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Second Circuit Becomes Latest Circuit Court to Hold SLUSA Precludes State Law Best Execution Claims

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Over the past eight months, the Eighth and Ninth Circuits have—consistent with the Seventh Circuit—each held that the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") precluded state law claims based on a brokerage firm's alleged violation of its duty of best execution when routing customer trades.[1] Last week, the Second Circuit joined this line of rapidly growing authority with its decision in *Rayner v. E*TRADE Fin. Corp.*, which unanimously affirmed the dismissal of a putative class action asserting state law "best execution" violations.[2]

The *Rayner* Decision

In *Rayner*, plaintiff filed a putative class action lawsuit against E*TRADE Financial Corporation[3] asserting claims for breach of fiduciary duty, unjust enrichment, and declaratory relief on behalf of E*TRADE customers who placed non-directed, standing limit orders. The *Rayner* complaint—like the complaints dismissed in other matters[4]—alleged that E*TRADE breached its duty to provide the best execution reasonably available for its customers' orders. Specifically, plaintiff claimed that, instead of ensuring "its clients can purchase and sell securities at the optimal price and volume," E*TRADE routed orders to trading venues willing to pay it the largest "kickbacks," *i.e.*, rebates in exchange for the order flow.[5]

The United States District Court for the Southern District of New York dismissed the complaint, finding plaintiff's state law claims were precluded by SLUSA. Plaintiff appealed to the Second Circuit and argued that SLUSA did not apply to its claims because (1) the complaint does not allege that E*TRADE engaged in fraudulent conduct (*i.e.*, made a "misrepresentation or omission or employed any manipulative or deceptive device"); and (2) even if the complaint did allege fraud, any such fraud was not "in connection with" the purchase or sale of covered securities.[6] The Second Circuit disagreed and unanimously affirmed the SDNY's decision.

The Second Circuit explained that it emphasizes "substance over form" when assessing whether a complaint's allegations fall within the ambit of SLUSA.[7] Although plaintiff "artfully characteriz[ed]" his breach of fiduciary claim as "'non-fraud' based," the Court found the substance of plaintiff's complaint "plainly allege[d] fraudulent conduct" because the claims were based on alleged material misrepresentations and omissions, namely E*TRADE represented it would "provide best execution for

its clients' limit orders," but failed to disclose the execution "would be more unfavorable than expected as a result of E*TRADE's routing practices."[8]

The Second Circuit also found that E*TRADE's conduct arose "in connection with" the purchase or sale of securities because the alleged fraud was "material" to plaintiff's decision to buy or sell the security. The Court noted that it was "frivolous" to suggest that "negatively influencing the price and quantity at which clients may buy and sell securities would not 'make[] a significant difference to someone's decision to purchase or sell'" the security.[9]

Practical Implications

The *Rayner* decision represents a significant addition to the collection of circuit court cases finding that SLUSA precludes state law claims based on alleged violations of the duty of best execution when the "gravamen" of the complaint is a purported material misrepresentation or omission.[10] Indeed, the decision reinforces the principle that even with the most artful of pleading techniques, courts will look to the substance of the allegations to determine whether SLUSA preclusion applies. This decision, along with those by the Seventh, Eighth, and Ninth Circuits, will arm brokerage firms with yet another piece of powerful authority when seeking to dispose of state law best execution claims at the pleading stage.

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If you have any questions concerning these developing issues, please do not hesitate to contact either of the following Paul Hastings New York lawyers:

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1 *See Zola v. TD Ameritrade, Inc.*, 889 F.3d 920, 926 (8th Cir. 2018); *Lewis v. Scottrade, Inc.*, 879 F.3d 850, 855 (8th Cir. 2018); *Fleming v. Charles Schwab Corp.*, 878 F.3d 1146, 1154-55 (9th Cir. 2017); *Kurz v. Fid. Mgmt. & Research Co.*, 556 F.3d 639, 642 (7th Cir. 2009); *see also* Anthony Antonelli, et al., *Eighth Circuit Finds State Law "Best Execution" Claims Are Precluded by SLUSA*, Paul Hastings Insights (May 30, 2018), http://www.paulhastings.com/publication-items/details/?id=41e2e46a-2334-6428-811c-ff00004cbded#_ednref6.

2 No. 17-1487, 2018 WL 3625378, at *1 (2d Cir. July 31, 2018).

3 E*TRADE Securities LLC was also named as a defendant. Both defendants are referred to herein as "E*TRADE."

4 *See Kurz,* 556 F.3d at 640; *Fleming*, 878 F.3d at 1150; *Lewis*, 879 F.3d at 851; *Zola*, 889 F.3d at 922.

5 *Rayner*, 2018 WL 3625378, at *1.

6 *Id.*, at *2. SLUSA precludes plaintiffs from filing in federal or state court "(1) a covered class action (2) based on state law claims (3) alleging that defendant made a misrepresentation or omission or employed any manipulative or deceptive device (4) in connection with the purchase or sale of (5) a covered security." There was "no dispute that Rayner filed a covered class action based on state law claims involving covered securities." *Id.* (citing 15 U.S.C. § 78bb(f)(1)).

7 *Id.,* at *2; *see also Fleming*, 878 F.3d at 1153; *Lewis*, 879 F.3d at 852; *Zola*, 889 F.3d at 924.

8 *Rayner*, 2018 WL 3625378, at *3.

9 *Id.*, at *4 (quoting *Chadbourne & Parke LLP v. Troice*, 571 U.S. 377, 387 (2014)).

10 *Id.,* at *3.