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U.S. Supreme Court Rules Against Extraterritorial Application of Antifraud Provisions in "Foreign-Cubed" Case

Financial Reform Bill Would Restore SEC Power

On June 24, 2010, in *Morrison v. National Australia Bank Ltd.*, No. 08-1191 (slip opinion here), the U.S. Supreme Court held that the antifraud provisions of the U.S. securities laws do *not* apply to foreign plaintiffs suing foreign defendants for fraud in connection with securities transactions on foreign exchanges – the so-called "foreign-cubed" cases.

The reasoning of the five-justice majority bars extraterritorial application of the Securities Exchange Act of 1934 (the Exchange Act) not only by private plaintiffs, but by the U.S. Securities and Exchange Commission (SEC) as well. Although the eight justices agreed unanimously on the result (Justice Sotomayor recused herself), the justices disagreed sharply on the reasons.

Morrison appears to invalidate preliminary note 1 to Regulation S of the Securities Act of 1933 (the Securities Act), which reserves the SEC's authority to apply the antifraud provisions of the federal securities laws in offerings made outside the United States under that regulation. Immediately after the Supreme Court's decision *Morrison*, however, the United States House-Senate conference committee added provisions to the U.S. financial reform legislation (the Dodd-Frank Bill) that would restore the SEC's extraterritorial power and study extending federal antifraud provisions to private foreign-cubed claims.

Accordingly, foreign issuers' exposure to securities fraud actions in the United States remains unsettled and may be the subject of legislative and other developments.

The Relevant Facts

Morrison involved the purchase of securities of a foreign issuer (National Australia Bank Ltd. or NAB) by foreign persons on a foreign exchange. Specifically, Australians who purchased the ordinary shares (common stock) of National Australia Bank Ltd., as well as Americans who purchased NAB's American Depositary Receipts (ADRs), filed a securities fraud class action in Manhattan federal district court against NAB, its CEO, its Florida subsidiary, and three of the subsidiary's U.S. officers under § 10(b) of the Exchange Act and Rule 10b-5 – the principal antifraud provisions of the U.S. securities laws.

NAB moved to dismiss and the district court agreed. The district court dismissed the claims of Morrison, the sole U.S. representative, because he failed to allege damages. The district court also dismissed the claims of the Australian plaintiffs for lack of subject matter jurisdiction under the U.S. Second Circuit Court of Appeals' then-governing conduct-and-effects test, which applies the antifraud provisions of U.S. securities laws to foreign transactions only (1) if significant conduct occurred in the United States or (2) if conduct had some effect on U.S. securities markets or investors, or some combination of (1) and (2). In *Morrison*, the district court held that insufficient conduct occurred in the United States because the domestic conduct was at most a link in an alleged securities fraud that occurred abroad. Plaintiffs did not allege effects on U.S. securities markets or investors.

Morrison himself did not appeal to the Second Circuit, but the Australian plaintiffs did appeal. As a result, on appeal the case presented the question whether the antifraud provisions of the U.S. securities laws apply to the foreign (Australian) plaintiffs suing foreign (Australian) and American defendants for alleged fraud in connection with foreign (Australian) securities transactions. After the district court's dismissal of the sole plaintiff representing purchasers of NAB's NYSE-listed ADRs, no plaintiff remaining in the case had bought or sold any security listed on any U.S. exchange or any security (wherever listed or unlisted) within the United States.

On the appeal of the Australian plaintiffs, the Second Circuit affirmed the dismissal for lack of subject matter jurisdiction on the basis of its conduct-and-effects test.

The Australian plaintiffs sought review in the U.S. Supreme Court.

The U.S. Supreme Court Decision

The Oral Argument

At oral argument in the U.S. Supreme Court, none of the justices expressed interest in applying the Exchange Act's antifraud provisions to the claims of the Australian plaintiffs. Although the questions of all eight participating justices suggested that they agreed on the result, their oral argument questions revealed disagreement about whether the antifraud provisions of U.S. securities laws apply extraterritorially and, if so, under what circumstances.

Consistent with the oral argument questions, the justices in their opinions in *Morrison* unanimously agreed that the antifraud provisions of the U.S. securities laws did not apply to the claims of the Australian plaintiffs, but they disagreed whether and when those provisions apply to transnational securities frauds.

The Court's Opinion

Writing for the Court, Justice Scalia, joined by the Chief Justice and Justices Kennedy, Thomas, and Alito, reasoned that the antifraud provisions apply only to transactions in securities listed on domestic (U.S.) exchanges and domestic transactions in other securities. Absent a contrary indication, the majority found that the U.S. securities law statutes apply "only within the territorial jurisdiction of the United States." Finding "no affirmative indication in the Exchange Act that § 10(b) applies extraterritorially," the Court "therefore conclude[d] that it does not."

The Court rejected as irrelevant plaintiffs' contention that the deceptive conduct originated domestically (in Florida) and explained that the Exchange Act focuses "not upon the place where the deception originated, but upon purchases and sales of securities in the United States."

The Court also rejected "the notion that the Exchange Act reaches conduct in this country affecting exchanges or transactions abroad." The Court observed that other countries regulate their securities exchanges with potentially "incompatibl[e]" laws. The Court cited *amicus curiae* briefs filed by France, other foreign sovereigns, and many foreign companies which pointed out the "interference with foreign securities regulation" that extraterritorial application of U.S. law would produce and "urge[d] the adoption of a clear test." The Court explained that "[t]he transactional test we have adopted . . . meets that requirement."

The Court further rejected the U.S. Solicitor General's test that the Exchange Act regulates transnational securities frauds involving "significant conduct in the United States that is material to the fraud's success." The Court rejected that test for its lack of textual support in the U.S. securities laws. In response to the Solicitor General's argument that the securities laws should be construed to prevent the U.S. from becoming a "Barbary Coast for those perpetrating frauds on foreign securities

markets" and to promote other "desirable consequences," the Court noted "some fear that [the U.S.] has become the Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets."

The Court concluded that "[s]ection 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."

Concurring Opinion by Justice Breyer

Justice Breyer concurred in part and in the judgment. In a separate, one-page opinion, he wrote that Exchange Act § 10(b) does not apply to purchases of securities that are not registered on a "national securities exchange" and where those purchases took place "in Australia and involved only Australian investors." Justice Breyer concurred in the Court's opinion only "[t]o the extent" that it "is consistent with these views."

Concurring Opinion by Justice Stevens

Justice Stevens, joined by Justice Ginsburg, concurred only in the judgment. Justice Stevens would have adopted the Second Circuit's conduct-and-effects test and affirmed the Second Circuit's judgment, thereby permitting the application of U.S. securities laws to transnational frauds in future cases. In apparent response to the concern of foreign issuers with the burden of discovery if cases are not dismissed at the outset and the consequent pressure to settle even meritless cases, Justice Stevens opined in a footnote that "virtually all 'foreign-cubed' actions . . . would fail the Second Circuit's test. As they generally should." Justice Stevens conceded that "it might have been appropriate to incorporate one bright line into the Second Circuit's test, by categorically excluding such [foreign-cubed] lawsuits from § 10(b)'s ambit." Justice Stevens understood the Solicitor General's test to be a "repackaging" of the conduct component of the Second Circuit's conduct-and-effects test.

In another footnote, Justice Stevens tried to reserve the SEC's authority to bring future enforcement cases. Justice Stevens asserted that "The Court's opinion does not, however, foreclose the Commission from bringing enforcement actions in additional circumstances, as no issue concerning the Commission's authority is presented in this case."

The Impact of *Morrison*

Limited private right of action for foreign securities transactions

Under *Morrison's* transaction test, securities transactions are subject to the antifraud provisions of the federal securities laws only if (1) the securities are listed on a U.S. exchange or (2) they were purchased or sold in the United States. The corollary of the Court's transaction test is that foreign transactions are outside the scope of Exchange Act § 10(b) and Rule 10b-5 unless the securities are listed on a U.S. exchange.

Because the antifraud provisions of the U.S. securities laws do not apply to foreign transactions in securities not listed on a U.S. exchange, pending securities class actions such as the ones against Vivendi, S.A. and BP p.l.c. would seem to be reduced in scope inasmuch as a substantial number of the transactions involved securities not listed on a U.S. exchange and occurred abroad.

SEC authority over foreign transactions in foreign securities questioned

In *Morrison*, the Court construed Exchange Act § 10(b) and Rule 10b-5 not to apply to foreign transactions unless those securities are listed on a U.S. exchange. If the antifraud provisions of the Exchange Act do not apply to such transactions as a matter of statutory construction, then the SEC would not seem to have any more authority to regulate them than private investors would have to sue for damages. Under a legal test that focuses on transactions, as does the Court's test in *Morrison*, one construction of § 10(b) cannot apply when private parties are plaintiffs and a different construction of the statute when the government is the plaintiff. Thus, although Justice Stevens may be correct that SEC enforcement proceedings differ from private securities class actions and pose a reduced threat to international comity, it is difficult to understand why the Court's reasoning "does not . . . foreclose the Commission from bringing enforcement actions in additional circumstances."

Under the Court's transaction test, the SEC's reservation of authority to apply the antifraud provisions to securities offerings exempt from registration under Regulation S would seem to be an empty power. Regulation S lists the requirements under which the SEC will deem securities offered and sold outside of the United States to be exempt from registration under the Securities Act. Preliminary Note 1 to Regulation S limits the exemption to registration requirements: "The following rules [in Regulation S] relate solely to the application of Section 5 of the Securities Act of 1933 (the Act) and not to antifraud or other provisions of the federal securities laws." By limiting the exemption and reserving the application of the antifraud provisions of the securities laws, Preliminary Note 1 implies that the antifraud provisions apply to at least some securities offered and sold outside the United States. Otherwise, the reservation of authority would be unnecessary since there would be no power to reserve.

Under *Morrison's* transaction test, however, if securities are not listed on a U.S. exchange (as would be the case if the sale is not registered under the Securities Act) and if they are offered and sold outside the United States (as contemplated by Regulation S), then the antifraud provisions would not apply. If *Morrison* remains the law of the land, then Preliminary Note 1 to Regulation S would appear to leave the SEC without antifraud enforcement power for purchases and sales of securities made under Regulation S.

SEC power may be restored if Congress passes the proposed Investor Protection and Securities Reform Act of 2010

Among the many provisions in the proposed Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Bill or the Bill) that emerged from a House-Senate conference committee last week are two provisions that would essentially restore the Second Circuit's conduct-and-effects test legislatively at least as to the SEC's authority and perhaps as to private rights of action as well. House members voted 237 to 192 to approve the final version of the bill on Wednesday, June 30. Senators are expected to vote on the bill no earlier than when they return from the Independence Day recess on Monday, July 12. The Bill's prospects in the Senate are uncertain.

Title IX of the Dodd-Frank Bill is entitled the "Investor Protection and Securities Reform Act of 2010." Section 929P(b), "Strengthening Enforcement by the Commission," would (among other things) restore the authority of the SEC and the U.S.

Justice Department to commence civil and criminal actions against issuers and control persons whose conduct occurred in the United States or whose conduct caused effects within the United States.[1]

In addition to restoring the SEC and Justice Department's authority under the Second Circuit's conduct-and-effects test, a later provision in the Bill would require the SEC to study restoring the conduct-and-effects test or some other measure of extraterritorial application to private rights of action. The study would consider the scope of extraterritorial private actions, whether they should be limited to institutional investors, their implications for international comity, and their economic costs and benefits. The study would be due 18 months after enactment.[2]

If the conduct-and-effects test were restored as to private actions, interesting questions of retroactivity might be posed. If the legislation were made retroactive, plaintiffs might seek to reinstate civil actions and even jury verdicts eliminated or reduced by *Morrison* on the theory that the defendants could not have had any reliance interest in the inapplicability of the Exchange Act because at the time they engaged in their primary conduct the Second Circuit's conduct-and-effects test made them subject to the antifraud provisions and the subsequent legislation merely restored the *status quo ante*.

[1] Section 929P(b) would restore the extraterritorial authority of the SEC and Justice Department under the Securities Act, the Exchange Act, and the Investment Advisors Act of 1940. *Id.* § 929P(b)(1)-(3). The three subsections use the same operative language. For example, § 929P(b)(2) would amend the jurisdictional provision of the Exchange Act, § 27 (15 U.S.C. § 78aa) to add a new subsection (b):

> (b) 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.

[2] Section 929Y, "Study on Extraterritorial Private Rights of Action," would provide:

> (a) IN GENERAL.—The Securities and Exchange Commission of the United States shall solicit public comment and thereafter conduct a study to determine the extent to which private rights of action under the antifraud provisions of the Securities and Exchange Act of 1934 (10 U.S.C. 78u) should be extended to cover—
>
> (1) conduct within the United States that constitutes a significant step in the furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; and
>
> (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.
>
> (b) CONTENTS.—The study shall consider and analyze, among other things—
>
> (1) the scope of such a private right of action, including whether it should extend to all private actors or whether it should be more limited to extend just to institutional investors or otherwise;
>
> (2) what implications such a private right of action would have on international comity;
>
> (3) the economic costs and benefits of extending a private right of action for transnational securities frauds; and
>
> (4) whether a narrower extraterritorial standard should be adopted.
>
> (c) REPORT.—A report of the study shall be submitted and recommendations made to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House not later than 18 months after the date of enactment of this Act.

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The fate of the Investor Protection and Securities Reform Act of 2010 depends on the votes of a handful of Republican Senators who have said that they are considering the proposed legislation.

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Shearman & Sterling LLP represented France as *amicus curiae* in *Morrison*.

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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