No. 13-317

IN THE

Supreme Court of the United States

HALLIBURTON CO. AND DAVID LESAR,
Petitioners,
v.

ERICA P. JOHN FUND, INC. F/K/A ARCHDIOCESE OF MILWAUKEE SUPPORTING FUND, INC.,
Respondent.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF OF *AMICI CURIAE* STATES OF OREGON, CONNECTICUT, PENNSYLVANIA, WASHINGTON, ARKANSAS, HAWAII, IDAHO, ILLINOIS, INDIANA, IOWA, KENTUCKY, MAINE, MISSISSIPPI, MISSOURI, NEW MEXICO, NEW YORK, NORTH CAROLINA, NORTH DAKOTA, RHODE ISLAND, TENNESSEE, VERMONT, AND TERRITORY OF GUAM SUPPORTING RESPONDENT

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Dated: February 5, 2014

BATEMAN & SLADE, INC. BOSTON, MASSACHUSETTS

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases:

Statutes:

Other Authorities:

BRIEF OF AMICI CURIAE STATES SUPPORTING RESPONDENT

INTEREST OF AMICI

This brief is filed on behalf of the States of Oregon, Connecticut, Pennsylvania, and Washington, as well as the States of Arkansas, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Maine, Mississippi, Missouri, New Mexico, New York, North Carolina, North Dakota, Rhode Island, Tennessee, Vermont, and the Territory of Guam.

State governments have an important interest in this case because state employee pension funds are frequently plaintiffs in securities fraud actions. Indeed, because state employee pension funds are often the plaintiffs with the largest claims (measured in monetary terms) in such cases, they are often appointed by courts as Lead Plaintiffs pursuant to the requirements of the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (1995), 15 U.S.C. § 78u-4(B)(iii)(I)(bb).[1] In addition, state attorneys

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[1] In 2007, pension funds were named as lead plaintiffs in 48% of securities class actions. Those cases represented 60% of the cases settling that year, and 94% of the total settlement dollars. (Grace Lamont, PricewaterhouseCoopers, *2007 Securities Litigation Study* 33 (Apr. 8, 2008), http://www.pwc.com/en_US/us/forensic-services/assets/2007_security_litigation_study.pdf.) By 2012, pension funds were projected to constitute 75% of the lead plaintiffs in securities class actions. (Patricia Etzold, *et al.*, PricewaterhouseCoopers, *2012 Securities Litigation Study* 24 (fig. 16), http://www.pwc.com/en_US/us/forensic-services/publications/assets/pwc-2012-securities-litigation-study.pdf.) Lead plaintiff status is a proxy for size of claim, because the PSLRA favors appointing as lead plaintiff the investor of group of investors with the largest financial stake in

general are the chief legal officers of their States and are typically charged with bringing civil actions to recover damages to state agencies. Attorneys general have historically played an important role in ensuring fair and non-deceptive marketplaces for all citizens of their States.

Accordingly, States have an important interest in the continued vitality of the fraud-on-the-market presumption adopted by this Court in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). The practical reality is that the *Basic* rule is critical both to the feasibility of private securities actions and for securing proper enforcement of the securities laws.

SUMMARY OF ARGUMENT

Petitioner and its amici have sought to convince the Court that private securities fraud actions "force settlement without regard to merit," "poorly compensate investors," "do not deter culpable parties" and "consume excessive judicial resources." Pet. Br. 40, 41, 43, 44. Those arguments do not withstand scrutiny.

The Securities and Exchange Commission has always recognized the important role played by private securities actions in enforcing the federal securities laws – just as private actions supplement federal enforcement in other areas, such as consumer protection and Medicaid fraud. In *Basic*, the SEC (under the Administration of President George H.W. Bush) filed an amicus curiae brief urging this Court to adopt the fraud-on-the-market presumption and warning that, without it, private

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the litigation. *See* 15 U.S.C. § 78u-4(B)(iii)(I)(bb) (creating a rebuttable presumption).

securities actions would face insuperable hurdles. The same is true today. Without the important check provided by *Basic* and private securities actions, the integrity of U.S. capital markets will be diminished, and investor confidence in the fundamental fairness of the financial system will decline.

Objective scholarly data confirm the importance of *Basic*, and this Court should not credit Petitioner's scare tactics. Studies show that private actions play a key role in deterring securities fraud and, in fact, are often more effective at returning compensation to victims than government suits. The SEC simply does not have the resources to adequately police the markets without the essential supplement of private securities litigation. For example, one recent study by Stephen Choi, professor of law at NYU, and A.C. Pritchard, professor of law at the University of Michigan, found that private class actions are more effective than SEC investigations at deterring securities fraud and lead to a higher incidence of top officer resignations. Another study by Brian Fitzpatrick, the first comprehensive empirical study of all types of class action settlements, showed securities class actions recovering more value for plaintiffs than any other type by a startling amount.

The U.S. has the best and strongest financial markets in the world, due in no small part to its vigorous anti-fraud laws and investor protection. Studies have shown that strong enforcement of securities fraud statutes leads to market integrity and investor confidence. Empirical examinations validate the connection between protection from fraud and capital formation. Quite simply, investors fear fraud much more than they fear securities litigation, and weakening securities law enforcement will damage the nation's economy.

In enacting the PSLRA, Congress intended that institutional investors, including state and local governments, would play a major role in deterring fraudulent conduct in the marketplace. Studies show that the private actions filed after the PSLRA are more meritorious than those filed before it – in effect, that the 1995 legislative reform worked.

The evidence also demonstrates that the criticisms of private securities actions are overblown. The data shows that the "in terrorem" effect of securities class actions is exaggerated.

Further, the evidence shows that Petitioner's "circularity" argument – the contention that private securities actions simply transfer money from one innocent investor to another – is flawed because it ignores incentive effects. The threat of civil liability leads officers and directors (who are often shareholders themselves) as well as large investors to establish procedures to reduce the incidence of fraud in the first place. Petitioner's contention that securities fraud cases have imposed an aggregate $73.1 billion in settlements since the PSLRA was enacted, Pet. Br. 41, is distorted and misleading.

Finally, Petitioner's argument that state courts have not followed the *Basic* presumption in construing their own securities laws (Pet. Br. 24) is irrelevant to how federal law should be interpreted. Federalism is a two-way street, and the states and the federal government are both free within their respective authority to enact their own laws and choose their own approaches.

ARGUMENT

States have an important interest in the fraud-on-the-market presumption adopted by this Court in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), because it plays a key role in the enforcement of the securities laws.

I. This Court Should Adhere To Its Decision In *Basic*.

In 1988, under the Administration of President George H.W. Bush, the Solicitor General (representing the SEC) filed an amicus curiae brief in *Basic* urging this Court to follow the decisions of every court of appeals to have considered the question and adopt the fraud-on-the-market presumption of reliance. The brief stressed the importance of the presumption to the effective enforcement of the securities laws:

> The courts have viewed the fraud on the market theory, and the accompanying presumption of reliance, as a means of furthering the statutory goal of ensuring honest securities markets. To the extent that private securities fraud actions may be prosecuted more efficiently by adoption of the fraud on the market theory and its presumption of reliance, the enforcement of the securities laws, and the underlying goal of honest markets, are furthered.[2]

The SEC added that private plaintiffs would face severe practical problems without the presumption:

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[2] Br. of SEC as Amicus Curiae at 25-26, *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (No. 86-279) (citations omitted).

> [P]lacing the burden of proof on a plaintiff alleging fraud on the market would impose an unrealistic evidentiary burden. Of course, a plaintiff could offer evidence that he relied on the integrity of the market in making his investment decision. But proving affirmatively that the market price of a security was affected by corporate misstatements may be difficult. A plaintiff might have to present extensive and hard to obtain evidence as to who in fact traded in the stock following the corporate statement, how many of those traders were in fact aware of the statement and whether they in fact relied on the statement in making their trading decisions.
>
> The fraud on the market theory merely accommodates these various concerns by recognizing the obvious, that market prices generally reflect corporate information and that investors generally rely on the integrity of the market price, and by relieving plaintiffs of the need to reprove these matters in each case.

Id. at 26-27 (citations omitted). The brief emphasized that the presumption "promote[s] important policies under the federal securities laws," including the "integrity" of the securities markets and "investor confidence" in them. *Id.* at 24.

The SEC's reasoning in 1988 is equally applicable today. Without the fraud-on-the-market presumption, private plaintiffs will face insuperable barriers in bringing securities fraud actions, either in class form or as individual actions, and the enforceability of the anti-fraud laws will suffer. Without this important check, the integrity of U.S. capital markets will be diminished, and investor confidence in the fundamental fairness of the financial system will decline.

State securities regulators have supported *Basic* in this Court.[3] Further, this Court has consistently cited the *Basic* presumption with approval, in *Amgen Inc. v. Conn. Retirement Plans and Trust Funds*, 133 S. Ct. 1184, 1193, ___ U.S. ___ (2013), *Erica P. John Fund v. Halliburton Co*., 131 S. Ct. 2179, 2186, ___ U.S. ___ (2011) ("*Halliburton I*"), *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 159 (2008), *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336, 342-43 (2005), and even in other areas of law, *see Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541, 2552 n.6, ___ U.S. ___ (2011). All of these decisions cite to the fraud on the market doctrine and *Basic* as an established way to show reliance in securities cases. Under Halliburton's view, all of these decisions should be disregarded.

Now is not the time for this Court to change course in a way that risks disruption of U.S. capital markets. After the financial crisis of 2008, many small investors fled U.S. stock markets out of concern that the system was stacked against them. Many such investors are only now beginning to return. This Court should not create a major roadblock to private securities fraud actions, given the important enforcement role they play. To do so

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[3] *See* Br. of AARP and North American Securities Administrators Assn., Inc. as Amici Curiae Supporting Petitioner, *Erica P. John Fund, Inc. v. Halliburton Co.* (No. 09-1403).

risks loss of investor confidence that would have severe repercussions for U.S. capital markets.

II. Private Actions Are A Necessary Supplement To SEC Enforcement.

A. Private Actions Are Essential To Proper Enforcement of Securities Laws.

This Court has long recognized that private actions to enforce the securities laws are a "necessary supplement" to the Commission's enforcement actions. *See Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).

This Court has recognized that "[t]he SEC enforcement program and the availability of private rights of action together provide a means for defrauded investors to recover damages and a powerful deterrent against violations of the securities laws." *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 778 n.10 (2008) (quoting S. Rep., at 8, U.S. Code Cong. & Admin. News 1995, pp. 679, 687). This Court reaffirmed that "private litigation under § 10(b) continues to play a vital role in protecting the integrity of our securities markets." *Id.* at 778.

Congress has likewise recognized the important role of institutional investors, including state and local governments. Indeed, in the PSLRA, Congress reaffirmed that "private securities litigation [i]s an indispensable tool with which defrauded investors can recover their losses—a matter crucial to the integrity of domestic capital markets." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 320 n.4 (2007) (brackets in original and internal quotation marks omitted). When it enacted the PSLRA, Congress adopted provisions favoring the selection of institutional investors as lead plaintiffs in private actions. *See id.* at 331.

B. The SEC's Resources Are Limited.

The SEC simply does not have the resources to police the markets by itself, without the essential supplement of private securities litigation. The drastic expansion of the SEC's responsibilities, coupled with the astonishing growth of trading technologies and strategies,[4] means that the SEC cannot be the sole entity responsible for the enforcement of the Nation's securities laws. Congress's response to the financial crisis caused the SEC's responsibilities to explode. The implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203, 124 Stat. 1376) ("Dodd-Frank") "thrust [the SEC] into the driver's seat for issuing 100 new rules, creating five new offices, producing more than 20 studies and reports, overseeing the over-the-counter derivatives market and hedge fund advisers, registering municipal advisors and security-based swap market participants, and creating a new

[4] *FY14 CFTC, SEC Budget Hearing*, Subcomm. on Fin. Servs. and Gen. Gov., Sen. Approps. Comm., 113th Cong. 7 (2013) (statement of Mary Jo White, Chair, Securities and Exchange Comm'n).

whistleblower program, among other new duties."[5] In addition, "[t]he Jumpstart Our Business Startups Act of 2012 added more to the plate, directing the SEC to write rules and issue studies on capital formation, disclosure, and registration requirements."[6]

A GAO report conducted in 2009 measured exactly how overstretched the agency had become. As its responsibilities were expanding, the number of investigative attorneys at the SEC dropped 11.5 percent between 2004 and 2008, from 566 to 501.[7] Total staffing for the Enforcement Division declined between 2005 and 2008.[8] From 2002 to 2008, the number of investigations and enforcement actions remained level[9] – fewer people were doing roughly the same amount of work as the financial crisis brewed. "In interviews and small group meetings, Enforcement management and investigative attorneys agreed that resource challenges have affected their ability to bring enforcement actions."[10] Unsurprisingly, both penalties and disgorgements exacted by the SEC have plummeted: since a high in

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[5] *FY14 CFTC, SEC Budget Hearing*, Subcomm. on Fin. Servs. and Gen. Gov., Sen. Approps. Comm., 113th Cong. 7 (2013) (statement of Sen. Mark Udall).

[6] *Id.*

[7] U.S. Gov't Accountability Office, GAO-09-358, Securities and Exchange Commission: Greater Attention Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement 4 (2009) ("GAO Report").

[8] *Id.* at 17.

[9] *Id.* at 21-22.

[10] *Id.* at 23.

2005, penalties have fallen 84 percent, and disgorgements are down 68 percent since their peak in 2006.[11]

The investment advisor industry, as an example of the SEC's responsibilities, has grown exponentially over the past decade: the number of advisors has risen forty percent, while the amount of assets has more than doubled to over $50 trillion.[12] In addition, the field has grown markedly more complex with the evolution of novel trading strategies, high-frequency and algorithm-based trading, and "complex 'families' of financial services companies with integrated operations."[13] Despite this rapid expansion, the SEC was able to examine only eight percent of investment advisors in FY 2012 and "over 40 percent of advisors have never been examined."[14] The industry is changing faster than the SEC can keep up.

The SEC's supervision of derivatives and clearing agencies is also at a critical juncture. With the evolution of swap-based markets, the SEC has also been tasked with overseeing "new categories of registered entities" such as "security-based swap execution facilities, security-based swap data repositories, security-based swap dealers, and major security-based swap participants."[15] Oversight

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[11] *Id.* at 37.

[12] *FY14 CFTC, SEC Budget Hearing*, 113th Cong. 6-7 (2013) (statement of Mary Jo White, Chair, Securities and Exchange Comm'n).

[13] *Id.* at 7.

[14] *Id.* at 6.

[15] *Id.* at 9.

includes supervision, mandatory reporting, dissemination of public information, and clearing of swaps. These new markets are in a critical phase: "bottlenecks and unintended market disruptions" may occur over the next two years as "the new requirements become operational."[16] The seven active registered clearing agencies are handling roughly $6.6 trillion worth of transactions per day, but the SEC has a full on-site presence in only three, with a total of 14 examiners spread across them all.[17] The number of these clearing agencies is expected to expand.[18] In addition, the SEC's monitoring of those clearing agencies designated as "systemically important" by the Financial Stability Oversight Council is also expected to increase dramatically.[19]

These responsibilities have come at the cost of enforcement of securities laws, particularly in a time of budgetary sequester and government shutdown. In the words of one federal judge, "the SEC has been hard hit by budget limitations," which have forced the agency to husband its resources and instead "to focus on the smaller, easily resolved cases that will beef up their statistics when they go to Congress begging for money."[20] Even before the sequester hit

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[16] *Id.*

[17] *Id.* at 10.

[18] *Id.*

[19] *Id.*

[20] Jed S. Rakoff, "The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?", *The New York Review of Books* (Jan. 9, 2014), http://www.nybooks.com/articles/archives/2014/jan/09/financial-crisis-why-no-executive-prosecutions.

the SEC, one manager in the Enforcement Division told the GAO that "the division did not have enough resources to pursue many leads involving offering fraud and market manipulation."[21]

C. Private Actions Have A Critical Deterrent Effect.

Even where it brings cases, SEC enforcement does not mean injured investors will recover at all, let alone what they may obtain through private litigation. The comparative results between what the SEC and private litigants recover are stark.[22] For example, in actions against Enron and aiders and abettors in the Enron fraud, the SEC recovered $440 million while investors recovered approximately $7.3 billion from private suits.[23] The SEC settlement fund in connection with WorldCom

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[21] GAO Report at 24. Promising cases were closed and some – including several involving the subprime mortgage crisis – went unstaffed. (*Id.*) The problems were pervasive: "investigative attorneys with whom we spoke cited a number of resource challenges that have undercut their efforts, causing significant delays in bringing cases, reducing the number of cases that can be brought, and potentially undermining the quality of cases." (*Id.*) Because of difficulties conducting thorough investigations, attorneys simply relied on representations made by defense counsel. (*Id.* at 25.)

[22] The GAO Report found that the SEC was hobbled by internal policies that discouraged penalties and forced the SEC to play a losing hand at settlement talks. *See* GAO Report at 43-44.

[23] *Compare* Securities and Exchange Comm'n, *Enron*, http://www.sec.gov/divisions/enforce/claims/enron.htm *with* Kristen Hays, "Enron Settlement: $7.2 Billion to Shareholders," *Houston Chronicle*, http://www.chron.com/business/enron/article/Enron-settlement-7-2-billion-to-shareholders-1643123.php (Sep. 9, 2008).

was $750 million – at the time the largest in the agency's history – compared to $6.1 billion recovered in the private action.[24] Notably, the private settlement with WorldCom included $24.75 million from individual directors while the SEC fine was paid only by the company.[25] The SEC did not recover anything for investors in the Cendant litigation, but the private action recovered $3.2 billion.[26] Similarly, while the SEC settled with Charter Communications in return for a cease-and-desist promise not to violate the securities laws again, the private lawsuits were settled for a $64 million cash fund and an $80 million equity distribution.[27] Hence, the reality is precisely the opposite of Petitioner's claim that SEC enforcement returns more to investors than private actions. *See* Pet. Br. at 41-44.

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[24] *Compare* AccountingWeb, "$750 Million MCI/WorldCom Settlement is Largest in SEC History," http://www.accountingweb.com/topic/750-million-mciworldcom-settlement-largest-sec-history (Jul. 7, 2003) *with Settlements*, http://www.worldcomlitigation.com/html/citisettlement.html (visited Jan. 5, 2014). The website http://www.worldcomlitigation.com is the information site administered by Lead Counsel.

[25] AccountingWeb, *supra*; http://www.worldcomlitigation.com, *supra*.

[26] *See In re Cendant Corp. Litig.*, 264 F.3d 201, 217 (3d Cir. 2001).

[27] *Compare* Business Wire, "Charter Communications Reaches Settlement in Class Action and Derivative Lawsuits," http://www.businesswire.com/news/home/20040805005892/en/Charter-Communications-Reaches-Settlement-Class-Action-Derivative (Aug. 5, 2004) *with* Stipulation of Settlement, Dkt. 292, *In re Charter Comm'cns, Inc., Sec. Litig.*, No. 02-cv-1186, §1.26 (Feb. 17, 2005, E.D. Mo.).

Empirical research confirms the importance of private actions. One recent study found that private class actions are more effective than SEC investigations in policing securities fraud.[28] In particular, the study by Stephen Choi, professor of law at NYU, and A.C. Pritchard, professor of law at the University of Michigan, compared SEC-only investigations with class action-only lawsuits and found a greater deterrent effect and higher incidence of top officer resignation as a result of class actions. The study was notable because it explained that conventional analyses comparing class actions and SEC enforcement actions are comparing apples and oranges. SEC enforcement actions are brought only after the SEC has completed a substantial investigation into the alleged wrongdoing, aided by the SEC's subpoena power, which yields cooperation from defendants even when it is not invoked. By contrast, plaintiffs filing securities class actions must do so on the basis of publicly available information. Accordingly, the more relevant comparison is between SEC investigations and class actions. On that score, the study concluded that the evidence "is consistent with private class actions pursuing more egregious securities law violations than SEC investigations and imposing greater sanctions against companies."[29] The authors conclude, "our findings are consistent with the private enforcement providing at least as much

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[28] *See* Stephen J. Choi & A.C. Pritchard, *SEC Investigations and Securities Class Actions: An Empirical Comparison*, University of Michigan Law School Law & Economics Research Paper Series, No. 12-022, Nov. 2012, available at http://ssrn.com/abstract=2144002.

[29] *Id.* (quoting abstract).

deterrent value, if not more, than public enforcement."[30]

D. Class Actions Are A Critical Enforcement Tool.

The utility of securities class actions as a method of deterring wrongdoing is also shown by their effectiveness compared to other class actions. The first comprehensive empirical study of all types of class action settlements, rather than only those under securities laws, showed securities class actions recovering more compensation for plaintiffs than any other type by a startling amount.[31] For the two years studied (2006 and 2007), securities class action settlements constituted 73% and 76% of the amount of monetary value recovered in *all* class actions.[32] The closest comparator in both years clocked in at only 7% of the total.[33] Even setting aside blockbuster securities settlements and focusing on average and median values, securities class action settlements are in the top tier alongside

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[30] *Id.*

[31] Brian T. Fitzpatrick, *An Empirical Study of Class Action Settlements and Their Fee Awards*, 7 J. EMPIRICAL LEGAL STUD. 811, 825-30 (2010).

[32] *Id.* at 825 (table 4). Even though securities class action settlements totaled $16 billion and $8 billion for 2006 and 2007 respectively (*id.*), securities class action settlements recover on average only 3% of investor losses (Cornerstone Research, *Securities Class Action Settlements—2012 Review and Analysis* 8 (fig. 7) (2013)). As enormous as the amount of these settlements are, they pale in comparison to the losses they are attempting to compensate.

[33] Fitzpatrick, 7 J. EMPIRICAL LEGAL STUD. at 825 (table 4).

commercial and antitrust class action settlements.[34] The study found that "securities settlements were quite distinctive from the settlements in other areas in their singular focus on cash relief: every single securities settlement provided cash to the class," as opposed to in-kind or "coupon" relief.[35] Juxtaposed with other uses for the class action mechanism, securities class actions are able to return more value to plaintiffs both in the aggregate and in the average or median case.

The strength of the class action mechanism to enforce securities laws can also be seen in the low rate of opt-outs. Out of the 1,272 securities class actions in the post-PSLRA period between 1996 and 2011, only 38 cases (0.03%) had parties who opted out and filed a separate suit.[36] While opt-outs do happen, this low figure confirms that the class action mechanism tends to be superior to individual litigation in policing securities fraud.

III. Private Enforcement of Securities Laws Enhances Economic Efficiency By Ensuring Market Integrity and Investor Confidence.

This Court has opined that "[t]he securities statutes seek to maintain public confidence in the marketplace. They do so by deterring fraud, in part, through the availability of private securities fraud

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[34] *Id.* at 827-29 & table 6 (explaining that the commercial and antitrust averages are distorted by huge outlier settlements and a small *n*).

[35] *Id.* at 825.

[36] Amir Rozen, *et al.*, Cornerstone Research, *Opt-Out Cases in Securities Class Action Settlements* 2 (2013).

actions." *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 345 (2005) (internal citation omitted).

This Court's assessment is correct. The U.S. has the best and strongest financial markets in the world, due in no small part to its vigorous anti-fraud laws and investor protection. This is no coincidence:

> [R]ecent research documents significant adverse consequences of the failure of a legal regime to protect investors. . . . [W]hen investor protection is poor, investment funds are not allocated efficiently across activities . . . , since entrepreneurs with profitable projects need not be the ones with access to funds and investors do not entrust their funds to entrepreneurs. These failures of markets to work well have significant real consequences. Levine and Zervos (2000) and Rajan and Zingales (1998) show that poor investor protection policies, through their adverse effect on capital market development, retard economic growth.[37]

Empirical studies of capital formation validate the connection between protection from fraud and capital formation. Simply put, investors fear fraud much more than they fear securities litigation.[38] Robust free markets work best only when investors

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[37] Andrei Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance* 1984 (Oxford 2000) (citations omitted).

[38] Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority,"* 108 HARV. L. REV. 438, 439-42 (1994).

feel confident enough to take business risks without the added fear of fraud.

A study by Jonathan M. Karpoff of the University of Washington, D. Scott Lee of the University of Nevada, Las Vegas, and Gerald S. Martin of American University confirmed the importance of private actions.[39] The study examined the sizes, types, and determinants of legal penalties imposed for all 697 enforcement actions initiated by the SEC for financial misrepresentation from 1978 through 2004. The penalties included private class action awards, monetary penalties imposed by the SEC and Department of Justice, and such non-monetary sanctions as censures, trading suspensions, and jail time. The study concluded: "Contrary to many criticisms of private lawsuits and regulatory actions, we find that legal penalties are highly systematic, and in particular, are positively related to the size and severity of the harm from the misconduct."[40] Further, the study placed its findings in context with the literature on the importance of both public and private enforcement actions:

> These findings illuminate the importance of public and private enforcement activities for financial misrepresentation. In an investigation of data from 49 countries, La Porta et al. (2007) find that public enforcement – i.e., direct regulatory enforcement activities such as those of the

[39] Jonathan M. Karpoff, *et al.*, *The Legal Penalties for Financial Misrepresentation* (May 2, 2007) (available at http://ssrn.com/abstract=933333).

[40] *Id.* at 1 (quoting Abstract).

> SEC – is not correlated with financial market development. Rather, private enforcement – in particular, the ability to seek recompense through legal actions – is strongly correlated with financial market development. This implies that public enforcement activities are relatively unimportant or ineffectual at disciplining and deterring financial misconduct. Using alternative measures of public enforcement, Jackson and Roe (2007) reach the opposite conclusion, that "public enforcement [is] more strongly associated with robust financial markets."
>
> Our results address a related aspect of this debate. We show that *both* private and public enforcement activities penalize financial misrepresentation. Both also are sensitive to the costs and complexities of the misconduct. These results indicate that, for the United States at least, private and public enforcement activities both are important in the control of managerial opportunism.[41]

The economic data strongly support the view that regulation of financial markets in the U.S. actually enhances its competitive position against other markets. Recent studies have found that foreign companies listing their stocks on their home exchanges and in the United States are able to raise capital on better terms, at a lower net cost than companies that list only outside the United States.[42]

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[41] *Id.* at 3-4 (emphasis in original).

[42] Craig Doidge *et al.*, *Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listing*

Economists refer to this as a cross-listing premium.[43] By contrast, companies that cross-list in their home exchanges and London, which is widely recognized to have less rigorous regulations than the United States, do not enjoy the cross listing premium.[44] This premium exists in the United States because of the superior protections that the regulatory regime in the United States provides investors.[45]

IV. Criticisms of Private Securities Actions Are Misplaced.

Petitioner contends that securities class action suits are "deadweight loss" Pet. Br. 43 and "gluttonous consumers of judicial resources" Pet. Br. 44 that "force settlement without regard to merit" Pet. Br. 40. To the contrary, an empirical study relating the progress of a private securities class action to proxies for merit shows that the PSLRA increased the number of meritorious lawsuits rather than diminishing it.[46] Petitioner's criticisms of

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Choices Over Time 5, 29 (Fisher Coll. of Bus. Working Paper Series, Paper No. 2007-03-012, 2007), *available at* http://www.ssrn.com/abstract=982193; Luzi Hail and Christian Leuz, *International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulations Matter?*, 44 J. OF ACCOUNTING RES. 485, 485 (2006).

[43] Doidge, *supra*, at 3.

[44] *Id.* at 31.

[45] *Id.* at 29.

[46] Marilyn F. Johnson, *et al.*, *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act* 3-7, 28-30 (U. Mich., John M. Olin Ctr. for Law & Econ., Working Paper No. 02-011, 2006), http://papers.ssrn.com/abstract=883684.

private securities actions fly in the face of how these suits play out in reality.

A. The In Terrorem Effect Of Class Certification Is Overstated.

The "in terrorem" effect of class certification, Pet. Br. 40-41, is greatly exaggerated: Petitioner mistakes correlation for causality, and fails to consider alternative causes. Facially, Petitioner's argument that class certification is the lever that forces settlement is flatly incorrect: 77% of securities class actions are resolved before a motion for class certification is even filed.[47] NERA Economic Consulting "did not find reliable statistical relationships between the resolution of a motion for class certification and expected settlements."[48] Without the causal connection, Petitioner is left with a simple *post hoc ergo propter hoc* mistake. When class certification is litigated, a class is certified 76% of the time,[49] which is hardly the inevitable parade of horribles Petitioner invokes. Pet. Br. 40-41.

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[47] Renzo Comolli, *et al.*, NERA, *Recent Trends in Securities Class Action Litigation: 2012 Full -Year Review* 20 (fig. 18) (2013), http://www.nera.com/nera-files/PUB_Year_End_Trends_2012_1113.pdf.

[48] NERA, *Dynamic Litigation Analysis: Predicting Securities Class Action Settlements as a Case Evolves* 4-5 (2013). While NERA did find a robust relationship between settlement size and the *filing* of a motion for class certification, the report rightly points out that may be as much a reflection of strategic maneuvering rather than some coercive force exerted by the class certification mechanism. (NERA, *Dynamic Litigation Analysis*, *supra*, at 5.)

[49] Comolli, *supra*, at 20 (fig. 18).

The denial of a motion to dismiss exerts a stronger force on settlement than class certification does. While 28% of cases settled prior to a ruling on a motion to dismiss, 71% settled after such a motion was decided.[50] The partial or whole denial of the motion to dismiss is a significant predictor of a larger settlement.[51] Petitioner's logic should have this Court revisiting or abandoning the motion to dismiss, not the private securities class action.

B. The "Circularity" Argument Is Flawed.

Petitioner and its amici take the position that private securities actions simply transfer money from one innocent investor to another. According to this "circularity" argument, when a securities class action goes to judgment, the company and current shareholders (who were not participants in misdeeds at issue) transfer money to the plaintiffs (who were past investors).

There is little empirical support for this criticism, and it suffers from numerous analytic flaws.[52] First, it equates shareholders who buy stock

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[50] Cornerstone, *2012 Analysis*, *supra*, at 6. The 71% includes cases that settle both before (64%) and after (7%) a motion for summary judgment is decided. (*Id.*) Because of the methodology for classification, the sample does not add up to 100%. (*Id.* at n.6.) *See also* Cornerstone, *Accounting Class Action Filings and Settlements: 2011 Review and Analysis* 6-7 (figs. 5A & 5B) (noting that 19% and 10% of accounting and non-accounting securities class actions settle before the motion to dismiss, compared to 32% and 19% afterward, respectively).

[51] NERA, *Dynamic Litigation Analysis: Predicting Securities Class Action Settlements as a Case Evolves* 4-5 (2013).

[52] *See* Thomas Dubbs, *A Scotch Verdict on "Circularity" and Other Issues*, 2009 WIS. L. REV. 455 (2009) (explaining that

after the fraud is disclosed or who hold stock knowing of the fraud, with shareholders who bought stock prior to the disclosure without knowledge of the fraud. However, a purchaser of securities prior to disclosure of the defendants' misdeeds is both "innocent" of the fraud and uninformed of the conditions of the company that underlie the true value of the stock. In contrast, an investor who maintains an investment or purchases an investment after the wrongdoing is disclosed makes a choice to take new investment risk with knowledge of the fraud and is thus not, to the same extent, an "innocent" investor. If the assets of a corporation are used to pay other wronged investors it is a risk that the investor has knowingly undertaken. Moreover, the market already discounts stock prices for litigation risk, which is the reason such litigation requires disclosure. Thus, the investor who buys after disclosure of the fraud has bought the stock at a value that reflects the likelihood that the company will later have to make a settlement payment or pay a judgment.

Second, the circularity argument fails to account for the central role of shareholders in corporate governance and the incentives that private litigation provides in the exercise of that role. Shareholders possess the power to help protect the integrity of the financial markets through their voting and

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the "circularity" objection is unproven and unsupported by evidence). For example, significant private settlements are sometimes paid by wrongdoing directors rather than the corporation. *See Settlements*, http://www.worldcomlitigation.com/html/citisettlement.html (visited Jan. 5, 2014).

trading.[53] They compose the sole class of persons legally empowered to determine the composition of corporate boards that select management. Moreover, recent developments have allowed shareholders to assume an increasingly active role in corporate governance. The SEC has taken steps to facilitate shareholder participation, while institutional investors and hedge funds have begun to assert their rights more actively.[54] The pressure from large shareholders has had a significant impact on management composition and sometimes even on corporate strategies and policies.[55]

Shareholders thus comprise an integral part of the mechanism that deters managerial fraud.[56] This is particularly true of long-term shareholders, who have the greatest stake in managerial behavior.[57] Such shareholders have a positive incentive to use their strengthened role to seek more accurate and complete disclosures, which lead to a more efficient

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[53] Lawrence E. Mitchell, *The "Innocent Shareholder": An Essay on Compensation and Deterrence In Securities Class Actions* 61 (Geo. Wash. Univ. Law Sch. Public Law Research Paper No. 404, 2008), *available at* http://ssrn.com/abstract=1118471.

[54] *Id.* at 58.

[55] *Id.* at 57-58.

[56] *Id.* at 60.

[57] *Id.* at 65. In addition, officers, directors and senior members of management are often among the largest individual shareholders. These individuals, who are in the best position to commit or prevent fraud, thus have a strong incentive to preserve the value of their shareholdings by preventing fraud, and strong disincentives to engage in fraud that would diminish the value of their shareholdings.

market and corresponding higher returns to investors.[58] The threat of litigation promotes this goal, influencing not only potential defendants but also, as an additional incentive to them, shareholders who seek to avoid the costs of such litigation. Indeed, it is precisely because shareholders receive benefits from the threat of private securities litigation in the form of improved disclosures and higher investment returns that it is appropriate that shareholders also share their pro rata portion of the cost of enforcement.[59] Securities lawsuits represent a kind of "user fee" to shareholders for enjoying the benefits of enforcement of our disclosure scheme.[60]

Third, the circularity argument also ignores the participation of outside advisors, such as accountants, attorneys and underwriters. Because of their key roles in corporate securities transactions, these advisors are often deeply involved in the events giving rise to a fraud. Thus, they are in an excellent position both to detect and perpetrate fraud. Settlement payments from outside advisors who commit fraud do not come out of corporate funds and therefore do not diminish the value of the shareholders' interest in the company.[61]

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[58] *See* Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade*, 2009 WIS. L. REV. 297.

[59] *Id.* at 327.

[60] *Id.*

[61] A recent study by two Stanford Law professors found that 1 out of every 7 securities class actions filed since 2000 has involved a bankrupt company. *See* Michael Klausner and Jason Hegland, D&O Diary, *Guest Post: Bankruptcy in Securities Class Actions: Case Outcomes, Individual Liability*

Although this Court has ruled that these advisors cannot be liable in a private action for aiding and abetting a fraud,[62] liability can still attach when they actually commit the fraud.

C. Petitioner's $73 Billion Figure Is Flawed.

Petitioner cites the aggregated $73.1 billion figure for all settlements since the PSLRA was enacted, Pet. Br. 41, but this figure hides a multitude of caveats. First, it includes *all* securities-related settlements, including IPO-laddering, merger objection, and Ponzi allegations, only some of which arise from Rule 10b-5.[63] This figure overstates how much of the aggregate settlement amount arises from suits that would be affected by this case. Comolli breaks down filings by type from 2005 onward; over that period, between 57% (2010) and 96% (2005) were based on core federal securities law (Rule 10b-5, Section 11, and Section 12).[64] Because Sections 11 and 12 do not require proof of

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and Side A Protection, http://www.dandodiary.com/2013/12/articles/securities-litigation/guest-post-bankruptcy-in-securities-class-actions-case-outcomes-individual-liability-and-side-a-protection/ (visited January 28, 2014). In such cases, D&O insurers are often the source of compensation for plaintiffs and therefore have an incentive *ex ante* to prevent the fraud in the first place.

[62] *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 511 U.S. 164 (1994).

[63] Renzo Comolli, *et al.*, NERA, *Recent Trends in Securities Class Action Litigation: 2012 Full -Year Review* 5-6 (2013), http://www.nera.com/nera-files/PUB_Year_End_Trends_2012_1113.pdf.

[64] Comolli, *supra*, at 5-6 (figs. 3 & 4).

reliance, the presence of those figures distorts the relevance of the $73.1 billion aggregate number. Over a different time period (2008-2012), Cornerstone shows a range of 66% to 85% of securities lawsuits make a claim under Rule 10b-5.[65] By including non-10b-5 suits in the aggregate figure, Petitioner distorts the size of the settlements that would be affected by this case. The aggregate figure also distorts the number and size of settlements. Roughly 40% ($29.7 billion) of that aggregate amount is driven by only the top 10 mega-settlements (out of 2,113 total settlements since 1996).[66] Over half of the remaining settlements are for less than $10 million, accounting for a mere fraction of the dollar total.[67] The aggregate number is distorted by a small number of mega-settlements, and underplays the numerous settlements that address smaller-scale frauds.

These smaller settlements are important evidence of the need for private enforcement of securities laws. During the run-up to the PSLRA, these small-value suits were characterized as nuisance or "strike" used to extort a settlement from the beleaguered company.[68] If this argument was

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[65] Cornerstone Research, *Securities Class Action Filings: 2012 Year in Review* 6 (fig. 4), http://securities.stanford.edu/clearinghouse_research/2012_YIR/Cornerstone_Research_Securities_Class_Action_Filings_2012_YIR.pdf.

[66] Comolli, *supra*, at 23 (fig. 21) & 30 (table 1).

[67] *Id.* at 31.

[68] *See*, *e.g.*, Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 505-23 (1991) (analyzing a small sample of cases to determine that merits do not affect settlement size).

true before the PSLRA — evidence suggests that it was incorrect[69] — the story has changed significantly since the PSLRA: fewer frivolous suits survive, and the rise in number of suits is probably due to a rise in actual fraud.[70] Nearly two-thirds (64%) of class actions settle after a court has adjudicated a motion to dismiss,[71] which is a preliminary legal indicator that the suit has some merit. Further, the size of the settlement increases at each stage of the litigation.[72] Thus, a greater proportion of an aggregate settlement figure would come from suits that have survived a motion to dismiss or summary judgment--signs that they are meritorious suits. Contrary to Petitioner's suggestion, Pet. Br. 40-41, the number of small suits may not be evidence of "in terrorem" settlements, but rather is "equally

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[69] Seligman, 108 HARV. L. REV. at 448-54).

[70] James D. Cox, *et al.*, *There Are Plaintiffs And ... There Are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements*, 61 VAND. L. REV. 355, 379-84 (2008) (arguing that the vast majority of suits are not strike suits, and that the PSLRA works to keep the number down); Marilyn F. Johnson, *et al.*, *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act* 3-7, 28-30 (U. Mich., John M. Olin Ctr. for Law & Econ., Working Paper No. 02-011, 2006), http://papers.ssrn.com/abstract=883684 (concluding that post-PSLRA lawsuits tend to be more meritorious than pre-PSLRA suits); Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1492-98 (2004) (canvassing post-PSLRA empirical analysis showing a reduction in frivolous suits); James D. Cox, *Making Securities Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 503-08 (1997) (criticizing Alexander's methods).

[71] Ellen M. Ryan, *et al.*, Cornerstone Research, *Securities Class Action Settlements: 2012 Review and Analysis* 6 (2012)

[72] *Id.* at 9 (fig. 9).

consistent with the view that highly meritorious suits are brought, but settled for too little."[73]

D. Criticisms of Attorney's Fees Are Misplaced.

Petitioner complains about the "prime, juicy 'cut'," Pet. Br. 43, that attorneys take from class action settlements, but does so by comparing apples to very small oranges. The criticism that investors pay one-third of their settlement recoveries to their attorneys[74] is simply misleading.[75] This commonly invoked claim originates from a 1999 study analyzing data of which the vast majority preceded the effective date of the PSLRA; its finding is thus outdated and of questionable relevance today.[76] In contrast, Fitzpatrick's exhaustive study of all class action settlements in 2006 and 2007 found that class

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[73] Cox, 39 ARIZ. L. REV. at 502.

[74] Pet. Br. 43; Richard A. Booth, *Class Conflict in Securities Fraud Litigation*, 14 U. PA. J. BUS. L. 701, 703 n.1 (2012).

[75] This criticism mirrors that of class actions generally. In reality, the "empirical evidence strongly suggests that class actions generate adequate compensation for claimants." Myriam Gilles and Gary B. Friedman, *Exploding the Class Action Agency Costs Myth: The Social Utility of Entrepreneurial Lawyers*, 155 U. PA. L. REV. 103, 131 (2006). According to a Class Action Reports analysis of 1,120 class actions from 1990 through 2003, for every dollar recovered, 81.6 cents went to class members, while 18.4 cents went to pay attorneys and other costs. *Id.*

[76] *See* Denise N. Martin et al., *Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions*, 5 STAN. J.L. BUS. & FIN. 121, 141 (1999). The effective date of the PSLRA was December 22, 1995, while the study's data set covered the period January 1991 through June 1998.

counsel received only 13% and 20% of the total settlement amounts, respectively.[77] When limited to securities class actions, the percentages are 11% and 20%.[78] These benchmarks are solidly *below* the usual 33% taken by a contingency-fee attorney.[79]

Indeed, as with other contingency litigation, the uncertain nature of investing in a private securities class action suit warrants a risk premium. Such lawsuits require attorneys to incur substantial upfront outlays in time and expenses that would never be recovered if the action were dismissed.[80] This risk is a significant one: of the resolved securities class actions that were filed since 1996, 41 percent were dismissed.[81] Courts generally acknowledge and compensate plaintiffs' attorneys for bearing this risk by finding that they are entitled to a risk premium.[82]

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[77] Fitzpatrick, 7 J. EMPIRICAL LEGAL STUD. at 830.

[78] *Id.*

[79] *Id.* at 830 & n.64.

[80] Michael A. Perino, *Markets and Monitors: The Impact of Competition and Experience on Attorneys' Fees in Securities Class Actions* 19 (St. John's Univ. Sch. of Law Legal Studies Research Paper Series, Paper No. 06-0034, 2006), *available at* http://ssrn.com/abstract=870577 ("The entrepreneurial plaintiffs' lawyer filing a securities class action obviously bears risk, both in terms of the possibility of non-payment should the case not result in a settlement and, even if a settlement is likely, in terms of how long it will take to reach that settlement and collect its contingency fee.").

[81] Laura E. Simmons and Ellen M. Ryan, Cornerstone Research, *Securities Class Action Settlements: 2007 Review and Analysis* 1, 14 (2008).

[82] Perino, *supra*, at 19.

Courts recognize that larger class actions should create economies of scale, so they award a lower percentage of fees as settlement size increases.[83] According to a 2004 analysis of mostly post-PSLRA data, while plaintiffs' attorney fees averaged 24% overall, "fees as a proportion of settlement declined with settlement size."[84] This conclusion is corroborated by a 2005 study, which found that fees in cases that settle for less than $5 million average 33% of the total settlement, but then drop to 26% for settlements in the $25-$100 million range, and drop even further to 19% for settlements of over $100 million.[85] Securities class counsel do not reap the obscene windfalls Petitioner contemplates.

V. The Decision of States Not To Adopt The *Basic* Presumption For Their Own Statutes Is Irrelevant.

Halliburton contends that the fact that state courts have declined to follow *Basic* and to adopt a fraud-on-the-market presumption under their own state securities statutes is a reason for this Court to disregard the presumption. Pet. Br. 24. Obviously, federalism is a two-way street and compels no such result. The states and the federal government are

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[83] Perino, *supra*, at 19.

[84] Theodore Eisenberg and Geoffrey P. Miller, *Attorneys Fees in Class Action Settlements: An Empirical Study* 1, 33 (Cornell Law Sch. Legal Studies Research Paper Series Research Paper No. 04-01, 2003), *available at* http://ssrn.com/abstract=456600. The data set for this study covered the period 1993 through 2002.

[85] Elaine Buckberg et al., NERA Economic Consulting, *Recent Trends in Shareholder Class Action Litigation: Are WorldCom and Enron the New Standard?* 7 (July 2005).

both free, within their respective authority, to enact their own laws and to enforce those laws in the manner they believe to be most suitable

This Court has recognized that the *Basic* presumption is "a substantive doctrine of federal securities-fraud law," ultimately premised on the federal securities statutes. *Amgen*, 133 S. Ct. at 1193. The federal securities laws have their own distinctive structures, histories, and purposes. Just as states are not compelled to follow federal decisions in adopting or interpreting their laws, so the federal government is not compelled to follow the states.

CONCLUSION

The judgment below should be affirmed.

Respectfully submitted.

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