Financial Fraud Law Report

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Second Circuit Clarifies the Limits on the Extraterritorial Application of U.S. Securities Laws

By Stan Chelney, Ryan M. Philp, and David R. Kolker*

In this article, the authors discuss a recent U.S. Court of Appeals for the Second Circuit decision affirming the dismissal of a putative securities class action brought by purchasers of foreign issued-securities on a foreign exchange.

Introduction

Recently, in *City of Pontiac Policemen's and Firemen's Ret. Sys. et al. v. UBS AG et al.*,[1] the U.S. Court of Appeals for the Second Circuit affirmed the dismissal of a putative securities class action brought by purchasers of foreign issued-securities on a foreign exchange. The court held that the claims were barred by the United States Supreme Court's decision in *Morrison v. National Australia Bank Limited*.[2] Addressing issues of first impression, the court refined Second Circuit precedent regarding the contacts necessary for a transaction to be considered "domestic" under *Morrison*. The court rejected plaintiffs' argument that application of U.S. securities laws is justified merely because a foreign security is cross-listed on a domestic exchange—the so-called "listing theory." The court also held that placing a buy order in the U.S., by itself, is insufficient to render a transaction "domestic" so as to warrant application of U.S. securities laws.

Case Summary

Plaintiffs, a group of foreign and domestic institutional investors, brought suit against UBS AG ("UBS") and a number of UBS officers and directors (collectively, "defendants"), alleging, *inter alia*, violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the "Exchange Act"). The suit arose out of plaintiffs' purchase of UBS shares, which were listed on foreign exchanges and the New York Stock Exchange ("NYSE"). Plaintiffs alleged defendants, in conjunction with the issuance of the shares, made fraudulent

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[1] *City of Pontiac Policemen's and Firemen's Ret. Sys. et al. v. UBS AG et al.*, No. 12-4355-CV (2d Cir. May 6, 2014).

[2] *Morrison v. National Australia Bank Limited*, 561 U.S. 247 (2010).

statements regarding UBS's mortgage-related assets portfolio and UBS's compliance with U.S. securities and tax laws. Plaintiffs claimed that UBS acquired and overvalued $100 billion in mortgage-related assets, and concealed the scope of, and losses associated with, those assets, all without disclosing this to shareholders in contravention of its risk management policies. In addition, one plaintiff alleged defendants violated Sections 11, 12(a)(2), and 15 of the Securities Act of 1933 (the "Securities Act") by making misleading statements regarding alleged tax fraud in connection with UBS's June 13, 2008 Rights Offering.

Procedural History

In 2011, the district court, relying on the Supreme Court's landmark 2010 decision in *Morrison*, dismissed the claims of plaintiffs who purchased UBS shares on foreign exchanges, and in 2012 dismissed all remaining claims. *Morrison* held that Section 10(b) of the Exchange Act only provides a private cause of action arising out of "[1] transactions in securities listed on domestic exchanges, and [2] domestic transactions in other securities"—as opposed to a cause of action brought by foreign plaintiffs against foreign defendants for misconduct in connection with securities traded on foreign exchanges. Plaintiffs subsequently appealed.

The Court's Holding and Reasoning

The Second Circuit first addressed the securities claims brought by the foreign institutional investors—*i.e.*, "foreign cubed" claims: (1) foreign plaintiffs suing (2) foreign issuers based on transactions in (3) foreign countries. The foreign plaintiffs argued that, pursuant to their "so-called 'listing theory,' the fact that the relevant shares were cross-listed on the NYSE brings them within the purview of Rule 10(b), under the first prong of *Morrison*—'transactions in securities listed on domestic exchanges.'" The court rejected this argument, finding that "while this language, which appears in *Morrison* and its progeny, taken in isolation, supports plaintiffs' view, the 'listing theory' is irreconcilable with *Morrison* read as a whole." The court, quoting *Morrison*, emphasized that the decision "evinces a concern with 'the location of the securities *transaction* and not the location of an exchange where the security may be dually listed.'" The court concluded that, "[i]n sum, Morrison does not support the application of § 10(b) of the Exchange Act to claims by a foreign purchaser of foreign-issued shares on a foreign exchange simply because those shares are also listed on a domestic exchange."

The court next turned to so-called "foreign squared" claims: domestic plaintiffs suing (1) foreign issuers based on transactions in (2) foreign countries. U.S.-based plaintiff Oregon Public Employees Board ("OPEB") purchased UBS shares via a "buy order" in the U.S., which was then executed on a Swiss

exchange. OPEB contended, *inter alia*, that it satisfied *Morrison*'s second prong because it purchased a security in the U.S. In rejecting this argument, the court relied on its recent decision in *Absolute Activist Value Master Fund Limited v. Ficeto*.[3] In that case, the Second Circuit clarified that a securities transaction is considered domestic for purposes of *Morrison*'s second prong when the parties incur "irrevocable liability" to carry out the transaction within the U.S. or when title is passed within the U.S. Applying those principles, the court concluded that placing a buy order in the U.S. for a foreign security that is executed on a foreign exchange—standing alone—is insufficient to create irrevocable liability in the U.S., and thus does not bring the transaction within U.S. securities laws. The court also made clear that a purchaser's citizenship or residency has no bearing on where a transaction occurs, thereby rendering the fact that OPEB was a U.S. entity irrelevant to determining whether the transaction was foreign or domestic.

The court also disposed of plaintiffs' Securities Act claims, finding plaintiffs failed to plead any misstatements in the 2008 Rights Offering. In addition, the court held that plaintiffs' Section 10(b) claims based on alleged fraud related to UBS's mortgage-related assets also were properly dismissed for failure to plead materiality or a strong inference of scienter.

Conclusion

This decision further clarifies the limits on the extraterritorial application of U.S. securities laws to transactions involving foreign securities issued by foreign issuers. It is now understood that the mere fact that a foreign security is dual listed on a U.S. exchange is insufficient to bring the transaction within the ambit of the U.S. securities laws if the purchase is consummated on a foreign exchange. Similarly, the mere fact that the purchaser is a domestic company is insufficient to justify the application of U.S. securities laws, and, in fact, may be entirely irrelevant to the analysis. Even if a buy order is placed in the U.S., that fact, standing alone, also is insufficient to support the application of U.S. securities laws to a transaction in foreign securities on a foreign exchange. Indeed, the Second Circuit's decision suggests that even if a transaction is consummated on a U.S. exchange, that fact alone also may not be sufficient to support the application of U.S. securities laws. To ascertain whether irrevocable liability was incurred in the U.S., courts will consider additional facts such as where the underlying contracts were formed, where purchase orders were placed, where title to the securities passed, and where money was exchanged. Given the realities of modern securities transactions, the determination whether

[3] *Absolute Activist Value Master Fund Limited v. Ficeto*, 677 F.3d 60 (2d Cir. 2012).

U.S. securities laws apply to complicated, cross-border transactions likely will be made on a case-by-case basis.