Second Circuit's *Absolute Activist* Decision Further Clarifies Extraterritorial Reach of U.S. Securities Laws

Last week the Second Circuit provided important clarification on the extraterritorial reach of the U.S. securities laws. In *Absolute Activist Value Master Fund Ltd. v. Ficeto*, the court held that the antifraud provisions of the federal securities laws reach transactions involving unlisted U.S. securities only when (i) one party incurs irrevocable liability within the United States to *purchase or deliver* a security, or (ii) *title is transferred* domestically. The decision puts important limitations on application of the U.S. securities laws to transactions involving foreign issuers and foreign exchanges, and sets margins on the Supreme Court's recent decision confining the antifraud laws to "domestic transactions."

In 2010, the Supreme Court addressed the reach of the federal securities laws in so-called "F-Cubed" cases – those involving transactions in foreign securities of foreign issuers by foreign investors. In *Morrison v. National Australia Bank*, the Court held that the principal antifraud provisions of the federal securities laws – Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 – do not apply extraterritorially, but are limited to "domestic transactions," which the Court defined as (1) "transactions in securities listed on domestic [U.S.] exchanges" and (2) "domestic transactions in other securities." That second prong provoked widespread debate. For securities *not* listed in the U.S., what is a "domestic transaction"? Does it involve only local "transactions"? Or domestic "investors"? Or U.S. issuers? Or some combination? In *Absolute Activist*, the Second Circuit answered those questions by limiting the phrase to encompass only trades in which irrevocable liability to purchase or deliver securities was incurred in the United States, or title was transferred here.

Absolute Activist arose out of an alleged "pump-and-dump" scheme in which off-shore investors were induced to buy U.S. securities at inflated prices. Nine Cayman Islands hedge funds alleged that Absolute Capital arranged for them to buy shares directly from multiple U.S. companies that subsequently went public in small offerings. The investment manager then traded and retraded those "penny stocks," generating commissions and trading profits for Absolute Capital, and substantial losses for the hedge funds when the market price of the penny stocks crumbled.

The district court dismissed the complaint. Although it was clear that the manipulated securities were issued in the United States by U.S. companies, the pleading did not sufficiently allege that the off-shore plaintiffs' "transactions" were "domestic." The shares were purchased directly, and not on an exchange. But where? Since *Morrison* had specifically rejected a "conducts and effects" test to describe "domestic transactions" that could provoke securities law liability, the complaint did not squarely suggest a transaction within the federal laws' reach.

The Second Circuit affirmed. It agreed that that the plaintiffs' complaint did not sufficiently articulate how the transactions were "domestic," and proceeded to describe just how and when transactions will meet that essential ingredient of a federal securities law claim. Relying on elementary notions of what constitutes a "purchase" or "sale," the Second Circuit held that a "domestic transaction" takes place when either (i) a trader incurs irrevocable *liability* within the United States to *purchase or deliver* a security, or (ii) when *title* to a security is *transferred* in the United States.

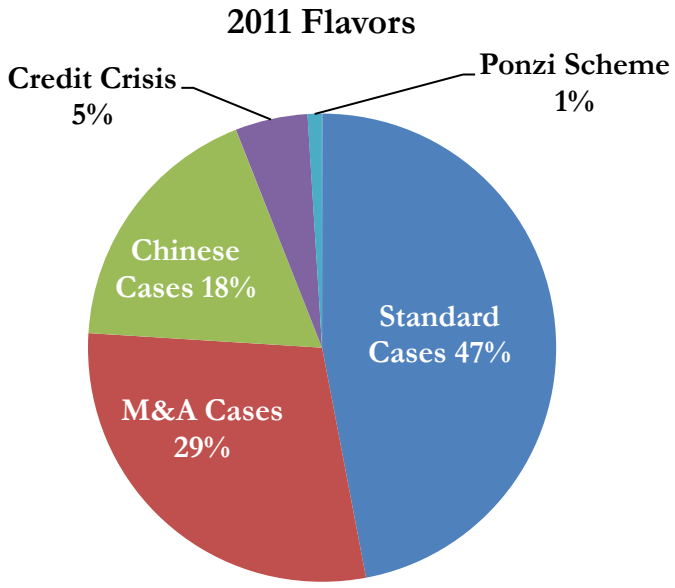
Importantly, in deciding that the appropriate definition of "domestic transactions" is rooted in traditional concepts of "purchase" and "sale," the Second Circuit rejected other, broader suggestions for limiting the contours of that phrase. According to the court, the involvement of a U.S. broker-dealer did not, by itself,

satisfy the "domestic transaction" requirement. Nor was it sufficient that the securities were issued by a United States company registered with the SEC. Conversely, the off-shore location of a buyer or seller did not preclude a conclusion that the transaction took place in the United States. And a defendant need not have acted in the U.S. at all, but could still be liable for a "domestic transaction."

The Second Circuit's ruling puts practical, easily understandable boundaries on the meaning of a "domestic transaction" and the resulting reach of the U.S. securities laws. By eschewing consideration of the location of conduct, effect, purchaser, seller, issuer, exchange, or decision making, *Absolute Activist* establishes a bright-line rule for when securities deals will – and will not – be subject to federal securities law enforcement.

The significance of that bright-line rule cannot be understated. Hedge funds organized off-shore now know that they do not automatically lose the protections of the federal securities laws simply by virtue of where they are. Investors who trade in foreign securities or on foreign exchanges can now structure trades to bring them within the ambit of the antifraud laws, or act to clearly avoid those statutes. And issuers of securities can more easily predict when and to whom they risk liability for misstatements.

That last point has particular significance for foreign issuers because – in the wake of *Morrison* and in view of the internationalization of the capital markets – the plaintiffs' securities bar has increasingly focused upon foreign issuers. Last year alone, fully 18% of U.S. securities class actions involved Chinese companies or transactions in some way (see below). Since the continued world-wide expansion of the capital markets is unlikely to abate, a bright-line test for application of the U.S. securities laws is an important – and welcome – clarification.



Ropes & Gray is continuing to closely monitor the potential effects of the Second Circuit's ruling. If you have any questions regarding the potential scope of the U.S. securities laws, please do not hesitate to contact your regular Ropes & Gray attorney.