The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 19884

March 24, 2006

U.S. Supreme Court Holds That Federal Preemption of State Class Actions Extends to Securities Holders

©2006 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [19884] March 24, 2006 TO: BOARD OF GOVERNORS No. 10-06 PRIMARY CONTACTS - MEMBER COMPLEX No. 7-06 SEC RULES MEMBERS No. 32-06 SMALL FUNDS MEMBERS No. 25-06 INDEPENDENT DIRECTORS COUNCIL No. 3-06 RE: U.S. SUPREME COURT HOLDS THAT FEDERAL PREEMPTION OF STATE CLASS ACTIONS EXTENDS TO SECURITIES HOLDERS I am pleased to report that the U.S. Supreme Court has issued a unanimous decision holding that the Securities Litigation Uniform Standards Act of 1998 (SLUSA), which preempts state class actions alleging fraud, extends to "holders" of securities.1 The Court's decision is consistent with the views expressed in an amicus brief the Institute filed in this case.2 As a result of the Court's holding, SLUSA precludes a purchaser, seller, or holder of a security who is a private party from maintaining in any state or federal court a "covered class action" based on state law that alleges a misrepresentation or omission of a material fact in connection with the purchase or sale of a "covered security." As defined in SLUSA, a "covered class action" is a lawsuit in which damages are sought on behalf of more than 50 people. A "covered security" is a security that is either issued by a registered investment company or traded nationally and listed on a regulated national exchange. The decision is discussed in more detail below. Background Congress enacted SLUSA in 1998 to establish uniform national standards for securities class actions and curb vexatious litigation. The statute preempts class actions that allege, under state law, fraud "in connection with the purchase or sale" of covered securities. Since SLUSA was enacted, there 1 See Merrill Lynch, Pierce, Fenner & Smith v. Dabit, 547 U.S. ____ (2006). A copy of the decision is available at: http://www.supremecourtus.gov/opinions/05pdf/04-1371.pdf. 2 See Institute Memorandum to Board of Governors No. 55-05, Primary Contacts-Member Complex No. 45-05, SEC Rules Members No. 119-05, and Small Funds Members No. 93-05 [19365], dated Nov. 14, 2005. 2 have been a number of cases raising the issue of whether it applies to class actions by persons holding a covered security, or only to those who purchased or sold covered securities. In light of the split in lower court decisions on this issue, last fall the Supreme Court agreed to consider this issue. The Institute filed an amicus brief in the Supreme Court arguing that SLUSA's preemptive provisions extend to class actions brought by "holders" of covered securities. The Court's Decision In reaching its decision, the Court first noted that "[t]he magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally-traded securities cannot be overstated." It then considered the background, text, and purpose of SLUSA. According to the Court, in 1995, Congress enacted

the Private Securities Litigation Reform Act (the Reform Act) to address concerns that securities class actions were being used to injure the entire U.S. economy. An unintended consequence of the Reform Act was that the plaintiffs' bar began filing class actions under state law to avoid the federal obstacles in the Reform Act. In response to this unintended consequence, Congress passed SLUSA. According to the Congressional Report on SLUSA, it was intended, in part, to stem "the shift from Federal to State courts" and "prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of [the Reform Act]." The Court held that reading SLUSA to limit its provisions to purchasers or sellers of securities "would undercut the effectiveness of [the Reform Act] and thus run contrary to SLUSA's stated purpose." Moreover, a narrow reading of SLUSA raises the prospect "of parallel class actions proceeding in state and federal court, with different standards governing claims asserted on identical facts." In reaching its decision, the Court did "not lose sight of the general 'presump[tion] that Congress does not cavalierly pre-empt state–law causes of action.'" In the Court's view, "that preemption carries less force here than in other contexts because SLUSA does not actually pre-empt any state cause of action. It simply denies plaintiffs the right to use the class action device to vindicate certain claims." As such, the Court's holding preserves to individual plaintiffs and any group of fewer than fifty plaintiffs the right to enforce any state-law cause of action that may exist. Paul Schott Stevens President

---

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.