ARTICLE

CAN'T SEE THE FOREST FOR THE TREES: WHERE DOES A PURCHASE OR SALE OF SECURITIES OCCUR?

CHRISTOPHER CALFEE*

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* J.D., *American University*, *Washington College of Law*; M.A. in International Economic Relations, *American University School of International Studies*; B.A. in Mathematics, *Williams College*; Enterprise Risk Services Consultant with Deloitte & Touche LLP, focusing on Governance, Risk & Regulatory Services. I would like to extend my great appreciation to the staff of the *American University Business Law Review* for their hard work and dedication. I would also extend my thanks to Professor Richard Symonds for his advice and to Averell Sutton for his support on this project.

INTRODUCTION

Whether Justice Scalia chopped down the "judicial oak which ha[d] grown from little more than a legislative acorn"[1] or cleared an entire forest of "botanically distinct tree[s]"[2] when he created the transactional test in *Morrison v. National Australia Bank, Ltd.*, he undoubtedly changed the legal landscape for both international and antifraud securities laws. The transactional test—which the Supreme Court designed to act as a bright-line rule to supplant the older "conduct" and "effects" tests developed by the Second Circuit—gauges whether a U.S. court can hear an antifraud securities case containing extraterritorial elements.[3] In clearing away decades of federal extraterritorial jurisprudence, *Morrison* dictates that an American court may no longer hear an antifraud securities case under Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act")[4] and Rule 10b-5[5] unless the purchase or sale of securities occurred within the United States.[6]

Since its creation, the transactional test has gained both positive and negative attention from the international legal community.[7] But after the hundreds of securities class action cases adjudicated since the day of the decision,[8] the question remains: Does the transactional test clarify when an international securities antifraud claim falls within U.S. jurisdiction?

1. Morrison v. Nat'l Austl. Bank, Ltd., 130 S. Ct. 2869, 2889 (2010) (Breyer, J., concurring in part) (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975)).

2. *Id.* at 2880 n.4.

3. *See id.* at 2877–84 (explaining the history behind the "conducts" and "effects" tests and concluding that Section 10(b) only applies to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities").

4. 15 U.S.C. § 78j(b) (2006).

5. 17 C.F.R. § 240.10b-5 (2010).

6. *See Morrison*, 130 S. Ct. at 2888 (Stevens, J., concurring in part).

7. *Compare* Andreas Tilp et al., *AGORA* – Morrison v. National Australia Bank, 35 DAJV NEWSLET. 116, 119 (2010) (Ger.) ("Foreign companies who had been subject to actions for damages for having violated securities laws heaved a great sigh of relief."), *with* David Greene, *The US Ruling on Morrison v NAB Deals a Blow to the International Claims Culture*, THE GUARDIAN (June 28, 2010, 11:05 EDT), http://www.guardian.co.uk/law/2010/jun/28/supreme-court-morrison-national-australia-bank/print ("[T]he supreme court [sic] decision is a major step back for UK investors.").

8. *See* Luke Green, Morrison v. National Australia Bank - *The Dawn of a New Age?*, ISS (June 25, 2010, 5:54 PM), http://blog.issgovernance.com/slw/2010/06/morrison-v-national-australia-bank---the-dawn-of-a-new-age.html (noting that over a thousand class action securities cases were pending following the decision).

This Article will show that while Justice Scalia may have cut down the occasionally thorny "conduct" and "effects" tests, the seeds he planted with the transactional test may be just as difficult to care for and administer. Courts must now grapple with defining the "purchase" and "sale" of a securities transaction, and then determine whether such actions occurred within the United States. Within a complex global marketplace experiencing frequent cross-border activity, such terms are not easily defined and lead to contrary holdings on similar fact patterns.

Part I of this Article looks at how courts were able to avoid the terms "purchase" and "sale" prior to *Morrison*. Part II examines how *Morrison* used those terms in its decision. Part III analyzes how courts have thus far interpreted the *Morrison* transactional test and breaks down the various methods used in reaching their decisions. Finally, Part IV suggests a method for unifying the disparate methods of identifying whether a securities transaction is domestic or not.

I. EXTRATERRITORIAL APPLICATION OF "PURCHASE" OR "SALE" LANGUAGE PRIOR TO *MORRISON V. NATIONAL AUSTRALIA BANK, LTD.*

Although courts prior to the *Morrison* decision agreed that there should be an extraterritorial reach for antifraud provisions, there was little consensus as to how it should be applied.[9] Most private parties rely on Section 10(b) of the Exchange Act and Rule 10b-5 to bring a transnational securities fraud case within the United States.[10] The

9. *Morrison*, 130 S. Ct. at 2880 ("Although the circuits . . . seem to agree that there are some transnational situations to which the antifraud provisions of the securities laws are applicable, agreement appears to end at that point." (quoting Kauthar SDN BHD v. Sternberg, 149 F.3d 659, 665 (7th Cir. 1998))); *see* Hannah L. Buxbaum, *Remedies for Foreign Investors Under U.S. Federal Securities*, 75 LAW & CONTEMP. PROBS. 161, 161 (2012) (explaining that while public enforcement of securities law has become more efficient over the years due to improved cooperation between regulators worldwide, private enforcement has been much less unified).

10. 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, 540–41 n.11 (2011) ("The securities regulatory regime seeks to prevent and punish fraud via numerous provisions in both the Securities Act of 1933 and the Exchange Act. However, the most far-reaching of these provisions is Section 10(b) of the Exchange Act, and its accompanying Rule 10b-5 . . . ."). While Congress explicitly provided for a private cause of action under Sections 9 and 18 of the Exchange Act, they failed to do so under Section 10(b). However, courts have taken the position "that a right to be free from fraud implie[s] a remedy to make that right effective." STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: THE ESSENTIALS 107–08 (Vicki Been et al. eds., 2008).

broad language of both Section 10(b) and Rule 10b-5 was written to "close[] a loophole in the protections against fraud."[11] Thus, courts determined that Congress meant for Section 10(b) to protect investors regardless of whether they purchased or sold securities on U.S. markets.[12] To determine if there was a sufficient jurisdictional nexus between the conduct abroad and the investors Congress intended to protect, courts applied the "conduct" and "effects" tests.[13]

The "effects" test states that the United States has jurisdiction over claims arising out of fraudulent extraterritorial conduct that caused losses within the United States or harmed U.S. markets.[14] *Schoenbaum v. Firstbrook* first articulated this test in 1968.[15] The case involved the sale of treasury shares of a Canadian corporation, Banff Oil, Ltd., at a market price Banff and its directors knew would undervalue the shares.[16] The plaintiff was an American citizen and Banff common stock was traded on both the American Stock Exchange and the Toronto Stock Exchange.[17] Although the fraudulent transaction occurred in Canada, the court found that since Banff was listed on a U.S. stock exchange, it was required to comply with certain U.S. securities laws.[18] In particular, the court held that Section 10(b) had an extraterritorial reach if such fraudulent actions had a detrimental effect on U.S. investors.[19]

The "conduct" test looks to the actions taken by the allegedly fraudulent parties.[20] If such actions occurred within the United States, directly caused harm to investors, and were material to the alleged fraud, then U.S. courts had jurisdiction—regardless of whether the investors were U.S. citizens or whether the securities were bought or sold within the United States.[21] Judge Henry

11. Exchange Act Release No. 34-3230, 1942 WL 34443 (May 21, 1942).

12. Beyea, *supra* note 10, at 541 (citing Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326, 1336 (2d Cir. 1972)).

13. *Id.* at 542; Buxbaum, *supra* note 9, at 161.

14. Beyea, *supra* note 10, at 542; Buxbaum, *supra* note 9, at 161.

15. Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir. 1968); *see* Morrison v. Nat'l Austl. Bank, Ltd., 130 S. Ct. 2869, 2879; Beyea, *supra* note 10, at 542.

16. *Schoenbaum*, 405 F.2d at 204.

17. *Id.*

18. *Id.* at 206.

19. *Id.*

20. *See* Beyea, *supra* note 10, at 543–44.

21. *See id.*

Friendly first laid out the test in the 1972 case *Leasco Data Processing Equipment Corp. v. Maxwell*.[22]

In *Leasco*, the plaintiffs, both U.S. and U.K. citizens, alleged that U.K. defendants fraudulently induced them to buy U.K. corporate stock at inflated prices.[23] Looking to Section 17 of the Restatement of Foreign Relations Law of the United States,[24] the court held that Section 10(b) could apply outside the United States so long as there was "significant conduct" related to the fraud.[25]

Judge Friendly further refined these two tests in *Bersch v. Drexel Firestone, Inc*.[26] As to the "conduct" test, Judge Friendly asserted that losses from securities sales to foreigners outside the United States would only fall under the jurisdiction of U.S. securities laws when the parties' conduct directly caused such losses.[27] However, losses occurring to Americans abroad would not have to meet such a high standard. Instead, such losses would fall under U.S. jurisdiction if the acts or omissions that occurred within the United States were of material importance.[28] For the "effects" test, Judge Friendly limited the test's scope to those actions that would injure "purchasers or sellers" of securities in whom the United States had an interest, excluding actions that had a general detrimental effect on the economy or U.S. investors.[29]

Until the Supreme Court overturned decades of precedent,[30] courts generally applied the principles found within the Restatement of

22. 468 F.2d 1326 (2d Cir. 1972).

23. *Id.* at 1330.

24. RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 17 (1965) ("A state has jurisdiction to prescribe a rule of law . . . relating to a thing located, or a status or other interest localized, in its territory.").

25. Conduct within the United States alone can be sufficient to allow a U.S. law to be applied extraterritorially, but courts need to interpret each statute to see if it is meant to be applied extraterritorially. Section 17(a) of the Securities Act of 1933, for example, explicitly applies to both foreign and domestic issuers and therefore can be applied extraterritorially. Since Section 10(b) was modeled after Section 17(a), it too can be applied extraterritorially so long as sufficient conduct occurs within the United States. *See Leasco*, 468 F.2d at 1334–35.

26. 519 F.2d 974 (2d Cir. 1975).

27. *See id.* at 993.

28. *Id.*

29. *Id.* at 989; *see* Richard B. Earls, Note, *Extraterritorial Application of Fraud Provisions of the Commodity Exchange Act*, 41 WASH. & LEE L. REV. 1215, 1222 n.51 (1984) (noting that the court held that a general deterioration of investor confidence resulting in a decline in securities prices is insufficient to trigger the "effects" test).

30. *See supra* notes 3 & 7 and accompanying text.

Foreign Relations Law to extraterritorial regulatory law.[31] Jurisdiction was based either on "conduct, that, wholly or in substantial part, takes place within its territory [the 'conduct' test] and conduct outside its territory that has or is intended to have substantial effect within its territory [the 'effects' test]."[32] While both of these tests mention the sale and purchase of securities, there was no need for courts to determine exactly where a purchase or sale of securities occurred.[33] Instead, courts focused on the parties, their actions, and the effects they had on either U.S. investors or U.S. markets. The broad scope of Section 10(b) and Rule 10b-5 allowed courts to assume congressional intent as to the extraterritorial reach of antifraud U.S. securities laws[34] and sidestep the issue of where a security was purchased or sold.[35]

II. THE LANGUAGE OF *MORRISON* AND WHAT "PURCHASE" OR "SALE" MEANS UNDER THE "TRANSACTIONAL TEST"

As an "F-cubed" case (foreign petitioners filing suit against foreign respondents over stocks sold on a foreign exchange), *Morrison* was the first Supreme Court case to address the

31. Genevieve Beyea, *Transnational Securities Fraud and the Extraterritorial Application of U.S. Securities Laws: Challenges and Opportunities*, 1 GLOBAL BUS. L. REV. 139, 145 (2011); *see* SEC, STUDY ON THE CROSS-BORDER SCOPE OF THE PRIVATE RIGHT OF ACTION UNDER SECTION 10(B) OF THE SECURITIES EXCHANGE ACT OF 1934, 59 n.218 (2012), *available at* http://www.sec.gov/news/studies/2012/929y-study-cross-border-private-rights.pdf [hereinafter *Cross-Border Private Rights Study*] ("*The Restatement of Foreign Relations Law* is one of the leading secondary authorities on international and foreign-relations law, and is also generally viewed as a persuasive authority on questions of international comity such as those implicated by the potential extraterritorial extension of a Section 10(b) private cause of action.").

32. Beyea, *supra* note 31, at 145–46.

33. *Compare* Schoenbaum v. Firstbrook, 405 F.2d 200, 210 (2d Cir. 1968) (explaining that a foreign purchase or sale of securities is sufficient to trigger the "effects" test, and therefore Section 10(b) has extraterritorial reach), *with* Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326, 1336–37 (2d Cir. 1972) (explaining that because Section 10(b) was intended to protect against fraudulent conduct in the purchase or sale of securities, it had extraterritorial reach so long as a sufficient amount of the fraudulent conduct occurred within the United States).

34. *See supra* notes 12 & 13 and accompanying text.

35. This is not to say that the "conduct" and "effects" tests were reliable tests in the U.S. judicial system. They often yielded fairly unpredictable results and the Second Circuit often did not give guidance as to what factors were determinative. *See* Morrison v. Nat'l Austl. Bank, Ltd. 130 S. Ct. 2869, 2879–80 (2010); Beyea, *supra* note 31, at 148; Joshua L. Boehm, Comment, *Private Securities Fraud Litigation after* Morrison v. National Australia Bank*: Reconsidering a Reliance-Based Approach to Extraterritoriality*, 53 HARV. INT'L L.J. 249, 254–55 (2012); Buxbaum, *supra* note 9, at 161–62.

extraterritorial reach of U.S. antifraud securities claims.[36] Petitioners were Australian nationals who had purchased common stock shares of respondent's Australian company, National Australia Bank, Ltd. ("National"), on the Australian Stock Exchange and other foreign stock exchanges.[37] HomeSide Lending, Inc., a Florida-based mortgage servicing company, was a wholly-owned subsidiary of National.[38] With National's knowledge, HomeSide manipulated its financial models to make it appear to be more profitable than it actually was.[39] National then included the company's inflated value in National's annual reports from 1998 through 2001 and touted its success.[40] In 2001, after National announced several write-downs related to the Florida-based company that amounted to over two billion dollars in losses, petitioners filed suit.[41] The district court dismissed petitioners' claims stating that they failed to provide sufficient evidence to create a jurisdictional nexus within the United States under either the "conduct" or "effects" tests.[42] A panel of five judges affirmed the holding on appeal.[43]

While the Supreme Court could have affirmed the lower courts' decisions, Justice Scalia instead decided to do away with both the "conduct" and "effects" tests. First, he pointed to the longstanding presumption against extraterritoriality in statutory law unless the language explicitly provided for one.[44] Then, after examining the history and application of the "conduct" and "effects" tests, the Court held that such tests were "judicial-speculation-made-law" and thus lead to incongruous results.[45] This analysis lead to *Morrison*'s main holding: Section 10(b) only applies to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities."[46] The newly dubbed "transactional test" focuses on the

36. Beyea, *supra* note 10, at 550.

37. *In re* Nat'l Austl. Bank Secs. Litig., No. 03 Civ. 6537(BSJ), 2006 WL 3844465, at *1 (S.D.N.Y. Oct. 25, 2006).

38. *Id.*

39. *Id.* at *1–2.

40. *See id.* at *2.

41. *Id.*

42. *See id.* at *8 ("[I]t is the foreign acts—not any domestic ones—that 'directly caused' the alleged harm here.").

43. Morrison v. Nat'l Austl. Bank, Ltd., 547 F.3d 167, 177 (2d Cir. 2008).

44. Morrison v. Nat'l Austl. Bank, Ltd.,130 S. Ct. 2869, 2877 (2010).

45. *Id.* at 2881.

46. *Id.* at 2884.

strict textual reading of Section 10(b), creating a bright-line rule centered solely on where the purchase or sale occurred.

While the terms "purchase" and "sale" are contained within Section 10(b),[47] as well as defined within the Exchange Act,[48] the term "transaction" is not. Throughout the opinion, Justice Scalia refers to the application of Section 10(b) using the words "purchase," "sale," and "transaction" but only uses all three terms together in a single sentence once.[49] While Justice Breyer's concurrence is more explicit in equating a "transaction" to a "purchase" and "sale" of securities,[50] Justice Stevens's concurrence never mentions those terms together in a single sentence.[51]

One could take such rhetoric to mean that the Supreme Court meant to equate "purchase" and "sale" as a "transaction" in its test, but such a reading could force the test to be applied too expansively or too narrowly.[52] Under the Exchange Act, a "purchase" is defined as "any contract to buy," and a "sale" as "any contract to dispose of."[53] Black's Law Dictionary defines "transaction" as the "discharge of a contract."[54] Therefore, depending on which definition a court looks to, a transaction could either be held to be the solicitation, formation, and execution of purchase and sale contracts or solely the discharge of such contracts. Finally, since Section 10(b) reads "purchase *or* sale," rather than "purchase *and* sale," one can infer that the statute recognizes temporal and geographic differences between when and where a security is sold and bought, unlike the term "transaction," which makes no such distinction.[55]

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47. 15 U.S.C. § 78j(b) (2012).

48. *Id.* § 78c(a)(13)–(14).

49. *Morrison*, 130 S. Ct. at 2886 ("The transactional test we have adopted—whether the purchase or sale is made in the United States, or involves a security listed on a domestic exchange—meets that requirement.").

50. *Id.* at 2888 (Breyer, J., concurring in part) ("Section 10(b) of the [Exchange Act] applies to fraud 'in connection with' two categories of transactions: (1) 'the purchase or sale of any security registered on a national securities exchange' or (2) 'the purchase or sale of . . . any security not so registered.'").

51. *Id.* at 2888–95 (Stevens, J., concurring).

52. *See* 2 VED P. NANDA & DAVID K. PANSIUS, LITIGATION OF INTERNATIONAL DISPUTES IN U.S. COURTS § 8:36, 8-235 (2d ed. 2012).

53. 15 U.S.C. § 78c(a)(13)–(14).

54. BLACK'S LAW DICTIONARY 1635 (9th ed. 2009).

55. *See* 2 NANDA & PANSIUS, *supra* note 52, § 8:36, at 8-235 to 8-236 ("There is only one reasonable conclusion consistent with *Morrison*. If *either* the offer to purchase or the acceptance of the sale offer occurred in the United States, or, if *either* the offer to sell or the acceptance of the purchase offer occurred in the United States, then section 10(b) applies."). *But see id.* § 8:36, at 8-236 ("The argument could be

While the transactional test attempted to simplify the determination of whether U.S. securities laws have an extraterritorial reach, it created its own ambiguity in terms of where a "sale" or "purchase" of securities occurs. Part of this ambiguity is due to the language Justice Scalia used in *Morrison* to describe the transactional test.[56] In stating that Section 10(b) only applies to domestically listed securities and domestic transactions in other securities,[57] the Court left open questions on how to interpret transactional elements in an extraterritorial context.[58] For example: Does the purchase occur where the order is placed or where the security was offered? Or neither? Does the transaction occur where the security was cleared?[59] Does either party have to be an American citizen in order to gain protection under Section 10(b) for a securities transaction not listed on a U.S. exchange? As this Article discusses below, different courts have interpreted *Morrison* in varying, and sometimes contradictory, ways.

III. HOW COURTS HAVE DETERMINED WHEN AND WHERE A "PURCHASE" OR "SALE" HAS OCCURRED POST-*MORRISON*

In being forced to give up the "conduct" and "effects" tests, courts have had to apply an entirely different rubric when analyzing the jurisdictional requirements of an international antifraud case. The transactional test the Supreme Court created in *Morrison* applies in one of two situations: transactions for securities listed on a domestic exchange or transactions for securities not listed on an exchange but that are domestic.[60] While the test easily applies to f-cubed

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made that what the statute means is that the [Exchange Act] only applies to securities traded on U.S. exchanges, and securities that are not traded on any national . . . exchange so long as the purchase or sale occurs in the United States.").

56. *See id.* § 8:33, at 8-207 to 8-209 (pointing to three separate mentions of *Morrison*'s "transactional test" which could each presumably be interpreted differently).

57. Morrison v. Nat'l Austl. Bank, Ltd., 130 S. Ct. 2869, 2884 (2010).

58. By focusing on what Section 10(b) does not say and not clarifying what it does say, *Morrison* only definitively states that an "f-cubed" case does not have extraterritorial jurisdiction. Terms like "purchase," "sale," "transaction," and "settles" have multiple interpretations which will force courts to make a decision on what Justice Scalia meant in his transactional test. *See* 2 NANDA & PANSIUS, *supra* note 52, § 8:36, at 8-223.

59. BLACK'S LAW DICTIONARY 1554 (9th ed. 2009) (defining "stock clearing" as "the actual exchange of money and stock between buyer and seller . . . .").

60. *See* Beyea, *supra* note 10, at 562; Boehm, *supra* note 35, at 263; Buxbaum, *supra* note 9, at 162.

transactions, the complex nature of international financial instruments in the global marketplace makes it difficult to uniformly apply the transactional test to other instances.[61] In noting the disparity between courts in interpreting the two prongs of *Morrison*, it is clear that having a strict, textual-based reading of a law can lead to, at best, abnormal and, at worst, unjust results.[62]

A. Applying Morrison *to Securities Listed on Domestic Exchanges*

The first prong under the *Morrison* transactional test seems deceptively easy to parse. A "transaction[] in securities listed on [a] domestic exchange[]"[63] is a domestic transaction and thus a purchase or sale of securities within the United States. However, the global nature of the securities marketplace makes this phrase somewhat less than clear. Companies can have shares cross-listed on both a foreign exchange and an American exchange. While courts have rejected the idea that shares purchased on a foreign exchange are a domestic transaction because they are cross-listed, a strict textual reading of *Morrison* implies that such transactions are domestic.[64]

American Depositary Receipts ("ADRs")[65] also complicate a court's interpretation of whether a purchase or sale traded on an exchange is domestic or not. Most international companies trade their shares on U.S. exchanges as ADRs.[66] Each ADR can represent

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61. *See* Buxbaum, *supra* note 9, at 173.

62. *See, e.g.*, Boehm, *supra* note 35, at 262–63 (explaining that a large number of cases that courts have struggled to answer consistently due to the circumstance-dependent questions present in complex securities transactions); Buxbaum, *supra* note 9, at 164–73 (comparing how courts have interpreted transactions of securities listed on domestic exchanges, foreign exchanges, and transactions of American Depositary Receipts as well as comparing how courts have interpreted various over the counter securities transactions).

63. Morrison v. Nat'l Austl. Bank, Ltd., 130 S. Ct. 2869, 2884 (2010).

64. *In re* Vivendi Universal, S.A. Secs. Litig., 765 F. Supp. 2d 512, 530 (S.D.N.Y. 2011) (noting that all courts interpreting *Morrison* have rejected the idea that transactions that involve securities listed but not traded on a domestic exchange are domestic transactions. "Read in this context, perhaps Justice Scalia simply made a mistake. He stated the test as being whether the alleged fraud concerned the purchase or sale of a security 'listed on an American stock exchange,' . . . when he really meant to say a security 'listed and traded' on a domestic exchange.") (quoting *Morrison*, 130 S. Ct. at 2888).

65. *See generally Cross-Border Private Rights Study*, *supra* note 31, at A1–A4 (giving an in-depth description of how ADRs are created and the ADR market in the United States).

66. *International Investing*, U.S. SEC. & EXCH. COMM'N (last modified Aug. 14, 2012), http://www.sec.gov/investor/pubs/ininvest.htm [hereinafter *International Investing*].

a single share, multiple shares, or a fraction of a share of an international company's stock.[67] While the ADR corresponds to the price of the foreign stock on its home market, trades of ADRs clear and settle in U.S. dollars.[68] A depositary bank, which issues the ADRs, generally sends the ADR owner any dividends or cash payments in U.S. dollars and arranges to vote the owner's shares as per the owner's instructions.[69] Additionally, ADRs cannot be issued within the United States unless they are subject to the periodic reporting requirements under the Exchange Act[70] or are exempt from these reporting requirements under Rule 12g3-2(b).[71] Finally, possession of an ADR gives an owner the right to obtain the foreign stock if the owner so chooses.[72] It has been difficult for courts to decide whether purchasing an ADR on a U.S. exchange is a domestic transaction or merely a proxy for a foreign purchase. Since ADRs are purchased and sold on a U.S. exchange, one could argue that they meet the transactional test requirement. But since they are a contract for purchasing foreign securities listed on a foreign market, one could also argue that, under *Morrison*, ADRs fall outside the jurisdiction of U.S. antifraud securities law.

1. *Purchases and Sales on Foreign Exchanges*

One of the first cases to deal with deciding whether purchasing shares on foreign exchanges is a domestic transaction is *Stackhouse v. Toyota Motor Co.*[73] *Stackhouse* was a class action suit which arose over intentional misstatements by Toyota about the safety of eight of its vehicles.[74] Between 2004 and 2010, Toyota, which was listed on the Tokyo Stock Exchange and the New York Stock Exchange ("NYSE"), claimed that numerous accidents involving

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67. *Id.*

68. *Id.*

69. *See id.* ("The depositary bank will convert any dividends or other cash payments into U.S. dollars before sending them to you.").

70. 15 U.S.C. § 78l(g) (2010).

71. *See* 17 C.F.R. § 240.12g3-2(b) (2010). *See generally* HAL S. SCOTT & ANNA GELPERN, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 115 (Robert C. Clark et al. eds., 18th ed. 2011) (explaining the registration and reporting requirements under the Securities Act of 1933 and the Securities and Exchange Act of 1934).

72. *See International Investing*, *supra* note 66.

73. No. 10-0922, 2010 WL 3377409 (C.D. Cal. July 16, 2010).

74. Complaint at *1–5, Stackhouse v. Toyota Motor Corp., No. 10-0922, 2010 WL 562034 (C.D. Cal. Feb. 8, 2010).

unintended acceleration were due to driver error or faulty placemats.[75] When Toyota finally revealed that it had known about the problem and issued a massive recall, its stock price fell sharply.[76] The plaintiffs in the class action were U.S. citizens "who purchased or otherwise acquired . . . securities of [Toyota], including [ADRs[77] traded on the NYSE]."[78] In determining who should be the lead plaintiffs in the class action suit, Judge Fischer dismissed the idea that buying or selling securities listed on a foreign exchange while residing in the United States constituted a domestic transaction.[79] Instead, Judge Fischer reasoned that purchasing or selling a security on a foreign exchange was akin to going to the exchange and completing the transaction through a foreign broker.[80] Domestic transactions, therefore, only occurred when the purchases and sales were explicitly solicited by the issuer within the United States.[81]

Cornwell v. Credit Suisse Group narrowed the definition of a domestic transaction from *Stackhouse* by rejecting all activity on a foreign exchange.[82] Plaintiffs were parties who had either bought Credit Suisse Group shares on the Swiss Stock Exchange or ADRs[83] on the NYSE.[84] Credit Suisse Group had allegedly made material misrepresentations or omissions about its risk practices and its stock price fell sharply due to the U.S. housing market crash.[85] The group that purchased shares on the Swiss Stock Exchange argued that the terms "purchase" and "sale" should be interpreted within the context of the choice of law provisions in the Restatement (First) of Conflict of Laws.[86] Judge Marrero rejected these arguments as merely trying

75. *Id.* at *2–4.

76. *Id.* at *3–5.

77. The case actually discusses purchases of American Depositary Shares ("ADSs"). ADRs and ADSs are basically synonymous. *International Investing*, *supra* note 66 ("An ADR is actually the negotiable physical certificate that evidences ADSs, . . . and an ADS is the security that represents an ownership interest in the [foreign security].").

78. Complaint, *supra* note 74, at *7.

79. Stackhouse v. Toyota Motor Co., No. 10-0922, 2010 WL 3377409, at *1 (C.D. Cal. July 16, 2010).

80. *Id.*

81. *Id.*

82. *See* Cornwell v. Credit Suisse Grp., 729 F. Supp. 2d 620, 625–26 (S.D.N.Y. 2010).

83. *See supra* note 77.

84. *Cornwell*, 729 F. Supp. 2d at 621.

85. *Id.* at 622.

86. *See id.* (reasoning that since the parties made the investment decision in the

to reinstate the "effects" test into the transactional test.[87] Instead, he looked to the corollary of the transactional test and held that trades executed on foreign exchange markets are never truly domestic transactions, even if some aspect of the transaction occurs within the United States.[88] Therefore, any transaction that occurs on a foreign exchange would be considered a purchase or sale that occurred outside the United States.

2. *Purchases and Sales of Cross Listed Securities*

Sgalambo v. McKenzie[89] and *In re Alstom SA Securities Litigation*[90] examined purchases and sales of securities on foreign exchanges when the shares were listed and sold on both domestic and foreign exchanges, rather than through ADRs. Both cases were class action suits brought against Canadian and French corporations, respectively, for material misstatements which violated Section 10(b) of the Exchange Act.[91] Each company was listed on an American exchange as well as a foreign exchange, but the plaintiffs purchased their shares off the foreign exchange.[92] While the parties in *Sgalambo* conceded that their purchases of securities were not made within the United States, and therefore did not meet the transactional test,[93] the plaintiffs in *Alstom* argued that because the purchases could have easily been made on the domestic exchange, they should be considered domestic purchases.[94] Further, the plaintiffs argued that their purchases of securities on a foreign exchange were "domestic" under *Morrison*, since those securities' ADRs were listed

United States, accepted the shares into its U.S. account, and incurred the risks within the United States, it was a domestic transaction).

87. *Id.* at 625 ("This Court is not convinced that the Supreme Court designed *Morrison* to be squeezed, as in spandex, only into the factual strait jacket of its holding.").

88. *See id.* at 623–26 (finding that even if foreign transactions include American investors or if portions of the transaction occur within the United States, the exception pursued by the plaintiffs would not comply with the new rule due to the rare occasion that foreign transactions lack any connectivity to the United States).

89. 739 F. Supp. 2d 453 (S.D.N.Y. 2010).

90. 741 F. Supp. 2d 469 (S.D.N.Y. 2010).

91. *Id.* at 471; *Sgalambo*, 739 F. Supp. 2d at 463–68.

92. *See In re Alstom*, 741 F. Supp. 2d at 471 (noting that the corporation was listed on the French Stock Exchange); *Sgalambo*, 739 F. Supp. 2d at 487 (noting that the corporation was listed on the Toronto Stock Exchange).

93. *Sgalambo*, 739 F. Supp. 2d at 487.

94. *In re Alstom*, 741 F. Supp. 2d at 471–72.

on a U.S. exchange.[95] Judge Marrero, using *Cornwell*, held that purchases and sales on a foreign exchange cannot be considered domestic transactions and that, despite the wording in *Morrison* regarding listed securities, Section 10(b) focuses solely on purchases and sales.[96] Therefore, because the actual purchases and sales were made on a foreign exchange, they could not be considered domestic even though they were also listed on a domestic exchange.[97]

3. *Purchases and Sales of ADRs*

Courts have not yet come to a single consensus on how to classify purchases and sales of ADRs. Earlier court decisions like *Stackhouse* and *Cornwell* assumed that since ADRs were securities listed and traded on a domestic exchange, they would fall within the scope of the transactional test.[98] But later courts have instead tried to analyze the economic realities behind what ADRs represent, making it more difficult for companies to predict whether they will be held liable for securities fraud under U.S. law.[99]

Judge Berman looked to the economic underpinnings of ADRs in *In re Société Générale Securities Litigation*.[100] *Société Générale* involved a class action suit against French company Société Générale by two sets of parties: those who had purchased securities on the Euronext Paris Stock Exchange and those who had purchased ADRs on the New York over-the-counter market.[101] The court quickly dismissed the parties who purchased shares on the Euronext Paris Stock Exchange as well as the parties who had purchased ADRs, even though they were purchased and traded on a domestic market.[102] The court concluded that ADR transactions were "predominantly foreign securities transactions"[103] since they

95. *Id.* at 472 ("[A] crucial paragraph of *Morrison* concludes that 'it is in our view only transactions in securities listed on domestic exchanges . . . to which § 10(b) applies.'" (citing Morrison v. Nat'l Austl. Bank, Ltd. 130 S. Ct. 2869, 2884 (2010))).

96. *Id.* at 472–73.

97. *Id.*

98. Stackhouse v. Toyota Motor Co., No. 10–0922, 2010 WL 3377409, at *1–2 (C.D. Cal. July 16, 2010) (holding that the largest ADR holder should represent the class action securities fraud case under the *Morrison* decision).

99. *See, e.g.*, *In re* Société Générale Secs. Litig. No. 08 Civ. 2495, 2010 WL 3910286, *6 (S.D.N.Y Sept. 29, 2010); SEC v. Compania Internacional Financiera S.A., No. 11 Civ. 4904(DLC), 2011 WL 3251813, *6 (S.D.N.Y. July 29, 2011).

100. No. 08 Civ. 2495(RMB), 2010 WL 3910286, at *5 (S.D.N.Y Sept. 29, 2010).

101. *In re Société Générale*, 2010 WL 3910286, at *1.

102. *Id.* at *5–7.

103. *Id.* at *6 (quoting Copeland v. Fortis, 685 F. Supp. 2d 498, 506 (S.D.N.Y.

represent foreign shares of stock and are "traded in a less formal market with lower exposure to U.S.-resident buyers."[104] Thus, under *Société Générale*, purchases and sales of ADRs—even in a domestic market between American investors—are foreign purchases and sales, due to what they represent.

The economic analysis of ADRs and their financial equivalents, however, can cut both ways in international securities law. The United States Securities and Exchange Commission ("SEC") successfully argued that shares sold on the London Stock Exchange were domestic purchases and sales in *SEC v. Compania Internacional Financiera S.A.*[105] The case involved a Swiss company acquiring an American company for twelve percent above its listed price on the NYSE.[106] A money manager based in Geneva, using inside information, purchased contracts-for-difference ("CFDs")[107] on the London Stock Exchange, which mirrored the American company's stock.[108] When the SEC filed an action against the defendants, freezing their assets, the money manager claimed that his purchase of CFDs was outside U.S. jurisdiction since it occurred entirely on the London Stock Exchange.[109] The court, however, held that *Morrison* dealt specifically with fraudulent activity in connection with domestic purchases and sales of securities.[110] Since the central issue in this case was insider trading of domestic securities listed on the NYSE, the defendants' purchases of CDFs constituted a domestic transaction under *Morrison*.[111] Further, the court argued that such a narrow reading of *Morrison* would protect

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2010)).

104. *Id.*

105. No. 11 Civ. 4904(DLC), 2011 WL 3251813, at *6 (S.D.N.Y. July 29, 2011).

106. *Id.* at *1.

107. A CFD is a contract whose purpose is to match "the price movements of individual shares or bonds, stock market indices, or futures contracts." For each day that the contract is open, the purchaser will either pay or receive payment based on the movement of the stock or bond on which the CFD is based. *CFM13130 - Understanding Corporate Finance: Derivative Contracts: Types Of Derivative: Limits To The Regulatory Definitions*, HM REVENUE & CUSTOMS, http://www.hmrc.gov.uk/manuals/cfmmanual/cfm13130.htm (last visited Aug. 5, 2012). As an ADR allows a U.S. investor to purchase the rights to foreign stocks without purchasing them on a foreign market via a foreign brokerage account, a CDF allows foreign investors to purchase U.S. securities without opening a U.S. brokerage account. *Compania*, 2011 WL 3251813, at *3.

108. *Compania*, 2011 WL 3251813, at *2–3.

109. *Id.* at *5.

110. *Id.* at *6.

111. *Id.*

individuals involved in complex securities frauds via the transactional test so long as they personally did not trade in securities, contrary to the *Morrison* court's intent.[112]

But not all judges view the economic realities of ADRs in the same light. In the cases of *In re Royal Bank of Scotland Group PLC Securities Litigation*[113] and *In re Vivendi Universal, S.A. Securities Litigation*,[114] Judges Batts and Holwell, respectively, each held that purchases and sales of ADRs could be considered domestic transactions.[115] Each case involved class action suits where the defendant companies sold securities on a foreign exchange and ADRs on the NYSE.[116] Unlike the court in *Société Générale*, the courts did not similarly dismiss the claims of parties holding ADRs.

In *Royal Bank of Scotland*, defendants admitted that the purchase and sale of ADRs would be considered a domestic transaction under *Morrison*.[117] Because the plaintiffs had not actually purchased any ADRs, Judge Batts dismissed the Section 10(b) claims, but hinted that purchasers of ADRs would have had standing.[118]

In contrast, Judge Holwell gave a detailed description of how ADRs are purchased and sold. First, the court pointed out that when a foreign issuer decides to issue ADRs within the United States, it subjects itself to SEC reporting requirements and, therefore, may create a nexus within the United States sufficient to constitute a domestic purchase and sale.[119] Judge Holwell then noted that registering with the SEC and being listed on an exchange are not one and the same.[120] While all shares of a company would be registered with the SEC, only those backing up the ADRs would be listed on a

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112. *Id.* at *7.

113. 765 F. Supp. 2d 327 (S.D.N.Y. 2011).

114. 765 F. Supp. 2d 512 (S.D.N.Y. 2011).

115. *Royal Bank of Scot.*, 765 F. Supp. 2d at 337–38; *In re Vivendi*, 765 F. Supp. 2d at 529.

116. *See In re Vivendi*, 765 F. Supp. 2d at 521; *Royal Bank of Scot.*, 765 F. Supp. 2d at 329–31.

117. *Royal Bank of Scot.*, 765 F. Supp. 2d at 337.

118. *Id.* at 337–38 ("[C]ase law supports dismissal on these ADR claims *where Plaintiffs are not purchasers*. . . . Lead Plaintiffs . . . do not have standing *to bring domestic ADR claims* . . . .") (emphasis added).

119. *In re Vivendi*, 765 F. Supp. 2d at 529 (noting that the nexus created may be enough to subject a company to the antifraud provisions of the Exchange Act).

120. *Id.* (looking at a sample NYSE listing application, the court noted that only the number of ordinary shares needed to back up the amount of ADRs were listed and not all shares of the company).

U.S. exchange.[121] Since not every common share backs up a domestically listed ADR, one cannot simply argue that ownership of a foreign common share gives someone U.S. jurisdiction under *Morrison.* However, by owning an ADR, one would own a share that was listed and traded on the NYSE, and therefore would be within *Morrison*'s purview, meaning that a purchase or sale of an ADR could be considered a domestic transaction.[122]

While courts have solidified around the concept that purchases on foreign exchanges fail the *Morrison* transactional test and therefore fall outside U.S. jurisdiction,[123] they have not yet coalesced around whether purchases and sales of ADRs are domestic transactions. *Société Générale*, on one hand, holds that all purchases and sales of ADRs, regardless of where they are bought and sold, are international transactions and therefore fail *Morrison*'s transactional test.[124] Alternatively, *Royal Bank of Scotland* and *Vivendi* each state that ADRs can be considered a domestic purchase so long as they were bought and sold on a domestic exchange.[125] Such holdings are troubling to both domestic investors and foreign companies. Investors cannot be sure whether they will be protected by U.S. securities laws and foreign companies do not know if they will be held liable for their actions outside the United States, contravening the purpose for creating *Morrison*'s transactional test.[126]

B. Applying Morrison *to Securities Not Listed on an Exchange*

When a purchase or sale of a security is not listed on a domestic exchange—also known as an over-the-counter ("OTC") transaction

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121. *Id.*

122. *See id.* ("The ADRs were both listed and traded on the NYSE, and thereby fall within any reading of *Morrison.*").

123. *See, e.g.*, Stackhouse v. Toyota Motor Co., No. 10–0922, 2010 WL 3377409, at *1 (C.D. Cal. July 16, 2010); Cornwell v. Credit Suisse Grp., 729 F. Supp. 2d 620, 623–26 (S.D.N.Y. 2010); *In re* Alstom SA Secs. Litig., 741 F. Supp.2d 469, 472–73 (S.D.N.Y. 2010); Sgalambo v. McKenzie, 739 F. Supp. 2d 453, 487 (S.D.N.Y. 2010).

124. *See In re* Société Générale Secs. Litig., No. 08 Civ. 2495, 2010 WL 3910286, at *5–7 (S.D.N.Y. Sept. 29, 2010).

125. *See Royal Bank of Scot.*, 765 F. Supp. 2d 327, 337–38 (S.D.N.Y. 2011) (stating so implicitly); *In re Vivendi*, 765 F. Supp. 2d at 529.

126. *See* Morrison v. Nat'l Austl. Bank, Ltd., 130 S. Ct. 2869, 2885–86 (2010) ("[Various foreign nations] complain of the interference with foreign securities regulation that application of § 10(b) abroad would produce, and urge the adoption of a clear test that will avoid that consequence. The transactional test we have adopted—whether the purchase or sale is made in the United States, or involves a security listed on a domestic exchange—meets that requirement.").

—courts have had to look more at the actions taken by parties to determine whether a domestic purchase or sale has occurred. An OTC transaction of a security has many elements, including the citizenship of the parties, the solicitation, the offer, the decision to invest, and the transferring of title for the instrument.[127] Courts have had to determine at what point in the process the transaction occurred and which of these factors were merely conduct and thus separate from the transaction. So far, courts have developed three main methods to determine whether a purchase or sale is domestic: the economic realities method, the irrevocable liability method, and the transfer of title method.[128] Unfortunately, each method can result in a different outcome for a purchaser or seller, making it difficult for courts to give proper guidance to issuers and investors.

1. *The Economic Realities Method*

As financial instruments become increasingly complex, courts have had to examine transactions where the purchases or sales of securities are based on pools of other securities and assets[129] or pools of asset-backed securities.[130] For example, if one were to invest in a foreign hedge fund, which, in turn, invested in domestic securities, would the purchase be a domestic transaction under *Morrison*? In these instances, the courts look at the "economic realities" of the transaction to determine whether the purchase of a complex security falls under *Morrison*'s transactional test.

In re Banco Santander Securities-Optimal Litigation[131] was one of the first cases to deal with an OTC transaction. The case dealt with multiple foreign entities that had invested in several Bahamian investment funds.[132] These funds had, in turn, invested in funds run by Bernard L. Madoff's firm.[133] Plaintiffs claimed that the defendants, financial services institutions managing the Bahamian funds, failed to perform adequate due diligence on the Madoff-run

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127. *See, e.g.*, Buxbaum, *supra* note 9, at 167–68 (noting the various ways plaintiffs have, post-*Morrison*, pointed to a variety of factors to prove that a transaction has occurred within the United States).

128. *See infra* Part IV.B.1–3.

129. *See generally* SCOTT & GELPERN, *supra* note 71, at 967–1030 (describing how mutual and hedge funds are formed and regulated).

130. *See generally id.* at 704–33 (describing how pools of assets are securitized, structured, and sold).

131. 732 F. Supp. 2d 1305 (S.D. Fla. 2010).

132. *Id.* at 1311.

133. *Id.*

funds and, therefore, asserted securities fraud claims under Rule 10b-5 when the funds became worthless after Madoff's Ponzi scheme came to light.[134] Plaintiffs argued that the Bahamian funds were purchased for the purpose of ultimately investing in U.S. funds through Madoff's firm.[135] Thus, plaintiffs claimed that their purchase was "in connection with" Madoff's investment funds and therefore a domestic transaction.[136] Judge Huck dismissed these arguments by holding that the phrase "in connection with" refers to the fraud alleged and not the actual purchase or sale of securities.[137] Even though the hedge fund was composed of domestic securities, the economic reality was that the securities were purchased in off-shore Bahamian investment fund.[138] Therefore, plaintiffs' fraud claims did not meet *Morrison*'s transactional test because the securities were purchased outside the United States and therefore governed by the laws of the Bahamas.[139]

Conversely, the court in *SEC v. Credit Bancorp, Ltd.* held that fraudulent activity outside the United States can fall within the scope of *Morrison*'s transactional test if the activity is in connection with purchases and sales of securities in the United States and is listed on a U.S. exchange.[140] The case involved defendant Credit Bancorp, a company based in Geneva, and Thomas Rittweger, an American citizen who was Credit Bancorp's managing director for North America.[141] Defendants solicited individuals to invest in its "Insured Credit Facility Program."[142] Using various assets as collateral, investors could borrow money at substantially lower rates than competing brokerage houses.[143] The assets would then earn interest and be paid back to the investors as a form of "dividend."[144] Despite promises to the contrary, defendants took the collateral assets and margined or sold them outright to fund a variety of different business

134. *See id.* at 1315–16.
135. *Id.* at 1317.
136. *Id.*
137. *Id.*
138. *Id.*
139. *Id.*
140. 738 F. Supp. 2d 376, 396–97 (S.D.N.Y. 2010).
141. *Id.* at 380; *see* Complaint in Intervention at *1, SEC v. Credit Bancorp Ltd., 738 F. Supp. 2d 376 (S.D.N.Y. 2010) (No. 99 Civ. 11395), 2003 WL 23671599, at *1.
142. *Credit Bancorp.*, F. Supp. 2d at 380.
143. *Id.*
144. *Id.*

investments and personal purchases within Europe.[145] Rittweger argued that since all the fraudulent activity had occurred in Europe, his conduct did not fall within the scope of *Morrison*.[146] Judge Sweet held that since Rittweger solicited American investors and received their stock certificates within the United States, his actions were a domestic transaction.[147] Rittweger also told domestic investors that their assets—some of which were stocks listed on U.S. exchanges—would be kept within the United States, further bolstering the SEC's assertion that Rittweger's fraudulent actions were in connection with a domestic securities transaction.[148] Therefore, despite the fraudulent purchases occurring outside the United States, the economic reality was that Rittweger's domestic actions were sufficient enough to fall under *Morrison*'s purview.

Interestingly, when the court in *Elliott Associates v. Porsche Automobil Holding SE*[149] applied the economic realities method to domestic hedge funds invested in domestic securities, it held that such transactions did not fall under *Morrison*'s transactional test. In *Elliott Associates*, plaintiffs were a collection of thirty-five hedge funds that were managed by nine investment managers in New York.[150] The funds entered into a security-based swap agreement which they created and carried out entirely within the United States to track the price of Volkswagen ("VW") shares traded in Germany.[151] The swap agreement was inversely proportional to the price of VW shares, so that if the price went up, the plaintiffs would generate losses.[152] The plaintiffs claimed that defendant, Porsche, made misleading statements about its desire to buy VW shares.[153] Later, when Porsche announced that it had accumulated a large portion of VW shares, causing a sharp price increase, the plaintiffs lost a considerable amount of money.[154] Plaintiffs argued that, while

145. *Id.* at 381.

146. *Id.* at 396.

147. *Id.* at 396–97.

148. *Id.* at 397 ("[T]he transactions for which Rittweger was prosecuted and sued satisfied both approaches to the application of § 10(b) under Morrison: they involved a securities transaction occurring domestically, and they involved the exchange of securities listed on domestic exchanges.").

149. 759 F. Supp. 2d 469, 476 (S.D.N.Y. 2010).

150. *Id.* at 471.

151. *Id.*

152. *Id.*

153. *Id.* at 473.

154. *Id.*

Porsche's actions were performed entirely outside of the United States, the purchases and sales of the domestic swap agreement were made entirely in the United States, falling within the scope of *Morrison*.[155] The court dismissed these arguments and instead compared the swap agreement to the plaintiffs actually going to Germany to purchase VW shares.[156] Under the economic realities method, the transactions were conducted on foreign exchanges and thus did not meet the *Morrison* transactional test.[157]

The divergent opinions of *Banco Santander*, *Credit Bancorp*, and *Elliot Associates* underlie the problems of applying the *Morrison* test to OTC transactions, as each decision must be interpreted on a case-by-case basis. While *Banco Santander* held that a foreign hedge fund invested with domestic securities did not meet the *Morrison* transactional test using the economic realities method[158] *Credit Bancorp* held that a domestic securities fund that made fraudulent foreign investments did.[159] *Elliott Associates* held, surprisingly, that domestic hedge funds invested in U.S. security swaps were not a domestic transaction.[160] Such disparate applications of the transactional test can lead to market inefficiency because neither the investors nor the managers of these securities have any certainty as to whether they may fall under U.S. jurisdiction.[161]

2. The Irrevocable Liability Method

Some courts have tried to solve the problem of determining where a "purchase" and "sale" occurs by first determining *when* it occurs. *Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.*,[162] *SEC v. Goldman Sachs & Co.* ("*Tourre*"),[163] and *Basis Yield*

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155. *Elliott*, 759 F. Supp. 2d at 474.

156. *Id.* at 476.

157. *Id.*

158. *In re* Banco Santander Secs.-Optimal Litig., 732 F. Supp. 2d 1305, 1317 (S.D. Fla. 2010).

159. SEC v. Credit Bancorp, Ltd., 738 F. Supp. 2d 376, 397 (S.D.N.Y. 2010).

160. *Elliott*, 759 F. Supp. 2d at 476.

161. *Cf. Cross-Border Private Rights Study*, *supra* note 31, at v (noting that twenty-three comment letters were written to the SEC arguing against enacting the *Morrison* transactional test under the argument that, among other things, it would be more costly for U.S. investment funds to trade on foreign securities as they may be forced to trade ADRs or forego U.S. investor protection).

162. 735 F. Supp. 2d 166 (S.D.N.Y. 2010).

163. 790 F. Supp. 2d 147 (S.D.N.Y. 2011).

Alpha Fund (Master) v. Goldman Sachs Group, Inc.[164] each focused on the idea that "an individual [becomes] a 'purchaser' when he or she [incurs] an irrevocable liability to take and pay for the stock."[165]

The *Plumbers'* case involved a pension fund that purchased stocks on the Swiss stock exchange from defendant's company that allegedly made fraudulent statements about its earnings and accounting statements.[166] Plaintiffs argued that the transaction occurred within the United States because (1) they were a U.S. entity, (2) they made the decision to invest within the United States, (3) they placed their orders for stocks within the United States, (4) they suffered harm in the United States, and (5) the traders who executed plaintiffs' orders were within the United States.[167] Looking at these five elements, Judge Koeltl held that none of them were determinative in deciding whether a purchase was made within the United States.[168] The location of the purchaser at the time the order was placed was not determinative because it would not necessarily be the same place that the transaction was formed.[169] Neither would the location of the purchaser be determinative because whenever the decision to invest was made or the damages were subsequently incurred, the location of the actual transaction would change.[170] Since the plaintiffs had failed to assert that their order was irrevocable when it was placed and conceded that the purchase was made on a foreign exchange, the purchase could not be considered domestic under *Morrison*.[171]

Both *Tourre* and *Basis* involved defendants providing misleading information when selling synthetic collateralized debt obligations ("CDOs")[172] to a foreign party.[173] Both courts, drawing heavily on

164. 798 F. Supp. 2d 533 (S.D.N.Y. 2011).

165. *Plumbers' Union*, 735 F. Supp. 2d at 177 (quoting Blau v. Ogsbury, 210 F.2d 426, 427 (2d Cir. 1954)).

166. *Id.* at 171–73.

167. *Id.* at 178.

168. *Id.* at 177–78; *see id.* at 178 ("There may be unique circumstances in which an issuer's conduct takes a sale or purchase outside this rule, but the mere act of electronically transmitting a purchase order from within the United States is not such a circumstance.").

169. *See id.* at 178.

170. *See id.*

171. *See id.*; *see also* Morrison v. Nat'l Austl. Bank, Ltd., 130 S. Ct. 2869, 2869 (2010).

172. *See generally* SCOTT & GELPERN, *supra* note 71, at 717 (describing how CDOs are created).

173. *Basis*, 798 F. Supp. 2d at 535–36; *Tourre*, 790 F. Supp. 2d at 150–54.

the decision in *Plumbers'*, held that to prove that a purchase was made within the United States, a plaintiff must show that the defendants incurred "irrevocable liability."[174] In *Tourre*, Judge Jones was somewhat unclear in her decision that, in order to prove a domestic purchase, one has to prove that securities have to incur irrevocable liability within the United States. In doing so, Judge Jones seemingly combined the temporal aspect of *when* irrevocable liability occurs with *where* irrevocable liability occurs.[175] She attempted to clear up this distinction in *Basis* by explaining that once the plaintiff shows when a security has incurred irrevocable liability, he or she can then prove where the security was purchased.[176] However, she gave no indication as to what factors would allow a court to draw a reasonable inference that the purchase or sale occurred within the United States.

Judge Krieger cleared up some of the ambiguity left by Judge Jones in *Cascade Fund, LLP v. Absolute Capital Management Holdings Ltd.*[177] In *Cascade*, Cayman Island investment fund manager defendants solicited the plaintiff, a U.S. entity, to invest in their funds, which were made up of unregulated U.S. "penny stocks."[178] The plaintiff alleged that defendants had fraudulently failed to disclose material facts, causing it to sustain losses on its investments.[179] In arguing that its purchase of defendants' funds occurred in the United States, the plaintiff used factors similar to the plaintiffs in *Plumbers'*[180] but also pointed out that "the money for the

174. *Basis*, 798 F. Supp. 2d at 537; *Tourre*, 790 F. Supp. 2d at 157–58.

175. *Tourre*, 790 F. Supp. 2d at 158–59 (looking at *Plumbers'*, Judge Jones held that the notion of *when* "irrevocable liability" occurs is the core of both purchase and sale, but then states that the SEC had failed to "demonstrate *where* any party to the [securities] purchases incurred 'irrevocable liability'") (quoting *Plumbers'*, 753 F. Supp. 2d at 177) (emphasis added).

176. *Basis*, 798 F. Supp. 2d at 537 ("Consequently, courts dealing with securities not traded on any exchange, like the CDO at issue here, have had to define *when* a purchase or sale occurs so that it can then determine *where* the transaction took place.") (emphasis in original).

177. No. 08-CV-01381-MSK-CBS, 2011 WL 1211511 (D. Colo. Mar. 31, 2011).

178. *Cascade*, 2011 WL 1211511, at *1; *see Important Information on Penny Stocks*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/investor/schedule15g.htm (last visited Aug. 23, 2012) ("Penny stocks are low-priced shares of small companies.").

179. *Cascade,* 2011 WL 1211511, at *1.

180. *Id.* at *7 ("Cascade points to four facts . . . : (i) the Offering Memoranda and other investment materials were disseminated to [the plaintiff] in the United States; (ii) [the defendants] traveled to the United States to solicit American investors; (iii) [plaintiff] made its decision to invest while in the United States . . . .").

purchase was wired to a bank in New York."[181] After dismissing the other factors as non-determinative under *Morrison*, the court stated that the transaction did not have "irrevocable liability" at the moment the money transferred but rather when the defendants accepted the application to invest in the funds.[182] Therefore, since the defendants presumably accepted the application while in their Cayman Island offices, the purchase did not occur within the United States and fell outside the scope of *Morrison*'s transactional test.[183]

While courts have applied the irrevocable liability method uniformly, there is still a lot of uncertainty as to how a potential plaintiff may overcome the extraordinarily high burden the method puts in place. In *Plumbers'*, *Tourre*, and *Basis*, the burden of proof was on the plaintiff to prove that the transaction was irrevocably liable.[184] However, those courts failed to provide determinative factors as to whether a transaction was irrevocably liable. They only pointed to factors which were not determinative.[185] Further, *Cascade*—which utilized, but did not explicitly state it was using, the irrevocable liability method—only made an allusion as to how deciding when a transaction occurred would allow a court to determine where a transaction occurred.[186] But using this method alone would create a simple loophole for fraudulent actors to merely open a foreign office and make sure to accept applications to invest funds in that office, leading to possibly unjust applications of the *Morrison* transactional test.

181. *Id.*

182. *See id.* (stating that the transfer of money "simply describes a step . . . to comply with [the] process for applying to invest in [defendant's] funds . . . . [The defendant] reserved the right to reject a request to invest for any reason, even if the purchase money had properly been wired to New York").

183. *Id.*

184. *Plumbers'*, 753 F. Supp. 2d at 178 ("The plaintiffs' construction would require a fact-bound, case-by-case inquiry into when exactly an investor's purchase order became irrevocable."); *Basis*, 798 F. Supp. 2d at 537 ("[T]o state a claim under Section 10(b), a plaintiff must allege that the parties incurred irrevocable liability to purchase or sell the security in the United States."); *Tourre*, 790 F. Supp. 2d at 159 ("[T]he [plaintiff] bears the burden of alleging the [defendant's securities] purchases were domestic transactions . . . . The Court need not address the [plaintiff]'s argument in view of the [plaintiff]'s failure to allege that *any* party to the [defendant's securities] purchases incurred 'irrevocable liability' in the United States.").

185. *Plumbers'*, 753 F. Supp. 2d at 178; *Basis*, 798 F. Supp. 2d at 537; *Tourre*, 790 F. Supp. 2d at 158.

186. *See Cascade*, 2011 WL 1211511, at *7.

3. The Transfer of Title Method

The transfer of title method is a way for courts to deal with more nuanced transactions without resorting to the confusing irrevocable liability method or bending the law to meet the economic realities method. For example, *Quail Cruise Ship Mgmt., Ltd. v. Agencia De Viagens CVC Tur Limitada* involved a Bahamian corporation who claimed that defendants, Brazilian and American entities, fraudulently induced it into buying a faulty cruise ship via a stock purchase from a Uruguayan corporation.[187] The plaintiff argued that the stock transfer was made pursuant to an agreement subject to Florida law and that the documentation required to transfer the stock was sent to Florida.[188] Therefore, the plaintiff argued, the purchase occurred within the United States since the parties intended the closing to occur in the Miami law office of one of the parties' counsel.[189] The district court held that the intent of the parties to close the sale is not dispositive of where a securities transaction occurs.[190] Instead, the location of the purchase or sale, not the closing, is determinative of where the securities transaction occurred.[191] Since the share purchase agreement was signed in Spain by Quail and in Uruguay by the Uruguayan corporation, the transaction did not occur within the United States and thus failed the *Morrison* transactional test.[192]

However, on appeal, the Eleventh Circuit remanded the district court's decision.[193] The court noted that Quail alleged that the transaction for the stock purchase closed by means of both parties submitting the stock transfer documents to the Miami law office.[194] In looking at the black letter definition of "closing" and "sale" in *Black's Law Dictionary* and the wording in the stock purchase agreement, the court held that the title to the shares was transferred to the plaintiff at the closing and that such a transfer constituted a

187. 732 F. Supp. 2d 1345, 1347 (S.D. Fla. 2010) *vacated*, 645 F.3d 1307 (11th Cir. 2011).

188. *Id.* at 1349.

189. *Id.*

190. *Id.* at 1350.

191. *Id.*

192. *Id*. at 1349–50.

193. Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada, 645 F.3d 1307, 1310 (11th Cir. 2011).

194. *Id.* at 1309.

domestic sale.[195] Therefore, the plaintiff's purchase fell within the scope of *Morrison*'s transactional test since the transfer of title signified that the transaction had been completed.[196]

The most recent case to be decided concerning *Morrison*'s extraterritorial reach attempted to find harmony between the irrevocable liability and the transfer of title methods. In *Absolute Activist Value Master Fund Ltd. v. Ficeto*,[197] plaintiffs were nine Cayman Islands hedge funds who, like the plaintiffs in *Cascade*, were induced by defendants to purchase nearly valueless "penny stocks" issued by companies within the United States.[198] The defendants then traded the stocks between the funds to artificially increase the stocks' prices.[199] The district court employed the transactional test by examining the market on which penny-stocks are traded.[200] Even though the trades were being performed by U.S. companies, the funds were being traded solely among the Cayman Island funds.[201] Therefore, the district court held that the purchases and sales were not domestic and failed the *Morrison* transactional test.[202]

On appeal, Judge Katzmann drew from *Plumbers'*, *Tourre*, and *Quail* to argue that a sale of securities can either be understood when the purchaser incurred irrevocable liability or when the title is transferred.[203] In using both the irrevocable liability and transfer of title methods, the court listed the following types of evidence that may indicate a domestic transaction: "facts concerning the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money."[204] However, since the plaintiffs had

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195. *Id*.

196. *Id.* at 1310–11.

197. 677 F.3d 60 (2d Cir. 2012), *aff'g in part*, *rev'g in part and remanding* Absolute Activist Value Master Fund Ltd. v. Homm, No. 09 CV 08862(GBD), 2010 WL 5415885 (S.D.N.Y. Dec. 22, 2010).

198. *Id.* at *62–63.

199. *Id.* at *63–64.

200. *Homm*, 2010 WL 5415885, at *5.

201. *Id.*

202. *Id.*

203. *Ficeto*, 677 F.3d at 68 ("Given that the point at which the parties become irrevocably bound is used to determine the timing of a purchase and sale, we similarly hold that the point of irrevocable liability can be used to determine the locus of a securities purchase or sale. . . . However, we do not believe this is the only way to locate a securities transaction . . . [A] sale of securities can be understood to take place at the location in which title is transferred.").

204. *Id.* at 70.

failed to give sufficient proof, Judge Katzmann held that their claims did not meet the transactional test of *Morrison*.[205]

The transfer of title method, therefore, allows for a more uniform application of the transactional test by various courts. Instead of arguing the economic realities of their securities transaction or providing evidence that the transaction was irrevocably liable within the United States, plaintiffs, like the ones in *Quail*, merely need to show that the transfer of title occurred within the United States in order to overcome the *Morrison* transactional test.[206] *Ficeto* encourages this view by stating that the transfer of title is a determinative factor in deciding whether or not a transaction is domestic.[207] However, the same loophole that could be used to circumvent the holding in *Cascade* is present here. Issuers could set up an offshore office to close a securities transaction and therefore avoid liability.

IV. HOW COURTS SHOULD INTERPRET *MORRISON* GOING FORWARD

Justice Scalia attempted in *Morrison* to replace the principles-based method of determining the extraterritorial reach of antifraud securities laws with a clear rules-based method. But with cross-listed securities being traded on a global scale and complex financial instruments being created and passed between various multinational institutions, strict, textual-based readings of a *Morrison* have created incongruous holdings. While there is not much courts can do to change the test, absent urging Congress or the Supreme Court to modify it, there are ways in which courts should approach an international antifraud case to minimize deviation between courts holdings while still adhering to the "spirit" of *Morrison*.

Despite the possibilities of allowing an investor to be taken advantage of by a fraudster on an international exchange, *Cornwell*'s holding that all "purchases" and "sales" made on a foreign exchange are outside the scope of *Morrison* should be adopted.[208] This bright-line rule would be easy and effective to manage by a court, and it would leave little room for parties to argue that their transactions

205. *Id.*

206. Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada, 645 F.3d 1307, 1310 (11th Cir. 2011).

207. *Ficeto*, 677 F.3d at 70.

208. Cornwell v. Credit Suisse Grp., 729 F. Supp. 2d 620, 625–26 (S.D.N.Y. 2010).

were domestic. Further, this rule would fall within the spirit of *Morrison* of avoiding the possibility of "judicial-speculation-made-law"[209] as to whether a foreign investor solicited within the United States. However, it should *only* apply to direct purchases and shares on the foreign market, and it should not be extended to mutual or hedge funds, which invest on a majority of different markets. Those kinds of transactions should be viewed as OTC transactions and be analyzed by the second *Morrison* prong rather than the first.

As for ADRs, courts should follow Judge Holwell's reasoning in *Vivendi*. Judge Holwell's textual analysis, which differentiates between being registered and being listed on an exchange, avoids forcing the courts to walk the judicial line of determining whether or not an ADR is a "predominantly foreign securities transaction"[210] and therefore falling outside *Morrison*. While one could use the *Société Générale* method of assuming all ADRs are foreign transactions, it goes against the textual reading of *Morrison* and the Exchange Act since ADRs are specifically mentioned within the Act.[211]

To harmonize the holdings concerning OTC securities transactions, courts should reject the economic realities method in favor of the more succinct, but still flexible, combination of irrevocable liability and transfer of title tests. As witnessed in *Banco Santander*, *Credit Bancorp*, and *Elliott*, understanding the "economic realities" can be an unwieldy test to administer and lead to entirely opposite outcomes—the very same problems Justice Scalia tried to avoid when creating the transactional test. Rather than determining if a transaction was actually in another country or was merely akin to being in another country, the temporal and financial determinations laid out by the irrevocable liability and transfer of title tests allow for the flexibility necessary to catch more complex securities litigation while still being clear enough to administer uniformly. For example, if a foreign hedge fund were to purchase domestic securities and then defraud its investors, the economic realities test would require courts to decide whether the transaction was domestic (i.e., the economic reality is that the hedge fund investors essentially purchased the domestic stocks themselves) or extraterritorial (i.e., the economic

209. *See* Morrison v. Nat'l Austl. Bank, Ltd., 130 S. Ct. 2869, 2881 (2010).

210. *In re* Société Générale Secs. Litig. No. 08 Civ. 2495, 2010 WL 3910286, at *4 (S.D.N.Y Sept. 29, 2010) (citing Copeland v. Fortis, 685 F. Supp. 2d 498, 506 (S.D.N.Y. 2010) (quoting *In re* SCOR Holding (Switzerland) AG Litig., 537 F. Supp. 2d 556, 562 (S.D.N.Y. 2008)).

211. 17 C.F.R. § 240.12g3-2(b) (2010).

reality is that the investors purchased shares of a foreign hedge fund). Different courts could come to different conclusions. Under the combined irrevocable liability and transfer of title tests, the investors would know that they would be protected under U.S. securities laws so long as they could prove that the title to their shares of the hedge fund passed to them within the United States. However, this method alone has the potential to create legal loopholes. Foreign or domestic entities could attempt to set up offshore offices for the sole purpose of transferring title outside the United States while leading investors to believe that the transfer occurred within the United States. In this circumstance, the irrevocable liability test could close those loopholes by pinpointing the time the transaction occurred and then the location of the parties when the transaction occurred—thus giving more flexibility to courts in interpreting complex financial securities transactions while minimizing any incongruence between varying court decisions.

CONCLUSION

The Supreme Court's opinion in *Morrison v. National Australia Bank* represents an attempt to move away from principles-based securities law analysis and towards a more rule-based assessment. However, the Court failed to realize the reason courts came to adopt such an analysis. Section 10(b)'s broad language allowed it to easily adapt to today's securities markets, despite the growth of cross-border securities transactions and increasingly complex financial instruments. But by limiting Section 10(b) to a strict textual analysis, courts have had to go back and analyze each term within the legislation, causing confusion among investors and issuers as to what rights they are afforded within the United States. As Justice Stevens noted, "While the clarity and simplicity of the Court's test may have some salutary consequences, like all bright-line rules it also has drawbacks."[212] In doing away with the "conduct" and "effects" test, Justice Scalia inadvertently planted several new judicial saplings, which the lower courts have had to tend without much guidance. Hopefully, with a little pruning, they will grow together and form the unified tree the Supreme Court envisioned.

212. *Morrison*, 130 S. Ct. at 2895 (Stevens, J., concurring in part).