



## Securities Litigation ADVISORY ■

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### Supreme Court Interprets Jurisdictional Provision of the Federal Securities Laws

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On May 16, 2016, the Supreme Court issued its opinion in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Manning*, in which the Court resolved a Circuit split concerning the jurisdictional provision of the Securities Exchange Act of 1934.<sup>1</sup> The Court held that the test for federal court jurisdiction under § 27 of the Exchange Act should be the same as the test governing “federal question” jurisdiction under 28 U.S.C. § 1331, *i.e.*, whether the case “arises under” federal law.<sup>2</sup> Based on this conclusion, and the Third Circuit’s unchallenged finding that the claims did not “arise under” the federal securities laws, the Court held that the case should be allowed to proceed in state court.<sup>3</sup>

Given the relatively unique facts of the case, it seems unlikely that this decision will result in an increase in the number of securities-related state court filings. The complaint in *Merrill Lynch* purported to rely exclusively on state law and alluded only in passing to the possibility that the same alleged conduct might also violate federal law. As discussed below, other provisions of the federal securities laws, not at issue in *Merrill Lynch*, continue to preclude plaintiffs from bringing the more common type of securities claims in state court. There were, for example, no putative class claims in *Merrill Lynch*, which is the reason why those claims were not preempted by the federal securities laws.

### Factual Background and Lower Court Decisions

Seven former shareholders of Escala Group, Inc., brought claims against certain financial institutions claiming that they engaged in “naked” short sales of Escala common stock, which drove down its stock price and allegedly harmed its investors.<sup>4</sup> The plaintiffs filed their complaint in New Jersey state court, alleging various New Jersey common

<sup>1</sup> Slip op., No. 14-1132 (May 16, 2016).

<sup>2</sup> Justice Kagan delivered the opinion of the Court, which Chief Justice Roberts and Justices Kennedy, Ginsburg, Breyer and Alito joined. Justice Thomas filed a separate opinion concurring in the judgment, which Justice Sotomayor joined.

<sup>3</sup> *Merrill Lynch*, slip op. at 18.

<sup>4</sup> *Id.* at 1. A short sale occurs when a person borrows stock from a broker and then sells the borrowed shares on the market in hopes that the stock price will decline thereafter. The short seller is betting that when the time comes to purchase the same number of shares to return them to the broker, the purchase price will be lower than the sale price and he or she will pocket the difference. *See id.* at 2. A “naked” short sale occurs when “the seller has not borrowed (or otherwise obtained) the stock he puts on the market, and so never delivers the promised shares to the buyer.” *Id.*

law and statutory claims.<sup>5</sup> While the plaintiffs did not purport to bring any claims under the federal securities laws or regulations, the complaint did specifically reference SEC Regulation SHO, which prohibits short sellers from intentionally failing to deliver borrowed securities.<sup>6</sup> The complaint described the purpose of that rule and repeated accusations that the defendants may have violated the rule in the past.<sup>7</sup>

The defendants removed the case to the District Court of New Jersey, asserting that the court had jurisdiction under § 1331's federal question jurisdiction, which grants District Courts jurisdiction over "all civil actions arising under" federal law and under § 27 of the Exchange Act, which grants federal courts exclusive jurisdiction over "all suits in equity and actions at law brought to enforce any liability or duty created by [the Exchange Act] or the rules and regulations thereunder."<sup>8</sup> Plaintiffs moved to remand the case, arguing that neither statute provided federal jurisdiction over their collection of state law claims. The District Court denied the motion, but the Third Circuit Court of Appeals reversed.<sup>9</sup> The Third Circuit held that § 1331 did not grant jurisdiction over the suit because all of the claims at issue were brought under state law and did not necessarily raise a federal issue.<sup>10</sup> Likewise, the Court of Appeals held that § 27 of the Exchange Act did not grant jurisdiction because it covers only those cases involving the Exchange Act that would satisfy the "arising under" test applied under § 1331.<sup>11</sup> The Supreme Court granted certiorari to resolve a Circuit split regarding the scope of federal court jurisdiction under § 27.<sup>12</sup>

## The Supreme Court's Analysis

The Supreme Court rejected the parties' proposed interpretations of § 27 and instead agreed with the Third Circuit, holding "that § 27's jurisdictional test matches the one we have formulated for § 1331, as applied to cases involving the Exchange Act."<sup>13</sup> The Court found that this conclusion was supported by the text of § 27, which speaks in terms of suits "brought to enforce" the Exchange Act.<sup>14</sup> Thus, § 27 "confers federal jurisdiction when an action is commenced in order to give effect to an Exchange Act requirement."<sup>15</sup> The "language [of § 27], in emphasizing what the suit is designed to accomplish, stops short of embracing any complaint that happens to mention a duty established by the Exchange Act."<sup>16</sup> This does not mean, however, that only suits explicitly asserting a cause of action under the Exchange Act are covered by § 27. The Supreme Court made clear that § 27 would also cover "a suit raising a state-

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<sup>5</sup> *Id.* at 2-3.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.* at 3.

<sup>8</sup> 28 U.S.C. § 1331; 15 U.S.C. § 78aa(a).

<sup>9</sup> *Merrill Lynch*, slip op. at 3.

<sup>10</sup> *Manning v. Merrill Lynch Pierce Fenner & Smith, Inc.*, 772 F.3d 158, 161, 163 (3d Cir. 2014).

<sup>11</sup> *Id.* at 166-67.

<sup>12</sup> *Merrill Lynch*, slip op. at 4 & n.1.

<sup>13</sup> *Id.* at 8.

<sup>14</sup> *Id.* at 6.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

law claim [if that claim] rises or falls on the plaintiff's ability to prove [a] violation of a federal duty."<sup>17</sup> In other words, "[i]f ... a state-law action necessarily depends on a showing that the defendant breached the Exchange Act, then that suit could also fall within § 27's compass."<sup>18</sup>

The Supreme Court went on to find that an existing jurisdictional test—the one used for federal question jurisdiction under § 1331—adequately captures the type of suits “brought to enforce” a duty under the Exchange Act.<sup>19</sup> Under § 1331, “a federal court has jurisdiction over a state-law claim if it ‘necessarily raise[s] a stated federal issue, [which is] actually disputed and substantial...’”<sup>20</sup> That description also fits cases “in which a state-law cause of action is ‘brought to enforce’ a duty created by the Exchange Act because the claim’s very success depends on giving effect to a federal requirement.”<sup>21</sup> Thus, the Supreme Court concluded § 27 provides federal court jurisdiction only where the case also meets the “arising under” standard for federal question jurisdiction under § 1331.<sup>22</sup>

The Third Circuit’s determination that § 1331 jurisdiction did not exist was not challenged on appeal. This fact was necessarily determinative of the outcome given the Court’s decision that § 27 covered the same ground as § 1331. Because on appeal there was no dispute that there was no jurisdiction under § 1331, it necessarily meant that there could be no jurisdiction under § 27 and the plaintiffs’ claims had to be remanded to state court.<sup>23</sup>

## Observations Regarding the Court’s Ruling

It is somewhat odd that the Court chose to give § 27 the exact same interpretation as § 1331, which essentially renders superfluous the separate (and distinctly worded) jurisdictional provision of the Exchange Act. But the Court was apparently motivated to stake out the middle ground rather than embrace the alternative interpretations offered by the litigants. The Court also stopped short of saying that purely state law claims can never proceed in federal court. Rather, the Court made clear that some complaints alleging only state law violations may nevertheless be pursued in a federal forum because of the inherent connection those claims have to federal law.

As noted above, it is also unlikely that the particular fact pattern that arose in *Merrill Lynch* will often be repeated—namely, the filing of a complaint that does not seek to recover under federal law nor is dependent on any federal law violation but nevertheless speculates (without seeking any relief on the subject) that the conduct at issue might also violate federal law. Indeed, the Supreme Court noted that, had it ruled a mere reference to federal law was sufficient to establish federal court jurisdiction, it would be easy for a plaintiff to simply “purge his complaint of any references to federal securities law, so as to escape removal.”<sup>24</sup> In other words, the reference to federal law in the *Merrill Lynch* Complaint appears to have been entirely gratuitous.

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<sup>17</sup> *Id.* at 7.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 8.

<sup>20</sup> *Id.* (internal citations omitted).

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *Id.* at 18.

<sup>24</sup> *Id.* at 17.

Moreover, *Merrill Lynch* is also unlikely to have much impact on where securities claims are litigated because other provisions of federal law, not at issue in *Merrill Lynch*, govern the preferred forum for class-based securities claims. Most securities claims are brought on behalf a putative class of shareholders. The Securities Litigation Uniform Standards Act (SLUSA) preempts any attempt to bring state law claims regarding a misrepresentation or omission of material fact or the use of a manipulative or deceptive device in connection with the purchase or sale of a publicly traded security if the claims are brought on behalf of a group of 50 or more persons.<sup>25</sup> The federal securities laws not only preempt state law claims under SLUSA, but SLUSA also provides for removal of state law claims to federal court and requires their dismissal post-removal.<sup>26</sup>

SLUSA did not apply in *Merrill Lynch* because the claims at issue were bought by seven shareholders who did not purport to represent a class of other investors. Had the case been brought by or on behalf of a large group of investors (which is the more typical scenario), there would have been no doubt that, under SLUSA, the claims could proceed only in federal court pursuant to the federal securities laws.

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<sup>25</sup> 15 U.S.C. § 78bb(f)(1).

<sup>26</sup> 15 U.S.C. § 78bb(f)(2)

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