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Securities Law Alert

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– The Legal 500

Supreme Court: Will Hear Case on Whether SEC Administrative Proceeding Can Be Challenged as Unconstitutional While Administrative Proceeding Is Ongoing

On May 16, 2022, the Supreme Court announced that it would consider whether a defendant in an ongoing SEC administrative proceeding can sue directly in federal district court to challenge the SEC's adjudication as unconstitutional—on the ground that the SEC's in-house administrative law judges (“ALJs”) are unconstitutionally protected from removal—or whether the defendant must first complete a lengthy administrative process before being able to challenge the adjudication in federal court.[1] SEC v. Cochran, (No. 21-1239).

1. The administrative process includes a full hearing before an ALJ, appeal of the ALJ's decision to the Commission, and appeal of the Commission's final order to a circuit court.

The case relates to an ongoing SEC enforcement proceeding against a CPA alleging that she failed to comply with Public Company Accounting Oversight Board (“PCAOB”) auditing standards. While the enforcement proceeding was pending, the defendant CPA filed suit in federal district court to enjoin the proceedings, claiming that SEC ALJs were unconstitutionally insulated from presidential removal. The Fifth Circuit held en banc that the defendant CPA could challenge the constitutionality of the ALJs in district court before undergoing an administrative adjudication, on the basis that the Exchange Act did not “explicitly or implicitly strip” the district court of jurisdiction to hear structural constitutional claims challenging SEC administrative proceedings. Cochran v. SEC, 20 F.4th 194 (5th Cir. 2021) (Haynes, J). Notably, *Cochran* joins another case, *Axon Enterprise v. FTC*, 21-86, which is already before the Supreme Court concerning largely the same issue. However, the Ninth Circuit reached the opposite result in *Axon*, holding that a district court lacks jurisdiction to hear constitutional challenges to ongoing FTC proceedings. *Axon*

Enter. v. FTC, 986 F.3d 1173 (9th Cir. 2021). The Supreme Court has consolidated the briefing schedules for the two cases, but the cases will be argued separately.

The Fifth Circuit Holds That a Claim Challenging the Constitution of the Tribunal Falls Outside of Section 78y of the Exchange Act

The SEC argued before the Fifth Circuit that Section 78y implicitly stripped district courts of jurisdiction to hear structural constitutional claims. However, the Fifth Circuit pointed out that Section 78y provides that only those aggrieved by a final order of the Commission may petition to review that final order. The court observed that the statute does not address those who have not yet received a final order of the Commission or whose claims have nothing to do with any final order that the Commission might one day issue. Concluding that the claim fell outside of Section 78y, the court observed that the CPA's claim challenged the tribunal's constitution, not the legality or illegality of its final order.

The Fifth Circuit Concludes That *Free Enterprise Fund v. PCAOB* Applies

The Fifth Circuit stated that the Supreme Court had already rejected the SEC's precise jurisdictional argument under Section 78y in *Free Enterprise Fund v. PCAOB*, 561 U.S. 477 (2010). In *Free Enterprise Fund*, the PCAOB inspected an accounting firm, issued a report criticizing its auditing practices, and opened a formal investigation. The accounting firm sued in federal district court, seeking a declaratory judgment that the PCAOB was unconstitutionally structured and arguing that the PCAOB's double for-cause removal protection violated the President's Article II removal power. The government in *Free Enterprise Fund* argued that Section 78y deprived the district court of jurisdiction to hear the accounting firm's constitutional challenges. The Supreme Court disagreed, holding that the text of Section 78y does not expressly or implicitly limit the jurisdiction of the district court. The Fifth Circuit described *Free Enterprise Fund* as "squarely on point," and concluded that it foreclosed any possibility that Section 78y strips district courts of jurisdiction over structural constitutional challenges. However, the Fifth Circuit's conclusion concerning *Free Enterprise Fund* conflicts with rulings from other circuits, including the Second Circuit, which have concluded that Section 78y implicitly strips jurisdiction over prefinal challenges to enforcement proceedings.[2] The Supreme Court will consider the issue in its upcoming term.

Second Circuit: No Duty to Disclose Payment for Promotional Articles Where Payor Did Not Have Ultimate Control Over the Articles

On May 24, 2022, the Second Circuit affirmed in part the dismissal of a putative securities fraud class action alleging that a company, its former CEO, and former CFO engaged in an illegal stock promotion scheme by allegedly concealing that they paid authors to write

2. *See, i.e.*, *Tilton v. SEC*, 824 F.3d 276 (2d Cir. 2016) (Exchange Act precluded district court jurisdiction over an Appointments Clause challenge to an ongoing SEC proceeding); *Bennett v. SEC*, 844 F.3d 174 (4th Cir. 2016) (Section 78y precluded district court jurisdiction over a removal power claim).

promotional articles about the company. [Noto v. 22nd Century Grp., 2022 WL 1633827 (2d Cir. 2022) (Walker, J.)]. The court held that plaintiffs failed to state a claim that the existence of the stock promotion scheme constituted a materially misleading omission because the complaint did not adequately allege that defendants had a duty to disclose that they paid for the articles' publication. The court held that "only an article's maker, not its benefactor, has a duty to disclose that it was paid for."

Background and Procedural History

In 2017, various writers published positive online articles about the prospects for the company's stock. Many of the articles repeated statements from company press releases, FDA press releases, and the CEO's statements in earnings calls, presentations, and at conferences. Defendants paid the writers to publish the articles, but did not disclose that the company was compensating the writers. Subsequently, the company's stock price fell after articles were published online claiming that the company had engaged in a paid stock promotion scheme to illegally inflate its share price. Plaintiffs sued claiming that defendants violated Section 10(b) of the Exchange Act and SEC Rule 10b-5 by not disclosing that they were paying authors to promote the company's stock. The district court dismissed.

No Duty to Disclose That Defendants Paid for the Articles' Publication

On appeal, plaintiffs argued that defendants had a duty to disclose that the company paid the authors "because defendants provided content for, edited, reviewed, and/or approved those articles." However, the court concluded that "[b]ecause the complaint does not adequately allege that defendants had a duty to disclose that they paid for the articles' publication, plaintiffs fail to state a claim . . . ." Citing *Janus Capital Group v. First Derivative Traders*, 564 U.S. 135 (2011), the Second Circuit stated that "only an article's maker, not its benefactor, has a duty to disclose that it was paid for." The court went on to state that *Janus* made it clear that neither the company nor the executives qualified as a maker. In *Janus*, the Supreme Court held that a mutual fund investment advisor could not be liable for misstatements included in its client mutual funds' prospectuses because "the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." The mutual funds in *Janus* were determined to be the makers of the statements in the prospectuses because they filed the prospectuses with the SEC and had ultimate control over their content, while the investment advisor was not a "maker," even if he was involved in the preparation of the prospectuses.

Plaintiffs Failed to Allege Defendants Had Ultimate Control Over the Articles

The Second Circuit determined that plaintiffs did not adequately allege that defendants had ultimate control over the articles. The court found that the complaint did not contain sufficient factual allegations to support the contention that "defendants furnished information and language for, prepared, reviewed, approved, and/or ratified the articles . . . ." While statements from the company's press releases were included in the articles, the court observed that preparing a press release that is repeated in a separate article by a different author does not qualify that press-release-preparer as the maker of the separate article's statements. The court stated that in *Janus* the Supreme Court "specifically rejected a holding that would allow plaintiffs to sue a person who provides the false or misleading information that another person then puts into a statement." The Second Circuit further noted that plaintiffs failed to adequately allege that the CEO directly wrote the articles, controlled what the authors put into the articles, or even saw them before their publication.

The court pointed out that even in the event that the CEO did provide some input on the articles' content, the complaint did not support the conclusion that he was the articles' maker. The court found that the complaint did not sufficiently allege that: (i) the articles were published by anyone except the authors; (ii) the authors lacked final control over the content of the articles; (iii) the authors did not make the ultimate decision as to what specific information to include; or (iv) defendants and authors collaborated to such an extent that defendants controlled the articles' publication.

Defendants Had a Duty to Disclose an Ongoing SEC Investigation to Make Their Statements Complete and Accurate

Separately, the Second Circuit vacated the dismissal of plaintiffs' claim that defendants' failure to disclose an ongoing SEC investigation into the company's accounting controls was a material misrepresentation. Drawing on the principle that once a company speaks on an issue or topic, there is a duty to tell the whole truth, the court agreed with plaintiffs that defendants had a duty to disclose the investigation because by not mentioning it, their disclosures were misleading. As defendants had specifically noted the accounting control deficiencies, stated that they were working on them, and later stated that they had solved the issue, the court concluded that "the failure to disclose the investigation would cause a reasonable investor to make an overly optimistic assessment of the risk." Quoting *Meyer v. Jinkosolar Holdings*, 761 F.3d 245 (2d Cir. 2014).

Ninth Circuit: Forum-Selection Clause Does Not Contravene Strong Public Policy Even Where It Forecloses Ability to Bring Section 14(a) Claims

On May 13, 2022, the Ninth Circuit affirmed the dismissal of a shareholder derivative action, which plaintiff had filed in a California federal district court despite a forum-selection clause in the company's bylaws designating the Delaware Court of Chancery as the exclusive forum for derivative claims. [*Lee v. Fisher*, 34 F.4th 777 (9th Cir. 2022) (Smith, J.)]. The court held that plaintiff had not carried her "heavy burden" to show that the forum-selection clause was unenforceable, as enforcement of the clause would not contravene strong federal public policy, despite this meaning that plaintiff's ability to bring a Section 14(a) claim would be foreclosed because federal courts have exclusive jurisdiction over these claims.

The Court Must Examine Whether the Clause's Enforcement Would Contravene a Strong Public Policy of the Forum

Plaintiff brought claims alleging that the company and its directors had made false statements in its proxy statements in violation of Section 14(a) of the Exchange Act. Plaintiff argued that the company's forum-selection clause violated public policy and was unenforceable because it designated a state court as the exclusive forum. Under Section 78aa of the Exchange Act, only federal district courts may adjudicate Section 14(a) claims.[3] Thus, the company's forum-selection clause prevented plaintiff from bringing a derivative Section 14(a) claim in any court. On the issue of the clause's enforcement, the court explained that in *Atlantic Marine Construction v. U.S. District Court*, 571 U.S. 49 (2013), the Supreme Court established the rule that "a district court should transfer the case [and thereby enforce the forum-selection clause] unless extraordinary circumstances

3. Section 78aa states in relevant part: "[t]he district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter." This section further provides that "[a]ny suit or action . . . may be brought in any such district or in the district wherein the defendant is found."

unrelated to the convenience of the parties clearly disfavor a transfer." To define the phrase "extraordinary circumstances," the Ninth Circuit looked to *M/S Bremen v. Zapata Off-Shore*, 407 U.S. 1 (1972)[4] and focused on its second factor: whether the clause's enforcement would contravene strong public policy. To determine whether a forum-selection clause contravenes public policy, the Ninth Circuit first looks to "the forum in which suit is brought" and then "determine[s] whether the plaintiff has identified a statute or judicial decision in that forum that clearly states strong public policy rendering the clause unenforceable."

The Federal Policy in Favor of Enforcing Forum-Selection Clauses Supersedes the Exchange Act's Antiwaiver Provisions

Plaintiff argued that the Exchange Act's antiwaiver provision in Section 78cc(a), was proof of strong public policy rendering the clause unenforceable. However, the court disagreed, stating that "the strong federal policy in favor of enforcing forum-selection clauses supersedes antiwaiver provisions in state statutes as well as federal statutes . . . ." Quoting *Sun v. Advanced China Healthcare*, 901 F.3d 1081 (9th Cir. 2018). The court further pointed out that the Exchange Act's antiwaiver provision does not contain a clear declaration of federal policy because it does not explicitly state that any waiver is void as against public policy.

Plaintiff claimed the clause should be unenforceable based on *Seafarers Pension Plan v. Bradway*, 23 F.4th 714 (7th Cir. 2022), which held that Section 115 of the Delaware General Corporation Law prohibited an identical forum-selection clause from entirely foreclosing plaintiff's derivative action under Section 14(a) and held that the bylaw violated the Exchange Act's antiwaiver provision. However, the court stated that plaintiff had waived reliance on Section 115 and, citing *Advanced China Healthcare*, the court explained that "[m]oreover, for the reasons previously discussed, our binding precedent forecloses reliance on the Exchange Act's antiwaiver provision."

Enforcement Does Not Violate Any Express Statutory Policy of the Exchange Act's Exclusive Federal Jurisdiction Provision

The court also found that the Exchange Act's exclusive federal jurisdiction provision, 15 U.S.C. § 78aa, does not provide a clear statutory declaration and instead merely forbids non-federal courts from adjudicating Section 14(a) claims. The court pointed out that the company's bylaws did not force the Delaware Court of Chancery to adjudicate the derivative claim and would only result in the claim being dismissed in federal court. Therefore, the court concluded, "enforcement of the forum-selection clause does not violate any express statutory policy of the Exchange Act's exclusive federal jurisdiction provision."

Federal Courts' Obligation to Hear Cases Is Overcome by the Strong Presumption in Favor of Enforcing Forum-Selection Clauses

As to plaintiff's argument that federal courts are obliged to hear cases within their exclusive jurisdiction, the court determined that "this obligation is overcome by the strong presumption in favor of enforcing forum-selection clauses 'regardless [of] whether the clause points to a state court, a foreign court, or another federal court.'" Quoting *Sun v. Advanced China Healthcare*, 901 F.3d 1081 (9th Cir. 2018).

4. Under *M/S Bremen*, the three principles that establish extraordinary circumstances, are: (1) when the forum-selection clause is invalid because of fraud or overreaching, (2) when enforcement of the clause would contravene a strong public policy of the forum in which suit is brought, whether declared by statute or by judicial decision, or (3) when the forum would be so gravely difficult and inconvenient that plaintiff will for all practical purposes be deprived of his or her day in court.

Eleventh Circuit: SLUSA Held to Bar Class Action for Breach of Fiduciary Duty Claims Brought Under State Law

On May 31, 2022, the Eleventh Circuit affirmed the dismissal of a putative class action against a brokerage firm/investment adviser alleging that, under Georgia law, the brokerage firm breached its fiduciary duties by recommending certain investments to clients. *Cochran v. Penn Mut. Life Ins.*, 2022 WL 1744239 (11th Cir. 2022) (Carnes, J.). The court held that the Securities Litigation Uniform Standards Act ("SLUSA") barred plaintiff from using a class action to bring his state law claims because the claims involved allegations of misrepresentation or omission that should have been brought under the federal securities laws. Referencing 15 U.S.C. Section 77p(b), the court concluded that the class action had been properly dismissed because the complaint alleged "an untrue statement or omission of material fact in connection with the purchase or sale of a covered security."

Background and Procedural History

Plaintiff alleged that the brokerage firm breached its fiduciary duties by recommending variable annuities to clients with individual retirement accounts, causing them to pay high fees without getting an extra tax benefit because the individual retirement accounts were already tax advantaged. The brokerage firm moved to dismiss, arguing that the use of a class action was barred by federal law. The district court granted the motion, agreeing that federal law barred the class action.

SLUSA Was Intended to Prevent Plaintiffs From Using State Law Claims to Circumvent the PSLRA

The court noted that SLUSA was a response to plaintiff attempts to circumvent the Private Securities Litigation Reform Act (which heightened pleading requirements for class actions alleging fraud in the sale or purchase of securities) by basing their securities fraud class action claims on state law, rather than federal law. SLUSA limits class actions by stating, "[n]o covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—(1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or (2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security." 15 U.S.C. § 77p(b).

To Determine if a Misrepresentation or Omission Is Alleged, the Court Looks to the Gravamen or Essence of the Complaint

Citing *Behlen v. Merrill Lynch*, 311 F.3d 1087 (11th Cir. 2002), the court explained that "SLUSA's bar applies when (1) the suit is a covered class action, (2) the plaintiffs' claims are based on state law, (3) one or more covered securities has been purchased or sold, and (4) the defendant allegedly misrepresented or omitted a material fact in connection with the purchase or sale of such security." The court stated that the only issue in the case was whether the complaint alleged a misrepresentation or omission, stating that if it does so, then it is barred. The court explained that under *Behlen*, "[t]o determine whether a complaint alleges a misrepresentation or omission, we look to its gravamen or the essence of it." The court further explained that a court should focus "on the substance of the complaint, not on the labels the plaintiff chooses to give his claims, and not on the artful way a plaintiff words his allegations."

The court determined that the essence of the complaint was that the brokerage firm, through its investment advice and recommendations, "affirmatively made false statements, or failed to disclose material facts, about the suitability of the variable annuity investment for the type of account plaintiff had, and in that way made misrepresentations to the plaintiff." The court observed that if the brokerage firm's recommendations had fully disclosed all material facts, including that a variable annuity would not have tax benefits and would be an unsuitable investment, that plaintiff would have no cause of action. While plaintiff argued the conflict of interest related to the brokerage firm recommending variable annuities to generate larger fees was enough to establish his breach of fiduciary duty claim, the court explained that alleging a conflict of interest alone was not enough under Georgia law and that instead plaintiff must allege both a conflict of interest and a material misrepresentation or omission. Thus, plaintiff's claim was necessarily premised on an allegation of a misrepresentation or omission and was barred by SLUSA.

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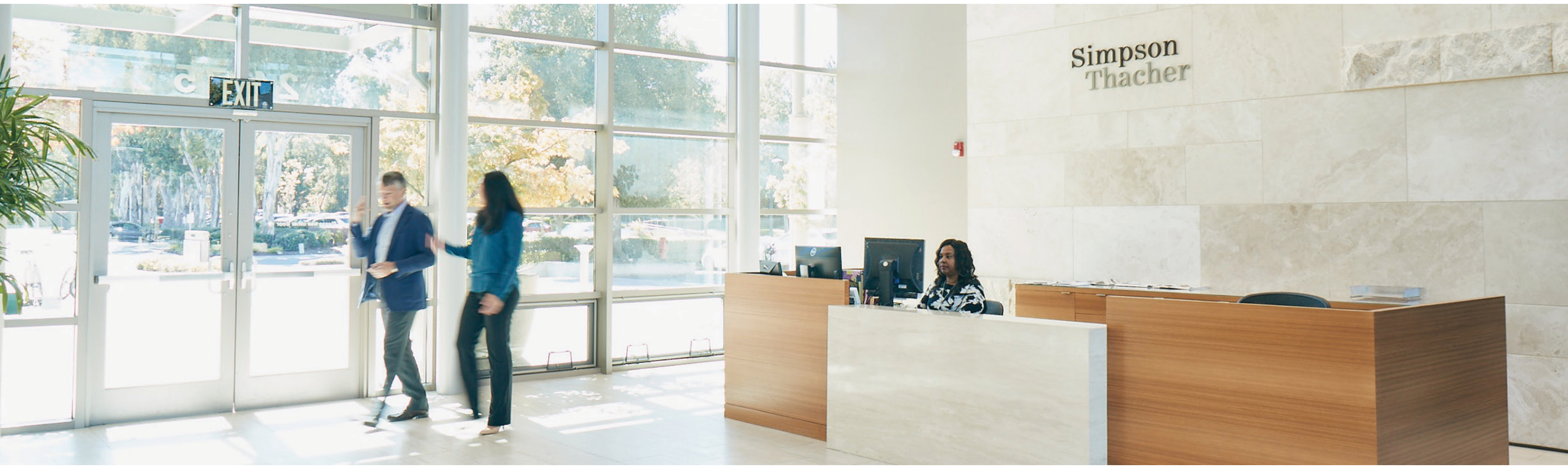

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