New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 247—NO. 59
WEDNESDAY, MARCH 28, 2012

SECOND CIRCUIT REVIEW

Expert Analysis

Determining 'Domestic Transaction' Under 'Morrison'

By **Martin Flumenbaum** | And **Brad S. Karp**

In this month's column, we discuss *Absolute Activist Value Master Fund Ltd.* v. *Ficeto*,[1] in which the U.S. Court of Appeals for the Second Circuit earlier this month addressed what constitutes a "domestic transaction" in securities not listed on a U.S. exchange permitting the extraterritorial application of Section 10(b) of the Securities Exchange Act and Rule 10(b)–5 promulgated thereunder. This decision, written by Judge Robert A. Katzmann and joined by Judges Jon O. Newman and Ralph K. Winter, held that under the Supreme Court's 2010 decision in *Morrison* v. *National Australia Bank*,[2] to establish a domestic transaction in securities not listed on a U.S. exchange, a plaintiff must allege facts plausibly showing either that irrevocable liability was incurred or that title was transferred within the United States.

Background

This case involved a classic "pump-and-dump" scheme. The plaintiffs, a group of Cayman Islands hedge funds (hereinafter the funds) with hundreds of investors around the world, including many investors in the United States, engaged Absolute Capital Management Holdings Limited (ACM) to act as the funds' investment manager. Defendants were officers and employees of ACM, including its chief investment officer (CIO), chairman/chief executive officer and head of investor relations and marketing. In addition, the complaint named as a defendant Todd Ficeto—a resident of California and registered securities agent in California, Florida, Illinois, Massachusetts, New Jersey, New York, Texas and Washington—who was the president, director, and along with ACM's CIO, a co-owner of defendant Hunter World Markets Inc., an SEC-registered broker-dealer incorporated and based in California, with offices in Beverly Hills.

The funds alleged that defendants' "pump-and-dump" scheme caused the funds to suffer losses of at least $195 million while generating millions of dollars for defendants. Defendants' fraud allegedly operated as follows: Defendants first caused the funds to purchase billions of shares of thinly capitalized U.S.-based companies (U.S. penny stock companies) directly from those companies in subscriptions pursuant to private offerings known as private investment in public equity (PIPE) transactions. All of these companies were incorporated in the United States and their shares, U.S. penny stocks, quoted on the Over-the-Counter Bulletin Board or by Pink OTC Markets Inc. At or around the time of these purchases, the U.S. penny stock companies registered their shares with the Securities and Exchange Commission.

Also at the time of each of these initial purchases by the funds, defendants either (1) already held, or otherwise controlled, substantial shares and/or warrants of the U.S. penny stock companies, or (2) received shares and/or warrants from the U.S. penny stock companies for little or no money in exchange for causing the funds to purchase shares from the U.S. penny stock companies.

After causing the funds to purchase the U.S. penny stocks directly from the U.S. issuers, defendants then artificially inflated the prices of those stocks by trading and re-trading the U.S. penny stocks, often between and among the funds, each time trading the stock at a higher price to artificially inflate the price to the point at which defendants were free to sell previously locked-up shares and exercise warrants to obtain additional shares, which they then sold to the funds.

In addition, defendant Ficeto allegedly created a vehicle called The Hunter Fund Ltd., which only had certain of the funds as investors and which invested the funds' money in the U.S. penny stock companies. The funds derived no benefit from the funneling of their money through The Hunter Fund and defendants allegedly used The Hunter Fund simply to earn additional fees and to make loans to the U.S. penny stock companies.

In addition to causing the funds' money to be invested in the U.S. penny stocks, defendants allegedly raised money from investors in furtherance of the fraudulent scheme. The head of investor relations and marketing at ACM allegedly marketed the funds heavily in the United States and, similarly, ACM's CEO allegedly traveled to the United States to meet with investors and potential investors.

The complaint alleges that defendants benefited substantially as a result of the fraudulent scheme at the expense of the funds. Millions of dollars in fees and commissions were charged on the funds' loans to, subscriptions in, and other purchases of, shares in the U.S. penny stock companies. After inflating the prices of the U.S. penny stocks, defendants profited by causing the funds to purchase

MARTIN FLUMENBAUM *and* BRAD S. KARP *are partners at Paul, Weiss, Rifkind, Wharton & Garrison LLP.* ALASTAIR WOOD, *a litigation associate at the firm, assisted in the preparation of this column.*

from them U.S. penny stocks that they owned and had acquired for pennies (or less). While defendants reaped enormous profits, the funds allegedly suffered over $195 million in losses.

Certain defendants moved to dismiss the complaint in March and May 2010 for failure to state a claim, lack of personal jurisdiction, and improper venue. On June 24, 2010, the day after oral argument on defendants' motion to dismiss, the Supreme Court issued its decision in *Morrison*. Following this decision, although no defendant moved for dismissal pursuant to the *Morrison* ruling, the district court dismissed the complaint in its entirety, ruling, sua sponte, that it lacked subject matter jurisdiction over the case under *Morrison*.[3] The funds appealed that decision.

'Domestic' Transactions?

Prior to the Supreme Court's ruling in *Morrison*, to determine whether §10(b) of the Exchange Act and Rule 10b–5 promulgated thereunder applied extraterritorially, the Second Circuit utilized the so-called "conduct and effects test," which focused on: "(1) whether the wrongful conduct occurred in the United States, and (2) whether the wrongful conduct had a substantial effect in the United States or upon United States citizens."[4] However, the Supreme Court in *Morrison* rejected the conduct and effects test and held that §10(b) and Rule 10b–5 do not apply extraterritorially, and instead apply to "transactions in securities listed on domestic exchanges[] and domestic transactions in other securities."[5] The Supreme Court explained that "[w]ith regard to securities not registered on domestic exchanges, the exclusive focus [is] on domestic purchases and sales…."[6]

As the appeal brought by the funds did not concern the first prong of *Morrison*—whether a transaction involves a security listed on a domestic exchange—the sole question for the court was to interpret *Morrison's* second prong and determine under what circumstances the purchase or sale of a security that is not listed on a domestic exchange should be considered "domestic."

While the court did not address the issue, it appears to have left unresolved whether the conduct alleged by the funds would have satisfied the first prong of the *Morrison* test. As it explained in a footnote, the funds argued on appeal that their complaint sufficiently pled the existence of domestic securities transactions within the second prong of *Morrison* and did not address whether their allegations satisfied the first prong of *Morrison*.

The court noted, however, that in another proceeding brought by the SEC against certain defendants in the instant case and involving many of the same allegations contained in the funds' complaint, the SEC successfully argued that the first prong of *Morrison* was satisfied because the case involved securities traded on the over-the-counter securities market, not securities sold on foreign exchanges.[7] In that case, the district court held that *Morrison* "did not purport to overturn the universally accepted principle that §10(b) applies with equal force to market manipulation on national exchanges and the domestic over-the-counter market." After noting this decision, the court stated that it took no position on the issue.

> The court considered under what circumstances the purchase or sale of a security that is not listed on a domestic exchange should be considered 'domestic.'

Turning to the second prong of the *Morrison* test, the court noted that while *Morrison* holds that §10(b) can be applied to domestic purchases or sales, it provides little guidance as to what constitutes a domestic purchase or sale. The court therefore first considered how these terms are defined in the Exchange Act. The act defines the terms "buy" and "purchase" to include any contract to buy, purchase, or otherwise acquire,[8] and the terms "sale" and "sell" to include any contract to sell or otherwise dispose of.[9] The court found that these definitions suggest that the act of purchasing or selling securities is the act of entering into a binding contract to purchase or sell securities. As the court reasoned, these definitions suggest that the "purchase" and "sale" take place when the parties become bound to effectuate the transaction. As such, the court held that the point of "irrevocable liability" can be used to determine the locus of a securities purchase or sale.

Thus, 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 United States. In other words, the plaintiff must allege that the purchaser incurred irrevocable liability within the United States to take and pay for a security, or that the seller incurred irrevocable liability within the United States to deliver a security.[10]

In reaching this result, the court relied on its 1972 decision in *Radiation Dynamics Inc.* v. *Goldmuntz*,[11] for the proposition that a securities transaction occurs when the parties incur irrevocable liability. In that case, the Second Circuit held that, in the context of a civil trial brought pursuant to Rule 10b–5, the district court correctly instructed the jury that "the time of a 'purchase or sale' of securities within the meaning of Rule 10b–5 is to be determined at the time when the parties to the transaction are committed to one another."

As the *Radiation Dynamics* court explained, "'[c]ommitment' is a simple and direct way of designating the point at which, in the classic contractual sense, there was a meeting of the minds of the parties; it marks the point at which the parties obligated themselves to perform what they had agreed to perform even if the formal performance of their agreement is to be after a lapse of time."

Additionally, looking to Black's Law Dictionary and the Uniform Commercial Code as guidance, the court held that a "sale" also can be defined by the passing of title. As the court noted, the U.S. Court of Appeals for the Eleventh Circuit held that, to survive a motion to dismiss premised on *Morrison*, it is sufficient for the plaintiff to allege that title to the shares was transferred within the United States.[12]

Accordingly, the court held that a securities transaction is considered "domestic" when the parties incur irrevocable liability to carry out the transaction within the United States or when title is passed within the United States.

Tests Rejected

In addition to explaining the two tests it found valid for fixing the location of the purchase or sale of securities, the court rejected alternative tests offered by both the funds and defendants. The funds suggested that the location of defendant Hunter, the broker-dealer incorporated and located in California, should be used to locate the securities transactions. While noting that the location of the broker could be relevant to the extent that the broker carries out tasks that irrevocably bind the parties to buy or sell securities, the court explained that the location of the broker alone would not necessarily demonstrate where a contract was executed.

Plaintiffs additionally argued that as the securities at issue were issued by U.S. companies and were registered with the SEC, the transactions

were domestic within the meaning of *Morrison*. The court rejected this test as well, finding that the second prong of the *Morrison* test refers to "domestic transactions in other securities" as opposed to "transactions in domestic securities" or "transactions in securities that are registered with the SEC."

The court also rejected alternative tests put forth by defendants. Certain defendants argued that the identity of the buyer or seller should be used to determine whether a transaction is domestic. Where the buyer and seller are both foreign entities, these defendants argued that a transaction cannot be considered domestic. The court disagreed, stating that a purchaser's citizenship or residency does not affect where a transaction occurs as a foreign resident can make a purchase within the United States, and a U.S. resident can make a purchase outside the United States.

One individual defendant attempted to argue that, despite the Supreme Court's rejection of the "conduct and effects" test in favor of a transactional approach, it still was necessary to determine whether each individual defendant engaged in at least some conduct in the United States. Specifically, the individual defendant contended that even if the U.S. penny stock transactions occurred in the United States, it still would be impermissible to apply §10(b) to him since he personally did not engage in any conduct in the United States. While the court agreed that the defendant's lack of contact with the United States may provide a basis for dismissing the case against him for lack of personal jurisdiction, the transactional test announced in *Morrison* does not require that each defendant allegedly involved in a fraudulent scheme engage in conduct in the United States.

Failure to Adequately Plead

Having explained what constitutes a domestic transaction, the court concluded that the complaint failed to state claims under §10(b) and Rule 10b–5 as it did not adequately allege the existence of domestic securities transactions. The funds principally argued that because the PIPE offerings described in the complaint were not transactions on a foreign exchange, but direct sales by U.S. companies to the funds, the complaint sufficiently alleges the existence of domestic purchases. The court, however, found that, upon careful review of the 61-page complaint, there were only a few allegations that mentioned the location of the securities transactions at issue in this case.

The court further held that the sole allegation affirmatively stating that the transactions took place in the United States did so in conclusory fashion. It explained that the other conduct that allegedly occurred in the United States or was directed at investors in the United States was insufficient under the reasoning of *Morrison*. Allegations that investors subscribed to the funds by wiring money to a bank located in New York was considered inapposite by the court as the case was brought by the funds themselves and was based on the funds' purchases and sales of U.S. penny stocks rather than individual investors' subscriptions to the funds. Similarly, allegations that the funds were heavily marketed in the United States and that U.S. investors were harmed by defendants' actions, while potentially satisfying the defunct "conduct and effects test," did not satisfy the transactional test announced in *Morrison*.

Having explained what constitutes a domestic transaction, the court concluded that the complaint failed to state claims under §10(b) and Rule 10b–5 as it did not adequately allege the existence of domestic securities transactions.

The court therefore held that, absent factual allegations suggesting that the funds became irrevocably bound within the United States or that title was transferred within the United States, including, but not limited to, facts concerning the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money, the mere assertion that transactions "took place in the United States" was insufficient to adequately plead the existence of domestic transactions. As the Supreme Court noted in *Morrison*, "the focus of the Exchange Act is not upon the place where the deception originated, but upon purchases and sales of securities in the United States."[13]

1. __F.3d__, 2012 WL 661771 (2d Cir. March 1, 2012).
2. __U.S.__, 130 S.Ct. 2869, 177 L.Ed.2d 535 (2010).
3. The court noted that the district court erred in dismissing the case for lack of subject matter jurisdiction. In *Morrison*, the Supreme Court rejected the idea that the extraterritoriality of §10(b) of the Exchange Act raises an issue of subject matter jurisdiction and distinguished subject matter jurisdiction, which relates to a "tribunal's power to hear a case," from the "merits question" of whether §10(b) applies to particular conduct. As the Supreme Court made clear in *Morrison*, a court does have jurisdiction to address whether §10(b) applies to defendant's conduct. Here, notwithstanding what the Second Circuit termed a "threshold error," and as all parties requested that the court reach the question of whether the district court erred in dismissing the complaint based on the determination that the transactions were not within the territorial reach of §10(b) and as the district court had already indicated in a footnote that dismissal would be "properly granted under Rule 12(b)(6) as well as 12(b)(1)," the court held that "remand would only require a new Rule 12(b)(6) label for the same Rule 12(b)(1) conclusion."
4. *SEC v. Berger*, 322 F.3d 187, 192–93 (2d Cir. 2003).
5. 130 S.Ct. at 2884.
6. Id. at 2885.
7. *SEC v. Ficeto*, No. 11 Civ. 1637(GHK), 2011 WL 7445580, at *9 (C.D.Cal. Dec. 20, 2011).
8. 15 U.S.C. §78c(a)(13).
9. Id. §78c(a)(14).
10. As the court noted, this test has already been adopted and applied by district courts within the Second Circuit. See *SEC v. Goldman Sachs & Co.*, 790 F.Supp.2d 147, 159 (S.D.N.Y. 2011); *Plumbers' Union Local No. 12 Pension Fund v. Swiss Reins. Co.*, 753 F.Supp.2d 166, 177 (S.D.N.Y. 2010).
11. 464 F.2d 876 (2d Cir. 1972).
12. See *Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada*, 645 F.3d 1307, 1310-11 (11th Cir. 2011).
13. The court ultimately concluded that the funds should be given leave to amend their complaint, observing the funds' complaint was filed before the Supreme Court issued its decision in *Morrison* and before the court provided guidance about how to adequately plead a domestic purchase or sale.