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Supreme Court Rejects Federal Jurisdiction over State Law Claims that Do Not Necessarily Raise Exchange Act Issues

In *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Manning*, No. 14-1132 (May 16, 2016), the Supreme Court held that the provision of exclusive federal jurisdiction in the Securities Exchange Act of 1934 (“Exchange Act”) does not generally extend to claims brought under state law even if the complaint refers to purported Exchange Act violations. This ruling gives greater latitude to plaintiffs seeking to keep their cases in state court while invoking the language of federal securities laws or regulations in their complaints – so long as they do not actually assert federal causes of action.

Background

Plaintiffs, shareholders in Escala Group, Inc. (the “Escala shareholders”) alleged that the defendant financial institutions had participated in “naked” short selling of Escala stock,¹ which increased the pool of tradable shares by creating fictitious or counterfeit shares. They claimed that this increase in Escala shares diluted their voting rights and caused the value of their shares to decline. Naked short selling is not per se illegal under federal law, but some naked short selling schemes may violate the Exchange Act and Regulation SHO, a regulation promulgated by the United States Securities and Exchange Commission. Regulation SHO, among other things, imposes “Locate” and “Close-Out” requirements on broker-dealers in an attempt to limit naked short-sales.²

The Escala shareholders asserted ten causes of action, all under New Jersey statutes and common law and none expressly asserting federal law causes of action. The complaint, however, repeatedly characterized the conduct as violative of rules, regulations or regulatory prohibitions: it repeatedly cited the federal Regulation SHO, the only federal rule or regulation governing naked short selling, and alleged violations of its Locate and Close-Out requirements.

The Lower Court Decisions

The Escala shareholders filed suit in New Jersey state court. The financial institutions removed the action to the United States District Court for the District of New Jersey, claiming federal question jurisdiction under 28 U.S.C. § 1331 and exclusive federal jurisdiction under § 27 of the Exchange Act. They asserted that federal question jurisdiction existed because the Escala shareholder claims necessarily raised substantial and disputed issues of federal law, and that jurisdiction existed under section 27 because the claims came with that section’s coverage of “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.” The Escala

shareholders moved to remand the case to state court because their claims were, on their face, all brought under state law.

The District Court denied the motion to remand. It concluded that it had jurisdiction under § 27 as well as federal question jurisdiction under 28 U.S.C. § 1331. On interlocutory appeal, the Court of Appeals for the Third Circuit reversed the district court's decision. 772 F.3d 158 (3d Cir. 2014). It found no general federal question jurisdiction pursuant to § 1331 under the test of *Grable & Sons Metal Products, Inc. v. Darue Engineering & Manufacturing* 545 U.S. 308 (2005),³ because, in its view, the federal issue under Regulation SHO was not “necessarily” raised. It concluded that the case might ultimately be resolved under New Jersey law without proof of a violation of that regulation. Turning to § 27, the Third Circuit held that the grant of federal jurisdiction in that statute was no greater in scope than jurisdiction under § 1331 – it differed only in that federal jurisdiction under § 27, where it existed, was exclusive and divested state courts of concurrent jurisdiction. *Id* at 167-68.

The Supreme Court granted certiorari to consider “[w]hether § 27 of the Securities Exchange Act of 1934 provides federal jurisdiction over state-law claims seeking to establish liability based on violations of the Act or its regulations or seeking to enforce duties created by the Act or its regulations.”

The Supreme Court Decision

The Supreme Court, in an opinion joined by six of the eight Justices, upheld the Third Circuit's ruling. It held that, while the language of § 27 (“brought to enforce any liability or duty created by” the Exchange Act) differs from that of § 1331 (“arising under federal law”), the two provisions have the same meaning. In each case, the four-part *Grable* test applies. In this particular case, because the defendants did not challenge the ruling below that the case could conceivably be resolved without resolving the Exchange Act issue – and thus the federal issue was not “necessarily raised” – the test for federal jurisdiction was not satisfied.

The Court held that § 27 would grant federal jurisdiction over state law claims only where the state law claims hinge entirely on a showing of a violation of the Exchange Act. It gave as an example a hypothetical state statute that “simply makes illegal ‘any violation of the Exchange Act involving naked short selling.’”

Two concurring Justices would have reached the same outcome, but would have applied under § 27 a test different from § 1331. The concurring Justices would have asked whether the state law claim necessarily depends on a breach of a requirement created by the Exchange Act, without regard to the other elements of the *Grable* test.

Analysis

The decision in *Manning* is likely to have limited practical impact. The defendants in this case had an argument for removal to federal court under § 27 because the plaintiff had repeatedly – and unnecessarily – invoked the federal Regulation SHO in his complaint. The plaintiff could instead have alleged that the conduct at issue violated New Jersey statutory and common law without referring specifically to Regulation SHO, and presented the same claims. Indeed the Supreme Court commented that if such invocation of federal regulation were a basis for federal jurisdiction, a plaintiff could simply “purge his complaint of any references to federal securities law,” which would “do nothing to change the way the plaintiff can present his case at trial; they will merely make the complaint less informative.” Careful plaintiffs wishing to avoid removal of claims such as these could have done so even if the Court had read § 27 more broadly. This case is therefore unlikely to have a substantial effect on the scope of federal jurisdiction over state law claims touching on issues of federal securities law.

The Supreme Court’s ruling downplays the substantial interest in uniformity of construction of the federal securities laws, which was reflected in Congress’ decision to make federal jurisdiction under § 27 exclusive. The Court’s opinion notes that it has the ability to review state court decisions and, in any event, that state courts could – under existing doctrine – already resolve Exchange Act issues arising from defenses or counterclaims. It gives greater weight to the desirability of uniform application of jurisdictional rules across the various statutes and respect for “constitutional balance between state and federal judiciaries.”

The Supreme Court did not address in its decision the issue of whether or when a federal question under the securities laws is “necessarily” raised. Its example, a state statute that does nothing more than incorporate and enforce a federal securities regulation, is a simple one. More complex situations sometimes arise, where the courts undertake their own exploration of the duties underlying state law claims and consider whether those duties turn on the Exchange Act.⁴ For example, a claim of negligence under state law, in the context of a claim against a broker-dealer, may entail analysis of that defendant’s performance of a duty imposed by the Exchange Act. In such cases, it may still be possible for defense counsel to construct an argument that a federal question is “necessarily” raised. However, the Court’s expressed solicitude for state court jurisdiction will likely lead lower courts to scrutinize such arguments carefully.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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¹ “Naked short selling” occurs when traders sell shares they do not own or borrow, or ever intend to own, and never deliver the shares that they sell, which leads to the creation and circulation of unauthorized shares.

² The “locate” requirement mandates a broker-dealer, before it executes a short sale order, to have “reasonable grounds” to believe that a security can be borrowed and delivered within three days. 17 C.F.R. § 242.203(b)(1). The “close out” requirement is triggered once a fail to deliver has occurred and persisted for thirteen days. At that point, a broker-dealer may be required to purchase and deliver securities “of like kind and quantity.” 17 C.F.R. § 242.203(b)(3).

³ The Court in *Grable* held that federal jurisdiction over a state law claim will lie if a federal issue is: “(1) necessarily raised, (2) actually disputed, (3) substantial, and (4) capable of resolution in federal court without disrupting the federal-state balance approved by Congress.” 545 U.S. at 312.

⁴ *E.g., NASDAQ OMX Group, Inc. v. UBS Securities, LLC*, 770 F.3d 1010 (2d Cir. 2014) (holding that state law claims against NASDAQ OMX required consideration of the exchange’s underlying duties based on the Exchange Act).