

CORPORATE LITIGATION:

SLUSA's 'IN CONNECTION WITH' REQUIREMENT

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The Securities Litigation Uniform Standards Act (SLUSA) precludes plaintiffs from bringing most state law class action claims in either state or federal court based on alleged misrepresentations or omissions made “in connection with” the purchase or sale of covered securities. SLUSA essentially precludes plaintiffs from attempting to impose state standards of liability for what is in substance a securities fraud claim involving nationally-traded securities. In *Chadbourne v. Troice*, 571 U.S. 377 (2014), the Supreme Court held that to bring a claim within SLUSA, the fraudulent misrepresentation or omission must be material to a decision by an investor to buy or sell a covered security.

Applying this principle to purported breach of fiduciary duty and breach of contract class action claims against securities brokers and financial advisors for improper fees has proved challenging. The U.S. Court of Appeals for the Ninth Circuit’s decision reversing a SLUSA dismissal of state law fiduciary claims last month in *Anderson v. Edward D. Jones & Co., L.P.*, 990 F.3d 692 (9th Cir. 2021), illustrates that particularly in fee-related cases the line between federal securities law claims and state law claims remains inexact. Although prior Ninth Circuit case law characterized SLUSA’s “in connection with” requirement as a “slim hurdle,” *Anderson* emphasized that SLUSA preclusion is not boundless and “does not transform every breach of fiduciary duty into a federal securities violation.”

Background

Congress enacted SLUSA to ensure that federal law generally governs securities class actions. It accomplished this by giving federal courts exclusive jurisdiction over most class actions involving nationally traded securities (investors in securities offerings who allege class action claims under the Securities Act of 1933 may bring those claims in state court if the suit asserts only 1933 Act claims). While SLUSA denies plaintiffs the ability to use the class action device to bring certain state law claims, it leaves intact the ability to bring such claims on an individual basis. SLUSA preclusion applies where: (1) the lawsuit is a “covered class action;” (2) the claim is based on state statutory or common law; (3) the claim concerns a “covered security;” (4) the plaintiff alleges a “misrepresentation or omission of a material fact;” and (5) the misrepresentation or omission is made “in connection with the purchase or sale of a covered security.” If a state court class action satisfies all the SLUSA criteria, the defendant may remove it to federal district court and the district court must dismiss. 15 U.S.C. §78bb(f)(2).

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‘Anderson’

Plaintiffs alleged that they were buy-and-hold investors whose accounts generated few trades and commissions per year, and that the defendants, components of a privately owned financial services firm, breached their fiduciary duties by moving plaintiffs (after in-person consultation with their financial advisors at defendants and receipt of substantial written disclosures) into accounts that charged an annual asset-based fee regardless of the activity in the account. Plaintiffs sued in California federal court alleging violations of the federal securities laws, including §§10(b) of the Securities Exchange Act of 1934, together with breach of state-law fiduciary duties, alleging that defendants acted deceptively in moving plaintiffs’ commission-based accounts to fee-based accounts.

The fiduciary duty claim alleged that defendants, contrary to standards promulgated in Financial Industry Regulatory Authority (FINRA) Rule 2111, failed to conduct a “suitability analysis” before inviting these limited-trading customers to switch to fee-based accounts. The federal securities claim alleged that defendants failed to disclose that financial advisors did not conduct a suitability analysis to assess whether a fee-based account was suitable or otherwise in the best interests of clients, before transferring clients from commission-based accounts to fee-based accounts. Plaintiffs claimed that “[t]he commission-based/fee-based dichotomy is critical and material to any investment decision, including Lead Plaintiffs’ and the Class members’ investment decisions to transfer them from commission-based accounts into fee-based accounts.”

The district court dismissed the federal securities claim because of various pleading defects, and the state law fiduciary duty claims under SLUSA. The district court characterized the fiduciary duty causes of action as alleging a misrepresentation or omission based on defendants not conducting a suitability analysis. Although plaintiffs asserted that their fiduciary allegations were not based on misrepresentations or omissions, the district court determined that SLUSA precluded plaintiffs from alleging a state law fiduciary duty claim and a federal securities claim based on the same conduct when plaintiffs sought to characterize the same lack of a suitability analysis as an omission for the federal law claim, but not an omission for the state law claim. Plaintiffs appealed only the SLUSA dismissal of the fiduciary duty claim.

The Ninth Circuit reversed, concluding that “[e]ven if Plaintiffs’ complaint is internally inconsistent, that does not mean that SLUSA automatically blocks them from bringing their state law claims as a class action.” The court acknowledged that SLUSA precludes a fiduciary duty claim from proceeding as a class action if those claims give rise to a Rule 10b-5 claim. The court, however, focused on a distinction between whether a plaintiff *could* have pursued a claim pursuant to Rule 10b-5 and whether a plaintiff *did* pursue that claim pursuant to Rule 10b-5.

For SLUSA to preclude a class action, the defendant’s alleged misrepresentation or omission must be “in connection with the purchase or sale of ... a covered security.” 15 U.S.C.A. §78bb(f)(1)(A). Evaluating whether the alleged breach of defendants’ fiduciary duties—i.e., the purported lack of client suitability analysis—was “in connection with” the purchase or sale of a covered security, the Ninth Circuit concluded it was not. The court surveyed recent Supreme Court guidance on the meaning of the phrase “in connection with,” and noted that the Supreme Court has stated that “it is enough that the fraud alleged ‘coincides’ with a securities transaction—whether by the plaintiff or by someone else.” *Merrill Lynch, Pierce, Fenner & Smith v. Dabit*, 547 U.S. 71, 85 (2006).

Then in *Chadbourne & Parke v. Troice*, 571 U.S. 377, 387 (2014), the Supreme Court ruled that the phrase requires a showing of materiality: “A fraudulent misrepresentation or omission is not made ‘in connection with’ such a ‘purchase or sale of a covered security’ unless it is material to a decision by one or more individuals (other than the fraudster) to buy or sell a ‘covered security.’” Most lower courts have concluded that *Troice*’s emphasis on materiality—insistence that the misrepresentation makes a significant difference to someone’s decision to

purchase or to sell a covered security—was a clarification, not a change of *Dabit*. But the Ninth Circuit in *Anderson* emphasized that the interpretive “shift” has real significance.

Acknowledging a lack of clarity in prior Ninth Circuit guidance concerning the effect of *Troice*’s materiality requirement on what is needed to trigger SLUSA preclusion, *Anderson* took the “opportunity to clarify that the fourth prong of [the SLUSA] test—‘in connection with the purchase or sale, ... — must include an inquiry into the materiality of the alleged misrepresentation or omission to the purchase or sale of a covered security.’” With this materiality requirement in mind, the Ninth Circuit agreed with plaintiffs’ assertion that defendants’ failure to conduct a suitability analysis lacked a connection to the purchase or sale of a covered security.

The court relied on case law from other circuits, including the Second, Seventh and Eleventh, holding that SLUSA does not preclude state law claims alleging excessive transaction fees because a reasonable investor would not have made different purchase or sale decisions based on the transaction fees at issue. See *Brink v. Raymond James & Assocs.*, 892 F.3d 1142 (11th Cir. 2018); *Appert v. Morgan Stanley Dean Witter*, 673 F.3d 609, 617 (7th Cir. 2012); *Feinman v. Dean Witter Reynolds*, 84 F.3d 539, 541 (2d Cir. 1996). While *Brink* challenged the nature of transaction fees (undisclosed profit on a processing fee for each transaction—because investors knew what they were paying overall, the allocation behind the scenes was immaterial), and *Appert* and *Feinman* challenged the amount of transaction fees, the Ninth Circuit concluded that the purported lack of a suitability analysis alleged in *Anderson* was even “less material to the trading of covered securities than the brokers’ actions in *Brink* and the other fees cases.”

According to the Ninth Circuit, it was not the amount of fees charged to plaintiffs which rendered those fees immaterial. “Instead, the fees are immaterial because the...complaint alleges that plaintiffs did not buy or sell any covered securities because [defendants] switched them to fee-based accounts. Nowhere do plaintiffs allege that they would have purchased or sold different covered securities had [defendants] conducted a suitability analysis, which might have resulted in plaintiffs remaining in commission-based accounts.” The Ninth Circuit also rejected the argument that plaintiffs’ closing their investment accounts was equivalent to buying or selling a covered security, reasoning that “[c]hoosing a broker or specific type of account is fundamentally different than choosing to buy or sell a covered security.”

The *Anderson* court also rejected defendants’ analogizing the alleged failure to conduct a suitability analysis to SLUSA preclusion case law based on broker-dealers’ alleged breach of the duty of best execution when making customer trades. In *Fleming v. Charles Schwab*, 878 F.3d 1146 (9th Cir. 2017), for example, the Ninth Circuit stated that the “in connection with” requirement is a “slim hurdle,” and held that the materiality requirement was satisfied and SLUSA precluded a fiduciary duty claim for a broker-dealer’s alleged breach of the duty of best execution in completing customer trades, because “[t]he net price obtained when purchasing or selling a security is plainly material to a buyer or seller.” *Id.* at 1155.

The flat fees at issue in *Anderson* differed from the charges in *Fleming*, the Ninth Circuit concluded, because the *Anderson* fees “affect[ed] the net value of plaintiffs’ assets stored in an ... account, but the fees as alleged d[id] not affect the net price of buying or selling securities for that account.” Because the purported lack of a suitability analysis did not affect the price of any security when it was bought or sold, Plaintiffs in *Anderson* did not allege that they would not have made certain trades, as plaintiffs had in *Fleming*.

Conclusion

As in other securities law contexts, the key materiality question when evaluating whether an alleged misrepresentation was “in connection with” a purchase or sale decision is whether a reasonable investor would attach importance to the fact misrepresented in determining their course of action. *Anderson* signals that, at least in the Ninth Circuit, courts will interpret SLUSA narrowly and not determine a misrepresentation to have

been made “in connection with” the purchase or sale of a covered security unless it is likely to influence the price or quantity (or some other factor with similar connection to the securities themselves) at which clients could buy and sell securities. In addition, the court is likely to follow a permissive approach to “pleading in the alternative,” so that state law claims in tension with or even contradictory of a federal securities law claim may be able to survive SLUSA challenge.

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