

Attys Eye Cases Impacting SEC Enforcement Powers In 2018

By **Dunstan Prial**

Law360, New York (January 1, 2018, 3:04 PM EST) -- Securities litigators in 2018 will be closely monitoring a handful of Supreme Court cases that could significantly impact how the U.S. Securities and Exchange Commission regulates the financial industry, including its ability to interpret statutes it's charged with enforcing and how it imposes disgorgement in enforcement rulings, for decades a powerful tool in its repertoire.

Should the U.S. Supreme Court re-evaluate the Chevron doctrine, which affirmed regulatory agencies' wide latitude in interpreting the federal laws they enforce, in its upcoming decision in *Digital Realty Trust Inc. v. Paul Somers*, the impact could be felt far beyond the SEC.

Meanwhile, a footnote included in the high court's June ruling in *Kokesh v. the SEC* could lead to challenges over the SEC's authority to seek disgorgements. And in *Lucia v. the SEC*, a decision favoring a former investment adviser hit with a lifetime ban by an SEC administrative law judge could call into question the legitimacy of past ALJ rulings.

While all three cases represent potential challenges to the status quo, a ruling in the *Digital Realty* case on the broader issue of the Chevron doctrine — which has given significant deference to agencies in interpreting federal law — could ultimately lead to a shift in the manner in which an array of regulators operate.

"If the court goes down that road, it might call into question all kinds of federal regulation where agencies have interpreted federal statutes that could impact all kinds of regulated industries, including energy, food and drugs, the environment, and labor relations," said David Kornblau, chair of Covington & Burling LLP's securities litigation group.

The case focuses on whether employees can bring whistleblower claims under the 2010 Dodd-Frank Act's anti-retaliation provision even if they didn't report their concerns about possible securities law violations to the SEC. Oral arguments were heard in November and a ruling is expected by June.

Dodd-Frank expanded whistleblower incentives and protections created under the 2002 Sarbanes-Oxley Act, while defining whistleblowers as employees who provide "information relating to a violation of the securities laws to the commission." A ruling that adheres strictly to the wording in Dodd-Frank would exclude employees who report internally, historically a much larger category than those who report to the SEC.

During oral arguments, several justices appeared to lean toward a narrow definition, citing the very precise wording of the statute. "But there you are — you have this definitional provision, and it says what it says," Justice Elena Kagan said, according to a transcript of the hearing.

But hovering over the specific statutory issue is whether the justices will use the case as a vehicle to challenge Chevron deference. Recently seated Justice Neil Gorsuch has been vocal in his opposition to the Chevron doctrine's concept of giving wide deference to federal regulatory agencies' interpretations of federal statutes, and Digital Realty could provide an opening to challenge that standard.

Justice Gorsuch offered a hint during oral arguments in Digital that he may well go down that road. He questioned lower court findings in the Digital case that deferred to the Chevron standard, affording the SEC latitude in interpreting the Dodd-Frank definition of whistleblowers, saying those rulings seemingly allow "an agency to swallow a large amount of legislative power and judicial power in the process."

Kornblau said it's possible some of the high court justices may want to explore reducing the level of deference that courts generally give to federal agencies in how they administer statutes, which he said touches on the larger question of "how much power do federal government agencies have as opposed to courts and Congress."

"It's a balance of power issue," Kornblau explained.

Another potential challenge to the SEC in 2018 involves the agency's ability to issue disgorgements, long a valued and lucrative SEC tool. The SEC said it ordered nearly \$3 billion in disgorgements in fiscal year 2017, up from \$2.8 billion a year earlier.

The Supreme Court has already ruled in *Kokesh v. the SEC*, finding in June that disgorgements authorized by the SEC in enforcement actions are penalties rather than equitable remedies and should be subject to the same five-year statute of limitations that applies to other SEC penalties.

It's a footnote in Justice Sonia Sotomayor's written opinion in *Kokesh*, however, that has attorneys eyeing the case into 2018. The footnote states the ruling should not be interpreted as a finding on whether the courts are authorized to order disgorgements in SEC enforcement proceedings.

By adding that footnote, attorneys say the justice left open the question of whether the SEC is, in fact, authorized to order disgorgements, potentially removing that important and lucrative tool.

The court "went out its way" in the footnote to separate its ruling in *Kokesh* from the larger question of whether the courts have the authority to order disgorgements, which suggests the "court may be skeptical of the SEC's authority to impose disgorgement in enforcement cases," said Peter Morrison, a partner at Skadden Arps Slate Meagher & Flom LLP.

The scope is also potentially broad in *Lucia v. the SEC*, in which the Supreme Court is poised to resolve a split between the Tenth Circuit and the D.C. Circuit over whether ALJs are inferior officers or regular federal employees. Defense lawyers say the case could call into question all past rulings by the SEC's in-house judges.

The high court is mulling whether to hear Lucia's case or that of Colorado resident David Bandimere, both of which stemmed from challenges to sanctions handed down by ALJs. Lucia's and Bandimere's

cases reached the high court due to split rulings at the D.C. and Tenth circuits, respectively.

The D.C. Circuit found in August 2016 that ALJs are not “inferior officers” that need to be appointed by the president or “head” of a department, upholding an ALJ’s sanctions against Lucia. The Tenth Circuit found the opposite last December, ruling in Bandimere’s case that ALJs are “inferior officers” subject to the appointments clause and overturned the sanctions against Bandimere.

Since Lucia filed his petition for writ of certiorari in July, the SEC has reversed its position on ALJs. The U.S. Office of the Solicitor General, writing last month on behalf of the SEC in a brief to the Supreme Court, said it now sees the in-house judges as officers of the United States who should be subject to the provisions within the appointments clause, and not merely employees. The SEC urged the court to grant Lucia’s petition and resolve the circuit split.

If the court takes that route and then sides with Lucia, finding the ALJs weren’t properly appointed, attorneys say it could open the door to challenges of prior rulings handed down by ALJs who weren’t hired under the provisions required in the appointments clause.

Scott D. Musoff, a partner at Skadden, said, “The question is going to be, ‘Are they going back to review all of their old decisions? Will this result in collateral attacks on prior decisions?’”

If that happens, it raises the possibility that many past rulings handed down by ALJs are no longer valid, said Alex Lipman, a partner at Brown Rudnick LLP who has challenged ALJ rulings on behalf of clients.

“In this circumstance, if the Supreme Court agrees that ALJs were not properly appointed, it’s my position that all of the prior cases are void. They just go away,” said Lipman. “This is a situation in which the whole proceeding is void. And because it’s void, we win.”

The SEC declined to comment on how it might be impacted by the rulings.

In a fourth case being watched into the new year, securities attorneys are hoping a ruling by the U.S. Supreme Court in *Cyan Inc. v. Beaver County Employees Retirement Fund* can bring clarity to a dispute over whether Congress had intended to bar state courts from hearing certain types of securities class actions brought under federal law. Litigators say the dispute has left California state courts awash in securities suits against newly public companies and led to confusion as to where securities suits should be filed.

“We’re all looking forward to clear guidance on that,” said Noelle Reed, a partner at Skadden.

The petitioner in the case, a former telecommunications company, argues that a 20-year-old federal law enacted to scale back alleged frivolous securities suits prohibits state judges from hearing covered class actions brought under the 1933 Act if they involve more than 50 shareholders. The respondent says the law actually just bans state courts from hearing suits that mix both federal and state securities law claims.

The issue is important to business interests that hope the Supreme Court will shut down what they see as a thriving cottage industry in California state courts, in which shareholder attorneys target newly public companies with allegedly frivolous and often duplicative claims over drops in their stock price.

Kevin Broughel, a partner in the litigation department at Paul Hastings LLP, said a ruling in the case

“presents an opportunity for the Supreme Court to slow the flow of securities acts cases to the state courts.”

“Plaintiffs asserting Securities Act claims have been filing more and more in state courts because they can circumvent the federal procedural requirements of the Private Securities Litigation Reform Act,” Broughel explained. The PSLRA is a 1995 law enacted in an effort to reduce frivolous securities suits by raising the standards of evidence required for a case to move forward.

Supreme Court justices didn’t indicate during oral arguments which way they were leaning, with two of them instead describing the statutes on which they need to base their ruling as “gibberish.” While there was no clear majority for either position, members of the court appeared to be set on resolving a complex statutory question buried in the dense wording of the statute.

“It’s difficult to say which way the case will go. The common theme was that the statute was gibberish,” said Broughel. “That doesn’t provide much input into what the outcome will be.”

--Editing by Philip Shea and Aaron Pelc.