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The Second Circuit Clarifies the Territorial Limits of U.S. Securities Laws

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In 2010, the U.S. Supreme Court ruled in *Morrison v. National Australia Bank Ltd.* that Section 10(b) of the Securities Exchange Act of 1934 (the ''Exchange Act'') does not apply extraterritorially.[1] According to the Supreme Court, this bedrock anti-fraud provision of U.S. securities law applies only to ''transactions listed on domestic exchanges and domestic transactions in other securities.'' Since *Morrison* was decided, plaintiffs' lawyers have been testing the limits of what constitutes a ''domestic'' transaction for purposes of a federal securities fraud claim.

On May 6, 2014, the U.S. Court of Appeals for the Second Circuit defined some of those limits. In *City of Pontiac Policemen's and Firemen's Retirement System v. UBS AG* (''*City of Pontiac*''), the Second Circuit held that *Morrison* precludes private claims arising out of foreign-issued securities purchased on foreign exchanges, even if the securities were cross-listed on a domestic exchange. The Second Circuit further held that mere placement of a buy order in the United States for the purchase of foreign securities on a foreign exchange is insufficient to establish a ''domestic transaction'' under the Exchange Act.[2]

As a result of the Second Circuit's *City of Pontiac* decision, investors—including U.S.-based investors who use U.S.-based broker dealers—will have a harder time bringing claims against foreign issuers for federal securities fraud. Foreign issuers, meanwhile, can rest easier knowing that cross-listing shares on a U.S. exchange will not create worldwide exposure to class action lawsuits under U.S. law. Nevertheless, *City of Pontiac* leaves open a number of questions about how U.S. securities laws will be enforced in an era where securities

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

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[2] *City of Pontiac Policemen's and Firemen's Retirement System v. UBS AG*, No. 12-4355-cv, Slip Op. at 31 (May 6, 2014).

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transactions are electronic and may not easily be classified as ''domestic'' or ''foreign.''

Background on 'City of Pontiac Policemen's and Firemen's Retirement System v. UBS AG.' The plaintiffs in *City of Pontiac Policemen's and Firemen's Retirement System v. UBS AG* (''*City of Pontiac*'') were foreign and domestic institutional investors who purchased shares of Swiss-based UBS AG (''UBS'') that were listed on foreign exchanges and cross-listed on the New York Stock Exchange (''NYSE''). The plaintiffs alleged, among other things, that UBS (and certain of its former officers and executives) violated the Exchange Act by making purportedly misleading statements regarding UBS's mortgage-related assets portfolio and compliance with U.S. tax and securities laws.[3] On September 13, 2011, Judge Richard Sullivan, of the U.S. District Court for the Southern District of New York, dismissed the claims of the plaintiffs who purchased UBS shares on foreign exchanges, relying on the Supreme Court's *Morrison* decision that barred the extraterritorial application of US securities laws.[4]

On May 6, a Second Circuit panel unanimously affirmed the District Court's dismissal with prejudice.

The Second Circuit's Ruling on What Constitutes a Domestic Transaction. The Second Circuit considered, and rejected, two principal arguments as to why *Morrison* permitted the plaintiffs to bring suit based on purchases of foreign shares on foreign exchanges. *First*, the Second Circuit addressed the plaintiffs' so-called ''listing theory''— that because the relevant shares were cross-listed on the New York Stock Exchange, they came within the purview of the Exchange Act. Specifically, the plaintiffs contended that, under *Morrison*, their purchase of these shares were ''transactions in securities listed on domestic exchanges.''

The Second Circuit disagreed. According to the Court, the relevant inquiry under *Morrison* is not the location of an *exchange* where securities may be dually listed, but rather the location of the securities *transaction*. Thus, so long as the plaintiffs' UBS shares were purchased outside the United States on foreign exchanges, the fact that the shares were also listed in the U.S. could not support the application of Section 10(b) of the Exchange Act. The Court held: ''In sum, *Morrison* does not support the application of [Section 10(b)] to claims by a foreign purchaser of foreignissued shares on a foreign exchange simply because those shares are also listed on a domestic exchange.''[5]

Second, a US-based plaintiff argued that, by placing a ''buy order'' in the United States for foreign securities to be purchased on a foreign exchange, the plaintiff satisfied the other prong of *Morrison*, which allows Exchange Act claims based on a ''domestic transaction in other securities.'' The panel rejected this theory too, applying the Second Circuit's 2012 decision in *Absolute Activist Value Master Fund Ltd. v. Ficeto*.[6] In *Absolute Activist*, the Court of Appeals held that ''[a] securities transaction is domestic [for purposes of *Morrison*'s second prong] when the parties incur irrevocably liability to carry out the transaction within the United States or when title is passed within the United States.''[7]

As a matter of first impression, the Second Circuit concluded in *City of Pontiac* that ''the mere placement of a buy order in the United States'' was insufficient to establish ''that a purchaser incurred irrevocable liability in the United States, such that the U.S. securities laws govern the purchase of those securities.'' The court also noted that ''a purchaser's citizenship or residency does not affect where a transaction occurs.''[8] Accordingly, the panel affirmed the judgment of the District Court dismissing the claims of a domestic purchaser insofar as the claims were based on purchases of foreign shares on foreign exchanges.

What 'City of Pontiac' Means for Securities Litigation in the United States. The Second Circuit's *City of Pontiac* decision helps clarify when the purchase of foreign securities will, or will not, be subject to Section 10(b) claims. At least in the Second Circuit, it is the location of the securities transaction, not the location of an exchange where the securities happen to be listed, that will determine whether investors in foreign securities can bring suit under Section 10(b) in the United States.

Foreign issuers now can take greater comfort that listing their shares in the U.S. will not expose them to costly U.S. securities class actions with respect to shares traded on other, non-U.S. exchanges. In this regard, *City of Pontiac* may encourage more foreign issuers to access U.S. capital markets by cross listing their shares here. Foreign issuers should bear in mind, however, that *City of Pontiac* and *Morrison* may not restrict the ability of the U.S. Securities and Exchange Commission (''SEC'') or other federal authorities to enforce the Exchange Act's antifraud provisions. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (enacted post-*Morrison*), federal courts have jurisdiction over claims brought by the government for any violation involving ''(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.''[9]

For private parties seeking to sue foreign issuers under U.S. antifraud law, *City of Pontiac* creates a number of practical difficulties. The Second Circuit has made clear that it will not consider a transaction ''domestic'' simply because a buy order was placed in the United States. The *Morrison* bar on extraterritorial suits

[3] *Id.* at 5-6.

[4] *See In re UBS Sec. Litig.*, No. 07 Civ. 11225 (RJS), 2011 WL 4059356, at *1 (S.D.N.Y. Sept. 13, 2011).

[5] *City of Pontiac*, Slip. Op. at 12-14.

[6] *Id.* at 14-15 (citing *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 69 (2d Cir. 2012)).

[7] For further discussion of the *Absolute Activist* decision, see the following advisory by Arnold & Porter LLP: ''The Second Circuit Clarifies the US Supreme Contacts Court's Ruling on the Extraterritorial Reach of US Securities Laws'' *available at* http://www.arnoldporter.com/resources/documents/Advisory-The_Second_Circuit_Clarifies_the_US_Supreme_Court%E2%80%99s_Ruling_on_the_Extraterritorial_Reach_of_US_Securities_Laws.pdf.

[8] *City of Pontiac*, Slip Op. at 15.

[9] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 § 929P(b)(1), Pub. L. No. 111-203, 124 Stat. 1376, 1864 (2010) (codified at 15 U.S.C. § 77v(c)). This test resembles the so-called ''conducts and effects'' test that certain federal courts applied before *Morrison*. We further note that regulators at the state, as well as federal, level may take an expansive view of their extraterritorial jurisdiction.

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therefore will apply to so-called ''foreign-squared'' transactions involving a foreign defendant and foreign securities, as well as to ''foreign-cubed'' transactions involving a foreign plaintiff, foreign defendant, and foreign securities. In other words, a U.S. investor who places an order in the U.S. through a U.S. broker still may not satisfy the Exchange Act's territorial requirements.

The Second Circuit left open, however, the question of what additional facts must be pled to establish that a purchase of foreign securities constitutes a ''domestic transaction'' for purposes of a Section 10(b) claim. In *City of Pontiac*, the court noted 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.''[10] But what combination of these facts will be sufficient to create U.S. jurisdiction remains unclear. Perhaps that is why a U.S. district court judge recently cited *City of Pontiac* as an example of the ''somewhat unsettled and evolving nature of the law with respect to *Morrison*.''[11]

As a practical matter, establishing that ''irrevocable liability was incurred in the United States'' may prove quite difficult for plaintiffs. When an investor places an order to buy the securities of a foreign issuer, the investor may not know (or care) where the order will be executed. A broker may execute the order on a U.S. exchange, on a foreign exchange, or through an institution's dark pool (away from a centralized exchange), depending on the execution price and other factors.

Indeed, a single order may be executed in multiple places. So assuming that an investor can ascertain the operative location(s) of a transaction—no easy task in an age of rapid electronic trading—the investor's right to sue the issuer of those securities could potentially be divided across jurisdictions.

While *Morrison* and its progeny may drive some shareholder litigation to other countries or simply out of U.S. courts, plaintiffs are likely to continue testing *Morrison*'s limits. After all, U.S. class actions remain enticing for investors in foreign securities and the lawyers who represent them. In comparison to other countries, the U.S. still offers liberal discovery rules and the prospect of large jury awards, which, among other factors, can lead to sizeable settlement payments. U.S. courts will have to continue to grapple with how *Morrison* should be applied to the realities of modern capital markets—unless the U.S. Congress or a future Supreme Court overrides *Morrison*'s territorial-based ''transaction'' test for Section 10(b) of the Exchange Act.

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[10] *City of Pontiac*, Slip Op. at 16 n.33 (citing *Absolute Activist*, 677 F.3d at 70).

[11] *Atlantica Holdings, Inc. v. Sovereign Wealth Fund Samruk-Kazyna JSC*, No. 12 Civ. 8852(JMF), 2014 BL 130541, at *1 (S.D.N.Y. May 9, 2014).