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What Counts as a Domestic Transaction Anymore: The Second Circuit and Other Lower Courts’ Struggles in Interpreting the Supreme Court’s Intent in *Morrison v. National Australia Bank* When Dealing with Derivative Securities Transactions

*Jacob True*

An investor decides that he wishes to diversify his portfolio and purchase some derivative shares to go with the common equity securities he owns in various companies. He speaks with his personal broker to discuss his options. The investor instructs his broker to execute a buy order on American Depository Receipts ("ADRs") issued by a U.S. domestic bank, but backed by the common stock of a foreign company publicly traded on an international exchange. Later, it is discovered that some alleged securities fraud by the company was discovered and investors of the derivative security were to make claims under the Exchange Act, specifically section 10(b) and Rule 10b-5, which prohibits fraud "in connection with the purchase or sale of any security." Though the investor may have assumed that U.S. securities law would protect him when the fraud occurs within U.S. territory, especially when the sale/purchase transaction occurred within the United States and by U.S. parties, the U.S. Supreme Court created uncertainty in the over-the-counter derivative securities market with its decision in *Morrison v. National Australia Bank Ltd*. Courts used to determine if claims involving fraudulent actions effecting securities transaction could be made under U.S. securities law by assessing whether the fraud was conducted or the effects of the fraud were felt within the United States, but after *Morrison* that changed. Now, a

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* J.D. Candidate, University of California, Hastings College of the Law, 2014. I wish to express my deepest gratitude and great appreciation for my loving and supportive family and friends.

securities transaction must be made on a "domestic exchange" or be a transaction occurring within the United States. The Supreme Court did not thoroughly define what constitutes a "transaction occurring within the United States" and now lower courts are have struggling to interpret the Supreme Court's intent when applying the Morrison test to derivative transactions cases. The Second Circuit Court has provided its interpretation of the test in the first case before it since Morrison, taking the approach of focusing on the underlying security transaction rather than the derivative transaction the subject of the litigation. Other courts have either differed with the Second Circuit's interpretation or only loosely followed it. At some point, further clarification by the Supreme Court will be necessary to remove the doubt and uncertainty surrounding the meaning of a domestic transaction.

I. INTRODUCTION

The extraterritorial application of U.S. securities law has had a muddled history and a recent switch of legal ideology when it comes to determining when section 10(b) and Rule 10b-5 apply. In Morrison v. National Australia Bank, the United States Supreme Court essentially rejected years of federal jurisprudence on the extraterritorial applications of section 10(b) of the Securities Exchange Act. The Court held that a claim brought by foreign investors against a foreign company based on shares bought on a foreign exchange—typically referred to as an "F-cubed" case—may not be litigated in United States courts under section 10(b).\(^2\) The larger impact of Morrison is its effect on global investment. The Court explained, through the literal interpretation of the language of §section 10(b), that U.S. securities law is silent on §10(b)'s scope beyond U.S. borders and, as such, prohibits fraud only (1) in connection with the purchase or sale of stock listed on a domestic exchange or (2) where the transaction was made in the United States.\(^3\) This decision has already made—and and will continue to make—U.S investors hesitant and cautious when it comes to getting involved with investments that are at all connected with a foreign company or territory. Though the transaction test the Supreme Court adopted, which will be discussed in further detail later in this note, states only the two scenarios where a claim for relief in U.S. courts would be

\(^3\) Id. at 2884–86.
allowed under section 10(b) and Rule 10b-5, the test proves not to be as much of a bright-line as the Supreme Court had possibly envisioned when it comes to the lower courts applying this test to cases that appear on their dockets, especially regarding the tricky determination of what constitutes the second prong's "transaction made within the United States." With the transactional test superseding the Second Circuit's former conduct and effects tests, investors once thought to be protected by U.S. securities law will now have to rethink and analyze whether the components of a particular security transaction involving any foreign party or element will qualify that transaction. Transactions that seemed domestic in nature, especially those involving derivative securities, may now in fact be classified as foreign and beyond the reach of section 10(b)'s authority.

This note tackles the complications that lie in categorizing transactions involving shares that are not listed on a domestic exchange, as domestic in nature or predominantly foreign transactions beyond the reach of section 10(b) and other applicable securities law. Part II covers the historical development of securities fraud jurisprudence, going into the creation of the Second Circuit's doctrine that proceeded Morrison's transactional test. Part III details the particulars of the Morrison case, as well as examines its initial impact on a handful of notable lower court cases. Part IV analyzes the Second Circuit's interpretation of the transactional test, thus far, in the court's first decision, Absolute Activist Value Master Fund Ltd. v. Ficeto, applying the Morrison transactional test. This Part also predicts how the court would have ruled in Elliott Assocs. v. Porsche Automobil Holding SE, where the Second Circuit was going to have its second opportunity to interpret and apply the transactional test before the lead plaintiffs dropped their suit. Finally, Part IV provides a suggestion on how to modify the court's application of the transactional test to improve upon it. Part V delves into the complications for investors resulting from the Morrison decision. In particular, this note looks at different equity derivatives that could possibly have foreign ties, and tries to see which derivatives may have a chance of being protected under §10(b) and which ones investors may not have that option for private action within the United States. A general look of the global investing horizon is then be looked at in the new legal environment under Morrison.
II. THE HISTORICAL PROGRESSION OF U.S. SECURITIES FRAUD PROTECTION

The Securities Exchange Act of 1934 ("Exchange Act") is part of a series of statutes enacted by the Roosevelt Administration to regulate the purchase and sale of publicly traded securities. It followed the Securities Act of 1933 and significantly expanded the scope of federal regulation of the private sector. As devious securities activities were widely believed to be a contributing force of the 1929 stock market crash, Congress wrote the antifraud provisions strongly favoring consumer protection.4 Included amongst the more notable provisions are Section 11, which provides civil liability if a registration statement contains "an untrue statement of material fact or omit[s] to state a material fact required to be stated therein or necessary to make the statement therein not misleading;"5 Section 12(a)(2), which creates civil liability for "material omissions or misstatements" in securities offerings and sales made by "means of a prospectus or oral communication;"6 and finally, Section 17, which permits the SEC to pursue equitable relief against individuals who make misleading statements in the offer or sale of securities.7 All issuers who must register with the SEC, as per Section 5 of the Securities Act, are subject to the above provisions.8

While the 1933 Act dealt predominantly with original issuances of securities, Congress recognized the significance of secondary trading markets and the need to extend federal regulation to include both securities issued and outstanding and responded by enacting the Exchange Act.9 One of the Exchange Act's most significant effects to securities regulation is its granting of authority to the Securities Exchange Commission ("SEC") to conduct investigations and impose sanctions against certain restricted practices, with section 10 being the SEC's most important enforcement authority, and Rule 10b-5 the most favorable tool for privates parties suing for securities fraud.10

6. Id. at § 77(a)(2).
7. Id. at § 77q.
8. Id. at § 77c(a).
9. PALMITER, supra note 4, at 307–11.
A. OVERVIEW OF THE EXCHANGE ACT §10B AND RULE 10B-5

The Exchange Act contains a number of antifraud provisions relating to its general focus on conduct in the markets, with section 10(b) as the most important antifraud provision in the Exchange Act.11 The bulk of all damages paid out in settlements and judgments of securities fraud class actions are filed under the section 10(b) provision and Rule 10b-5 promulgated there under.12 Section 10(b) forbids certain fraudulent conduct “in connection with the purchase or sale of any security.”13 This includes the prohibition of “any manipulative or deceptive device or contrivance” and the violation of any rules and regulations that the SEC may employ to protect investors.14 The SEC established Rule 10b-5 pursuant to its authority under section 10(b).15 Under 10b-5, a cause of action may arise when a defendant makes a material omission or misrepresentation, with scienter, connected with the purchase or sale of a security, causing economic loss to the plaintiff due to reliance on that omission or misrepresentation.16 When initially proposed in 1942 by the SEC’s regional administrator in Boston, Rule 10b-5 was created to address the gap regarding fraudulent purchases because the regulations of the time prohibited only fraudulent sales.17 Thus, Rule 10b-5 forbids deceptive practices that could mislead investors in both the purchase and sale of securities where no such all-encompassing rule had before existed.18

14. Id.
15. Id.; 17 C.F.R. § 240.10b-5 (2010).
16. 17 C.F.R. § 240.10b-5 (2010) (Rule 10b-5 provides that: “It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”).
18. 17 C.F.R. §240.10b-5 (2010); Chiappini, supra note 17, at 1799 (explaining that Rule 10b-5 is mostly used in five standard situations: (1) insider trading, (2) tipping, (3) corporate mismanagement in connection with securities transactions, (4) market-manipulation related to
The language of section 10(b) and Rule 10b-5 are silent on their applicability outside of the United States.\(^{19}\) Congress failed to address how far the Exchange Act’s geographic scope reached and if the securities laws were supposed to have extraterritorial limits. Though section 10(b) is silent on its extraterritorial limits, the language does hint at possible extraterritorial reach from the reference of “interstate commerce” where it is defined as commerce between any foreign country and State.\(^{20}\) Despite such reference, the lower courts have generally interpreted the securities laws to be silent on extraterritorial application.\(^{21}\)

B. SECOND CIRCUIT’S CONDUCT AND EFFECTS TESTS DOCTRINE

To address the uncertainty of section 10(b) and Rule 10b-5’s reach beyond U.S. borders, the U.S. Court of Appeals for the Second Circuit developed two tests for the extraterritorial application of Rule 10b-5, the conduct and effects tests. These tests were considered neither interdependent nor independent of each other, which allowed the courts to exercise a substantial amount of discretion in weighing the relative importance of each.\(^{22}\) Both focused on the details and origin of the alleged deception rather than the details or origin of the transaction.\(^{23}\) Though Morrison would overrule these tests in private actions by investors, through the Congressional restoration of the use of the tests specifically in government actions resulting from explicit language addressing extraterritoriality in the Dodd-Frank Act, a direct response to Morrison, these two intertwined tests still prove to have relevance in securities law when it comes to SEC enforcement, with the possibility of future expansion to private rights of action.\(^{24}\)

I. The Effects Test

The effects test centers on the adverse effect on U.S. markets and investors caused by specific foreign conduct. The Second Circuit first

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22. Morrison, 130 S. Ct. at 2879.
23. See id.
employed the test in 1968 in Schoenbaum v. Firstbrook.\textsuperscript{25} In that case, a U.S. plaintiff who held shares in a Canada-based company brought suit against the company under section 10(b), alleging that directors had failed to disclose material information leading to misrepresentation in order to sell shares at an artificially low price.\textsuperscript{26} Even though the fraud-induced sale took place between Canadian sellers and buyers located in Canada, the plaintiff was able to establish that jurisdiction was proper because the decrease in the value of the company's share on the U.S. markets qualified as a sufficient effect for the test.\textsuperscript{27} The court reasoned that Congress would have wanted the Exchange Act to go beyond U.S. borders when necessary to protect American investors who purchased foreign-based shares on American exchanges, regardless where the deception or transaction took place.\textsuperscript{28} The court also believed that there was a strong U.S. interest in protecting U.S. stock markets from the negative impact that would result from fraudulent foreign transactions of U.S. securities.\textsuperscript{29}

In a later decision, the Second Circuit refined its effects test to limit subject matter jurisdiction over fraudulent acts abroad only when the fraud results in injury to intended purchasers or sellers of the securities at issue who are United States investors, and not where fraudulent acts have a general adverse effect on the American economy and its investors.\textsuperscript{30} Some commentators note this leads to a crucial limitation to the effects test, as foreign conduct that only has general effects in the United States does not establish sufficient subject matter jurisdiction for the courts, and U.S. investors must prove specific harm within the U.S. to litigate under section 10(b).\textsuperscript{31}

2. \textit{The Conduct Test}

The conduct test focuses on whether the underlying activity that was material to the fraud directly caused the harm in question and whether that fraud occurred in the United States rather than having

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\textsuperscript{25} 405 F.2d 200, 204–08 (2d Cir. 1968).
\textsuperscript{26} Id.
\textsuperscript{27} Id.
\textsuperscript{28} Schoenbaum, 405 F.2d at 204–08.
\textsuperscript{29} Id. at 207–09.
\textsuperscript{30} Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 989 (2d Cir. 1975).
\end{flushright}
concern of where the effects or transaction to place. The Second Circuit first crafted this test in a 1972 securities fraud decision. The court reasoned that when the “significant conduct” occurs in the United States, the effects issue of whether U.S. shareholders or foreign shareholders were the ones to incur fraud-induced loss does not matter to establish subject matter jurisdiction under the Exchange Act.\textsuperscript{34}

The conduct test has generally been more difficult for the courts to apply than the effects test. The main struggle has been measuring what level of conduct within the United States is sufficient to warrant jurisdiction under the Exchange Act. In a global economy, a securities transaction can have multiple components, spanning various territories, and differing levels of fraud can occur in various territories besides fraud found in the United States.\textsuperscript{35} An example is in \textit{Bersch v. Drexel Firestone, Inc.}, where the fraud focused on a securities prospectus that failed to reveal material facts pursuant to the company’s stock offering.\textsuperscript{36} The fraudulent prospectus at issue was partially drafted in the United States, but the process was predominantly executed in Canada.\textsuperscript{37} The court found the activity that took place in the U.S. was “merely preparatory” and thus did not reach sufficient conduct necessary to satisfy the test.\textsuperscript{38} This is just one example that illustrates how much trickier applying the conduct test with its causal intricacies can be compared to the effects test.

C. ADOPTION AND INTERPRETATION OF THE CONDUCT AND EFFECTS TESTS BY OTHER CIRCUITS

When it comes to using the conduct and effects tests, disagreement has been the common theme in how to properly interpret and apply the tests. The Fifth and Seventh Circuits adopted

\begin{itemize}
\item \textsuperscript{32} \textit{Bersch}, 519 F.2d at 993 (holding that U.S. securities laws apply to losses from sales of securities to foreign investors abroad only when fraudulent acts performed in the United States directly caused such losses).
\item \textsuperscript{33} Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326, 1330 (2d Cir. 1972). In this case, a group of U.S. and U.K. plaintiffs alleged the U.K. defendants had deceived them into buying artificially high-priced stock of a corporation located in the U.K.
\item \textsuperscript{34} Id. at 1334.
\item \textsuperscript{36} 519 F.2d at 978–80.
\item \textsuperscript{37} Id.
\item \textsuperscript{38} Id. at 985. The court found that, due to the level of conduct outside of U.S. borders, the matter was really more of a foreign issue.
\end{itemize}
the Second Circuit’s application, stating that “U.S. conduct must have a direct causal relationship to the loss.” The Third Circuit adopted a more permissive conduct test allowing for jurisdiction when “at least some activity designed to further a fraudulent scheme” took place in the United States. The Eight Circuit adopted a similar test to the Third Circuit’s, in which it found that U.S. conduct could give rise to U.S. jurisdiction when that conduct was “in furtherance of a fraudulent scheme and was significant with respect to its accomplishment.” The Ninth Circuit would adopt a similar test used by the Third and Eight Circuits, with those three courts’ tests “facially more plaintiff-friendly” than the Second Circuit’s “substantial conduct” requirement. With such a divergence and each of the circuit courts taking sides, companies and investors were set to face an unpredictable horizon. The spawning of variations of the two tests was one of the principal reasons why the Supreme Court chose to replace the Second Circuit’s doctrine for its own transactional test in *Morrison*.

### III. BIRTH OF THE TRANSACTIONAL TEST

#### A. THE *Morrison* LITIGATION AND BIRTH OF THE SUPREME COURT’S TRANSACTIONAL TEST

*Morrison* was an F-cubed case initially brought on a “conduct test” theory of subject matter jurisdiction. Investors filed a lawsuit against National Australia Bank, Ltd. (“NAB”), an Australian bank whose American Depositary Receipts ("ADRs"), a type of equity derivative, are traded on the New York Stock Exchange, and whose ordinary shares are listed on multiple foreign exchanges. The

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42. Bochm, supra note 39, at 256–57.

43. Bochm, supra note 39, at 257.

44. *Morrison*, 130 S. Ct. at 2875–76. The banks shares traded on the Australian Stock Exchange, as well as exchanges in Tokyo, New Zealand, and London. Though the only connection to an American exchange was the ADRs listed on the New York Stock Exchange (“NYSE”), the only plaintiff who purchased ADRs was dismissed for failing to allege damages.
plaintiffs claimed that one of NAB’s wholly owned subsidiary, HomeSide Lending, Inc., a Florida-based mortgage servicer, used fraudulent accounting causing it to overstate the value of some of its assets on its balance sheets. The fraudulent accounting occurred by HomeSide’s executives allegedly manipulating and submitting to NAB’s Australian headquarters the subsidiary’s financial models to make the probability of early repayment artificially low, resulting in their mortgage servicing rights to seem more valuable.\textsuperscript{45} NAB’s executives were also allegedly aware of the subsidiary’s fraud when it included HomeSide’s inflated value in NAB’s annual reports and issued press releases of its success from 1998 to 2001.\textsuperscript{46} After NAB announced several write-downs relating to HomeSide in late 2001, amounting to a loss of more than two billion in U.S. dollars, a group of international shareholders of the NAB brought a putative class action against the bank in U.S. federal court, claiming violations of the securities antifraud rules, including Rule 10b-5.\textsuperscript{47} The loss was the largest single loss reported in Australian corporate history during that time and resulted in an initial drop in share price between ten percent and thirteen percent.\textsuperscript{48}

In Justice Scalia’s opinion for the majority, the Court first clarified that section 10(b)’s extraterritorial reach is a merits question and not a matter of subject matter jurisdiction.\textsuperscript{49} The Court next held that section 10(b) does not provide a cause of action to foreign plaintiffs suing either U.S. or foreign defendants for alleged fraudulent activity relating to securities traded on foreign exchanges.\textsuperscript{50} The Court based its holding on the “presumption against extraterritoriality” which is a longstanding canon of American law that legislation of Congress is meant to apply only within the territorial jurisdiction of the United States, unless a contrary intent appears, regardless of any existence of conflict between American and foreign law.\textsuperscript{51} And though the Court considered reasons why Congress may have intended some extraterritorial application of

\begin{itemize}
\item \textsuperscript{45} \textit{id.}
\item \textsuperscript{46} \textit{id.}
\item \textsuperscript{47} \textit{id. at} 2876.
\item \textsuperscript{48} Beyea, \textit{supra} note 31, at 548.
\item \textsuperscript{49} \textit{Morrison}, 130 S. Ct. at 2877. The Court concluded that the remand would also result in dismissal, but for failure to state a claim rather than for lack of subject matter jurisdiction because nothing in the lower courts’ analysis turned on a mistake. The remand would only require a “new label” for the “same conclusion.”
\item \textsuperscript{50} \textit{id. at} 2883.
\item \textsuperscript{51} \textit{id. at} 2877 (citing EEOC v. Arabian America Oil Co., 499 U.S. 244, 248 (1991)).
\end{itemize}
section 10(b), such as references to foreign commercial activity noted in sections of the Exchange Act, it ultimately did not find sufficient support to show extraterritorial intent. The Court stressed that when a statute like section 10(b) gives no clear indication of an extraterritorial application, then no extraterritorial reach exists. All this led to the central holding that established that section 10(b) applies “only to transactions in securities listed on domestic exchanges and domestic transactions in other securities.” The Court validated the transactional test by declaring that the language of the Exchange Act focuses on the purchases and sales of securities within the United States and not on the place of deception. With its decision the private right of action under the conduct and effects tests no longer are the standard and now a more limited test giving deference to the presumption against extra-territoriality now takes those tests’ place.

B. APPLICATION OF THE TRANSACTIONAL TEST IN SUBSEQUENT DISTRICT COURT CASES

Since Morrison has been handed down, the lower courts have applied the transactional test to several complex and diverse factual situations with varying results. While some cases have been straightforward, especially those dealing with common stock on a domestic exchange, others involving over-the-counter ("OTC") transactions have led to the courts to struggle to provide consistent judgments. Because Morrison dealt with securities transactions on an exchange, the case offered little insight from the Justices as to how their far-reaching rule would apply in scenarios involving transactions not listed on an exchange. As a result, the bright-line rule has led to varying interpretations of the struggling lower courts as decisions have resulted in the narrowing of section 10(b) to the point where the loan foreign execution of the transaction has led to dismissals, causing investor concern of protection, to the broadening of section 10(b) in other decisions that goes beyond what the conduct and effects test would have allowed.

52. Id. at 2878–79.
53. Id. at 2878.
54. Id. at 2884.
55. Id. This is unlike antitrust law that where the Court ruled that the location of deception is the focus of the Sherman Act, which the Supreme Court held that the Act has extraterritorial application if the conspired restriction of trade and effect on commerce was direct at the United States. See Hartford Fire Ins. v. California, 509 U.S. 764, 797–98 (1994).
1.  **The First Prong: Transactions on Domestic Exchanges**

Though some opacity remained after the Supreme Court crafted the transactional test in *Morrison* for “transactions in securities listed on domestic exchanges,” the lower courts have only had one minor hiccup that would have to be immediately confronted. In the Southern District of New York case *In re Alstom SA Securities Litigation*, the court recognized the first prong’s “most natural and elementary reading” over the literal reading of the test. The court referred to multiple sections of *Morrison* that exposed a “focus on where the securities transaction actually occurs, not the stock exchange where ministerial pre-purchase activities were directed.” The Second Circuit later refined its interpretation of the first prong further by ruling that a placement of an electronic order in the United States that is ultimately executed abroad does not satisfy *Morrison*’s transactional test. Brokers must execute the buy orders on a U.S. exchange, regardless of the investor’s intent to purchase shares on a domestic exchange, in order to retain the possibility of bringing a section 10(b) claim. With these modest clarifications by the Second Circuit, *Morrison*’s first prong seems relatively straightforward when interpreted in this context, especially when compared to the many challenges of the transactional test’s second prong.

2.  **The Second Prong: Domestic OTC Transactions—Where the Issue Truly Lies**

*Morrison*’s second prong focuses on the much more complicated and ambiguous issue of what constitutes a “domestic transactions on other securities” outside of an exchange commonly referred to as OTC transactions. The Second Circuit has stressed that the transactional test is indifferent to whether plaintiffs are American or to whether certain elements of the transaction occurred in the United States because these are elements of the conduct and effects tests that

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56. *Morrison*, 130 S. Ct. at 2884.
57. *In re Alstom SA Sec. Litig.*, 741 F. Supp. 2d 469, 472 (S.D.N.Y. 2010). In this case, the plaintiff’s purchase of shares, which were listed on the NYSE, occurred overseas.
58. *Id.*
59. Plumbers Union Local No. 12 Pension Fund v. Swiss Reinsurance Co., 753 F. Supp. 2d 166, 178 (S.D.N.Y. 2010). The plaintiff had placed a buy order for Swiss Reinsurance shares through traders in Chicago, but the buy order was executed electronically on trading platform based in London.
were supplanted by the transactional test, which only is concerned with whether the actual securities transaction consummated in the United States.\textsuperscript{60} The combination of the increasing globalization of the modern economy and the decentralized nature and multiple types of OTC transactions makes for a difficult and complex situation for the courts to apply the transactional test.\textsuperscript{61} Unlike transactions that occur on an exchange, it is often difficult to determine not only where the actual location of the transaction occurred, but also when the securities transaction occurred because of the less routine nature of OTC transactions.\textsuperscript{62}

Prior to the Second Circuit’s determination of irrevocable liability as a key element of the transactional test in \textit{Ficeto},\textsuperscript{63} the Southern District of New York had started converging on its own irrevocable liability standard for determining the geographical location of a transaction for purposes of \textit{Morrison’s} second prong.\textsuperscript{64} The court first expressed the standard in a 2011 fraud case over the misrepresentation of the risk in a credit-default transaction that “to 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.”\textsuperscript{65} The plaintiff failed to allege adequately a purchase in the United States, focusing instead on the fraudulent statements made by Goldman Sachs in the United States, which lead to a dismissal by the court based on the rationale in \textit{Morrison}.\textsuperscript{66}

Sometimes the courts focused on the contractual language to determine irrevocable liability, like in \textit{In re Optimal U.S. Litigation}, where the Southern District of New York ruled that the shares were

\textsuperscript{60} Cornwell v. Credit Suisse Grp., 729 F. Supp. 2d 620, 622–23 (S.D.N.Y. 2010).
\textsuperscript{61} Types of OTC transactions include Regulation D private placements, Regulation S sales, and equity derivative transactions. This paper focuses on \textit{Morrison’s} effect on equity derivative transactions. Regulation D private placements allow a foreign issuer to privately place securities in the United States without being subject to the Section 5 registration requirements of the Securities Act. 17 C.F.R. §§230.504–506 (2010). Regulation S sales allow securities issuers to avoid the SEC’s Section 5 registration requirements if the sale qualifies as an “offshore transaction” as defined in the rule. 17 C.F.R. § 230.902(h) (2010).
\textsuperscript{62} See Boehm, \textit{supra} note 39, at 265.
\textsuperscript{63} See infra, Part IV.
\textsuperscript{64} Boehm, \textit{supra} note 39, at 268.
\textsuperscript{66} \textit{Basis Yield Alpha Fund}, 2011 U.S. Dist. LEXIS 80298, at *10
formally purchased in New York because the contract referenced that the shares were sold to an account in New York, even though U.S. plaintiff investors conceded that the acceptance took place in Ireland.\textsuperscript{67} In another case, a Colorado district court, in dismissing a case, found that because the subscription agreement had indicated that the defendant could reject the agreement at any time, the transaction would not be officially consummated until the Cayman Island located defendant accepted the executed transaction, despite the fact that the defendant solicited the investor’s business in New York.\textsuperscript{68} Because of all the scenarios and fact-intensive elements that can be intertwined into a securities transaction dispute, it is ultimately difficult for courts to make consistent holdings when applying their fact-dependent interpretations of the transactional test in cases involving the OTC market.

C. **CONGRESSIONAL RESPONSE THUS FAR – THE DODD-FRANK ACT ALLOWING SEC ACTION BASED ON THE OLD CONDUCT AND EFFECTS TESTS.**

Congress reacted quickly to the Supreme Court’s *Morrison* decision by including language on the extraterritorial reach of the Security Exchange Commission’s (“SEC”) enforcement powers in the Dodd-Frank Act (“Dodd-Frank”).\textsuperscript{69} Section 7216 of Dodd-Frank was originally drafted to provide extraterritorial jurisdiction with respect to antifraud provisions in the federal securities laws if there is conduct within the United States that constitutes significant steps in furtherance of the violation of securities laws, even if the transaction occurs outside of U.S. borders and involves only foreign investors.\textsuperscript{70} The SEC favored a similar provision, but wanted it limited to extending U.S. jurisdiction to only those cases brought by the SEC.\textsuperscript{71} Unfortunately, the language, drafted by the SEC, referenced the federal court’s subject matter jurisdiction rather than the issue on the merits of section 10(b), but the Court recognized that the scope of section 10(b) is a question of merit and not subject matter jurisdiction. Due to this apparent drafting error, courts might be in

\textsuperscript{67} In Re Optimal U.S. Litig., 813 F. Supp. 2d 351, 373 (S.D.N.Y 2011).


\textsuperscript{69} See H.R. 4173, 111th Cong. (2010). The move was actually a preemptive response to what Congress believed the Court would decide in *Morrison*.

\textsuperscript{70} Painter, supra note 24, at 15.

\textsuperscript{71} Id.
the difficult position of weighing Congressional intent against the literal language. In *Morrison*, the Court had already held that U.S. district courts have subject matter jurisdiction over extraterritorial actions brought under section 10(b) of the Exchange Act.\(^{72}\) One could argue that Dodd-Frank does not affect the Court's holdings in *Morrison* as to what transactions fall within section 10(b) because its provisions merely give federal courts jurisdiction that the *Morrison* decision recognized courts already had and left out language that speaks to the real issue in *Morrison*: the substantive reach of section 10(b).\(^{73}\) Such a literal reading of Dodd-Frank clearly does not reflect the intent of Congress, but for judges who care more about language of the statute rather than intent this could cause undesirable results. While Congress's intent in including the extraterritoriality language was clearly to preserve the conduct and effects tests for cases brought by the SEC, the language of Dodd-Frank does not actually do so because of this drafting error. For its part, the SEC's position is that there is ample evidence of congressional intent for courts, agencies and affected parties to proceed as if section 929P(b) of Dodd-Frank has restore the conduct-effects test for SEC and the Department of Justice to implement, but it is yet to be seen whether all courts will agree.\(^{74}\)

IV. THE SECOND CIRCUIT'S APPLICATION OF THE SUPREME COURT'S TRANSACTIONAL TEST

A. *ABSOLUTE ACTIVIST VALUE MASTER FUND LTD. v. FICETO* CASE

The Second Circuit had its first opportunity to apply the *Morrison* transactional test in a claim under section 10(b) and Rule 10b-5 for securities fraud, in place of its previously crafted conduct and effects tests, in early 2012 in *Absolute Activist Value Master Fund Ltd. v. Ficeto.*\(^{75}\) In that case, the Second Circuit had to decide whether foreign funds' purchases and sales of securities issued by U.S.

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72. *Morrison*, 130 S. Ct. at 2877 (referencing the holding in Union Pacific R. Co. v. Locomotive Eng'rs, 130 S. Ct. 584, 596-99 (2009), which states that Congress alone controls the jurisdictional reach of a statute, jurisdiction is distinct from issues pertaining to merits of a case, and courts may not refuse to exercise its jurisdiction because it seems no claim exists on the merits).

73. Painter, supra note 24, at 19.


75. 677 F.3d 60 (2d Cir. 2012).
companies brokered through a U.S. broker-dealer constitute “domestic transactions” for section 10(b) to apply pursuant to the *Morrison* transactional test.\textsuperscript{76} Cayman Islands hedge funds (the “Funds”) filed suit against defendants, Absolute Capital Management Holdings Limited (“ACM”) and its executives, for allegedly engaging in “a variation on the classic ‘pump-and-dump’ scheme, causing the Funds to suffer losses of at least $195 million through cycles of fraudulent trading of securities.”\textsuperscript{77} The scheme operated where defendants would first cause the Funds to purchase billions of shares of “thinly capitalized” U.S. incorporated companies (“U.S. Penny Stock Companies”) directly from them.\textsuperscript{78} Over three years the defendants allegedly caused the Funds to purchase the U.S. Penny Stocks in subscriptions pursuant to private offerings known as private investment in public equity, or “PIPE” transactions.\textsuperscript{79} After causing the Funds to purchase the stock through these PIPE derivative transactions, the defendants handling the trading artificially inflated the stock prices by trading and re-trading the penny stocks, often between and among the Funds, increasing the stock price and creating the illusion of trading volume.\textsuperscript{80} The alleged purpose of the fraud was to (1) generate substantial commissions for the defendant executives and (2) artificially inflate the stock price to where the defendants were free to sell previously locked-up shares and exercise warrants to acquire additional shares, selling those shares at inflated prices to the Funds for a windfall.\textsuperscript{81} While the defendants’ actions reaped them massive profits, the Funds saw a loss of $195,916,216.\textsuperscript{82}

In its decision, the Second Circuit expanded on the definition of a domestic purchase or sale. The court held that to sufficiently allege a domestic transaction in securities not tied to a domestic exchange, a plaintiff must allege facts suggesting that irrevocable liability was incurred or title was transferred within the United States.\textsuperscript{83} The court reasoned that a “purchase” and a “sale” are deemed to occur when the parties become bound to effectuate the transaction.\textsuperscript{84} The court further determined that when the parties are committed to one

\textsuperscript{76} Ficeto, 677 F.3d at 62.
\textsuperscript{77} Id. at 63.
\textsuperscript{78} Id.
\textsuperscript{79} Id.
\textsuperscript{80} Id.
\textsuperscript{81} Id. at 64-65.
\textsuperscript{82} Id.
\textsuperscript{83} Id. at 68.
\textsuperscript{84} Id. at 67.
another in the contractual sense, reaching the point of irrevocable liability, the “locus of the securities purchase or sale” may be determined.\textsuperscript{85} The court rejected other tests finding them irrelevant and held that a securities transaction can only be determined to be domestic when the parties incur irrevocable liability to carry out the transaction within the United States or when title is passed within the United States.\textsuperscript{86} Using their newly developed definition of a domestic transaction, the court determined the plaintiffs failed to provide factual allegations suggesting that the Funds “became irrevocably bound within the United States” or that “title was transferred within the United States, including . . . facts concerning the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money.”\textsuperscript{87} The plaintiffs’ assertion that transactions took place in the United States, without more, was not sufficient “to adequately plead the existence of domestic transactions” but the court granted the plaintiffs leave to amend their complaint to properly plead the existence of domestic transactions.\textsuperscript{88}

\section*{B. HOW THE SECOND CIRCUIT’S RULING WILL CHANGE THE PRIOR DISTRICT COURT RULINGS}

\subsection*{1. Elliot Assocs. v. Porsche Automobil Holding SE: What Was to Be the Second Circuit’s Next Case Applying the Morrison Domestic Transaction Test}

There still remains additional unresolved litigation over domestic transactions in other securities. There was an appeal pending in the Second Circuit relating to Morrison’s application to securities-based swap agreements where securities at issue are traded on a foreign exchange.\textsuperscript{89} It would be more complicated to apply Ficeto to swap agreements or other security derivatives because they are fundamentally different from U.S. company shares at issue in

\textsuperscript{85} Ficeto, 677 F.3d at 67–68 (referencing Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 891 (2d Cir. 1972), in which the court held that “in the context of a civil trial brought pursuant to Rule 10b-5, the district court correctly instructed the jury that ‘the time of a ‘purchase of sale’ of securities within the meaning of Rule 10b-5 is to be determined as the time when the parties to the transaction are committed to one another”).

\textsuperscript{86} Id. at 69.

\textsuperscript{87} Id. at 70.

\textsuperscript{88} Id. at 70–71.

\textsuperscript{89} See Elliot Assocs. v. Porsche Automobil Holding SE, 759 F. Supp. 2d 469 (S.D.N.Y. 2010).
Morrison. In Porsche, plaintiffs entered into securities-based swap agreements for German car company, Volkswagen ("VW"), where decreases in VW's share price would be gains for them. Unlike standard equity shares, no title or ownership passes in swap transactions. They are private, bilateral "bets" on the price of a stock which, in Porsche, was traded on a foreign exchange.

Plaintiff hedge funds claim that Porsche misled investors by denying through much of 2008 that it intended to acquire the Wolfsburg, Germany-based carmaker, Volkswagen. Plaintiffs base their allegations on a theory that Porsche caused a "dramatic rise in VW stock prices" by purchasing practically all the freely traded voting shares of VW as part of a secret plan to take over VW. When Porsche later revealed its holdings in VW, the share price jumped and caused huge losses to Plaintiffs. The Second Circuit’s addition of "irrevocable liability" to the transactional test may not seamlessly apply to swaps because "it would ignore the location of the transactions that determine the swaps' economics." One law firm convened that because "Congress added security-based swaps to Section 10(b) to prevent fraud in the 'functionally equivalent' U.S. securities markets and provided that Section 10(b) applies to swaps only 'to the same extent' as securities, the location where the referenced stock trades should determine whether such swaps are 'domestic transactions.'"

Another manner of thought would interrupt Ficeto's "irrevocable liability" to focus on where the transaction of the securities at issue was contractually entered, and not on the location of the transactions that would determine the "swap economics." The court dismissed the complaint in Porsche despite the fact that plaintiffs alleged they signed confirmations of the swap agreements in New York, because the court found that a "domestic transaction" meant "purchases and sales of securities explicitly solicited by the issuer in the U.S." and not

90. Id. at 470.
92. Id.
94. Id.
95. Musoff, supra note 91.
96. Id.
derivative transactions that referenced foreign-traded securities.\textsuperscript{98} Thus, the interpretation of a “domestic in nature transaction” under the Second Circuit and the lower courts below seems to indicate a focus only on the underlying security and not on any dependant derivatives, whether foreign or not.

The Second Circuit was to rule on the Porsche case this year, as it was supposed to be the second post-Morrison case involving derivative securities backed by common shares of foreign companies to be decided by the Second Circuit.\textsuperscript{99} Unfortunately, the unanswered questions that remain from the lower court’s decision in Porsche will not be clarified by a Second Circuit decision. Elliot International LP, the named plaintiff, and eleven other hedge fund plaintiffs (“Plaintiffs”) agreed to drop its suit over Porsche’s failed takeover bid of Volkswagen AG at the U.S. Court of Appeals for the Second Circuit.\textsuperscript{100} Porsche Automobil Holding SE was defending against market manipulation allegations in three countries, but now looks like it will consolidate most of its litigation in Germany.\textsuperscript{101} The hedge funds will target its focus on a parallel German suit seeking 1.8 billion euros, or 2.8 billion U.S. dollars.\textsuperscript{102} The decision by Plaintiffs did not end U.S. litigation entirely, as twenty other hedge funds are continuing a separate lawsuit,\textsuperscript{103} so there still is a possibility the issue will come before the Second Circuit in the near future. As for now, only Ficeto provides any sort of clue on how the Second Circuit, and

\textsuperscript{98} Porsche, 759 F. Supp. 2d at 476.

\textsuperscript{99} Steven A Davidoff, Securities Law Ruling Creates Unintended Problems, N.Y. TIMES DEALBOOK (June 1, 2012), http://dealbook.nytimes.com/2012/06/01/securities-law-ruling-created-more-problems-than-it-solved/?_r=0.


\textsuperscript{101} Id. Elliott International filed one of four separate cases seeking more than 4 billion euros combined at a court in Braunschweig, Germany. Juergen Pieper, an analyst at Bankhaus Metzler who covers ratings for Porsche, provides his thoughts in stating that “[t]he litigation now more and more concentrates on Germany . . . . [b]ut this isn’t the end of the case, it’s continuing in Germany, so the story isn’t over yet.”

\textsuperscript{102} Id. German prosecutors are also continuing a criminal probe into the issue. Former Chief Executive Officer Wendelin Wiedeking and ex-Chief Financial Officer Holger Haerter were charged with market manipulation in December, and prosecutors have extended their investigation to include members of Porsche’s supervisory board in 2008.

perhaps other sister circuits, will handle the vague and complex application of the Morrison to test to derivative domestic transactions until similar case opportunities are brought before U.S. circuit courts.

2. What Specific Fact Scenario Might Warrant Second Circuit Review?

With Porsche having settled, the Second Circuit has still only had one opportunity to interpret the extent of the domestic limitations imposed on section 10(b) and Rule 10b-5 in determining which categories of transactions qualify as “a purchase or sale of . . . [a] security in the United States.” The potential case that would be ideal to come before the Second Circuit would provide a decision based on rationale conflicting with the Second Circuit’s reasoning in Ficeto. The most likely case would be one where derivative securities, backed by foreign common stock, were sold and purchased in America by a bank or broker-dealer with the lower court deciding that because the derivative transaction itself, looking at nothing outside of the derivative sale, commenced entirely within the United States by a U.S. seller and a U.S. investor, the transaction was domestic in nature as defined in Morrison even if some point of “irrevocable liability” occurred outside of the U.S., perhaps the commencing of a signature. That would conflict with the Second Circuit’s current thought basis as expressed in Ficeto, and though there are other scenarios where a case with a different fact background could come before the Second Circuit, it seems very likely that a decision by a lower court directly conflicting with the Second Circuit on its interpretation of the Morrison test as applied to derivative securities would be the ideal case for the court to further elaborate and refine its interpretation of a “domestic transaction.”

C. How Will the Second Circuit’s Interpretation Be Received by Other Circuit Courts?

It is difficult to determine how other circuits will follow the Second Circuit’s detailed understanding of the transactional test because the vagueness of the Morrison transactional test allows for

104. Morrison, 130 S. Ct. at 2888.
105. The Southern District of New York’s decision in Porsche, 759 F. Supp. 2d 469 (S.D.N.Y. 2010), would have been the perfect case with the factual occurrences and conflicting judicial ruling that would have positioned the Second Circuit to further elaborate its interpretation of Morrison.
loose interpretations and multiple readings of the test. If variance in the application of the Second Circuit’s conduct and effects test by the other federal courts give any indication as how the other circuit courts will follow, then the application of the transactional test could vary due to differing thought processes.

One example of an appellate decision could shed some light on whether other circuit courts would be willing to adopt the fundamental concepts of the Second Circuits interpretation of the transactional test. In *Quail Cruises Ship Mgmt. Ltd. v. Agencia de Vaigens C.V.C. Tur Limitada*, the Eleventh Circuit held that since *Morrison*’s second prong focused “exclusively on the purchase or sale of the security,” the plaintiff’s allegation that the sale formally closed in Miami, despite the fact that it agreement was signed in Spain and Uruguay, was enough to survive a motion to dismiss.\(^{106}\) A holding like this, on the one hand, could lead one to believe that other circuit courts would follow the Second Circuit’s interpretation since it continues to focus on the transaction. At the same time, the ruling could be construed as an example of some circuits not agreeing with the Second Circuit’s ruling in *Ficeto* because *Quail Cruises* does not focus on the true action that is the transaction, or where the parties have contractually reached the point of “irrevocable liability,” thus broadening section 10(b)’s extraterritorial reach since it would be likely that under the conduct and effects tests *Quail Cruises* would have been dismissed. Though this is just one example, and only time will how other appellate courts will view the Second Circuit’s interpretation of a transaction being consummated, it seems more than likely that each court will have its own take similar to how the conduct and effects tests were utilized and the Supreme Court down the road might look at the Second Circuit’s interpretations of its transactional test and make its own determinations.

D. HOW TO FURTHER IMPROVE THE SECOND CIRCUITS INTERPRETATION OF THE TRANSACTION

Below are just two suggestions that could be added to modify the Second Circuit’s current interpretation of the transactional test. Each have their benefits of detractions that makes it difficult whether the interpretation would be better or fairer modifying it or whether it

\(^{106}\) Quail Cruises Ship Management LTD. v. Limitada, 645 F.3d 1307, 1310 (11th Cir. 2011).
would just make the *Morrison* test and *Ficeto* application more convoluted.

1. Adding "Purposeful Availment" Element

A purposeful availment factor would allow for a transaction that might have many foreign and domestic components to be determined based on whether the issuer relied on the protections of benefits of the U.S. securities market. The one problem, that some have considered,\(^{107}\) is that the addition of considering a fact-intensive form of reliance and intent moves the transactional test back to the conduct and effects tests, specifically the conduct test because of the varied analysis. It is true that a reliance feature to the transactional test, strays away from focusing solely on the transaction, but at the same time it is not only looking at reliance as the conduct and effects tests did, but brings an element of fairness to deciding whether U.S. securities law should apply.

Without a purposeful availment factor, parties can manipulate the U.S. securities laws by contracting the forum and law of choice even if the substantial elements comprising the transaction occur within the United States.\(^{108}\) In order to determine the true nature of the transaction, measuring the foreign issuer's purposeful availment is key to determining if the foreign company has relied on the benefits of transacting in the United States, and thus, should be regulated by U.S. law. At the same time, adding a purposeful availment factor would see the Supreme Court's intent served when it formulated the transactional test in *Morrison*. Having this additional factor would suggest that it would only be fair to call a transaction domestic when the foreign corporation “has purposefully entered into the U.S. market and sought

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107. See generally Alex Reed, *But I am an American! A Text-Based Rationale for Dismissing F-Squared Securities Fraud Claims After Morrison v. National Australia Bank*, 14 U. PA. J. BUS. L. 515, 529 ("[F]-squared plaintiffs seek to replace the [Supreme] Court's bright-line rule with a fact-intensive inquiry reminiscent of the conduct and effects test."); Boehm, *supra* note 39, at 286 (noting that parsing the factual developments that provide for variance and complexity in some securities transactions would present challenges similar to conducts-effects, thus "vitiating a key purported advantage of the 'transactional' approach").

out American investors.\textsuperscript{109} The purposeful availment factor would be a fail-safe element in the transactional test so that no plaintiff could argue that the deal was predominately completed in the U.S., or that substantial elements of the transaction had U.S. connections if the defendant issuer never solicited U.S. investors to enter into a transaction narrowing U.S. securities law's reach. By adding this factor to the transactional test, Scalia’s limit on the reach of securities laws would be served, while still preventing defendant issuers from loopholes through contractual clauses.

2. A Predominance of the Transaction Taking Place Rule

Another addition to the Supreme Court’s transactional test that may clear up some confusion would be to add a predominance of the transaction test. By having a quasi-balancing test that would weigh the domestic components of the transaction with that of the foreign elements in order to determine whether the transaction predominately occurred within the United States or elsewhere, could more accurately decide the location of the transaction. This would of course take away from the closing, or “passing of title,” transaction determination, but would keep issuers from the loophole of having the majority of the transaction taking place in one sovereign region only to be determined to have concluded somewhere else because the agreement, signature, or closing was officially conducted to avail itself to that legal system.

Of course, if the agreement allows for such an arrangement, what place would it be for the U.S. legal system to disregard the terms of a contractual agreement? There is also the criticism that if courts focus on a “fact-intensive inquiry reminiscent of the conduct and effects tests” that “foreign-squared” plaintiffs seek instead of the text of the transaction test itself, then the courts are engaging in the unnecessary and inconsistent analysis that the Supreme Court looked to avoid in implanting the test in the first place.\textsuperscript{110} One scholar has pointed out that the Supreme Court’s introduction of the transactional test was to limit lower courts’ analyses to “whether the relevant transactions involved a security listed on a domestic stock exchange or traded in

\textsuperscript{109} Chiappini, supra note 17, at 1819.

\textsuperscript{110} Boehm, supra note 39, at 268 (stating that such standards that consider reliance elements such as purposeful availment and irrevocable liability would “partially undercut one of Justice Scalia’s key rationales for discarding conducts-effects in the first place—namely, the fact-intensive, occasionally unpredictable analyses that conducts-effects required”)}
the domestic OTC market," but the opposite has resulted in where courts are delving more into their facts to classify a specific transaction rather than follow the rules literal language.\textsuperscript{111} Though adding a predominance of the transaction factor to the transactional test for the second prong of the transactional test would be extremely useful, it is arguable that it would be difficult to apply in a consistent manner. Thus, it would be debatable whether the Supreme Court or the Second Circuit would be willing to include such a provision even if beneficial because of what it would take away from the Supreme Court's intent to focus solely on the limited view of a "transaction."

E. DIFFICULTIES IN FILING PRIVATE CLASS ACTIONS AFTER \textit{MORRISON} AND \textit{FICETO}

Some experts believe that after the Second Circuit's reading of the \textit{Morrison} transactional test in \textit{Ficeto} courts will now be required to determine which parts or events of transactions occurred in the United States in order to assess the point of "irrevocable liability" or where title passed.\textsuperscript{112} While the "wide range of transaction-related facts that the Second Circuit held could tend to demonstrate irrevocable liability," making it perhaps easier for plaintiffs to survive a motion to dismiss, it also appears that the Second Circuit's holding will also likely make it more difficult for plaintiffs pursuing claims under \textit{Morrison}'s second prong to achieve class certification for OTC transactions.\textsuperscript{113} Under \textit{Ficeto}, determining what constitutes a "domestic transaction" will require a fact-intensive inquiry dependent on the particular circumstances leading up to the purchase or sale at issue.\textsuperscript{114} This is in conflict with a key requirement of class certification that mandates all of the class members be readily identifiable in a "non-burdensome and practical manner."\textsuperscript{115} Because \textit{Ficeto} requires detailed fact-finding to determine if the transaction in question is domestic, it would make defining a class a complex matter that could lead to a roadblock for securities class actions with any international components.

Fraud-on-the-market class actions allow investors in secondary markets to recover losses that they incur from purchasing shares at

\textsuperscript{111} Reed, supra note 107, at 538–39.
\textsuperscript{112} Rudzin, supra note 97.
\textsuperscript{113} \textit{Id.}
\textsuperscript{114} \textit{Id.}
\textsuperscript{115} \textit{Id.}
inflated prices due to the misrepresentation of the issuing company.\footnote{116} This class certification problem would be detrimental to the investing community because these class actions give rise to the bulk of all damages paid out in settlements and judgments pursuant to private litigations based on violations of section 10(b) and Rule 10b-5.\footnote{117} Additionally, by excluding foreign investors from class actions, “causing a shrinkage of class sizes,” the incentive, the incentive for U.S. plaintiffs’ attorneys to bring class actions suits might well be diminish, thereby making class action suits unavailable.\footnote{118} If class action suits are unavailable for a segment of securities transactions that have some foreign context because of the inability to succinctly define a class due to the exactitudes in determining if a transaction is domestic, then the transactional test may prevent securities litigation even if a transaction is eventually held to be domestic.

V. INVESTORS’ APPROACH FOR BUYING SECURITIES WITH FOREIGN TIES AFTER MORRISON & FICETO

A. EQUITY DERIVATIVE TRANSACTIONS TYPICALLY RELATED TO FOREIGN SECURITIES AND HOW THEY MAY BE AFFECTED

Commonly, equity derivatives are financial devices that allow for rights, interests, or options in an underlying security, or whose settlement amount or values is determined by that security.\footnote{119} Simply put, a derivative’s value depends on the security that it represents. Since Morrison, different types of equity derivative instruments have been the subject of section 10(b) securities fraud cases that have further illustrated the complexities and inconsistencies that come with applying the transactional test to purchases and sales that involves a foreign element, especially in OTC transactions.

1. American Depositary Receipts

American Depositary Receipts, or ADRs, are hybrids of U.S. and foreign securities, and represent actual shares in a specific

\footnote{116} Fox, supra note 12, at 1176.  
\footnote{117} Id.  
\footnote{119} Boehm, supra note 39, at 268.
This particular type of security has had the most attention since the birth of the *post-Morrison* security environment, both in the academic and legal community. Typically, large U.S. depositary banks purchase foreign securities in foreign markets and issue ADRs in America to investors, but the investor never owns any right in the foreign security the ADR is backed by. The sales and purchases of ADRs are done completely in U.S. dollars with dividends also paid in U.S. dollars.

There are two categories of ADRs: unsponsored and sponsored. For an unsponsored ADR, a depositary bank sells ADRs representing actual shares in the foreign company, without establishing any formal relationship with the issuer. Sponsored ADRs mean that the underlying issuer of the foreign securities enters into an agreement with the depositary bank, helps establish the ADR facility, and actively participates in the issuance of the ADRs.

The *Morrison* and *Ficeto* decisions make it appear as though sponsored ADRs that are traded on a U.S. securities exchange would qualify under the transactional test and would be protected by U.S. securities regulations because they would qualify under the first prong. Prior to *Ficeto*, courts rejected the argument that the listing of an ADR on a U.S. exchange was not enough to survive *Morrison* because the trading of the securities that back the ADRs was still a foreign transaction, making it similar to a foreign security cross-listed in the United States. With the Second Circuit focusing on the point of “irrevocable liability” and the passing of title, it appears likely that lower courts would focus more on the ADR transaction itself, rather

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120. Chiappini, *supra* note 17, at 1816. ADRs were first utilized in 1927.
122. Chiappini, *supra* note 17, at 1816–17. The shares of ADRs are backed by are “technically owned by the depositary banks” and are “held by and registered to a custodian, a foreign bank owned by or allied with the U.S. depositary bank.” However, the investor usually still retains voting rights to the foreign share.
123. *Id.* at 1817.
124. *Id.; see also* Pinker v. Roche Holdings Ltd., 292 F.3d 361 (3d Cir. 2002).
126. *Id.* There are four types of sponsored ADRs. Level I ADRs are characterized by their trading in the OTC market, reduced reporting requirements, and inability to raise new capital in the U.S. Rule 144 A offerings are private transactions, which can only be sold to “qualified institutional buyers in both the primary and secondary markets. Both of these ADRs are not listed on any domestic exchange. Level II and Level III ADRs are listed on a U.S. exchange and are subject to the same reporting requirements imposed by the SEC as U.S. corporations. Level II ADR programs do not issue new shares; thus no new capital is raised. Level II ADR programs issue new shares of foreign corporations, which make it subject to greater reporting requirements. *Id.* at 1818–19.
than the securities the ADRs are backed by.

As for ADRs actually purchased in the United States (prong two, supra Part III.B.2), there has been much more difficulty in resolving those ADR-related claims. In In re Societe Generale Securities Litigation, certain plaintiffs who bought Societe Generale ("SocGen") ADR shares in the U.S. OTC market alleged that SocGen misled investors by "failing to put in place adequate internal risk controls, concealing the extent and nature of SocGen’s exposure to the U.S. subprime mortgage market, and making false financial statements." The court held that section 10(b) was inapplicable because "trade in ADRs is considered to be a predominantly foreign securities transaction" and granted a motion to dismiss.

Subsequent case law indicates that the court in SocGen went too far in concluding that all ADR transactions are foreign. In In re Vivendi Universal, S.A. Securities Litigation, the parties stipulated that Morrison had no impact on the claims of ADR purchasers because Vivendi’s ADRs were listed and traded on the NYSE. In both Cornwell v. Credit Suisse Grp. and In re Alstom SA Securities Litigation, the courts never considered dismissing plaintiffs who had purchased ADRs of the defendant foreign corporations. In Stackhouse v. Toyota Motor Co., the court dismissed all plaintiffs who had bought the foreign corporation’s common shares on an overseas exchange, while appointing a lead plaintiff who had purchased ADRs in the United States backed by the same foreign defendant’s shares.

After Ficeto, it appears that ADRs will be analyzed as if they were ordinary securities under Morrison’s second prong when categorized as sponsored ADRs. Again, the focus of the “domestic transaction” will be on the ADR itself and not the foreign security that backs it. The harder question issue is dealing with unsponsored ADRs. One would think that Ficeto would still focus on the ADR and the transaction that revolves around it, rather than the security, but it would also be in tension with foundational principle in Morrison, avoiding unnecessary intrusion into foreign regulatory regimes. If reading Ficeto literally, even unsponsored ADR transactions will probably be analyzed based on the purchase or sale

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129. Id. at 14.
130. Vivendi, 765 F. Supp. 2d at 527. The parties’ legal disagreement was only those claims based on ordinary shares.
133. Boehm, supra note 39, at 270.
of the ADR itself, rather than the foreign based security, even though this may intrude into foreign regulatory regimes the Supreme Court looked to avoid, because the Second Circuit would only be concerned with the point of “irrevocable liability” or passing of the title of the ADR at issue.

2. Security-Based Swaps

Another significant equity derivative at issue in post-Morrison section 10(b) cases is that of the security-based swap. Security-based swaps are privately negotiated contracts whose value fluctuates according to the price of an underlying referenced security. As discussed previously in Porsche, the court held that the security-based swap agreements referencing foreign shares were the “functional equivalent” of transactions on a foreign exchange.

After Ficeto, it appeared that the Second Circuit would reverse the lower court’s decision, when Porsche was to go before the court for a decision prior to the plaintiffs’ withdrawal. Under Ficeto’s rationale, it would seem that though the security-based swap agreements reference foreign shares, the allegation that plaintiff signed confirmations for securities swap agreements in New York, would either provide enough to satisfy the point of irrevocable liability or the passing of title if proven to actually have happened. In SEC v. Wyly, the court rejected defendants’ argument that “security-based swap agreements were not included within the Exchange Act’s definition of a ‘security’ and were not otherwise subject to section 10(b) or Rule 10b-5.” This reflects the lower court’s admonition of Ficeto, in recognizing that the swap agreements are, in themselves, the security transaction, more than the securities they represent. Under Ficeto, a security-based swap agreement transacted in the United States would most likely be considered a domestic transaction under the Second Circuit’s interpretation of Morrison, despite the fact that the derivatives are backed by foreign securities, because the literal passing of title is that of the swap agreement.

134. Porsche, 759 F. Supp. 2d at 471.
135. Id. at 471, 476.
136. Id. at 476.
3. **Contracts-for-Difference**

Contracts-for-Difference ("CFD") are another equity derivative that reference securities of a U.S. corporation.\(^{138}\) A purchaser of a CFD can "acquire the future price movement of the underlying company without taking formal ownership of the underlying shares," allowing investors a straightforward way to access securities traded on a foreign country's exchange.\(^{139}\) In *S.E.C. v. Compania Internacional Financiera S.A.*, the SEC charged multiple foreign investment management firms with section 10(b) insider trading violations connected to CFD transactions representing a U.S. company whose shares are traded on the NYSE.\(^ {140}\) The CFDs were transacted in London, but the Southern District of New York held that section 10(b) applied under *Morrison*'s first prong because the "in connection with" language in the *Morrison* opinion language would allow a derivative instrument traded abroad to come under section 10(b) if the underlying security were traded on a U.S. exchange.\(^ {141}\) This is in stark contrast to this court's same decision in *Porsche*, where it focused more on the actual derivative transaction, rather than the domestic shares for which it represented when determining if the requirements of the *Morrison* transaction test are satisfied.

This last example exemplifies that investing in derivatives with any type of foreign ties can be risky and unpredictable. The court one minute might find some rationale that a derivative, though foreign in nature, has certain U.S. elements that makes the transaction "domestic" under the transactional test. The next minute the court might find some reason to hold a derivative security that seems, on the surface, to be domestic in nature to have some foreign connections that makes the transaction in question fall outside the rationale in *Morrison*. Because of this, investors should be weary before investing in CFDs or any other derivative type transaction when a foreign issuer or investing firm is involved. On scholar said it best when he asserting that, "by narrowing § 10(b) to purchases of securities listed on domestic

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\(^{138}\) Bochn, *supra* note 39, at 271.


\(^{140}\) *Compania Internacional Financiera*, 2011 WL 3251813 at *6. *Morrison*'s first prong states that §10(b) "reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange." The court seemed to have equated the derivative instrument as the "connection" rather than the security, and the domestic share it represented as the actual "security." *Morrison*, 130 S. Ct. at 2888.
exchanges, *Morrison* fails the longstanding mandate to encourage investor confidence in connection with the assurance of honest markets."142

4. *Restrict Depository Shares*

Similar to ADRs, Restricted Depository Shares ("RDSs") are derivative securities that represent the shareholder's ownership of a foreign security trade on a foreign exchange.143 RDSs are securities made available during a company offering and are available for purchase only to those who are categorized as a "qualified purchaser."144 Though both ADRs and RDSs are representative of the shares that back them, RDS tend to be less dependent in nature as they have more shareholder privileges besides dividend distributions.145

In the parallel cases in front of the United States District Court for the District of Columbia, *Wu v. Stomber* and *Phelps v. Stomber*, identical opinions were issued by the Second Circuit in which the court ignored the foreign backed securities and concentrated on domestic transactions of the RDS shares, similar to the Second Circuit's theory of the "point of irrevocable liability."146 Defendant's company, Carlyle Capital Corporation ("CCC"), incorporated under the laws of Guernsey, raised funds by selling two types of securities during a private placement offering (the "Offering").147 CCC sold two types of securities during the Offering. Class B shares were issued directly by CCC to investors on the foreign exchange, Euronext, and were only available to foreign investors.148 Restricted Depository

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142. Kirby, *supra* note 118, at 239.
144. *Id.* at 241.
145. *Id.* at 241–42.
146. *Id.* at 253. The defendants tried to suggest that the Court employ the "economic reality" theory or "functional equivalent" test to determine whether the RDSs were the equivalent to the foreign-based shares they represented and thus have plaintiff's claims barred under *Morrison*. See also *Phelps v. Stomber*, 883 F. Supp. 2d 188 (D.C. 2012).
147. CCC's sole business consisted of using highly leveraged financing in the form of repurchase loan agreements to invest in residential mortgage-backed securities on margin. CCC's securities were sold only to sophisticated investors and were marketed with numerous warnings about the high risks involved with the investment in the shares. The housing crash and subsequent financial crisis resulted in a decline in the value of CCC's investments and substantial margin calls by its repo counterparties, which lead to diminished liquidity of CCC and its eventual winding down of the company and substantial losses to its investors. *Wu*, 883 F. Supp. 2d at 241–47.
148. Though the Offering Memorandum explicitly stated that Class B shares could not be offered or sold within the United States or to a U.S. investor, some U.S. shareholders purchased
Shares were the second type of securities available during the Offering. These derivative securities were issued at the direction of CCC by Bank of New York Mellon under Regulation D and Rule 144A. RDSs were available to U.S. investors who met the requirements of being a "qualified investor."

The court found that federal securities claims with respect to the Offering related to the RDS transactions were not barred by Morrison because plaintiffs' purchases constituted a "sale" and a "purchase" within the United States regardless of whether the transaction was dependent on a corresponding overseas transaction. The District of Columbia's shifts follows the fundamental interpretation of the Morrison domestic transaction test of the Second Circuit, as applied in Ficeto, and its courts under it by focusing on the derivative security sale that is the subject of the case, rather than the underlying security that the derivative represents. The court, like the Second Circuit in Ficeto, rationalized that even where an investor could not execute a transaction without a corresponding overseas transaction that does not change the fact that the focal transaction in question took place in the United States.

Thus, though the Southern District of New York court's decisions in Porsche and Société Générale might see RDS transactions much like other derivative securities, in that they serve as "the functional equivalent of trading the underlying [company's] shares" and therefore the "economic reality" of such derivatives are foreign if backed by securities transactions "conducted upon foreign exchanges or markets," the district court in Washington believes that is too broad a net to cast and the sole focus of Morrison is the derivative transaction in question, much like the Second Circuit's theory in Ficeto. With the splits amongst courts, one would be careful in

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Class B shares in the aftermarket. These shareholders made a claim which the district court determined did not survive the motion to dismiss under Morrison because the shares were not sold on a domestic exchange. Id. at 251–52.

149. Wu, 883 F. Supp. 2d at 253 (citing Morrison, 130 S. Ct. at 2993) ("The federal securities claims with respect to the Offering are not barred by Morrison because plaintiffs' purchases of RDSs constituted a 'purchase or sale of a security in the United States.'").

150. Id. The court was critical of the decisions in Societe Generale and Porsche to use the "economic reality" or "functional equivalent" test to determine whether claims at issue were barred under Morrison because it found that the test was inconsistent with the bright line test set by the Supreme Court, which focused "specifically and exclusively on where the plaintiff's purchase occurred."

151. Id.

152. Porsche, 759 F. Supp. 2d at 476 (citing Morrison, 130 S. Ct. at 2882, 2884).

trading in RDS or similar derivative securities and pay close attention to where the underlying shares are traded. If litigation is being decided in the District of Columbia or a jurisdiction of similar mindset, then claims under section 10(b) and Rule 10b-5 may be allowed, but if litigants are under the jurisdiction of the Southern District of New York prior to the Second Circuit’s ruling in *Ficeto*, and the underlying shares are foreign in nature, one’s claims may be dismissed under *Morison* even if the purchase or sale in question was conducted entirely in the United States by U.S. parties. If anything, *Morrison* requires investors of derivative securities to be more educated and knowledgeable about the derivative’s associations and origins at the very least.

**IV. CONCLUSION**

Since *Morrison* and now *Ficeto*, the courts have looked to narrow the reach of private claims under securities law, specifically section 10(b) and Rule 10b-5, but in doing so, complications and confusion has been unleashed onto the investing community. Without more detail and further explanation on how to correctly apply the transactional test standard, either by Congress or the higher courts, in order to bring more uniformity to the test, investors will be hesitant entering into securities transactions with any foreign connections because of the impending risk of having no legal recourse in the U.S. because the transaction may be more foreign in nature than domestic. The uncertainty of the reach of section 10(b) and Rule 10b-5 also leads to additional obstacles in class action claims when it comes to plaintiff shareholders attempting to define a class in simple terms for class certification. In the years to come, it will be interesting to see whether Congress will step in, if the courts will revise and provide more detail to the transactional test, or if the investing community will see a reverse in the globalized market preferring to go back to more national-based markets. As of the present time, if the Supreme Court or the Second Circuit does not revise the transaction test to include some type of purposeful availment factor, in order to bring more certainty to the U.S. investor, then the investing community will see “non-domestic exchange” investments dwindle due to a feeling of no protection, and a globalized market regressing back to a much more regional investing market along with the decline of the over-the-counter markets.
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