SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

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THE PEOPLE OF THE STATE OF NEW YORK by ANDREW M. CUOMO, Attorney General of the State of New York,

Plaintiff,

- against -

CHARLES SCHWAB & CO., INC.,

Defendant.

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Index No. 453388/2009
The Hon. James A. Yates
IAS Part 49

PLAINTIFF's MEMORANDUM OF LAW IN OPPOSITION TO DEFENDANT CHARLES SCHWAB & CO, INC.'s MOTION TO DISMISS

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PRELIMINARY STATEMENT

The motion of defendant Charles Schwab & Co., Inc. ("Schwab") to dismiss the State's complaint (the "Complaint") under CPLR 3211(a)(7) and CPLR 3016(b) should be denied in its entirety. The Complaint alleges in great detail that Schwab engaged in fraudulent and deceptive conduct in connection with the sale of hundreds of millions of dollars of auction rate securities ("ARS") to the investing public. Schwab misrepresented those securities as safe, liquid investments that were suitable for the short-term, cash management objectives of its customers. In fact, however, ARS were complex, long-term, and in some cases perpetual, financial instruments with significant, inherent, and increasing liquidity risks. Schwab persistently failed to disclose, and made misrepresentations that concealed, the risk that ARS would become illiquid should auctions fail, even though it had knowledge of these risks. The Complaint's detailed and particularized allegations, all of which the Court must accept as true on this motion to dismiss, properly plead securities, consumer, and statutory fraud claims against Schwab.

Schwab's arguments against the adequacy of the Complaint are without merit. Schwab pretends that the State's allegations are not sufficiently specific to give them notice of the wrongful conduct alleged, but a review of the 38-page Complaint puts that contention to rest. The State's allegations are supported with reference to detailed and specific evidence obtained directly from Schwab's own files, including numerous audio recordings of interactions between Schwab's own brokers with Schwab's own customers, thousands of pages of e-mails and other Schwab internal documents, and sworn testimony of Schwab's own employees.

Schwab also incorrectly argues that the State is trying to hold it responsible for failing to foresee the overall failure of the ARS market. In doing so, Schwab repeatedly misstates particular allegations in the Complaint and mischaracterizes the Complaint as a whole. Contrary to Schwab's assertion, however, this case is not about a failure by Schwab to be prescient. It is about Schwab's misrepresentations regarding the fundamental nature of ARS, its repeated false assurances to its customers that ARS were fully liquid investments, and its concomitant failure to disclose the potential liquidity risks inherent in ARS – all things that the Complaint alleges, and the evidence plead establishes, Schwab as an institution knew, and that its brokers knew or should have known, at the time. The Complaint also alleges that Schwab knew more about both ARS and the problems of the ARS market than it told its customers then, or admits now. Schwab's attempt to contest the materiality of the information it misrepresented or failed to disclose to its customers is equally incredible, when, as the Complaint clearly alleges, Schwab promoted the supposed liquidity of ARS to its customers as the key feature of those securities.

Schwab also attacks the State's legal authority to pursue its case. But the State's authority to concurrently seek relief on behalf of investors and consumers under the Martin Act, Executive Law § 63(12), and GBL § 349, as the State does here, is not nearly so limited as Schwab suggests. This suit lies well within the Attorney General's authority under those statutes to protect New York residents and the integrity of New York's markets. Schwab cannot dispute that it sold ARS to New York residents and that, even as to non-New York investors, the ARS were underwritten and issued by New York entities, and the ultimate auction-rate transactions at issue were executed through New York entities and consummated in New York markets. As explained herein, New York's statutes apply to the entirety of the conduct alleged here because the requisite connections to New York are established under each of the statutes upon which the State has sued.

Next, Schwab claims to have had a limited role in the ARS market, and that it somehow was a victim of the practices of the major underwriter broker-dealers whose ARS Schwab distributed to its customers. If Schwab truly was such a simpleton in the marketplace as it suggests, then it was reckless in selling products it did not understand. But the evidence alleged in the Complaint belies any claim by Schwab that it was unaware of the risks in selling ARS. Indeed, by the admission of its own employees, Schwab at all relevant times knew about potential liquidity risks inherent in ARS – the very risks that its own employees also admit Schwab did not disclose to its customers. There also is ample testimonial and documentary evidence cited in the Complaint that Schwab knew that the major underwriters were supporting the ARS market with proprietary bids, and that the support was intended to prevent auctions from failing. The Complaint also presents evidence that Schwab knew that the auctions that did fail in the period between August 2007 and February 2008, of which Schwab was aware, failed because the underwriters of those issues refused to support those auctions.

At base, this motion is another attempt by Schwab to delay adjudicating the case on the merits, and, more importantly, doing something to alleviate the suffering of its customers who continue to experience illiquidity for twenty-eight months and counting since the failure of the ARS market. For all of these reasons, and others described below, this Court should deny Schwab's motion to dismiss in its entirety.

STATEMENT OF THE CASE

I. <u>The State's Complaint</u>

The Attorney General sues to enforce Schwab's compliance with the blue sky, consumer protection and anti-fraud statutes of the State of New York – namely, Executive Law §§ 63(1) and 63(12) of the State of New York, Article 22-A of the General Business Law of the State of New York ("GBL"), § 349 et seq., and Article 23-A of the GBL, § 352 et seq. (also known as the "Martin Act"). The Martin Act authorizes the Attorney General to prosecute a civil action "in the name and on behalf of the People of the State of New York" for injunctive relief and restitution to redress "any device, scheme or artifice … deception, misrepresentation, concealment, suppression, fraud, false pretense or false promise" in connection with the promotion or sale of securities "within or from this state." GBL §§ 352 and 353. Section 352-c(1)(c) declares illegal "any representation or statement which is false, where the person who made such representation or statement: (i) knew the truth; or (ii) with reasonable effort could have known the truth; or (iii) made no effort to know the truth; or (iv) did not have knowledge concerning the representation or statement made." Executive Law § 63(12) empowers the Attorney General to sue in the name of the People for an injunction, restitution, and damages in cases of "persistent fraud or illegality in the carrying on, conducting, or transaction of business." Executive Law § 63(12) defines actionable "fraud" as including "any deception, misrepresentation, concealment, suppression, [or] false pretense," and also makes the violation of any statute, law, or regulation an actionable "illegality." Similarly, GBL § 349(h) authorizes the Attorney General to sue "in the name of and on behalf of the [P]eople" to enjoin and obtain restitution as to "[d]eceptive acts or practices in the conduct of any business or in the furnishing of any service in this state," and § 350-d further empowers the Attorney General to seek civil penalties of up to $5,000 per violation, "which shall accrue to the state of New York."

The Attorney General's complaint alleges that Schwab violated the Martin Act, Executive Law § 63(12) and GBL § 349 by misrepresenting ARS to its customers as safe, liquid investments that were suitable for their short-term, cash management purposes, when, in fact, ARS were complex financial instruments with significant, inherent, and increasing liquidity risks. The Complaint alleges that Schwab persistently failed to disclose, and made misrepresentations that concealed, the risk that customers would not be able to sell their ARS and could thus lose liquidity should auctions fail. Compl. ¶ 1.

The Complaint sets forth specific evidence supporting these allegations. The Complaint excerpts a number of audio recordings that evidence misrepresentations that Schwab brokers made concerning the risks of investing in ARS. For example, one Schwab broker "guaranteed" that a customer would be able to "get out of [his auction rate security] on the auction date." Compl. ¶ 63. Another Schwab broker assured a customer that "getting out [of ARS] is something as easy as just selling it," Compl. ¶ 55, while still another assured a customer that ARS are "so short-term that, you know, your money is, within a week you're gonna have it to do whatever you need," Compl. ¶ 63. Additional recordings excerpted in the Complaint reflect the widespread nature of the misrepresentations made by Schwab's brokers. Compl. ¶¶ 53-63.

The Complaint summarizes the sworn testimony of Schwab brokers who admitted that they sold ARS to the customers they served as liquid investments that could be sold at every auction, without ever disclosing the liquidity risks associated with those securities. Compl. ¶¶ 30-52. The Complaint alleges that the misrepresentations made by these Schwab brokers were emblematic of a broader pattern of fraudulent conduct engaged in by Schwab. Compl. ¶ 52.

The Complaint further alleges that Schwab brokers persistently misrepresented the risks of investing in ARS because Schwab did not train its brokers concerning these complex investments, and failed to ensure that its brokers properly described the risk of investing in ARS. Compl. ¶¶ 71-85. Consequently, Schwab brokers typically either did not understand ARS or did not have the knowledge necessary to make accurate disclosures to Schwab's customers. One broker whose testimony is quoted admitted to selling ARS even though he did not possess even a basic understanding of their structure or risks. Compl. ¶ 43. This broker admitted: "I don't know what measuring scale you would want to use to assess my knowledge about ARS … but on whatever measuring scale my knowledge was pretty low." Compl. ¶ 44. He supposedly only learned that auctions could fail after the market collapsed in February 2008. Compl. ¶ 44.

The Complaint also alleges that Schwab's failure to train its brokers concerning ARS stood in stark contrast to Schwab's marketing materials. Compl. ¶ 74. Schwab marketed itself as providing "extensive fixed-income research" and invited customers to "[t]ake advantage of our expertise" by "[c]all[ing] on our seasoned bond traders, who have an average of 15 years of industry experience." Compl. ¶ 73. According to the Complaint, these "seasoned bond traders" are the same people who misrepresented or failed to disclose the liquidity risks inherent in ARS, and testified to receiving no training, and knowing little or nothing about, ARS. Compl. ¶ 75.

Finally, the Complaint alleges that Schwab knew, or should have known, about the deteriorating conditions in the ARS market. Compl. ¶¶ 86-103. Schwab received non-public information from major broker-dealers underscoring the problems in the market. Compl. ¶¶ 93-95. Although Schwab executives monitored early auction failures, primarily for Schwab's own "exposure," Schwab took no action to review or correct the disclosures it made to its customers. Compl. ¶¶ 89-95.

The Complaint seeks an order enjoining Schwab from engaging in the fraudulent practices alleged, requiring that Schwab buy back ARS from defrauded customers at par and reform certain of its business practices, and directing that Schwab disgorge all gains, and pay restitution, damages, statutory penalties, and costs. Compl. ¶¶ 10, 14, Prayer for Relief.

II. <u>Procedural History</u>

The State filed this action on August 17, 2009. Schwab removed the action to federal court, but on January 19, 2010, the U.S. District Court for the Southern District of New York (McKenna, J.) granted the State's motion to remand the case back to this Court for lack of federal subject matter jurisdiction. On March 15, 2010, Schwab moved to dismiss the Complaint under CPLR 3211 and 3016.

ARGUMENT

I. <u>The Complaint Adequately Pleads Claims Under the Martin Act, Executive Law § 63(12), and GBL § 349</u>

Contrary to Schwab's contention that the State's allegations are not sufficiently particular, the Complaint states in great detail that Schwab and its brokers touted ARS as highly liquid securities that should be considered cash alternatives, without disclosing to investors that auctions could fail, and that if auctions did fail, investors would be stuck holding the securities unable to cash them out. These allegations alone sufficiently allege violations of the Martin Act, GBL § 349, and Executive Law § 63(12). Schwab also argues that it could not have foreseen the widespread market decline that led to auction failures. But this argument is a red herring. The Complaint alleges that during the entire time it sold ARS, Schwab knew of the risks and consequences to liquidity that would ensue should auctions fail, yet misrepresented or failed to disclose these risks to its customers. The market collapse only brought Schwab's misconduct to light. Finally, Schwab contends that the Complaint fails to allege that the information it misrepresented or withheld from its customers was material. But, the Complaint alleges that Schwab promoted the supposed liquidity of ARS to investors as the essential feature of those securities, and it is difficult to imagine information that would have been more material to customers seeking investments to manage their cash. Schwab is thus hard-pressed to contest the materiality of the facts going to liquidity.

A. The Complaint Specifically Alleges that Schwab Brokers Misrepresented the Liquidity of Auction Rate Securities to Customers and Failed to Disclose the Risk That the Auction Rate Securities Could Become Illiquid

It is well established that, on a motion to dismiss pursuant to CPLR 3211, the Court must "accept the facts as alleged in the complaint as true, accord plaintiffs the benefit of every possible favorable inference, and determine only whether the facts as alleged fit within any cognizable legal theory." *Arnav Indus. Inc. Ret. Trust v. Brown, Raysman, Millstein, Felder &*

Steiner, LLP, 96 N.Y.2d 300, 303 (2001). "The criterion is whether the proponent of the pleading has a cause of action, not whether he has stated one." *Guggenheimer v. Ginzburg*, 43 N.Y.2d 268, 275 (1977). "Whether a plaintiff can ultimately establish its allegations is not part of the calculus in determining a motion to dismiss." *EBC I, Inc. v. Goldman Sachs & Co.*, 5 N.Y.3d 11, 19 (2005).

The complaint here more than adequately alleges claims against Schwab under the Martin Act, Executive Law § 63(12) and GBL § 349. These remedial statutes are broadly construed, and the terms "fraud" and "deceptive acts or practices" under them are given the widest possible meaning. *See*, *e.g.*, *People v. Federated Radio Corp.*, 244 N.Y. 33, 37-39 (1926) (Pound, J.). The Court of Appeals has stated that fraud under the Martin Act "includes all deceitful practices contrary to the plain rules of common honesty" and covers "all acts, although not originating in any actual evil design or contrivance to perpetrate fraud or injury upon others, which do by their tendency to deceive or mislead the purchasing public come within the purpose of the law." *Id.; accord People v. Lexington Sixty-First Assocs.*, 38 N.Y.2d 588, 595 (1976). Moreover, "given the liberal construction to be accorded the Martin Act, an omission as well as a concealment or suppression of information may be actionable as a fraudulent practice." *State v. Rachmani Corp.*, 71 N.Y.2d 718, 726 (1988).

The "virtually identical" language of Executive Law § 63(12) is construed similarly expansively. *Id.* at 721 n.1. Applying § 63(12), courts "broadly constru[e] the definition of fraud so as to include acts characterized as dishonest or misleading" and do not require "proof of an intent to defraud." *People v. Apple Health & Sports Clubs, Ltd.*, 206 A.D.2d 266, 267 (1st Dep't 1994). The test of fraudulent conduct under Executive Law § 63(12) is "whether the targeted act has the capacity or tendency to deceive, or creates an atmosphere conducive to fraud." *People v. Gen. Elec. Co., Inc.*, 302 A.D.2d 314 (1st Dep't 2003); *see also State v. Gen.*

Motors Corp., 120 Misc.2d 371, 374 (Sup. Ct., N.Y. Cty. 1983) (Under § 63(12), "[if] one party has superior knowledge or has a means of knowledge not available to both parties, then he is under a legal obligation to speak and silence would constitute fraud.").

GBL § 349 is likewise liberally construed. A misrepresentation or omission is deceptive under GBL § 349 – even absent consumer reliance or intent to deceive – if the statement or non-disclosed fact is "likely to mislead a reasonable consumer acting reasonably under the circumstances." *Stutman v. Chem. Bank*, 95 N.Y.2d 24, 29 (2000) (*quoting Oswego Laborers' Local 214 Pension Fund v. Marine Midland Bank*, 85 N.Y.2d 20, 26 (1995)). All of these statutes were "meant to protect not only the average consumer, but also 'the ignorant, the unthinking and the credulous.'" *Gen. Elec.*, 302 A.D.2d at 314.

In this case, the Attorney General alleges that Schwab committed fraud and deception under each of the statutes both by affirmatively misrepresenting the liquidity of ARS in communications with its customers, and by omitting to disclose material information about those securities to its customers. Specifically, the Complaint sets forth excerpts of taped conversations in which Schwab brokers affirmatively misrepresented to customers that ARS were liquid securities. Compl. ¶¶ 2, 30, 55-63, and 70. The Complaint also describes or quotes sworn admissions by Schwab brokers that they misrepresented ARS to customers as safe and liquid securities, failed to inform customers about the liquidity risks inherent in them, or, in some cases, knew little or nothing about ARS, even though these same brokers sold ARS to Schwab's customers. Compl. ¶¶ 4, 31, 34-37, 39-41, 43, 44, 46, 47, 49-52, 78, and 84. The Complaint further alleges that this evidence reflects a systemic practice of making improper disclosures to its customers, and pleads that Schwab failed to train its brokers properly about the risks of ARS. Compl. ¶¶ 3, 4, 5, 30, 31, 35, 36, 43, 44, 46, 51, 52, 54, 69, 74, 77-79, 81-84, 95, and 104. The Complaint also alleges that Schwab failed to disclose material features of ARS, such as the fact that the securities would become illiquid if auctions failed and remain so if auctions were to continue to fail. Compl. ¶¶ 1, 30, 31, 37, 39, 41, 52, 55-56, 58-69, 75, 81, 84, 95. 99, and 104. These alleged misstatements and omissions had the clear potential to deceive investors who were deprived of sufficient information to make informed investment decisions about the ARS they purchased from Schwab. Consequently, the Complaint adequately pleads claims for violations of the Martin Act, Executive Law § 63(12), and GBL § 349.

B. Schwab's Challenge to the Adequacy of the Pleading Is Without Merit

Schwab argues that the Complaint does not plead fraud with particularity because it fails to allege the "who, what, where, and how for each supposed misstatement," does not "allege that the supposed misrepresentations and omissions were false when made," and fails to allege the materiality of information allegedly withheld by Schwab. MTD, pp. 9-11. None of these arguments withstands scrutiny.

The Court of Appeals has never held that the particularity requirement of CPLR 3016(b) applies to the broad remedial statutes under which the Attorney General sues here, although the First Department admittedly has suggested that it does. *People v. Katz*, 84 A.D.2d 381, 384-85 (1st Dep't 1982). But even assuming that particularity were required, the Complaint easily satisfies that standard. CPLR 3016(b) together with CPLR 3013 "mandate only that the misconduct complained of in *sufficient detail* to inform the defendants of the substance of the claims." *Bernstein v. Kelso & Co.*, 231 A.D.2d 314, 320 (1st Dep't 1997) (emphasis in original); *see also Pludeman v. N. Leasing Sys., Inc.*, 10 N.Y.3d 486, 491 (2008) (noting that the essential purpose of CPLR 3016(b) is to "inform a defendant with respect to incidents complained of"); *Wiener v. Lazard Freres & Co.*, 672 N.Y.S.2d 8, 14 (1st Dep't 1998) ("In determining whether pleadings meet the statutory requirement, we have subordinated the threshold pleading requirement of CPLR 3016 (subd. [b]) to the notice standard of CPLR 3013.") (quotations omitted). The standard of particularity is met "when the facts are sufficient to permit a reasonable inference of the alleged conduct." *Pludeman*, 10 N.Y.3d at 492.

The State's complaint hardly leaves Schwab guessing about the nature and circumstances of the fraudulent and deceptive conduct alleged here. Among other things, the 38-page Complaint contains numerous specific allegations of misrepresentations and omissions based upon evidence that Schwab itself provided in the Attorney General's investigation, including internal e-mails, testimony of Schwab employees, and transcripts of recorded conversations between Schwab's employees and Schwab's customers, which Schwab is required to maintain under federal law. Compl. ¶¶ 2, 4, 34-37, 39-41, 43-44, 46-47, 49-52, 55-63, , 76, 83, 84, 87-92, 96-98, 100, 102 and 103. Given the detailed nature of the Complaint, based upon the recorded, transcribed or written words of Schwab's own employees, Schwab's demand for further information about this evidence is baseless. Moreover, Schwab knows the identities of the brokers whose recorded conversations it produced, the names of the customers with whom they had contact, which employees gave testimony during the investigation and what they testified to, and whose e-mails are excerpted in the Complaint.

Schwab argues that the Complaint fails to adequately allege that Schwab made misrepresentations and omissions beyond the specific instances described in the Complaint. MTD, pp. 10-11. But that argument is irrelevant at this initial stage and, in any event, is incorrect. A single misrepresentation or material omission suffices to state a claim under the Martin Act or GBL § 349, and only two "separate and distinct fraudulent or illegal act[s], or conduct which affects more than one person" are required to state a claim for repeated or persistent illegality under Executive Law § 63(12).[1] The numerous specific instances described in the Complaint clearly satisfy these requirements, and defeat Schwab's motion to dismiss.

[1] As the Martin Act, GBL § 349, and Executive Law § 63(12) each authorize prospective injunctive relief, none requires that a transaction even take place for the conduct to be actionable.

Whether those misrepresentations or omissions were systematic, as the State alleges, may affect the scope of relief ultimately awarded here, but need not be considered in determining whether the Complaint states claims for violations of New York's antifraud statutes, which it does.

At any rate, contrary to Schwab's assertion, MTD pp. 10-11, the Complaint specifically pleads facts supported by persuasive evidence that the misrepresentations and omissions alleged were systematic and representative of a widespread pattern of misconduct by Schwab. For instance, as the Complaint alleges, of the eight Schwab brokers and their supervisors questioned during the investigation, four admitted that they did not know about, did not fully understand, or did not discuss with customers the liquidity risks associated with ARS, and one admitted that he knew nearly nothing at all about auction rate securities, even though he sold auction rate securities to Schwab customers. Compl. ¶ 52. The Complaint also specifically alleges that Schwab, as an organization, was reckless in the way it offered and sold ARS because, among other things, it provided its brokers absolutely no formal training or guidance with respect to the features and substance of ARS, or the manner in which they should be sold, in spite of the fact that Schwab knew about these features and risks.[2] Compl. ¶¶ 3, 4, 5, 43, 44, 46, 52, 74, 77-79, and 81-84. These allegations more than sufficiently support an inference that misrepresentations and omissions regarding the risks inherent in ARS were commonplace at Schwab, if such an inference were needed here to survive a motion to dismiss. *Cf. State v. Princess Prestige Co., Inc.*, 42 N.Y.2d 104, 107 (1977) (affirming injunctive relief where proceeding was initiated on the basis of 16 complaints out of 3,600 transactions).[3]

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[2] Contrary to Schwab's suggestion, MTD, pp. 17-19, the State does not plead that Schwab's failure to train, in and of itself, is actionable fraud. Rather, these allegations are intended to reinforce, and do reinforce, the conclusion that Schwab's conduct was systematic, and its fraud not just the product of the conduct of a few individual brokers.

[3] On this point, Schwab mistakenly relies on *People v. Direct Revenue, LLC*, 19 Misc.3d 1124(A), 2008 WL 1849855 (Sup. Ct. N.Y. Cty. Mar. 12, 2008). In that case, the court had already concluded as a matter of law that none of the 29 transactions specifically alleged in the Complaint were fraudulent, before it reached the question of whether the identified transactions were adequate to support an inference that they were representative of millions of other transactions in which the defendants engaged. *Id*. at *3. Here, the Complaint alleges specific instances of

Schwab is also incorrect in asserting that the Complaint attempts to plead a claim of "fraud by hindsight." MTD, pp. 14. Schwab argues that it is not possible to conclude that statements made by Schwab employees about liquidity were false when made, because there is no indication that ARS were in fact illiquid at the time of any of its alleged misrepresentations or omissions. MTD, pp. 14. But this misses the point. The Complaint does not allege that Schwab told its customers that ARS were liquid at a time when the securities were illiquid. Rather, the Complaint alleges that Schwab failed to explain the risks of future illiquidity that were both knowable and known to Schwab at the time. Compl. ¶¶ 1, 2, 5, 6, 7, 30, 31, 37, 39, 41, 52, 55-56, 58-69, 74, 75, 76, 81, 84, 86-88, 90, 92-95, 98, 99, and 104. Schwab failed to tell its customers that auctions could fail and also what would happen if an auction did fail for any reason – namely, that the securities would lose liquidity because they could not be sold until the auctions cleared again, if they ever did. Compl. ¶¶ 1, 30, 31, 37, 39, 41, 52, 55-56, 58-69, 75, 81, 84, 95. 98, 99, and 104. The Complaint sets forth detailed allegations supported by evidence that Schwab actually knew about these very features and risks that its sales representatives misrepresented and failed to disclose during the entire period that it sold ARS to its customers. Compl. ¶¶ 1, 2, 5, 74, 75, 76, 86-88, 90, 92-95, and 98. Moreover, the State's allegations of what Schwab knew or did not know and when must be accepted at the pleading stage as true, and, in any event, are questions that need not be resolved on a motion to dismiss. Even if Schwab had not actually known these things, given the facts plead, they certainly could have known them "with reasonable effort," which suffices to support a claim here.[4] GBL § 352-c(1)(c)(ii).

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representations and omissions that are actionable, and also alleges a failure to train that bolsters the inference that Schwab's failings were systemic.

[4] Hedging its bets, Schwab falls back to the position that the Court should not consider claims for misrepresentations or omissions before August 2007, suggesting there is no allegation that Schwab had the relevant information any earlier. MTD, p. 16, n.4. But this is factually inaccurate. The Complaint alleges that Schwab possessed the requisite knowledge from the time it began selling ARS. Compl. ¶¶ 76, 86. Moreover, even if there were no such allegation, Schwab's liability would not be limited to the information that it actually knew and failed to convey, but would extend also to information that Schwab "with reasonable effort could have known." GBL § 352-c(1)(c)(ii).

Schwab also argues that "the only 'material' information supposedly withheld from Schwab customers was that underwriters would periodically enter 'support bids,'" and remarkably, that "there is no indication in the Complaint that it would have actually mattered to investors had they been advised of these support bids." MTD, p. 15. It further contends, in Footnote 5 of its brief, that the only information that could have mattered to investors was that underwriters were planning to end the practice of support bids. MTD, p. 16. First, Schwab again mischaracterizes the Complaint. The Complaint alleges that Schwab promoted ARS as a highly liquid investment, yet failed to disclose, or made misrepresentations that obscured, the risk that customers could lose liquidity should auctions fail. Compl. ¶¶ 1-4, 29-32, 34-37, 39-41, 43-44, 46-47, 49-52, 55-70, 76, 84, 95, 98-99, and 104. Second, Schwab's makes a factual argument that has basis in the record and is wholly inappropriate on a motion to dismiss. "Courts do not grant motions to dismiss … on grounds of immateriality, unless the misstatements 'are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance.'" *In re JP Morgan Chase Sec. Litig.*, 363 F. Supp. 2d 595, 625-26 (S.D.N.Y. 2005) (quotations omitted). *See also ECA & Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187, 197 (2d Cir. 2009) (noting that materiality is a mixed question of fact and law, and therefore generally inappropriate for resolution on a motion to dismiss); *People v. Merkin*, 26 Misc.3d 1237(A), 2010 WL 936208, at *4 (Sup. Ct. N.Y. Cty. Feb. 8, 2010) (same).

Certainly, the Complaint alleges sufficient facts to support an inference that there 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." *State v. Rachmani Corp.*, 71 N.Y.2d 718, 726 (1988) (*quoting TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)) (emphasis in original) (quotations omitted). As the Complaint alleges, liquidity was the essential feature of the ARS Schwab sold its customers, and the core reason why so many people invested in them. Under the applicable test, it is hard to imagine that information directly relevant to the question of whether securities advertised as liquid could or could not be sold, which is the very information Schwab misrepresented or omitted to state, would not be material to a prospective investor in ARS. Indeed, the fact that Schwab advertised the liquidity of the securities is a virtual concession that information about risks regarding that liquidity would have been material to customers.

II. The Court Has Jurisdiction over Claims Relating to Auction Rate Securities Transactions Involving Non-New York Investors

Contrary to Schwab's arguments, MTD, p. 20-22, the Martin Act, Executive Law § 63(12), and GBL § 349 embrace all the fraudulent transactions alleged in the Complaint, including those involving non-New York residents, because the requisite connections to New York are established under each of those statutes. Because the Complaint alleges that Schwab's misrepresentations and omissions led both in-state and out-of-state residents to invest money in ARS in New York, the Complaint adequately pleads grounds for seeking relief for both resident and non-resident Schwab customers.

A. The Martin Act

Schwab incorrectly argues that the defendant's deceptive conduct must occur in New York or harm a New York resident in order for the Martin Act to apply. MTD, pp. 16-17. But the statute requires only that the securities transaction at issue be carried out "within or from this state," not that the deceptive conduct occur here. The Martin Act makes unlawful the use of *any* fraudulent or deceptive practice leading to a securities transaction within or from New York.

In construing a statute, the Court must give primary consideration to legislative intent, as discerned from the statute's language, Statutes §§ 92 and 94, and give effect to the natural and obvious meaning of the words used, Statutes § 94. "Relative or qualifying words of clauses in a statute ordinarily are to be applied to the words or phrases immediately preceding, and are not to be construed as extending to others more remote, unless the intent of the statute clearly indicates otherwise." Statutes § 254 (also known as the "last antecedent rule"); *see also People v. Shulman*, 6 N.Y.3d 1, 34 (2005) (applying Statutes § 254, finding that the qualifying phrase applies to the immediately preceding phrase, rather than to the more distant clause); *A.J. Temple Marble & Tile, Inc. v. Union Carbide Marble Care, Inc.*, 87 N.Y.2d 574, 580 (1996) ("Where, as here, a descriptive or qualifying phrase follows a list of possible antecedents, the qualifying phrase generally refers to and modifies all of the preceding clauses.").

Section 352 of the Martin Act declares it unlawful whenever, "in the issuance, exchange, purchase, sale, promotion, negotiation, advertisement, investment advice or distribution *within or from this state*, of any stocks, bonds, notes, … or other securities, … [whenever] any person … or any agent or employee thereof, shall have employed, or employs, or is about to employ any device, scheme or artifice to defraud." The phrase "within or from this state" modifies, and is indeed imbedded within, the phrase "the issuance, exchange, purchase, sale, promotion, negotiation, advertisement, investment advice or distribution … of … any securities." *See Budd v. Valentine*, 283 N.Y. 508, 511 (1940) ("The grammatical rule, which is also the legal rule in construing statutes, is that where general words occur at the end of a sentence, they refer to and qualify the whole; while, if they are in the middle of a sentence, and sensibly apply to a particular branch of it, they are not to be extended to that which follows.") (*quoting In re N.Y. Tel. Co.*, 257 A.D. 415, 419 (4th Dep't 1939)).

Thus, under the Martin Act, it is the securities transaction at issue that must have a New York nexus in order for the statute to apply. By its plain terms, the statute does not require that the defendant's deceptive conduct itself must occur in New York or be directed at a New York resident. Importantly, the statute aims broadly to ensure the integrity of New York's securities markets, not merely to regulate New York defendants or protect New York residents. *See People v. H&R Block, Inc.*, 58 A.D.3d 415, 417 (1st Dep't 2009) ("The court properly rejected defendants' argument that the Attorney General has no authority to recover on behalf non-New York residents in this case. New York's vital interest in securing an honest marketplace in which to transact business was threatened when defendants used a New York business to complete the deceptive transactions at issue here …."); *see also State v. Gen. Motors Corp.*, 547 F. Supp. 703, 705-06 (S.D.N.Y. 1982) ("(s)urely some of the most basic of a state's quasi-sovereign interests include maintenance of the integrity of markets and exchanges operating within its boundaries, (and) protection of its citizens from fraudulent and deceptive practices") (quotations omitted).

If there were any doubt about the proper territorial nexus of the Martin Act, § 352-c puts it to rest. That section states "[i]t shall be illegal and prohibited for any person … or any agent or employee thereof, to use or employ any of the following acts or practices: [subsections detailing prohibited acts and practices]; where engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase *within or from this state* of any securities … regardless of whether issuance, distribution, exchange, sale, negotiation or purchase resulted." (emphasis supplied.) Again, the words "within or from this state" refer to the locus of the securities transaction at issue, not of the deceptive practice alleged.[5]

Here, the State's allegations describe securities transactions occurring "within or from" New York, both where New York investors were harmed and where non-New York investors

[5] Ultimately, even Schwab appears to understand that the territorial reach of the Martin Act is defined by the location of the securities transaction, not the site of the defendant's deceptive conduct. Schwab itself argues that the statute is restricted "to securities fraud claims relating to securities transactions originating 'within or from' New York." MTD, p. 20. But the word "originating" is not in the statute. Under the statute's plain language, the securities transaction need not "originate" from or within New York, but must occur within or from New York.

were harmed. The Complaint alleges, and, tellingly, Schwab does not dispute, that "[a]uction rate securities can only be bought or sold in a successful auction through the underwriter broker-dealers that brought each particular auction rate issue to market," and that "all of the ARS issues sold by Schwab to its customers were underwritten and/or managed either entirely or primarily by New York-based financial institutions." Compl. ¶ 26. The Complaint further alleges that "[t]o transact its ARS business, Schwab transmitted the buy, sell and hold orders of its customers to the auction rate trading desks of these financial institutions," and that "[a]ll of these trading desks … were located in New York City." Compl. ¶ 27. And the Complaint alleges that "[t]he substantial majority of the auctions for the ARS Schwab sold were held in the State of New York by auction agents located here." Compl. ¶ 29. These allegations are sufficient at the pleading stage to satisfy the requirement that the ARS transactions in connection to which Schwab made misstatements and omissions have occurred "within or from" New York as the statute requires. Indeed, at least one court has held that ARS transactions are consummated in New York. *ExpressJet Airlines, Inc. v. RBC Capital Mkts. Corp.*, 2009 WL 2244468, at *6 (S.D. Tex. July 27, 2009) ("New York … is … where the ARS market operated[,and h]ence, ARS sales were actually consummated in New York City, New York. The consummation of the sales of ARS is not only material, but essential to the ultimate objective of the alleged fraudulent scheme.").

Schwab attacks a straw man in arguing that recognizing the Martin Act claims here would "grant the AG the authority to sue under New York law over a securities transaction occurring anywhere in the world, so long as that security was traded on any stock exchange located in New York." MTD, p. 22. This contention overlooks that the New York connections in this case were not "merely incidental," but integral to Schwab's sale of ARS nationwide. Here, the New York nexus is not just that ARS transactions were consummated in New York, but that without the New York-based underwriters and managing broker-dealers there would have been no ARS for Schwab to sell _and_ no market in which to buy or sell them. Schwab distributed securities created and managed by the New York underwriters and managing broker dealers to its customers nationwide, and was paid by those New York-based financial institutions to do so. And auctions in which the securities were bought and sold took place regularly in New York. Whatever the hypothetical frontiers of Martin Act jurisdiction may be, in this case, the quality and degree of the New York connections are so strong here that there is no danger of "[eviscerating] the limitation in the Martin Act restricting its application to transactions 'within or from' New York." MTD, p. 22.

Moreover, the case that Schwab cites in support of its argument, *State v. Samaritan Asset Mgmt. Servs. Inc.*, 22 Misc.3d 669 (Sup. Ct. N.Y. Cty. 2008), actually upheld jurisdiction over conduct similar to that alleged here. In *Samaritan*, the foreign defendants engaged in unlawful market timing of mutual funds by, among other means, using non-defendant New York broker-dealers to conduct their trading. The court found that "insofar as the alleged deceptive acts were effectuated through New York brokers, the State has sufficiently alleged a violation of the Martin Act and the Executive Law." *Id*. at 677 (*citing People v. Coventry First LLC*, 52 A.D.3d 345 (1st Dep't 2008)). As to the trades over which the court in *Samaritan* declined to find jurisdiction, any New York connection was far more attenuated than the New York connections here. In those transactions, the out-of-state defendants did not deal directly with any New York entity, but instead effectuated the trades using an out-of-state trust company, which, in turn, maintained a relationship with a New York-based securities clearing house for the purpose of processing the trades. The court found with respect to those transactions that "there [were] insufficient contacts with the State of New York to either maintain jurisdiction over the defendants or to allege violations of the Martin Act and/or Executive Law." 22 Misc.3d at 677. Here by contrast, integral New York connections – both in making available products for

Schwab to sell at one end of the transaction, and in providing a market in which to consummate the sales through New York brokers and institutions at the other – are present. The portion of *Samaritan*'s holding denying jurisdiction is, therefore, wholly distinguishable from the facts presented here.[6]

Schwab also mistakenly argues that "serious constitutional issues" would attend the State's interpretation of the Martin Act's reach. MTD, p. 22. Schwab quotes *Edgar v. MITE Corp.*, 457 U.S. 624, 642 (1982), for the proposition that the Commerce Clause "precludes the application of a state [blue-sky law] to commerce that takes place *wholly outside* of the State's borders." MTD, p. 22 (emphasis added). But here, Schwab's ARS transactions with its customers did not take place "wholly outside" of New York's borders. Rather, they took place, in critical respects, "within or from" New York, thus satisfying any constitutional constraint on the territorial application of the Martin Act.

B. Executive Law § 63(12)

The same transactional nexus that supports the State's Martin Act and GBL § 349 claims, discussed *infra*, also authorizes the Attorney General to seek relief under Executive Law § 63(12). Executive Law § 63(12) contains no geographic restriction that bars the Attorney General from seeking relief for out-of-state victims harmed by transactions occurring in New York. *See, e.g., State v. Camera Warehouse, Inc.*, 130 Misc.2d 498, 499 (Sup. Ct. Dutchess Cty. 1985) ("[T]he plain meaning of the language of Executive Law § 63(12) indicates that the Legislature intended that all consumers be protected from illegal practices regardless of their

[6] Schwab also cites *People v. Coventry First LLC*, 2007 N.Y. Slip Op. 33089(U), 2007 WL 2905486 (Sup. Ct. N.Y. Cty. Sept. 25, 2007). But that case, too, is distinguishable. In *Coventry*, the Court correctly observed that the Martin Act "only regulates securities transactions occurring 'within or from' New York." *Id*. The court partially dismissed claims "insofar as they pertain to life settlement transactions that have no identified connection with New York brokers, New York sellers, or alleged misconduct in New York," finding that those claims "lack[ed] any direct connection with New York." *Id*. But here, the complaint alleges the direct connection with New York that was lacking in *Coventry*.

residency and that the Attorney-General … is mandated to take necessary action as provided in the statute to protect all of these consumers.”).

Indeed, Executive Law § 63(12) contains no language whatsoever that purports to establish geographic limits upon its application. This strongly suggests that the legislature intended its subject matter jurisdiction to be coextensive with constitutionally permissible limits. That geographic nexus is satisfied, where, as here, critical steps of the business transactions at issue are executed in New York. Moreover, courts uniformly have upheld the Attorney General’s authority to seek Executive Law § 63(12) relief on behalf of non-residents without requiring a showing of actual deception in the State. In *People v. Telehublink Corp.*, for example, the Third Department upheld the Attorney General’s authority to seek damages and restitution under Executive Law § 63(12) for out-of-state credit-card customers although the out-of-state customers were not deceived in New York, because the defendant “used a New York address to send and receive correspondence related to the telemarketing scheme.” 301 A.D.2d 1006, 1009 (3d Dep’t 2003). Similarly, in *People v. Coventry First LLC*, the First Department affirmed the Attorney General’s authority to bring an Executive Law § 63(12) claim challenging bid-rigging and other fraud with respect to life settlement transactions by both in-state and out-of-state residents who sold life insurance policies for less than fair value. 52 A.D.3d 345, 345-46 (1st Dep’t 2007). Although out-of-state policy sellers were not deceived in New York, the First Department held that the involvement of a New York broker was sufficient to authorize Executive Law § 63(12) relief for non-resident policy sellers. *Id.*; *see also People v. H&R Block, Inc.*, 16 Misc.3d 1124(a), 2007 WL 2330924 at *8 (Sup. Ct. N.Y. Cty. July 9, 2007) (Moskowitz, J.) (“Neither GBL Section 349 nor Executive Law 63(12) impose geographical restrictions upon the consumer complaints that properly serve as a basis for an enforcement action by the Attorney General.”).

There is nothing in Executive Law § 63(12) or authority interpreting the statute that would bar relief for out-of-state victims under the circumstances presented here: where a defendant has acted as a paid distributor of securities underwritten and managed by New York-based financial institutions and traded on markets in New York for the purpose of soliciting customer investments in such securities. Because Schwab wrongfully induced customers across the nation to invest their funds in New York-centered securities, which remained subject to ongoing management and control of New York-based financial institutions, the relief sought by the Attorney General appropriately extends to recovery for non-resident Schwab customers. Here, moreover, the jurisdictional predicate is further satisfied because the State's Executive Law § 63(12) claim is also based upon Schwab's repeated and persistent violations of the Martin Act and GBL § 349. Since the jurisdictional nexus to New York for those statutes is established, it is *ipso facto* established for Executive Law § 63(12) as well.

C. GBL § 349

Schwab's ARS transactions also fall within the territorial scope of GBL § 349. That statute prohibits the use of "[d]eceptive acts or practices in the conduct of any business, trade or commerce or in the furnishing of any service in this state." The territorial reach of GBL § 349 extends to any transaction that occurs in New York as a result of consumer deception. *Goshen v. Mut. Life Ins. Co.*, 98 N.Y.2d 314, 324 (2002). Because the ARS Schwab sold were New York-centered investment products, the actual investment transaction could not take place without the conduct of business or the furnishing of services in New York.

The Complaint pleads a sufficient New York nexus to pass muster under GBL § 349. The Complaint specifically alleges that "Schwab distributed numerous issues of ARS underwritten and/or managed by several major, New York-based underwriter broker-dealers … which it deceptively sold to investors in the State of New York and throughout the United

States." Compl. ¶ 24. The Complaint also alleges that "Schwab was generally paid an agreed-upon fee by these firms for successfully selling their ARS to its customers," and that "the fee ranged from 7.5 to 25 basis points depending upon the nature of the auction rate security and the relationship with the financial institution." Compl. ¶ 28. Moreover, as discussed above, the Complaint alleges that no matter where the customers resided, their ARS trades were sent to New York, and their ARS transactions took place in New York. Thus, the customer interaction was not the end but only the beginning of one indivisible transaction that was consummated in New York.

Contrary to Schwab's arguments, GBL § 349 does not require that consumers actually be deceived in this State, where, as here, they are wrongfully induced to engage in a New York transaction. In the controlling decision of *People v. H&R Block, Inc.*, 58 A.D.3d 415, 417 (1st Dep't 2009), the First Department held that GBL § 349 may be applied where, as the Complaint alleges here, some part of the fraudulent transaction occurs in New York. In *H&R Block*, the State sued a tax preparation company and various subsidiaries for offering and selling an unsuitable individual retirement account product to customers throughout the United States on the basis of false representations that customers would get great rates, and without informing customers, among other things, that the fee structure of the product would wipe out their promised returns. The First Department affirmed the trial court's ruling that the State had jurisdiction under GBL § 349 over all the transactions, not just those involving New York residents, even where no misrepresentations and omissions were made in New York with respect to those customers. The court held that it was enough that the misrepresentations and omissions led the defendants' customers to invest money in a money market account maintained in New York by a non-defendant, third-party financial institution. *Id*. *H&R Block* controls here since the State's complaint alleges that ARS transactions were executed in New York, even when they involved non-New York investors. *See also People v. Telehublink Corp.*, 301 A.D.2d 1006, 1009-10 (3rd Dep't 2003) (jurisdiction upheld over out-of-state telemarketing firm for fraudulently selling credit cards to non-New York consumers, because New York's interests were "threatened when [the telemarketer] used a New York address to complete the deceptive transactions"). Where fraudulent transactions are executed using New York institutions, it is not surprising that the State can reach such conduct under statutes intended to protect the integrity of the New York markets. *See, e.g., Oswego Laborers' Local 214 Pension Fund v. Marine Midland Bank, N.A.*, 85 N.Y.2d 20, 25 (1995).

Although Schwab relies on *Goshen*, MTD, p. 20, the First Department's 2009 decision in *H&R Block* was rendered long after and in full view of *Goshen*. *H&R Block*, 58 A.D.3d at 416 (*affirming* 16 Misc.3d 1124(A), 2007 WL 2330924 at *8 (Sup. Ct. N.Y. Cty. July 9, 2007) (Moskowitz, J.) (discussing *Goshen*). Schwab quotes the statement in *Goshen* that "the transaction in which the consumer is deceived must occur in New York," *Goshen*, 98 N.Y.2d at 324, but misunderstands its import. That statement does not require a showing of consumer deception or deceptive acts <u>*solely*</u> within New York, but rather focuses on the location of "the transaction" in which the deception occurs. Indeed, *Goshen* elsewhere makes clear that the statute extends to "deceptive acts *leading* to *transactions* within the state." *Id*. at 325 (emphasis supplied). The decision thus confirms that GBL § 349 authorizes relief for out-of-state customers when there is a transactional nexus with New York, such as that sustained in *H&R Block* and alleged here.

Moreover, *Goshen* does not hold, as Schwab suggests, that every step of the ultimate transaction must occur in New York. Rather, as *H&R Block* recognizes, the required transactional nexus is present where, as here, essential steps in the transaction occur in New York. In *Goshen*, the claims of the out-of-state plaintiffs did not allege that any step in the challenged transaction occurred in New York. Instead, the alleged connection to New York was solely the "hatching [of] a scheme" or the development of "a marketing campaign in New York" that, when implemented elsewhere, deceived consumers about transactions that occurred elsewhere. *Id*. at 324. Here, by contrast, the Complaint does not allege a New York nexus based merely on preparatory acts preceding the alleged deceptive conduct, but rather alleges that Schwab's misrepresentations and omissions led consumers to invest in ARS in New York, thus triggering the State's strong interest in promoting and protecting an honest marketplace. Consequently, the Complaint alleges more than a sufficient New York nexus under GBL § 349, including as to transactions involving non-New York investors.

III. <u>The State Has Ample Legal Authority to Pursue the Claims It has Brought and the Remedies It Seeks</u>

Schwab' remaining challenges to the State's legal authority to pursue the claims here are also without merit.

A. Martin Act and Executive Law § 63(12) Claims Are Not Duplicative

Schwab argues that the Attorney General cannot seek remedies under both Executive Law § 63(12) and the Martin Act for the same actionable conduct. Schwab's contention boils down to the argument that the remedies under Executive Law § 63(12) should not be available here to the extent they differ from those under the Martin Act. As an initial matter, questions of remedy are premature at the motion to dismiss stage. *See infra* at 30-32. Moreover, in any event, nothing in the Martin Act purports to make its remedies exclusive of other remedies otherwise available under New York law, and Executive Law § 63(12) expressly contemplates that the Attorney General may sue for "repeated illegality," which often arises from violations of other state statutes with their own set of remedies.[7] Although Schwab fails to acknowledge it,

[7] Executive Law § 63(12) defines as actionable two kinds of conduct: (1) persistent and repeated "fraud" and (2) persistent and repeated "illegality." *See State v. Cortelle Corp.*, 38 N.Y.2d 83 (1975); *see also People v. Am. Motor Club, Inc.*, 179 A.D.2d 277 (1st Dep't 1992). The former extends broadly to deceptive conduct, without any

the First Department has squarely confirmed the Attorney General's authority to sue under Executive Law § 63(12) to obtain remedies for violations of other state statutes that are not available under the predicate statutes themselves. *See People v. Am. Motor Club, Inc.*, 179 A.D.2d 277 (1st Dep't 1992); *People v. Frink Am., Inc.*, 2 A.D.3d 1379 (4th Dep't 2003); *see also State v. Princess Prestige Co., Inc.*, 42 N.Y.2d 104, 106 (1977).

In *American Motor Club*, the First Department held that the Attorney General could obtain both penalties for violations of Insurance Law § 2117 and damages and restitution under Executive Law § 63(12) for repeated illegality, based upon the violations of Insurance Law § 2117. The Court observed that the defendant's argument that the Insurance Law remedies were exclusive "overlook[ed] the fact that [the Attorney General] further alleged that the violations of Insurance Law § 2117 itself constituted repeated and consistent illegality under Executive Law § 63(12), pursuant to which restitution is a permitted remedy." 179 A.D.2d at 283. Similarly, in *Frink*, the Fourth Department rejected the lower court's view that the State "may not use Executive Law § 63(12) to expand the remedies contained in the Labor Law." 2 A.D.3d at 380. Here, too, the Attorney General is not barred from seeking remedies under Executive Law § 63(12) for conduct that is also actionable under the Martin Act, or from seeking remedies under Executive Law § 63(12) that the Martin Act itself may not provide. *Cf. Princess Prestige*, 42 N.Y.2d at 107 (once a violation is established under any other statute and shown to be persistent or repeated, the State has authority to pursue additional remedies beyond even those available under the underlying predicate statute).[8] And to the extent Schwab argues that an

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showing of scienter. *See supra*. The latter makes actionable the violation of any statute, law or regulation, including the Martin Act. *See State v. Princess Prestige Co., Inc.*, 42 N.Y.2d 104, 107 (1977). Schwab's conduct constitutes both persistent and repeated "fraud" under Executive Law § 63(12), and persistent and repreated "illegality," given its violations of the Martin Act and GBL § 349. Nothing in the text or legislative history of Executive Law § 63(12) suggests that its application should be limited where the predicate illegality is the violation of a statute which declares unlawful fraudulent or deceptive conduct like Executive Law § 63(12) itself does. *Cf. Cortelle*, 38 N.Y.2d at 83 (1975).

[8] Failing to cite the controlling authority in this Department, Schwab instead relies upon two inapposite trial court cases, *People v. Daicel Chem. Indus., Ltd.*, 2005 N.Y. Slip Op. 30193(U), 2005 WL 6056054 (Trial Order) (Sup. Ct.

Executive Law § 63(12) action will not lie because the Martin Act comprehensively regulates securities, it is difficult to imagine two areas that are more "comprehensively" regulated than those at issue under *American Motor Club* (insurance) and *Frink* (labor).

B. GBL § 349 Applies to the Attorney General's Claims Here

Schwab contests whether the Attorney General may sue under GBL § 349 based upon alleged deceit in the promotion of ARS, MTD, p. 24, but there is no bar to a GBL § 349 claim on these facts. The language of GBL § 349(a), which declares unlawful "[d]eceptive acts or practices in the conduct of any business, trade or commerce or in the furnishing of any service in this state," allows no exceptions from the act's coverage. *See also* GBL § 349(g) (the statute "shall apply to all deceptive acts or practices declared to be unlawful, whether or not subject to any other law of this state"). Thus, the Court of Appeals has held that GBL § 349 "on its face, applies to virtually all economic activity." *Small v. Lorillard Tobacco Co., Inc.*, 94 N.Y.2d 43, 55 (1999); *Karlin v. IVF Am., Inc.*, 93 N.Y.2d 282, 290 (1999); *see also Scalp & Blade, Inc. v. Advest, Inc.*, 281 A.D.2d 882, 883 (4th Dep't 2001) ("Given the statute's explicit prohibition of '[d]eceptive acts and practices in the furnishing of any service,' and given the Court of Appeals'

N.Y. Cty. Aug. 9, 2005) and *Gift & Luggage Outlet, Inc. v. People*, 194 Misc.2d 582 (Sup. Ct. N.Y. Cty. 2003). MTD, pp. 19. In *Daicel Chemical*, the trial court rejected the State's attempt to obtain duplicate antitrust recovery for both direct and indirect purchasers under Executive Law § 63(12), based upon claims predicated on the Donnelly Act where the recovery sought was expressly barred by the Donnelly Act itself. Here, by contrast, the Martin Act contains no express bar to the recovery the State seeks under Executive Law § 63(12). Moreover, on appeal in *Daicel Chemical*, the First Department did not embrace the Supreme Court's ruling, but instead dismissed the Executive Law § 63(12) claim on statute of limitations grounds. 42 A.D.3d 301, 303 (1st Dep't 2007).

In *Gift & Luggage*, the state sued under GBL § 873, a statute authorizing injunctive relief and civil penalties for the sale of certain imitation firearms, and also sued under GBL §§ 349 and 350-c and Executive Law § 63(12). After imposing civil penalties under GBL § 873, the court declined to impose additional penalties under the other statutes on the ground that this would "impose double penalties for the same violation in a manner not intended by the Legislature." 194 Misc.2d at 587. Here, there is no issue of double penalties since GBL § 349 is the only statute involved that authorizes civil penalties. The court's conclusion in *Gift & Luggage* is contrary to the plain language of GBL § 349(g), which states that GBL § 349 "shall apply to all deceptive acts or practices declared to be unlawful, whether or not subject to any other law of this state," and to the plain language of Executive Law § 63(12), which makes "the continuance or carrying on of *any* fraudulent or illegal act or conduct" (emphasis supplied), including the violation of any statute, a predicate violation. In light of the foregoing and the First Department's ruling in *American Motor Club*, it is respectfully submitted that *Gift & Luggage Outlet* was wrongly decided.

characterization of the statute as 'appl[ying] to virtually all economic activity,' we see no basis for invoking any blanket exception under the statute for securities transactions or for limiting the statute's applicability to the sale of 'goods.'"). So long as a deceptive business conduct falls within the "consumer oriented ambit of § 349," it is actionable under the statute. *Oswego Laborers' Local 214 Pension Fund v. Marine Midland Bank, N.A.*, 85 N.Y.2d 20, 26 (1995).

To be sure, the departments of the Appellate Division are split on the question whether private plaintiffs may assert GBL § 349 claims involving investment securities, with the First Department holding generally that they may not, as Schwab observes.[9] But none of those courts has even considered whether the Attorney General may bring such claims under GBL § 349, and neither has the Court of Appeals. Moreover, even as to private parties, no court has specifically addressed GBL § 349 claims involving securities that are marketed as cash equivalents, and therefore closely analogous to banking accounts, which the Court of Appeals has explicitly held to fall within the scope of GBL § 349.

In *Oswego*, the Court of Appeals sustained GBL § 349 claims brought by funds managing union pension and health insurance benefits for alleged deception by a bank in connection with the opening of a savings account. The Court concluded that "the acts of defendant fall within the "consumer-oriented" ambit of General Business Law § 349." 85 N.Y.2d at 26-27 (internal citation omitted). Here, the Complaint challenges ARS, which were marketed by Schwab and others as cash equivalents, and thus essentially as substitutes for savings accounts. Accordingly, the Court of Appeals' decision in *Oswego* is controlling.

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[9] The First and Third Departments have held that GBL § 349 does not apply to securities transactions. *See, e.g., Fesseha v. TD Waterhouse Investor Servs., Inc.*, 305 A.D.2d 268 (1st Dep't 2003); *Gray v. Seaboard Sec., Inc.*, 14 A.D.3d 852 (3d Dep't 2005). The Second Department has held that it does. *See, e.g., B.S.L. One Owners Corp. v. Key Int'l Mfg., Inc.*, 225 A.D.2d 643 (2d Dep't 1996). The Fourth Department has held both that it does and that it does not. *See, e.g., Scalp & Blade*, 281 A.D.2d at 883 (does); *Smith v. Triad Mfg. Group, Inc.*, 255 A.D.2d 962, 964 (4th Dep't 1998) (does not).

Furthermore, the decisions cited by Schwab rest on a federal court decision predating *Oswego* that is inconsistent with the Court of Appeals' opinion in that case. All of the Appellate Division panels and federal courts that have ruled that GBL § 349 does not embrace securities transactions in private plaintiff actions under GBL § 349(h), including the cases Schwab cites, appear to have endorsed an analysis originating with *Morris v. Gilbert*, 649 F. Supp. 1491 (E.D.N.Y. 1986). In *Morris*, Judge Glasser wrote: "securities are purchased as investments, not as goods to be 'consumed' or 'used,'" and that "securities markets are subject to pervasive federal regulation." *Id*. at 1497. Notably, *Morris* precedes *Oswego* by almost a decade, and cannot be squared with the Court of Appeals' later analysis. The "threshold test" used by the Court of Appeals in *Oswego* to determine whether or not a transaction is consumer-oriented does not involve any consideration of "goods to be 'consumed' or 'used,'" the focus of the analysis in *Morris*. Under the Court of Appeals' test, a transaction is "consumer oriented" if it is "not unique to [the] two parties [,] private in nature or [ ] single-shot," but rather "potentially affect(s) similarly situated consumers." *Oswego*, 85 N.Y.2d at 26-27 (quotations omitted). Likewise, GBL § 349 itself makes no reference to goods at all, but rather applies far more broadly to "the conduct of any business, trade or commerce or [ ] the furnishing of any service." *Morris* also cites the fact that the securities markets are heavily regulated by the federal government, but so is banking, yet the Court of Appeals sustained GBL § 349 claims challenging banking transactions in *Oswego*. *Cf. also Riordan v. Nationwide Mut. Fire Ins. Co.*, 977 F.2d 47, 51-52 (2d Cir. 1992) (rejecting pervasive statutory scheme argument and holding that GBL § 349 provides no exception for insurance companies). To the extent the rationales of the *Morris* case have any vitality at all in the wake of *Oswego*, they should certainly not be extended to actions brought under GBL § 349 by the Attorney General involving securities marketed as cash equivalents, and thus closely analogous to the savings accounts at issue in *Oswego*.[10]

C. Schwab's Arguments about Permissible Remedies Are Premature and Without Merit

Schwab argues that the Court lacks the authority to order a buy-back of the ARS under the statutes at issue here, and spins a confusing web of assertions regarding the scope of restitution provided for by the statutes, while conveniently ignoring other forms of monetary relief, such as damages, which the Complaint also seeks and the statutes also authorize. MTD, pp. 22-24. But, as already noted, issues concerning the scope of available remedies for proved violations of the statutes under which the State has sued here are premature at the motion-to-dismiss stage of this case. The Attorney General's complaint seeks a range of injunctive and monetary remedies, most of which Schwab does not dispute, beyond its challenges as to liability. This Court should not entertain questions about remedy at this stage.

It is settled law that questions about the scope of equitable relief are not appropriately raised on motions to dismiss, and that a court should not dismiss a request for an equitable remedy when the underlying cause of action is sufficiently pleaded. *See Lichtyger v. Franchard Corp.*, 18 N.Y.2d 528, 538 (1966) ("a motion to dismiss the complaint will not search out the nature of the relief or judgment to which a plaintiff may be entitled [and] will be denied if the complaint 'states a case for relief either at law or in equity.'") (*citing Advance Music Corp. v. Am. Tobacco Co.*, 296 N.Y. 79, 84 (1946)); *see also Sec. Investor Prot. Corp. v. Stratton Oakmont, Inc.*, 234 B.R. 293, 333 (Bankr. S.D.N.Y. 1999) (applying a "wait and see" approach to allow the court to retain jurisdiction in order to "mold [its] judgment to the needs of the case")

[10] And whatever the circumstances were with respect to the manner in which securities were sold at the time the *Morris* case was decided, given the rise since of discount brokers like Schwab, advertising incessantly as they do on television and other media with appeals clearly directed toward individual retail investors, it is hard to fathom how anyone could deny that the services offered by these companies are anything other than consumer-oriented.

(internal citations omitted). Questions about the nature and shape of equitable relief to be awarded "do [ ] not affect the sufficiency of the complaint and may not be taken advantage of on the motion to dismiss." *Bush Terminal Bldgs. Co. v. Bush Terminal R. Co.*, 47 N.Y.S.2d 330, 333 (Sup. Ct. Kings Cty. 1944) (citing *Standard Fashion Co. v. Siegel-Cooper Co.*, 157 N.Y. 60, 67, 68 (1898)); *see also, People v. Merkin*, 26 Misc.3d 1237(A), 2010 WL 936208 at *11 (Sup. Ct. N.Y. Cty. Feb. 8, 2010) ("It is entirely premature to determine [on a motion to dismiss] whether the AG will be entitled to an injunction, and the extent of any such injunction under the Martin Act, the Executive Law § 63(12), or the Not-for-Profit Law. The exact nature of injunctive relief that may be awarded will await further determination of the claims.").

All this being said, the State's authority to seek, and the Court's power to grant, equitable and monetary remedies extends far broader than Schwab contends. Contrary to Schwab's contention, the Court retains equitable power under the Martin Act, Executive Law § 63(12), and GBL § 349 to order a buy-back remedy. Once the Court's equitable powers are invoked, as they are when the State sues under equitable statutes such as those here, the Court retains power in its equitable discretion to fashion appropriate remedies. *See Porter v. Warner Holding Co.*, 328 U.S. 395, 398 (1946) ("Unless a statute in so many words, or by a necessary and inescapable inference, restricts the court's jurisdiction in equity, the full scope of that jurisdiction is to be recognized and applied."). And when, as here, a statute provides a remedy in addition to those existing under common law, the statutory remedy is cumulative unless declared exclusive by the statute. *E.g.*, *People v. N.Y. Central H.R.R. Co.*, 29 Sickels 302, at *4 (1878).[11] Ordering a buy-

[11] This history of the Martin Act well illustrates this point. The Attorney General long obtained restitution under the Act, even though its text did not expressly mention "restitution" until 1976. *See, e.g.*, 1930 N.Y. Att'y Gen. Ann. Rep. 34 (Securities Bureau recovered over $3,250,000 for defrauded investors); 1931 N.Y. Att'y Gen. Ann. Rep. 35-37 (detailing how over $1,200,000 was recovered in restitution). The 1976 amendment merely made explicit a power that was previously implied as an incident to injunctive relief, and placed the existence of the power beyond any question. Memorandum of Attorney General for the Governor (July 9, 1976), *reprinted in* Bill Jacket for ch. 559 ("This amendment is intended to codify existing powers of the Attorney General and the Courts under various equitable doctrines."). Similarly, courts awarded damages under Executive Law § 63(12) long before the statute expressly mentioned "damages." Once more, the word "damages" was not added to the statute to add a remedy that

back remedy would require little more than for the court to exercise its traditional power incidental to its power to order injunctive relief. *See Porter*, 328 U.S. at 398 ("since the public interest is involved … those equitable powers assume an even broader and more flexible character than when only a private controversy is at stake.").

Equitable remedies are inherently more than flexible enough to encompass a buy-back remedy such as the one the State seeks here. Indeed, the Martin Act explicitly empowers the Court to issue an injunction permanently and completely barring a malefactor from engaging in the securities business in New York. GBL § 353(1). If the Court has the power to bar Schwab entirely from the New York market, it follows that the Court could, for example, permit Schwab's continued operation in New York only on the condition that Schwab repurchase the securities it fraudulently sold its customers in violation of the Martin Act, a far less restrictive remedy. The text of the Martin Act already embodies just such an understanding of the Court's inherent power. *See* GBL § 353-a ("In an action brought by the attorney-general as provided in this article the court may grant such other and further relief as may be proper.").[12]

Accordingly, the Court should decline Schwab's attempt, at this stage in the case, to have determined whether a buy-back remedy is an appropriate one under the evidence of liability to be proven later in the case.

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courts could not previously award, but rather to put beyond any dispute the existence of a power the courts had traditionally exercised. Memorandum of Attorney General for the Governor (July 11, 1977), *reprinted in* Bill Jacket for ch. 539.

[12] Other remedies are also available here to make Schwab's suffering customers whole. The court may award damages under the Martin Act, *see Kerusa Co. LLC v. W10Z/515 Real Estate Ltd. P'ship*, 12 N.Y.3d 236, 244 (2009), as well as under Executive Law § 63(12). Further, the scope of restitution available under these statutes is not nearly as circumscribed as Schwab contends. The word "restitution," which is referenced in Executive Law § 63(12) and GBL § 349(b), is generally understood to encompass "compensation for damage, loss, or injury." Memorandum of Attorney General for the Governor (July 11, 1977), *reprinted in* Bill Jacket for ch. 539. And contrary to Schwab's contention, restitution under the Martin Act and GBL § 349 is not limited to monies "retained" by Schwab, but applies to monies it "obtained directly or indirectly" by its actionable conduct (indeed, the text of neither statute even specifies that it be the defendant who "obtained" the money or property). In facilitating its customers' purchases of ARS, Schwab transferred funds from the accounts of its customers into a riskless principal account it itself maintained before transmitting those funds to the managing broker-dealers to execute the trades. Schwab may be compelled to make restitution to its customers of the monies thus "obtained."

CONCLUSION

For the foregoing reasons, this Court should deny Schwab's motion to dismiss in its entirety.

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Dated: July 1, 2010
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New York County Index No.: 453388/2009

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

THE PEOPLE OF THE STATE OF NEW YORK,
by ANDREW M. CUOMO, Attorney General of the State
of New York,

Plaintiff,

- against -

CHARLES SCHWAB & CO., INC.,

Defendant.

PLAINTIFF's MEMORANDUM OF LAW IN OPPOSITION TO DEFENDANT CHARLES SCHWAB & CO, INC.'s MOTION TO DISMISS

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