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SECURITIES LAW ALERT

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This month's Alert addresses two recent grants of certiorari by the Supreme Court: in *Fifth Third Bancorp v. Dudenhoeffer* (No. 12-751), the Court will consider the presumption of prudence for employee stock ownership plan (ESOP) fiduciaries under the Employee Retirement Income Security Act (ERISA); and in *Loughrin v. United States* (No. 13-316), the Court will address the elements of a claim under 18 U.S.C. § 1344(2), the federal bank fraud statute.

We also discuss two decisions from the Southern District of New York: one dismissing a securities fraud action against UBS AG in connection with losses incurred by rogue trader Kweku Adoboli; and another holding that Section 10(b) governs American Depositary Receipts (ADRs) traded on the New York Stock Exchange pursuant to the Supreme Court's decision in *Morrison v. Nat'l. Austl. Bank Ltd.*, 130 S.Ct. 2869 (2010).

Supreme Court Will Consider the *Moench* Presumption of Prudence for Employee Stock Ownership Plan Fiduciaries

On December 13, 2013, the Supreme Court granted certiorari to consider the presumption of prudence for employee stock ownership plan (ESOP) fiduciaries. *Fifth Third Bancorp v. Dudenhoeffer* (No. 12-751) (*Fifth Third Bancorp III*).

The Presumption of Prudence

In the seminal case of *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995) (Greenberg, J.), the Third Circuit considered the "difficult question" of when ESOP fiduciaries may "be held liable under [ERISA] for investing solely in employer common stock, when both Congress and the terms of the ESOP provide that the primary purpose of the plan is to invest in the employer's securities." The *Moench* court held that "an ESOP fiduciary who invests the assets in employer stock is entitled to a presumption that it acted consistently with ERISA by virtue of that decision." The court further ruled that a "plaintiff may overcome that presumption by establishing that the fiduciary abused its discretion by investing in employer securities."

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The Second, Fifth, Sixth, Ninth and Eleventh Circuits have all adopted the *Moench* presumption of prudence. *In re Citigroup ERISA Litig.*, 662 F.3d 128 (2d Cir. 2011); *Kuper v. Iovenko*, 66 F.3d 1447 (6th Cir. 1995) (Milburn, J.); *Kirschbaum v. Reliant Energy Inc.*, 526 F.3d 243 (5th Cir. 2008); *Quan v. Computer Scis. Corp.*, 623 F.3d 870 (9th Cir. 2010); *Lanfear v. Home Depot, Inc.*, 679 F.3d 1267 (11th Cir. 2012).

Three circuits—the Second, Third and Eleventh Circuits—have applied the presumption of prudence at the pleading stage. *Citigroup*, 662 F.3d 128; *Edgar v. Avaya Inc.*, 503 F.3d 340 (3d Cir. 2007); *Lanfear*, 679 F.3d 1267. However, the Sixth Circuit has held that the presumption of prudence "does not apply at the motion to dismiss stage." *Pfeil v. State St. Bank and Trust Co.*, 671 F.3d 585 (6th Cir. 2012) (Anderson, J.).

Background

The case before the Supreme Court stems from an ERISA stock drop class action brought by participants in the Fifth Third Bancorp Master Profit Sharing Plan (the "Plan") who invested in Fifth Third common stock through the Fifth Third Stock Fund, one of twenty separate investment funds offered under the Plan. According to the complaint, "the price of Fifth Third stock declined 74% from the beginning of the class period, July 19, 2007, through September 18, 2009." *Dudenhoeffer v. Fifth Third Bancorp*, 757 F. Supp. 2d 753 (S.D. Oh. 2010) (Beckwith, J.) (*Fifth Third Bancorp I*).

Plaintiffs alleged that "during the class period, Fifth Third switched from being a conservative lender to a subprime lender," and consequently "Fifth Third's loan portfolio became increasingly at risk due to defaults." Plaintiffs claimed that "this change in lending philosophy and/or mismanagement of the company made investing in Fifth Third common stock too risky for a retirement plan." Plaintiffs asserted that the fiduciaries of the Fifth Third Stock Fund "knew or should have known that Fifth

Third stock was too risky," and contended that the fiduciaries "should have stopped further investment of Plan assets in Fifth Third stock, and … divested the Plan of Fifth Third stock."

Among other claims, plaintiffs alleged that defendants had breached their fiduciary duties under ERISA by continuing to offer "Fifth Third stock as an investment option," and "maintaining [the Plan's] preexisting investment in Fifth Third stock … after it became an imprudent investment for the Plan" (the prudence claims). Defendants moved to dismiss the complaint in its entirety based, *inter alia*, on plaintiffs' failure to plead facts sufficient to overcome the presumption of prudence.

Southern District of Ohio Finds Plaintiffs Failed to Plead Sufficient Facts to Overcome the Presumption of Prudence

At the outset of its analysis, the Southern District of Ohio explained that the Sixth Circuit's decision in *Kuper*, 66 F.3d 1447, "control[ed] the disposition of [d]efendants' motion to dismiss." *Fifth Third Bancorp I*, 757 F. Supp. 2d 753. There, the Sixth Circuit held that courts may "presume that [an ESOP] fiduciary's decision to remain invested in employer securities was reasonable." 66 F.3d 1447. The *Kuper* court further

ruled that plaintiffs may "rebut this presumption of reasonableness by showing that a prudent fiduciary acting under similar circumstances would have made a different investment decision."

Plaintiffs contended that it was "inappropriate to apply the *Kuper* presumption at the motion to dismiss stage." *Fifth Third Bancorp I*, 757 F. Supp. 2d 753. Acknowledging a "split of authority among district courts" on this issue, the Southern District of Ohio held that "the *Kuper* presumption may be applied at the pleading stage." The court explained that "[i]f an ESOP plan fiduciary starts with a presumption that the decision to remain invested in plan securities was reasonable, then a claim for breach of fiduciary duty only becomes plausible if there are sufficient facts alleged" to overcome that presumption.

The court found that plaintiffs had not met this standard. While Fifth Third Bancorp may have "embarked on an improvident and even perhaps disastrous foray into subprime lending, which in turn caused a substantial decline in the price of its common stock," the court determined that "the complaint fails to establish that Fifth Third was in the type of dire financial predicament sufficient to establish a breach of fiduciary duty under *Kuper* and *Moench*." The court found it particularly significant that "Fifth Third remained a viable company throughout the class period."

The court granted defendants' motion to dismiss; plaintiffs appealed.

Sixth Circuit in *Pfeil* Holds the Presumption of Prudence Does Not Apply at the Pleading Stage

While the appeal was pending, the Sixth Circuit held in a separate case that the "presumption of reasonableness adopted in *Kuper* … does not apply at the motion to dismiss stage." *Pfeil*, 671 F.3d 585. The *Pfeil* court explained that its decision stemmed "from the plain language of *Kuper*," in which the Sixth Circuit had stated that "an ESOP plaintiff could 'rebut [the] presumption of reasonableness by *showing* that a prudent fiduciary acting under similar circumstances would have made a different investment decision.'" *Pfeil*, 671 F.3d 585 (quoting *Kuper*, 66 F.3d 1447). The *Pfeil* court emphasized that "[t]he presumption of reasonableness in *Kuper* was cast as an evidentiary presumption, and not a pleading requirement." Moreover, the *Pfeil* court pointed out that the Sixth Circuit in *Kuper* had "applied the presumption to a fully developed evidentiary record, and not merely the pleadings." The Sixth Circuit in *Pfeil* therefore concluded that "a plaintiff need not plead enough facts to overcome the presumption [of prudence] in order to survive a motion to dismiss."

Sixth Circuit Relies on *Pfeil* to Reverse the Southern District of Ohio's Decision in *Fifth Third Bancorp I*

On June 7, 2012, the Sixth Circuit relied on *Pfeil* to reverse the Southern District of Ohio's decision in *Fifth Third Bancorp I*. *Dudenhoefer v. Fifth Third Bancorp*, 692 F.3d 410 (6th Cir. 2012) (Stranch, J.) (*Fifth Third Bancorp II*). "Following the teaching of *Pfeil*," the Sixth Circuit declined to "apply the *Kuper* presumption of reasonableness to test the sufficiency" of plaintiffs' prudence claims in the *Fifth Third Bancorp* action. The Sixth Circuit stated that under *Pfeil*, "[p]laintiffs need only allege a fiduciary breach and a causal connection to losses suffered by the Plan" in order to state an ERISA claim against ESOP fiduciaries.

Here, plaintiffs "allege[d] that Fifth Third [had] engaged in lending practices that were equivalent to participation in the subprime lending market, that [d]efendants were aware of the risks of such investments by the start of the class period, and that such risks made Fifth Third stock an imprudent investment." Moreover, plaintiffs contended that "[a]

prudent fiduciary acting under similar circumstances would have acted to protect participants against unnecessary losses, and would have made different investment decisions." The Sixth Circuit determined that the complaint "plausibly alleges a claim of breach of fiduciary duty and the requisite causal connection" with respect to defendants' "failure to divest the Plan of Fifth Third Stock and remove that stock as an investment option."

Citing a Circuit Split, Defendants Petition the Supreme Court for Certiorari

Defendants petitioned the Supreme Court for certiorari. On December 13, 2013, the Supreme Court granted certiorari to determine "[w]hether the Sixth Circuit [had] erred by holding that [plaintiffs] were not required to plausibly allege in their complaint that the [ESOP] fiduciaries … [had] abused their discretion by remaining invested in employer stock, in order to overcome the presumption that their decision to invest in employer stock was reasonable." *Fifth Third Bancorp v. Dudenhoeffer* (No. 12-751).

In their petition for certiorari, defendants-petitioners ("Petitioners") argued that the Sixth Circuit's decision was "in direct conflict" with rulings from the Second, Third and Eleventh Circuits holding that ESOP fiduciaries are "entitled to a presumption of reasonableness at the pleading stage." Petition for a Writ of Certiorari, *Fifth Third Bancorp v. Dudenhoeffer* (No. 12-751), 2012 WL 6636191 (Dec. 14, 2012). Petitioners contended that the Sixth Circuit had "erroneously recast the *Kuper* presumption as an evidentiary presumption, rather than a standard of review." Petitioners pointed out that the Eleventh Circuit in *Lanfear*, 679 F.3d 1267, had expressly "criticized the Sixth's Circuit's holding" in *Pfeil* for this approach.

Respondents Dispute the Circuit Split, Arguing That the Other Circuit Court Decisions Are Distinguishable

In their brief in opposition, plaintiffs-respondents ("Respondents") argued that the Sixth Circuit's decision in *Fifth Third Bancorp II* does "not conflict with any decision of any other court of appeals." Brief in Opposition, *Fifth Third Bancorp v. Dudenhoeffer* (No. 12-751), 2013 WL 660668 (Feb. 22, 2013). Respondents emphasized that the different circuit court decisions "in large measure turn[ed] on the varying duties of the fiduciaries, which in turn depend[ed] on the terms of the particular ERISA plan in each case."

According to Respondents, the ESOP plans at issue in the other circuit decisions cited by Petitioners "directed the fiduciaries to invest in employer stock." Respondents claimed that "in this case, the Plan gave [P]etitioners full authority to cease investing in or divest the employer's stock, and the complaint alleges that they acted imprudently in failing to exercise that authority." Respondents contended that this distinction "makes the legal analysis" in the *Fifth Third Bancorp* action "different from that in each of the allegedly conflicting cases," and posited that "there [was] no reason to believe that … any other court of appeals would have reached a different conclusion in this case."

In their reply brief, Petitioners stated that the "Plan language at issue in this case is essentially identical to the plan language analyzed in *Citigroup*, *Edgar* and *Lanfear*." Petitioners' Reply Brief, *Fifth Third Bancorp. v. Dudenhoeffer* (No. 12-751), 2013 WL 860364 (Mar. 5, 2013). "Therefore, all four circuit court cases confronted essentially identical factual circumstances, making the split in authority all the more glaring."

* * *

The Supreme Court will hear oral argument in the *Fifth Third Bancorp* case on April 2, 2014.

Supreme Court Will Address the Elements of a Federal Bank Fraud Claim under 18 U.S.C. § 1344(2)

On December 13, 2013, the Supreme Court granted certiorari to consider "[w]hether the Government must prove that the defendant intended to defraud a bank and expose it to risk of loss in every prosecution under 18 U.S.C. § 1344," the federal bank fraud statute. *Loughrin v. United States* (No. 13-316).

The Federal Bank Fraud Statute

The federal bank fraud statute provides as follows:

> Whoever knowingly executes, or attempts to execute, a scheme or artifice—
>
> (1) to defraud a financial institution; or
>
> (2) to obtain any of the moneys, funds, credits, assets, securities, or other property owned by, or under the custody or control of, a financial institution, by means of false or fraudulent pretenses, representations, or promises;
>
> shall be fined not more than $1,000,000 or imprisoned not more than 30 years, or both.

18 U.S.C. § 1344 (2012).

Background

The case currently pending before the Supreme Court stems from "a scheme to steal checks from people's mail." *United States v. Loughrin*, 710 F.3d 1111 (10th Cir. 2013) (Tymkovich, J.). "After stealing the checks," defendant would then "alter them to make purchases at a local Target store" and subsequently "return those purchases to Target for cash." The Government prosecuted the defendant under 18 U.S.C. § 1344(2), among other counts.

At trial, defendant "proposed that the jury instruction for bank fraud, 18 U.S.C. § 1344(2), specifically require the jury to find that he had an intent to defraud a financial institution in order to convict." The District of Utah found that neither the federal bank fraud statute nor Tenth Circuit precedent required the Government to establish an intent to defraud a bank or financial institution under § 1344(2), and rejected defendant's proposed

jury instructions. The jury convicted defendant of bank fraud under § 1344(2), among other counts. Defendant appealed.

Tenth Circuit Holds the Government Need Not Prove Intent to Defraud a Bank under § 1344(2)

At the outset of its analysis, the Tenth Circuit explained that § 1344 sets forth two separate offenses: subsection (1) prohibits "a scheme to defraud" while subsection (2) prohibits "a scheme to obtain money by means of false or fraudulent pretenses, representations, or promises." The Tenth Circuit stated that a "scheme to defraud" under § 1344(1) "must necessarily be directed at a financial institution or bank." However, the Tenth Circuit noted that § 1344(2) "does not explicitly state who must be the object of the scheme." The court found "no requirement in either [Tenth Circuit precedent] or the text of § 1344(2) that the fraud must be intentionally directed at a bank."

The Tenth Circuit determined that "[t]he differences in the prohibited conduct for each offense extend to the type of proof the government needs to offer." In order "[t]o establish that a bank was *defrauded* under § 1344(1)," the Government must prove that "the bank was put at potential risk by the scheme to defraud." But the Tenth Circuit held that "a conviction under § 1344(2) requires no proof that a bank was 'at risk' [of loss] because there is no explicit requirement [in the statute] that a particular bank be defrauded." The court found that "under [Tenth Circuit] precedent, an individual can violate § 1344(2) by obtaining money from a bank while intending to defraud someone else."

The Tenth Circuit concluded that the district court had not "err[ed] in refusing to instruct the jury that an intent to defraud the bank was required" in order for the Government to prevail in its § 1344(2) case against defendant. Moreover, the Tenth Circuit found that the Government had "satisfied the fraudulent intent requirement of § 1344(2) with proof that [defendant had] intended to defraud Target rather than a bank."

Notably, the Tenth Circuit "recognize[d] that [its] interpretation of § 1344(2) may cast a wide net for bank fraud liability." But the court emphasized that its decision was "dictated by the plain language of the statute" and the Tenth Circuit's "prior precedent."

Petitioner Cites a Circuit Split on the Government's Burden of Proof under § 1344(2)

Defendant petitioned the Supreme Court for certiorari to review the Tenth Circuit's decision. On December 13, 2013, the Supreme Court granted certiorari.

In his petition for certiorari, defendant ("Petitioner") argued that "the courts of appeals are in open, acknowledged conflict" on the question of "whether intent to defraud a bank and expose it to risk of loss is a required element in every prosecution under the federal bank fraud statute," including prosecutions under § 1344(2). Petition for a Writ of Certiorari, *Loughrin v. United States of America*, 2013 WL 4855971 (Sept. 9, 2013).

Petitioner contended that six circuits (the First,

Second, Third, Fifth, Seventh and Eighth) "hold that the Government must prove that the defendant intended to defraud a covered financial institution" in order to establish a claim under § 1344(2). According to Petitioner, "it is not enough" in these circuits "that the defendant intended to defraud a non-bank victim even if a bank was involved in the scheme in some way." Petitioner further asserted that in these six circuits, the "Government must show that the defendant's scheme exposed the bank to a risk of loss" in order "to prove intent to defraud a bank."

According to Petitioner, three circuits (the Sixth, Ninth, and Tenth) "disagree" with the majority approach. These three circuit courts "have held that § 1344(2) establishes an independent crime that dispenses with any requirement to prove intent to defraud a bank or expose it to a risk of loss." Under the law in these circuits, "§ 1344(2) requires only intent to defraud *someone* and some nexus between the fraudulent scheme and a financial institution."

Petitioner claimed that these "differing legal standards regularly lead to opposite results in factually similar cases." In Petitioner's view, this inconsistency is especially problematic because "§ 1344 is a predicate offense for a number of other federal crimes, such as aggravated identity theft and racketeering." Petitioner argued that "[s]uch an important and consequential criminal statute should have the same meaning throughout the country."

Petitioner Contends the Tenth Circuit's Interpretation of § 1344(2) Is Overbroad

Citing the legislative history, Petitioner argued § 1344 "was intended to federalize fraudulent schemes only to the extent they intentionally targeted a bank and put its assets at risk." Petitioner contended that "[t]he Tenth Circuit's contrary construction gives the statute a breadth far in excess of what is necessary to accomplish Congress's purpose of protecting the financial integrity of federally related financial institutions." Moreover, Petitioner asserted that the Tenth Circuit's reading of § 1344(2) "federalizes broad swaths of traditional state crimes, like the simple fraud and theft alleged here, simply because they have some nexus to a federally related bank."

Petitioner also argued that the Tenth Circuit's interpretation of § 1344, as establishing two separate offenses, is inconsistent with the Supreme Court's interpretation of the mail and wire fraud statutes, on which Congress based the two-clause structure of § 1344. Petitioner stated that the Supreme Court "has repeatedly held" that the two clauses of the mail and wire fraud statutes "establish a single offense, the essence of which is captured in the original, first clause prohibiting schemes to 'defraud.'"

Government Acknowledges Circuit Split, but Argues This Case Is Not a Proper Vehicle for Resolving the Risk of Loss Question

In its brief in opposition, the Government acknowledged the existence of a circuit split with respect to the proof required to establish a violation of § 1344(2). Brief for the United States in Opposition,

Loughrin v. United States, 2013 WL 6091775 (Nov. 18, 2013). However, the Government argued that "[t]he division among the courts of appeals principally concerns" the question of "whether the [G]overnment must prove that the defendant caused or intended to cause a risk of loss to a financial institution." The Government stated that Petitioner "did not press that question" before the Tenth Circuit, and therefore the Tenth Circuit "did not address it."

In the Government's view, the only question the Tenth Circuit did address in the case at hand was "whether the [G]overnment must prove that the defendant intended to defraud a financial institution directly rather than obtaining funds in a financial institution by defrauding a third party." The Government recognized that "a majority of the circuits has held that bank fraud under either prong of § 1344 requires an intent to deceive the bank directly." But the Government explained that "even those courts that construe the statute to require proof that the defendant intended to victimize a financial institution regularly find that element satisfied when a third party (*e.g.*, the defendant's employer) is the primary victim and fraudulent documents are presented to a bank." Therefore, the Government pointed out that "[t]he distinction between the majority position and the view adopted by the [Tenth Circuit] … will rarely be of practical importance."

The Government further contended that if the Tenth Circuit had imposed a risk of loss requirement, the requirement would have been met in this case. The Government stated that "fraudulent schemes designed to obtain funds in the custody of a bank by the negotiation of an altered or forged check inherently pose a risk to the bank sufficient to satisfy the risk-of-loss" requirement.

* * *

The Supreme Court will hear oral argument in the *Loughrin* case on April 1, 2014.

Southern District of New York Dismisses Securities Fraud Action against UBS in Connection with Rogue Trader's Losses

On December 13, 2013, the Southern District of New York dismissed a securities fraud action against UBS AG in connection with unauthorized trades by rogue trader Kweku Adoboli that ultimately cost the bank $2.3 billion in losses. *C.D.T.S. No. 1 v. UBS AG*, 2013 WL 6576031 (S.D.N.Y. Dec. 13, 2013) (Forrest, J.). The court found the fact "that a 'rogue' trader was able to cause such a significant loss to UBS … more akin to a claim of mismanagement than of fraud."

Background

On September 15, 2011, UBS acknowledged that a "'rogue' trader in the Investment Bank division had engaged in unhedged proprietary trades with non-existent counterparties," resulting in losses in excess of $2.3 billion. Plaintiffs subsequently brought suit alleging that the incident had "forced" UBS to acknowledge that its "risk and disclosure controls were inadequate."

According to plaintiffs, UBS had made "a series of alleged material misstatements and omissions 'regarding UBS's purportedly robust risk management systems and internal controls.'" Plaintiffs claimed that these statements were untrue given the bank's alleged "failure to integrate risk assessment into UBS's compensation framework;" its "incentivized high risk trading" policies; and its practice of "permit[ting] individual traders to maintain 'umbrella' or 'suspense' accounts," among other factors. In support of these allegations, plaintiffs pointed to "ex post facto reports, filings, and statements criticizing UBS's risk controls."

Court Finds Plaintiffs' Internal Control-Related Allegations Insufficient to State a Securities Fraud Claim

The Southern District of New York found that plaintiffs had alleged only "a litany of general statements regarding risk controls at UBS." Plaintiffs did not point to any specific "reports, filings, or subsequent statements" that were "directly tied to any particular alleged misstatements." For example, none of the subsequent statements conveyed, "in substance," that UBS knew "the prior statement[s] … were wrong at the time." Rather, plaintiffs effectively alleged that UBS's "statements regarding risk controls must have been false because they occurred while a rogue trader racked up a massive loss."

The court noted that it had "confronted … a situation similar to that here" in the case of *In re Royal Bank of Scotland Group PLC Sec. Litig.*, 2012 WL 3826261 (S.D.N.Y. Sept. 4, 2012) (Batts, J.). The *Royal Bank of Scotland* court found "alleged misstatements concerning internal control and risk management procedures … not actionable" because plaintiffs "fail[ed] to cite any contemporaneous support to show that the credit management procedures were not followed." 2012 WL 3826261. Like the *Royal Bank of Scotland* court, the *UBS* court determined that plaintiffs had failed to "provide sufficient information that would allow [the] [c]ourt to draw … even circumstantially" "an inference of falsity at the time the alleged statements were made." *UBS*, 2013 WL 6576031.

Moreover, the *UBS* court found that the internal control-related statements at issue were "akin to … inactionable puffery." The court emphasized that "[a]t the time the statements regarding risk controls were made here, the banking sector had experienced enormous losses." When viewed against this backdrop, the court explained that "touting good risk controls is the equivalent of positive, aspirational puffery."

Finally, the court determined that plaintiffs had "failed adequately to allege loss causation." The court explained that the "significant number of steps" it would take "to tie the alleged misstatements and omissions [regarding UBS's internal controls] to the diminution in UBS's stock price" was "too speculative … to sustain a claim of securities fraud."

The court therefore dismissed plaintiffs' complaint in its entirety. In so holding, the court observed that "[o]ver the past several years, it has been ever so easy to make banks the target of lawsuits alleging securities fraud." The court emphasized that "the securities laws have limits" and "do not, for instance, require that banks be prescient or omniscient."

Southern District of New York Finds Section 10(b) Applies to Transactions in American Depositary Receipts Traded on Domestic Exchanges

On December 17, 2013, the Southern District of New York applied the Supreme Court's decision in *Morrison v. Nat'l. Austl. Bank Ltd.*, 130 S.Ct. 2869 (2010), to hold that Section 10(b) reaches transactions involving American Depositary Receipts (ADRs) traded on the New York Stock Exchange. *U.S. v. Martoma*, 2013 WL 6632676 (S.D.N.Y. Dec. 17, 2013) (Gardephe, J.).

Background

The Government brought suit against Matthew Martoma, a hedge fund employee, alleging "securities fraud … based on [Martoma's] alleged insider trading in Elan ADRs," among other claims. Martoma moved to dismiss the insider trading count on the grounds that the ADR transactions at issue "constitute[d] extraterritorial transactions under *Morrison*." Martoma contended that the "Elan ADRs were derivatives that simply repackaged Elan stock, which is traded abroad."

Court Holds ADRs Traded on a Domestic Stock Exchange Meet Both Prongs of the *Morrison* Test

The Southern District of New York explained that "*Morrison* requires courts to apply a two-prong[ed] test in determining the applicability of Section 10(b)." Under the first prong, courts must consider whether the transaction involves "securities listed on domestic exchanges." *Morrison*, 130 S.Ct. 2869. If "the first prong is not satisfied, courts must then consider whether there has been a domestic purchase or sale of a security" under *Morrison*'s second prong. *Martoma*, 2013 WL 6632676; *see also Morrison*, 130 S. Ct. 2869 (stating that Section 10(b) reaches "domestic transactions in other securities").

In the case before it, the Southern District of New York found that "the first prong of *Morrison* [was] satisfied" "[b]ecause the Elan ADRs are securities that are listed and traded on" the New York Stock Exchange (NYSE). *Martoma*, 2013 WL 6632676.

The court acknowledged that in the case of *In re Société Générale Sec. Litig.*, 2010 WL 3910286 (S.D.N.Y. Sept. 29, 2010),[1] the Southern District of New York had stated that "[t]rade in ADRs is considered to be a 'predominantly foreign securities transaction.'" However, the court distinguished *Société Générale* on the grounds that the ADRs at issue there "were not traded on an official American securities exchange" but were "instead … traded in a less formal market with lower exposure to U.S.-resident buyers." Here, on the other hand, "the Elan ADRs were in fact traded on 'an official American securities exchange.'" The Southern District of New York found it significant that Martoma could not cite to any case "in which a court has concluded that Section 10(b) does not apply to transactions in ADRs that are listed and traded on a domestic exchange."

With respect to the second prong of the *Morrison* test, Martoma contended that the Elan ADRs were "merely 'receipts that may be redeemed for … foreign [Elan] stock at any time,'" and thus transactions in Elan ADRs were "mere proxies for transactions occurring outside the United States." The court found this argument "not persuasive" because it did "not address where the transactions in the ADRs took place" under *Morrison*'s second prong.

In *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60 (2d Cir. 2012), the Second Circuit held that a transaction is "domestic" under the second prong of *Morrison*'s test if "irrevocable liability was incurred or … title was transferred within the United States."[2] *Absolute Activist*, 677 F.3d 60. Courts must consider, *inter alia*, "facts concerning the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money."

Applying *Absolute Activist*, the Southern District of New York explained that the "ADRs at issue [here] were traded on the NYSE, which means that the formation of contracts for those trades, the passing of title to those securities, and the incurring of liability on the part of sellers and purchasers of those ADRs occurred in the United States." *Martoma*, 2013 WL 6623676. The court held that "[u]nder these circumstances, the second prong of *Morrison* is satisfied."

Based on its finding that Section 10(b) applied to the Elan ADRs transactions, the court denied Martoma's motion to dismiss the insider trading count.

1. Please click here to read our discussion of the *Société Générale* decision in the October 2010 edition of the Alert.

2. Please click here to read our discussion of the *Absolute Activist* decision in the March 2012 edition of the Alert.

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Simpson Thacher "is arguably the leader" in defending securities litigation "in the private equity sector."

—LEGAL 500 2013

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