WHITE & CASE

Client**Alert**

Commercial Litigation

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Absolute Activist Value Master Fund Ltd. v. Ficeto: Second Circuit Decision Further Defines the Extraterritorial Limits of US Securities Laws

In *Absolute Activist Value Master Fund Ltd. v. Ficeto*[1], the Second Circuit clarified the extraterritorial reach of Section 10(b) of the Securities Exchange Act of 1934. The Court held that transactions involving securities that are not traded on a domestic exchange may still be subject to Section 10(b) (and therefore Rule 10b-5) if title to a security is transferred within the United States or one party incurs irrevocable liability within the United States to purchase or deliver a security. This decision provides a bright line as to when civil liability under Section 10(b) and Rule 10b-5 may arise for foreign investors and foreign issuers of securities in securities transactions not listed on a US exchange.

Morrison and the extraterritorial reach of Section 10(b)

In 2010, the US Supreme Court ruled in *Morrison v. National Australia Bank Ltd.,* that Section 10(b) of the 1934 Act does not apply extraterritorially.[2] In so holding, the Supreme Court adopted a "transactional test" which provides that Section 10(b) only applies to "transactions in securities listed on domestic exchanges" or to "domestic transactions in other securities." The Supreme Court further noted that with respect to securities not registered on domestic exchanges, "the exclusive focus [is] on 'domestic' purchases and sales."[3]

In *Absolute Activist*, the Second Circuit interpreted the second prong of the *Morrison* test—under what circumstances the purchase or sale of a security not listed on a domestic exchange should be considered "domestic" within the meaning of *Morrison*.

The Second Circuit refines *Morrison*

The plaintiffs in *Absolute Activist* were nine now-defunct Cayman Islands hedge funds ("Funds"), which suffered US$195 million in losses in an alleged "pump-and-dump" scheme perpetrated by their US-based broker and investment manager. The defendants allegedly caused the Funds to purchase shares of thinly capitalized US companies in which defendants also had secretly invested, and then traded those stocks among the Funds in a way that artificially drove up the value of the stocks so that defendants profited from the churning of the stock and from the run-up in price. The shares of these US companies were traded on the US over-the-counter market, but the Funds did not trade on this market.

1 No. 11-0221-cv, Slip. Op. (2d Cir. Mar. 1, 2012). A copy of this decision is linked to this alert.

2 130 S. Ct. 2869, 2875 (2010).

3 *Id.* at 2885.

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Relying on *Morrison*, the district court dismissed the complaint. Although the securities were issued in the United States by US companies, the pleading did not sufficiently allege that the off-shore plaintiffs' "transactions" were "domestic." The shares were purchased directly, and not on a US exchange. Although the Second Circuit affirmed the dismissal, it remanded the case to give the plaintiffs an opportunity to amend their complaint with additional factual allegations in an effort to establish domestic transactions consistent with the Court's ruling.[4]

Significantly, the Second Circuit went to great lengths to explain how a transaction that did not take place on a US exchange could still be deemed a "domestic transaction" for purposes of civil liability under Section 10(b). The Court held that a transaction is "domestic" when either (i) a party incurs irrevocable liability within the United States to purchase or deliver a security or (ii) title to a security is transferred within the United States.[5]

In so holding, the Second Circuit rejected several other potential tests proposed by the parties. For example, the Court explained that the *Morrison* test is not based on the location of the person who made the trades in question, the identity of the securities (i.e., whether the securities were issued by US companies or registered with the SEC) or whether each defendant engaged in some US conduct.[6] The Court also rejected defendants' argument that where the buyer and seller are both non-US entities, the transaction cannot be domestic, noting that a purchaser's citizenship or residency does not affect where a transaction occurs.[7]

Implications

The Second Circuit's ruling in *Absolute Activist* provides important clarification on the meaning of a "domestic transaction" under *Morrison* and the resulting reach of the US securities laws. By eschewing consideration of the location of conduct, effect, purchaser, seller, issuer, exchange or decision making, *Absolute Activist* establishes a clear test for determining when securities transactions will and will not be subject to federal securities laws.

Offshore funds are now on notice that their location outside the United States is not dispositive of their potential liability under Section 10(b). Furthermore, investors who trade in foreign securities or on foreign exchanges may be able to structure trades to bring them within the ambit of the US securities laws, or take steps to clearly avoid those laws. Issuers of securities and other participants in securities transactions should also be able to more easily predict when and to whom they risk civil liability under US securities laws.

4 The Second Circuit did not take a position on whether securities traded on the over-the-counter securities markets satisfied the first prong of the *Morrison* test, which applies Section 10(b) to "transactions in securities listed on domestic exchanges." *See SEC v. Ficeto*, No 11 Civ. 1637, 2011 U.S. Dist LEXIS 150141, at *31 (C.D. Ca. Dec. 20, 2011) (action against defendants Ficeto, Homm, Colin Heatherington and Hunter in which SEC successfully argued that the first prong of *Morrison* applied since the securities were purchased and sold in the over-the-counter markets).

5 *Absolute Activist*, Slip. Op. at 11.

6 *Id.* at 14 – 16.

7 *Id.* at 15.