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JUDGE KAVANAUGH: Good for Corporations, Bad for Your Wallet

INTRODUCTION

When people think of the Supreme Court, they think of cases about women's rights, abortion rights, health care, immigration, gay rights, race and discrimination, the death penalty, the right to privacy, climate change, the environment and civil rights. That's because they are important, controversial and, often, politically charged cases widely covered by the media. However, there is another large category of important Supreme Court cases that impact the livelihoods, wealth, financial well-being and quality of life of every American: economic and financial cases that rarely get any mention beyond legal publications, much less mainstream media coverage.

Every year, the Supreme Court decides many critically important cases relating to all of those issues. The upcoming term of the Supreme Court starting this October will be no different, except that a new justice may be deciding those cases. That potential justice, Brett Kavanaugh, has a record on business and financial cases that is hostile to the economic interests of working Americans, particularly if they are ripped off or injured by corporations. There is little doubt that if Judge Kavanaugh is confirmed, he will tilt the scales of justice in favor of corporations over consumers, workers, investors and retirees, while gutting the financial regulatory agencies' ability to protect the public from scammers, predators and crooks.

The bottom line is that anyone who has a savings or checking account, credit card, debit card, mortgage, student loan, car loan, retirement plan, personal loan, college savings fund, publicly traded stock or any other financial product or service – meaning every single American – has to care about the Supreme Court's momentous decisions that affect every one of those critical financial issues for every American family. Put differently, if you care about what's in your wallet, you should be very worried if judge Kavanaugh becomes Justice Kavanaugh on the Supreme Court.

In this report, we first review key pending Supreme Court cases, then analyze elements of Judge Kavanaugh's record on the Court of Appeals for the D.C. Circuit and, finally, detail the key Supreme Court holdings in the economic and financial arena, demonstrating the high stakes all Americans have in the next Justice of the Court.

ANALYSIS

I. CRITICALLY IMPORTANT SUPREME COURT CASES COMING THIS YEAR.

The Supreme Court's October 2018 docket is packed with important cases, and a vote by Kavanaugh will be critical to them all, as one commentator recently observed:

> Why, then, is [Republican Senate Majority Leader Mitch] McConnell so eager to push through Kavanaugh's nomination before the documents are released? Aside from the looming election, there is one clear reason: The Supreme Court has stacked its October docket with major cases that will require Kavanaugh's vote for a conservative victory. In the first 10 days of October, the court will hear cases involving environmental protections, age discrimination in employment, the execution of mentally disabled death-row inmates, mandatory arbitration, and immigrant detention. Without Kavanaugh's vote, any or all of these cases could deadlock 4–4, allowing the liberal justices to thwart a conservative rout. With Kavanaugh's vote, the Supreme Court could quickly begin rolling back the liberal components of Justice Anthony Kennedy's legacy.[1]

That docket, however, also includes important cases in the areas of economics, finance and consumer and investor protection, and Judge Kavanaugh's vote will be equally crucial in those areas. They involve interpretation of the anti-fraud provisions of the securities laws, the enforceability of arbitration agreements, class action pleading standards and class certification, and pre-emption of state law. Every one of those cases will affect the financial health of almost every American worker, consumer, investor, saver or retiree. Here is a snapshot of just a few of those forthcoming cases. Depending on how the Court decides them, it may –

> ***Every one of those cases will affect the financial health of almost every American worker, consumer, investor, saver or retiree.***

- **Vastly limit the scope of the laws and rules written to prevent securities fraud:** Whether an allegation that does not meet the elements of Rule 10b-5(b), as established in *Janus Capital Group, Inc. v. First Derivative Traders*, because the misstatement was made by someone other than the defendant, can nevertheless be pursued as a fraudulent-scheme claim under Rule 10b-5(a) and (c). *Lorenzo v. Securities and Exchange Commission*, No. 17-1077. This case will make a huge difference in how the antifraud provisions of the securities laws are applied to those who are heavily involved in acts of securities fraud but do not technically "make" fraudulent statements.

- **<u>Close the courthouse door to injured plaintiffs and force them into a confidential, biased, and ineffective arbitration process:</u>** Whether a court can decline to enforce an agreement delegating questions of arbitrability to an arbitrator if the court concludes the claim of arbitrability is "wholly groundless." *Henry Schein Inc. v. Archer and White Sales Inc.*, No. 17-1272. Cases involving mandatory arbitration clauses are almost always important, since they determine whether an injured consumer or investor will be allowed to seek meaningful damages in court or will be relegated to the arbitration process, which typically affords little relief.

- **<u>Narrow specific exemptions in the Federal Arbitration Act that are designed to allow at least some classes of plaintiffs to seek remedies in court:</u>** Whether the exemption in the FAA for "contracts of employment" covers independent contractor agreements, and whether an arbitration panel or a court should decide the issue. *New Prime Inc. v. Oliveira*, No. 17-340. Here again, the scope of the Federal Arbitration Act and its carve-outs are central to consumer and workers' rights—in this case—independent contractors.

- **<u>Stifle the rights of consumers to seek relief under state law:</u>** Whether the Food and Drug Administration's decision not to require a risk warning for an osteoporosis drug preempts a state-law failure-to-warn claim brought by those injured by the drug. *Merck Sharp & Dohme Corp. v. Albrecht*, No. 17-290. State laws and remedies are increasingly important, and this case will have a profound impact in at least one area of consumer law.

[Kavanaugh] is likely to side consistently with corporations over investors and consumers and to rule against the financial regulatory agencies seeking to protect the public.

- **<u>Alter the way proceeds in class action settlements are distributed, especially where sending the money to individual members of the class is impracticable:</u>** Whether a lower court abused its discretion in deciding to devote the bulk of a class action settlement to public interest organizations, where distribution to class members was impracticable. *Frank v. Gaos*, No. 17-961. Class actions are especially important mechanisms for securing relief where the injury suffered by each individual plaintiff is not large enough to justify a stand-alone case. They also serve the important purpose of deterring future misconduct. The outcome of this case will shape several important factors that determine how class actions can best be resolved to achieve these goals.

If Judge Kavanaugh is confirmed for the Supreme Court, he will be ruling on these and many more critically important cases that will impact the lives and financial well-being of all Americans. As detailed in the next section on Judge Kavanaugh's decisions as a judge on the D.C. Circuit Court of Appeals and as a legal commentator, he is likely to side consistently with corporations over investors and consumers and to rule against the financial regulatory agencies seeking to protect the public.

II. <u>JUDGE KAVANAUGH'S DECISIONS CONSISTENTLY FAVOR CORPORATIONS OVER CONSUMERS, INVESTORS, WORKERS AND ALL HARDWORKING AMERICANS.</u>

Shortly after Judge Kavanaugh was nominated to the Supreme Court by President Trump on July 9, 2018, the Trump Administration began touting his pro-business decisions and his track record of voting against regulatory agencies charged with protecting the health, safety, welfare and financial security of Americans. But being good for business, which usually means the largest corporations in the world, is often bad for workers, consumers, investors and victims of all sorts of illegal conduct. Judge Kavanaugh has repeatedly shown solicitude for corporations and a lack of concern for, or even awareness of, the extensive harm they can cause to hardworking Americans, who should be compensated when harmed.

A. <u>Judge Kavanaugh's record shows extreme hostility towards independent regulatory agencies that protect the health, safety, welfare and financial well-being of Americans.</u>

A good deal of attention has rightly focused on Judge Kavanaugh's strongly held view that independent regulatory agencies pose a grave threat to individual liberty and the bedrock principle of separation of powers. Epitomizing that view is his opinion in a key case relating to the Consumer Financial Protection Bureau ("CFPB"), arguably the most successful consumer protection agency in the history of the country, which has returned more than $12 billion to more than 27 million ripped off Americans in just five years.[2]

Judge Kavanaugh's opinion is filled with hostility toward independent agencies charged with protecting consumers, along with baseless assessments of the alleged threat they pose to individual liberty and our system of government.

That case was ***PHH Corp. v. Consumer Financial Protection Bureau*, 839 F. 3d 1 (D.C. Cir. 2016).** In *PHH Corporation*, the Court held that the CFPB's structure violated the separation of powers doctrine because the Bureau (1) was headed by a single director, rather than by multiple directors, who (2) could only be removed for cause. According to Judge Kavanaugh's majority opinion, these two flaws made the agency far too unaccountable to the President.

Judge Kavanaugh's opinion is filled with hostility toward independent agencies charged with protecting consumers, along with baseless assessments of the alleged threat they pose to individual liberty and our system of government. After opening his opinion by declaring that "This is a case about executive power and individual liberty," Judge Kavanaugh summarized his view this way:

> The independent agencies collectively constitute, in effect, a headless fourth branch of the U.S. Government. They exercise enormous power over the economic and social life of the United States. Because of their massive power and the absence of Presidential supervision and direction, independent agencies pose a significant threat to individual liberty and to the constitutional system of separation of powers and checks and balances.[3]

Noticeably absent from Judge Kavanaugh's extensive analysis of the history of independent agencies and the separation of powers doctrine is any acknowledgement of the enormous benefit that executive branch agencies confer on consumers, investors, workers and other Americans by protecting them from the relentless, ingenious, and harmful predatory actions by corporations, including many in the financial services industry. Nor does he address the CFPB's significant track record established in just a few years in furtherance of critical consumer protection goals, such as compensating ripped off consumers while also reducing the likelihood of another horrific financial crash.

Judge Kavanaugh's decision to undermine the consumer protection bureau is a one-sided, pro-corporation, anti-consumer, ideologically driven opinion.

Adding insult to injury, his opinion also suffers from the absence of credible evidence that the CFPB structure has actually led to any abuses threatening individual liberty, which, even if they occurred, could be corrected by the courts or Congress. Put differently, protecting and compensating consumers ripped off by the biggest financial firms in the world simply cannot constitute a threat to their "individual liberty." In fact, the opposite is true: Allowing corporations to prey on unprotected consumers is a threat to their savings, their investments, their livelihoods and their standard of living. It is fair to say that Judge Kavanaugh's views are a threat to the life, liberty and pursuit of happiness of Americans fighting to achieve the American Dream for their families.

In short, Judge Kavanaugh's decision to undermine the consumer protection bureau is a one-sided, pro-corporation, anti-consumer, ideologically driven opinion, which will likely be the model for a Justice Kavanaugh on the Supreme Court.

Fortunately, Judge Kavanaugh's decision on the structure of the CFPB was later reversed by the full D.C. Circuit Court sitting *en banc* (over Kavanaugh's strenuous dissent) (***PHH Corp. v. Cons. Fin. Protec. Bur.*, 881 F. 3d 75 (D.C. Cir. 2018)**). But it provides a troubling forecast of the approach he likely will take in cases challenging acts of independent regulatory agencies—no matter how effective those agencies have been at enforcing the law and protecting consumers and investors. Worse, once on the Supreme Court, there will be no opportunity for an *en banc* court to overturn his unwise and unsupported opinions, which will become the law of the land.

B. Judge Kavanaugh would limit the ability of the SEC to punish and deter fraud.

Judge Kavanaugh believes that the SEC should be very limited in its ability to pursue and punish fraudsters, even when they intentionally rip people off, which will greatly limit the agency's ability to protect investors. Moreover, he thinks he knows better than all of the experts at the SEC, including the Chairman and Commissioners, who collectively have many decades of experience in dealing with lawbreakers and applying the law to protect investors. In attempting to substitute his conception of market oversight for all of that collective expertise, in a recent case regarding the anti-fraud provisions of the securities laws, Judge Kavanaugh cherry-picked a few facts from the fully-developed record in an SEC enforcement action to support his position that the SEC's best judgment was wrong.

In ***Lorenzo v. Securities and Exchange Commission,*** **872 F. 3d 578 (D.C. Cir. 2017)**, the D.C. Circuit held that an investment banker had participated in a scheme to commit fraud where he knowingly disseminated fraudulent emails to investors that were written by his boss. The D.C. Circuit upheld the SEC's factual finding that although Lorenzo acted with intent to break the law (known as "scienter"), he was not the "maker" of the statements that he assembled into an email he sent to investors "on behalf of" his boss, and thus did not violate Rule 10b-5(b).[4] The panel did find, however, that as a matter of law, even where a person does not "make" a fraudulent statement within the meaning of Rule 10b-5(b), he may nevertheless be liable for participating in a scheme to defraud in violation of subsections Rule 10b-5(a) and (c).

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Judge Kavanaugh disagreed and his dissenting opinion is noteworthy for several reasons.

- He chose to place his faith in selected exculpatory factual findings of the administrative law judge ("ALJ") (including self-serving testimony of Lorenzo that he "sent the emails without even thinking about the contents"), despite the fact that the ALJ and the full Commission had concluded that these facts were sufficient to show that Lorenzo acted "willfully."[5] Ignoring much of the comprehensive record, Judge Kavanaugh said "the SEC's rewriting of the findings of fact deserves judicial repudiation, not judicial deference or respect."[6]

- He took a hyper-narrow view of the anti-fraud provisions in the securities laws and faulted the SEC for attempting "for decades" to expand the scope of primary liability under the securities laws.[7] In other words, he faulted the SEC for protecting ripped off investors and victims and pursuing fraudsters and other lawbreakers.

- He expressed hostility toward the "administrative adjudication of individual disputes," which he described as "in some tension with Article III of the Constitution, the Due Process Clause of the Fifth Amendment, and the Seventh Amendment right to a jury trial in civil cases."[8]

- And in an almost bizarre turn, even after acknowledging the dubious character of "securities brokers such as Frank Lorenzo," who Judge Kavanaugh conceded was perhaps really "guilty of negligence (or worse)," he nevertheless urged reversal of the sanction, without once mentioning the victims of Lorenzo's fraud.[9]

Judge Kavanaugh joined in a unanimous decision striking down an important provision of the Dodd-Frank Act designed to prevent the financial market time bomb that resulted from complex and worthless securities being sold to millions of unsuspecting investors.

This case is now on the Supreme Court docket and, if Judge Kavanaugh is confirmed as a Supreme Court justice, he will once again get to vote on the case and try to convince his colleagues to agree with his views. If he succeeds and the Supreme Court rules in accordance with those views, then he will have created innumerable loopholes for fraudsters to avoid getting caught and punished. Worse, countless investors will never be compensated for their losses.

C. <u>Judge Kavanaugh would undermine financial reform protections for Main Street by very narrowly interpreting laws.</u>

One of the main causes of the 2008 financial crash was the "originate to distribute" model of creating fraudulent and worthless securities investments, with the aim of churning out massive profits for the financial industry. This happened because the banks and bankers creating and distributing those products pocketed large fees or commissions upfront regardless of what happened to those investments. Even if they failed or defaulted, bankers got their money. As a result, millions of borrowers and investors ended up with worthless pieces of paper, inflating the subprime bubble that ultimately collapsed the financial system.

One Congressional solution to this dire problem was a risk retention requirement – those originating and packaging mortgages, for example, were required to retain a certain amount of economic exposure to the securitized products that they were selling. Originators forced to keep "skin in the game" would be less likely to sell worthless investments if they too were exposed to loss.

In ***Loan Syndications & Trading Association v. Securities and Exchange Commission,* 818 F.3d 716, 724 (D.C. Cir. 2016)**, Judge Kavanaugh joined in a unanimous decision that carved out a huge loophole in the new risk retention requirements. The three-judge panel reversed the district court and held that companies that manage or assemble open-market "collateralized loan obligations" (CLOs) cannot be regarded as "securitizers" under the Dodd-Frank Act. Accordingly, the court held, those managers do not have to retain any portion of the risks created when they bundle already risky commercial loans into securities for sale to investors. In short, at least for one type of CLO, the managers do not have to keep any "skin in the game" and Congress's additional incentive to select only quality loans for inclusion in those CLOs has been judicially nullified.

The court concluded that Congress had spoken directly to the issue of risk retention through clear, unambiguous statutory language, and thus declined to afford the agencies' reading of the law any deference under *Chevron*. Specifically, the court latched on to narrow dictionary definitions of the statutory language used to define a "securitizer," concluding that CLO managers could not fit within that category and therefore could not be subject to the risk retention requirement.

The court gave credence to the classic industry fear-mongering about the supposedly adverse market impact of the rule.

The *Loan Syndications* decision is marked by a number of flaws. First, the court discounted other definitions of the statutory terms that clearly support the agencies' interpretation. Those plausible, alternative readings of the statute should have created enough ambiguity to warrant deference to the agencies' judgment. Second, the court applied a double standard when it comes to the policy implications of the rule. The court gave credence to the classic industry fear-mongering about the supposedly adverse market impact of the rule. At the same time, however, the court swept aside the agencies' primary concern that exempting CLOs from the risk retention rule would create a huge loophole, in effect supplying a blue print for structuring all kinds of securitizations so that no entity whatsoever is subject to the risk retention requirement. Thus, rather than using the policy implications of its statutory interpretation to inform and shape the application of the law—as it did with the **industry's** "sky-will-fall" argument—the court, including Judge Kavanaugh, was content to segregate the **agencies'** policy concerns entirely from the legal analysis and cling to a rigid reading of the statute.

D. <u>Judge Kavanaugh would limit the authority of agencies charged with protecting the American people.</u>

Congress decided a long time ago to create agencies like the SEC and CFPB to implement various laws, oversee industries and protect people from unlawful behavior. The agencies were directed by and staffed with professionals who, as experts in their fields, had deep knowledge from years of interpreting, applying and enforcing the statutes passed by Congress. Fulfilling that congressional intent and public purpose, courts defer to the best judgment of those experts at those agencies in interpreting and applying statutes as long as the interpretation is reasonable.[10] This judicial deference is referred to as the "*Chevron* doctrine."[11]

Judge Kavanaugh is plainly hostile to the *Chevron* doctrine, a well-established principle of administrative law. It provides that courts should defer to an agency's statutory interpretation where the statute is silent or ambiguous with respect to the issue at hand, provided the agency's approach "is based on a permissible construction of the statute." ***Chevron, U.S.A., Inc. v. National Resources Defense Council, Inc.*, 467 U.S. 837, 843 (1984)**. The application of this judicial doctrine has empowered independent agencies to issue many important rules and regulations with the confidence that they will survive judicial challenge, ultimately for the benefit of the public.

If confirmed to the Supreme Court, Judge Kavanaugh can be expected to work aggressively to narrow if not abolish the Chevron doctrine.

Unfortunately, if confirmed to the Supreme Court, Judge Kavanaugh can be expected to work aggressively to narrow if not abolish the *Chevron* doctrine. Judge Kavanaugh has attacked the *Chevron* doctrine as "an atextual invention by courts" that is in many ways "nothing more than a judicially orchestrated shift of power from Congress to the Executive Branch."[12] Indeed, Judge Kavanaugh has gone so far as to decry *Chevron* as a doctrine that "encourages the Executive Branch (whichever party controls it) to be extremely aggressive in seeking to squeeze its policy goals into ill-fitting statutory authorizations and restraints."[13] Ironically, Judge Kavanaugh has not acknowledged or discussed the massive shift of unreviewable power to the courts and judges like himself who will unilaterally determine all issues of statutory interpretation and congressional intent if the *Chevron* doctrine is overruled.

E. Judge Kavanaugh would vastly expand the scope of the "major rules" doctrine to limit the ability of regulators to do their jobs in especially important areas.

Closely related to Judge Kavanaugh's animosity towards *Chevron's* deference to administrative agencies is his fondness for what has become known as the "major rules" or "major questions" doctrine. Based upon a series of Supreme Court cases, the major rules doctrine is a judicially created standard that requires clear congressional authorization for an agency to adopt a "major rule," one that has vast economic or political significance.[14] Under this approach, the very legislative ambiguity that supports the exercise of agency discretion under *Chevron* actually prohibits the agency from exercising its discretion with respect to major rules; Congress must unambiguously authorize the agency to adopt a major rule.

An important example of Judge Kavanaugh's adoption of the major rules doctrine is found in ***United States Telecommunications Association v. FCC,* 855 F. 3d 381 (D.C. Cir. 2017)**. This challenge to the FCC's net neutrality rule, which classified internet service providers ("ISPs") as common carriers subject to the regulatory requirements of the Communications Act of 1934, was front page news for the first half of 2017. After previously upholding the rule, the D.C. Circuit was confronted with a petition for rehearing *en banc*, and Judge Kavanaugh split from the panel's denial of that petition.

Judge Kavanaugh first argued that the rule was plainly a "major" one, as it would have "vast 'economic and political significance.'"[15] He then insisted that Congress had not clearly authorized the FCC to issue the net neutrality rule.[16] In his view, therefore, the rule was invalid.

[The case reveals] deeper attitudes that animate many of Judge Kavanaugh's rulings: a strong preference for minimal business and industry regulation, coupled with a steadfast refusal to be guided by clearly articulated policy considerations.

The majority opinion critiqued Judge Kavanaugh's dissent by pointing out that Supreme Court precedent interpreting the Communications Act made clear that the FCC did have clear statutory authority "to institute common-carrier regulation of all ISPs."[17] Setting aside the merits, the case is significant not only because of Kavanaugh's adherence to the major rules doctrine, but also because of the deeper attitudes that animate many of Judge Kavanaugh's rulings: a strong preference for minimal business and industry regulation, coupled with a steadfast refusal to be guided by clearly articulated policy considerations, even wise ones. In his dissent, Judge Kavanaugh lamented the FCC's net neutrality rule because it "upended the agency's traditional **light-touch** regulatory approach to the internet."[18]

Kavanaugh pronounced this dismissive approach to the policies that federal rules are meant to serve:

> The net neutrality rule might be wise policy. But even assuming that the net neutrality rule is wise policy, congressional inaction does not license the Executive Branch to take matters into its own hands. Far from it.[19]

Judge Kavanaugh will almost certainly lead that fight and be the corporation's best friend on the Supreme Court.

The major rules doctrine recently surfaced in another important case, illustrating again its power as a potent legal device for striking down agency rules. In ***Chamber of Commerce v. U.S. Department of Labor,*** **885 F. 3d 360 (5th Cir. 2018)**, the Fifth Circuit killed a rule promulgated by the Department of Labor that broadly imposed a strong fiduciary duty on financial advisers serving retirement account holders. The court reasoned in part that the rule would transform the market for IRA investments, annuities and insurance products and would subject thousands of advisers to new regulation, running afoul of Supreme Court precedent requiring clear congressional authority for rules of "vast economic and political significance."[20]

As made clear by these and innumerable other cases, corporations have been trying to gut the *Chevron* doctrine and elevate the "major rules" doctrine for years, so that their army of lawyers can sue the agencies and persuade courts to overturn agency protections whenever an agency refuses to adopt a rule that they want. Judge Kavanaugh will almost certainly lead that fight and be the corporation's best friend on the Supreme Court.

III. THE SUPREME COURT FREQUENTLY DECIDES IMPORTANT CASES AFFECTING PROTECTIONS FOR CONSUMERS, INVESTORS AND WORKERS AND THE COMPENSATION OF VICTIMS OF FINANCIAL FRAUD.

The Supreme Court has issued countless decisions that have directly impacted the wallets and financial lives of all Americans. It routinely decides how, if at all, ripped off Americans will get compensated and whether financial predators get punished. The Supreme Court also decides who can sue and for what, meaning that the right of everyday Americans to have their day in court hangs in the balance. Everyone who is a consumer or investor is affected by these decisions, which means that every American has a huge stake in what the Supreme Court does and, therefore, who is on the Supreme Court.

The cases are diverse in many respects. Some are positive in that they protected and preserved some aspect of the government's regulatory authority or the rights of investors and consumers to be compensated for fraud and abuse. Many others, especially more recently, steer the law away from vital regulatory authority and investor protection. Some decisions are unanimous, while others reflect a sharply divided Court. Above all, however, the Court's decisions have an immense impact on our economic lives.

A. The Supreme Court has a long history of interpreting the law to protect investors.

Merely by defining a word, the Supreme Court can determine whether ripped off Americans can sue or will be able to recover lost money. For example, the Supreme Court's interpretation of what is or is not a "security" largely determined what the SEC could regulate and what investors could sue over.

In an early case handed down just over a decade after Congress enacted the securities laws, the Supreme Court issued a landmark decision broadly defining the types of investments that are subject to regulation as securities. In ***S.E.C. v. W.J. Howey Co.,*** **328 U.S. 293 (1946)**, the Court held that sale and leaseback agreements covering Florida orange groves, coupled with service contracts for the cultivation and sale of the fruit, were "investment contracts" and therefore securities subject to the registration requirements of the Securities Act of 1933.

The Court established a broad yet simple test to determine whether an investment contract is a security: "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[21] Guiding the Court's decision was its desire to create a definition that could fulfill "the statutory purpose of full and fair disclosure," regardless of the particular form an investment might take: "It embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[22] Thus, in *Howey*, the Court relied heavily on the remedial purposes of the law and established a broad test to maximize investor protection.

Merely by defining a word, the Supreme Court can determine whether ripped off Americans can sue or will be able to recover lost money.

Thanks to this broad statutory interpretation, countless investment scams have been subject to the provisions of the securities laws. As a direct result, the SEC had the authority to regulate them and punish violators, and many such schemes undoubtedly never saw the light of day given the deterrent effect of federal regulation and enforcement. Investors saved untold billions of dollars that they otherwise would have lost without a method of recourse under the securities laws, but for the Court's interpretation of the law. *See* ***S.E.C. v. Edwards,*** **540 U.S. 389 (2004)** (relying on *Howey* to find that a $300 million-dollar payphone sale and leaseback scheme was a security, rejecting the technical argument that a contractual fixed rate of return could not serve as "profit" within the meaning of *Howey*).

B. Recent Supreme Court decisions that set back the SEC's enforcement program.

Recognizing that consumers, investors and all Americans will continue to be victimized, Congress created special protections for whistleblowers. Whistleblowers are critically important to stopping fraud and other scams, particularly by big corporations. But the Supreme Court is cutting back on those protections, which will result in more fraud going undetected and millions if not tens of millions of Americans being ripped off when would-be whistleblowers are scared into silence by threats of retaliation.

Whistleblowers.

In ***Digital Realty Trust v. Somers,*** **138 S. Ct. 767 (2018)**, the Court held that whistleblowers who internally report corporate wrongdoing but do not report out to the SEC cannot invoke the anti-retaliation provisions in the securities laws. The Court found that the SEC's expansive reading of the law that offered protection for internal reporting did not warrant *Chevron* deference because the statute was unambiguous regarding its applicability. The decision is likely to discourage many whistleblowers with uniquely valuable information about illegal conduct from coming forward at all, thus undermining the core purposes of the statutory whistleblower provisions. The inhibiting effect of the decision will ultimately harm investors and financial markets more broadly, as illegal schemes go completely undetected or are caught by regulators in far later stages, after significant harm has been done.

<u>*Disgorgement.*</u>

But the Supreme Court decided differently, opening the door for fraudsters to keep millions if not billions of dollars ripped off from hard-working Americans who will now not be compensated.

When someone commits fraud or rips people off, there a several actions the government can take against them, civilly and criminally. Fines, jail time, bans from working in the securities industry and other remedies are necessary to really punish and deter lawless conduct. At minimum, one of the most important remedies available is disgorgement, which requires the fraudster to give up their ill-gotten gains, i.e., the money they ripped off. This is the very least that should happen to every lawbreaker so that crime doesn't pay and victims can be compensated. But the Supreme Court decided differently, opening the door for fraudsters to keep millions if not billions of dollars ripped off from hard-working Americans who will now not be compensated.

The case was ***Kokesh v. Securities and Exchange Commission,*** **137 S. Ct. 1635 (2017),** and it held that the SEC couldn't recover ill-gotten gains from securities frauds dating back more than five years. This decision upended decades of SEC enforcement practice by holding that a federal five-year statute of limitations applied to SEC actions to recover ill-gotten gains through the disgorgement remedy. The Court reversed the Ninth Circuit and found that although widely regarded as a remedial device, disgorgement had taken on a punitive rather than a compensatory character and should therefore be subject to the statutory limitations period applicable to penalties. The decision imposes an enormous new limitation on the SEC, since it means that the agency cannot recover illicit profits from fraudulent schemes that were reaped more than five years prior to the action. This deadline is particularly unrealistic, as many frauds are complex, hidden from detection, and once identified take years to investigate and prosecute through an enforcement action. Imagine the implications in a fraud like Bernie Madoff's Ponzi scheme that ran for decades. As a result of the *Kokesh* decision, over time, fraudsters will be able to retain billions of dollars stolen from investors so long as five years have passed since the money was taken.

<u>The ALJ hearing process.</u>

The SEC and other agencies can pursue civil enforcement actions involving less severe lawbreaking and lesser sanctions through administrative actions adjudicated by Administrative Law Judges ("ALJs"). This has enabled the SEC and others to take more enforcement actions and move them relatively quickly, often resulting in speedy relief to securities fraud victims. However, the Supreme Court recently upended the ALJ system, calling into question the validity of countless ALJ orders and potentially requiring the SEC and other agencies to rehear or possibly dismiss many cases.

The Lucia decision has profound implications, as it is unclear how many SEC enforcement actions already decided by now unconstitutionally appointed ALJs may have to be reheard at a minimum, or possibly even dismissed.

The case was ***Lucia v. Securities and Exchange Commission,* 138 S. Ct. 2044 (2018)**, holding that the SEC's ALJs, who preside over the majority of the Commission's enforcement actions, are "officers of the United States" subject to the Constitution's Appointments Clause. The Court granted Lucia a new hearing—even though he had been found liable for fraud under the Investment Advisers Act by the ALJ **and** the Commission—because the presiding ALJ had not been appointed in accordance with the Constitution (that is, by the President, a court, or the Commission itself).[23]

The *Lucia* decision has profound implications, as it is unclear how many SEC enforcement actions already decided by now-unconstitutionally appointed ALJs may have to be reheard at a minimum, or possibly even dismissed. And the case is already having an impact beyond the SEC since other agencies also rely heavily on ALJs to adjudicate regulatory violations. For example, the National Law Journal recently reported that attorneys for JPMorgan Chase & Co. moved to stay the U.S. Department of Labor's gender bias case against the bank in light of the *Lucia* decision. The asserted purpose for the requested stay was to allow "the attorneys and presiding judge to resolve how the high court's ruling in *Lucia v. SEC* might affect the government's discrimination case."[24] Corporations and individuals involved in wage-and-hour disputes, whistleblower claims and immigration matters at the DOL may be entitled to new hearings in front of different administrative judges or even dismissal.

C. <u>Slamming shut the courthouse door to victims of fraud and other federal law violations.</u>

It's bad enough to be ripped off, but those victims then have to hire a lawyer and file a lawsuit to have a chance at justice and, hopefully, some compensation. However, corporations that rip off consumers and investors usually have an army of lawyers trying to prevent those victims from getting their cases heard, often using hyper-technical arguments to prevent the courts from even hearing the case in the first place. These cases often involve "private rights of action" and issues of "standing," and, when corporations and fraudsters are successful, they close the courthouse door to victims.

Over fifty years ago, the Supreme Court began to recognize implied private rights of action under various provisions of the securities laws. For example, in ***J.I. Case v. Borak,* 377 U.S. 426 (1964)**, the Court held that a private right of action should be implied under Section 14(a) of the 1933 Act (for false or misleading proxy solicitation materials). Under the circumstances, the Court said, it was "the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose."[25]

While the Supreme Court has expanded the rights of victims to have their day in court by finding various implied rights of action, the Court has also narrowed those rights in numerous ways. For example, it has made clear that there is no private right of action against secondary actors or aiders and abettors.[26] This reading of the law immunizes many participants who play a central role in securities fraud.

Corporations that rip off consumers and investors usually have an army of lawyers trying to prevent those victims from getting their cases heard, often using hyper-technical arguments to prevent the courts from even hearing the case in the first place.

The Court has also heightened the pleading requirements for the elements of a private securities fraud lawsuit. For example, in ***Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336 (2005)**, the Court held that a plaintiff cannot make the required showing that his loss was caused by the wrongdoer's misstatement or omission simply by alleging that a security's price was inflated at the time of purchase because of the misrepresentation; that inflated price will not by itself constitute or proximately cause the economic loss necessary to allege and prove loss causation. Rather than focusing on the remedial purposes of the securities laws and the need to protect the marketplace from fraud, the Court prioritized the need to protect companies and executives from purportedly abusive investor lawsuits.

D. <u>Forcing investors into secret, biased arbitration takes away the right to seek damages for fraud and abuse in open court.</u>

In ***Shearson/American Express v. McMahon*, 482 U.S. 220 (1987)**, the Supreme Court held that claims under Section 10(b) of the Exchange Act, the core anti-fraud provision in the securities laws, can be forced into arbitration under pre-dispute, mandatory arbitration agreements between brokers and their clients. The Court reached this decision based on the policy favoring arbitration reflected in the Federal Arbitration Act,[27] even though the securities laws contain clauses expressly voiding any waiver of compliance with those laws. The Court chose to view those anti-waiver provisions as applicable only when an arbitration agreement interferes with a party's substantive rights, rather than applying broadly to the procedural issues of where and how those rights could be vindicated.

The Court even went so far as to hold that private RICO claims could be forced into arbitration, and in so doing, chose to subordinate the public interest or "private attorney general" function of such claims to the compensatory role of the treble damages provision. Widely recognized as one of the most important securities laws decisions ever issued by the Supreme Court, *Shearson* has done incalculable damage by forcing millions of investors with claims for fraud and abuse at the hands of brokers and others into a biased, industry-run arbitration process that affords little relief.

E. <u>The Supreme Court has created a major obstacle for those seeking damages or other remedies in court.</u>

In ***Lujan v. Defenders of Wildlife*, 504 U.S. 555 (1992)**, the Supreme Court held that a wildlife conservation organization was unable to challenge a regulation under the Endangered Species Act of 1973, which set a limit on the international geographic reach of the Act. The Court found that even if there was a threat to certain species of wildlife, there was no showing of "actual or imminent" injuries to particular respondents who might "someday" wish to visit the foreign countries in question and be deprived of the opportunity to observe the endangered animals.[28] The Court created three hurdles that litigants must overcome to establish the presence of a constitutionally cognizable case or controversy and to press their claims in court:

> Over the years, our cases have established that the irreducible constitutional minimum of standing contains three elements. **First**, the plaintiff must have suffered an "injury in fact"—an invasion of a legally protected interest which is (a) concrete and particularized, and (b) "actual or imminent, not 'conjectural' or 'hypothetical'." **Second**, there must be a causal connection between the injury and the conduct complained of—the injury has to be "fairly ... trace[able] to the challenged action of the defendant, and not ... th[e] result [of] the independent action of some third party not before the court." **Third**, it must be "likely," as opposed to merely "speculative," that the injury will be "redressed by a favorable decision." [29]

Widely recognized as one of the most important securities laws decisions ever issued by the Supreme Court, Shearson has done incalculable damage by forcing millions of investors with claims for fraud and abuse at the hands of brokers and others into a biased, industry-run arbitration process that affords little relief.

Had the states been permitted a greater role in policing the mortgage lending market in the years leading up to the 2008 financial crisis, they may have at least curtailed the massive flow of subprime mortgages that ultimately fueled the crisis, possibly mitigating its severity and duration.

The Court specifically found a "citizen suit" provision in the law insufficient to establish standing, concluding that it did not confer on "all persons an abstract, self-contained, non-instrumental 'right'" to have the Executive Branch adhere to the law.[30] Rather, the plaintiff must have suffered a tangible and particular harm. *Lujan* and its progeny have made it extremely difficult for litigants, especially those seeking to challenge government action and protect the public interest, to survive motions to dismiss and have their claims heard by a federal court.

F. <u>Preemption: Barring the states from acting to protect consumers.</u>

In ***Watters v. Wachovia Bank, N.A.*, 550 U.S. 1 (2007)**, the Supreme Court held that federal authority over national banks preempted Michigan from imposing licensing, registration, and inspection requirements upon national banks and their operating subsidiaries engaged in mortgage lending. This and other holdings effectively preclude the states from acting to protect consumers and investors from illegal and fraudulent conduct in many areas subject to federal regulation. The *Watters* case provides a dramatic illustration of the potential impact such decisions can have: Had the states been permitted a greater role in policing the mortgage lending market in the years leading up to the 2008 financial crisis, they may have at least curtailed the massive flow of subprime mortgages that ultimately fueled the crisis, possibly mitigating its severity and duration.

The scope of federal preemption may prove to be an increasingly important issue. State attorneys general have begun not only challenging many of the Trump Administration's de-regulatory measures in court, but also promising to strengthen state-level financial rules to fill the vacuum caused by the federal retreat from investor and consumer protection.[31]

IV. <u>CONCLUSION</u>

It is clear that the Supreme Court's rulings on cases concerning economic and financial issues are vitally important to the livelihoods, wealth, financial well-being and quality of life of every American. It is equally clear that, as a Supreme Court justice, Judge Kavanaugh will stick to his established jurisprudence, siding with corporations and showing hostility to federal regulatory agencies and the economic interests of working Americans. Consumers and regulators, beware.

[1] Mark Joseph Stern, *So Many Guns, So Much Smoke*, August 20, 2018, https://slate.com/news-and-politics/2018/08/brett-kavanaugh-papers-more-documents-wont-teach-us-anything-new-about-the-supreme-court-nominee.html.

[2] Dennis M. Kelleher, *Why Every American Should Want A Strong CFPB*, December 6, 2017, http://www.latimes.com/opinion/op-ed/la-oe-kelleher-why-the-cfpb-is-important-20171206-story.html.

[3] *PHH Corp.*, 839 F.3d at 6.

[4] *Lorenzo*, 872 F.3d at 583.

[5] *Id.* at 597.

[6] *Id.* at 600.

[7] *Id.* at 601.

[8] *Id*. at 602.

[9] *Id*. at 602.

[10] *See Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc*., 467 U.S. 837, 843 (1984).

[11] The *Chevron* doctrine provides for judicial deference to agency determinations within the authority vested to that agency by Congress.

[12] Brett M. Kavanaugh, Book Review, *Fixing Statutory Interpretation*, 129 Harv. L. Rev. 2118, 2150 (2016).

[13] *Id*.

[14] *Loving v. IRS*, 742 F. 3d 1013 (D.C. Cir. 2014).

[15] *United States Telecomms. Ass'n.*, 855 F. 3d at 417 (cited authorities omitted).

[16] *Id.* at 417-18 (noting that the "Act does not supply clear congressional authorization for the FCC to impose common-carrier regulation on internet service providers").

[17] *Id.* at 385 (citing *National Cable & Telecomms. Ass'n v. Brand X Internet Services*, 545 U.S. 967 (2005)).

[18] *Id.* at 425 (emphasis added).

[19] *Id.* at 426.

[20] *Id.* at 387.

[21] *Howey*, 328 U.S. at 301.

[22] *Id.* at 299.

[23] *Lucia*, 138 S. Ct. at 2055.

[24] Erin Mulvaney, *JPMorgan Asked to Freeze Gender-Bias Case After SCOTUS Ruling*, August 16, 2018, https://www.law.com/nationallawjournal/2018/08/15/jpmorgan-asked-to-freeze-gender-bias-case-after-scotus-ruling/?slreturn=20180720142136.

[25] *Borak*, 377 U.S. at 433.

[26] *See Stoneridge Investment Partners, LLC v. Scientific–Atlanta, Inc*., 552 U.S. 148 (2008) (private right does not cover suits against "secondary actors" who had no "role in preparing or disseminating" a stock issuer's fraudulent financial statements); *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N. A.,* 511 U.S. 164 (1994) (private right does not extend to actions against "aiders and abettors" of securities fraud); *see also Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (private right extends only to purchasers and sellers, not to holders, of securities).

[27] 9 U.S.C. § 1 *et seq.*

[28] 504 U.S. at 564.

[29] *Id.* at 560-61 (emphasis added) (cited authorities omitted).

[30] *Id.* at 573.

[31] Dechert LLP, *Activist States Move Forward with Fiduciary Standards for Broker-Dealers and Investment Advisers*, April 4, 2018, https://www.jdsupra.com/legalnews/activist-states-move-forward-with-72055/.

About the Authors

Better Markets is an independent, nonprofit, nonpartisan organization that promotes the public interest in economics, finance and financial reform throughout the policymaking process in Washington. It fights for transparency, oversight and accountability so that the country has a stronger, safer financial system that is less prone to crisis and failure thereby eliminating or minimizing the need for more taxpayer funded bailouts. Its goals are greater economic security, opportunity and prosperity for the American people by ensuring finance serves society and makes the American Dream available to all Americans. **www.bettermarkets.com**

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From 2001 through 2009, Hall served as Counsel to the North American Securities Administrators Association, Inc., the association of state securities regulators. He supported all aspects of NASAA's mission, including regulatory analysis, appellate advocacy, and enforcement. His written work included over 15 amicus briefs addressing a wide range of investor protection issues arising under State and Federal securities law, including four briefs filed in the U.S. Supreme Court. Steve also advised NASAA on corporate governance and transactional matters.