INSURANCE-LINKED SECURITIES AND THE EXTRATERRITORIAL SCOPE OF RULE 10b-5

In its landmark decision in *Morrison v. National Australia Bank* in 2010, the U.S. Supreme Court significantly limited the extraterritorial reach of Rule 10b-5, which is the main U.S. antifraud remedy for nonpublic offerings of securities, such as insurance-linked securities (commonly referred to as ILS). In light of *Morrison*, as well as more recent guidance by the Second Circuit Court of Appeals in *Absolute Activist Value Master Fund Ltd. v. Ficeto*, this memorandum analyzes whether and how ILS offering participants can mitigate their exposure to U.S. federal securities liability. While we do not believe that the robust disclosure and review standards currently employed in ILS offerings should be weakened in any respect, there may be relatively simple steps to help those involved in a transaction further reduce litigation risk by taking advantage of the territorial limits of Rule 10b-5.

Background of Rule 10b-5

The principal antifraud remedy that can be sought by investors under the U.S. federal securities laws against ILS offering participants is damages under Section 10(b) of the Securities Exchange Act of 1934, including Rule 10b-5 promulgated thereunder. Because catastrophe bonds and other insurance-linked securities have traditionally been offered and sold in reliance on the exemption from registration provided by Rule 144A or Section 4(2) of the Securities Act of 1933, liability under Sections 11 and 12(a)(2) of the Securities Act, which relate to securities fraud in connection with public offerings, does not apply.

Rule 10b-5 makes it unlawful for any person, directly or indirectly in connection with the purchase or sale of any security, to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made not misleading. In order to establish a claim under Rule 10b-5, an investor must demonstrate that the defendant (i) made a misstatement or omission of a material fact, (ii) in connection with the purchase or sale of a security, (iii) with the requisite scienter (*i.e.*, an intent to deceive or reckless disregard for the truth), (iv) upon which the investor justifiably relied, (v) that proximately caused (vi) the investor's economic loss.

Extraterritorial Scope of Rule 10b-5

Prior to the Supreme Court's ruling in *Morrison*, the Second Circuit had long applied judicially-created "conduct" and "effects" tests to determine whether sufficient domestic conduct or effects existed in a given case to warrant the application of the federal securities laws abroad. While there were many variations on this theme, the effects test generally centered its inquiry on whether domestic investors or markets were affected as a result of actions occurring outside the United States, whereas the conduct test focused "on the nature of conduct within the United States as it relates to carrying out the alleged fraudulent scheme."

In *Morrison*, however, the Supreme Court significantly limited the extraterritorial scope of Section 10(b) to "transactions in securities listed on domestic exchanges…and domestic transactions in other securities." In *Morrison*, the Court rejected the conduct and effects tests, which it characterized as overly expansive, nebulous and inconsistently applied. The new "transactional test" posited by the Court sought to establish a bright-line standard, but did not suggest practical guidance for specifically determining the applicability of Rule 10b-5 to those transactions that have both domestic and foreign components, such as many ILS transactions.

More recently, in March 2012, the Second Circuit Court of Appeals in *Absolute Activist* further clarified the second prong of the *Morrison* transactional test, which relates to domestic transactions in securities not listed on a U.S. exchange, such as insurance-linked securities. In *Absolute Activist*, 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." Such relevant facts would include "facts concerning the formation of the contracts, the placement of purchase orders, the passing of title or the exchange of money." In its ruling, the Second Circuit rejected the notion that the locations of the broker-dealer and the issuer or the domicile of the investor were dispositive for determining whether a transaction was domestic.

Although *Absolute Activist* clarified the legal standard generally applicable to determine whether off-exchange securities transactions are subject to Rule 10b-5, it did not provide specific guidance as to whether particular kinds of off-exchange transactions are subject to Rule 10b-5, particularly when the initial purchaser (*i.e.*, the underwriter) is in the United States but the investor for whose account the securities are purchased is located outside of the United States. As the courts work through different factual scenarios in applying the *Absolute Activist* test, it is likely that the common law of contracts—when an issuer's offer to purchase or sell securities is accepted and becomes a binding obligation on the investor—will play a significant role in evaluating whether and where irrevocable liability is established or title passes. In addition, it is important to remember that, for enforcement cases brought by the SEC or the DOJ, the old conduct and effects tests are once again the law: Section 929P of the Dodd-Frank Act has amended the antifraud provisions of the securities laws to specifically provide for their extraterritorial application if there is substantial conduct in the United States or conduct abroad has substantial effects in the United States, but these amendments do not apply to private litigants. More practical guidance will presumably develop as the *Morrison* framework continues to be applied by the lower courts.

Application to Insurance-Linked Securities

It is important not to overstate the Rule 10b-5 risk in ILS offerings or to suggest that it is critical to offer securities only in transactions designed to occur outside of the United States from a Rule 10b-5 perspective. For purposes of establishing that irrevocable liability was incurred abroad, we have assumed that there is very little offering participants can do, short of targeting foreign investors, to ensure that investors execute trade confirmations or otherwise incur irrevocable liability from outside of the United States. While many investors are located overseas in Europe or in Bermuda, there is a strong ILS market in the United States that is critical for the success of specific issuances and the market in general.

Materially changing the structure and marketing of transactions in order to be outside of the extraterritorial reach of Rule 10b-5 could be a case of the tail wagging the dog. Further, the risk of liability under Rule 10b-5 can be effectively managed by experienced and attentive bankers and legal counsel and a continuing commitment to full disclosure of the risks intrinsic to ILS transactions.

However, there may be relatively simple steps that offering participants should consider in order to increase the likelihood that sales to investors acting outside of the United States are not considered domestic from a Rule 10b-5 perspective, particularly with respect to the transfer of title. Insurance-linked securities, like most Rule 144A securities in general, are typically offered in book-entry form, whereby title to the securities is held in the name of a nominee of The Depository Trust Company (*i.e.*, Cede & Co.) in the United States. In addition, the physical global certificates representing the securities are often held by the indenture trustee in New York as custodian for the depositary. Investors typically do not hold title to the security itself, but a beneficial interest in the security through the depositary (often mediated through broker-dealers), who will make appropriate entries in its books to reflect the beneficial interest of the investor.

In these types of Rule 144A book-entry transactions, there are three separate transfers of ownership before beneficial ownership comes to rest with the investor. In the initial instance, title to the security is transferred when the indenture trustee authenticates the global certificate upon payment by the initial purchaser, which authenticated security is held by the trustee on behalf of the depositary. The books and records of the issuer will also reflect ownership by the depositary as the sole registered holder of the security. Concurrent with the authentication of the global certificate, the depositary will transfer beneficial ownership of the security through a book entry to the initial purchaser, who a short time later will settle with the investor and cause the depositary to further transfer beneficial ownership to a broker-dealer depositary participant acting on behalf of the investor.

From a Rule 10b-5 perspective, the consequential transfer of ownership likely occurs in connection with the sale from the initial purchaser upon settlement of the purchase price by the investor and the related book-entry notation by the depositary. To the extent that the marketing or liquidity of an offering will not be adversely impacted, transaction participants should offer the securities in book-entry form through Euroclear or Clearstream outside of the United States. We have seen this approach used in several transactions without adverse consequences. Such a step may be a significant fact in establishing that title was transferred offshore for those investors otherwise acting outside of the United States. For the same reason, parties may also want to have the indenture trustee authenticate and hold the physical security certificate as custodian from a branch outside of the United States. Again, while this approach is not the norm, we have seen it used in prior transactions.

Conclusion

What *Morrison* and *Absolute Activist* mean for sponsors and initial purchasers of insurance-linked securities is still a judicial work in progress and, therefore, is not entirely free from doubt. It is worth stressing that the rigorous drafting and review processes and disclosure standards currently undertaken in ILS transactions should not be undermined or weakened in any respect,

not only because of the obvious legal consequences, but also for important reputational and marketing reasons. As previously noted, certain ILS investors will continue to act within the United States, and how the recent developments on extraterritoriality affects these investors remains to be seen. In addition, for those investors acting from outside of the United States, offering participants may be subject to the securities laws of other jurisdictions. Therefore, any of the mitigating techniques described in this memorandum may be helpful in defending a claim after the fact for certain non-U.S. investors, but should not be relied upon as the sole means of sidestepping liability. In law, as in many things, prevention is typically the best policy.

* * * * * * * * * * * * * * *

If you have any questions regarding this memorandum, please contact Richard Bernstein (202-303-1108, rbernstein@willkie.com), James Dugan (212-728-8654, jdugan@willkie.com), Joseph Ferraro (+44 207-153-1218, jferraro@willkie.com), Michael Groll (212-728-8616, mgroll@willkie.com), Robert Rachofsky (212-728-8088, rrachofsky@willkie.com), John Schwolsky (212-728-8232, jschwolsky@willkie.com), Matthew Stern (212-728-8533, mstern@willkie.com), or the Willkie attorney with whom you regularly work at (212) 728-8000.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

May 30, 2012