Securities Regulation Daily Wrap Up, TOP STORY—SCOTUS nominee Kavanaugh, if confirmed, may influence cases disputing structure, powers of federal agencies, (Jul. 10, 2018)

Securities Regulation Daily Wrap Up

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By Mark S. Nelson, J.D.

President Trump tapped D.C. Circuit Judge Brett Kavanaugh to replace retiring Supreme Court Justice Anthony Kennedy. The nomination is pivotal because it is widely expected to alter the balance on the Supreme Court which, in recent years, tended to rely on Justice Kennedy's vote to resolve some high-profile cases. While many will focus on Judge Kavanaugh's views on issues such as reproductive rights (*See, e.g.*, *Garza v. Hargan* (Kavanaugh, J., dissenting), remanded on mootness grounds, *Azar v. Garza*, June 4, 2018, per curiam), securities practitioners may look instead to Judge Kavanaugh's business law cases to discern his views on a range of issues, including separation of powers and administrative law judges (ALJs), commercial speech, corporate governance, SEC enforcement, and private securities suits.

Judicial philosophy. President Trump, at an evening press event, explained that he believes judges should "apply the constitution as written." Trump repeatedly invoked the Reagan era, during which Justices Scalia and Kennedy became members of the court. Trump noted the attendance at the press event of Scalia's widow and former President Reagan's Attorney General Edwin Meese.

Judge Kavanaugh spoke briefly and said he was "grateful" to President Trump for the nomination and "humbled by your confidence in me." He too noted that President Reagan appointed Justice Kennedy, for whom Judge Kavanaugh had clerked. The judge also said that an "independent judiciary is the crown jewel of our constitutional republic" and that he would "keep an open mind in every case." As for his judicial philosophy, Judge Kavanaugh said: "A judge must be independent and must interpret the law, not make the law. A judge must interpret statutes as written. And a judge must interpret the constitution as written, informed by history and tradition and precedent." This latter point about history and tradition is a recurring theme in Judge Kavanaugh's judicial opinions.

Judge Kavanaugh also observed that his law clerks have diverse backgrounds and that the majority of them are women. He further noted that Justice Kagan, then-dean of Harvard Law School, had hired him as an instructor, in which role he said he taught students that the constitution's separation of powers protects individual liberty, another frequent theme in his judicial writings.

Separation of powers. Judge Kavanaugh has been involved in two of the most significant separation of powers cases in recent memory involving financial regulators. In both instances, the judge looked to the "history and tradition" he referenced in his remarks when President Trump announced that he would be nominated to the Supreme Court. The first case involved the Public Company Accounting Oversight Board (PCAOB), although a more recent case involving the SEC's ALJs suggests how, if confirmed, Judge Kavanaugh could influence additional separation of powers questions regarding the SEC's ALJs. The second case involved the Consumer Financial Protection Bureau (CFPB) and reinforces Judge Kavanaugh's beliefs about separation of powers.

The recently concluded Supreme Court term brought to the fore an important question about the reach of executive authority over independent agencies and the separation of powers. In *Lucia v. SEC*, a majority led by Justice Kagan held that the SEC's ALJs are inferior officers of the U.S. and, thus, must be appointed in compliance with the Appointments Clause of the U.S. Constitution. The decision resolved a split between the D.C. Circuit (the SEC's ALJs are employees) and the Tenth Circuit (the SEC's ALJs are inferior officers). However, the court declined to expand the question presented to include whether the SEC's ALJs enjoy too

many layers of tenure protection, as the government had urged the court to do; Justice Breyer, who concurred in the judgment in part and dissented, thought it odd that the court declined to take up the removal question.

In a related case, when the issue of SEC ALJs was confined to district courts, Judge Kavanaugh joined a unanimous panel in holding that an SEC respondent could not invoke concurrent jurisdiction to bring a law suit in federal district court for the purpose of halting an SEC administrative proceeding. Although the case involved different claims than *Lucia*, the panel concluded that Congress drafted the securities laws to provide an exclusive channel through which cases would first be decided by the Commission and then, in the event of an adverse decision, a respondent could petition for review of the Commission's order by a federal appeals court. Many other SEC respondents brought similar cases only to be turned away by the federal appeals courts and the Supreme Court. The *Lucia* case made it to the Supreme Court because the respondent there had followed the Congressionally-mandated appeals procedure.

Although the officer or employee question has been decided with respect to the SEC, the removal issue is likely to return to the Supreme Court, possibly in another case pending in the D.C. Circuit that also involves the SEC. However, the Supreme Court's *Free Enterprise* opinion, in which a majority of the justices held that members of the PCAOB enjoyed too many layers of good cause removal protection (two layers) is likely to factor in any future cases on the removability of SEC ALJs. The solution in *Free Enterprise* was to sever two provisions in the Sarbanes-Oxley Act to achieve the dual purposes of upholding the PCAOB as an institution while also giving the Commission power to fire PCAOB members and, thus, ensuring the president's ability to faithfully execute the laws by holding PCAOB members accountable.

The Supreme Court's *Free Enterprise* decision reversed the part of the D.C. Circuit's majority decision in that case holding that dual for-cause removal of PCAOB members was not constitutionally infirm. Judge Kavanaugh dissented from the decision arguing that two layers of tenure protection made it impossible for the president to properly control the PCAOB.

Moreover, Judge Kavanaugh wrote the panel majority opinion in *PHH v. CFPB* finding the CFPB's single-director structure unconstitutional, although that decision was later vacated and, in pertinent part, reversed by the full D.C. Circuit. Both *Free Enterprise* and *PHH* illustrate the point Judge Kavanaugh said he taught his law students, that separation of powers is a structural element protecting liberty. One district judge has since agreed with Judge Kavanaugh's analysis regarding the CFPB.

First Amendment. Judge Kavanaugh, as a member of the en banc D.C. Circuit, concurred with the majority's judgment in a case that expanded the Supreme Court's *Zauderer* commercial speech test to encompass issues beyond deception. The case arose from a challenge to the Agriculture Department's regulation requiring meat products to be labeled with their country of origin. Judge Kavanaugh said protection of U.S. farmers was a substantial governmental interest (the government had shied away from stating explicitly the Congressional purpose involved due to concerns about retaliation by U.S. trading partners). Judge Kavanaugh went on to posit that it is a false choice to pick between the Supreme Court's *Central Hudson* commercial speech test (a "tough" test) and *Zauderer* (a "lenient" test); he also said in a footnote that he disagreed with other circuit opinions, including the first panel opinion in the SEC conflict minerals case, which he said falsely equated *Zauderer* with rational basis review. The majority in *AMI* explicitly overruled its prior decisions, such as the conflict minerals case, to the extent they applied a more limited view of *Zauderer*.

A D.C. Circuit panel that did not include Judge Kavanaugh had initially held that a disclosure requirement under the SEC's conflict minerals rule violated the First Amendment. Following the en banc decision in *AMI*, the conflict minerals panel reiterated its previous conclusion: "that 15 U.S.C. § 78m(p)(1)(A)(ii) & (E), and the Commission's final rule, 77 Fed. Reg. at 56,362-65, violate the First Amendment to the extent the statute and rule require regulated entities to report to the Commission and to state on their website that any of their products have 'not been found to be 'DRC conflict free.'"

But to further insulate the conflict minerals panel's conclusion from attack, the panel added that even if the disclosure compelled by the statute and the SEC's rule was commercial speech, and if *AMI*'s expanded

Zauderer test applied, the panel would nevertheless hold that the required disclosure violated the First Amendment. The government later declined to ask the Supreme Court to review the conflict minerals decision.

Corporate governance. The Supreme Court in 1981 held that corporations can enjoy attorney-client privilege (*Upjohn Co., v. U.S.*, 449 U.S. 383). The D.C. Circuit, in a unanimous panel opinion authored by Judge Kavanaugh, concluded that a district judge erred in finding that the attorney-client privilege did not apply to documents created pursuant to an internal investigation because that investigation was done not to seek legal advice but rather to achieve regulatory and corporate purposes.

In reaching its conclusion, the D.C. Circuit was unpersuaded by the district judge's attempt to distinguish *Upjohn*. As a result, the court found the attorney-client privilege does not hinge on: (1) whether counsel is in-house or outside counsel; (2) whether attorneys, rather than attorney-directed non-attorneys, conduct interviews; and (3) whether the company tells employees the purpose of the investigation is to seek legal advice. The panel further observed that the presence of other purposes for the investigation, such as regulatory purposes, would not change the result in the case. According to the panel, the key is whether "obtaining or providing legal advice was one of the significant purposes of the internal investigation." The district judge had focused on the fact that the company conducted the internal investigation because Defense Department regulations mandated companies to have compliance programs to combat possible wrongdoing by employees. The panel also rejected the district judge's use of a "but for" test to determine if the privilege applied.

The panel concluded by emphasizing the limits of the attorney-client privilege to communications, not facts. The panel then ordered mandamus, but declined the company's request to re-assign the case to another district judge.

SEC enforcement and other cases. In 2017, the Supreme Court held in *Kokesh v. SEC* that disgorgement is a penalty for purposes of the five-year limitations period contained in 28 U.S.C. §2462. The decision has caused the SEC to mull bringing cases earlier than it might prefer in order not to miss the opportunity to obtain disgorgement. The D.C. Circuit's *Riordan* opinion, authored by Judge Kavanaugh, was typical of pre-*Kokesh* circuit splits and provides an example of a panel that abided by circuit precedent.

In *Riordan*, New Mexico's treasurer pleaded guilty to extortion charges related to the abuse of that office in selecting brokerage firms to handle portions of the state's securities investments. The treasurer cooperated with law enforcement authorities and named Guy Riordan as someone who had paid kickbacks to the treasurer in exchange for the state directing securities transactions to Riordan's brokerage.

Riordan was not criminally prosecuted, but the SEC brought civil charges against him under its antifraud authorities. An ALJ found Riordan liable and ordered him to pay, among other things, $1.4 million in disgorgement. Riordan asserted the limitations period in 28 U.S.C. §2462, which, if applied, could have reduced the amount of disgorgement he owed. However, the D.C. Circuit followed its precedent and held that disgorgement was not a penalty if it was "causally related to the wrongdoing," although the panel said the limitations argument was Riordan's best one. A footnote suggested that another circuit precedent could stand for the proposition that disgorgement also is not a forfeiture.

In other cases more generally impacting SEC enforcement or private securities suits, Judge Kavanaugh's opinions tend to be protective of the court's jurisdiction. In one case, a unanimous panel held that the target of a shareholder suit could not directly seek testimonial subpoenas for SEC employees in the appeals court. Judge Kavanaugh also joined a unanimous panel opinion by Judge Brown holding that a reporter had no common law or First Amendment rights to obtain independent consultant reports generated pursuant to a consent decree between the SEC and American International Group, Inc.

In another opinion, Judge Kavanaugh wrote that the district court properly dismissed a Great Recession-era case involving Carlyle Capital Corporation: "In sum, Carlyle Capital had no duty under federal securities laws to make further disclosures in the Offering Memorandum or, as plaintiffs suggested at oral argument, to put 'a skull and crossbones' on the press releases accompanying the Supplemental Memorandum."

The Supreme Court also recently agreed to hear a case in which Judge Kavanaugh sat on the D.C. Circuit panel. The *Lorenzo* case involved a respondent in a matter brought by the SEC alleging that an employee was liable for securities fraud for forwarding an email at his boss's request. Judge Kavanaugh agreed with the majority that the employee was not a "maker" of the statements in the email and that the lifetime ban imposed on the respondent was too severe, but he dissented from the majority's "'very deferential'" review standard that resulted in the majority upholding much of the Commission's findings regarding securities fraud liability. The case asks the Supreme Court to decide whether a misstatement that fails the Supreme Court's *Janus* "maker" test can still result in liability for a fraudulent scheme. According to the petition for certiorari, three federal appeals courts have said "No" while two, including the D.C. Circuit, have said "Yes." If confirmed to the Supreme Court, Judge Kavanaugh likely would have to grapple with recusing himself in the *Lorenzo* case because of his participation in deciding the case below.

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