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Second Circuit Narrows Reach of Federal Securities Laws as to Foreign Securities Transactions

May 6, 2014

On May 6, 2014, the U.S. Court of Appeals for the Second Circuit issued a decision clarifying the applicability of the anti-fraud provisions of the Securities Exchange Act of 1934 to transactions in foreign securities. The court held in *City of Pontiac Policemen's and Firemen's Retirement System v. UBS AG* that the Exchange Act does not apply to purchasers of a foreign issuer's shares on a foreign exchange, even if those shares were also cross-listed on a United States exchange, and even if the purchasers on the foreign exchange were U.S. residents who had placed their buy orders in the United States.

The *UBS* case is the latest decision construing the Supreme Court's landmark ruling in *Morrison v. National Australia Bank* and continues the trend of narrowing the Exchange Act's applicability to only domestic transactions.

Background of the Second Circuit's Decision

Until June 2010, most courts throughout the United States had analyzed the Exchange Act's extraterritorial application under the so-called "conduct/effects test." The conduct test had traditionally considered whether the defendant's conduct in the United States was so significant as to have been more than merely preparatory to the alleged fraud and to have directly caused non-U.S. investors' losses. The effects test had considered the alleged fraud's effects on U.S. markets or investors.

In June 2010, the Supreme Court in *Morrison* rejected the conduct/effects test and adopted a supposedly bright-line rule that § 10(b) of the Exchange Act applies only to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities."

The first prong of this transactional test – "transactions in securities listed on domestic exchanges" – has generally seemed the more comprehensible prong, although it has raised questions about whether § 10(b) applies to transactions in securities that are not listed on domestic exchanges if those securities are backed by domestically listed securities or if the securities are dually listed. The second prong – "domestic transactions in other securities" (*i.e.*, securities not listed on domestic exchanges) – has generated extensive litigation.

In 2012, in *Absolute Activist Value Master Fund Ltd. v. Ficeto*,the Second Circuit construed the second prong of the *Morrison* test, dealing with securities not listed or registered on a domestic exchange. The Second Circuit held that, "to sufficiently allege the existence of a 'domestic transaction in other securities,' plaintiffs must allege facts indicating that irrevocable liability was incurred or that title was transferred within the United States." A plaintiff can demonstrate that irrevocable liability was incurred in the United States by pleading facts showing that "the purchaser incurred irrevocable liability within the United States to take and pay for a security, or that the seller incurred irrevocable liability within the United States to deliver a security." A plaintiff can also satisfy the *Morrison* test by showing that the United States was "the location in which title is transferred."

The *UBS* Decision

The *UBS* case was filed by plaintiffs who had purchased shares of UBS – a Swiss corporation – on one or more non-U.S. exchanges. The plaintiffs nevertheless sued in the United States under the Exchange Act.

Some of the named plaintiffs were non-U.S. investors, who argued that, because UBS's shares were cross-listed on the New York Stock Exchange, investors could invoke *Morrison*'s first prong – for U.S.-listed securities – even though their own transactions had taken place on a non-U.S. exchange. The Second Circuit rejected this so-called "listing theory," reasoning that *Morrison* "evinces a concern with the location of the securities *transaction* and not the location of an exchange where the security may be dually listed" (emphasis in original).

Another plaintiff was a U.S. entity that had purchased UBS shares on a foreign exchange by placing a buy order in the United States; the buy order was later executed on a Swiss exchange. This plaintiff invoked *Morrison*'s second prong – for domestic transactions in unlisted securities – and contended that, under the *Absolute Activist* test, it had incurred "irrevocable liability" in the United States by placing its buy order in this country.

The Second Circuit addressed what it called "an issue of first impression – whether the *mere placement of a buy order* in the United States for the purchase of foreign securities on a foreign exchange is sufficient to allege that a purchaser incurred irrevocable liability in the United States, such that the U.S. securities laws govern the purchase of those securities" (emphasis added). The court concluded that the placement of "a buy order in the United States that was then executed on a foreign exchange, *standing alone*," does not establish that the plaintiff "incurred irrevocable liability in the United States" (emphasis added).

What's Next?

The *UBS* decision appears to have dealt a death blow to the "listing theory," at least within the Second Circuit. The fact that a foreign security might be dually listed in the U.S. appears to be irrelevant if the plaintiff's own transaction took place on a foreign exchange.

But the decision might not be quite as dispositive as to *Morrison*'s second prong. The Second Circuit has clearly foreclosed an argument that the placement of a buy order in the United States is enough – on its own – to constitute a domestic transaction. But the court's use of the words "mere placement of a buy order" and "standing alone" could lead to further litigation about whether other factors – in addition to the location of the buy order – could collectively constitute a domestic transaction under *Morrison*'s second prong.

The Second Circuit recognized in a footnote that it had stated in *Absolute Activist* that "facts concerning the formation of the contracts, *the placement of purchase orders*, the passing of title, or the exchange of money may be relevant to determining whether irrevocable liability was incurred in the United States." The court also noted that it had made that statement "in the context of transactions [not] on a foreign exchange." But the court did not suggest whether those same factors would or would not apply to transactions on a *non-U.S.* exchange. Some of the questions that *Absolute Activist* left open might therefore remain unresolved – except as to the "mere placement of a buy order," without any additional factors that might allegedly cause the purchaser to incur irrevocable liability in the United States.

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