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Securities Fraud

The Supreme Court Limits Transnational Securities Fraud Cases

BY SCOTT M. HIMES

Among the vexing issues of securities law has been the application of the anti-fraud provisions, principally Section 10(b) of the Securities Exchange Act of 1934[1] and Securities and Exchange Commission Rule 10b5,[2] to extraterritorial transactions—that is, securities transactions involving fraud that have some United States connection but are predominately foreign in nature. Consider, for example, the situation where a non-U.S. citizen invests abroad in a foreign company that has a U.S. subsidiary that had misrepresented its financial condition due to accounting manipulations; as a consequence, the foreign parent, by incorporating its subsidiary's reporting, issued false financial reports abroad. Or, foreign parties invest in an offshore fund organized under the laws of a foreign jurisdiction; the fund, as it turns out, was involved in an investment fraud masterminded by its U.S.-citizen promoter from New York City. Or, a foreign company buys a controlling block of shares of another non-U.S. company on a foreign exchange; the to-be-acquired foreign company had made Securities and Exchange Commission filings to meet certain U.S. regulations for foreign issuers, and those filings were fraudulent. In these scenarios, can the investors maintain Section 10(b) claims in U.S. courts? ''[T]he question is a difficult one,'' as one court has put it, ''because Congress has given little meaningful guidance on the issue.''[3]

As a consequence, a substantial body of case law developed over the years to address the scope of Section 10(b) liability for securities transactions having cross-border characteristics. The U.S. Court of Appeals for the Second Circuit led the way in a series of noteworthy cases.[4] What emerged were related ''conduct'' and ''effects'' tests: ''(1) whether the wrongful conduct occurred in the United States, and (2) whether the wrongful conduct had a substantial effect in the United States or upon United States citizens.''[5] With variations of the theme, numerous other U.S. Courts of Appeals adopted similar approaches for determining the extraterritorial application of Section 10(b).[6] Fundamentally, the

[1] 5 U.S.C. § 78j(b).
[2] 17 CFR § 240.10b-5 (2009).

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[3] *Kauthar SDN BHD v. Sternberg*, 149 F.3d 659, 663-64 (7th Cir. 1998) (fn. omitted).
[4] *See Schoenbaum v. Firstbrook*, 405 F.2d 200 (2d Cir.), *modified on other grounds enbanc*, 405 F.2d 215 (2d Cir. 1968); *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326 (2d Cir. 1972); *Bersch v. Drexel Firestone Inc.*, 519 F.2d 974 (2d Cir. 1975); *IIT v. Vencap Ltd.*, 519 F.2d 1001 (2d Cir. 1975); *Psimenos v. E.F. Hutton & Co.*, 722 F.2d 1041 (2d Cir. 1983); *Itoba Ltd. v. Lep Group Plc*, 54 F.3d 118 (2d Cir. 1995); *Securities and Exchange Commission v. Berger*, 322 F.3d 187 (2d Cir. 2003).
[5] *Morrison v. Nat'l Australia Bank Ltd.*, 547 F.3d 167, 171 (2d Cir. 2008), *aff'd on other grounds*, __ U.S. __, 78 U.S.L.W. 4700, 2010 WL 2518523 (U.S. 2010).
[6] *E.g., In re CP Ships Ltd. Sec. Litig.*, 578 F.3d 1306, 1313, 78 U.S.L.W. 1108 (11th Cir. 2009); *Kauthar*, 149 F.3d at 665-67; *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 30-32 (D.C. Cir. 1987); *Grunenthal GmbH v. Hotz*, 712 F.2d 421, 424-25

judicially-created tests, which arose due to lack of clear legislative guidance, were nuanced analyses that sought to balance the competing concerns implicated in transnational securities transactions.

These cases are no longer the law. At the end of its recent term, the U.S. Supreme Court decided *Morrison v. Nat'l Australia Bank Ltd.*, No. 08-1191, __ U.S. __, 78 U.S.L.W. 4700, 2010 WL 2518523 (U.S. 2010), which rejected the Second Circuit approach (as well as that of the other circuits) and set forth a new ''transactional test'' for determining the extraterritorial application of Section 10(b). Justice Antonin Scalia (joined by Chief Justice John G. Roberts Jr. and Justices Anthony M. Kennedy, Clarence Thomas, and Samuel A. Alito Jr.) wrote the court's opinion, using particularly harsh language to repudiate the lower court cases. His opinion relied on a presumption against extraterritorial application of congressional enactments and keyed on the text of Section 10(b). Justice John Paul Stevens (joined by Justice Ruth Bader Ginsburg) concurred in the judgment but vigorously disagreed with the court's analysis and its new test, pointedly endorsing the judge-made approach to construing Section 10(b) based on considerations beyond its text alone. In essence, the competing opinions set forth differing approaches to analyzing Section 10(b)—a ''bright-line'' rule from the statutory language *vs.* consideration of the history, purpose and intent of the statute.[7]

Aside from highlighting the divergent views among the justices to statutory interpretation, *Morrison* significantly limited the scope of Section 10(b). Particularly given the increased globalization of capital markets, the decision likely will have important—and perhaps uncertain—ramifications for future securities cases and, consequently, for the capital markets.

The Facts of Morrison. National Australia Bank Limited (''National'') was the largest bank in Australia. It issued ordinary shares—what we would call ''common stock''—that were traded on an Australian exchange and other foreign exchanges, but not on any U.S. exchange.[8] National, however, did list on the New York Stock Exchange its American Depositary Receipts (''ADRs''), ''which represent the right to receive a specified number of National's Ordinary Shares.''[9]

According to the plaintiffs' complaint,[10] in 1998, National acquired HomeSide Lending Inc., a mortgage servicing company headquartered in Florida (''HomeSide''). HomeSide's business was to receive fees for servicing mortgages, which can provide a valuable income stream. HomeSide calculated the value of its mortgage-servicing rights using certain valuation models and thus recorded the value of its assets, which were included in the financial statements of its parent National.[11]

After National's public disclosures had promoted HomeSide's success for several years, in 2001, National announced write-downs of the value of HomeSide's assets of about $2 billion. Not surprisingly, the prices for National's ordinary shares and ADRs dropped. The complaint alleged that HomeSide and its executives had manipulated HomeSide's financial models to misrepresent the value of its mortgage-servicing rights and that National was aware of the deception but failed to act.[12]

Plaintiffs (as relevant to the Supreme Court's opinion) were all Australians who had purchased National's ordinary shares before the write-downs.[13] They sued National, HomeSide, and several of the companies' senior officers in the U.S. District Court for the Southern District of New York, alleging violations of Section 10(b) and Rule 10b-5 (and also asserting control-person liability under Section 20(a) based on the Section 10(b) violation). Plaintiffs sought to represent a class of foreign purchasers of National's ordinary shares during a period prior to the write-downs.[14]

The Second Circuit's (Now-Discredited) Analysis. The companies and their executives won dismissal in the district court for lack of subject-matter jurisdiction, and the Second Circuit affirmed.[15] Citing its precedents, the Second Circuit noted that ''[w]hen Congress wrote the Securities Exchange Act, . . . it omitted any discussion of its application to transactions taking place outside of the United States.''[16] Thus, the Second Circuit explained that ''when faced with securities law claims with an international component, we turn to the underlying purpose of the anti-fraud provisions as a guide to discern whether Congress would have wished the precious resources of the United States courts and law enforcement agencies to be devoted to such transactions.''[17] The Second Circuit stated that the underlying purpose of Section 10(b) is ''to remedy deceptive and manipulative conduct with the potential to harm the public interest or the interests of investors.''[18] With respect to extraterritoriality, the Second Circuit concluded that ''it is consistent with the statutory scheme to infer that Congress would have wanted to redress harms perpetrated abroad which have a substantial impact on investors or markets within the United States.''[19]

(9th Cir. 1983); *Continental Grain (Australia) Pty. Ltd. v. Pac. Oilseeds Inc.*, 592 F.2d 409, 415-19 (8th Cir. 1979); *Securities and Exchange Commission v. Kasser*, 548 F.2d 109, 113-15 (3d Cir. 1977).

[7] Justice Stephen G. Breyer concurred in part, and concurred in the judgment, by a brief opinion. Justice Sonia Sotomayor (who was on the Second Circuit when the case was decided below, but not on the panel) took no part in the consideration or decision of the case by the Supreme Court.

[8] 2010 WL 2518523, at *3.

[9] *Id.*

[10] Plaintiffs below, the shareholders who invested in National, were petitioners in the Supreme Court. They are referred to here as the plaintiffs.

[11] 2010 WL 2518523, at *3.

[12] *Id.*

[13] *Id.* at *4. The court noted that the lead plaintiff (Morrison) was an American who had invested in National's ADRs but that his claims were dismissed by the district court for failure to allege damages. That ruling was not appealed, although Morrison continued to be listed as a party on appeal and before the Supreme Court. *Id.* n. 1.

[14] *Id.* at *4.

[15] 2006 WL 3844465 (S.D.N.Y. Oct. 25, 2006) (Jones, J.), *aff'd*, 547 F.3d 167, 77 U.S.L.W. 1269 (2d Cir. 2008) (B.D. Parker, J.).

[16] 547 F.3d at 170 (citing *Itoba*, 54 F.3d at 121). Through a footnote, the Second Circuit ''urge[d] that this significant omission'' receive attention from Congress and the SEC. *Id.* n. 4.

[17] *Id.* at 170 (citations and internal quotation marks omitted).

[18] *Id.* (citations and internal quotation marks omitted).

[19] *Id.* at 171 (citations and internal quotation marks omitted).

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Based on this framework, the Second Circuit reiterated the ''conduct'' and ''effects'' tests from its precedents, as described above. The court noted that, where appropriate, the two tests are applied together, because that combination ''often gives a better picture of whether there is sufficient United States involvement'' to justify jurisdiction by a U.S. court; plaintiffs here, however, relied solely on the conduct test.[20] The Second Circuit further explained that subject-matter jurisdiction exists under the ''conduct'' test if the U.S. activities ''were more than merely preparatory to a fraud and culpable acts or omissions occurring here directly caused losses to investors abroad.''[21] Thus, the analysis is to ''identify which action or actions constituted the fraud and directly caused harm . . . and then determine if that act or those actions emanated from the United States.''[22] In affirming dismissal, the Second Circuit concluded that the actions and omissions of National in Australia were ''significantly more central to the fraud and more directly responsible for the harm to investors than the manipulation of the numbers in Florida.''[23]

It is noteworthy that *Morrison*, as the Second Circuit highlighted, involved the ''foreign-cubed'' securities case—that is, where *foreign* plaintiffs sue a *foreign* issuer in the U.S. based on transactions in a *foreign* country.[24] While this scenario has received much attention, the Second Circuit observed that ''despite this unusual fact-pattern, the usual rules still apply.''[25] And the scenario was of little significance when the case was before the Supreme Court.

The Supreme Court's Opinion. At the outset of its analysis, the Supreme Court addressed what it described as the Second Circuit's ''threshold error''—that the extraterritorial application of Section 10(b) involves a question of subject-matter jurisdiction.[26] The court explained that subject-matter jurisdiction ''refers to a tribunal's power to hear a case,'' which is a separate question from whether ''the allegations the plaintiff makes entitle him to relief.''[27] Determining what conduct Section 10(b) reaches, the court ruled, is a ''merits question.''[28] Thus, the analysis for extraterritoriality is a Rule 12(b)(6) inquiry for failure to state a claim, rather than a Rule 12(b)(1) subject-matter determination. The Supreme Court held, nonetheless, that the Second Circuit's error below was of no consequence—that a remand ''would only require a new Rule 12(b)(6) label for the same Rule 12(b)(1) conclusion''[29]—and so the court addressed extraterritoriality as an issue of whether the plaintiffs stated a claim.

■ *Reliance on the Presumption Against Extraterritoriality*. The starting point of Justice Scalia's analysis was the presumption against extraterritorial application of the law. As the opinion noted: ''It is a longstanding principle of American law that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.''[30] Justice Scalia characterized this as ''a canon of construction, or a presumption about a statute's meaning, rather than a limit upon Congress's power to legislate''; it is based on ''the perception that Congress ordinarily legislates with respect to domestic, not foreign matters.''[31] Congressional silence, accordingly, is significant. ''When a statute gives no clear indication of an extraterritorial application, it has none.''[32]

The Supreme Court criticized the Second Circuit as having departed from this principle. The court stated that the Second Circuit had believed that because Congress was silent as to extraterritorial application of Section 10(b), it was up to the courts ''to 'discern' whether Congress would have wanted the statute to apply.''[33] Justice Scalia also explained that this ''disregard of the presumption against extraterritoriality'' did not originate with the Second Circuit in this case, but occurred over several decades from various Courts of Appeals in determining Section 10(b)'s reach.[34] That process, Justice Scalia explained critically, ''has produced a collection of tests for divining what Congress would have wanted, complex in formulation and unpredictable in application.''[35]

Particularly given the increased globalization of capital markets, the *Morrison* decision likely will have important—and perhaps uncertain—ramifications for future securities cases and, consequently, for the capital markets.

Justice Scalia then traced the development of the approaches for ascertaining Section 10(b)'s extraterritorial application in the Southern District of New York and Second Circuit cases from 1967, which culminated in the ''effects'' and ''conduct'' tests.[36] Justice Scalia found that the Second Circuit ''had excised the presumption against extraterritoriality from the jurisprudence of § 10(b),'' having ''replaced it with the inquiry whether it would be reasonable (and hence what Congress would have wanted) to apply the statute to a given situation.''[37] He emphasized, further, that the Second Circuit ''never put forward a textual or even extratextual basis'' for its tests and that ''these tests were not easy to administer.''[38]

[20] *Id.*
[21] *Id.* (citations omitted).
[22] *Id.* at 173.
[23] *Id.* at 176.
[24] *Id.* at 172.
[25] *Id.*
[26] 2010 WL 2518523, at *4.
[27] *Id.* (citations omitted).
[28] *Id.*
[29] *Id.* at *5.

[30] *Id.* (citations and internal quotation marks omitted).
[31] *Id.* (citations and internal quotation marks omitted).
[32] *Id.*
[33] *Id.* (citing Second Circuit decision).
[34] *Id.*
[35] *Id.*
[36] *Id.* at *6-7.
[37] *Id.* at *6.
[38] *Id.* at *7. In particularly harsh terms, Justice Scalia stated that there is ''no more damning indictment'' of the ''conduct'' and ''effects'' tests ''than the Second Circuit's own declaration that 'the presence or absence of any single factor which was considered significant in other cases . . . is not necessarily dispositive in future cases.' '' *Id.* (quoting *IIT v. Cornfeld*, 619 F.2d 909, 918 (2d Cir. 1980) (internal quotation marks omitted)).

The Supreme Court also critiqued the other circuits. Justice Scalia stated, disapprovingly: ''While applying the same fundamental methodology of balancing interests and arriving at what seemed the best policy, [the other Courts of Appeals] produced a proliferation of vaguely related variations on the 'conduct' and 'effects' tests.''[39] He noted, for example, the Seventh Circuit's observation that while the circuits seem to agree that the anti-fraud provisions of the securities laws apply for some transnational situations, ''agreement appears to end at that point.''[40] Justice Scalia also referred to various commentators who criticized the decisions applying Section 10(b) to transnational cases.[41]

In short, the Supreme Court wholly rejected virtually all the prior case law on Section 10(b)'s extraterritorial application. The court viewed the Courts of Appeals as having abandoned the presumption against extraterritoriality, instead adopting judge-made rules beyond expressed congressional intent and imbued with policy considerations. Thus, Justice Scalia stated: ''The results of judicial-speculation-made-law—divining what Congress would have wanted if it had thought of the situation before the court—demonstrate the wisdom of the presumption against extraterritoriality. Rather than guess anew in each case, we apply the presumption in all cases, preserving a stable background against which Congress can legislate with predictable effects.''[42]

■ *The Textual Analysis*. Having held that the presumption against extraterritorial application of our laws is front-and-center, the court's opinion turned to Section 10(b) to ascertain whether its text supports extraterritorial application.[43]

Quoting the statute, the court held that ''[o]n its face, § 10(b) contains nothing to suggest it applies abroad.''[44] That observation, in fact, appears to be the crux of the court's analysis. Nonetheless, the court next addressed three contentions advanced by the plaintiffs and the solicitor general (who filed a brief for the United States as amicus curiae) that Section 10(b) generally provides for extraterritorial application. It rejected each.

Specifically, the plaintiffs and solicitor general relied on the definition of ''interstate commerce'' (which is used in Section 10(b)), arguing that it includes '' 'trade, commerce, transportation, or communication . . . between any *foreign* country and any State.' ''[45] The court explained that even broad statutory definitions of ''commerce'' that include foreign commerce do not prescribe extraterritorial application; thus, the court held that the general reference in the Exchange Act to foreign commerce in the ''interstate commerce'' definition does not overcome the presumption against extraterritoriality.[46]

Plaintiffs and the solicitor general also argued that an Exchange Act provision describing its purposes states that the ''prices established and offered in such transactions are generally disseminated and quoted throughout the United States and *foreign* countries.''[47] The court construed ''such transactions'' in this provision as referring to an earlier sentence that, in turn, concerned the ''national'' public interest, and the court reasoned that the *national* public interest did not pertain to transactions conducted on *foreign* exchanges and markets; thus, this ''fleeting reference'' to the dissemination and quotation abroad of the prices for domestically-traded securities also did not overcome the presumption against extraterritoriality.[48]

Finally, the court noted that another Exchange Act provision, Section 30(b), *does* refer to extraterritorial application. That section states that the Exchange Act's provisions (or its implementing rules and regulations) do not apply to any person who transacts a business in securities ''without the jurisdiction of the United States,'' unless the person does so in violation of SEC regulations promulgated '' 'to prevent . . . evasion of [the Act].' ''[49] The solicitor general argued that this exemption would have no purpose '' 'if the Act did not apply in the first instance to securities transactions that occur abroad.' ''[50] The court rejected this argument, interpreting the provision narrowly to refer to actions abroad that might conceal a domestic violation, or might cause a domestic violation to escape on a technicality[51]—rather than as a grant of extraterritorial application generally. The court stated that while the solicitor general's contended inference from the language ''is possible, . . . possible interpretations of statutory language do not override the presumption against extraterritoriality.''[52] The court further observed that the solicitor general did not consider Section 30(a), which contains ''a clear statement of extraterritorial effect'' for certain transactions.[53] The court explained that Section 30(a) contains ''what § 10(b) lacks,'' and that Section 30(a)'s ''explicit provision for a specific extraterritorial application would be quite superfluous if the rest of the Exchange Act already applied to transactions on foreign exchanges—and its limitation of that application to securities of domestic issuers would be inoperative.''[54] It was undisputed that Section 30(a) did not apply in *Morrison*.

[39] *Id.*

[40] *Id.* (quoting *Kauthar SDN BHD v. Sternberg*, 149 F.3d 659, 665 (7th Cir. 1998)).

[41] *Id.* at *8.

[42] *Id.*

[43] The court noted that since Rule 10b-5 was promulgated under Section 10(b), it does not extend beyond conduct prohibited by statute; thus, Rule 10b-5 is not extraterritorial if Section 10(b) is not. *Id.* at *9.

[44] *Id.*

[45] *Id.* (quoting 15 U.S.C. § 78c(a)(17)) (emphasis added).

[46] *Id.*

[47] *Id.* (quoting 15 U.S.C. § 78b(2)) (emphasis added).

[48] *Id.*

[49] *Id.* (quoting § 30(b), 15 U.S.C. § 78dd(b)).

[50] *Id.* (quoting Brief for United States as Amicus Curiae at 14).

[51] *Id.* at *10.

[52] *Id.* (citing *Equal Employment Opportunity Commission v. Arabian Am. Oil Co.*, 499 U.S. 244, 253 (1991)).

[53] *Id.* Section 30(a) of the Exchange Act, 15 U.S.C. § 78dd(a) (emphasis added), states:

It shall be unlawful for any broker or dealer . . . to make use of the mails or of any means or instrumentality of interstate commerce for the purpose of effecting on an exchange *not within or subject to the jurisdiction of the United States*, any transaction in any security the issuer of which is a resident of, or is organized under the laws of, or has its principal place of business in, a place within or subject to the jurisdiction of the United States, in contravention of such rules and regulations as the Commission may prescribe.

[54] 2010 WL 2518523, at *10. The court also stated that ''[e]ven if that were not true, when a statute provides for some extraterritorial application, the presumption against extraterritoriality operates to limit that provision to its terms.'' *Id.* (cit-

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As a final explanation for its textual analysis, the court addressed what it characterized as a "clear statement rule" (which the concurrence raised) for giving a statute extraterritorial application—meaning a requirement that a statute expressly state that the law applies abroad.[55] Somewhat ambiguously, Justice Scalia explained that the presumption against extraterritoriality is *not* a clear statement rule and that "context can be consulted," but he concluded that "whatever sources of statutory meaning one consults" to give meaning to the text, "there is no clear indication of extraterritoriality here."[56] The court's reasoning thus appears to leave open the opportunity to consult context, beyond text alone, for determining statutory meaning in general, while concluding here that nothing supported an intent of extraterritorial application for Section 10(b) specifically.

The court ended its textual analysis where it had begun—finding that since there is "no affirmative indication in the Exchange Act" that Section 10(b) applies extraterritorially, it therefore does not.[57]

The Supreme Court in *Morrison* ended its textual analysis where it had begun—finding that since there is 'no affirmative indication in the Exchange Act' that Section 10(b) applies extraterritorially, it therefore does not.

■ *The New "Transactional Test."* The court then addressed the plaintiffs' contention that even if Section 10(b) does not apply extraterritorially, that conclusion does not resolve the case because (plaintiffs argued) they were only seeking domestic application anyway, since HomeSide's conduct and misrepresentations occurred in Florida. Justice Scalia explained that this contention is simply a recognition that the presumption against extraterritoriality typically requires further analysis, because most cases will involve at least some domestic activity.[58] This analysis, the court concluded, considers "the 'focus' of congressional concern" underlying the statute in question.[59]

The court ruled that the focus of the Exchange Act "is not upon the place where the deception originated, but upon *purchases and sales of securities in the United States*."[60] Again relying on specific statutory language, the court explained that Section 10(b) punishes only deceptive conduct " 'in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered.' "[61] The court therefore held that Section 10(b) applies only to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities."[62]

In explaining its congressional-concern focus further, the court referred to other explicit statutory language and specific provisions of both the Exchange Act and the Securities Act of 1933. The court emphasized that the prologue to the Exchange Act suggests the primacy of the domestic exchange; that the statute's registration requirements apply to securities on domestic exchanges; that for securities not registered on domestic exchanges, other Exchange Act provisions (Section 30(a) and (b), discussed above) focus exclusively on domestic purchases and sales; and that the registration requirements of the Securities Act likewise focus on domestic transactions.[63]

The Supreme Court thus set forth a bright-line rule, denominated as a "transactional test"—that Section 10(b) applies to securities transactions where "the purchase or sale is made in the United States, or involves a security listed on a domestic exchange."[64]

Applying this new test in *Morrison* was straightforward. Without further factual analysis, the court affirmed dismissal of the investors' complaint because it did not involve securities listed on a domestic exchange, and all aspects of the purchases in issue occurred outside the United States.[65]

The Alternative View of the 'Concurrence.' Justice Stevens concurred, believing that the complaint failed to state a claim based on the Second Circuit's reasoning, but he thoroughly disagreed with Justice Scalia's analysis, and so his opinion is essentially a dissent. Justice Stevens' position was that the determination of the scope of Section 10(b) should not be confined to a textual analysis. Rather, he asserted that since the text and history of Section 10(b) are "famously opaque" on extraterritoriality, the courts over the years appropriately

ing *Microsoft Corp. v. AT&T Corp.*, 550 U.S. 437, 455-56, 75 U.S.L.W. 4307 (2007)).

[55] *Id.*

[56] *Id.*

[57] *Id.* at *11.

[58] *Id.*

[59] *Id.* (citation omitted).

[60] *Id.* (emphasis added).

[61] *Id.* (quoting Section 10(b)).

[62] *Id.* The court explained that as to the language "any security not so registered" in Section 10(b), the presumption against extraterritorial application requires that this phrase be read as involving only *domestic* purchases and sales of securities. *Id.* at *12 & n. 10.

[63] *Id.* at *11-12. The court also rejected extraterritorial application for another reason. It noted that the probability of incompatibility with other countries' laws from applying Section 10(b) abroad "is so obvious" that if Congress had intended foreign application "it would have addressed the subject of conflicts with foreign laws and procedures." *Id.* at *12 (quotation marks and citation omitted). In contrast, the Second Circuit, while noting the concern of conflict with other countries' laws, had found it not compelling, principally because anti-fraud enforcement generally is a similar objective among nations. *See* 547 F.3d at 174-75.

[64] 2010 WL 2518523, at *12. *See also id.* at *14 ("Section 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, and the purchase or sale of any other security in the United States.").

In adopting this test, the court rejected a different test advanced by the solicitor general. Under the solicitor general's proposal, Section 10(b) would apply abroad when the fraud involves "significant conduct in the United States that is material to the fraud's success." *Id.* at *13 (quoting Brief for United States as Amicus Curiae at 16). The court rejected this proposed test principally because it lacked textual support, and the court otherwise did not accept the solicitor general's proffered arguments for the proposal. *Id.* at *13-14.

[65] *Id.* at *14.

have sought to discern legislative intent—and he concluded that the Second Circuit's conduct-and-effects test properly addressed the question of extraterritoriality.[66]

Justice Stevens contended that given the decades-long history of cases considering the issue, the court's criticism of the Second Circuit for ''applying 'judge-made rules' is quite misplaced.''[67] Noting that the private right of action comes from judicial interpretation, Justice Stevens stated: ''This entire area of law is replete with judge-made rules, which give concrete meaning to Congress' general commands.''[68] To Justice Stevens, the long history of the courts' fleshing out Section 10(b) and Rule 10b-5 generally, and their transnational reach in particular, was a solid basis to credit the Second Circuit's doctrine, not a reason for the court to denigrate it.[69]

Justice Stevens also believed that the court misapplied the presumption against extraterritoriality. He asserted that the court was treating the presumption not as a ''flexible rule of thumb'' but as ''a clear statement rule.''[70] (As noted, Justice Scalia's opinion specifically responded to this point.) Justice Stevens did not view the presumption as prohibiting extraterritoriality *unless* Congress makes a clear statement that it does apply overseas. Rather, he asserted that the court should give effect to all the available evidence about the meaning of a statute when considering its extraterritorial application—and taking a head-on approach, he wrote that ''[c]ontrary to Justice Scalia's personal view of statutory interpretation, that evidence legitimately encompasses more than enacted text.''[71]

Indeed, some would contend that in recent years the plaintiffs securities bar increasingly has targeted major foreign financial institutions, in particular, for securities-fraud lawsuits in the U.S. courts. . . . *Morrison* will put the brakes on this development.

Justice Stevens also took issue in a more fundamental way with using the presumption to decide the case. Recognizing that Section 10(b) does not apply to ''wholly foreign frauds,'' Justice Stevens emphasized that the real question is ''how much, and what kinds of, *domestic* contacts are sufficient to trigger application of § 10(b).''[72] He noted, approvingly, that the Second Circuit had tried to resolve this question based on the Exchange Act's ''text, structure, history and purpose.''[73] Justice Stevens believed that Section 10(b) extends to at least some activities with an international component, and he endorsed the Second Circuit's test for determining that scope. As he summarized it: ''[I]n my view, the Second Circuit has done the best job of discerning what sorts of transnational frauds Congress meant in 1934—and still means today—to regulate.''[74] Justice Stevens therefore criticized the court ''for beginning *and ending* its inquiry with the statutory text,'' since the text was imprecise on geographic scope, and for dismissing the long history and persuasiveness underlying the Second Circuit's rule.[75]

As Justice Stevens saw it, the court's ''transactional rule''—which he described as ''novel,'' ''turn[ing] § 10(b) jurisprudence . . . on its head''[76]—will too narrowly foreclose private parties from Section 10(b) relief. He envisioned scenarios where Section 10(b) now will be unavailable simply because the securities in issue were purchased or sold abroad and are not listed on a domestic exchange—even though there was both wrongful conduct in the U.S. and injurious effects on U.S. markets and citizens. To Justice Stevens, this result would be inconsistent with Congress' intent in passing the Exchange Act.[77] In the end, he vigorously disagreed with both the court's reasoning for arriving at its ''transactional test'' and with the limitations on the scope of Section 10(b) that the test now creates.[78]

Ramifications and Consequences; Some Unanswered Questions. As capital markets have become more international in recent years, the shareholder base for companies has likewise become more global, and U.S. securities class actions have expanded to include foreign investors as plaintiffs and foreign companies as defendants more frequently. Indeed, some would contend that in recent years the plaintiffs securities bar increasingly has targeted major foreign financial institutions, in particular, for securities-fraud lawsuits in the U.S. courts. This extraterritorial expansion of Section 10(b) claims is particularly significant because foreign parties (and foreign governments) often view the U.S. courts as being ''plaintiff friendly'' and involving more costly and onerous procedures than judicial proceedings in their own countries—and so the U.S. cases are deemed very intrusive abroad.

Morrison will put the brakes on this development. There will be fewer securities-fraud cases involving foreign investors or foreign issuers in the future, since the transactional test of *Morrison* affords less leeway to bring these cases in the U.S. than under the conduct-and-effects test. The ''foreign-cubed'' scenario, in particular, should be a thing of the past. Indeed, reflecting the view that greater limits on the reach of Section 10(b) are warranted, Justice Scalia commented, colorfully, that ''[w]hile there is no reason to believe that the

[66] *Id.* at *15.
[67] *Id.*
[68] *Id.*
[69] *Id.* at *16.
[70] *Id.* at *17.
[71] *Id.*
[72] *Id.* at *18 (emphasis in original).
[73] *Id.*
[74] *Id.*
[75] *Id.* (emphasis in original).
[76] *Id.* at *19.
[77] *Id.*
[78] With respect to his concurrence in the judgment, Justice Stevens suggested that the plaintiffs had failed to allege that the heart of the fraud occurred in the United States or that the fraud adversely affected U.S. investors or markets. Justice Stevens therefore would have affirmed based on the Second Circuit's reasoning because the case ''has Australia written all over it.'' *Id.* at *20. Indeed, Justice Stevens noted that virtually all ''foreign-cubed'' securities cases—such as *Morrison* itself—would fail under the Second Circuit's test, ''[a]s they generally should.'' *Id.* at *13 n.11.

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United States has become the Barbary Coast for those perpetrating frauds on foreign securities markets, some fear that it has become the Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets.''[79]

Morrison might also affect the nature and number of U.S. securities class actions in other ways. Securities cases often include both domestic and foreign investors as part of the putative class. (For example, foreign companies often have investors who acquired ADRs on a U.S. exchange and shareholders who purchased the company's stock on a foreign exchange.) If foreign investors will no longer have a cognizable claim, pursuing a class action may be more problematic because the size of the putative investor-class will be narrowed, thereby affecting the potential value of a recovery. So, as a practical matter it might be less likely that a securities-fraud class action will be pursued in certain circumstances. Pending cases that involve such a ''mixed'' investor class could also be significantly narrowed in this way.

Significantly, *Morrison* gives companies strong incentives to structure capital-raising activities as *non-U.S.* transactions.

As yet broader ramifications from *Morrison*, foreign companies might now be encouraged to increase capital-raising activities worldwide, being less fearful of facing litigation in the United States due to some activity here. Similarly, foreign companies could be more inclined to expand their U.S.-based business activities, because domestic activities alone should not subject them to securities-fraud claims here.

Also significantly, *Morrison* gives companies strong incentives to structure capital-raising activities as *non-U.S.* transactions. By avoiding U.S. exchanges and the sale of securities in the United States, companies are more likely to be protected from securities-fraud claims in the United States. As a result, use of the U.S. markets for securities transactions could be affected. In contrast, however, investors generally, and particularly institutional investors who play such a major role in the capital markets, will have the opposite incentive—they will want transactions to be structured as domestic transactions in order to be protected by our anti-fraud laws. Indeed, foreign institutional investors filed amicus briefs in *Morrison* arguing in favor of extraterritorial application of Section 10(b), asserting an interest in preserving the right to maintain a claim under U.S. law.[80]

Morrison's bright-line approach—and its prescription for structuring transactions to avoid the United States—could produce a harmful incentive as well. As Justice Stevens observed, ''while the clarity and simplicity of the court's test may have some salutary consequences, like all bright-line rules it also has drawbacks.''[81] A clear rule against fraud can give a roadmap for evading the scope of Section 10(b).[82] Will *Morrison* lead to an increase in securities fraud through transactions structured abroad precisely to avoid Section 10(b)?

By limiting the application of U.S. law abroad, *Morrison* also minimizes conflict with other countries over securities transactions. In adopting the transactional test, the Supreme Court noted that other nations often have differing securities regulations, and it cited the amicus briefs of several foreign governments and various international organizations that complained of interference with their securities regulation caused by application of Section 10(b) internationally.[83] As a result, the Supreme Court's opinion can be seen as advancing globalization of the securities markets by constricting application of U.S. law in the recognition that other countries will apply their own securities regulation to overseas capital-raising activity. But that consequence, in turn, could have further ramifications for U.S. interests. When fraud claims cannot be maintained in the U.S. because the purchase or sale occurred abroad, will U.S. companies (and their U.S. managers) who are involved in cross-national securities transactions now end up being sued abroad more frequently?

Despite prescribing a supposedly more-certain test for the application of Section 10(b), *Morrison* creates other unanswered questions. The Supreme Court did not address the extraterritorial scope of an SEC enforcement action under Section 10(b). Much of the prior case law that developed the conduct-and-effects test arose in the context of the implied private right of action under Section 10(b). In the amicus brief for the United States, the solicitor general (joined by the SEC) sought to differentiate an SEC enforcement action from a private-plaintiff case. Nonetheless, the Supreme Court's opinion interpreted Section 10(b) generally and did not limit its reasoning to the private right of action. Furthermore, the court (as noted above; *see* fn. 64) rejected an alternative test proposed by the solicitor general. Thus, while distinctions exist, a principled basis to differentiate the SEC from a private plaintiff might not prevail.[84]

In any event, new financial reform legislation appears to resolve the question. Just days ago, Congress passed the landmark Dodd-Frank Wall Street Reform and Consumer Protection Act (the ''the Dodd-Frank Act''), a sweeping overhaul of our financial system, which involves extensive changes to many aspects of the securities, banking, and other laws. (President Obama is expected to sign it into law imminently.) The Dodd-Frank Act includes a provision that authorizes the SEC (or Department of Justice) to bring extraterritorial enforcement proceedings under the anti-fraud provisions based essentially on the lower courts' ''conduct'' and ''effects'' tests.[85]

[79] *Id.* at *13.

[80] *See, e.g., Brief for Amici Curiae Alecta Pensionsförsäkring, et al.*

[81] 2010 WL 2518523, at *19.

[82] *See* Transcript of Oral Argument at 50, *Morrison*, 2010 WL 2518523 (Mar. 29, 2010) (comments of counsel for the United States).

[83] 2010 WL 2518523, at *12.

[84] Justice Stevens, however, alluded to a distinction. While concurring in the result that the investors could not maintain a Section 10(b) claim, Justice Stevens asserted that National and the other defendants might nonetheless be held liable for a Section 10(b) violation in an SEC enforcement action. *Id.* at *20.

[85] *See* Dodd-Frank Conference Report on H.R. 4173, 111th Cong. § 929P(b) (as passed by the House of Representatives

Another important question is exactly what it means for a purchase or sale of securities to be ''made in the United States.'' Even though *Morrison* seemingly prescribed a bright-line test, it is not difficult to imagine that lawyers will argue over the meaning of this prong of the test—and so the court's opinion might not have accomplished the intended bright-line approach after all. What will the answer be, for example, where a company or its underwriters undertake significant marketing activities (and perhaps even obtain purchase commitments) in the United States but then actually close the sale of securities abroad? What happens if a U.S. investor buys securities abroad on a foreign exchange through a U.S. broker? What about when the purchase of securities listed on a U.S. exchange takes place abroad in secondary markets, a private placement or otherwise in an off-U.S.-exchange transaction? What if a purchase occurs abroad for securities that are listed on both a U.S. and foreign exchange? *Morrison* might not fully resolve these questions, which will have to play out through the lower courts.

Finally, some will no doubt view the demise of the conduct-and-effects standard as weakening investor protections against fraud in the globalization of the securities markets. Indeed, for the scenarios at the outset of this article, the investors probably would not be able to maintain a Section 10(b) claim now. A remaining—and central— unanswered question is whether Congress will resolve the issue of applying Section 10(b) abroad for shareholder actions.

The new financial reform legislation side-steps a resolution for the implied private right of action (unlike for government enforcement proceedings); instead, the Dodd-Frank Act directs the SEC to solicit public comment and then conduct a study to determine whether private rights of action for class actions under Section 10(b) should be given extraterritorial application.[86] This process will no doubt generate significant interest and input from various constituencies of the securities markets, the financial world generally and the Bar. Interestingly, Congress framed the study to address the basic conduct-and-effects test but also directed consideration of several specific topics, including whether extraterritorial application should cover all private actors, or be more limited to just institutional investors or otherwise limited; the implications for international comity; and economic costs and benefits generally. These broad matters are sure to generate a robust and multifaceted study on extraterritoriality for Section 10(b).

The Dodd-Frank Act requires that a report of the study—with recommendations—be submitted to Congress not later than 18 months after enactment of the statute (i.e., by January 2012). The debate over the scope of Section 10(b) will thus continue—and since *Morrison* construed Section 10(b), the last word on the statute's extraterritorial application is with Congress.

on June 30, 2010, and by the Senate on July 15, 2010). The provisions on extraterritoriality are cast as jurisdictional. For the Exchange Act, the provision states:

Extraterritorial Jurisdiction.—The district courts of the United States and the United States courts of any Territory shall have jurisdiction of an action or proceeding brought or instituted by the Commission or the United States alleging a violation of the antifraud provisions of this title involving—

(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or

(2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

The Dodd-Frank Act makes the same jurisdiction changes for anti-fraud provisions under the Securities Act of 1933 and the Investment Advisers Act of 1940.

[86] *See id.* § 929Y (''Study on Extraterritorial Private Rights of Action''). Prescribing further analysis on the issue for Congress is a change in the reform legislation just passed. An earlier version of the House bill included a provision authorizing extraterritorial jurisdiction for the anti-fraud provisions generally, based on the conduct-and-effects test. *See* The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 7216 (as passed by the House of Representatives on Dec. 11, 2009).

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