

The New Supreme Court Term: Three Securities Cases

Three securities cases are on the docket as the new Supreme Court Term. A fourth significant action is pending certiorari. The three cases currently on the docket are:

- *Digital Realty Trust, Inc. v. Somers*, No. 16-1276, centered on whistleblowers;
- *Cyan, Inc. v. Beaver County Employees Retirement Fund*, No. 15-1439, focused on SLUSA and state court jurisdiction of securities class actions; and
- *Leidos, Inc. v. Indiana Public Retirement System*, No. 16-581, on the scope of Exchange Act Section 10(b), the primary claim in securities class actions.

Whistleblowers

Digital Realty centers on the question of who is a whistleblower and is entitled to the protections of the Dodd-Frank anti-retaliation provisions. The case is based on a complaint filed by former Digital Realty executive Paul Somers who brought suit after being dismissed following internal complaints about possible securities law violations. The firm's motion to dismiss, arguing that Mr. Somers was not a whistleblower as defined under Section 922 of Dodd-Frank because he did not report to the Securities and Exchange Commission, was denied by the district court. The ninth circuit affirmed. That ruling created a split among the circuits on the question of whether a whistleblower must file with the SEC or if it is sufficient to lodge a complaint with the firm under the Dodd-Frank provisions.

The case turns on the construction of two Dodd-Frank provisions. One is Section 922(a)(6) which defines a "whistleblower" as "any individual who provides . . . information relating to a violation of the securities laws to the . . ." SEC. The second is Section 922(h)(1)(A), the anti-retaliation provision, which states in part that "No employer may discharge . . . threaten, harass . . . a whistleblower . . . (i) in providing information to the Commission . . . (ii) in initiating, testifying in, or assisting . . . the Commission . . . (iii) in making disclosures that are required or protected under . . . [SOX] and any other law, rule, or regulation subject to the jurisdiction of the Commission."

Related Capabilities

- Securities & Financial Services Litigation & Enforcement

Petitioners argue that under the plain language defining the term “whistleblower,” the anti-retaliation provision does not cover a person who does not report to the SEC but only internally at the firm. In contrast, the ninth and second circuits, along with the SEC claim that read together, along with the legislative history, one need not report to the SEC to be covered by the Dodd-Frank anti-retaliation provisions. *See, e.g. Berman v. Neo@Ogilvy LLC*, 801 F. 3d 145 (2nd Cir. 2015)(agreeing with SEC that need not report to the agency first); *but see Asadi v. G.E. Energy (USA) LLC*, 720 F. 3d 620 (5th Cir. 2013)(rejecting SEC view).

The case may expand the class of those considered to be whistleblowers under Dodd-Frank. That in turn will determine, and potentially expand, the number of claims brought for retaliation under Dodd-Frank in federal court rather than under SOX which requires pursuing an administrative claim with the Department of Labor. It will also directly impact the validity of the SEC’s rule on the question which is in accord with the second circuit’s view.

SLUSA

Cyan centers on the jurisdiction of state courts over “covered class actions” – essentially those involving 50 or more persons alleging false and misleading statements. It focuses on the amendment to Section 22(a) of the Securities Act of 1933 made by the Securities Litigation Uniform Standards Act of 1998 or SLUSA regarding the jurisdiction of state court class actions. SLUSA was enacted to stem the migration of certain securities class actions to state court to avoid the strictures of the Private Securities Litigation Reform Act of 1995 or the PSLRA. That Act imposed stringent pleading standards and other requirements on securities class actions to avoid abuse.

Section 22(a) the Securities Act originally provided for concurrent jurisdiction by the federal and state courts over claims arising under the Act. SLUSA adding what is called the “except clause.” The amended Section provides for concurrent jurisdiction “except as provided in section 77q of this title with respect to covered class actions, of all suits. . .” to enforce any provision of the Securities Act. Section 77q contains a number of provisions which provide for, among other things, the removal of covered class actions and which precludes state courts from hearing state law claims that essentially mirror those typically brought as federal securities class actions – covered securities class actions.

The underlying action is based on a suit filed in state court alleging violations of the Securities Act. No state claims were included. The state courts refused to dismiss the action at the request of the defendants. While there was no split in the circuits on the meaning of the “except clause,” the United States urged the Court to hear the case, citing “confusion” in the district courts over the meaning of the “except clause.”

Petitioners argue that the plain text of the except clause requires the dismissal of the complaint here. Essentially, they read the provision as precluding state courts from hearing either federal or state law “covered” class actions. While the Respondents (plaintiffs) have not filed their briefs to date, their position is similar to, but not identical to,

that of the SEC. The agency reads the “except clause” as precluding state courts from entertaining state law claims that are essentially identical to those which are typically brought in federal class actions, that is, so-called “covered class actions.” Suits such as this one can be removed to federal court where the PSLRA standards apply, thereby effectuating the purpose of SLUSA.

The case is significant because it will define the role of state courts in “covered” securities class actions going forward.

Scope of Section 10(b)

The issue for resolution in *Leidos*, as framed by Petitioner (defendant), is “whether Item 303 of SEC Regulation S-K creates a duty to disclose that is privately enforceable under Section 10(b) . . .” of the Exchange Act. That Item, which governs disclosures in the MD&A Section of filings, requires, that “any known trends . . . events or uncertainties that will result in . . . the registrant’s liquidity increasing or decreasing in any material way . . .” be disclosed.

The case arises from a contract between the company and the City of New York, called City Time. It required the firm to develop and implement an automated time, attendance and workforce management solution for city agencies. During the term of the agreement certain employees were found to have engaged in a kickback scheme. Ultimately the firm offered to reimburse the city; it also entered into a deferred prosecution agreement with the USAO, paid about \$500 million in fines and forfeitures, and accepted responsibility for the conduct of its employees. The complaint claimed that the company made false statements and omissions regarding City Time in its SEC filings by omitting material facts about the contract and kickback scheme that should have been disclosed in accord with Item 303. The district court dismissed the complaint based on the PSLRA pleading requirements. The second circuit reversed, holding that Item 303 required that the omitted information be disclosed. In reaching that conclusion the court acknowledged that its holding conflicted with that of *In re NVIDIA Corp. Securities Litigation*, 768 F. 3d 1064 (9th Cir. 2014).

Petitioners argued in their merits brief that the resolution here hinges on whether the implied cause of action under Section 10(b) should be expanded. It should not in their view. Rather, the question in this case is one involving a “pure admission” -- that is, one where there is no duty to disclose. Here there is no such duty since the Court has only recognized such an obligation in the case of half truths or where there is a fiduciary duty. Neither theory applies here. To the contrary, the PSLRA essentially codified the elements of a private right of action under Section 10(b). Engrafting Item 303 onto those elements would redefine and impermissibly expand the cause of action.

Respondents, and the United States, reframe the issue as one centered on a “half-truth.” Item 303 requires a narrative to accompany the firm’s financial statements, ensuring that investors have sufficient information to judge the quality of the earnings. Users of SEC filings expect and rely on, compliance with the applicable regulations when using those filings. Absent compliance with Item 303 and the other applicable regulations, the filings

are essentially half-truths which deceive investors because material information is omitted. In this case it is not disputed that material information called for by Item 303 was omitted. There is no reason that the company should be able to ignore that obligation, according to respondents and the United States.

The case brings into focus the High Court's years long effort to curtail the scope of implied causes of action and, in particular, the one created by the courts under Section 10(b) and the SEC's disclosure obligations. It has the potential to define the scope of disclosures required by issuers and impact liability in securities class actions. Underlying the case is the holding in *Oran v. Stanford*, 226 F. 3d 275 (3rd Cir. 200) which, in an opinion authored by then circuit Judge Alito, reached the same conclusion as *NVIDIA*.

The docket

A key case pending certiorari is *Raymond J. Lucia Cos. Inc. v. SEC*, No. 17-130. The issue here is whether SEC Administrative Law Judges must be appointed in accord with the Constitution's Appointments Clause. The D.C. circuit agreed with the SEC that they do not. That holding was affirmed by an *en banc* court which divided evenly on the question. The tenth circuit has reached the opposite conclusion. *Brandimere v. SEC*, 844 F. 3d 1169 (10th Cir. 2016). *See also Burges v. FDIC*, No. 17-060579 (5th Cir. Sept. 17, 2017)(finding probability of success on the merits on motion for a stay by a petitioner arguing that FDIC ALJ's appointments violate the Clause). This case has the potential to invalidate the appointments of SEC ALJs and those at other federal agencies.