Second Circuit Clarifies Elements of a Domestic Securities Transaction Under Morrison v. National Australia Bank

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On March 1, 2012, the United States Court of Appeals for the Second Circuit held that a foreign plaintiff may assert a fraud claim under the federal securities laws based on its purchases of securities issued by U.S. companies that are not listed on a U.S. securities exchange only when irrevocable liability to purchase or sell the securities was incurred or title to the securities transferred in the United States. In the decision, *Absolute Activist Master Fund Ltd. v. Ficeto*, the Second Circuit was required to interpret the second prong of the U.S. Supreme Court's decision in *Morrison v. National Australia Bank* restricting the extraterritorial application of Section 10(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and related Rule 10b-5 in transactions that do not occur on a U.S. securities exchange. While the Second Circuit held in *Absolute Activist* that the plaintiffs had failed to state a claim under section 10(b), it granted plaintiffs leave to amend their complaint because it was filed prior to the U.S. Supreme Court's decision in *Morrison*. However, the decision in *Absolute Activist* provides useful insight into the elements of a claim for securities fraud under *Morrison* when the securities sold are not listed on a U.S. securities exchange.

Morrison Decision

The *Morrison* decision involved a claim under the U.S. federal securities laws by Australian plaintiffs against an Australian defendant based on purchases of the defendant's stock on Australian stock exchanges – referred to by U.S. securities practitioners as an "F-Cubed" case, or a case involving three foreign elements. In the 2010 decision, the *Morrison* court held that, unless a contrary intent appears, legislation of the U.S. Congress is intended to apply only within the territorial jurisdiction of the United States and limited the application of Section 10(b) to transactions in securities listed on domestic exchanges and "*domestic transactions in other securities*." So with respect to securities that are not registered on domestic exchanges, the exclusive focus of the test is on whether the transaction is a *domestic* purchase or sale. However, the *Morrison* opinion did not discuss what it means for a purchase or sale to be made in the U.S. It is on this prong of the *Morrison* test that *Absolute Activist* is focused.

The Events in Absolute Activist

In *Absolute Activist*, nine Cayman Islands hedge funds alleged that they had been victimized by a fraudulent "pump and dump" scheme in which the defendants caused the funds to purchase billions of shares directly from U.S.-based companies. Although the shares of the companies were traded on the Over the Counter Bulletin Board or on the Pink OTC Markets, these trading platforms are not considered securities exchanges within the meaning of U.S. securities laws. As a result, the court in *Absolute Activist* was required to focus on what makes a transaction that does not occur on a U.S. securities exchange a "domestic transaction."

The Elements of a Domestic Transaction

By reference to the definitions of "purchase" and "sale" in the Exchange Act and applying traditional notions of contract formation, the Second Circuit first concluded that a "purchase" or "sale" occurs when the parties become bound to effectuate the transaction – when the parties become obligated to perform and incur irrevocable liability, even if formal performance is to be after a lapse of time. Having determined *when* a purchase or sale occurs, the

Second Circuit then applied the same analysis to determine *where* it occurred. To adequately allege the existence of a domestic transaction, it is sufficient for a plaintiff to allege facts leading to the plausible inference that the parties incurred irrevocable liability within the U.S. – that the purchaser incurred irrevocable liability within the U.S. to take and pay for a security, or the seller incurred irrevocable liability within the U.S. to deliver a security. Additionally, the Second Circuit stated that a sale of securities could be understood to take place at the location in which title is transferred. So under the elements established in *Absolute Activist*, 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.

In reaching this conclusion, the Second Circuit rejected a number of other tests proposed by the parties – the location of the broker or dealer in the U.S.; the status of the securities as being issued by U.S. companies and part of a class registered under the Exchange Act; and the identity of the buyer or seller as domestic or foreign. The court focused on the transactional character of the *Morrison* test rather than the status of the parties or the securities.

The court dealt in a similar way with the plaintiffs' argument that the allegations in the complaint alleging that a direct sale by a U.S. company to the plaintiffs should be taken to sufficiently allege the existence of a U.S. transaction. However, the court found the plaintiffs' statements on the location of the sale to be conclusory. The absence of allegations suggesting that the funds became irrevocably bound or that title was transferred in the U.S. was insufficient to establish a "domestic transaction." The court suggested that facts concerning the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money were the type of allegations that would be needed.

Conclusion

The Second Circuit's decision in *Absolute Activist* provides an analytical framework to be used in analyzing whether transactions in securities that do not occur on a U.S. exchange are subject to Section 10(b) of the Exchange Act under *Morrison*. The suggestions provided by the court regarding the types of facts that will be required to be demonstrated on remand provide a roadmap for the plaintiffs to follow in repleading the case. The court's decision demonstrates the need to apply a transaction-based analysis to determine whether the antifraud provisions of the U.S. securities laws will be applied extraterritorially.