked standing to sue for the five offerings in which it did not purchase securities, but allowed Plaintiff leave to replead to include allegations specific to the securities that were issued in the one offering in which Plaintiff purchased securities. Order and Mem. at 13-15, 29, *N.J. Carpenters Health Fund v. NovaStar Mortg., Inc.*, 08-CV-5310 (S.D.N.Y. Mar. 31, 2011).

Plaintiff thereafter filed its SAC including only those securities issued in the offering in which it purchased securities. In limiting Plaintiff to that one offering, the amount of MBS at issue in this action decreased by almost *$6.5 billion*, more than 80%, as Plaintiff now alleges that the defendants "underwrote and sold to Plaintiff and the Class *$1.32 billion* of Home Equity Loan Asset-Backed

Certificates." SAC ¶ 2 (emphasis added). This illustrates how limiting a plaintiff to only those claims based on offerings in which it actually purchased securities drastically reduces the improper *in terrorem* value of a plaintiff's case and the concomitant risks, costs and expenses for defendants exposed to such claims.

To that end, this Court's ruling will have a significant impact on the landscape of MBS litigation and the U.S. capital markets. There is no disputing that the strength of the U.S. capital markets is integral to the strength of the U.S. economy as a whole. *See* WSJ Staff, *Geithner Remarks on the Financial Stability Plan*, WALL ST. J., Feb. 10, 2009, http://blogs.wsj.com/economics/2009/02/10/geithner-remarks-on-financial-stability-plan/tab/article/. In addition to the underwriter defendants in this case, numerous investment banks that participate actively in the U.S. capital markets, including many SIFMA members, have participated in the issuance or underwriting of MBS. Those banks are exposed to litigation as a result of the collapse of the financial markets and the U.S. housing industry. Indeed, another matter is currently before this Court addressing the same standing issues as in this action. *See NECA-IBEW Health & Welfare Fund v. Goldman, Sachs & Co.*, No. 11-cv-2762 (2d Cir.) (pending) (pending).

The frequency and scope of these MBS lawsuits will be impacted by the Court's decision in this case. If plaintiffs are permitted to pursue claims on behalf

of investors who purchased securities in offerings in which plaintiffs did not purchase, the size and scope of plaintiffs' MBS lawsuits would increase dramatically. *See, e.g., Countrywide*, 2011 WL 4389689, at *7 ("The logical extension of Plaintiffs' theory is that their allegations of systematic disregard of underwriting guidelines confers standing upon them to challenge every single person or entity that purchased from any offering which was originated or underwritten by the Defendants."). This approach is inconsistent with the statutory language of Sections 11 and 12. *Id.* (The Securities Act and Article III do not support conferring standing on plaintiffs to sue on behalf of investors who purchased in offerings in which plaintiffs did not purchase securities).

Moreover, American businesses and citizens, and the United States economy as a whole, would suffer from increased and more expensive securities litigation. Proceeding to summary judgment or trial would impose on U.S. capital markets participants, including SIFMA members, risks of exposure to significant monetary liability. In addition, SIFMA members would incur additional substantial litigation costs to conduct document and deposition discovery and to engage experts even when they are ultimately successful on the merits. Ultimately, this increased "cost of doing business" is likely to have an adverse impact on the nation's capital markets through increased financing costs and fees needed to cover the potential

increased exposure to litigation costs. *See* Kovachevic, *Fin. Servs. Roundtable, The Blueprint for U.S. Financial Competitiveness*, at 63 (opining that "[e]xcessive litigation and the threat of litigation are the most significant impediments to the competitiveness of U.S. businesses" and that "the growth in class action lawsuits, especially securities class-action cases, imposes substantial uncertainties and costs and presents a major competitive challenge to U.S. financial services firms in comparison to foreign firms that are not subject to a similar risk."). For these reasons, this Court should affirm the district court's dismissal on standing grounds.

II. GENERAL ALLEGATIONS OF INDUSTRY-WIDE MISCONDUCT ARE INSUFFICIENT TO STATE A SECURITIES ACT CLAIM UNDER *IQBAL* AND *TWOMBLY*, ESPECIALLY IN LIGHT OF EXTENSIVE RISK DISCLOSURES

The second issue facing this Court raises similar public policy considerations. As the District Court below twice emphasized in analyzing the sufficiency of Plaintiff's complaints, a plaintiff must do more than allege "the subprime market melted down and Defendants were market participants, so they must be liable for my losses in my risky investment." Order and Mem. at 15, *N.J. Carpenters Health Fund v. NovaStar Mortg., Inc.*, 08-CV-5310 (S.D.N.Y. Mar. 29, 2012) (citing SAC at ¶ 109). In other words, a plaintiff cannot rely on broad allegations of industry misconduct – without particularized facts regarding the specific securities at issue – to state a plausible securities class action claim.

This position is consistent with *Iqbal* and *Twombly's* well-settled pleading standards. As the Supreme Court explained in *Twombly,* Rule 8(a) requires a plaintiff to make "a 'showing,' rather than a blanket assertion, of entitlement to relief." *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 556 n.3 (2007). Such a showing "demands more than an unadorned, the-defendant-unlawfully-harmed-me accusation." *Iqbal*, 556 U.S. at 678. Thus, a plaintiff must allege "enough *facts* to state a claim to relief that is plausible on its face." *Twombly*, 550 U.S. at 547 (emphasis added). Pleadings containing "no more than conclusions[] are not entitled to the assumption of truth," and "[f]actual allegations must be enough to raise a right to relief above the speculative level . . . .". *Iqbal*, 556 U.S. at 679; *Twombly*, 550 U.S. at 555. And, the "sheer possibility that a defendant has acted unlawfully" is not enough. *Iqbal*, 556 U.S. at 678. Such a complaint "has alleged – but it has not 'show[n]' – 'that the pleader is entitled to relief.'" *Id.* at 678 (quoting Fed. R. Civ. P. 8(a)).

A. Supreme Court Precedent Was Intended to Relieve Defendants in Federal Actions of Excessive and Unnecessary Costs

Iqbal and *Twombly* reflect an important jurisprudential and public policy goal: to relieve defendants of the unnecessary costs and risks associated with meritless litigation. In both *Iqbal* and *Twombly*, the Court noted the dangers of allowing a plaintiff's weak claims to proceed to discovery, given the "potentially

enormous" expense that it often places on defendants. *Twombly*, 550 U.S. at 559 (quoting Easterbrook, *Discovery as Abuse*, 69 B.U. L. REV. 635, 638 (1989) for the proposition that "[j]udges can do little about impositional discovery when parties control the legal claims to be presented and conduct the discovery themselves" and noting that "the threat of discovery expense will push cost-conscious defendants to settle even anemic cases before reaching those proceedings."); *Iqbal*, 556 U.S. at 678-79 (noting that Rule 8 does not "unlock the doors of discovery for a plaintiff armed with nothing more than conclusions."). As one scholar states, *Iqbal* and *Twombly* recognize that "as the costs of litigation increase and the scope of discovery expands, the need for more stringent pleading standards increases." *See* Douglas G. Smith, *The Evolution of a New Pleading Standard: Ashcroft v. Iqbal*, 88 OR. L. REV. 1053, 1055-56 (2009).

Allowing meritless cases to proceed is inefficient, costly, and often leads to *in terrorem* settlements unwarranted by the merits. *Id.* at 1055. Keith N. Hylton's economic study of pleading and summary judgment standards indicates that a court's failure to dismiss implausible claims leads to two types of social cost: "First, by permitting substantial litigation costs to be imposed on complying defendants, failures to dismiss low merit claims weaken incentives to comply with the law and to take socially desirable actions. Second, by directly increasing total

litigation costs, failure to dismiss low merit claims reduces social welfare." Keith N. Hylton, *When Should a Case Be Dismissed? The Economics of Pleading and Summary Judgment Standards*, 16 SUP. CT. ECON. REV. 39, 50–53 (2008). *Iqbal*, then, is a logical step in the "march toward greater judicial scrutiny at the outset of litigation", designed to avoid the inefficiencies and burdens that defendants may face later in the process. Smith, 88 OR. L. REV. at 1055.

B. The Supreme Court's Longstanding Concerns About Excessive and Unnecessary Costs to Defendants Apply Especially to Securities Litigation

The Supreme Court has acknowledged the same concern in the specific context of securities class actions which are, as one noted scholar put it, "the 800-pound gorilla that dominates and overshadows other forms of class actions." Coffee, 106 COLUM. L. REV. at 1539.

For example, in *Dura Pharmaceuticals, Inc. v. Broudo*, the Supreme Court emphasized that courts should not allow a plaintiff "with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the [discovery] process will reveal relevant evidence." 544 U.S. 336, 347 (2005) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U. S. 723, 741 (1975)); *see Tellabs*, 551 U.S. at 308. In the same vein,

Congress enacted the Private Securities Litigation Reform Act to curb perceived abuses associated with securities class action suits: "nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests and manipulation by class action lawyers." *Id.* at 313 (2007) (quoting *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 81 (2006)).

In the context of a securities case, then, a plaintiff must do more than generally allege that industry players (including the defendants) engaged in misconduct, without any particularized *facts* related to the actual securities the plaintiff purchased. *See, e.g.*, *City of Ann Arbor Employees' Ret. Sys. v. Citigroup Mortg. Loan Trust Inc.*, 703 F. Supp. 2d 253, 263 (E.D.N.Y. 2010) (dismissing 1933 Securities Act claims and requiring plaintiff to demonstrate a link between the alleged misstatements and/or omissions regarding loan origination guidelines and the actual loans in which they invested); *Footbridge Ltd. Trust v. Countrywide Home Loans, Inc.*, No. 09-CV-4050(PKC), 2010 WL 3790810 at *10-13 (S.D.N.Y. Sept. 28, 2010) (holding that broad allegations that defendant "deviated from the loan-origination practices that it represented in the offering documents, effectively *abandoning* rather than loosening its standards" are insufficient, without more, to state a plausible claim); *Republic Bank & Trust Co. v. Bear, Stearns & Co.*, 707 F. Supp. 2d 702, 712 (W.D. Ky. 2010) (dismissing a claim based on bank's failure to

follow its own underwriting standards because the complaint failed to allege any misconduct tied to the specific loans and securities at issue), *aff'd*, 683 F.3d 239 (6th Cir. 2012). To hold otherwise would be to allow a plaintiff to sue virtually any industry player based on allegations of collective industry failings. *Iqbal, Twombly*, and the principles underlying those decisions and the PSLRA require more.

In addition, a securities plaintiff cannot state a claim unless it plausibly alleges materiality, that is, a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *See Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (adopting the standard in *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). Where no reasonable investor could consider an alleged misrepresentation important in light of adequate cautionary language set out in the same offering, dismissal is appropriate. *Halperin v. eBanker USA.com, Inc.*, 295 F.3d 352, 357 (2d Cir.), *aff'd*, 40 F. App'x 624 (2002). And, a defendant has no duty to disclose information that was publicly available at the time the plaintiff made its investment. *Seibert v. Sperry Rand Corp.*, 586 F.2d 949, 952 (2d Cir. 1978) ("Although the underlying philosophy of federal securities regulations is that of full disclosure, there is no

duty to disclose information to one who reasonably should already be aware of it.") (internal citations and quotation marks omitted); *N.J. Carpenters Vacation Fund*, 720 F. Supp. at 272 (dismissing a plaintiff's disclosure claims because, in part, "[a] reasonable investor would be expected to know that the rating agencies were paid by the investment banks that hired them, and that they had a hand in determining the structure of securitizations.").

C. This Case Illustrates the Danger of Allowing Meritless Cases to Proceed

Here, Plaintiff's SAC generally alleged that Defendants systematically disregarded underwriting guidelines, relying almost exclusively on generic news articles, general statements made in connection with government investigations regarding industry-wide misconduct, loan delinquency and default data, credit rating downgrades, and confidential statements by anonymous NovaStar employees. None of these sources linked the purported behavior at issue – failure to follow underwriting guidelines – to the specific loans supporting the 2007-2 offering. To the contrary, the SAC failed to specify a single loan that Plaintiffs contend violated the underwriting guidelines at issue.[3]

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[3] In its appellate brief, Plaintiff contends that its allegations were, in fact, specific as to the loans in the 2007-2 offering because the 2007-2 offering was subject to ratings downgrades and increased delinquency and default rates. *See* Pl.'s App. Br. at 39-40. However, virtually *all* MBS offerings were subject to ratings

This case exemplifies the danger of allowing a plaintiff to proceed on general, industry-wide allegations untethered to the actual securities at issue.[4] According to Defendants, more than 80 percent of the loans in the 2007-2 pool were originated *after* NovaStar announced that it had implemented new quality control mechanisms (and, for that matter, *after* many of Plaintiff's confidential witnesses were no longer employed at NovaStar). *See* NovaStar Defendants' Reply Memorandum in Support of Motion to Dismiss Corrected Second Amended Complaint, *N.J. Carpenters Health Fund v. NovaStar Mortg., Inc.*, 08-CV-5310, at 5 (S.D.N.Y. Sept. 16, 2011). Moreover, it is unclear whether *any* loans affected by the allegedly improper underwriting practices actually ended up in the 2007-2 loan pool. According to Defendants, NovaStar purchased, rather than originated, a substantial percentage of the loans in the 2007-2 pool, and many of the loans it did originate were sold to investors rather than securitized. *Id.*

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downgrades and increased delinquency and default rates. Because Plaintiff's allegations are true across the board, they offer no specific or distinguishable link to the actual loans in the 2007-2 pool.

[4] Plaintiff's claims are an offshoot of the "most common allegation levied by plaintiffs", "that the defendants misrepresented the strength of their underwriting standards for issuing mortgage loans or insuring financial products with exposure to subprime." Miller, 80 FORDHAM L. REV. 1 at 291 (analyzing the cases related to the financial crisis that had resulted in a decision on a motion to dismiss as of October 2011).

The dangers of allowing this case to proceed are especially acute in light of the extensive disclosures and public information available to Plaintiff – an institutional investor[5] – regarding the risks associated with M-1 Certificates as part of the 2007-2 offering. *See* Order and Mem. at 14, *N.J. Carpenters Health Fund v. NovaStar Mortg., Inc.*, 08-CV-5310 (S.D.N.Y. Mar. 29, 2012) (describing the extensive risk disclosures that "explicitly warned Plaintiff" and concluding that no reasonable investor could consider the alleged misstatements and omissions material in light of that cautionary language). Plaintiff acknowledged that it was aware of the "publicly known financial issues at NovaStar" and the "publicly disclosed information regarding developments in the subprime market during 2006 and 2007." *Id.* at 15.

Where, as here, an investor is a sophisticated institutional actor, the loosened pleading standard Plaintiff advocates is particularly inappropriate. *Cf.* Fletcher, 1988 Duke L.J. at 1153. A plaintiff should not profit from its own failure to use common sense in assessing the risks of its investment. *Cf. Republic Bank & Trust*

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[5] In its Memorandum of Law in Support of its Motion for Appointment of Lead Plaintiff and Approval of Lead Counsel, New Jersey Carpenters Health Fund represented itself as a "large institutional investor" with a "major financial stake in this litigation." *See* Mem. of Law in Supp. of N.J. Carpenters Health Fund's Motion for Appointment of Lead Pl. and Approval of Lead Counsel, *N.J. Carpenters Health Fund v. NovaStar Mortg., Inc.*, 08-CV-5310 (S.D.N.Y. (Jan. 6, 2009).

Co. v. Bear Stearns & Co., Inc., 683 F.3d 239, 258 (6th Cir. 2012) (affirming the lower court's dismissal of disclosure claims, noting: "Were [the plaintiff] a country bumpkin, not a financial institution, this argument might be colorable. However, a large institutional investor, in its exercise of 'common sense,' should understand that when offering document refers to courts determining that loans are predatory, then lays out a specific remedial procedure for such loans, some of the lending practices at issue might be predatory.") (citation omitted).

In sum, allowing a plaintiff to plead claims with nothing more than general allegations of industry-wide misconduct in the MBS market – especially in light of extensive disclosures and publicly-available information regarding the risks associated with its investment – not only contravenes *Iqbal* and *Twombly*, but represents bad public policy. The *Iqbal* and *Twombly* plausibility threshold unlocks the courtroom doors only for claims that are plausible on their face. Applying the Plaintiff's loosened standard would enable the filing of even more lawsuits grounded in legally insufficient generalized, industry-wide allegations untethered to the specific securities at issue. As a result, reversing the judgment below could subject courts to a litany of conclusory complaints that allege nothing more than "the mere possibility of misconduct," imposing significant cost on the courts, SIFMA members, and the financial services industry at large. *See Iqbal*,

556 U.S. at 679; *see also* Section I(D) (discussing the impact of increased security litigation risks and costs on the capital markets industry at large). For this additional and independent reason, this Court should affirm the decision below.

CONCLUSION

For these reasons, the Court should affirm the judgment of the District Court dismissing Plaintiff's claims.

Dated August 14, 2012

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Second Circuit by using the appellate CM/ECF system.

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CERTIFICATE OF COMPLIANCE

The foregoing brief complies with the type-volume limitation of Federal Rules of Appellate Procedure 29(d) and 32(a)(7)(B) because it contains 6,536 words, excluding those parts of the brief exempted by Federal Rule of Appellate Procedure 32(a)(7)(B)(iii).

The foregoing brief complies with the typeface requirements of Federal Rule of Appellate Procedure 32(a)(5) and the type-style requirements of Federal Rule of Appellate Procedure 32(a)(6) because it has been prepared in a proportionally spaced typeface, 14-point Times New Roman font, using Microsoft Word 2010.