

Second Circuit Extends Application of U.S. Securities Laws to Foreign Trades Matched on U.S.-Based Electronic Trading Platform

June 18, 2018

As securities trading goes global, increasingly complex questions arise as to the extraterritorial application of U.S. securities laws. In *Myun-Uk Choi v. Tower Research Capital LLC*, 2018 U.S. App. Lexis 12122 (2d Cir. Mar. 29, 2018), the U.S. Court of Appeals for the Second Circuit held that such laws apply to foreign trades “matched” on U.S.-based trading platforms.

In *Choi*, five Korean traders sued Tower Research Capital LLC (“Tower”), a New York-based high-frequency trading firm, and its founder, Mark Gorton, for alleged violations of the Commodity Exchange Act (“CEA”). The CEA prohibits “any manipulative or deceptive device or contrivance” used in connection with a futures contract. 7 U.S.C. § 9(1), (3).

The claims in *Choi* arose out of a series of futures transactions undertaken on the “night market” of the Korea Exchange (“KRX”), a derivatives and securities exchange located in Busan, South Korea. During the night hours in Korea, KRX trades are matched with counterparties via CME Globex, an electronic trading platform located in Aurora, Illinois. Trades are then cleared and settled on the KRX when it opens for business the next morning.

Plaintiffs claimed that Tower engaged in illegal “spoofing” transactions. The Court described the alleged spoofing scheme this way: “Tower’s traders would enter large volume buy or sell orders on the KRX night market and then ... immediately cancel their orders or ensure that they themselves were the counterparties on the trades. ... the intent was not to execute the trades but to create a false impression about supply and demand and thereby drive the market price either up or down. ... traders would sell contracts at the artificially inflated price or buy contracts at the artificially deflated price, ... reaping substantial profits either way.”

In May 2014, a Korean government regulator, the Financial Services Commission (“FSC”), uncovered the alleged scheme and referred the matter to Korean prosecutors. The FSC asserted that Tower’s traders “accessed the KOSPI 200 Overnight Futures Market and traded with the use of the proprietary algorithmic trading technique, which manipulated prices to build their buy and sell positions by creating automatically and repeatedly fictitious trades.

In December 2014, plaintiffs filed a class action complaint in the Southern District of New York. The case was assigned to Judge Kimba Wood, who coincidentally had previously presided over the same defendants in an unrelated litigation over LimeWire, the music-sharing site that Gorton had run before Tower. In 2010, Judge Wood found that LimeWire and Gorton had committed copyright infringement, and ordered them to disable all “searching, downloading, uploading, file trading and/or

file distribution functionality” on the LimeWire web site. Gorton had to pay the thirteen record company plaintiffs \$105 million to settle those claims.

This time, in contrast, Judge Wood ruled in the defendants’ favor, holding that U.S. securities laws did not apply to KRX trades. On appeal, however, the Second Circuit reversed.

At issue in both decisions was the proper application of *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247 (2010), the U.S. Supreme Court case that sets the standard for extraterritorial application of U.S. securities laws. In *Morrison*, the Supreme Court defined the territorial reach of § 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, as limited to only the following: (i) “transactions in securities listed on domestic exchanges;” and (ii) “domestic transactions in other securities.”

According to the Second Circuit, the alleged facts satisfied the second, “domestic transactions” prong of the *Morrison* test. As the Court explained, “*Morrison* does not preclude the application of the CEA to trades made on a foreign exchange when irrevocable liability is incurred in the United States.” The Court further explained that, in the “classic contractual sense,” the parties in *Choi* incurred irrevocable liability at the moment the trades were matched with counterparties. As the matching occurred in the U.S., these were domestic transactions.

The *Choi* decision applies well beyond CME Globex. Other electronic trading platforms also match foreign trades in the U.S. As these become more prevalent, one can expect to see more non-U.S. trades litigated in U.S. courts, particularly in the Second Circuit which encompasses New York. There are regulatory implications as well. These same statutes authorize SEC and CFTC enforcement actions. Thus, non-U.S. traders may now be within the regulatory reach of the U.S. Proper securities compliance has thus become more important than ever.