$200M Suit by Hedge Funds Dismissed as Beyond the Reach of Section 10(b)

Written by Jeffrey D. Collins

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Second Circuit Defines What Deals Are "Domestic Transactions" Under Federal Securities Law

Earlier this month, in *Absolute Activist Value Master Fund Ltd. et al. v. Ficeto et al.*, 11-cv-0221 (2d Cir. Mar. 1, 2012), the Court of Appeals for the Second Circuit affirmed the dismissal of a $200M fraud case brought by nine Cayman Island hedge funds that claimed to be the victims of a classic "pump-and-dump" scheme involving penny stocks in U.S. companies. The appeals court ruled, however, that the hedge funds should have an opportunity to file an amended complaint, alleging violations of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, against the defendants, who included an investment manager, its executives, a registered broker and others. Thus, the final chapter for these hedge funds has not yet been written. Nevertheless, the decision in *Absolute Activist* has important implications for non-U.S. funds — both as securities investors and potential plaintiffs — that invest in private placements or other securities that are not listed on domestic exchanges.

The central issue in *Absolute Activist* is whether the hedge funds' claims involve domestic transactions that are covered by Section 10(b), or whether those claims involve foreign transactions that fall beyond the reach of federal securities law. The text of the Exchange Act does not clearly resolve that issue, and the case law has recently and dramatically changed as a result of the Supreme Court's decision in *Morrison et al. v. National Australia Bank Ltd. et al.*, 130 S. Ct. 2869 (2010).

For decades, the prevailing view about Section 10(b)'s extraterritorial application was known as the "conduct or effects" test. Under that framework, which was first established by the Second Circuit and later followed by most other federal circuit courts, a federal securities fraud claim could be brought so long as the plaintiff alleged that the wrongful conduct either had "a substantial effect in the United States or upon United States citizens" or "occurred in the United States." SEC v. Berger, 322 F.3d 187, 192-193 (2d Cir. 2003). Then, in 2010, the Supreme Court decided *Morrison*. In that landmark securities case, the Court rejected the long-standing "conduct or effects" test. In its place, the Court established a new transactional test under which Section 10(b) applies only to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities." 130 S. Ct. at 2884.

The Supreme Court was concerned, at least in part, that the U.S. not become "the Shangri-la" for securities litigation brought by foreign investors who are harmed by fraud in foreign transactions and want to seek recourse under federal securities law. *Id.* at 2886. For these purposes, non-U.S. hedge funds would seem to be the types of foreign plaintiffs for whom the courts have shown little sympathy. In fact, in dismissing the non-U.S. hedge funds' claims in *Absolute Activist*, the district court commented: "By all accounts, Plaintiffs took great pains to avoid the regulations imposed by federal securities laws that apply to domestic market transactions." That judicial perspective makes it all the more important for non-U.S. hedge funds to be aware of, and responsive to, the important implications of these recent decisions.

Whether an alleged fraud involved "securities listed on domestic exchanges" is straightforward enough. But whether an alleged fraud involved "domestic transactions in other securities" is not always so clear. In *Morrison*, the Supreme Court did not define the term "domestic transactions." It had no reason to do so, because that case featured a "foreign cubed" dispute, one involving foreign plaintiffs suing a foreign issuer based on a foreign transaction. Australian investors (Morrison and others) sued an Australian company (National Australia Bank) for fraud in connection with purchases of Australian securities. As Justice Stevens commented in his concurring opinion, "this case has Australia written all over it." *Id.* at 2895.

The decision in *Absolute Activist* lays down ground rules for that analysis. The Second Circuit held that a "domestic transaction" has occurred if "the parties incurred irrevocable liability within the United States" or "title was transferred within the United States." At the same time, the appeals court ruled that many other factors, which may be relevant, do not necessarily prove that a purchase or sale was a domestic transaction and, thus, that a claim may proceed under Section 10(b). These factors include "the location of the broker," "the identity of the security" (e.g., a security registered with the SEC), the "citizenship or residency" of the parties, and whether the defendants "engaged in at least some conduct in the United States." Some might be surprised to learn that, after *Morrison*, a non-U.S. hedge fund that, through a broker located in the U.S., purchases securities of a U.S. company which are registered with the SEC (but not listed on any domestic exchange) may be unable to bring Section 10(b) claims. Further, the fact that a fraud against a non-U.S. hedge fund harmed U.S. investors in the fund will not, without more, satisfy *Morrison*'s transactional test.

The Second Circuit decided that the plaintiff hedge funds in *Absolute Activist* should have a chance to re-plead their complaint because they may be able to allege that the deals at issue were, in fact, "domestic transactions" under *Morrison*. The opinion notes that, at oral argument, the funds claimed to possess transactional documents, trading records, private placement memoranda and other documents that show the purchases of penny stocks became irrevocable upon payment and that payment was made through one of the defendants in California. Those facts, the appeals court implied, would be enough. (Notably, on appeal, the funds did not argue that their investments in penny stocks listed on the OTC Bulletin Board or OTC Pink Sheets involved "securities listed on domestic exchanges." The SEC, which has brought a related enforcement action against many of the defendants in Absolute Activist, made that argument in federal court in California, and it won. See SEC v. Ficeto, 11-cv-1637-GHK (C.D. Cal. Dec. 20, 2011) (denying defendants' motion to dismiss under *Morrison*).

A critical take-away for non-U.S. hedge funds that work with U.S. investment managers or invest in the securities of U.S. companies is that, if those hedge funds want the protection of federal securities laws, they must carefully structure their transactions (at least those that do not involve securities listed on domestic exchanges) to ensure that they qualify as "domestic transactions" under *Morrison* and *Absolute Activist*. That means the funds must incur irrevocable liability in the United States or actually transfer title here. Further, if the funds fall victim to fraud, and decide to sue under Section 10(b), they must be careful to plead that the alleged fraud involved "domestic transactions." Conclusory allegations that the transactions "took place in the United States" will not suffice, however. Rather, as plaintiffs after *Morrison*, hedge funds must allege particularized facts that permit reasonable inferences to satisfy the new standard in *Absolute Activist*.

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