Second Circuit: Federal Securities Laws Inapplicable to Cross-Listed Securities Purchased on Foreign Exchanges

In *City of Pontiac Policemen's and Firemen's Retirement System* v. *UBS AG*, the United States Court of Appeals for the Second Circuit considered "as a matter of first impression, whether the bar on extraterritorial application of the United States securities laws, as set forth in *Morrison* v. *National Australia Bank Ltd.*, 561 U.S. 247 (2010), precludes claims arising out of foreign-issued securities purchased on foreign exchanges, but cross-listed on a domestic exchange."[1] The court concluded that it does: both to domestic and foreign investor-plaintiffs.[2] In addition, the court held that the plaintiffs had failed to adequately plead actionable misstatements.

I. Background and Procedural History

In 2007, a group of domestic and foreign investors sued UBS and certain of its officers and directors in New York federal court, alleging violations of the Securities Act of 1933, as amended (the "Securities Act"), and the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The plaintiffs alleged that UBS:

- "accumulated and overvalued $100 billion in residential mortgage backed securities … and collateralized debt obligations … without disclosing this to shareholders and in contravention of its representations [to investors] regarding its risk management policies."
- "concealed the scope" of its mortgage-related assets and, "as the subprime market began to collapse in February 2007, concealed the losses in that portfolio"; and
- "made materially misleading statements" in public disclosures regarding ongoing Department of Justice and Securities and Exchange Commission investigations into "an alleged scheme in which UBS Swiss bankers traveled in and out of the United States to illegally advise American clients on the purchase of investments."[3]

The United States District Court for the Southern District of New York dismissed the claims in a pair of decisions in 2011 and 2012. The plaintiffs appealed.[4]

II. Morrison v. National Australia Bank Ltd. Narrows Scope of Exchange Act

In 2010, the Supreme Court ruled in *Morrison* that Exchange Act Section 10(b) does not provide "'a cause of action to foreign plaintiffs suing foreign[ ] defendants for misconduct in connection with securities traded on foreign exchanges.'"[5] The Court held that "[Section] 10(b) only provide[s] a private cause of action

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[1] *City of Pontiac Policemen's & Firemen's Retirement System* v. *UBS AG, et al.*, No. 12-4355-cv, slip op. at 4 (2d Cir. May 6, 2014), *available at*: http://www.ca2.uscourts.gov/decisions/isysquery/ddf2c1b7-1e73-45bb-810e-a470fd416a54/3/doc/12-4355_opn.pdf#xml=http://www.ca2.uscourts.gov/decisions/isysquery/ddf2c1b7-1e73-45bb-810e-a470fd416a54/3/hilite/

[2] *Id.* at 4-5.

[3] *Id.* at 7-8

[4] *Id.* at 9-10.

[5] *Id.* at 11, citing *Morrison* v. *National Australia Bank Ltd.*, 561 U.S. 247, 250-251 (2010).

arising out of [1] transactions in securities listed on domestic exchanges, and [2] domestic transactions in other securities."[6]

The plaintiffs in *Pontiac* unsuccessfully tried to plead around this standard.

A. "Foreign Cubed" Claims: A *Foreign Plaintiff* Suing a *Foreign Issuer* in an American Court Alleging Violations of American Securities Laws Based on Securities Transactions in *Foreign Countries*

Certain of the foreign plaintiffs in *Pontiac* purchased UBS shares listed on foreign exchanges and then sued UBS in federal court alleging Exchange Act violations. In order to get around *Morrison*'s bar on claims by foreign plaintiffs suing foreign defendants for misconduct in connection with securities traded on foreign exchanges, the *Pontiac* plaintiffs manufactured a novel argument. While the UBS shares were listed on a foreign exchange, they were also "cross-listed" on the New York Stock Exchange. "Under plaintiffs' 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.'"[7]

The Second Circuit rejected the plaintiffs' theory. The test in whether a claim is properly brought under the Exchange Act is "'the location of the securities *transaction* and not the location of an exchange where the security may be dually listed.'"[8] The "domestic listing" language in *Morrison* did not intend to bring within the scope of the Exchange Act securities that are listed on foreign exchanges and cross-listed on domestic exchanges, but rather the language was intended "as a proxy for a domestic transaction."[9] Indeed, in *Morrison* "the Supreme Court explicitly rejected the notion that the '*national* public interest pertains to transactions conducted upon *foreign* exchanges and markets.'"[10]

As a result, the Second Circuit held that an alleged violation of Exchange Act Section 10(b) is not a viable cause of action for "a foreign purchaser of foreign-issued shares on a foreign exchange simply because those shares are also listed on a domestic exchange."[11]

B. "Foreign Squared" Claims: A Domestic Plaintiff Suing a *Foreign Issuer* in an American Court Alleging Violations of American Securities Laws Based on Securities Transactions in *Foreign Countries*

The Second Circuit, after *Morrison*, had previously held that "a securities transaction is domestic for purposes of *Morrison's* second prong when the parties incur irrevocable liability to carry out the transaction within the United States or when title [to the security] is passed within the United States."[12]

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[6] *Id.*, citing *Morrison*, 561 U.S. at 267 (internal quotation marks omitted, second brackets in original).

[7] *Id.* at 11-12

[8] *Id.* at 12 (emphasis in original).

[9] *Id.* at 12.

[10] *Id.* at 12-13 (emphasis in original).

[11] *Id.* at 14.

[12] *Id.* at 14-15, quoting *Absolute Activist Value Master Fund Ltd.* v. *Ficeto*, 677 F.3d 60, 69 (2d Cir. 2012) (internal brackets and quotation marks omitted).

One of the domestic plaintiffs in *Pontiac* based its claim on that standard. It had "purchased some of its UBS shares on a foreign exchange by placing a so-called 'buy order' in the United States, which was later executed on a Swiss exchange." The plaintiff argued that "its purchase satisfies the second prong of *Morrison* because it constitutes a 'purchase of a security in the United States.'"[13]

This theory was also an issue of first impression and was rejected by the Second Circuit. The "mere placement of a buy order in the United States for the purchase of foreign securities on a foreign exchange is [not] 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."[14]

In addition, "the fact that [the plaintiff] was a U.S. entity, does not affect whether the transaction was foreign or domestic."[15]

III. Whether Certain Statements Were Actionable Misstatements Under the Securities Act

The Second Circuit also held that the misstatements alleged by the plaintiffs were not adequately pleaded for purposes of claims brought under Securities Act Sections 11 and 12(a)(2) and Exchange Act Section 10(b).

A. Plaintiffs Failed to Plead Actionable Misstatements Under the Securities Act

First, the court held that statements in UBS's offering materials that it "held its employees to the highest ethical standards and complied with all applicable laws, and that UBS's wealth management division did not provide services to clients in the United States" (when it allegedly was engaged in a "cross-border tax scheme"), were not sufficient to meet the heightened pleading standard that is required by Federal Rule of Civil Procedure 9(b) for fraud claims. The Second Circuit emphasized that "[i]t is well-established that general statements about reputation, integrity, and compliance with ethical norms are inactionable 'puffery,' meaning that they are 'too general to cause a reasonable investor to rely upon them.'" Furthermore, the plaintiffs' claims that "these statements were knowingly and verifiably false when made does not cure their generality, which is what prevents them from rising to the level of materiality required to form the basis for assessing a potential investment."[16]

Second, UBS was not required to disclose whether allegedly current, ongoing conduct could be within the scope of an ongoing investigation. UBS had disclosed to investors "that the DOJ was investigating whether, from 2000-2007, UBS client advisors entered the United States to help U.S. clients evade their tax obligations, in violation of U.S. law." The Second Circuit rejected plaintiffs' argument that "in addition to disclosing the existence of an investigation, defendants were required to disclose that UBS was, in fact, engaged in an ongoing tax evasion scheme."[17] The court emphasized that "disclosure is not a rite of confession, and companies do not have a duty to disclose uncharged, unadjudicated wrongdoing."[18] UBS had "complied with its disclosure obligations" by "disclosing its involvement in multiple legal proceedings and government investigations and

[13] *Id.* at 14 (internal ellipses and brackets omitted).

[14] *Id.* at 15.

[15] *Id.* at 15-16.

[16] *Id.* at 17, 19.

[17] *Id.* at 20.

[18] *Id.* at 21 (internal quotation marks omitted).

indicating that its involvement could expose UBS 'to substantial monetary damages and legal defense costs,' as well as 'injunctive relief, criminal and civil penalties, and the potential for regulatory restrictions."[19]

B. Plaintiffs Failed to Plead Actionable Misstatements Under the Exchange Act

The plaintiffs also failed to plead adequately misstatements under Section 10(b) of the Exchange Act. The plaintiffs alleged that UBS knew, or recklessly disregarded, that certain representations to investors concerning the concentration of certain risks, were materially false and misleading. They argued that UBS invested more in certain asset-backed securities than their disclosures suggested.

The Second Circuit held that "UBS's representations that it prioritized '*adequate* diversification of risk' and 'avoidance of *undue* concentrations,' are too open-ended and subjective to constitute a guarantee that UBS would not accumulate a $100 billion RMBS portfolio, comprising 5% of UBS's overall portfolio or 16% of its trading portfolio."[20] In addition, the court pointed out that plaintiffs' claims were undercut by the fact that UBS had also disclosed to investors that it was "seeking to expand its fixed income business" by making additional investments in asset-backed securities.[21] Accordingly, the plaintiffs did not "plausibly allege [ ] that UBS's representations regarding asset concentrations and risk diversification were materially misleading or that defendants were consciously reckless in making such representations."[22]

The plaintiffs also alleged that UBS made material misrepresentations regarding its valuations of its mortgage-related assets. "In essence, plaintiffs allege[d] that [UBS] *should have* predicted the impairment of the highly-rated … assets held" because those highly-rated assets were "collateralized by lower-rated assets," and UBS had previously written-down certain lower-rated assets in its portfolio.

The Second Circuit rejected such "allegations of 'fraud by hindsight.'"[23]

While there was "uncertainty and disagreement within UBS and in the market at large, about the valuation and risk exposure of mortgage-related assets," the plaintiffs did not adequately plead "a strong inference that the UBS defendants recklessly disregarded known facts contradicting their public valuation of their highly-rated RMBS/CDO assets, or that their behavior represented an extreme departure from the ordinary standards of care."[24]

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Guillaume Buell at 212.701.3012 or gbuell@cahill.com.

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[19] *Id.* (internal brackets and quotation marks omitted).

[20] *Id.* at 24-25 (internal quotation marks omitted).

[21] *Id.* at 26 (internal quotation marks omitted).

[22] *Id.* at 27-28.

[23] *Id.* at 29.

[24] *Id.* at 28-29.

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