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PERSPECTIVE

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Securities law at the high court

By Alex Romain and Jenna Williams

This term, the U.S. Supreme Court will consider three cases related to securities litigation and enforcement. These cases deal with a broad range of topics — the statutory interpretation of the Dodd-Frank Act and its whistleblower protections, the jurisdictional reach of state courts in certain securities class actions, and separation of powers issues related to the appointments clause of the U.S. Constitution. We also discuss a fourth case, which was accepted for review but which has since been stayed pending settlement, because it presents an important question that the court is likely to review in the future.

Digital Realty Trust, Inc. v. Somers (on appeal from the 9th Circuit). The issue at stake in this case is how to define a "whistleblower" under the Dodd-Frank Act. Do anti-retaliation provisions for whistleblowers apply to individuals who report misconduct internally to their companies but have not reported the conduct to the SEC? The 5th U.S. Circuit Court of Appeals found that a person is a whistleblower only when that individual reports conduct to the SEC. By contrast, the 2nd and 9th Circuits have held that an internal report is enough to confer whistleblower protections.

Whatever the Supreme Court's ruling, it will remain a best practice to encourage and foster a culture of internal reporting, and to ensure that the first hint of a problem is not coming from the SEC. And regardless of the court's interpretation of Dodd-Frank, other whistleblower protections exist under both federal law (principally, Sarbanes-Oxley) and state law for employees who report internally. In California, for example, individuals receive protection as whistleblowers for reporting violations of local, state or federal law internally. Cal. Labor Code Section 1102.5. Numerous other states have similar protections, including but not limited to New Jersey, Florida, Hawaii, Minnesota, New Hampshire and Missouri. See Brief of Lime Energy Services Co. and Prestige Cruises International as Amicus Curiae, at 12-21.

ROMAIN

WILLIAMS

Cyan, Inc. v. Beaver County Employees Retirement Fund (on appeal from the California Court of Appeal). In this case, the Supreme Court will decide whether the Securities Litigation Uniform Standards Act permits class action plaintiffs bringing only claims under the Securities Act of 1933 to use state courts to circumvent the tougher provisions that now apply only in federal court (under the Private Securities Litigation Reform Act).

This case will have an outsized impact on litigants in California. State courts in California — including the decision before the Supreme Court — have ruled that the Securities Litigation Uniform Standards Act allows state courts to preside over class actions brought under the '33 Act. And class action plaintiffs have taken the cue, increasingly choosing California state courts as their forum. The Supreme Court's decision, however, may limit plaintiffs' freedom to shop for a favorable forum.

Lucia v. Securities and Exchange Commission (on appeal from the D.C. Circuit). In this case, the Supreme Court will determine whether SEC administrative law judges are "inferior Officers" under the appointments clause. At present, the SEC staff selects judges from a group of candidates identified by the Office of Personnel Management. But if the Supreme Court concludes that the SEC judges are "inferior Officers," and not mere "employees," they must be appointed pursuant to the requirements of the appointments clause, which would require the "Head of [the] Department[]," or the commission, to appoint them.

The short-term impact of this case for litigants will depend on how the court crafts a remedy if it finds a constitutional violation. If the court holds that the SEC judges have been "inferior Officers" all along, and have, for decades, been unconstitutionally presiding over proceedings, what happens next? Will all past and present administrative actions heard by SEC judges be dismissed and expunged because of the unconstitutionally appointed judge who presided over the case? That is unlikely. But if the court finds that the SEC's practice violates the appointments clause, the appropriate remedy is not easy to determine.

In the meantime, the SEC has purported to fix, preemptively, any possible appointments clause violations by issuing an order "ratif[ying] the

New York Times News Service

agency's prior appointment of" the SEC judges and ordering them to undertake a review of existing cases. Order, *In re Pending Administrative Proceedings*, Securities Act Release No. 10,440 (Nov. 30, 2017). While we wait to see how the court decides the appointments clause question and whether it provides any guidance on the sufficiency and effect of the SEC's order, defendants subject to SEC administrative actions (and even defendants subject to other administrative proceedings in front of SEC judges) should preserve this argument in ongoing proceedings.

Leidos, Inc. v. Indiana Public Retirement System (on appeal from the 2nd Circuit, held in abeyance pending settlement). The issue presented to the Supreme Court is whether the failure to disclose "known trends or uncertainties" (under Item 303 of Regulation S-K) constitutes an actionable omission under Rule 10b-5.

The 2nd Circuit has allowed a company's violation of Item 303 to serve as a basis for a Rule 10b-5 claim, which requires a plaintiff to allege that a defendant made a material misrepresentation or omission about the purchase or sale of a security. This ruling created inconsistency with several circuits and a split with the 9th Circuit, which has held that a violation of Item 303 does not give rise to an actionable omission under Rule 10b-5, because the standard for a material omission under Rule 10b-5 is higher than the standard required for a violation of Item 303. *See Basic Inc. v. Levinson*, 485 U.S. 224, 237 (1988).

Defendants should raise and preserve the argument that Item 303 is not an appropriate hook for a Rule 10b-5 claim. Defendants should also consider making this argument when plaintiffs use other rules or sections of the securities regulations as the predicate for Rule 10b-5 violations, particularly where the applicable standard is different than the one that applies to Rule 10b-5.

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