Absolute Activist Decision Provides Further Clarification Regarding The Extra-Territorial Reach Of U.S. Securities Laws

By: Neil R. Morrison

On March 1, 2012, the United States Court of Appeals for the Second Circuit (the "Court of Appeals" or "Court") issued its decision in *Absolute Activist Value Master Fund Ltd. v. Ficeto*,[1] clarifying the circumstances under which transactions by foreign investors in securities not listed on a U.S. exchange would qualify as "domestic" pursuant to the U.S. Supreme Court's opinion in *Morrison v. National Australia Bank Ltd.*[2] In *Morrison*, the Supreme Court set forth the standard for the extra-territorial reach of the provisions of the Securities Exchange Act of 1934 ("Exchange Act"), specifically Section 10(b), and provided a bright-line rule as to when civil liability may arise for foreign participants in domestic transactions that are not listed on U.S. exchanges. The Supreme Court noted that with respect to those securities not registered on domestic exchanges, the exclusive focus would be on "domestic" purchases and sales. In *Absolute Activist*, the Court of Appeals provided further clarification and made clear that, no matter what other U.S. contacts or connections may attend a transaction in securities not listed on a U.S. exchange, a transaction is "domestic", and thus within the ambit of Section 10(b) of the Exchange Act, only if "irrevocable liability is incurred or title passes within the United States."[3]

I. Factual Background

The plaintiffs in *Absolute Activist* were comprised of several hedge funds located offshore in the Cayman Islands that invested in a variety of assets and securities on behalf of investors around the world including investors in the U.S. According to the complaint, the hedge funds suffered losses of at least $195 million as a result of an alleged "pump-and-dump" scheme in the purchase of shares of thinly capitalized U.S. companies (so-called "penny stock" companies), purportedly orchestrated by U.S.-based broker-dealer and investment manager defendants.[4] At the time of these purchases, the defendants allegedly either held or otherwise controlled a substantial amount of shares and/or warrants of the penny stock companies. According to the plaintiffs, the defendants caused the plaintiffs to purchase billions of shares in these penny stock companies (all incorporated in the United States) directly from those companies in private offerings. Then the price of the shares was allegedly manipulated through excessive trading and re-trading of the shares generating illicit commissions and windfall profits for defendants from the inflated price of those securities.[5] At or around the time of these purchases, the U.S. penny stock companies registered their shares with the SEC.

The hedge fund plaintiffs alleged fraud claims under Section 10(b) of the Exchange Act and Rule 10b-5 as well as common law fraud and conspiracy claims. Several of the defendants then moved to dismiss the complaint, in part for failure to state a claim under the Exchange Act. The day after the United States District Court for the Southern District of New York heard oral argument on motions to dismiss, the U.S. Supreme Court issued its decision in *Morrison.* The district court dismissed the complaint in its entirety ruling, *sua sponte*, that it lacked subject matter jurisdiction over the case relying on *Morrison*. The plaintiff investor funds then appealed the dismissal of their case to the Court of Appeals.

II. Court Of Appeals Decision

On appeal, in determining whether violations of Section 10(b) and Rule 10b-5 were properly alleged and could apply in *Absolute Activist*, the Court of Appeals turned to the U.S. Supreme Court's decision in *Morrison*. The Court noted that in *Morrison*, the Supreme Court held that Section 10(b) and Rule 10b-5 did not apply extraterritorially but only applied to "transactions in securities listed on domestic exchanges[] and domestic transactions in other securities."[6] The Court noted that under *Morrison's* new transactional test, the application of Section 10(b) was a merits-based inquiry and not an issue of subject matter jurisdiction, and that "[w]ith regard to securities not registered on domestic exchanges, the exclusive focus [is] on *domestic* purchases and sales …."[7]

The *Absolute Activist* case did not deal with the first prong of *Morrison* — whether a transaction involves a security listed on a domestic exchange. Rather, the Court only addressed the second prong of *Morrison* dealing with whether a purchase or sale of a security that is not listed on a domestic exchange should be considered "domestic" within the meaning of *Morrison*. The Court of Appeals observed that the securities purchased by plaintiff investors were obtained in private offerings known as "private investment in public equity transactions," or "PIPE" transactions, and not purchased on a "domestic" exchange. The Court, therefore, had to determine the scope of what would be a "domestic transaction" of securities within the meaning of *Morrison*.

The Court of Appeals, while acknowledging that the Supreme Court provided little, if any, guidance as to what constituted a "domestic purchase or sale," held that in order to determine the meaning of a domestic "purchase" or "sale," it would initially have to consider how those terms were defined in the Exchange Act.[8] Relying on the statutory provisions of the Exchange Act, the Court determined that "[t]he terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire," while "[t]he terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of," all of which suggested that the act of purchasing or selling securities is the act of entering into a binding contract to purchase or sell securities.[9] In other words, according to the Court's interpretation of the Exchange Act, a "purchase" or "sale" takes place when the parties become bound to effectuate the transaction. The creation of that irrevocable liability indicates also where the sale or purchase of securities occurred.[10] The Court of Appeals further held that the *locus* of the transaction could be determined to "take place at the location in which title is transferred."[11]

The Court thus set forth a definitive, bright-line test in determining whether plaintiff under Section 10(b) of the Exchange Act has alleged a "domestic" securities transaction in securities not listed on a domestic exchange — that is, plaintiff must allege facts suggesting that irrevocable liability was incurred or title was transferred, within the United States.[12] The Court of Appeals added that this approach in determining the *locus* of a securities purchase or sale had already been adopted and applied by several district courts within the Second Circuit as well as within the Eleventh Circuit.[13]

In reaching its decision, the Court of Appeals rejected and dismissed other alternative tests suggested by the parties in determining whether the plaintiffs' claims met the standard for invoking Section 10(b) liability under *Morrison's* "domestic" transactional test. The Court indicated that the identity of the parties (their residence or citizenship), the type of securities (where the securities are issued by U.S. companies and/or are registered with the SEC), and individual defendant conduct engaged within the U.S., would not be determinative of whether a transaction is "domestic" under *Morrison's* transactional test.[14] The Court of Appeals concluded that a securities transaction is deemed to be "domestic" only when the parties incur irrevocable liability to carry out the transaction within the U.S. or when title is passed within the U.S.[15]

Under this standard, the Court of Appeals held that the plaintiffs in *Absolute Activist* had failed to allege facts demonstrating "domestic securities" transactions in their complaint and thus did not state a claim under Section 10(b) Exchange Act and Rule 10b-5.[16] In its decision, the Court again confirmed the Supreme Court's holding in *Morrison* that "'the focus of the Exchange Act is not upon the place where the deception originated, but upon purchases and sales of securities in the United States.'"[17] The Court of Appeals stated, however, that plaintiffs should be granted leave to amend their complaint on remand as the complaint was drafted prior to the Supreme Court's decision in *Morrison* and before the Second Circuit had adequately explained the pleading requirements for "domestic" securities transactions.[18]

III. Implications

The ruling of the Court of Appeals in *Absolute Activist* provides important and needed clarification on the meaning of a "domestic transaction" under *Morrison* and the resulting extraterritorial reach of the U.S. securities laws. The Court of Appeals squarely rejected alternative scenarios espoused by the parties to determine if a transaction may be considered to be "domestic," such as the location of the conduct, the identity of the purchaser or seller or security, and/or whether or not the securities are issued by U.S. companies and/or are registered with the SEC. Rather than accepting such alternative theories, the Court of Appeals has provided a definitive, bright-line standard that a securities transaction is "domestic" within the meaning of Section 10(b) of the Exchange Act only when the parties incur irrevocable liability to carry out the transaction within the U.S. or when title is passed within the U.S.

Under this new, bright-line standard, mere general allegations of some U.S.-based connections to a securities transaction whether through an issuing company, underwriter, investor or broker-dealer will not be enough. Rather, only factual allegations showing that the purchaser or seller became irrevocably bound to the transaction in the U.S., or received title or ownership to the securities in the U.S., will survive a motion to dismiss.

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[1] *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 672 F. 3d 143 (2d Cir. 2012).
[2] *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010).
[3] *Absolute Activist*, at 145.
[4] *Id.* at 146.
[5] *Id.* at 146-47
[6] *Id.* at 149 (quoting *Morrison*, 130 S. Ct. at 2884).
[7] *Id.(* quoting *Morrison*, 130 S. Ct. at 2885).
[8] *Id.* at 150.
[9] *Id.* at 150-51.
[10] *Id*. at 151.
[11] *Id.*
[12] *Id.*
[13] *Id. (citing SEC v. Goldman Sachs & Co.*, 790 F. Supp. 2d 147, 159 (S.D.N.Y. 2011); *Plumbers' Union Local No. 12 Pension Fund v. Swiss Reins. Co.*, 753 F. Supp. 2d 166, 177 (S.D.N.Y. 2010); *Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada*, 645 F.3d 1307, 1310-1311 (11th Cir. 2011)).
[14] *Id.* at 152-53. The Court acknowledged, however, that the location of the broker-dealer defendants could be relevant to the extent that the broker-dealer carried out tasks that irrevocably bound the parties to buy or sell securities, but that the location of the broker by itself would not demonstrate where the contracts or transactions took place. *Id.* at 152.
[15] *Id.* at 152-53.
[16] *Id.*
[17] *Id.* at 154 (quoting *Morrison*, 130 S. Ct. at 2884).
[18] *Id*.