Simpson Thacher

# Securities Law Alert

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Simpson Thacher's securities litigation team has "a deep bench with top talent, and their young lawyers and associates provide a depth of experience."

*– Chambers USA*

## Supreme Court: The Court Hears Oral Argument on Whether Challenges to the Constitutionality of In-House Agency Enforcement Proceedings Must Wait Until Agency's Final Order Is Issued

On November 7, 2022, the Supreme Court heard separate oral arguments in *SEC v. Cochran*, No. 21-1239, and *Axon Enterprise v. FTC*, No. 21-86. At issue in both actions is whether those facing agency action before administrative law judges (ALJs) may immediately challenge the constitutionality of the in-house enforcement proceedings in federal district court—on the alleged basis that ALJs have "a blatant constitutional defect, dual-layered protection from removal"—or whether they must wait until the agency issues a final order and thereafter appeal that order to a circuit court.

In *Axon Enterprise*, the company was facing an FTC antitrust investigation and sued in federal district court, claiming that the FTC's in-house administrative proceedings violated its due process and equal protection rights and that the agency's ALJ was unconstitutionally protected from removal. Axon Enterprise alleged that the district court had subject matter jurisdiction under 28 U.S.C. Section 1331 because its claims arose under federal law. The Ninth Circuit upheld the lower court's dismissal of the case on the grounds that the judicial review section of the FTC Act "impliedly barred" district court jurisdiction under the general grant to Section 1331. *Axon Enter. v. FTC*, 986 F.3d 1173 (9th Cir. 2021). The Ninth Circuit explained that in 15 U.S.C. Section 45(c) the FTC Act provides "a detailed overview of how the FTC can issue complaints and carry out administrative

proceedings" and how respondents who are subject to an FTC cease-and-desist order can obtain review in a circuit court of appeals.[1] The Ninth Circuit noted that Section 45(c) "is almost identical to the statutory review provision in the SEC Act, which other circuits have held shows a fairly discernible intent to strip district court jurisdiction."

In *Cochran*, a CPA accused by the SEC of failure to comply with auditing standards in violation of the Exchange Act similarly filed an action in the district court to challenge the SEC's use of ALJs in its administrative proceedings. As had the district court in *Axon Enterprises*, the district court dismissed the case finding it lacked jurisdiction under 28 U.S.C. Section 1331. On appeal, however, the Fifth Circuit reversed, setting up a circuit split. The Fifth Circuit held that the constitutionality of the ALJs could be challenged in district court before an administrative adjudication because the Exchange Act's statutory review provision 15 U.S.C. Section 78y(a)(1)[2] did not "explicitly or implicitly strip" the district court of federal question jurisdiction to hear structural constitutional claims challenging SEC administrative proceedings. *Cochran v. SEC*, 20 F.4th 194 (5th Cir. 2021) (en banc).

1. "Any person, partnership, or corporation required by an order of the Commission to cease and desist from using any method of competition or act or practice may obtain a review of such order in the court of appeals of the United States, within any circuit where the method of competition or the act or practice in question was used or where such person, partnership, or corporation resides or carries on business, by filing in the court, within sixty days from the date of the service of such order, a written petition praying that the order of the Commission be set aside."

2. "A person aggrieved by a final order of the Commission entered pursuant to this chapter may obtain review of the order in the United States Court of Appeals for the circuit in which he resides or has his principal place of business, or for the District of Columbia Circuit, by filing in such court, within sixty days after the entry of the order, a written petition requesting that the order be modified or set aside in whole or in part."

Both Axon Enterprise and Cochran argued that the text of the FTC Act's and Exchange Act's statutory review provisions did not expressly limit the district court's jurisdiction. They further argued that if those Acts were read to implicitly strip the district courts of federal question jurisdiction to hear constitutional challenges, then they may face a years-long delay until the administrative process concludes to raise their constitutional challenges and would have no remedy for being forced to face allegedly unconstitutional enforcement proceedings in the first place.

During the *Axon Enterprise* oral argument, Justice Gorsuch emphasized the broad nature of the district courts' jurisdiction under 28 U.S.C. Section 1331, stating that "1331 says that district courts have jurisdiction over these claims absent any other consideration. And, normally, we consider district courts bound to exercise their jurisdiction when they have a claim." Justice Gorsuch then stated that "the FTC Act that says cease-and-desist orders can be reviewed in the courts of appeals rather than the district courts." Pointing out that there is no cease-and-desist order here, Justice Gorsuch concluded, "I would have thought that might have been the end of the game . . . ." Similarly, in the *Cochran* oral argument, Justice Alito focused on the text of the Exchange and FTC Acts, pointing out that "these two statutes don't even say exclusive jurisdiction." He appeared to question whether it was appropriate to "infer it's exclusive." Justice Alito continued to question whether the Court should further "infer that, except for some categories, some subcategory of cases, this not only gives the courts of appeals exclusive jurisdiction, but it precludes jurisdiction that district courts would have under 1331."

With respect to the Axon Enterprise's argument about a prejudicial delay, Justice Alito inquired, "What sense does it make for a claim that goes to the very structure of the agency having to go through the administrative process?" The government's attorney responded that doing so avoids piecemeal litigation and forces a party to bring all of its challenges at the same time. Weighing the practical consequences of allowing challenges to proceed in district court, Justice Kavanaugh similarly commented in the *Cochran* oral argument that the "upside" of permitting such lawsuits would be "more certainty, more clarity quicker about a basic fundamental question about the constitutionality of the agency itself or the agency's structure itself."

Chief Justice Roberts also questioned why an agency would be better suited than a district court to consider such structural claims. The government's attorney suggested that "the agency could explain, for instance, why from its perspective it was either a good or a bad characteristic to have ALJ's with for-cause removal protection." Chief Justice Roberts responded by stating, "It sounds to me like you're just saying the agency might write a brief, presumably, defending the structure of the agency, which it can do when the case goes before the district court."

## Central District of California: Claim That an Electric Vehicle Company Made a Material Misrepresentation About Customer Demand Survives Dismissal

On October 20, 2022, the Central District of California granted in part and denied in part dismissal of a putative securities fraud class action against an electric vehicle manufacturer, certain of its executives, and certain executives of the SPAC with which it merged, alleging that defendants made materially false and misleading statements regarding the number of vehicle reservations the manufacturer received for one vehicle model (the "FF 91") and the FF 91's expected launch date. *Zhou v. Faraday Future Intelligent Electric*, 2022 WL 13800633 (C.D. Cal. 2022) (Snyder, J.). The court held that plaintiffs adequately alleged that the reservation statement was a material misrepresentation because it gave investors a false impression that the company had received significantly more paid reservations than it had.

### Background and Procedural History

The company and the defendant SPAC announced their merger plans in a January 2021 press release stating that the company "had received over 14,000 reservations" for the FF 91. Subsequently, a short seller claimed in a report that the number of reservations was "fabricated because 78% of the reservations were made by a single, undisclosed affiliate" and that former executives did not believe the model was ready for production. In response, the company formed a special committee of independent directors to investigate the short seller's claims. The special committee subsequently publicly released its findings that the statements that the company had received more than 14,000 FF 91 reservations were "potentially misleading because only several hundred of those reservations were paid, while the others (totaling 14,000) were unpaid indications of interest." The stock price subsequently dropped. Plaintiffs principally claimed that the defendants' statements about the reservations violated Section 10(b). Defendants moved to dismiss for failure to state a claim.

### Plaintiffs Adequately Alleged That the Reservations Statement Was a Material Misrepresentation

In considering whether the statement about the number of reservations was a material misrepresentation, the court explained that plaintiffs must show that defendants

made a statement that was "misleading as to a material fact" such that there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available." *Matrixx Initiatives v. Siracusano*, 563 U.S. 27 (2011). While defendants argued that plaintiffs failed to plead facts controverting the literal veracity of the reservations statement, the court reasoned that plaintiffs need only "demonstrate that a particular statement, when taken in context, conveyed a false or misleading impression." The court found that plaintiffs specified each allegedly misleading statement and provided the reasons each statement was misleading with particularity. Specifically, plaintiffs alleged that: the reservations statement was misleading because the level of consumer interest and potential revenue from 14,000 paid reservations differed "dramatically" from having only several hundred paid reservations; the special committee concluded that the reservations statement was "potentially misleading" because only a few hundred reservations were paid; the short seller report claimed that 78% of the paid reservations came from an undisclosed affiliate; and the stock drop occurred after investors learned that the company had not received 14,000 paid reservations. The court determined that these allegations were "sufficient to demonstrate that the reservations statement was misleading because it gave investors a false impression that [the company] had received significantly more than several hundred paid reservations from independent potential customers."

## Northern District of California: Plaintiff Sufficiently Alleged That an Online Broker's "Significant" Receipt of Certain Payments Was an Indirect Commission Fee

On October 13, 2022, the Northern District of California granted in part and denied in part dismissal of a putative securities fraud class action alleging that an online broker violated Section 10(b) by omitting payment for order flow ("PFOF")[3] from its FAQ webpage discussion of the company's revenue sources and made false and misleading representations that its platform was commission free, when it in fact was not. *In re Robinhood Order Flow Litig.*, 2022 WL 9765563 (N.D. Cal. 2022) (Rogers, J.). The court held that plaintiff adequately pleaded that the broker made fraudulently misleading statements by omitting PFOF as a revenue source and by stating that it was a commission-free platform.

### Plaintiff's Allegations

The broker ran a mobile app and website that allowed users to engage in "self-directed securities brokerage services." Among other things, plaintiff challenged the broker's omission of PFOF from descriptions of its revenue sources on its FAQ webpage. Plaintiff claimed that this omission was misleading because PFOF was a large revenue source for the broker. Plaintiff also challenged the broker's representations that its platform provided "commission free" trading. Plaintiff alleged that the broker's receipt of PFOF served as an indirect commission fee that it passed on to users.

### Broker's Failure to Disclose PFOF in its FAQ Response on Revenue Was Actionable

In challenging the broker's omission of PFOF from descriptions of its revenue sources on its FAQ webpage, plaintiff alleged that the omission was misleading because PFOF was a large source of revenue for the broker. The broker argued that the omission was not

3. PFOF "is the payment or compensation that a brokerage or retail firm receives from principal trading firms directing orders to different market makers."

actionable because it had publicly disclosed its receipt of PFOF through various means, including on other parts of its websites, in customer agreements and in trade confirmations, and because the information was widely reported in the news. The court rejected the broker's argument, stating that by suggesting that it was answering "How [our company] Makes Money" on its FAQ webpage, it "was under a duty to ensure its disclosures on that page were complete, accurate, and not misleading." The court determined that the omission was actionable because plaintiff sufficiently alleged that the omission caused its disclosures to be "incomplete, false and misleading."

### Plaintiff Sufficiently Alleged That Broker's Commission-Free Representation Was False and Misleading

Plaintiff also alleged that the broker's description of its platform as "commission free" was false and misleading because its customers received inferior execution prices compared to its competitors' customers. Plaintiff alleged that the broker would agree to an inferior execution price for its customers than what principal trading firms were offering in exchange for receiving a higher PFOF rate, which increased the broker's profits. Plaintiff claimed that these inferior execution prices amounted to an "indirect" commission fee because the PFOF costs were effectively passed on to customers. While the broker argued that its platform was in fact commission free, the court determined that plaintiff sufficiently alleged that the broker's "significant receipt of PFOF acts as a backdoor or indirect commission fee passed to [its] users," and the challenged statement was therefore misleading.

## Southern District of New York: Class Action Dismissed Where Manufacturer Warned of Existing Regulatory Strictures, the Prospect of Heightened Regulation and Attendant Investor Risks

On September 30, 2022, the Southern District of New York dismissed with prejudice a putative securities fraud class action against a China-based manufacturer and merchant of e-cigarettes, alleging that it made misstatements and omissions in connection with its U.S. IPO concerning the prospect of stricter e-cigarette regulation in China. *Garnett v. RLX Tech.*, 2022 WL 4632323 (S.D.N.Y. 2022) (Engelmayer, J.). The court held that plaintiffs failed to plausibly plead that the company made any misleading statement or omission because, on the whole, the company's IPO offering materials fairly alerted investors to existing regulatory strictures, the prospect of heightened regulation, and the attendant risks to investors.

### Background and Procedural History

Soon after the company's IPO, Chinese regulators posted draft regulations stating that e-cigarettes would be subject to stricter regulations, bringing them in line with traditional tobacco products. Thereafter, the company's stock price dropped. Plaintiff purchasers of the company's securities claimed violations of Sections 11 and 12(a)(2) of the Securities Act. Plaintiffs alleged that, among other things, the company's offering materials provided a false and misleading narrative that the company was not facing imminent regulatory changes, characterized "existing regulatory efforts as limited in scope, rather than as harbingers of a forthcoming national standard," misleadingly claimed to be unaware of how government authorities planned to regulate e-vapor products, and inadequately disclosed the likelihood of regulation by using the word "may" to describe the prospect of future regulatory action rather than "will" or "shall." Plaintiffs alleged that Chinese regulators were preparing these stricter regulations at the time of the company's IPO and

publicly disclosed that the regulations were certain to be enacted. Defendants moved to dismiss pursuant to Federal Rule of Civil Procedure 12(b)(6).

### Viewed Together and In Context, the Offering Materials Did Not Misrepresent or Omit Material Facts

The court held that plaintiffs failed to plausibly allege a misstatement or omission that was actionable under Sections 11 or 12(a)(2). Citing *In re Morgan Stanley Info. Fund Securities Litigation*, 592 F.3d 347 (2d Cir. 2010), the court explained that "taken together and in context" the offering materials "did not misleadingly state or omit facts related to the prospect of more stringent regulation of e-cigarettes in China." The court pointed out that the offering materials "explicitly noted, as a risk factor, that changes in existing laws, regulations and policies and the issuance of new laws, regulations and policies have materially and adversely affected and may further materially and adversely affect our business operations." The court explained that the offering materials stated that Chinese government authorities "may impose more stringent laws, regulations and policies" on the e-vapor industry. The offering materials also cited strict regulatory measures taken by other countries, including taxes and outright e-cigarette prohibition. The offering materials additionally recited the various regulatory measures that Chinese authorities had already put in place as of the time of the IPO. The court further found that the offering materials alerted investors to the facts of China's existing national regulations on tobacco products while noting that they did not currently apply to e-cigarettes. The court found that the offering materials warned that there could be "no assurance" that the regulatory regime would be favorable and that the regulatory landscape was uncertain.

As to plaintiffs' argument that the offering materials should have gone further by disclosing that regulators would "inevitably" bring e-cigarettes under the same regulatory regime as tobacco, the court found that plaintiffs did "not allege facts that made the adoption of such laws a foregone conclusion."[4] The court stated that the factual allegations "depict an environment in which regulation of e-cigarettes in China had gradually tightened and could well continue over time to tighten." However, the court determined that plaintiffs' allegations did not plausibly show that regulation of e-cigarettes as tobacco products was inevitable. The court stated that "[c]ompanies subject to government regulation are not required to speculate or foresee coming regulation or its potential effect on the company."

4. Examining communications issued by Chinese regulators, the court characterized the approaches under consideration as "preliminary and precatory." The court noted that even the last regulator statement on the issue before the company's IPO did not announce that e-cigarettes would be regulated as traditional tobacco products, instead declaring only that the regulator would "actively promote the introduction of control measures for new tobacco products such as Electronic cigarettes."

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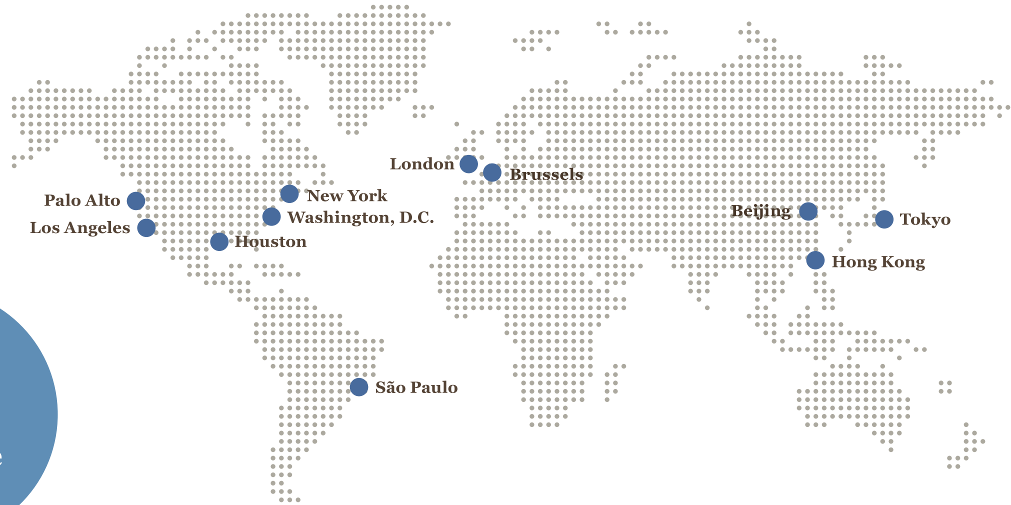


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