Morrison's 'Clear' Transactional Test After *Toshiba*—the Search for the Border between Domestic and Foreign Transactions in Complex Financial Instruments

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Few U.S. court decisions have gained such notoriety as the U.S. Supreme Court's 2010 decision in *Morrison v. National Australia Bank*, 561 U.S. 247 (2010). In *Morrison*, the high court famously substituted its 'transactional test' for what was known as the 'conduct and effects' test—a close cousin to the internationally widely accepted *lex loci delicti* rule to determine the law governing fraud claims in cross-border situations on the basis of the place where the fraud was committed. '[T]he focus of the Exchange Act is not upon the place where the deception originated,' the court said, 'but upon purchases and sales of securities in the United States' (*id*. at 266). In the eyes of the court, this transactional test provided a 'clear test' to limit the territorial scope of the Securities Exchange Act's anti-fraud provision Section 10(b), whereas the conduct and effects test suffered from imprecision, depended on multiple factors tipping the scales, and was 'not easy to administer.'

The prediction of clarity which the *Morrison* court thought its new rule would bring, has not panned out. Under the new transactional test, 'only transactions in securities listed on domestic exchanges, and domestic transactions in other securities' fall within the scope of Section 10(b) (*id*. at 267). With respect to both the first prong (securities listed in the United States) and the second prong (purchases or sales in the United States) the court's standard has been proven to be less clear in practice than the plain meaning of the words 'listed' and 'in the United States' would suggest. The Supreme Court appears to have had only the most basic and straightforward financial transactions in mind. A recent unpublished opinion issued by the District Court for the Central District of California, *Stoyas v. Toshiba Corp.*, No. CV 15-04194 (C.D. Cal. May 20, 2016) regarding Toshiba's unsponsored over-the-counter American depositary shares, which significantly adds to the confusion, illustrates that in the more complex reality of sophisticated global financial markets, *Morrison*'s transactional test has created substantial uncertainty.

Expansive Readings of *Morrison*

By the time *Morrison* reached the Supreme Court, it involved three Australian investors who had purchased an Australian issuer's stock on the Australian Stock Exchange. Although much has been written about the 'F-cubed' character of the case—*foreign* purchasers of a *foreign* company's stock on a *foreign* exchange—which the concurring opinion described as having 'Australia written all over it,' courts have liberally applied the transactional test to situations that were not exclusively foreign but presented a mix of foreign and domestic elements—*e.g.* foreign securities purchased by U.S. investors or a U.S. company's securities purchased on a foreign market. *See, e.g., City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173, 181 (2d Cir. 2014) (applying *Morrison* to U.S. entity purchasing UBS stock in Switzerland).

Section 10(b) is inapplicable to U.S. investments in foreign stock, even when a substantial portion of the wrongful conduct, or the entire fraud, was planned and committed in the United States.

A second line of cases has pushed *Morrison* beyond the context of the Section 10(b) claim at issue in the case and past the *Morrison* court's textual analysis of the Securities Exchange Act into a rule of general application that now also limits the scope of the Securities Act of 1933 (*In re RBS Sec. Litig.*, 765 F. Supp. 2d 327, 338 (S.D.N.Y. 2011)), as well as the Commodities Exchange Act of 1936 and additional provisions of the Exchange Act. *Starshinova v. Batratchenko*, 931 F. Supp. 2d 478, 486 (S.D.N.Y. 2013).

A third line of cases concerns paired or so-called synthetic securities, where one security is connected to, and mimics, the properties of another security. If cases where the paired security is traded in one country, while the underlying security trades in another, courts have encountered grave difficulty determining the place of transaction for either leg of the pair, and adopted solutions that substantially altered the wording of *Morrison*'s purportedly bright-line rule.

Securities 'Listed on Domestic Exchanges'

The most expansive reading of *Morrison* that has pushed the transactional test considerably beyond the court's clear wording involved the courts' interpretations of 'securities listed on domestic exchanges' simply as if they were not listed in the United States at all.

An ADR (short for American depositary receipt) is a receipt issued by a depositary bank and then offered to the U.S. market, which represents a specified amount of a foreign security that has been deposited with a foreign branch or agent of the depositary. ADRs are tradeable in the same manner as any other registered American security and may be either listed on a U.S. exchange or traded over-the-counter (OTC). ADRs listed and traded on a U.S. exchange meet *Morrison*'s first prong, and are therefore governed by U.S. law, even if the security to which the ADR is tied is traded abroad and the alleged fraud occurred elsewhere in the world. *See, e.g., United States v. Martoma*, 2013 WL 6632676, at *3 (S.D.N.Y. Dec. 17, 2013).

Courts have, however, imposed additional requirements not found in *Morrison* on a foreign issuer's listing in the United States through ADRs or by way of dual listing (cross-listing). In *Pontiac*, investors purchased stock in UBS, listed on the New York Stock Exchange, but they effected the transaction in Switzerland where UBS was also listed. The investors argued that by *Morrison*'s clear wording, the requirement that the purchase occurred 'in the United States' applies only to securities not listed in the United States, while for all others their U.S. listing alone is sufficient to be governed by U.S. securities laws. The Second Circuit Court of Appeals rejected this 'listing theory' and instead interpreted *Morrison* as requiring that even transactions in U.S.-listed securities must have occurred on the U.S. exchange where those securities are listed; a mere listing in the United States is therefore not sufficient to render U.S. securities laws applicable. *Pontiac*, 752 F.3d 179-81); *see also In re Petrobras Sec. Litig.*, 2015 WL 9266983, at *2 (S.D.N.Y. Dec. 20, 2015) (mere listing, without trading, insufficient to satisfy *Morrison*'s first prong).

The *Pontiac* and *Petrobras* courts' interpretations are not intuitive, given that *Morrison* made a distinction between securities registered and not registered on domestic exchanges, stating that "[w] ith regard to securities *not* registered on domestic exchanges, the exclusive focus [is] on *domestic* purchases and sales' (*Morrison*, 561 U.S. at 268 (emphasis in original)). If the registered securities *also* required a domestic purchase and sale, it would make no sense for the court to draw this distinction, as *both* types of securities would then be subject to the exact same domestic transaction requirement. Thus, the Supreme Court could simply have said that in order to make the Exchange Act applicable, the securities at issue—registered or not registered—must always be purchased in the United States. There would be no need to have two separate prongs.

Obviously, it did not say that. The *Morrison* court described the transactional test it adopted as 'whether the purchase or sale is made in the United States, ***or*** involves a security listed on a domestic exchange' (*id*. at 269-70 (emphasis added)). And before *Pontiac*, the Second Circuit itself had interpreted the two-prong test as imposing alternative requirements. *See Absolute Activist Value Master Fund v. Ficeto*, 677 F.3d 60, 69 n.4 (2d Cir. 2012) ('Of course, pursuant to the first prong of Morrison, § 10(b) does apply to transactions in securities that are listed on a domestic exchange.').

The 'Best Execution' Rule

A significant practical difficulty with *Morrison*'s emphasis on the place of transaction, now aggravated by *Pontiac*'s extension of the domestic transaction requirement to all transactions, is the so-called 'best execution' rule. U.S. regulations impose a rule of best execution, which requires broker-dealers to use reasonable diligence to determine the best market for a security, and buy or sell the security in that market, so that the price to the customer is as favorable as possible under prevailing market conditions. Accordingly, when a security is listed in multiple countries by way of a cross-listing place of transaction will vary along with the circumstances that may make the use of one exchange more advantageous than the other. Investors may not know which exchange, foreign or domestic, ended up as the place of transaction, and may not discover whether they satisfy the *Morrison* test until defendants seek dismissal of their fraud claims.

'Purchases or Sales Made in the United States'

The *Morrison* court's second prong has also proven problematic. For securities not listed on a U.S. exchange but sold OTC, *Morrison*'s test is 'whether the purchase or sale is made in the United States'. But in the OTC market the place of the sale is not always so easily determined. The Second Circuit has held that 'buying' or 'selling' means either transferring title or entering into a binding contract that makes the buyer liable to take and pay for the security and the seller to deliver it. *Absolute Activist*, 677 F.3d at 67-68. Thus, transactions involving unlisted securities are domestic 'if irrevocable liability is incurred or title passes within the United States' (*id*. at 67). The Second Circuit acknowledged that this standard is not black-and-white but requires consideration of a number of factors concerning the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money (*id*. at 70).

This factor test reintroduces a dependency on multiple factors tipping the scales, which *Morrison* had rejected, and is a far cry from the bright-line rule it was supposed to introduce. For example, in *Anwar v. Fairfield Greenwich*, 728 F. Supp. 2d 372 (S.D.N.Y. 2010), the court found that determining the place of the transaction presented a 'more complex' question that required a more developed record, and declined to dismiss plaintiffs' fraud claims without discovery. The investment process in several Madoff feeder funds had involved plaintiffs sending their subscription agreements to an administrator in the Netherlands and an investment manager in Bermuda, followed by ultimate acceptance of the subscriptions by the funds themselves through the funds' operator in New York City, where it had an office and much of its executive staff was concentrated.

But even where the place of transaction *is* clear and undisputed, several courts have managed to deconstruct what it means to purchase securities 'in the United States.' A recent unpublished decision involved the unsponsored American depositary shares (ADSs) of Toshiba Corporation, a Japanese company, which traded in the United States. *See Stoyas v. Toshiba Corp.*, No. CV 15-04194, slip op. at 3, 12 (C.D. Cal. May 20, 2016). The underlying Toshiba common stocks were listed in Tokyo and Nagoya and purchased there by the depositary bank, who then sold ADSs to investors in the United States (*id*. at 17). There was no doubt, and the court expressly found, that 'the ADS transactions are securities transactions that occurred domestically: they were both sold and purchased in the United States' (*id*. at 23).

The court nonetheless found that the ADS investments did not meet *Morrison*'s transactional test, which the court construed as further requiring that *Toshiba itself* sold the securities in the United States. The court reasoned that foreign issuers ought to have a chance to avoid liability under U.S. law by deciding not to sell their securities in the United States; any other view could create a liability exposure for foreign issuers created by the independent actions of depositary banks selling on OTC markets (*id*. at 24). Because Toshiba had not been involved in, and had not sponsored, the trading of its ADSs, they did not involve domestic transactions under *Morrison* (*id*.).

The *Toshiba* court's reasoning is difficult to reconcile with the language of *Morrison* that the relevant inquiry is simply 'whether the purchase or sale is made in the United States' and that the place of the transaction must be 'the *exclusive* focus' (*Morrison*, 561 U.S. at 268-70 (emphasis added)).

Toshiba is also at odds with a line of cases involving synthetic securities. For example, in *SEC v. Compania Internacional Financiera S.A.*, 2011 WL 3251813 (S.D.N.Y. July 29, 2011), the defendant was alleged to have engaged in insider trading when it purchased CFDs (contracts for difference) in the United Kingdom for the shares of a U.S. company traded on the NYSE. CFDs are futures contracts that provide for the difference in the value (higher or lower) of an underlying security to be paid over by one party to the other. It gives a purchaser of a CFD the economic interest (profits or losses) in the underlying security without owning it, and thus allows foreign investors to access U.S. exchange-traded securities without the need to open a U.S. brokerage account.

Although the defendant had traded in London, its purchase of a foreign security tied to securities traded in the United States was sufficient to allege insider trading in connection with the underlying U.S.-listed security. The court held there is no requirement that the U.S. transactions were the fraudster's own; to hold otherwise—as the *Toshiba* court did—'misreads *Morrison*, which never states that a defendant must itself trade in securities listed on domestic exchanges . . .' (*id*. at *6).

The Southern District held the same in *SEC v. Maillard*, 2014 WL 1660024 (S.D.N.Y. Apr. 23, 2014), with respect to CFDs purchased in Luxembourg, hedged by purchases of the underlying security on the NYSE (*id*. at *2 (*Morrison*'s first prong not limited 'to transactions in which the defendant himself actually purchases or sells a listed security')). And the *Toshiba* court's sister court in California similarly rejected the *Toshiba* line of reasoning in a case where the defendant had placed 'spread bets' in the United Kingdom. *SEC v. Sabrdaran*, 2015 WL 901352 (N.D. Cal. Mar. 2, 2015). Spread bets function like CFDs in that the purchaser, betting on the increased price of the underlying security (in this case U.S. securities traded on NASDAQ), pays money to a broker who hedges the bets by purchasing call options on the underlying security. Because in this case the paired transactions included securities purchases in the United States, U.S. securities laws applied (*see id*. at *14 (circumstance 'that [the fraudster] did not purchase the underlying domestic securities himself is not fatal to the complaint')).

Security-Based Swaps

Another area where the courts have undermined the clear meaning of transactions 'in the United States' concerns swap instruments, which may be indisputably entered into in the United States, yet escape scrutiny under the U.S. securities laws when the underlying security is traded only on foreign exchanges.

In *Elliott Associates v. Porsche Automobil Holding* SE, 759 F. Supp. 2d 469 (S.D.N.Y. 2010), investors had entered into securities-based swap agreements that referred to the price of Volkswagen shares traded in Germany, meaning that the swap contracts fluctuated in value as the price of the underlying Volkswagen shares rose or fell. Securities-based swap agreements are privately negotiated contracts that are not traded on any exchange. There is no doubt that such swap agreements are securities within the meaning of Section 10(b) of the Exchange Act (*see* 15 U.S.C. § 78j(b)). Nor was there any doubt that the swaps at issue had been concluded in the United States (*id*. at 475). Notwithstanding *Morrison*'s purportedly 'clear test' that for such unlisted securities the exclusive focus is on the place of the transaction, the court added that the nature of the underlying security also 'must play a role.' According to the *Porsche* court, the economics of the swaps made them the functional equivalent of a purchase of Volkswagen shares and therefore 'effectively' transactions on a foreign exchange (*id*. at 475-76). Other district courts have rejected this 'functional equivalent' approach as inconsistent with *Morrison*'s bright-line test, which focuses exclusively on the place of purchase. *See, e.g., Wu v. Stomber*, 883 F. Supp. 2d 233, 253 (D.D.C. 2012).

On appeal, the Second Circuit struggled with the question. Strict application of the *Morrison* test would make U.S. securities laws applicable to any fraudulent conduct anywhere in the world, whenever a foreign security is referenced in a swap agreement made in the United States. *Morrison*'s domestic transactions prong would thus have significant extraterritorial implications and undermine its own rationale of avoiding conflict with foreign regulations. *See Parkcentral Global Hub v. Porsche Automobil Holdings SE*, 763 F.3d 198, 215 (2d Cir. 2014).

Although the Second Circuit expressly disavowed any general application of its ruling beyond the specific facts of the

Porsche case, it did rule as a matter of law that while a transaction in securities in the United States may be *necessary* to state a claim under Section 10(b), it cannot be *sufficient*—suggesting that, in addition, courts would have to consider 'the foreignness of the facts' constituting the fraud and the foreign issuer's awareness of the U.S. transactions (*id*. at 215-16). The relevance of these additional '*Porsche* factors' is, of course, difficult to reconcile with the Supreme Court's statement that its test is simply 'whether the purchase or sale is made in the United States' or with its rejection of the conduct and effects test as too dependent on the need for additional factors to tip the scales. *See Morrison*, 561 U.S. at 259-60, 269-70. It is also at odds with the Supreme Court's view that 'the place where the deception originated' (that is, 'the foreignness of the facts' constituting the fraud) is *not* 'the focus of the Exchange Act' (*id*. at 266) and the Second Circuit's holding in *Absolute Activist* that *Morrison* does not require that a foreign defendant engaged in any conduct in the United States (677 F.3d at 69).

Conclusion

The report card for the Supreme Court's purported bright-line rule is thus quite disappointing. Courts have liberally construed *Morrison* as a general rule with application beyond Section 10(b) of the Exchange Act and the F-cubed context in which it was decided. Worse: with respect to each of *Morrison*'s two prongs, courts have invented new requirements that are not apparent from the transactional test itself.

While some courts have stayed true to the Supreme Court's wording, which requires *either* a transaction *or* a listing in the United States, others have construed *Morrison* to require a purchase in the United States under *all* circumstances, whether the securities are U.S.-listed or not. Meanwhile, when securities *were* purchased in the United States, some courts have found even that to be insufficient. While most courts hold that *Morrison*'s exclusive focus on the place of purchase leaves no room for additional requirements, at least one court, in *Toshiba*, has now required that the foreign issuer had control over the availability of its securities in the United States and it discarded even U.S. purchases when those related to over-the-counter ADSs unsponsored by the foreign issuer. At least one other court, in *Porsche*, has suggested the foreign issuer's awareness of the U.S. transactions and 'the foreignness' of the fraudulent act as additional factors.

Whether *Toshiba* will be followed by other courts remains unclear, given that at least three other courts have refused to read into *Morrison* a requirement that the transactions at issue are the alleged fraudster's own. On the other hand, at least one other court, in *Porsche*, has stated that the economic reality and the nature of the underlying security also 'must play a role,' and may have the effect of treating a domestic transaction as 'effectively' foreign.

Even without applying the *Toshiba* or *Porsche* factors, however, courts have held *Morrison*'s second prong (transactions in the United States) requires consideration of a number of factors concerning the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money—inevitably re-introducing a need to weigh several factors and turning *Morrison*'s seemingly straightforward test into an inherently indeterminate balancing act. It is now clear that *Morrison*'s criticism of the conduct and effects test has come back to haunt *Morrison* itself. Like the conduct and effects test, the transactional test has proven 'not easy to administer' and suffers from considerable imprecision. The court's criticism that the presence or absence of any single factor considered significant in some cases could end up 'not necessarily dispositive in future cases' squarely applies to factors like the 'foreignness' of the fraudulent acts (rejected by *Morrison* but dispositive in *Porsche*), the place of the transaction (dispositive in *Morrison*, but not sufficient in *Porsche*), or whether the defendant had control over the trades in the United States (dispositive in *Toshiba*, but irrelevant in *Compania*, *Maillard*, and *Sabrdaran*). In the *Morrison* court's own words, for a judicially developed test there is 'no more damning indictment' (*Morrison*, 561 U.S. at 258).

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