UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF CALIFORNIA

JAMES JIAO et al.,

Plaintiffs,

v.

MERRYLL LYNCH PIERCE, FENNER & SMITH, INC. et al.,

Defendants.

Case No.: 17-cv-409-L(MDD)

ORDER GRANTING DEFENDANTS' MOTION TO DISMISS

In this putative securities class action, pending before the Court is Defendants' motion to dismiss. Plaintiffs filed an opposition, and Defendants replied. For the reasons stated below, the motion is granted. Plaintiffs' request for leave to amend is denied.

I. BACKGROUND

On June 23, 2016, in an administrative proceeding against Defendants Merrill Lynch, Pierce, Fenner & Smith, Inc. ("MLPF&S") and Merrill Lynch Professional Clearing Corp. (collectively "Defendants"), the Securities and Exchange Commission ("SEC") released a consent Order Instituting Administrative Cease-and-Desist Proceedings, Pursuant to Sections 15(b) and 21C of the Securities and Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order. (Doc. no. 43 (Second Am. Compl. ("SAC")); Doc. no. 43-1 (SAC Ex. A ("SEC Order")).) The SEC Order was issued pursuant to a settlement between the SEC and

Defendants. It is incorporated by reference into the second amended complaint. (SAC at 2.)[1] The SEC found, and Defendants admitted (*id.*), that Defendants violated two provisions of the Customer Protection Rule of the Securities Exchange Act of 1934. Specifically, the Customer Protection Rule, 15 U.S.C. § 78aaa; 17 C.F.R. § 240.15c3-3, required Defendants to maintain physical possession or control over customers' fully paid and excess margin securities, yet from 2009 to 2015, Defendants allowed its clearing bank to impose a lien on such securities in violation of the requirement. (SEC Order at 3-4, 17-20, 22.) In addition, 17 C.F.R. § 240.15c3-3(e) required Defendants to maintain a balance in the Customer Reserve Bank Account ("Reserve Account") calculated according to a formula; however, from 2009 to 2012, Defendants executed a series of trades referred to as Leveraged Conversion Trades ("LCTs"), designed to artificially reduce the amount they were required to hold in the Reserve Account by billions of dollars in order to use the freed-up funds to finance securities trading for their own gain. (SEC Order at 3, 7-17.)

As part of the settlement, Defendants admitted (SEC Order at 2) that they "conceived of and executed the [LCTs] during an extremely precarious period of time in the financial markets." (*Id.* at 16.) The risk of default by Defendants and their parent company Bank of America ("BAC") "remained heightened throughout the life of the [LCTs]." (*Id.*) Specifically, had Defendants or BAC

> failed, the funds [Defendants] set aside in [the] Reserve Account would have been distributed to customers in liquidation administered by the Securities Investor Protection Corporation ("SIPC"). By improperly reducing [the] Reserve Account by up to $5 billion to finance business activities, [Defendants] failed to maintain the required minimum amount in [the] Reserve Account. During this period, the SIPC Fund, which SIPC maintains to cover shortfalls, was less than $2 billion, and prior to the adoption of the Dodd-Frank Act, SIPC, through the [SEC], was authorized to obtain a loan from Treasury of only an additional $1 billion.

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[1] All page citations in this Order refer to the page numbers generated by the court's CM/ECF system.

(*Id.* at 16-17.) If Defendants failed financially, the Reserve Account they "maintained to make customers whole would be underfunded." (*Id.* at 17.) The SEC found, and Defendants admitted, that regardless of the protections built into the LCTs, the "customers would be exposed to significant market risk." (*Id.*)

Because Defendants did not fail and did not default on their obligations to the clearing bank, the SEC found that no customers were harmed by Defendants' wrongdoing. (*Id.* at 15, 19.) Nevertheless, in light of the violations and pursuant to the settlement, the SEC ordered, among other things, that Defendants disgorge their profits of $50 million and pay $7 million in prejudgment interest. (SEC Order at 23.) In addition, MLPF&S was ordered to pay a civil money penalty of $385 million. (*Id.*) All amounts were payable to the SEC. (*Id*.)

Finally, the SEC Order provided that

> [t]o preserve the deterrent effect of the civil penalty, MLPF&S agrees that in any Related Investor Action, it shall not argue that it is entitled to, nor shall it benefit by, offset or reduction of any award of compensatory damages by the amount of any part of its payment of a civil penalty in this action . . ..

(*Id*. at 24.) A "Related Investor Action" is "a private damages action brought against the MLPF&S by or on behalf of one or more investors based on substantially the same facts as alleged in the [SEC] Order . . .." (*Id.*)

Upon learning of the SEC Order, Plaintiffs, who were Defendants' customers, filed this action on their own behalf and on behalf of similarly situated individuals in California alleging claims for fraud, negligence, violation of California securities fraud statutes and violations of the federal Racketeer Influenced and Corrupt Organizations Act ("RICO"). (Doc. no. 1.)

When Defendants filed a motion to dismiss (doc. no. 19), Plaintiffs voluntarily amended their complaint in lieu of opposing. Their first amended complaint omitted the negligence per se and RICO claims. (Doc. no. 23.) Defendants filed a second motion to dismiss, which was based in part on federal preemption. (Doc. no. 33.) The Court found

the complaint preempted by Securities Litigation Uniform Standards Act of 1998, 15 U.S.C. § 78bb(f), and dismissed it with leave to amend. (Doc. no. 42.)

Plaintiffs' operative second amended complaint alleges a securities fraud claim for violation of § 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, based on the facts in the SEC Order. Pending before the Court is Defendants' third motion to dismiss under Rule 12(b)(6).

II. DISCUSSION

Among other things, Defendants argue that Plaintiffs failed to sufficiently allege their securities fraud claim. A Rule 12(b)(6) motion tests the sufficiency of the complaint. *Navarro v. Block*, 250 F.3d 729, 732 (9th Cir. 2001). Dismissal is warranted where the complaint lacks a cognizable legal theory. *Shroyer v. New Cingular Wireless Serv., Inc.*, 622 F.3d 1035, 1041 (9th Cir. 2010) (internal quotation marks and citation omitted). Alternatively, a complaint may be dismissed where it presents a cognizable legal theory yet fails to plead essential facts under that theory. *Robertson v. Dean Witter Reynolds, Inc.*, 749 F.2d 530, 534 (9th Cir. 1984).

In reviewing a Rule 12(b)(6) motion, the Court must assume the truth of all factual allegations and construe them most favorably to the nonmoving party. *Huynh v. Chase Manhattan Bank*, 465 F.3d 992, 997, 999 n.3 (9th Cir. 2006). However, legal conclusions need not be taken as true merely because they are couched as factual allegations. *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 555 (2007). Similarly, "conclusory allegations of law and unwarranted inferences are not sufficient to defeat a motion to dismiss." *Pareto v. Fed. Deposit Ins. Corp.*, 139 F.3d 696, 699 (9th Cir. 1998).

> To recover damages for violations of section 10(b) and Rule 10b–5, a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.

Halliburton Co. v. Erica F. John Fund, Inc., 573 U.S. 258, 267 (2014).

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Defendants contend that Plaintiffs have not alleged that they suffered an economic loss. Plaintiffs seek "general and compensatory damages" (SAC at 24) for "lost opportunity cost, interest, other income and/or gains" (*id.* at 3, 17-18, 23). Their theory of damages is that the LCTs, which artificially reduced the balance Defendants were required to hold in the Reserve Account, subjected Plaintiffs to an increased risk of loss if Defendants failed.[2] (*Id.* at 9; *see also id.* at 15, 16.) Plaintiffs argue that they should be compensated for the increased risk to which their deposits were exposed, although they did not suffer an actual loss of funds. (*Id.* at 11, 23.) They allege that if they had knowingly subjected their investments to a greater risk, they would have demanded a greater rate of return. (*Id.* at 12, 16, 17-18, 23.)

Plaintiffs "do not contend the LCTs caused [their] accounts to lose value" (Opp'n at 29) and their theory of damages, as alleged in the complaint, is based on the lost opportunity to earn a higher return. In their opposition, Plaintiffs also claim that they are entitled to disgorgement of the profits Defendants earned from their wrongdoing. (*Id.* at 30.) Defendants contend that neither lost opportunity cost nor disgorgement is recoverable in a private federal action for securities fraud.

"A private plaintiff who claims securities fraud must prove that the defendant's fraud caused an economic loss." *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 338 (2005); *see also Halliburton*, 573 U.S. at 267. In this regard, "Section 10(b) claims for damages

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[2] Plaintiffs suggest that the funds Defendants invested for their own gain belonged to the customers. (Opp'n at 29; *see also id.* at 30 (Defendants "secretly used money belonging to Plaintiffs").) This assertion is inaccurate. "Customer funds" is defined in the Customer Protection Rule as "liabilities of a broker or dealer to customers which are subject to immediate cash payment to customers on demand . . .." 17 C.F.R. § 240.15c3-3(a)(8)-(10). The Reserve Account was maintained "for the exclusive benefit of customers" in an amount calculated according to a formula, *id.* § 240.15c3-3(e), however, it did not contain cash and securities belonging to the customers. Defendants manipulated the Reserve Account formula to arrive at an artificially low required balance, and used the resulting reduction to finance their trading. They did not withdraw funds from customers' accounts.

are governed by Section 28(a), which limits all claims brought under the Exchange Act to actual damages." Ninth Cir. Model Civ. Jury Instr. 18.9 Comment; *see also Dura*, 544 U.S. at 344 (the common-law-fraud roots of private securities fraud actions require a plaintiff to "show actual damages"). Section 28(a) provides that "[n]o person permitted to maintain a suit for damages under the provisions of this chapter shall recover . . . a total amount in excess of the *actual damages* to that person on account of the act complained of." 15 U.S.C. § 78bb(a) (emphasis added). This language has been interpreted "as governing the measures of damages that are permissible under §10(b)." *Randall v. Loftsgaarden*, 478 U.S. 647, 663 (1986). Accordingly,

> The usual measure of damages for securities fraud claims under Rule 10b–5 is out-of-pocket loss . . .. Consequential damages may also be awarded if proved with sufficient certainty. . . . The district court may apply a rescissory measure of damages in appropriate circumstances.

Ambassador Hotel Co., Ltd. v. Wei-Chuan Inv., 189 F.3d 1017, 1030 (9th Cir. 1999) (citing *DCD Programs v. Leighton*, 90 F.3d 1442, 1449 (9th Cir.1996)). Plaintiffs are not requesting any of the foregoing measures of damages.

Plaintiffs' argument that they are entitled to lost opportunity cost or disgorgement of profits in the absence of any out-of-pocket loss is unsupported. All binding precedents they cite involve a plaintiff who suffered an out-of-pocket loss. To the extent the court awarded more to prevent unjust enrichment, it was in addition to rather than in lieu of the out-of-pocket loss.

In *Superintendent of Insurance v. Bankers Life and Casualty Company*, the Court noted that "Section 10(b) must be read flexibly, not technically or restrictively," 404 U.S. 6, 12 (1971). However, the case addresses liability and not damages. It involved a fraudulent purchase of a large block of stock where the purchaser financed the purchase by selling the acquired company's assets. The result of the transaction was that a third-party received the proceeds of the sale rather than the seller. (*Id.* at 7-8, 9-10 ("the seller was duped into believing that it, the seller, would receive the proceeds . . .. [P]roceeds of

the sale that were due the seller were misappropriated").) The Court held this theory could support liability. *Id.* at 13-14. While the Court did not rule on damages, it is apparent that the plaintiff had suffered an out-of-pocket loss. *See id.* at 9-10 ("We cannot agree . . . that no investor was injured."), 12-13.

In *Affiliated Ute Citizens v. United States*, the securities fraud consisted of facilitating sales of stock below their actual value. 406 U.S. 128, 153 (1972). Under defendants' scheme, the sellers of the stock suffered an out-of-pocket loss because they received less than their stock was worth. *Id.* at 154-55; *see also Randall*, 478 U.S. at 663; Ninth Cir. Jury Instr. 18.9 Comment (defining out-of-pocket loss)). The Court held they could recover the out-of-pocket loss and added that in "the situation where the defendant received more than the seller's actual loss[,] damages are the amount of the defendant's profit." *Affiliated Ute Citizens*, 406 U.S. at 155. "This alternative standard aims at preventing unjust enrichment [because] it is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them." *Randall*, 478 U.S. at 663. Accordingly, the potential of awarding unjust enrichment was possible where the plaintiffs had suffered an out-of-pocket loss.

In *Randall v. Loftsgaarden*, the action was filed by defrauded investors in a motel project which had been promoted as a tax shelter. 478 U.S. at 650. The project defaulted on its obligations and was foreclosed. *Id.* at 651. The investors sued for damages alleging that defendants had misrepresented the financial soundness of the project. *Id.* The relevant issue was "whether the recovery available to a defrauded tax shelter investor, entitled under . . . § 10(b) . . . to rescind the fraudulent transaction or obtain rescissory damages, must be reduced by any tax benefits the investor has received from the tax shelter investment."[3] 478 U.S. at 649. The Court reiterated that "ordinarily the correct measure of damages" is the out-of-pocket loss measure. *Id.* at 662. It reasoned,

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[3] The Court did not decide, but assumed, that "rescission or rescissory measure" was available because this issue was not disputed. *Id.* at 661-62, 666.

however, that the effect of allowing a tax benefit offset against the loss "would often be substantially to insulate those who commit securities frauds from any appreciable liability to defrauded investors." *Id.* at 664. It noted that it has "never interpreted § 28(a) as imposing a rigid requirement that every recovery . . . must be limited to the *net* economic harm suffered by the plaintiff" and that the limits of § 28(a) recovery were "flexible." *Id.* at 663 (emphasis added). It therefore concluded, based on *Affiliated Ute Citizens*, that as between the plaintiff and the defendant, the deterrence goals of federal securities laws were better served if any windfall was left with the plaintiffs rather than given to the defendant as an offset. *Id.* at 663-64. The fact that the *Randall* plaintiffs were not required to offset the tax gains from the years when their investment was viable does not support Plaintiffs' position here that they are entitled to lost opportunity damages or disgorgement in the absence of any out-of-pocket loss at all. The *Randall* plaintiffs had suffered an out-of-pocket loss when the project was foreclosed.

In *Nesbit v. McNeil*, the plaintiff was damaged by excess commissions paid due to churning her account, although her account balance realized a net gain. 896 F.2d 380, 381-82 (9th Cir. 1990). The issue was whether the plaintiff should be required to offset her gains against the excessive churning fees. *Id.* at 386. The Court reasoned that once the trier of fact "finds that the trading was excessive [and] should not have taken place[, i]t should not be forced to decide whether the gains or losses were a result of market forces, luck, good times, or intrinsically good stock." *Id.* It concluded that the gains should not be offset. *Id.* There was no question that the plaintiff, regardless of the net gain to her account, had suffered an out-of-pocket loss by paying commissions "for trading that never should have taken place." *Id.* at 386 n.6.

Finally, Plaintiff's reliance on *F.T.C. v. AMG Capital Management LLC*, 910 F.3d 417 (9th Cir. 2018), is unavailing. It is not a securities fraud case and does not discuss damages under § 28(a). It cites to *Kokesh v. SEC*, __ U.S. __, 137 S.Ct. 1635, 1640 (2017), which found that disgorgement to the SEC for securities fraud was "a form of restitution measured by the defendant's wrongful gain." *AMG Capital Mmgt.*, 910 F.3d

at 426. The disgorgement penalty in *Kokesh*, however, was recovered by the SEC and not, as here, by a private action plaintiff. Accordingly, § 28(a) and its limitation to actual damages did not apply. Moreover, the issue decided in *Kokesh* was statute of limitations and not remedies for securities fraud violations. Neither *AMG Capital Management* nor *Kokesh* assist Plaintiffs here.

For the foregoing reasons, Plaintiffs have not alleged any actual damages as required by § 28(a). Accordingly, they have failed to allege securities fraud under § 10(b) or Rule 10b-5. Because Defendants' motion is granted on this basis, the Court need not also consider whether Plaintiffs have failed to properly allege any other elements of their claim or if the claim is time barred.

Plaintiffs seek leave to amend "in the interests of justice." (Opp'n at 34.) Rule 15 advises leave to amend shall be freely given when justice so requires. Fed. R. Civ. P. 15(a)(2). "This policy is to be applied with extreme liberality." *Eminence Capital, LLC v. Aspeon, Inc.*, 316 F.3d 1048, 1051 (9th Cir. 2003) (internal quotation marks and citation omitted).

> In the absence of any apparent or declared reason – such as undue delay, bad faith or dilatory motive on the part of the movant, repeated failure to cure deficiencies by amendments previously allowed, undue prejudice to the opposing party by virtue of allowance of the amendment, futility of the amendment, etc. – the leave sought should, as the rules require, be freely given.

Foman v. Davis, 371 U.S. 178, 182 (1962) (internal quotation marks and citation omitted). Dismissal without leave to amend is not appropriate unless it is clear the complaint cannot be saved by amendment. *Id.*

Plaintiffs do not specify how they could amend the complaint to allege actual loss as required by § 28(a). Moreover, the nature of Plaintiffs' loss was briefed in Defendants' two prior motions to dismiss (*see, e.g.*, doc. no. 19-1 at 19-20 (injury for purposes of Article III and RICO standing), doc. no. 33-1 at 19 (Article III standing)), yet Plaintiffs have not remedied their allegations in their first and second amended

complaints. Leave to amend is therefore denied. *See Salameh v. Tarsadia Hotel*, 726 F.3d 1124, 1133 (9th Cir. 2013).

III. CONCLUSION

Defendants' motion to dismiss is granted. Plaintiffs' request for leave to amend is denied.

IT IS SO ORDERED.

Dated: February 26, 2020

Hon. M. James Lorenz
United States District Judge