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Second Circuit Rules on Legal Standard Required to Establish a "Domestic Transaction" in Securities under *Morrison*

In its 2010 decision in *Morrison v. National Australia Bank*, 130 S. Ct. 2869 (2010), the Supreme Court addressed whether Section 10(b) of the Securities Exchange Act applies to a securities transaction involving foreign investors, foreign issuers and/or securities traded on foreign exchanges. The *Morrison* decision curtailed the extraterritorial application of the federal securities laws by holding that Section 10(b) applies only to (a) transactions in securities listed on domestic exchanges or (b) domestic transactions in other securities.

Last Thursday, in *Absolute Activist Value Master Fund Ltd. v. Ficeto, et al.*, Docket No. 11-0221-cv (2d Cir. Mar. 1, 2012), the Second Circuit addressed for the first time what constitutes a "domestic transaction" in securities not listed on a U.S. exchange. The Court held that, to establish a domestic transaction in securities not listed on a U.S. exchange, plaintiffs must allege facts plausibly showing either that irrevocable liability was incurred or that title was transferred within the United States.

Plaintiffs in *Absolute Activist* were nine Cayman Island hedge funds (the "Funds") that had engaged Absolute Capital Management Holdings ("ACM") to act as their investment manager. Plaintiffs alleged in their complaint that the ACM management defendants engaged in a variation of a pump-and-dump scheme. Specifically, defendants were alleged to have caused the Funds to purchase billions of shares of U.S. penny stocks issued by thinly capitalized U.S. companies – stocks that defendants themselves also owned – and then to have traded those stocks among the Funds in a way that artificially drove up the share value. Defendants thereby were alleged to have profited both from the fees generated through the fraudulent trading activity and the profits they earned when they sold their shares of the penny stocks at a profit to the Funds.

Relying on the Supreme Court's decision in *Morrison*, the district court had *sua sponte* dismissed the complaint, and this appeal followed. The Second Circuit concluded that a securities transaction will be deemed domestic in two situations:

- *First*, if the location at which the parties become irrevocably bound to effectuate the transaction is within the United States, then the transaction is domestic. Slip op. at 13.
- *Second*, if title to the securities at issue is transferred within the United States, then the transaction is domestic. Slip op. at 14.

In reaching this holding, the Court rejected several of the tests that had been proposed by the parties. For example, the Court held that the location of the broker-dealer, while it might be relevant to the extent that the broker carries out tasks that irrevocably bind the parties, is not

alone dispositive. Slip op. at 14. The Court further held that whether a security is domestic or is registered with the Securities and Exchange Commission does not necessarily have any bearing on whether the purchase or sale of that security is domestic under *Morrison*. *Id.* at 15. Likewise, the Court ruled that the citizenship of the purchaser or seller of the security does not determine whether a transaction is domestic. *Id.* And, finally, the Court held that each defendant need not have personally engaged in fraudulent conduct in the United States for a transaction to be deemed domestic. *Id.* at 16.

Applying these criteria, the Court concluded that plaintiffs' allegations were insufficient to plead a domestic transaction. The Court ruled that the allegations that the transactions took place within the United States were entirely conclusory, and did not establish where the Funds became irrevocably bound or where title was transferred. Because the complaint had been drafted several years ago and therefore could not have anticipated the changed legal standard set forth in *Morrison*, the Court granted plaintiffs leave to amend the complaint so that they would have the opportunity to plead factual allegations supporting their claim that the transactions were domestic. The Court did suggest, however, that the transactions between and among the foreign funds themselves – transactions that comprise part of the alleged fraudulent inflation of the value of the U.S. penny stocks – would not be domestic.

The Second Circuit's decision in *Absolute Activist* elucidates the boundaries of *Morrison* by setting forth the circumstances in which transactions in securities not listed on a U.S. exchange can be domestic transactions. The Second Circuit has directed district courts and litigants to focus on facts indicating where the parties become irrevocably bound to effectuate the transaction or where title to the security passes. The decision does, however, leave some open questions. Courts and litigants must now grapple with the question of where, precisely, a transaction becomes irrevocable, particularly if the citizenship of the parties and the location of their agents are not alone dispositive factors. For this reason, the application of the legal standard articulated in *Absolute Activist* to various types of securities transactions may take some time to crystalize.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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