Second Circuit Defines Extraterritorial Reach of Exchange Act Section 10(b)

On March 1, 2012, the Second Circuit issued a decision in *Absolute Activist Value Master Fund Ltd.* v. *Ficeto*, defining the extraterritorial reach of Section 10(b) of the Securities Exchange Act of 1934 – an issue previously left open by the Supreme Court in *Morrison* v. *National Australia Bank Ltd*. The Court of Appeals held that "to sufficiently allege a domestic securities transaction in securities not listed on a domestic exchange, . . . a plaintiff must allege facts suggesting that irrevocable liability was incurred or title was transferred within the United States."[1]

I. Factual Background and Procedural History

Plaintiffs, Cayman Island hedge funds, filed a complaint against defendant Absolute Capital Management Holdings Limited, their investment manager, alleging fraud under Section 10(b) and related Rule 10b-5, claiming defendants conducted "cycles of fraudulent trading of securities."[2] The companies involved were incorporated in the United States, and had shares registered with the Securities and Exchange Commission ("SEC") and listed on either Over-the-Counter Bulletin Board or on Pink OTC Markets, Inc. Some defendants moved to dismiss the complaint, in part for failing to state a claim under the Exchange Act. However, the District Court dismissed the complaint *sua sponte* for lack of subject matter jurisdiction per the Supreme Court's decision in *Morrison*. The plaintiffs appealed.

II. *Morrison* and the Extraterritorial Reach of Section 10(b)

Section 10(b) states it is illegal "[t]o use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[3] To that end, the SEC promulgated Rule 10b-5:

> [i]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) 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, in the light of the circumstances under which they were made, not misleading, or
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[4]

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[1] *See Absolute Activist Value Master Fund Ltd.* v. *Ficeto*, No. 11-0221-cv, Slip. Op. at 14 (2d Cir. Mar. 1, 2012), defining standards set forth in *Morrison* v. *National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010).

[2] *See id.* at 5, 7-8. The plaintiffs also made claims under the common law. *See id.* at 8.

[3] 15 U.S.C.A. § 78j(b).

[4] 17 C.F.R. § 240.10b-5.

The Supreme Court considered the extraterritorial reach of Section 10(b) and Rule 10b-5 in *Morrison*, specifically whether Section 10(b) allowed a cause of action for activity relating to securities traded on foreign exchanges.[5] The Court held Section 10(b) does not have extraterritorial reach, and established a "'transactional test'" which limited its applicability to "'transactions in securities listed on domestic exchanges[] and domestic transactions in other securities.'"[6] According to the Court, for "'securities *not* registered on domestic exchanges, the exclusive focus [is] on *domestic* purchases and sales . . . .'"[7] *Morrison* did not fully explain what conduct would satisfy this second prong.

III. The Second Circuit's Decision in *Absolute Activist*

The Second Circuit addressed this open issue and held that "transactions involving securities that are not traded on a domestic exchange are domestic if irrevocable liability is incurred or title passes within the United States."[8] The Court of Appeals determined a purchase or sale occurs "when the parties become bound to effectuate the transaction," and held that the creation of that irrevocable liability can indicate where the actual sale or purchase of the securities occurred.[9] As a result, a plaintiff can allege a securities transaction was domestic by stating facts indicating irrevocable liability formed between the parties in the United States. In addition, the locus of the transaction can be determined to "take place at the location in which title is transferred."[10] The court suggested potential facts that would support these allegations, including information regarding contract formation, purchase orders, title transfers or monetary exchanges.[11]

The Second Circuit discussed and dismissed several other tests suggested by the parties. The court first rejected the idea that a broker's location, on its own, could be used to determine the location of a contract.[12] The court also rejected tests based on the identity of the security itself and the citizenship or residency status of a purchaser. Lastly, the court stated that while *Morrison's* transactional test does not require specific conduct by each defendant within the United States, facts suggesting a defendant had no contact with the United States may speak to personal jurisdiction instead.

Under its holding, the Second Circuit concluded plaintiffs failed to allege facts demonstrating domestic securities transactions in their complaint and therefore did not state a claim under the Exchange Act and Rule 10b-

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[5] *See Morrison* v. *National Australia Bank Ltd.*, 130 S. Ct. 2869, 2875 (2010).

[6] *See Absolute Activist Value Master Fund Ltd.*, Slip Op. at 10 (quoting *Morrison*, 130 S. Ct. at 2884, 2886). This test ran counter to the conduct and effects test previously used in the Second Circuit. *See id.* at 9.

[7] *Id.* at 11 (quoting *Morrison*, 130 S. Ct. at 2885).

[8] *Id.* at 11. While the plaintiffs argued their case satisfies *Morrison's* second prong, the court noted the first prong was addressed by a district court in California in a prior SEC proceeding, which held the first prong was "satisfied because the case involves securities traded on the over-the-counter securities market, not securities sold on foreign exchanges." *See id.* at 11, n.4. The Second Circuit did not address this issue.

[9] *See id.* at 13.

[10] *See id.* at 14.

[11] *See id.* at 17. Facts deemed insufficient to satisfy *Morrison* included the wiring of money to a New York bank or the harm to United States investors by defendants' marketing efforts. *See id.* at 17. Also insufficient were whether the "[s]tocks were issued by United States companies and were registered with the SEC" and whether the fraud itself occurred in the United States. *See id.* at 18 (citing *Morrison*, 130 S. Ct. at 2884).

[12] *See id.* at 14. This fact could be relevant, however, to show the location of the creation of irrevocable liability. The location of an underwriter, on its own, was similarly insufficient to satisfy *Morrison*. *See id.* at 17.

5. The court stated the plaintiffs should be granted leave to amend the complaint on remand, however, as the complaint was drafted prior to the Supreme Court's *Morrison* decision and before the Second Circuit explained the pleading requirements for domestic securities transactions.

IV. Significance of the Decision

The Second Circuit's decision brings clarity to an issue previously left open by the Supreme Court: the extraterritorial reach of the Exchange Act and the defining characteristics of a domestic securities transaction.

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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; or John Schuster at 212.701.3323 or jschuster@cahill.com.