

## SCOTUS Ruling Shows Limits of Securities Exchange Act's Exclusive Jurisdiction Clause

A look at the implications of 'Merrill Lynch v. Manning'

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On May 16, in *Merrill Lynch v. Manning*, the U.S. Supreme Court affirmed the Court of Appeals for the Third Circuit's remand of the litigation to New Jersey Superior Court despite allegations in the complaint of violations of federal securities regulations and the exclusive federal jurisdiction clause of the Securities Exchange Act of 1934. The opinion, which resolved a Circuit split, certainly will directly impact plaintiffs' strategic decisions in choosing to file in federal or state forums and how they plead their causes of action. It also could prove to substantially impact litigations involving other federally-regulated industries, such as energy and natural gas.

In *Merrill Lynch*, the Supreme Court was asked to determine what standard courts must apply when determining whether an action falls within section 27 of the Exchange



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Act's exclusive jurisdiction clause, which states "The district courts of the United States ... shall have exclusive jurisdiction of violations of [the Exchange Act] or the rules and regulations thereunder, and 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." 15 U.S.C. §78aa(a).

*Merrill Lynch* declares, or at least reinforces, that the exclusive jurisdiction clause has its limits. Merely because an action includes allegations (but not claims) of violations of the Exchange Act does not mean federal question jurisdiction will exist. Instead, in determining

whether a suit asserting only state law causes of action has been "brought to enforce any liability or duty" under section 27 of the Exchange Act, the Supreme Court expressly held that courts must apply the same four-part test used to analyze general federal jurisdiction under 28 U.S.C. §1331. Thus, shareholders of a publicly traded company may avoid federal jurisdiction even when filing state law causes of action that are based, in part, on allegations of violations of federal securities regulations. Although one immediate consequence of the decision is a road map for how plaintiffs may inject federal securities issues into state law claims in state court

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without triggering removal, *Merrill Lynch* may impact litigations beyond securities laws, as at least nine other federal statutes include jurisdictional provisions similar to section 27 of the Exchange Act.

## From NJ Superior Court to the Third Circuit

In May 2012, shareholders of Escala Group, led by Greg Manning, filed a complaint in New Jersey Superior Court against Merrill Lynch and other financial institutions, alleging that the defendants participated in “naked” short selling of Escala’s stock. This, they allege, increased the amount of shares on the public market and drove down Escala’s stock price. Naked short selling means short selling without first borrowing the stock from a broker or determining that the stock may be borrowed in time to deliver it to the buyer. There are legitimate reasons for engaging in a naked short sale, but naked short selling also can violate federal law, such as when it is used to manipulate the price of securities by flooding the market with additional shares. The complaint in *Merrill Lynch* alleges only state law causes of action, including a violation of New Jersey’s RICO Act and New Jersey securities fraud. However, to demonstrate liability on the state law claims, the complaint also includes extensive allegations of violations of Regulation SHO, which the Securities and Exchange Commission promulgated to govern the practice of short selling.

Arguing that the allegations of the underlying violations of a federal regulation form a basis for federal question jurisdiction, the defendants removed to the United States District Court for the District of New Jersey. The district court denied plaintiffs’ motion for

remand, but certified an interlocutory appeal to the Third Circuit.

The Third Circuit reversed and ordered remand to state court. The Third Circuit first rejected the argument that federal question jurisdiction existed under 28 U.S.C. §1331. In its analysis, the Third Circuit applied the four-part test set forth in *Grable & Sons Metal Products v. Darue Engineering & Manufacturing*, 545 U.S. 308 (2005), for determining if there is federal jurisdiction over a suit concerning only state law claims: (1) a question of federal law must be “necessarily raised” within the suit, (2) actually disputed, (3) substantial, and (4) capable of resolution in federal court without disrupting the federal-state balance approved by Congress. The Third Circuit found the first element—whether a question of federal law was “necessarily raised”—not satisfied because the plaintiffs did not completely predicate their state law claims on a violation of Regulation SHO, and because a court could decide the case without reference to federal law by finding, for example, that the defendants committed a fraud in violation of New Jersey law regardless of whether such conduct also violated Regulation SHO.

The Third Circuit also rejected the argument that section 27 of the Exchange Act provided a basis for finding federal jurisdiction independent from section 1331. Relying on *Pan American Petroleum Corp. v. Superior Court of Delaware Insurance for New Castle County*, 366 U.S. 656 (1961), which interpreted a similar exclusive jurisdiction provision in the Natural Gas Act, the Third Circuit held that “exclusive jurisdiction” in section 27 of the Exchange Act “merely serves to divest state courts of jurisdiction” after federal jurisdiction has been established, but

it did not affirmatively create federal jurisdiction. Merrill Lynch appealed to the Supreme Court on this issue.

## The Supreme Court’s Decision

The Supreme Court unanimously affirmed the Third Circuit, 8-0. Justice Kagan wrote the opinion for the court, in which five other justices joined. Justice Thomas wrote a separate opinion concurring in the judgment, in which Justice Sotomayor joined. The two opinions take two different paths to get to the same judgment.

The court rejected both sides’ interpretations of the import of section 27. On the one hand, Merrill Lynch argued that section 27’s seemingly broad language of “brought to enforce any liability or duty created by [the Exchange Act]” means that any time a state law claim is based, in part, on an explicit or implicit allegation of a breach of a duty created by the Exchange Act or its regulations, the action automatically is exclusively the subject of federal jurisdiction. This is too broad of a view of section 27, said Justice Kagan. Meanwhile, the plaintiffs argued that courts should only look to the source creating the claims, and if all claims asserted are based in state law, then federal question jurisdiction should never be found. Justice Kagan found this interpretation of section 27 to be too narrow because it would result in no federal question jurisdiction even when a plaintiff asserts a state law claim in a way that necessarily requires the plaintiff to prove a violation of the Exchange Act or its regulations.

Consistent with the Third Circuit’s rationale, the court declared that the correct approach to determine whether federal district courts have exclusive jurisdiction over a given dispute asserting only state law claims

but concerning duties and liabilities created by the Exchange Act and its regulations is to apply the four-part test of *Grable* to determine whether the action “arises under” the act. Only then will section 27 serve to divest state courts of jurisdiction.

The court acknowledged that, in practice, this means district courts essentially must interpret section 27’s “brought to enforce” language the same as section 1331’s “arising under” language, despite Congress’ obviously different choices of words in the two statutes. For Justice Kagan and five other justices of the Supreme Court, however, such a result is more desirable and more “straightforward and administrable” than creating a new test for determining when federal jurisdiction exists specially made for certain securities cases.

In addition to valuing simplicity and consistency, the court emphasized federal-state comity. Although sensitive to the need to promote uniformity of federal law—in particular, a robust regulatory scheme like the securities laws that provides for exclusive federal jurisdiction—the court appeared more concerned with avoiding an interpretation of section 27 (or the other nine federal statutes like it) that would divest state courts of jurisdiction over a complaint asserting only state law claims simply because the complaint includes allegations (but not claims) of violations of federal law.

Justice Thomas and Justice Sotomayor, like the court, also rejected both sides’ interpretation of section 27. However, Justice Thomas argued that the plain text of section 27 and section 1331 demonstrate that they should not be interpreted exactly the same way.

For whatever value *Grable* has when analyzing most instances in which a defendant removes a complaint of wholly state law claims based on federal question, Justice Thomas wrote that, in the context of section 27 of the Exchange Act, the only issue that matters is whether the resolution of a claim in the action “necessarily depends on a breach of a requirement created by the Act.” Essentially, to determine whether section 27 confers federal jurisdiction, Justice Thomas would analyze only the first *Grable* factor, ignoring the other three factors. The court rejected Justice Thomas’ approach as inconsistent with precedent and as undermining the goal of establishing consistent, predictable jurisdictional rules.

### Significant Consequences

Resolving a split among the Circuits on the interpretation of section 27, *Merrill Lynch* provides a road map for how plaintiffs may file and keep an action in state court while still using alleged violations of federal securities laws to support state law claims and obtain remedies that may not be available or are more difficult to obtain under the Exchange Act (e.g., treble and punitive damages, attorney fees). According to a report published quarterly by Davis Polk & Wardwell, since the Dodd Frank Act was enacted in 2010 amending the Exchange Act and other statutes, federal agencies have promulgated over 200 final rules pursuant to the act, dozens of which the SEC promulgated. To be sure, several of these regulations relate to other statutes or are technical, compliance issues unlikely to be the focus of litigation, but many constitute regulations under the Exchange Act and could be

relevant to demonstrating liability for state law causes of action. A plaintiff mindful of the *Grable* factors now knows how to insert such issues into state claims in state court without risking removal.

The impacts of this decision stretch beyond securities litigation. At least nine other statutes contain similar jurisdiction provisions: the Federal Power Act of 1935, the Natural Gas Act of 1938 and the Hot Oil Act of 1935 contain the same exclusive jurisdiction provision; the Securities Act of 1933, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the International Wheat Agreement Act of 1949 and the Interstate Land Sales Full Disclosure Act of 1968 contain similar language, but jurisdiction is not exclusive. Thus, for example, in litigations involving the rates and transmission of electricity and natural gas, plaintiffs may attempt to use allegations of violations of complex federal regulations promulgated by the Federal Energy Regulatory Commission to underpin state law claims in state court complaints while still avoiding removal.

Critics might decry that *Merrill Lynch*’s interpretation of section 27 could increase the risk of inconsistent applications of federal laws between state and federal courts. However, even if this risk is real, the court found it to be a risk better worth taking rather than unnecessarily divesting state courts of jurisdiction, as it is “less troubling for a state court to consider [such federal issues] than to lose all ability to adjudicate a suit raising only state-law causes of action.” Time will tell if that risk becomes a reality.