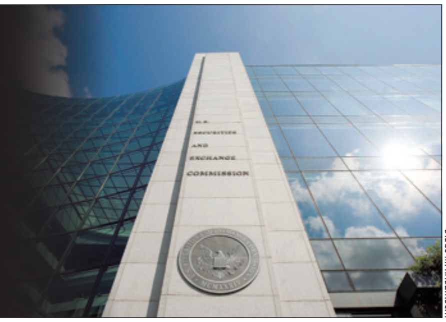
THE NATIONAL
LAW JOURNAL

MAY 30, 2016

An ALM Publication

SECURITIES LITIGATION | A SPECIAL REPORT

Litigators who focus on securities enforcement and appellate law take the pulse of the courts this week on significant trends involving the U.S. Securities and Exchange Commission. More and more cases test the constitutionality of the agency's administrative law judges, and the commission is fashioning a new norm for clawbacks that target executive bonus compensation. Plus, a look at the challenges posed by securities that are listed on more than one exchange.



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Cross-Listed Securities Cases Present Challenges

Where a transaction clears could determine whether or not investors have a remedy under U.S. law.

BY JOSEPH A. FONTI AND CYNTHIA HANAWALT

Public companies that choose to participate in the U.S. securities markets avail themselves of a wide range of benefits, including access to the capital markets, increased liquidity for shareholders and increased visibility and credibility, including coverage from U.S. securities analysts.

To access these benefits, companies must register with the U.S. Securities Exchange Commission, submitting themselves to the jurisdiction of the SEC and agreeing to comply with a range of regulations, including affirmative certifications of the company's internal controls in accordance with Sarbanes-Oxley; the application of U.S. Generally Accepted Accounting Principles to financial statements; compliance with New York Stock Exchange rules and regulations; and extensive reporting requirements.

Although all of these regulations are triggered by registration, the key enforcement mechanism of this regulatory regime—the anti-fraud provision in Section 10(b) of the Securities Exchange Act—has recently been interpreted not to apply by virtue of registration.

Instead, some courts have read the Supreme Court's decision in *Morrison v. National Australia Bank Ltd.* (2010) to require that the application of Section 10(b) turns on the happenstance of where a transaction in registered securities clears.

This interpretation diverges from the text of Section 10(b) and *Morrison*, and, more pragmatically, is divorced from the actual function of global securities markets.

PRACTICAL CONSEQUENCES

There are certain practical consequences of this interpretation of *Morrison*, particularly for securities cross-listed on both the NYSE and Canada's Toronto Stock Exchange, given the uniquely integrated nature of those exchanges.

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The Supreme Court's analysis in *Morrison* was fundamentally textual, beginning with Section 10(b), which makes it unlawful to employ deception "in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered."

The Supreme Court divided its analysis into two distinct categories that track the language of Section 10(b): transactions involving securities registered on a national exchange, and securities not so registered. The court's ultimate reasoning was predicated on the fact that the "case involve[d] no securities listed on a domestic exchange, and all aspects of the purchases complained of … occurred outside the United States."

On this factual basis, the Supreme Court used the two categories to create a bright-line holding that "[w]ith regard to securities not registered on domestic exchanges, the exclusive focus [is] on domestic purchases and sales."

The high court noted that the "transactional test we have adopted—whether the purchase or sale is made in the United States, or involves a security listed on a domestic exchange," specifically addressed the concerns of foreign entities about interference with foreign securities regulation.

Although the court emphasized that the Exchange Act was not intended to regulate foreign markets, it repeatedly points to the significance of registration on a domestic exchange. And of course, since 1933, the United States has imposed extensive regulation on issuers and trading of all registered shares, irrespective of their location.

SECOND CIRCUIT'S APPLICATION

Initially, the Second Circuit embraced the bright-line distinction in applying *Morrison*.

While addressing nonregistered securities, the Second Circuit's 2012 ruling in *Absolute Activist Value Master Fund v. Ficeto* recognized that "[o]f course, pursuant to the first prong of Morrison, Section 10(b) does apply to transactions in securities that are listed on a domestic exchange."

The distinction was again recognized in *United States v. Vilar*, which reasoned that Section 10(b) applies to "(1) a security listed on an American exchange, or (2) a security purchased or sold in the United States."

More recently, the Second Circuit has applied *Morrison* to registered securities and unregistered securities using a single question: Did the transaction happen in the United States?

In *City of Pontiac v. UBS A.G.*, the Second Circuit in 2014 held that the location of the transaction is the sole consideration, and limited the application of Section 10(b) to domestic transactions.

Facing the direct application of *Morrison* to securities registered on the NYSE and foreign exchanges for the first time, the Second Circuit held that only domestic transactions of registered securities fall under the securities fraud protections.

The court expressly rejected what it termed the "listing theory," finding that although support for the argument that listing on a U.S. exchange should bring transactions within the purview of Section 10(b) can be found in the express language of *Morrison*, "read as a whole" *Morrison* is "irreconcilable" with the theory.

The reality is that investors purchase registered securities for a variety of reasons, but significantly because they are registered and thus heavily regulated. The happenstance of where that transaction occurs is not part of the investment decision, but a function of how global markets work.

Today, of course, registered securities are not physically transacted on a trading floor—instead, millions of shares are processed in split seconds in remote server rooms, where the computers housing one exchange may sit next to another exchange's servers.

With respect to securities registered in the U.S. and Canada, the exchange on which the transaction clears is the byproduct of regulations calling for "best execution," enacted to avoid inefficiency and arbitrage and promote liquidity.

The U.S. Financial Industry Regulatory Authority imposes on its members a "best execution" rule, requiring registered brokers to use reasonable diligence to execute a trade at the venue that offers the best price in the shortest amount of time.

A parallel rule has been imposed by Part 5 of the Investment Industry Regulatory Organization of Canada. Indeed, the uniquely integrated nature of the New York and Toronto stock exchanges means cross-listed securities are also cross-registered; the same registered share could be bought on one exchange and sold on the other.

NOT BEHOLDEN TO A SPECIFIC EXCHANGE

Best-execution rules render it difficult for investors to even determine, let alone require, that their transactions are executed on a U.S. exchange.

A single investment decision that may result in a large block trade may, as a result of liquidity and best price, call for transactions on both sides of the border. Under *City of Pontiac*, in such a transaction, only the shares that happened to clear in the U.S. would have the protection of Section 10(b), while the balance would be foreclosed from legal claims.

Without further clarification from the courts, investors in today's interconnected, transnational securities markets will be left without the means to ensure that public companies comply with the obligations under the regulatory scheme.

The unintended consequence of such rulings is to undercut investors' rights. Simply due to happenstance of where their transactions cleared, any number of U.S. shareholders who sought to purchase securities registered and listed on a U.S. exchange from a U.S. broker may be left without a remedy under U.S. laws.

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