SECURITIES REGULATION — SECURITIES EXCHANGE ACT — SECOND CIRCUIT HOLDS THAT TRANSACTIONS IN UNLISTED SECURITIES ARE DOMESTIC IF IRREVOCABLE LIABILITY IS INCURRED OR IF TITLE PASSES WITHIN THE UNITED STATES. — *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60 (2d Cir. 2012).

When confronting securities transactions that involve multiple jurisdictions, U.S. courts have struggled to delimit the extraterritorial reach of U.S. securities law. Whereas a narrow application of U.S. securities law to global securities transactions could turn the United States into "a 'Barbary Coast' for malefactors perpetrating frauds in foreign markets,"[1] an expansive application could make the United States "a Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets."[2] The Second Circuit historically has played a prominent role in navigating this thorny issue, having developed two influential tests — the conduct and effects tests[3] — for determining whether section 10(b) of the Securities Exchange Act[4] (Exchange Act) applies extraterritorially. But in its 2010 decision *Morrison v. National Australia Bank Ltd.*,[5] the Supreme Court rejected the flexible conduct and effects tests and replaced them with a bright-line transactional test.[6] Reaffirming the presumption against extraterritoriality,[7] the Court held that section 10(b) of the Exchange Act applies only to (1) "transactions in securities listed on domestic exchanges," and (2) "domestic transactions in other securities."[8]

Recently, in *Absolute Activist Value Master Fund Ltd. v. Ficeto*,[9] the Second Circuit interpreted the second prong of the *Morrison* extra-

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[1] Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2886 (2010).

[2] *Id.*

[3] The conduct test focuses on whether and to what extent "the wrongful conduct occurred in the United States." SEC v. Berger, 322 F.3d 187, 192 (2d Cir. 2003). The effects test focuses on "whether the wrongful conduct had a substantial effect in the United States or upon United States citizens." *Id.* The Third, Fifth, Seventh, Eighth, Ninth, and D.C. Circuits each adopted variations of these tests, prompting Justice Stevens to call the Second Circuit's tests the "the 'north star' of § 10(b) jurisprudence." *Morrison*, 130 S. Ct. at 2889 (Stevens, J., concurring in the judgment).

[4] 15 U.S.C. § 78j (2006 & Supp. V 2011). This section makes it "unlawful for any person" to commit securities fraud "by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange." *Id.*

[5] 130 S. Ct. 2869.

[6] *See id.* at 2884–85.

[7] *See id.* at 2877–78, 2881. *But see id.* at 2891 (Stevens, J., concurring in the judgment) (arguing that the majority distorted the presumption by transforming it "from a flexible rule of thumb into something more like a clear statement rule").

[8] *Id.* at 2884 (majority opinion).

[9] 677 F.3d 60 (2d Cir. 2012).

territoriality test. The court held that transactions in securities unlisted in the United States are "domestic," and thus subject to U.S. securities law, if the parties incur irrevocable liability or if title passes within the United States.[10] Given the complexities associated with locating the site of irrevocable liability, the Second Circuit's test facilitates a context-specific application of U.S. securities law that is likely to protect against the evasion of U.S. law. But the court's test could also lead to arbitrary results, reflecting the problematic nature of the Supreme Court's standard of using a transaction's "location" as the basis for applying U.S. law.

In 2004, a group of nine Cayman Islands hedge funds enlisted Absolute Capital Management (ACM) as their investment manager, paying monthly management and performance fees to ACM based on the net asset values of their respective funds.[11] Employees of ACM, working with U.S.-registered securities agent Todd Ficeto, directed the hedge funds to purchase billions of shares of thinly capitalized U.S. companies ("U.S. Penny Stock Companies") during three years through over-the-counter domestic offerings.[12] At the time of these transactions, the ACM investment managers owned substantial shares in the U.S. Penny Stock Companies and received more shares from the companies in exchange for directing the hedge funds to invest in them.[13] The ACM managers then traded and re-traded the shares at successively higher prices, "often between and among the [hedge funds]" themselves.[14] The purpose of this "pump-and-dump" scheme was to generate greater fees for the ACM managers and to inflate prices artificially so the managers could reap a windfall by selling their own personal shares to the hedge funds.[15] The hedge funds filed a federal complaint asserting securities fraud claims against the ACM managers under the Exchange Act and under New York common law.[16]

The district court dismissed the case for lack of subject matter jurisdiction.[17] The court based its dismissal on *Morrison*, which was decided the day after the district court heard oral argument in *Absolute Activist*.[18] The court held that the transaction failed to satisfy *Morri-*

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[10] *Id.* at 69.

[11] *Id.* at 62–63.

[12] *Id.* at 63. While the shares of these U.S. Penny Stock Companies were registered with the Securities and Exchange Commission, the shares themselves were not listed on a domestic exchange. *Id.*

[13] *Id.*

[14] *Id.*

[15] *Id.* at 64.

[16] *Id.*

[17] *Absolute Activist Value Master Fund Ltd. v. Homm*, No. 09 CV 08862(GBD), 2010 WL 5415885, at *1 (S.D.N.Y. Dec. 22, 2010).

[18] *Id.* at *4.

son's first prong because the securities were not listed on any domestic exchange.[19] The court then held that the transaction failed to satisfy *Morrison*'s second prong because "[t]he [hedge funds] were based in the Cayman Islands and managed in Europe," placing the transactions outside the United States.[20] The court noted that allowing this predominantly foreign case to proceed "would be the functional antithesis of *Morrison*'s directive."[21]

The Second Circuit affirmed in part, reversed in part, and remanded. Writing for a unanimous panel, Judge Katzmann[22] held that a transaction is domestic when the parties incur irrevocable liability — that is, when the parties become bound to effectuate the transaction — or transfer title within the United States.[23] The court agreed with the district court that the case "does not concern the [domestic-exchange] prong of *Morrison*."[24] But the panel held that the district court erred in dismissing the case for lack of subject matter jurisdiction because the issue of whether section 10(b) of the Exchange Act applies extraterritorially is a "merits" question.[25]

Turning to the merits, the Second Circuit observed that the *Morrison* test "provides little guidance as to what constitutes a domestic purchase or sale" under its second prong.[26] In order to determine the meaning of these terms, the court first looked to the text of the Exchange Act, which it found supports a contractual interpretation: purchase and sale occur where "parties become bound to effectuate the transaction."[27] The court found further support for this interpretation in its prior decision in *Radiation Dynamics, Inc. v. Goldmuntz*,[28] which held that the timing of a securities purchase or sale should be determined by the moment of irrevocable liability.[29] Noting that there are multiple ways to locate a securities transaction, the court also embraced the Eleventh Circuit's "title transfer" test for determining whether a transaction is domestic.[30] The court rejected several alternative tests, proposed by the parties, that turned on the location of the

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19 *Id.* at *5.

20 *Id.*

21 *Id.*

22 Judge Katzmann was joined by Judges Newman and Winter.

23 *Absolute Activist*, 677 F.3d at 69.

24 *Id.* at 66.

25 *Id.* at 67 (quoting Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2877 (2010)) (internal quotation marks omitted).

26 *Id.*

27 *Id.*

28 464 F.2d 876 (2d Cir. 1972); *see Absolute Activist*, 677 F.3d at 67–68.

29 *Radiation Dynamics*, 464 F.2d at 891.

30 *Absolute Activist*, 677 F.3d at 68; *see* Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada, 645 F.3d 1307, 1310–11 (11th Cir. 2011).

broker-dealer, the identity of the securities, the identity of the buyer or seller, or the location of the fraudulent conduct.[31]

Although the court concluded that the plaintiffs' complaint did not allege sufficiently that purchase or sale took place in the United States, it directed the district court to give the plaintiffs leave to amend.[32] The Second Circuit then remanded to the district court to determine whether the case should be dismissed on alternate grounds.[33]

The Second Circuit's test facilitates context-specific application of U.S. securities law — particularly when compared to alternative bright-line rules — in large part due to the unclear and fact-intensive nature of the irrevocable liability inquiry. This contextual inquiry is likely to protect against the evasion of U.S. law. But the Second Circuit's test could also lead to arbitrary results, though this arbitrariness is essentially a byproduct of the Supreme Court's location-based standard for assessing jurisdiction over section 10(b) claims, as transactional location is of increasingly limited value.

The policy implications of the *Absolute Activist* test ought to be evaluated in light of *Morrison*, which significantly altered the policy balance underlying securities fraud claims by shifting from a conduct and effects framework to a transactional location framework.[34] The *Morrison* Court sought to advance two main policies: (1) to replace the unpredictable, "judicial-speculation-made-law"[35] of the conduct and effects tests with a bright-line rule characterized by "clarity, simplicity, certainty and consistency,"[36] and (2) to reaffirm the presumption against extraterritoriality by limiting the application of U.S. securities law to domestic transactions.[37] Justice Scalia, who authored the ma-

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[31] The Second Circuit rejected these tests as either contrary to *Morrison* or irrelevant to the extent that they fail to illuminate the location of irrevocable liability or title transfer. *Absolute Activist*, 677 F.3d at 68–69.

[32] *Id.* at 69–71.

[33] *Id.* at 71.

[34] One might think that Congress signaled a preference for the pre-*Morrison* framework and policy balance in the Dodd-Frank Act, which codified the conduct and effects tests with respect to actions brought by the Securities and Exchange Commission. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929P(b)(2), 124 Stat. 1376, 1865 (2010) (codified at 15 U.S.C. § 78aa(b) (2006 & Supp. V 2011)).

[35] Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2881 (2010).

[36] Cornwell v. Credit Suisse Grp., 729 F. Supp. 2d 620, 624 (S.D.N.Y. 2010). Justice Scalia, the author of *Morrison*, elsewhere has praised the benefits of clear, categorical rules. Antonin Scalia, Essay, *The Rule of Law as a Law of Rules*, 56 U. CHI. L. REV. 1175, 1178 (1989). Given the number of ambiguities that have arisen since *Morrison*, however, many have questioned whether *Morrison* actually imposes a clearer test. *See, e.g.*, Vincent M. Chiappini, Note, *How American Are American Depositary Receipts? ADRs, Rule 10b-5 Suits, and* Morrison v. National Australia Bank, 52 B.C. L. REV. 1795, 1795–96, 1806 (2011).

[37] *See Morrison*, 130 S. Ct. at 2877–78; *see also id.* at 2884 ("[T]he presumption against extraterritorial application would be a craven watchdog . . . if it retreated to its kennel whenever *some* domestic activity is involved in [a securities fraud] case."). For a discussion of the internal policy

jority opinion in *Morrison*, grounded both of these policies in the admittedly sparse text of the Exchange Act.[38] But as many commentators have noted, the Exchange Act is at its core a remedial statute designed to protect investors and the integrity of U.S. securities markets, as well as to provide adequate deterrence and compensation for fraud; the old conduct and effects tests may have better reflected these policies.[39] Under this view, *Morrison* poses two main remedial policy concerns: (1) its emphasis on bright-line rules may make it easier for investors to evade the application of U.S. securities law,[40] and (2) its focus on transactional location as opposed to the significance of the transaction's relationship to the United States may have perverse and arbitrary consequences.[41] Though the context-specific nature of the Second Circuit's test may mitigate the first concern, the test ultimately runs the risk of arbitrariness as a result of *Morrison*.

The inquiry into irrevocable liability often involves complex, fact-intensive determinations, as evidenced by courts' experiences with section 16 of the Exchange Act.[42] (The same difficulties that arise in determining *when* a purchase or sale occurs for section 16 purposes also arise in determining *where* a purchase or sale occurs for section 10 purposes.[43]) For example, courts have reached different conclusions about when irrevocable liability arises in the context of a contract that contains conditions before closing[44] and a transaction that involves

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tensions in *Morrison*, see generally Hannah L. Buxbaum, *Remedies for Foreign Investors Under U.S. Federal Securities Law*, LAW & CONTEMP. PROBS., Winter 2012, at 161.

[38] *See Morrison*, 130 S. Ct. at 2881–83. Judge Katzmann has argued elsewhere that "[i]t is unreasonable to expect Congress to anticipate all interpretive questions [about a statute] that may present themselves in the future." Robert A. Katzmann, Madison Lecture, *Statutes*, 87 N.Y.U. L. REV. 637, 680 (2012). Given that the Exchange Act was enacted in 1934 — that is, before the advent of today's complex, multijurisdictional securities transactions — one might argue that the Act should be read in light of its overarching purpose and not limited strictly to its text.

[39] *See* Elizabeth Cosenza, *Paradise Lost: § 10(b) After* Morrison v. National Australia Bank, 11 CHI. J. INT'L L. 343, 386–87 (2011); *see also* Genevieve Beyea, Morrison v. National Australia Bank *and the Future of Extraterritorial Application of the U.S. Securities Laws*, 72 OHIO ST. L.J. 537, 556–57 (2011) ("[T]he Second Circuit's traditional tests may have served an important role in preventing much fraud from slipping through the cracks in the global financial regulatory system.").

[40] *See* Nidhi M. Geevarghese, Note, *A Shocking Loss of Investor Protection: The Implications of* Morrison v. National Australia Bank, 6 BROOK. J. CORP. FIN. & COM. L. 235, 246 (2011).

[41] *See* Joshua L. Boehm, Note, *Private Securities Fraud Litigation After* Morrison v. National Australia Bank*: Reconsidering a Reliance-Based Approach to Extraterritoriality*, 53 HARV. INT'L L.J. 249, 285 (2012).

[42] 15 U.S.C. § 78p (2006 & Supp. V 2011). Section 16 of the Exchange Act imposes strict liability on public-company insiders for realizing profits on any purchase or sale of the company's equity securities within a period of less than six months, among other offenses. *Id.* § 78p(b).

[43] *See Absolute Activist*, 677 F.3d at 68.

[44] *Compare* Provident Sec. Co. v. Foremost-McKesson, Inc., 506 F.2d 601, 607 (9th Cir. 1974) (holding that conditions "that the registration statement become effective on the date of the agreement, that no stop order issue prior to closing and that Foremost furnish Provident with an

significant preliminary discussions before closing[45] because of close factual distinctions regarding when the agreement was effectively consummated.[46] In recognition of the potentially complicated and fact-intensive nature of this inquiry, the Second Circuit encouraged the *Absolute Activist* plaintiffs to include, at the very least, "facts concerning the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money" in their amended complaint.[47] Thus, the irrevocable liability test is more likely to function as an "elusive,"[48] contextual standard than as a bright-line rule, somewhat cutting against the policies *Morrison* sought to advance.[49]

Nevertheless, had the Second Circuit adopted a clearer bright-line rule with more predictable implications, investors would have been better able to evade the application of U.S. securities law. To illustrate this dynamic, imagine that the Second Circuit had adopted a place-of-closing rule. Compared to irrevocable liability, this rule would have been relatively straightforward to administer because a transaction's place of closing is typically unambiguous.[50] Further, the universe of relevant facts would have been comparatively narrow: only those related to the place of closing. But this rule would have enabled investors to evade U.S. securities law by simply ensuring that the place of closing was outside the United States. Similarly, had the Second Cir-

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opinion letter on the legality of the transaction" did not prevent the court from recognizing an agreement prior to the date of closing), *with* Colan v. Cutler-Hammer, Inc., No. 80 C 4118, 1986 WL 6233, at *7 (N.D. Ill. May 27, 1986), *aff'd per curiam*, 812 F.2d 357 (7th Cir. 1987) (holding that conditions precedent including shareholder approval, Federal Trade Commission antitrust clearance, and an absence of merger litigation were significant enough to prevent an agreement from being recognized until the date of closing).

[45] *See* Lewis v. Bradley, 599 F. Supp. 327, 330–31 (S.D.N.Y. 1984) (holding that irrevocable liability did not occur until the date of closing given the tentative nature of the preclosing agreement and the fact that price was to be fixed on the date of closing).

[46] In determining when irrevocable liability arises in the section 16 context, courts look to a number of factors, including "existence of a firm price," "exchange of documents," "retention of rights . . . by the seller," and "existence of express substantial conditions precedent." Timothy M. Hall, Annotation, *What Amounts to "Purchase" or "Sale" for Purpose of Short-Swing Profits Provisions of § 16(b) of Securities Exchange Act of 1934 (15 U.S.C.A. § 78p(b))*, 123 A.L.R. FED. 203, § 28[a] (1995).

[47] *Absolute Activist*, 677 F.3d at 70.

[48] John Chambers, Note, *Extraterritorial Private Rights of Action: Redefining the Transactional Test in* Morrison v. National Australia Bank, 31 REV. BANKING & FIN. L. 411, 427 (2011); *see also* Boehm, *supra* note 41, at 267 (arguing that the irrevocable liability test would function as a "rule-of-reason . . . in many practical settings"). Although one could argue that this test will become more like a bright-line rule over time as courts refine it, the variety of securities transactions and factual scenarios surrounding purchase and sale casts doubt on this possibility.

[49] *See* Richard D. Bernstein et al., *Closing Time: You Don't Have to Go Home, But You Can't Stay Here*, 67 BUS. LAW. 957, 963 (2012) ("*Absolute Activist*'s 'irrevocable liability' test . . . is not quite the bright-line test that the Supreme Court envisioned in *Morrison*.").

[50] *See* Arnold S. Jacobs, *An Analysis of Section 16 of the Securities Exchange Act of 1934*, 32 N.Y.L. SCH. L. REV. 209, 503–09 (1987).

cuit adopted a blunt rule that treats an entire class of securities the same way,[51] investors would have been able to evade U.S. law easily by avoiding transactions in particular securities.

The Second Circuit's test, by contrast, makes it more difficult for investors reliably to evade U.S. securities law, in part because of the context-specific nature of the irrevocable liability inquiry and in part because both irrevocable liability and title transfer function as jurisdictional hooks for bringing defendants within the scope of U.S. securities law.[52] By limiting evasion of U.S. securities law, the Second Circuit's test may further the remedial purposes of the Exchange Act by preventing fraud from "slipping through the cracks."[53]

Although the Second Circuit's test will likely make evasion of U.S. securities law more difficult, this test could well operate in arbitrary ways. The fluid, international, and fragmented nature of contemporary markets ineluctably complicates any transactional location–based exercise.[54] As scholars have noted, "[m]arkets are moving to a point where the 'site' of a trade is happenstance," such that there is little "connection between the place of trade and the injury."[55] Over-the-counter securities,[56] American Depositary Receipts,[57] and swap-based transactions[58] all exemplify this trend.

The potential arbitrariness of the Second Circuit's test has already been borne out in at least two district court cases related to *Absolute Activist*. In *In re Vivendi Universal, S.A. Securities Litigation*,[59] the plaintiffs argued — pursuant to *Absolute Activist* — that title was transferred in the United States in part because "registration and delivery of the shares" took place in the United States.[60] But the New York federal district court held that title transfer occurred in France because title was maintained in book entries in a French depository

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[51] *See, e.g.*, SEC v. Ficeto, 839 F. Supp. 2d 1101, 1106–08 (C.D. Cal. 2011) (holding that transactions in U.S. over-the-counter securities per se qualify as domestic).

[52] To the extent that irrevocable liability and title transfer do not overlap, the Second Circuit's test provides some flexibility in determining whether a transaction is domestic.

[53] Beyea, *supra* note 39, at 556–57.

[54] Comment Letter from Forty-Two Law Professors to Elizabeth M. Murphy, Sec'y, SEC, on Study on Extraterritorial Private Rights of Action in Release No. 34-63174, at 7 (Feb. 18, 2011), *available at* http://www.sec.gov/comments/4-617/4617-28.pdf.

[55] *Id.*

[56] As opposed to securities exchanges, over-the-counter markets do not exist in any physical location but rather exist "among dealers who communicate electronically and by telephone." Michael K. Molitor, *Will More Sunlight Fade the Pink Sheets? Increasing Public Information About Non-Reporting Issuers with Quoted Securities*, 39 IND. L. REV. 309, 327 (2006).

[57] *See* Chiappini, *supra* note 36, at 1826 ("ADRs muddy the *Morrison* holding because they occupy a borderland between foreign and domestic transactions.").

[58] *See* Chambers, *supra* note 48, at 427.

[59] 284 F.R.D. 144 (S.D.N.Y. 2012).

[60] *Id.* at 151.

according to French securities law.[61] This result demonstrates the potential arbitrariness of the title transfer test: its application may hinge on the peculiarities of a single jurisdiction's law, regardless of that jurisdiction's relative importance within the scheme of the transaction.

In a similar vein, the potential arbitrariness of the irrevocable liability test became clear in *Cascade Fund, LLP v. Absolute Capital Management Holdings Ltd.*[62] There, the plaintiffs argued that the transaction was effectively consummated in the United States because the funds to complete the transaction were wired to New York.[63] But the Colorado federal district court held that because ACM "reserved the right to reject a request to invest . . . , the transaction was not completed until ACM finally accepted an application — presumably in its Cayman Islands offices."[64] Thus, the vagaries of contract law may result in haphazard determinations of transactional location, unguided by any overarching principle.

Given this potential for arbitrariness, some have suggested that courts employ a reliance-based approach to securities fraud claims that would focus on whether solicitation occurred in the United States.[65] A solicitation standard has the potential to further the remedial purposes of the Exchange Act as well as provide "clarity, simplicity, certainty and consistency."[66] But such a standard finds no support in *Morrison* and would likely run afoul of the presumption against extraterritoriality as delineated by the majority in *Morrison*.[67] While the Second Circuit's irrevocable liability and title transfer test may have some salutary effects in terms of making evasion more difficult, it ultimately reflects and illustrates the same fundamental problems underlying *Morrison*'s location-based standard. Regardless of whether one favors a narrow or expansive application of U.S. securities law, in a world where physical location is becoming increasingly illusory, a location-based standard does not serve as a meaningful principle for distinguishing which cases should stay in the United States.

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[61] *Id.*

[62] No. 08-cv-01381-MSK-CBS, 2011 WL 1211511 (D. Colo. Mar. 31, 2011).

[63] *Id.* at *7.

[64] *Id.*

[65] *See, e.g.*, Chambers, *supra* note 48, at 412; Chiappini, *supra* note 36, at 1824–25 (arguing that the standard for applying U.S. law should be based on "the extent of [the issuer's] purposeful entry into the U.S. market").

[66] Cornwell v. Credit Suisse Grp., 729 F. Supp. 2d 620, 624 (S.D.N.Y. 2010).

[67] *See* Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2885–86 (2010); Buxbaum, *supra* note 37, at 170.