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Private Securities Fraud Litigation after *Morrison v. National Australia Bank*: Reconsidering a Reliance-Based Approach to Extraterritoriality

Joshua L. Boehm

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Introduction

In June 2010, the U.S. Supreme Court issued a momentous decision in *Morrison v. National Australia Bank*, upending decades of federal appeals court precedent in transnational securities law. The Court established a bright line, transaction-based test for when Section 10(b) ("Sec. 10(b)") of the Securities Exchange Act of 1934 ("Exchange Act") can apply extraterritorially. *Morrison* essentially requires that the fraud-related transactions at issue be conducted in the United States to allow a claim for relief in U.S. courts.[1] This has had a significant impact on securities litigation because Sec. 10(b) and its implementing regulation, Rule 10b-5, provide the most common cause of action for securities fraud in the United States.[2]

This new test has resulted in a narrower field for private Sec. 10(b) litigation than that available under the dominant regime before *Morrison*, the Second Circuit's conducts and effects test ("conducts-effects").[3] Lower federal courts, principally the Southern District of New York ("SDNY"), have already cited *Morrison* to dismiss multiple Sec. 10(b) cases with a transnational element. But this effect may well be short-lived. In July 2010, with the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "DFA"), Congress restored conducts-effects for transnational securities fraud suits brought by the U.S. government, while also directing the Securities and Exchange Commission ("SEC") to conduct a study on whether and to what extent a private right of action should be extended beyond *Morrison*'s transactional test.[4]

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1. Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869 (2010).
2. Jennifer Antolini, *Securities Fraud*, 34 Am. Crim. L. Rev. 983 (1997).
3. *See* Cornwell v. Credit Suisse Grp., 729 F. Supp. 2d. 620, 620 (S.D.N.Y. 2010).
4. Dodd-Frank Wall Street Reform and Consumer Protection Act [hereinafter Dodd-Frank Act or DFA], Pub. L. No. 111-203, 124 Stat. 1376, 1376–2223 §§ 929P, 929Y (2010) (codified in scattered sections of the U.S.C.).

For years before *Morrison*, the conducts-effects test was consistently criticized on the grounds that it was overly broad and unevenly applied.[5] While *Morrison* answered those who called for predictability, the Dodd-Frank Act's partial overruling of the decision has, at least for the moment, infused this area of law with more ambiguity than it had pre-*Morrison*. Courts, shareholders, and companies will continue to operate in this uncertain state until at least early 2012, when Congress will receive the SEC's report on private rights of action and decide how to finalize the extraterritorial scope of that realm of law.[6]

The financial, legal, and even diplomatic implications of these developments are immense. Yet all ultimately relate to a fundamental tension arising from the goal of ensuring that the United States is neither a "Barbary Coast" for "international securities pirates"[7] nor a "Shangri-La of class-action litigation representing those allegedly cheated in foreign securities markets."[8] Reconciling such aims requires consideration of the ever-internationalizing nature of corporate activity and securities markets, as well as class-action litigation trends, the availability of securities fraud remedies abroad, and coherence with other areas of law in which presumptions of extraterritoriality are made.

This Article proceeds as follows. Part I covers the historical development of securities fraud jurisprudence in the United States up to *Morrison* and the Dodd-Frank Act. Part II evaluates Sec. 10(b) case law after *Morrison*, offering a critical appraisal of the way in which the transactional test has been applied in practice. Part III then endorses a hybrid approach, with conducts-effects as the baseline standard and a U.S. transaction requirement for fraud-on-the-market theories,[9] similar to several proposals advanced by *Morrison* amici but rejected by the Court.[10] Drawing lessons from post-*Morrison* case law and comments to the SEC,[11] this part suggests that this hybrid approach should address the most serious flaws of the pre-*Morrison* regime while restoring many of its benefits. Part IV concludes.

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5. *See, e.g.*, Hannah Buxbaum, *Multinational Class Actions Under Federal Securities Law: Managing Jurisdictional Conflict*, 46 Colum. J. Transnat'l L. 14, 16 (2007); Stephen J. Choi and Linda J. Silberman, *The Continuing Evolution of Securities Class Actions Symposium: Transnational Litigation and Global Securities Class-Action Lawsuits*, 2009 Wis. L. Rev. 465, 466–68; John C. Coffee, Jr., *Foreign Issuers Fear Global Class Actions*, Nat'l L.J., June 14, 2007, at 1.

6. *See* DFA § 929Y.

7. S.E.C. v. Kasser, 548 F.2d 109, 116 (3d Cir. 1977) (internal quotation marks omitted).

8. *Morrison*, 130 S. Ct. at 2886.

9. In other words, actual reliance would be required for Sec. 10(b) claims arising from foreign transactions.

10. *See* Brief for Professors and Students of the Yale Law School Capital Markets and Financial Instruments Clinic as Amici Curiae Supporting Respondents at 2, Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869 (2010) (No. 08-1191) [hereinafter "Yale Brief"]; Brief for the United States of America as Amicus Curiae Supporting Respondents at 13, 25, Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869 (2010) (No. 08-1191) [hereinafter "*Morrison* Solicitor General Brief"].

11. These comments were submitted pursuant to the SEC's study under DFA § 929Y. *See supra* note 6 and accompanying text.

I. Historical Development of U.S. Securities Fraud Jurisprudence

A. *Basis in statute and regulation*

Both of the foundational statutes in U.S. securities law, the Securities Act of 1933 ("Securities Act") and the Exchange Act, contain anti-fraud provisions that supply private causes of action. As unscrupulous securities activities were widely believed to be a contributing cause of the 1929 stock market crash, Congress wrote the anti-fraud provisions quite liberally.[12] Section 11 of the Securities Act allows for civil liability when a registration statement contains "an untrue statement of a material fact or omit[s] to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[13] Section 12(a)(2) of the Securities Act, meanwhile, creates civil liability for material omissions or misstatements in securities offerings and sales made by "means of a prospectus or oral communication,"[14] and Section 17 allows the SEC to pursue equitable relief against sellers and offerors of securities who use misleading statements.[15] These provisions apply to all issuers who are subject to Section 5 of the Securities Act, which requires that all securities be registered with the SEC unless an exemption applies.[16]

Likewise, the Exchange Act contains a number of anti-fraud provisions relating to its general focus on conduct in the markets, as distinguished from the Securities Act's general coverage of registration and disclosure matters. Section 10(b) is the most important anti-fraud provision in the Exchange Act.[17] The "overwhelming majority" of class actions based on securities fraud claims, including transnational cases, are filed under this provision.[18] To give rise to a cause of action under Rule 10b-5, a defendant must have made, with scienter, a material omission or misrepresentation connected with the purchase or sale of a security, causing economic loss to the plaintiff due to reliance on that omission or misrepresentation.[19] It is

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12. Alan Palmiter, Securities Regulation: Examples and Explanations 528 (4th ed. 2008).
13. Securities Act of 1933 [hereinafter "Securities Act"] § 11, 15 U.S.C.A. § 77k (West 2010).
14. 15 U.S.C.A. § 77l(a)(2) (West 2010).
15. 15 U.S.C.A. § 77q (West 2010).
16. Securities Act § 5(a), 15 U.S.C.A. § 77e(a) (West 2010).
17. Securities Exchange Act of 1934 [hereinafter "Exchange Act"] § 10(b), 15 U.S.C.A. § 78j(b) (West 2010).
18. Amanda Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 Colum. L. Rev. 1301, 1302 (2008).
19. Rule 10b-5, 17 C.F.R. § 240.10b-5 (2010) (promulgated pursuant to the Exchange Act). 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

also important to note that Rule 10b-5 still applies to foreign issuers that obtain a safe harbor from the SEC's registration and disclosure requirements under Section 5 of the Securities Act.[20] The basic idea behind these safe harbors—principally, Regulation S and Rule 144A—is that when securities activity is sufficiently removed from the United States, economic efficiency and international comity warrant some exemption from the Securities Act, which can otherwise be quite expensive to comply with.

Moreover, Congress failed to indicate in either the Securities or the Exchange Act how far the securities laws were intended to reach. Section 27 of the Exchange Act gives federal courts jurisdiction over suits "brought to enforce any liability or duty created by [the Exchange Act] or the rules or regulations thereunder," without mentioning geographical scope.[21] While the text of Sec. 10(b) is likewise silent on extraterritorial limits, its jurisdictional hook—"interstate commerce"—provides a hint: Sec. 10(b)'s definition of "interstate commerce" includes commerce "between any foreign country and any State."[22] There is also some evidence of scope in the Exchange Act's description of purpose, which notes briefly that "prices established and offered in [certain] transactions are generally disseminated and quoted throughout the United States and foreign countries."[23] Finally, Section 30(b) of the Exchange Act provides that neither the Act nor its implementing regulations shall apply "to any person insofar as he transacts a business in securities without the jurisdiction of the United States, unless he does so in violation of regulations promulgated by the Securities and Exchange Commission to prevent . . . evasion of [the Act]."[24] Notwithstanding these clues, lower federal courts have generally interpreted the securities laws to be silent on extraterritorial application.[25]

B. *Second Circuit doctrine*

Just as the SEC has engaged in rulemaking and enforcement in order to delineate the extraterritorial bounds of the Securities and Exchange Acts' anti-fraud provisions, so too have federal courts. The U.S. Court of Appeals for the Second Circuit has played the principal role in shaping this jurisprudence; because it encompasses New York City, it has had the opportunity to hear a disproportionate number of securities fraud cases. In the four decades prior to *Morrison*, the Second Circuit gave shape to two largely separate, but

(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."

20. Kun Young Chang, *Multinational Enforcement of U.S. Securities Laws: The Need for the Clear and Restrained Scope of Extraterritorial Subject-Matter Jurisdiction*, 9 FORDHAM J. CORP. & FIN. L. 89, 94–95 (2003).

21. 15 U.S.C.A. § 78aa (West 2010).

22. Exchange Act § 3(a)(17), 15 U.S.C.A. § 78c(a)(17) (West 2010).

23. Exchange Act § 2(2), 15 U.S.C.A. § 78b(2) (West 2010).

24. Exchange Act § 30(b), 15 U.S.C.A. § 78dd(b) (West 2010).

25. *Morrison*, 130 S. Ct. at 2878.

occasionally intertwined, doctrines for determining whether it had jurisdiction to hear a certain extraterritorial Sec. 10(b) claim: "conducts" and "effects." Even though *Morrison* has explicitly overruled these tests, because Congress has now restored them for government actions—and will potentially do so, at least partially, for private actions—a discussion of how conducts-effects developed is essential for understanding how those doctrines compare with the new *Morrison* regime.[26]

The effects test centers on foreign conduct that has an adverse effect on U.S. markets, investors, or both. The Second Circuit first articulated this doctrine in the 1968 case *Schoenbaum v. Firstbrook*.[27] In that case, a U.S. plaintiff who held shares in a Canada-based company brought suit against the company under Sec. 10(b), alleging that directors had failed to disclose material information in order to sell shares at an artificially low price. The plaintiff successfully argued that jurisdiction was proper because the fraud-induced sale had sufficient effects in the United States by decreasing the value of the company's shares on U.S. markets, even though it took place between Canadian sellers and buyers in Canada.[28]

The court gave two related reasons for extending jurisdiction here, and its analysis became the foundation of the effects test. First, the court noted that Congress would have wanted the Exchange Act to reach overseas when necessary to protect American investors who purchased foreign companies' stock on American exchanges, irrespective of where the underlying fraudulent conduct or transaction took place.[29] Second, the court flagged the U.S. regulatory interest in protecting the U.S. securities market from the impact of fraudulent foreign transactions in American securities.[30] Over time, the Second Circuit has attempted to sharpen the edges of the effects test. In a 1975 case, *Bersch v. Drexel Firestone, Inc.*, the court clarified that subject matter jurisdiction over fraudulent acts committed abroad only exists when the acts "result in injury to purchasers or sellers of those securities in whom the United States has an interest, not where acts simply have an adverse effect on the American economy or American investors generally."[31]

The conduct test, by contrast, focuses on the underlying activity that caused the alleged fraud. The Second Circuit first outlined this test in a 1972 case, *Leasco Data Processing Equipment Corp. v. Maxwell*.[32] In *Leasco*, a

26. The *Morrison* Court clarified that the question of Sec. 10(b)'s extraterritorial reach is a merits issue (i.e., an issue that concerns the substantive limits of the statute). Previously, the federal courts consistently treated it as a subject matter jurisdiction issue. *See* Genevieve Beyea, *Morrison v. National Australia Bank and the Future of Extraterritorial Application of the U.S. Securities Laws*, 72 Ohio St. L.J. 537, 546–47 (2011). This Article will discuss pre-*Morrison* cases in jurisdictional terms, as originally decided; it will not undertake counterfactual analysis of how those cases would have been resolved on a merits basis.

27. 405 F.2d 200, 204–08 (2d Cir. 1968).

28. *Id.*

29. *Id.* at 206.

30. *Id.* at 207–09.

31. Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 989 (2d Cir. 1975).

32. 468 F.2d 1326 (2d Cir. 1972).

group of U.S. and U.K. plaintiffs alleged that U.K. defendants had deceived them into buying stock of a U.K. corporation at inflated prices.[33] The critical factor was that "significant conduct" in furtherance of the fraud occurred in the United States; it did not necessarily matter, in the court's view, whether U.S. shareholders or foreign shareholders ultimately incurred the fraud-induced loss.[34]

Judge Henry Friendly elaborated on the rationale for this test, as well as the proper limit of "significant conduct," in an important case three years later, *IIT v. Vencap, Ltd.*[35] This case centered on a number of transaction-related activities that a Bahama-based corporation executed in the United States.[36] Making an explicit attempt to address Congress's silence on the extraterritorial scope of the Exchange Act, Judge Friendly reasoned that Congress must not have wanted the United States "to be used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners."[37] The "significant conduct" threshold was clearly passed in that case, according to Judge Friendly, as the U.S.-based activity effectively encompassed the entirety of the fraudulent activity.[38]

Bersch serves as a jurisprudential bookend to *Vencap* in defining the conduct test.[39] In *Bersch*, the fraud centered on a securities prospectus that contained allegedly misleading information; while it was partially drafted in the United States, every other part of its production, issuance, and distribution took place in Canada.[40] But in contrast to *Vencap*, the court in *Bersch* concluded that the alleged activity was "merely preparatory" and thus fell short of the "significant conduct" barrier. Judge Friendly's rationale, which, as in *Vencap*, reflects a deeply purposivist inquiry, was that Congress would not have "wished the precious resources of United States courts and law enforcement agencies to be devoted to them rather than leave the problem to foreign countries."[41]

To complicate matters further, the Second Circuit has not always applied the conducts and effects tests in a distinct manner. Occasionally, it has found that some mixture of the two tests can give rise to jurisdiction, as in *Itoba Ltd. v. Lep Group P.L.C.*[42] In that case, a foreign issuer's filing of Form 20-F in the United States, along with evidence that the fraudulent conduct had some effect on U.S. markets, was enough to support jurisdiction for an F-cubed claim even though the foreign investors had not read that form and

33. *Id.* at 1330.
34. *Id.* at 1334.
35. 519 F.2d 1001, 1004 (2d Cir 1975).
36. *Id.*
37. *Id.* at 1017.
38. *Id.* at 1018.
39. *See Bersch*, 519 F.2d at 974.
40. *Id.* at 978–80.
41. *Id.* at 985.
42. 54 F.3d 118 (2d Cir. 1995).

only bought the issuer's common shares on a foreign exchange.[43] The court explained that even where conducts or effects alone would not warrant jurisdiction, "an admixture or combination of the two often gives a better picture of whether there is sufficient United States involvement" to exercise jurisdiction.[44]

However, the court chose not to specify any working guidelines for how the effects and conducts tests ought to be applied when used in concert. Despite this ambiguity, it seems that allowing the possibility of a hybrid conducts-effects regime would necessarily work in favor of plaintiffs; as a logical matter, if a plaintiff could satisfy either conducts or effects alone, the court could presumably settle the jurisdictional question without invoking the hybrid test.[45]

C. Three-way circuit split

Although the Second Circuit took the lead in developing Sec. 10(b) jurisprudence, not all circuits followed in lockstep. The principal divergence was in how the conduct test was interpreted and applied. The Fifth and Seventh circuits largely adopted the Second Circuit's approach, holding that the U.S. conduct must have a direct causal relationship to the ultimate loss. The Fifth Circuit explicitly adopted the Second Circuit test in *Robinson v. TCI/US W. Communications, Inc.*,[46] whereas the Seventh Circuit, in *Kauthar SDN BHD v. Sternberg*, held that the U.S. conduct must form a "substantial part of the alleged fraud and is material to its success."[47] This language echoes the "substantial conduct" threshold that Judge Friendly set forth in *Vencap*.

Meanwhile, the Third Circuit adopted an even more permissive test, holding in a 1977 case, *S.E.C. v. Kasser*, that the conduct test could allow for jurisdiction when "at least some activity designed to further a fraudulent scheme" occurred in the United States.[48] Two years later, the Eighth Circuit adopted a similar, but somewhat stronger, test, finding that U.S. conduct could give rise to jurisdiction when it was "in furtherance of a fraudulent scheme and was significant with respect to its accomplishment."[49] In a 1983 case, the Ninth Circuit considered these tests to be substantially similar in adopting "the test used by the Third and Eighth Circuits" on the grounds that it most closely comported with the policies and purpose of the securities laws.[50] Both the Third Circuit's "some activity" threshold and the Eighth Circuit's "significant" benchmark were facially more plaintiff-

43. *Id.* at 122, 125.
44. *Id.* at 122.
45. Julie Rubenstein, Note, *Fraud on the Global Market: U.S. Courts Don't Buy It; Subject-Matter Jurisdiction in F-Cubed Securities Class Actions*, 95 Cornell L. Rev. 627, 640 (2010).
46. 117 F.3d 900, 906 (5th Cir. 1997).
47. 149 F.3d 659, 667 (7th Cir. 1998).
48. 548 F.2d 109, 114 (3d Cir. 1977).
49. Cont'l Grain (Austl.) Pty Ltd. v. Poe Oilseeds, Inc., 592 F.2d 409, 421 (8th Cir. 1979).
50. Grunenthal GmbH v. Hotz, 712 F.2d 421, 424 (9th Cir. 1983).

friendly than the "substantial" requirement imposed by the Second Circuit and its brethren. It is important to note, though, that the Third Circuit's case involved a suit brought by the SEC, not a private plaintiff; this distinction remains relevant to the current policy debate over how far to extend private rights.

On the other end of the spectrum, the D.C. Circuit adopted an arguably more stringent version of the conducts test in an F-cubed setting, holding in *Zoelsch v. Arthur Andersen & Co.* that the U.S. conduct must itself be tantamount to a securities law violation to allow a foreign plaintiff to file suit.[51] Some commentators, though, have argued that the holding in *Zoelsch* is effectively in line with the Second Circuit's reasoning in *Bersch*.[52] On this view, the D.C. Circuit did not necessarily split from the Second Circuit, but rather endorsed a narrower conducts test.

Ultimately, the number and variety of approaches between circuits created a confusing and unpredictable landscape for companies to navigate. Indeed, the Supreme Court in *Morrison* focused intensely on this problem, noting that it had been the target of much scholarly criticism.[53] Justice Scalia remarked that in trying to follow the Second Circuit's lead, other circuits applied "the same fundamental methodology of balancing interests and arriving at what seemed the best policy" but in doing so "produced a proliferation of vaguely related variations on the 'conduct' and 'effects' tests."[54]

D. The Morrison *litigation*

Morrison was an F-cubed case brought on a "conduct test" theory of subject matter jurisdiction. National Australia Bank ("NAB") had bought HomeSide, a Florida-based mortgage servicer, in 1998, and for several years thereafter HomeSide's executives allegedly manipulated the subsidiary's financial models to make the probability of early repayment artificially low, making their mortgage servicing rights seem more valuable, and submitted that information to NAB's Australia headquarters.[55] NAB's Australia-based executives were also allegedly aware of this fraud, but nonetheless included HomeSide's inflated value in NAB's annual reports from 1998–2001, touting HomeSide's success in other public statements as well.[56] After NAB announced several write-downs relating to HomeSide in late 2001, amounting to over two billion U.S. dollars, several Australia-based shareholders who had bought NAB stock in Australia filed suit.[57]

51. 824 F.2d 27, 35–36 (D.C. Cir. 1987).
52. *See, e.g.*, Chang, *supra* note 20, at 97.
53. *Morrison*, 130 S. Ct. at 2880 (citing academic articles critical of the conducts-effects test).
54. *Id.*
55. *Id.* at 2875–76.
56. *Id.*
57. *Id.* at 2876.

The Second Circuit concluded that the U.S.-based conduct was not "at the heart of the fraud" in *Morrison* and thus insufficient to support jurisdiction.[58] Whereas HomeSide's mandate was "to run its business well and make money," it was NAB's Australia-based executives' responsibility to oversee operations and report to shareholders. In the court's view, NAB's oversight shortcomings were "significantly more central to the fraud and more directly responsible for the harm to investors than the manipulations of the numbers in Florida."[59]

The court also declined to establish a bright-line transactional test, citing several related concerns. First, it felt that it could not "anticipate all the circumstances in which the ingenuity of those inclined to violate the securities laws should result in their being subject to American jurisdiction."[60] Second, it reiterated Judge Friendly's policy rationale from *Vencap*, stating that the "United States should not be seen as a safe haven for securities cheaters; those who operate from American soil should not be given greater protection from American securities laws because they carry a foreign passport or victimize foreign shareholders."[61] Finally, the court downplayed the danger that its conduct test would cause conflicts of law, arguing that such conflicts are less problematic for issues of fraud, for which enforcement objectives are "broadly similar" between countries, than for provisions such as registration, for which requirements "may widely vary."[62]

The Supreme Court disagreed sharply with the Second Circuit's analysis. The majority opinion, written by Justice Scalia and joined by Chief Justice Roberts and Justices Kennedy, Thomas, and Alito, first clarified that Sec. 10(b)'s extraterritorial reach is a merits question, not a matter of subject matter jurisdiction.[63] The Court then held that Sec. 10(b) does not provide a cause of action to foreign plaintiffs suing either U.S. or foreign defendants for allegedly fraudulent activity relating to securities traded on foreign exchanges.[64] This conclusion flowed from the interpretive canon that presumes no extraterritorial application when a statute is silent on the matter; there was no reason, in the Court's view, for the Second Circuit to persistently refuse to apply that canon.[65] It considered the principal arguments for why Congress may have intended some extraterritorial application of Sec. 10(b),

58. Morrison v. Nat'l Austl. Bank Ltd., 547 F.3d 167, 176 (2d Cir. 2008).

59. *Id.* at 175.

60. *Id.*

61. *Id.*

62. *Id.*

63. *Morrison*, 130 S. Ct. at 2877. Because nothing in the lower courts' analysis in this case turned on the mistake, the Court opined that a remand would only require a "new label" for the "same conclusion." *Id.* That is, the remand would also result in dismissal, but simply for failure to state a claim rather than for lack of subject matter jurisdiction. Following prior practice, then, the Court proceeded with an analysis of whether petitioners properly stated a claim under Sec. 10(b). *Id.* (citing Romero v. Int'l Terminal Operating Co., 358 U.S. 354, 359, 381–84 (1959)).

64. *Id.* at 2883.

65. *Id.* at 2878.

including references to foreign commercial activity in several sections of the Exchange Act, and reasoned that none of them were sufficiently compelling to allow federal courts to conduct ad hoc inquiries as to what Congress would have wanted in any given case.[66]

This chain of logic led to the core holding in *Morrison*: that Sec. 10(b) applies "only to transactions in securities listed on domestic exchanges and domestic transactions in other securities."[67] The Exchange Act, according to the Court, focuses not on the place of deception, but on "purchases and sales" of securities in the United States, as suggested by various textual indicia in the Act's prologue and several other provisions, thus warranting the transaction-oriented test.[68] It is the "rare case of prohibited extraterritorial application," the Court continued, that lacks all contact with U.S. territory.[69] Further, because the SEC's interpretations of Sec. 10(b)'s extraterritoriality were based on Second Circuit jurisprudence, rather than an independent analysis of the statute, the Supreme Court refused to afford *Chevron* deference to the SEC.[70]

Justice Stevens wrote a concurrence in the judgment, joined by Justice Ginsburg, which advocated retention of the conducts-effects test. Justice Stevens emphasized the well-established nature of the Second Circuit's Sec. 10(b) jurisprudence, endorsing a prior Supreme Court case that found that "the longstanding acceptance by the courts, coupled with Congress' failure to reject [its] reasonable interpretation of the wording of Sec. 10(b) . . . argues significantly in favor of the acceptance of the [Second Circuit] rule by this Court."[71] Justice Stevens also criticized the majority's invocation of the presumption against extraterritoriality, asserting that it sought "to transform the presumption from a flexible rule of thumb into something more like a clear statement rule."[72] As evidence of this goal, he cited Justice Scalia's categorical statement that "when a statute gives no clear indication of an extraterritorial application, it has none."[73] In Justice Stevens' view, the presumption is more properly used as a "background norm" or "tiebreaker" but does "not relieve courts of their duty to give statutes the most faithful reading possible."[74]

66. *Id.* at 2878–79.
67. *Id.* at 2884.
68. *Id.*
69. *Id.*
70. *Id.* at 2887–88. The current *Chevron* doctrine sets forth a two-step analytical framework for judicial review of statutory interpretation by agencies. The first step concerns the plausibility of the agency's interpretation on the merits, while the second step concerns the reasonableness of the agency's decision-making process. *See* Chevron, U.S.A., Inc. v. Natural Resources Def. Council, Inc., 467 U.S. 837, 843 (1984).
71. *Morrison*, 130 S. Ct. at 2891 (Stevens, J., concurring).
72. *Id.*
73. *Id.* at 2892.
74. *Id.*

Justice Stevens set forth several interesting hypotheticals to illustrate how the majority's transactional test might not be consistent with congressional intent.[75] In one hypothetical, an American investor buys shares in a company that is listed only on a foreign exchange, but that has a major New York-based subsidiary in which a massive fraud was hatched and carried out; the investor would not be able to bring a Sec. 10(b) claim against that company in U.S. federal district court.[76] According to Justice Stevens, "the oddity of that result should give pause," as it indicates that the transactional test "narrows [Sec. 10(b)'s] reach to a degree that would surprise and alarm generations of American investors . . . [and] the Congress that passed the Exchange Act."[77] The hypothetical further illustrates how the transactional test can withdraw Sec. 10(b)'s application "from cases in which there is *both* substantial wrongful conduct that occurred in the United States *and* a substantial injurious effect on United States markets and citizens," thus turning the presumption against extraterritoriality "on its head."[78]

E. The Dodd-Frank Act

In July 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, the most sweeping financial reform legislation since the Great Depression. The two sections of the Dodd-Frank Act pertinent to the extraterritorial reach of Sec. 10(b), as noted above, are Sections 929P and 929Y. Section 929P, "Strengthening Enforcement by the Commission," addresses the securities laws' anti-fraud provisions in subsection (b), which is entitled "Extraterritorial Jurisdiction of the Antifraud Provisions of the Federal Securities Laws." Section 929(P)(b)(2) contains the provisions relevant to the Exchange Act:

> UNDER THE SECURITIES EXCHANGE ACT OF 1934.—Section 27 of the Securities Exchange Act of 1934 (15 U.S.C. 78aa) is amended—
> (A) by striking "The district" and inserting the following: "(a) IN GENERAL.—The district"; and
> (B) by adding at the end the following new subsection: "(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

75. *See id.* at 2893, 2895.
76. *Id.* at 2895.
77. *Id.*
78. *Id.* (emphasis in original). Justice Breyer wrote a separate, very short concurrence, in which he effectively agreed with the majority's interpretation of how the presumption against extraterritoriality ought to apply to Sec. 10(b), while remarking that the facts of *Morrison* "[do] not require us to consider other circumstances [beyond the presumption against extraterritoriality]." *Id.* at 2888 (Breyer, J., concurring). Justice Sotomayor took no part in the judgment.

> 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."[79]

In a June 30, 2010, floor statement in the U.S. House of Representatives, Rep. Paul Kanjorski, who was then Chairman of the House Financial Services Committee, addressed the purpose of Section 929P(b) as drafted in his committee. He noted that the bill's provisions concerning the foreign scope of Sec. 10(b) are "intended to rebut" the presumption against extraterritoriality in *Morrison* "by clearly indicating that Congress intends extraterritorial application in cases brought by the SEC or the Justice Department."[80]

But the Supreme Court in *Morrison* held that the issue of Sec. 10(b)'s extraterritorial application is a question of substantive statutory scope—not subject matter jurisdiction, which is what Congress was addressing in Section 929P(b). If read strictly to cover jurisdiction, Section 929P(b) would be effectively superfluous, since the Supreme Court also held in *Morrison* that U.S. district courts do have subject matter jurisdiction over extraterritorial actions brought under Sec. 10(b) of the Exchange Act. That fact, taken with the principal drafter's expressed intent to overrule *Morrison* and restore conducts-effects for SEC and Department of Justice ("DOJ") actions, suggests that the phrasing of Section 929P(b) is erroneous.

Obviously, it would be ideal for Congress to fix this error on its own initiative, and some commentators have insisted that *Morrison*'s holding should remain unaltered until it does so.[81] For its part, the SEC seems to have assumed its restored authority under DFA Section 929P without acknowledging the drafting error, as evinced by its request for comments per DFA Section 929Y.[82] The SEC's position is ultimately the more reasonable one: there is ample evidence of congressional intent for courts, agencies, and affected parties to proceed as if Section 929P(b) has restored the conducts-effects test for the SEC and the DOJ.[83]

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79. DFA § 929(P)(b)(2).

80. 156 CONG. REC. H5237 (daily ed. Jun. 30, 2010) (statement of Rep. Kanjorski).

81. *See* George T. Conway III, *Extraterritoriality after Dodd Frank*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 5, 2010, 8:58 AM), http://blogs.law.harvard.edu/corpgov/2010/08/05/extraterritoriality-after-dodd-frank/.

82. SECURITIES AND EXCHANGE COMM'N, STUDY ON EXTRATERRITORIAL PRIVATE RIGHTS OF ACTION, Rel. No. 34-63174, File No. 4-617 (Oct. 25, 2010) at 2, *available at* http://www.sec.gov/rules/other/2010/34-63174.pdf.

83. Professor Richard Painter and several colleagues argue that the SEC would likely prevail if challenged on this point, yet emphasize that Congress should nonetheless fix this error so as to save unnecessary burdens of litigation. Richard Painter et al., *When Courts and Congress Don't Say What They Mean: Initial Reactions to Morrison v. National Australia Bank and the Extraterritorial Jurisdiction Provisions of the Dodd-Frank Act*, 20 MINN. J. INT'L L. 1, 24–25 (2011).

In DFA Section 929Y, as noted above, Congress directed the SEC to solicit comments and conduct a study on the extent to which the conducts-effects test should be restored for private anti-fraud actions under the Exchange Act.[84] Congress also set forth particular areas for consideration and analysis, including whether the private right of action should be limited by the type of actor (e.g., institutional investors), how the right would affect international comity, what the economic costs and benefits of the right would be, and whether a narrower extraterritorial standard ought to be adopted.[85] The SEC has already collected public comments and must submit the results of the study, along with its recommendations, to the Senate Banking Committee and House Financial Services Committee by December 2011.[86]

II. Application of *Morrison* in Subsequent Cases

Since *Morrison* was handed down, lower federal courts have applied the new transactional test to dozens of complex and varied factual scenarios.[87] While some cases have been straightforward, a surprisingly high number, especially in the over-the-counter ("OTC") (i.e., off-exchange) context, have presented difficult, circumstance-dependent questions that courts have struggled to answer consistently. This is likely an unintended but unsurprising consequence of the Supreme Court's decision to issue such a far-reaching rule in *Morrison*. Because *Morrison* involved transactions on a securities exchange, the litigation offered little insight to the justices as to how their rule might work in off-exchange situations.

More broadly, as the following discussion will show, practical application of the transactional test has not only created conflicts with a core purpose of the U.S. securities laws—to protect American markets and investors—but has also revealed tensions within the Supreme Court's own reasoning in *Morrison*. It has frequently proven difficult for courts to maintain fidelity to *Morrison*'s bright-line approach without coming to a result that is over- or under-inclusive with regard to Sec. 10(b), on one extreme allowing for dismissal when the only foreign aspect of a case was the execution of a transaction (raising concerns about U.S. investor protection), and on the other extreme broadening the reach of Sec. 10(b) in several cases beyond what

84. DFA § 929Y(a).

85. DFA § 929Y(b).

86. DFA § 929Y(c).

87. *See In re* Royal Bank of Scot. Grp. P.L.C. Sec. Litig., 765 F. Supp. 2d 327 (S.D.N.Y. 2011); Absolute Activist Value Master Fund Ltd. v. Homm, No. 09 CV 08862 (GBD), 2010 WL 5415885 (S.D.N.Y. Dec. 22, 2010); Elliott Assocs. v. Porsche Automobil Holding SE, 759 F. Supp. 2d 469 (S.D.N.Y. 2010); Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co., 753 F. Supp. 2d 166 (S.D.N.Y. 2010); *In re* Societe Generale Sec. Litig., No. 08 Civ. 2495 (RMB), 2010 WL 3910286 (S.D.N.Y. Sept. 29, 2010); *In re* Alstom SA Sec. Litig., 741 F. Supp. 2d 469 (S.D.N.Y. 2010); Terra Secs. ASA Konkursbo v. Citigroup, Inc., 740 F. Supp. 2d 441 (S.D.N.Y. 2010); Sgalambo v. McKenzie, 739 F. Supp. 2d 620 (S.D.N.Y. 2010); Cornwell v. Credit Suisse Grp., 729 F. Supp. 2d 620 (S.D.N.Y. 2010).

conducts-effects would have allowed (thus conflicting with the spirit of *Morrison*, if not its literal terms). Ultimately, this discussion should raise doubts about the appropriateness of a bright-line test to govern the extraterritorial application of Sec. 10(b) and demonstrate the need for flexibility in the complicated and ever-evolving landscape of securities trading.

This section will first consider how *Morrison*'s two prongs (covering "domestic" on-exchange and OTC transactions, respectively) have been interpreted thus far. It then analyzes *Morrison*'s impact in several specific Sec. 10(b) litigation scenarios. Finally, it discusses how *Morrison* has affected other provisions in the securities laws, as well as statutes outside the securities regime that are silent on extraterritorial reach but have nonetheless been applied abroad.

A. Morrison*'s first prong: transactions on domestic exchanges*

In providing that Sec. 10(b) applies only to "transactions in securities listed on domestic exchanges" in *Morrison*'s first prong,[88] the Supreme Court left an ambiguity that lower courts would immediately confront. In the SDNY case *In re Alstom SA Securities Litigation*, the plaintiffs argued that even though their purchases of defendants' securities had taken place overseas, the fact that those securities were also listed on the New York Stock Exchange ("NYSE") was sufficient to satisfy *Morrison*'s first prong.[89] The court found this to be a "selective and overly technical reading of *Morrison* that ignores the larger point of the decision."[90] In eschewing the first prong's literal reading in favor of its "most natural and elementary reading," the court cited several sections of *Morrison* that revealed a "focus on where the securities transaction actually occurs, not the stock exchange where ministerial pre-purchase activities were directed."[91]

This reading almost certainly reflects Justice Scalia's true intent: the first prong of *Morrison* appears to have been inaccurately phrased, warranting this correction by the lower courts. Otherwise, Sec. 10(b) would allow plaintiffs who bought securities on any exchange to bring suit in the United States if the issuer had U.S. cross-listed shares, thus effectively rendering the extraterritorial reach of Sec. 10(b) broader than it had been under the conducts-effects regime (under which such suits would likely be dismissed). Indeed, subsequent case law has corroborated *In re Alstom* in making this correction.[92]

Shortly after *In re Alstom*, another SDNY case, *Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.*, further trimmed the first prong of

88. *Morrison*, 130 S. Ct. at 2884.
89. *See* 741 F. Supp. 2d at 471–72.
90. *Id.* at 472.
91. *Id.*
92. *See Royal Bank of Scot.*, 765 F. Supp. 2d at 336; *In re* UBS Sec. Litig., No. 07 Civ. 11225 (RJS), 2011 U.S. Dist. LEXIS 106274, at *15-16 (S.D.N.Y. Sept. 13, 2011).

Morrison. In *Plumbers' Union*, the U.S.-based plaintiff had placed a buy order for Swiss Re shares through traders in Chicago.[93] The order was executed, cleared, and settled electronically on a London-based trading platform that was a subsidiary of the SX Swiss Exchange. A placement of an electronic order in the United States that is ultimately executed abroad, according to the court, falls short of *Morrison*'s transactional threshold.[94] This holding, by virtue of its sharp focus on the exchange's location, seems to impose a potentially substantial burden on U.S. securities purchasers, particularly retail-type buyers who would be likely to use brokers. To retain the possibility of bringing a Sec. 10(b) claim against an issuer in U.S. court, those buyers must make an affirmative effort to ensure that their brokers execute buy orders on U.S. exchanges.

Courts have also rejected nationality-related arguments by American investors seeking a Sec. 10(b) remedy for securities purchases abroad. In one of the first post-*Morrison* cases, *Cornwell v. Credit Suisse*, an SDNY judge dismissed a case brought by American investors in Credit Suisse who had alleged that the firm understated how severely it was hit by the subprime mortgage crisis and misrepresented the robustness of its risk management framework.[95] The court held that the transactional test is indifferent to whether plaintiffs are American or to whether certain elements of the transaction occurred in the United States; all that matters is whether the actual purchase of securities took place on a U.S. exchange. He further opined that the "conduct and effect" analysis is now "dead letter" and that the plaintiffs' "cosmetic touch-ups will not give the corpse a new life," thus creating a high bar to equitable circumventions of *Morrison*'s transactional test.[96]

While *Morrison*'s first prong seems relatively straightforward when interpreted in light of Justice Scalia's broader opinion, there remain other potential tensions that have yet to emerge in the case law. Most notably, it is unclear how a court would define "domestic exchange" in circumstances where a U.S. stock exchange somehow became affiliated with a foreign exchange, whether by merger, acquisition, joint venture, or otherwise. This is more than a theoretical possibility: currently, the Deutsche Boerse (based in Germany) has a pending merger agreement with the NYSE.[97] If courts were to apply the Supreme Court's new "nerve center test" for determining the geographic location of such entities, as set forth in *Hertz Corp. v. Friend*, it is conceivable that all exchange-based transactions through an international conglomerate could be deemed outside the reach of Sec. 10(b) if the place where the corporate officers "direct, control, and coordinate" the group's

93. *See* 753 F. Supp. 2d at 172.
94. *Id.* at 178.
95. 729 F. Supp. 2d. at 621.
96. *Id.* at 622.
97. *Deutsche Boerse Shareholders Approve Proposed Combination with NYSE Euronext*, NYSE Euronext, Jul. 15, 2011, http://www.nyse.com/press/1310724336979.html. As of October 5, 2011, the combination remains subject to regulatory approval and other closing conditions.

activities is foreign.[98] By making the location of the exchange's corporate headquarters dispositive, this approach could bar Sec. 10(b) remedies in a number of scenarios where substantial U.S. regulatory interests are implicated.

Alternatively, courts might look to the particular subsidiary or unit through which transactions were executed, but this could entail a very difficult, case-by-case evaluation of exchange execution systems, given the electronic nature of much securities trading. This approach could also render Sec. 10(b) under-inclusive, should an international exchange conglomerate decide to execute most or all of its transactions on electronic systems located outside of the United States.

B. Morrison*'s second prong: domestic over-the-counter transactions*

Morrison's second prong, "domestic transactions in other securities," focuses on OTC transactions (i.e., those that are not conducted on an exchange) and will likely prove more challenging to courts than the exchange-oriented first prong.[99] Although the transactional bright-line rule presents some complexities in the exchange trading context, as discussed above, OTC transactions are much more decentralized and can take myriad forms.[100] And as the SDNY has pointed out, *Morrison* was "largely silent regarding how lower courts should determine whether a purchase or sale is made in the United States."[101] Unlike exchange transactions, moreover, it is often unclear when an OTC purchase or sale occurs, thus creating an additional question for courts to answer before they can consider the actual location of the transaction.[102]

The district court dismissal and appellate court reversal in *Quail Cruises Ship Management Ltd. v. Agencia de Viagens CVC Tur Limitada* illustrates the difficulty of establishing a workable standard in this area. In *Quail Cruises*, a plaintiff trying to avoid dismissal in U.S. court argued that even though the transaction agreement at issue had been signed in Spain and Uruguay, the closing was structured to take place in a Miami law firm (by the parties' mailing of stock transfer certificates to that office).[103] The district court endorsed the defendants' argument that it would be inconsistent with *Morrison*

98. 130 S. Ct. 1181, 1192 (2010).

99. *See Morrison*, 130 S. Ct. at 2884.

100. These include, for instance, Regulation D private placements, Regulation S sales, and various equity derivative transactions. The latter two transaction types will be discussed later in this section, with respect to litigation in which they are implicated. Regulation D private placements allow a foreign issuer to privately place securities in the United States while being exempt from registration requirements of Sec. 5 of the Securities Act. As Professor Genevieve Beyea has argued, these transactions would likely be subject to Sec. 10(b) liability under *Morrison*'s second prong. Beyea, *supra* note 26, at 569.

101. S.E.C. v. Goldman Sachs & Co. and Fabrice Tourre [hereinafter *Tourre*], No. 10 Civ. 3229(BSJ)(MHD), 2011 U.S. Dist. LEXIS 62487, at *24 (S.D.N.Y. June 10, 2011).

102. Basis Yield Alpha Fund v. Goldman Sachs Grp., Inc., No. 10 CV 4537(BSJ)(DCF), 2011 U.S. Dist. LEXIS 80298, at *10 (S.D.N.Y. July 20, 2011).

103. 732 F. Supp. 2d 1345, 1349 (S.D. Fla. 2010).

to allow parties to "elect United States securities law merely by designating the law offices of one of the parties' counsel, located in the United States, as the place of closing the transaction when the transaction otherwise has no relation to the United States."[104] On appeal, however, the Eleventh Circuit disagreed, noting that because *Morrison* was "based exclusively on the location of the purchase or sale of the security," the plaintiff's allegation that the sale formally closed in Miami was enough to survive a motion to dismiss.[105] Even if it comports more closely with a literal reading of *Morrison*, the Eleventh Circuit's holding demonstrates potential inflexibility in the transactional test that could be manipulated by sophisticated parties. It also appears incongruent with the broader intent in *Morrison*, given that *Quail Cruises* would likely have been dismissed under conducts-effects, and thus reflects an instance where the transactional test has arbitrarily broadened Sec. 10(b)'s extraterritorial reach.

Confronting similar complexity in various OTC cases post-*Morrison*, the SDNY now appears to be converging on an "irrevocable liability" standard for determining the geographical location of a transaction for purposes of *Morrison*'s second prong. That is, as the court in *Basis Yield Alpha Fund v. Goldman Sachs & Co.* recently held, "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."[106] This formulation has strong foundations in both the statutory text of the Exchange Act and case law, as reviewed by the court in *Plumbers' Union*.[107]

But *S.E.C. v. Goldman Sachs & Co. and Fabrice Tourre* ("*Tourre*"), a prominent case decided in July 2011, demonstrates how the "irrevocable liability" standard may be in tension with *Morrison*'s plain terms. Fabrice Tourre, a New York-based employee of Goldman, was charged[108] with securities fraud in making a collateralized debt obligation ("CDO") sale to German buyers under Regulation S in 2007.[109] The SEC argued that the transaction effec-

104. *Id.* at 1350.

105. Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens C.V.C. Tur Limitada, 645 F.3d 1307, 1310 (11th Cir. 2011).

106. 2011 U.S. Dist. LEXIS 80298, at *10. In *Basis Yield*, a Cayman Islands-based mutual fund bought $100 million worth of collateralized debt obligation ("CDO") securities from a Goldman Sachs-controlled entity in the Caymans via a credit-default swap ("CDS") transaction structure. After the securities dropped precipitously in value, prompting Goldman to issue massive margin calls under the CDS contract that drove the mutual fund into insolvency, the mutual fund alleged that Goldman had misrepresented the risk in pitching the investment. But because the plaintiff failed to adequately allege a purchase in the United States, as its allegations focused instead on fraudulent statements made by Goldman officials in the United States, the district court dismissed the suit under *Morrison*.

107. *See* 753 F. Supp. 2d at 177 (analyzing how the definition of "purchase" in Sec. 3 of the Exchange Act had been interpreted by the Second Circuit and Supreme Court in earlier case law).

108. The SEC also charged Tourre with Sec. 10(b) violations arising from sales to a U.S. plaintiff, which the court refused to dismiss. *Tourre*, 2011 U.S. Dist. LEXIS 62487, at *39. Because it was uncontested that those sales were domestic for purposes of *Morrison*, only the SEC's allegations with respect to the German purchasers are discussed here.

109. Regulation S provides two kinds of safe harbors from the Securities Act's registration requirements for transactions defined as outside of the United States. These safe harbors concern issuer offerings

tively took place in New York, despite the fact that the Goldman circular stipulated off-shore transactions in reliance on Regulation S and that the trade confirmations listed Goldman's U.K. affiliate as the seller, because Tourre was in New York when he made the offer.[110] The SEC argued further that the "sale" requirement of Sec. 10(b) of the Exchange Act covers the "entire selling process," and was thus satisfied by Tourre's actions in New York.[111] But the court rejected this "entire selling process" focus as an "invitation for this Court to disregard *Morrison* and return to the 'conduct' and 'effects' tests."[112] Although the SEC had also tried to rely on the CDO place of closing (New York) to satisfy *Morrison*, the court found that this was an insufficient allegation of "irrevocable liability."[113]

As a policy matter, the *Tourre* court's approach is preferable to the *Quail Cruises* appeals court's reasoning, as *Tourre* rightly looks past contractual formalities to the question of when and where the parties effectively consummated their deal. But *Quail Cruises* is arguably more faithful to the bright-line spirit of *Morrison*; indeed, it is ironic that the *Tourre* court rejected the SEC's "entire selling process" suggestion as a return to conducts-effects when the "irrevocable liability" standard would similarly function as a rule-of-reason (a characteristic for which conducts-effects was criticized) in many practical settings. Depending on the specific terms of a given securities purchase agreement, it may well vary whether, and to what extent, the parties are bound before closing. Although neither the *Basis Alpha* nor the *Tourre* court had occasion to decide on what would constitute "irrevocable liability," given the plaintiffs' insufficient allegations of U.S. transactions for purposes of *Morrison*,[114] the highly complex transactions at issue (CDOs in *Tourre*, and credit-default swaps ("CDS") in *Basis Alpha*) would have likely required detailed and factually-specific inquiries.

Other cases involving international OTC transactions, in implicitly applying the "irrevocable liability" standard, further demonstrate the need for detailed analysis of contractual provisions. In *Cascade Fund, LLP v. Absolute Capital Mgmt. Holdings, Ltd.*, a Colorado district court case, the Cayman Islands-based defendant investment fund contacted the U.S.-based plaintiff to solicit an investment.[115] The plaintiff then made several investments; it did so by executing a subscription agreement and sending it to the defendant in the Cayman Islands for its acceptance, and then wiring funds via

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and resales. To qualify, both offerings and resales must be made in what the SEC defines as an "offshore transaction" and cannot involve "directed selling efforts" (again, as defined by the SEC) in the United States. To guard against risk of flowback to the United States, the SEC imposes a variety of additional conditions on certain types of offerings. PALMITER, *supra* note 12, at 528.

110. *Tourre*, 2011 U.S. Dist. LEXIS 62487, at *30.

111. *Id.* at *28. Because the Dodd-Frank Act is not retroactive, the SEC could not invoke Sec. 929P's restoration of the conducts-effects test and had to overcome *Morrison* in its action against Tourre.

112. *Id.* at *29.

113. *Id.* (citing *Quail Cruises*, 732 F. Supp. 2d at 1350).

114. *Id.* at *32; *Basis Alpha*, 2011 U.S. Dist. LEXIS 80298, at *11.

115. No. 08-cv-01381-MSK-CBS, 2011 U.S. Dist LEXIS 34748, at *3–4 (D. Colo. Mar. 31, 2011).

New York and European banks. In dismissing the case, the court cited a clause in the subscription agreement that allowed the defendant to reject the agreement for any reason, thus concluding that the transaction was not formally "completed until the defendant accepted the application—presumably in its Cayman Islands offices."[116]

By contrast, close contractual scrutiny allowed a plaintiff to survive a motion to dismiss in *In re Optimal U.S. Litigation*, an SDNY case involving a solicitation agreement arrangement very similar to that of *Cascade Fund*.[117] An Ireland-based fund administrator sent subscription forms to U.S. investors for their agreement and return, with the forms expressly providing that the Irish administrator "reserve[d] the right to defer acceptance of such subscription until monies are cleared."[118] While conceding that the "acceptance" took place in Ireland, the plaintiffs successfully argued (for purposes of surviving the motion to dismiss) that the shares were formally "purchased" when they were issued in New York because the contract notes read: "We bought [sold] for your account in: NYS."[119]

Unless more courts begin to embrace the Eleventh Circuit's closing-focused approach in *Quail Cruises*, looking past its inflexibility and ease of manipulation, the "irrevocable liability" standard or a variant thereof will likely become predominant due to its adoption by the SDNY. Should "irrevocable liability" be the eventual test for *Morrison*'s second prong, it would at least 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. This is because the variety and complexity of OTC transaction arrangements seem to require a similar approach under "irrevocable liability."

C. *Equity derivative transactions*

Generally, equity derivatives are financial instruments which allow for rights, interests, or options in an underlying security, or whose settlement amount or value is determined by that underlying security.[120] Several types of equity derivative instruments have been the subject of post-*Morrison* Sec. 10(b) litigation thus far; these cases further demonstrate the difficulties and inconsistencies in applying *Morrison*'s transactional test.

American Depositary Receipts ("ADR"), which allow U.S. investors to trade in foreign securities without purchasing them on a foreign exchange,

116. *Id.* at *22.

117. *See In re* Optimal U.S. Litig., No. 10 Civ. 4095, 2011 U.S. Dist. LEXIS 46745 (S.D.N.Y. May 2, 2011).

118. *Id.* at *47.

119. *Id.* at *51.

120. Equity derivatives can be exchange-traded or OTC-traded. For more details on the definition of equity derivatives, see Hong Kong Securities and Futures Comm'n, *Outline of Part XV of the Securities and Futures Ordinance (CAP. 571)—Disclosure of Interests*, Sec. 2.3 (Rev'd. June 8, 2003), *available at* http://www.sfc.hk/sfc/doc/EN/faqs/disclosure/sfc_outline.pdf.

have been greatly impacted by *Morrison*.[121] In establishing an ADR facility, a U.S. depositary bank issues an ADR representing a certain amount of foreign security that is on deposit with one of its foreign branches or agents. If the underlying issuer of the foreign security establishes the facility with the depositary bank, the ADR is "sponsored" and is classified in one of three levels, which generally correlate with the degree of issuer involvement and amount of required disclosure. If the issuer does not participate, the ADR is "unsponsored." All unsponsored ADRs are traded OTC, whereas sponsored ADRs can be OTC or exchange-traded, depending on their level of classification.

ADRs have been implicated in litigation involving *Morrison*'s first prong, with plaintiffs arguing that even if they bought a defendant's securities on a foreign exchange, the listing (but not trading) of the defendant's securities on a U.S. exchange as part of an ADR program should allow them to survive *Morrison.* Courts have roundly rejected this argument as inconsistent with *Morrison*, following the same logic as in cases where a foreign security had cross-listed common shares in the United States, as discussed earlier.[122]

The more difficult ADR-related litigation has involved claims arising from plaintiffs' actual purchases of ADRs in the United States. In *In re Société Générale Securities Litigation*, certain plaintiffs who bought Société Générale's ADR shares in the U.S. OTC market alleged that Société Générale made a number of misrepresentations relating to risk controls and exposure to subprime mortgage liabilities.[123] In granting a motion to dismiss, the SDNY judge held that "trade in ADRs is considered to be a predominantly foreign securities transaction," rendering Sec. 10(b) inapplicable.[124]

Subsequent case law, however, indicates that *Société Générale* went too far in categorizing all ADR transactions as foreign. In *In re Vivendi Universal, S.A. Securities Litigation*, the parties even agreed that *Morrison* did not affect the claims of ADR purchasers because Vivendi's ADRs were listed and traded on the NYSE.[125] And in *Stackhouse v. Toyota Motor Co.*, a judge for the Central District of California, in appointing a lead plaintiff who had pur-

121. Within sponsored ADRs, Level 1 ADRs represent the lowest level of issuer involvement and required disclosure, and are only traded OTC. Level 2 ADRs are quoted on the NASDAQ or listed on a national securities exchange, but cannot be publicly offered in the United States. Level 3 ADRs, representing the highest level of issuer involvement and required disclosure, are quoted on the NASDAQ or listed on a national securities exchange after a U.S. public offering of ADRs. *SEC Release*, 1991 SEC LEXIS 936, at *8, *10–*11 & n. 21. Both sponsored and unsponsored ADRs generally provide the holder the right to exchange ADRs for the underlying ordinary shares at any time. *Royal Bank of Scot.*, 765 F. Supp. 2d at 337.

122. *See In re* Vivendi Universal, S.A. Sec. Litig., No. 02 Civ. 05571 (RJH)(HBP), 2011 U.S. Dist. LEXIS 17514, at *47 (Feb. 17, 2011) (citing cases).

123. 2010 WL 3910286, at *2.

124. *Id.*, at *4 (internal quotation marks omitted).

125. 11 U.S. Dist. LEXIS 17514, at *38.

chased ADRs in the United States, dismissed all plaintiffs who had bought the defendant's common shares on an overseas exchange.[126]

Although courts have not expressly stated as much, it appears that ADRs will be analyzed as if they were ordinary securities under *Morrison*'s first prong (if exchange-traded) or second prong (if OTC). Because exchange-traded ADRs are only traded on U.S. exchanges, it follows that all such ADRs will easily survive *Morrison*; furthermore, there should be no particular problem subjecting sponsored OTC ADRs to the same test as other OTC securities. The harder question, which is yet to be addressed by courts, is how unsponsored ADRs (which are all OTC) should be treated. Given that the issuer in such cases, by definition, had no involvement with the ADR facility, subjecting them to Sec. 10(b) liability if the ADR was transacted in the United States raises fairness and regulatory overreach concerns. Accordingly, it would also be in tension with a core rationale of *Morrison*: avoiding unnecessary intrusion into foreign regulatory regimes. But on balance, it is entirely possible that the Supreme Court would countenance such inconsistencies, considering the benefits of the bright-line test. After all, the majority in *Morrison* expressly rejected similar equitable considerations, as evidenced by Justice Stevens' U.S. investor hypothetical in his concurrence.[127]

Security-based swaps are another important equity derivative at issue in post-*Morrison* Sec. 10(b) cases. These swaps are privately negotiated contracts whose value fluctuates according to the price of an underlying reference security.[128] In *Elliott Assocs. v. Porsche Automobil Holding SE*, the court held that the security-based swap agreements, which were transacted OTC in the United States and referenced the price of Volkswagen shares traded on overseas exchanges, were the "functional equivalent" of transactions on a foreign exchange.[129] Similar to the emerging "irrevocable liability" standard, as discussed above, this holding arguably goes beyond *Morrison*'s plain terms in an effort to follow the territorial rationale underlying the transactional test. Since it is well settled that Sec. 10(b) applies equally to securities and securities-based swaps,[130] and that the swap at issue in *Porsche* was executed in the

126. No. 10 Civ. 0922, 2010 U.S. Dist. LEXIS 76543, at *2 (C.D. Cal. July 16, 2010). A year later, the district court declined to exercise supplementary jurisdiction over the suit, which also involved Japanese claims the court considered predominant, noting that while "there may be instances where it is appropriate to exercise supplemental jurisdiction over foreign securities fraud claims, any reasonable reading of Morrison suggests that those instances will be rare." *In re* Toyota Motor Corp. Sec. Litig., No. CV 10-922 DSF (AJWx), 2011 U.S. Dist. LEXIS 75732, at *21 (C.D. Cal. July 7, 2011).

127. *See Morrison*, 130 S. Ct. at 2895 (Stevens, J., concurring).

128. *Porsche*, 759 F. Supp. 2d at 471. It should be noted that pursuant to Title VII of Dodd-Frank, securities-based swap agreements will no longer be a purely OTC instrument, given Title VII's exchange trading requirements for derivatives under certain circumstances. As of the writing of this Article, however, the relevant implementing regulations for exchange trading of swaps have not yet been promulgated.

129. *Id.* at 471, 476.

130. As the *Porsche* court noted, Congress expressly amended Sec. 10(b) in 2000 to grant anti-fraud protection to purchasers of security-based swaps "to the same extent" as securities. *Id.* at 475.

United States, a literal interpretation of *Morrison* should have allowed the plaintiff to avoid dismissal. But, as the *Porsche* court observed, that view would effectively expand the extraterritorial reach of Sec. 10(b) as compared to conducts-effects, and would thus be inconsistent with the Supreme Court's fundamental intention (if not its phrasing) in *Morrison*.[131] More subtly, this reasoning also seems to reflect a concern over the propriety of bringing a foreign defendant into a U.S. court when the defendant made no affirmative effort to enter the U.S. securities markets, similar to the problem of unsponsored ADRs.

An alternative interpretation of *Morrison*'s application to equity derivatives aims to reconcile the *Porsche* court's approach with the Supreme Court's phrasing in *Morrison*. In *S.E.C. v. Compania Internacional Financiera*, the SEC charged several foreign investment management firms with Sec. 10(b) insider trading violations in connection with contracts-for-difference ("CFD"), another type of equity derivative that referenced securities of a U.S. company.[132] 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 simple way to access securities traded on a foreign country's exchange.[133] Although the CFDs were transacted in London, the *Compania* court held that Sec. 10(b) applied under *Morrison*'s first prong, using a somewhat novel analysis. *Morrison*'s first prong reads literally that Sec. 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."[134] The *Compania* court concluded that the "in connection with" part of this phrase would allow a derivative instrument traded abroad to come under Sec. 10(b) if the underlying security were traded in the United States, citing the effectively mirror-opposite facts and disposition of *Porsche* (i.e., dismissal where U.S.-traded derivative referenced a foreign security) as support.[135]

Essentially, *Compania* attempts to solve the derivative dilemma by equating the derivative instrument as the "connection" (in *Morrison*'s terms), and the reference stock as the "security." This is an attractive approach, but it is problematic upon closer scrutiny. First, it does not sufficiently account for the Supreme Court's key statement that "[the] focus of the Exchange Act is . . . upon purchases and sales of securities in the United States."[136] The most natural interpretation of *Morrison*'s holding in light of this guidance is that the plaintiff must have actually (1) purchased or sold U.S.-listed securi-

131. *Id.* at 474.

132. No. 11 Civ. 4904 (DLC), 2011 U.S. Dist. LEXIS 83424, at *1–*2, *12 (S.D.N.Y. July 29, 2011).

133. Freudenberg v. E*Trade Fin. Corp., No. 07 Civ. 8538 (RWS), 2008 U.S. Dist. LEXIS 62767, at *19 (S.D.N.Y. July 16, 2008).

134. *Morrison*, 130 S. Ct. at 2888.

135. *Compania*, 2011 U.S. Dist. LEXIS 83424, at *20.

136. *Morrison*, 130 S. Ct. at 2884.

ties or (2) purchased or sold other securities in the United States. While there is a strong policy argument supporting the court's decision in *Compania* because the defendants' alleged insider trading of CFDs affected the prices of the underlying U.S. shares, the court's basic rationale lacks a principled limitation that would ensure consistency with *Morrison*'s transactional focus. Under *Companía*'s logic, for instance, plaintiffs in ADR cases such as *Société Générale* and *Vivendi* could argue that, because the defendants' alleged manipulation was clearly "in connection with" a U.S.-traded security (the ADRs), their suits should survive *Morrison* even though they did not buy the U.S. securities themselves.

D. *Securities Act registration requirement and Regulation S safe harbor*

As noted above, Regulation S is an important provision that allows securities issuers to avoid the SEC's onerous registration requirement (in Section 5 of the Securities Act) if the sale qualifies as an "offshore transaction" as defined in the rule.[137] It was not immediately clear how *Morrison*'s transactional test would impact the Sec. 10(b) liability of issuers who used the Regulation S safe harbor. On the one hand, the fact that all Regulation S transactions are by definition "offshore" could imply blanket immunity from Sec. 10(b). On the other hand, the preliminary note to Regulation S specifically provides that the safe harbor only pertains to the Securities Act registration requirement and not to other provisions of the securities laws, including anti-fraud measures.[138]

In the *Stackhouse* decision in the Central District of California, the judge indicated in dicta that the broader concept of Regulation S transactions as "offshore" could bear on the *Morrison* transactional test, notwithstanding the limits set forth in the rule's preliminary note. Specifically, a footnote in *Stackhouse* states that Regulation S "may be relevant to discerning what the Supreme Court meant by domestic transactions" through its enumeration of certain kinds of "offshore transaction[s]."[139] But in *Tourre*, the SDNY took a different tack on Regulation S. The CDOs at issue in *Tourre* had been sold under the Regulation S safe harbor, allowing Tourre to argue that the SEC's position created a logical inconsistency: how could his transaction be both "domestic" within the meaning of *Morrison* (as the SEC argues) and "foreign" within the meaning of Regulation S? Noting simply that Regulation S, "by its own terms" pertains only "to *Section 5* of the Securities Act . . . and not to antifraud or other provisions of the federal securities laws," the court found that Regulation S had no bearing on the *Morrison* analysis.[140]

137. *See* 17 C.F.R. § 230.902(h) (2011).
138. 17 C.F.R. § 230.901 prelim. note (2011).
139. 2010 U.S. Dist. LEXIS 79837, at *4 n.2 (internal quotation marks omitted).
140. 2011 U.S. Dist. LEXIS 62487, at *32.

Under *Tourre*, then, the analysis in Regulation S cases would be identical to that applicable to all other OTC (second prong) factual scenarios. This appears to be the more sensible interpretation, and even though the *Tourre* court considered the SEC's preliminary note sufficient to dispose of the issue, its conclusion would also be superior to *Stackhouse*'s when read in light of *Morrison*. Regulation S's detailed conditions and requirements for an "offshore transaction," including restrictions on "directed selling efforts" and provisions relating to "flowback" (i.e., shares eventually migrating back to the United States) reflect a deeply conducts-effects oriented view of extraterritorial regulatory reach, which the Supreme Court expressly rejected in *Morrison*. Thus, allowing those factors to influence the transactional test analysis would arguably be contrary to *Morrison*'s strict focus on the actual location of a purchase or sale.

More strikingly, *Morrison* and subsequent case law on Regulation S cast doubt on whether the SEC's registration requirement can still be applied extraterritorially. This could have an unsettling effect on U.S. securities regulation, for the registration requirement has been termed the "heart" of the Securities Act.[141] It stipulates that, unless registered, securities cannot be offered, sold, or delivered by "use of any means . . . in interstate commerce or of the mails."[142] Section 2 of the Securities Act, in turn, defines interstate commerce to include securities activities "between any foreign country and any State."[143] Concern over the Securities Act's broad extraterritorial scope motivated the SEC to state its view that Section 5 does not cover offerings to foreign investors if the offering is designed to come to rest outside the United States and not be redistributed to U.S. persons, and ultimately to adopt safe harbors like Regulation S.[144]

There is no clear statement of extraterritoriality in Section 5; its geographical scope is indicated solely by the reference to "interstate commerce," as defined in Section 2. *Morrison* provided vague guidance in determining whether the presumption against extraterritoriality should trump in such cases, insofar as "assuredly context can be consulted" but that "uncertain indications" are not enough.[145] The *Morrison* court did hold that a "general reference to foreign commerce in the definition of 'interstate commerce' . . . does not defeat the presumption against extraterritoriality,"

141. *See* Edward Gadsby, Chairman, Sec. Exch. Comm'n, Gun-Jumping Problems Under Section 5 of the Securities Act of 1933, Address Before the Inv. Bankers Ass'n Annual Convention (Dec. 3, 1958), *available at* http://www.sec.gov/news/speech/1958/120358gadsby.pdf.

142. 15 U.S.C.A. § 77e (West 2010).

143. 15 U.S.C.A. § 77b (West 2010).

144. *See* S.E.C., Regulation of Foreign Offerings by Domestic Issuers; Regulation of Underwriters of Foreign Offerings as Broker-Dealers, Release No. 4708 (July 9, 1964); S.E.C., Offshore Offers and Sales, Securities Act Rel. No. 33-6779, 1988 WL 239804, *9 ("The Regulation [S] proposed today is based on a territorial approach to section 5 of the Securities Act. Under such an approach, the registration of securities is intended to protect the U.S. capital markets and all investors purchasing in the U.S. market, whether U.S. or foreign nationals.").

145. *Morrison*, 130 S. Ct. at 2883.

which suggests that the Supreme Court's view on the jurisdictional hook of Section 5 would likely be similar to its view on the Exchange Act's antifraud provision.[146] When the Court did mention Section 5 in passing, it argued that its "focus on domestic transactions" is evinced by the SEC's general statement in Regulation S that Section 5 should not apply to "sales that occur outside the United States."[147]

But this reference reveals a subtle inconsistency in the Court's reasoning. Regulation S was an agency effort to narrow the extraterritorial scope of Section 5, which the 1933 Congress had deliberately drawn to have broad foreign effect because of the "heavy losses U.S. investors had suffered in foreign offerings during the early 1930s."[148] The Second Circuit's jurisprudence and SEC practice regarding Sec. 10(b), by contrast, gave broad effect to statutory provisions that Congress may well have intended to have narrower scope.[149] It is striking that the same Court that allowed formalistic principles of interpretation to trump decades of agency and lower court decisions interpreting Sec. 10(b) would endorse agency views whose interpretation of Section 5 likely conflicts with congressional intent.

Furthermore, the Court did not account for the fact that Regulation S's offshore transaction provision is a necessary, but not sufficient, condition for gaining an exemption from Section 5. As noted earlier, both issuer offerings and investor resales cannot involve directed selling efforts and must satisfy additional flowback safeguards.[150] Indeed, the SEC's elaborate framework of requirements for a Section 5 exemption suggests serious agency concern with the effect that foreign transactions may have on U.S. investors. Had the SEC wanted to deprive Section 5 of extraterritorial reach, it would have simply imposed a bright-line transactional test.

Ultimately, if the extraterritorial scope of Section 5 were challenged, it is unclear whether a court would find sufficient "context" to override *Morrison*'s presumption against extraterritoriality. Long-standing precedent and agency understanding may not be enough, as the treatment of Sec. 10(b) in *Morrison* indicates. Even though there are stronger indications in the legislative history of Section 5 (as compared to Sec. 10(b)) that Congress intended the statute to have extraterritorial reach, the current Supreme Court is generally reluctant to rely on such sources.

Should courts eventually conclude that the presumption against extraterritoriality limits Section 5, the validity of Regulation S would come into question. The SEC might claim *Chevron* deference for its interpretation, as it

146. *Id.* at 2874.

147. *Id.* at 2885 (citing 17 C.F.R. § 230.901).

148. Palmiter, *supra* note 12, at 528.

149. *See* Andrew S. Gold, *Reassessing the Scope of Conduct Prohibited by Section 10(b) and the Elements of Rule 10b-5: Reflections on Securities Fraud and Secondary Actors*, 53 Cath. U.L. Rev. 667, 670 (2004) (arguing that there is no evidence in the legislative history of the Exchange Act that Congress contemplated a private cause of action under Sec. 10(b)).

150. 17 C.F.R. §§ 230.902–230.904 (2011).

was expressly interpreting an organic statute in Regulation S. However, the very act of applying the presumption against territoriality to Section 5—and overturning decades of established practice—would seem to render the SEC's interpretation in Regulation S impermissible under *Chevron* Step One.[151]

E. *Securities laws covering "offers" as well as "sales"*

The SEC's charges against Fabrice Tourre, the Goldman Sachs trader, were not limited to Sec. 10(b) of the Exchange Act.[152] The agency also alleged securities fraud under Section 17(a) of the Securities Act, which broadly prohibits the use of interstate commerce for fraudulent purposes in "the offer or sale of any securities . . . or any security-based swap agreement."[153] In evaluating this claim, the SDNY bifurcated Section 17(a) into "offer" and "sale" prongs. Because the definition of "sale" in Section 17(a) is "virtually identical" to that in Sec. 10(b), the court rejected the SEC's "sale" prong claims relating to the German purchasers by invoking *Morrison*.[154] On the "offer" prong, however, the court refused to dismiss the claims, noting the SEC's allegations that Tourre had made solicitations by phone and email from his office in New York.[155]

Citing prior case law that compared Section 17(a) and Sec. 10(b), the court considered it quite clear that Congress wanted to create a separate remedy for fraudulent offers that did not result in a sale.[156] The disjunctive "or" between "offer" and "sale" in Section 17(a) further supports this view. By this logic, the court found that the fact that the SEC's sale-based claims regarding the German buyers were barred under *Morrison* had no effect on the offer-based claims.[157] And because the Securities Act's definition of "offer" includes "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interests in a security, for value," the court rejected Tourre's argument that his offer was foreign due to the location of the recip-

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151. *See* Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842–43 (1984) (stating that the first step in reviewing an agency's construction of a statute is to ask "whether Congress has directly spoken to the precise question at issue"). The SEC's rule on registration requirements for broker-dealers, Rule 15(a)(6) of the Exchange Act, may be on shaky ground for similar reasons. In promulgating the rule, the SEC found that the underlying statutory provision in the Exchange Act, which was silent on extraterritorial reach, should apply abroad simply because the definition of "broker" and "dealer" did draw distinctions based on nationality. If *Morrison*'s strict formulation of the presumption against extraterritoriality were applied to the underlying provision, it seems unlikely that the SEC's rationale for Rule 15(a)(6) would qualify as a plausible interpretation for *Chevron* purposes.

152. *See supra* note 108 and accompanying text.

153. Securities Act § 17(a), 15 U.S.C.A. § 77q(a) (West 2010).

154. *Tourre*, 2011 U.S. Dist LEXIS 62487, at *45.

155. *Id.* at *49.

156. *Id.* at *46.

157. Tourre again invoked Regulation S to argue that the "offer" could not be domestic because it was "offshore" for purposes of that rule, but the court rejected this argument on the same grounds as in the "sale" context: Regulation S, by its own terms, applies only to Section 5 of the Securities Act. *Id.* at *47–*48.

ients, and rightly concluded that the "offer" definition focuses solely on the actions of the offeree.[158]

If this interpretation stands on appeal, it will create important guidance for how courts should construe *Morrison*'s effect on other securities law provisions. Specifically, *Tourre* indicates that while *Morrison*'s presumption against extraterritoriality applies fully to other provisions that are silent on foreign scope, it does not necessarily follow that *Morrison*'s transactional test should be automatically imported. Instead, a close textual analysis of the focus of such provisions is required to determine how exactly the presumption against extraterritoriality impacts them.[159] Although not yet the subject of litigation post-*Morrison*, other provisions focusing on offers may have foreign implications,[160] thus amplifying the potential precedential value of *Tourre*'s holding with respect to Section 17(a).

F. *Other laws that are silent on extraterritoriality, yet are traditionally applied abroad*

Although this Article is primarily concerned with *Morrison*'s effect within the securities law regime, it is worth highlighting the broader impact of its presumption against extraterritoriality. To be sure, Congress has only requested that the SEC conduct a study and make recommendations on the proper scope of Sec. 10(b) for private rights.[161] But if Congress is inclined to restore (either partially or wholly) conducts-effects as a result of that study, it should also be aware that *Morrison* has similarly affected statutes far beyond Sec. 10(b). As such, Congress may wish to consider whether the Supreme Court's invigorated presumption against extraterritoriality reflects its actual intent in circumstances outside the securities context. Moreover, *Morrison*'s application beyond the securities context further illuminates the difficult task of discerning a statute's "focus" for purposes of the presumption against extraterritoriality.[162]

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158. *Id.* at *47.

159. *See Morrison*, 130 S. Ct. at 2884 (holding that the "focus" of the statute is "the object of the statute's solicitude" and the activities that "the statute seeks to regulate [and] parties or prospective parties to those [activities] that the statute seeks to protect.").

160. These include Section 5(c) of the Securities Act, which generally provides that a registration statement is necessary before any sale of, or offer to sell, securities, and Section 14(e) of the Exchange Act, which addresses untrue statements of material fact (or omissions of material fact) with respect to tender offers. 15 U.S.C. § 78e(c); 15 U.S.C. § 78n(e).

161. *See supra* note 84 and accompanying text.

162. Professor Lea Brilmayer has criticized the Court's concept of "focus" as a "judicially imposed requirement that Congress express itself more clearly in international applications of a statute than is required in domestic applications," noting further that the "presumption that results is not so much a presumption against extraterritoriality, but rather a presumption in favor of the judicially crafted definition of focus." Lea Brilmayer, *The New Extraterritoriality: Morrison v. National Australia Bank, Legislative Supremacy, and the Presumption Against Extraterritorial Application of American Law*, 40 Sw. L. Rev. 655, 668 (2011).

As noted above, *Morrison* provided little guidance on how much contextual evidence would overcome the presumption against extraterritoriality.[163] The Dodd-Frank Act only partially clarified this ambiguity. Congress unmistakably indicated that Sec. 10(b) and several other securities anti-fraud provisions apply abroad in actions brought by the SEC or the DOJ when it codified the conducts-effects test for such actions.[164] Yet nothing in the Dodd-Frank Act or Rep. Kanjorski's floor statement indicates that Congress intended to rebut the Court's presumption against extraterritoriality beyond the provisions in DFA Section 929P. Accordingly, it appears that *Morrison*'s holding on that presumption applies not only with respect to other extraterritorially-silent provisions within the securities laws, but also to statutory regimes not discussed in *Morrison*. This will have particular impact on laws for which courts or agencies have, similar to Sec. 10(b), looked past statutory silence and imputed congressional desire for foreign application absent explicit congressional authorization.

Perhaps the most prominent example of this kind of statute is the Racketeering Influenced and Corrupt Organizations Act ("RICO"), which provides civil remedies and criminal penalties for certain acts committed via criminal organizations.[165] Because RICO is silent on extraterritorial scope, courts had traditionally followed Sec. 10(b) jurisprudence pre-*Morrison* and applied a conducts-effects test to determine how the statute would apply abroad.[166] Three courts, the Second Circuit, SDNY, and the D.C. District Court ("DDC"), have already found that conducts-effects can no longer be applied in RICO cases.[167]

In a case filed by the European Community against RJR Nabisco relating to money laundering allegations, the SDNY cited extensive statutory and case law sources to conclude that the "focus" of RICO is the criminal "enterprise," which must be based in the United States for a case to survive *Morrison*.[168] This logic forecloses plaintiffs' argument that because certain RICO predicate acts (e.g., money laundering laws) apply extraterritorially, Congress intended the RICO statute to have foreign reach.[169] The DDC used similar reasoning to drop British American Tobacco from the United States' massive RICO suit against tobacco manufacturers, which arose from charges

163. *See supra* note 145 and accompanying text.

164. *See* DFA § 929P.

165. Organized Crime Control Act of 1970 § 901(a), 18 U.S.C. § 1962. Although RICO contains four separate operative subsections, claims under RICO generally have three common elements: "1) a person who engages in 2) a pattern of racketeering activity, 3) connected to the acquisition, establishment, conduct, or control of an enterprise." St. Germain v. Howard, 556 F.3d 261, 263 (5th Cir. 2009).

166. *See* N. S. Fin. Corp. v. Al-Turki, 100 F.3d 1046, 1051 (2d. Cir. 1996) (expressly stating that RICO was silent on extraterritorial application and applying the conducts-effects test).

167. *See* Norex Petroleum Ltd. v. Access Indus. Inc., 631 F.3d 29 (2d Cir. 2010); European Cmty. v. RJR Nabisco, No. 02-CV-5771 (NGG)(VVP), 2011 U.S. Dist. LEXIS 23538, at *15 (S.D.N.Y. Mar. 8, 2011); United States v. Philip Morris USA, 783 F. Supp. 2d 23 (D.D.C. 2011).

168. *Nabisco*, 2011 U.S. Dist. LEXIS 23538, at *13–*17. The court then applied the Supreme Court's "nerve center" approach from *Hertz* to determine the location of the RICO enterprise. *Id.* at *18.

169. The Second Circuit upheld this argument in a separate case. *See Norex*, 631 F.3d at 33.

that the manufacturers had hidden the health hazards of smoking.[170] As with Sec. 10(b), allegations of substantial conduct in furtherance of the scheme in the United States will likely no longer suffice for RICO claims.

The Ninth Circuit's analysis of the Lanham Act's extraterritorial reach in *Love v. Associated Newspapers Ltd.* forms an instructive contrast with post-*Morrison* case law on RICO.[171] The Lanham Act, which sets forth federal trademark law, is also silent on foreign application but has been construed to apply abroad under a type of "effects" test.[172] The Lanham Act provides a civil remedy against anyone who uses a registered trademark "in commerce" in an improper manner (as specified in the Act), while defining "commerce" as "all commerce which may lawfully be regulated by Congress."[173] The Ninth Circuit found this sweeping, yet expressly stated, definition of "commerce" sufficient to distinguish the Lanham Act from Sec. 10(b) of the Exchange Act.[174]

Taken together, these RICO and Lanham Act cases illustrate the challenging task courts confront in determining whether, and to what extent, prior interpretations of silent statutes should be influenced by *Morrison*. In particular, lengthy and complicated statutory frameworks could make it difficult to glean a given provision's "focus" for purposes of the presumption against extraterritoriality.

III. A Reliance-Based Approach for Extraterritorial Sec. 10(b) Claims

The foregoing discussion revealed the complexity of competing factors in the debate over extraterritorial application of the securities laws. It also highlighted important shortcomings of the transactional test, arising principally from how the test's rigidity often precludes claims that implicate significant U.S. investor and market protection interests.

In its request for comments regarding DFA Section 929Y, the SEC specifically requested parties to comment on potential approaches other than the

170. *Philip Morris*, 783 F. Supp. 2d 23. Professor William Dodge has argued that the DDC wrongly dropped British American Tobacco from this suit, highlighting the trial court's earlier findings that the defendant's foreign predicate acts affected a U.S.-based "enterprise." William Dodge, *Morrison's Effects Test*, 40 Sw. L. Rev. 687, 695 (2011).

171. 611 F.3d 601 (9th Cir. 2010).

172. *Id.* at 613 (providing that for the Lanham Act to apply extraterritorially, "1) the alleged violations must create some effect on American foreign commerce; 2) the effect must be sufficiently great to present a cognizable injury to the plaintiffs under the Lanham Act; and 3) the interests of and links to American foreign commerce must be sufficiently strong in relation to those of other nations to justify an assertion of extraterritorial authority").

173. 15 U.S.C. § 1127 (2006).

174. *Id.* With respect to Sec. 10(b), by comparison, the Supreme Court found that a "general reference to foreign commerce in the definition of 'interstate commerce' . . . does not defeat the presumption against extraterritoriality." *Morrison,* 130 S. Ct. at 2874.

transactional and conducts-effects tests for private rights under Sec. 10(b).[175] However, only several of the fifty-eight comments took the opportunity to offer an alternative approach, and the vast majority advocated either of those two tests.[176] Policymakers need not restrict themselves to that binary consideration.

In retrospect, the *Morrison* Court should have followed Professor Jeffrey Meyer's "dual-illegality" principle in interpreting the extraterritorial reach of statutes that are "geoambiguous": unless Congress specifies otherwise, courts should not construe such statutes to apply abroad "in a manner that is inconsistent with the law of the place where the conduct occurred."[177] As Meyer argues, the dual-illegality principle is consistent with long-established measures in treaties and cross-border enforcement agreements, pursues the comity goals that the Supreme Court considers the key rationale for the presumption against extraterritoriality, and charts a middle course between territorialism and unilateralism without resorting to vague and unpredictable interest balancing.[178]

Although this principle is intended to guide judicial interpretation, it also sets forth a helpful analytical framework for the SEC's report to Congress per DFA Section 929Y. Under the logic of "dual-illegality," Sec. 10(b) should apply extraterritorially as needed to protect U.S. investors and markets, except in circumstances where substantial conflicts of law arise with foreign jurisdictions. Along these lines, the SEC and Congress could consider a more surgical approach to reforming Sec. 10(b), with an eye to restoring the flexibility and fairness of conducts-effects while limiting the comity tensions posed by U.S. class actions.

Specifically, the courts could reinstate conducts-effects as a baseline standard, while limiting "fraud-on-the-market" based claims to transactions on U.S. exchanges. George Conway of Wachtell, Lipton, Rosen, & Katz, who argued successfully on behalf of National Australia Bank in the *Morrison* litigation, advocated such an approach in his comment letter to the SEC (regarding the DFA Section 929Y study).[179] The fraud-on-the-market doctrine, first set forth explicitly by the Supreme Court in the 1988 case *Basic, Inc. v. Levinson*, holds that when securities markets are efficient, an investor "who buys or sells stock at the price set by the market does so in reliance on

175. *See supra* note 84 and accompanying text.

176. Comments on Study on Extraterritorial Private Rights of Action, *available at* http://www.sec.gov/comments/4-617/4-617.shtml (last visited Nov. 8, 2011). The SEC received forty-eight unique and substantive comments. Of these, twenty-two advocated no change to the *Morrison* transactional test for private rights of action under Sec. 10(b), eighteen favored a full return to the conducts-effects standard, and three suggested some alternative form. Five comments focused on a specific aspect of the SEC's prompt, such as swaps, ADRs, or comity.

177. Jeffrey A. Meyer, *Dual Illegality and Geoambiguous Law: A New Rule for Extraterritorial Application of U.S. Law*, 95 MINN. L. REV. 110, 165 (2010).

178. *Id.* at 166–70.

179. *See* Comment on Study on Extraterritorial Private Rights of Action from George Conway, *supra* note 176, at 3–5.

the integrity of that price" and that because "most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations" can be "presumed for purposes of a Rule 10b-5 action."[180]

This doctrine substantially lowers the potential burden for plaintiffs in satisfying the reliance prong of Sec. 10(b). While it may help individual plaintiffs to some extent, the biggest impact of the doctrine is in the class action arena. An individual plaintiff may be able to show reliance in fact—for instance, by presenting evidence that he or she read the defendant's misleading statements and relied on them in making the transaction at issue. But it would be nearly impossible for every member of a potential class to make such a showing.

As Professor Jonathan Macey has argued, the facts of *Morrison* effectively required a geographical extension of the "fraud-on-the-market" doctrine from the United States to global markets in order for the plaintiff's claim to prevail. Professor Macey strongly discouraged the Court from taking that step, largely for comity and conflict of law concerns.[181] Most critically, the United States is one of very few jurisdictions to have adopted the doctrine.[182] Accordingly, requiring plaintiffs to show actual reliance when they allege securities fraud arising from a foreign transaction would greatly reduce the potential for conflict with foreign regulatory regimes.[183] As will be discussed in the following sections, U.S. class actions arising from foreign transactions likely pose comity and efficiency concerns that outweigh their benefits, but once that issue is addressed, the conducts-effects test better promotes the market and investor protection goals of Sec. 10(b).

A. *The conflicts and costs of extraterritorial class actions under Sec. 10(b)*

The Supreme Court in *Basic v. Levinson* allowed Sec. 10(b) class plaintiffs to use a "fraud-on-the-market" theory to satisfy the reliance requirement in a securities fraud cause of action. Although the Court concluded that requiring class plaintiffs to show actual reliance would be an "unrealistic evidentiary burden,"[184] other countries have declined to adopt "fraud-on-the-market" on a number of well-reasoned policy grounds.[185] As Professor Donald Langevoort has argued, the doctrine "is distinctly American and is *not*

180. 485 U.S. 224, 247 (1988).

181. *See* Yale Brief, *supra* note 10, at 3.

182. *See id.* at 2.

183. *See id.* at 9. Some commentators have argued that there is no logical reason to limit fraud-on-the-market territorially for multiple-listed securities, assuming relatively liquid trading and efficient market activity. Rubenstein, *supra* note 45, at 652. Yet allowing a global-fraud-on-the-market theory for transactions conducted on overseas exchanges seems to impermissibly transgress the boundary between protecting U.S. investors and markets and engaging in regulatory overreach.

184. *Basic*, 485 U.S. at 245.

185. Buxbaum, *supra* note 5, at 61.

adopted by" all advanced jurisdictions.[186] A New Zealand judge, for instance, feared that the doctrine would create a major disincentive for investors in conducting due diligence, and a Canadian judge expressed concern that it would increase the costs of preparing financial statements.[187]

From a comity standpoint, these tensions yield several important observations. First, the U.S. policy decision to allow presumptive reliance for exchange-traded securities is not a minor evidentiary issue. Rather, it creates a serious divergence with other jurisdictions by allowing all purchasers of a given security a Sec. 10(b) cause of action, regardless of whether they actually relied on a defendant's fraudulent misrepresentation. Further, it is clear that foreign jurisdictions have evaluated the merits and drawbacks of fraud-on-the-market and explicitly rejected it. As opposed to a situation where a foreign jurisdiction simply had not contemplated, or was indifferent to, a contrasting provision in U.S. law, the comity concerns regarding fraud-on-the-market claims should be more accentuated in light of such express consideration. To be sure, the United States and other advanced jurisdictions share the goal of preventing securities fraud. But the foregoing observations suggest that where substantial, measured policy differences exist in how to pursue that goal, the United States cannot simply invoke a shared interest to justify any extraterritorial application of Sec. 10(b).

Along similar lines, many foreign countries refuse to enforce U.S. judgments involving class actions. This practice exposes foreign firms to the risk that a victory in U.S. court will not be recognized in their home country, thus exposing them to the additional cost and burden of a second suit.[188] The U.S. system of "opt-out" class formation is a key reason why claim preclusion in such judgments often does not extend abroad.[189] Many countries view the "opt-out" system as bad policy because it allows plaintiffs' attorneys to include class members in lawsuits without their knowledge (i.e., parties who may not actually have had a grievance) and thus unjustly inflate their potential settlement or damage recovery.[190] France's constitutional court, for instance, has held that "opt-out" class actions are unconstitutional and inimical to public policy.[191] German companies, moreover, claimed in their *Morrison* amicus brief that German courts do not "recognize

186. Yale Brief, *supra* note 10, at 11 n.5.

187. *See id.* at 10.

188. *See* Ilana T. Buschkin, *The Viability of Class Action Lawsuits in a Globalized Economy—Permitting Foreign Claimants to be Members of Class Action Lawsuits in the U.S. Federal Courts*, 90 CORNELL L. REV. 1563, 1566 (2005).

189. The United States is not the only country with an "opt-out" system. The Netherlands, for instance, has adopted such a regime, and in recent years the United Kingdom also considered doing so. Stefano Grace, *Strengthening Investor Confidence in Europe: U.S.-Style Securities Class Actions and the Acquis Communautaire*, 15 J. TRANSNAT'L L. & POL'Y 281, 292 (2006).

190. Buxbaum, *supra* note 5, at 63.

191. Conseil Constitutionnel [CC] [Constitutional Court] decision No. 2007-556 DC, Aug. 16, 2007, *available at* http://www.conseil-constitutionnel.fr (search "no. 2007-556"; then follow hyperlink under "Decisions").

any judgment that purports to adjudicate the claims of absent class members nor enforce any such judgment."[192]

Further, even where the United States and foreign jurisdictions may agree on the key substantive elements of anti-fraud laws, procedural differences in U.S. litigation may still warrant a narrower application of Sec. 10(b). In particular, the United States is distinctive because it allows contingency fee arrangements and lacks a "loser pays" rule. Most E.U. countries, for instance, not only require the losing party to pay the winner's legal fees, but also limit or simply prohibit contingency fees.[193] The United States also differs sharply from many peer jurisdictions with regard to the scope and process of discovery. Unlike many European countries, where the discovery process generally covers only evidence that will be admissible at trial and is closely overseen by the judge to prevent abuse, the U.S. process is controlled mainly by the litigants and allows parties to request any information "reasonably calculated to lead to the discovery of admissible evidence."[194] Such sweeping discovery rules are a key reason why the discovery process is often exorbitantly costly and motivates many defendants to settle as soon as they lose a motion to dismiss. Opponents of the U.S. framework point to this phenomenon, claiming that it effectively allows plaintiffs to "win" if they reach the discovery phase of litigation.[195]

Beyond substantive and procedural conflicts, efficiency implications of Sec. 10(b) class actions are a major concern, as highlighted by many comments to the SEC study.[196] According to NERA Economic Consulting, a leading analytics firm, the proportion of U.S. class actions against foreign companies increased markedly from 1999 to 2004, rising from 4.5% to 15.1%.[197] The average number of such filings between 2001 and 2004, 33.5, is roughly triple the number from 1999 or 2000—by any measure, a striking uptick.[198]

These figures help to explain the growing perception that the U.S. class action landscape has become increasingly hostile to foreign issuers over the past decade. In 1999, Professors Howell Jackson and Eric Pan interviewed scholars and practitioners to learn their views on barriers to entering U.S.

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192. Brief for Infineon Techs. AG as Amicus Curiae Supporting Respondents, Morrison v. Nat'l Austl. Bank, Ltd., 130 S. Ct. 2869 (2010) (No. 08-1191), 2010 WL 723007, at *18.

193. Tiana L. Russell, *Exporting Class Actions to the European Union*, 28 B.U. INT'L L.J. 141, 179 (2010).

194. FED. R. CIV. P. 26(b)(1).

195. *See* Comment on Study on Extraterritorial Private Rights of Action from Vivendi, *supra* note 176, at 17.

196. *See* Comment on Study on Extraterritorial Private Rights of Action, *supra* note 176, from ClearingHouse/IIB at 5; EuropeanIssuers at 3; U.S. Chamber of Commerce at 20; SIFMA/AFME at 4–5; Skadden at 13.

197. NERA ECONOMIC CONSULTING, TRENDS 2010 YEAR END UPDATE: SECURITIES CLASS ACTION FILINGS ACCELERATE IN SECOND HALF OF 2010; MEDIAN SETTLEMENT VALUE AT AN ALL-TIME HIGH 8 (2010) [hereinafter "NERA"].

198. *Id.* at 9.

capital markets. Fear of litigation was never ranked as a "top concern" by respondents—as were other matters such as accounting issues, managerial effort, or timing—and was instead characterized as either a "concern" or a "less important" barrier.[199]

The tenor of the Jackson and Pan 1999 study contrasts markedly with another set of interviews that Professor Jackson and his research assistants conducted in 2008; by that point, the U.S. anti-fraud laws had become the paramount concern for many practitioners and scholars, on account of being "most intrusive" and having the "biggest" impact on transnational business.[200] That study further revealed that foreign companies were not principally worried about U.S. regulatory compliance but instead the "fear that listing on a U.S. exchange exposes" them "to potentially bankrupting securities liabilities if its stock price were to decline sharply."[201] Taken in light of the steep increase in securities class actions against foreign issuers between 1999 and 2004, this change in sentiment is not surprising. These findings comport with Professor Hannah Buxbaum's observation in 2007 that "class action complaints increasingly include not merely general allegations broad enough to include foreign claimants, but specific allegations directly addressing their status."[202] According to Professor Buxbaum, the growing involvement of foreign claimants in U.S. class actions "may be traced in large part to efforts of the U.S. plaintiffs' bar to cultivate foreign investors."[203]

Further, progressively increasing settlement amounts have become a common target of criticism. Median settlement amounts have risen steadily over the past decade, from $4.5 million in 2001 to $11.1 million in 2010.[204] Many comments responding to DFA Section 929Y mentioned this factor as a reason for upholding the *Morrison* test.[205] And once a securities class action survives a motion to dismiss, the defendant will settle in the vast majority of cases. From 2000 to 2006, the average rates of dismissal and settlement were 39.4% and 51.8%, respectively; an average of 8.8% of cases from each of those years remained pending as of December 2010.[206] Of cases filed between 2000 and 2006 that survived dismissal, over eighty-five percent have settled to date.[207] These settlement rates make sense when one considers the

199. Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe—Part II*, 3 Va. L. & Bus. Rev. 208, 237 (2008).

200. Howell E. Jackson, *Summary of Research Findings on Extra-Territorial Application of Federal Securities Law*, *in* Global Capital Markets and the U.S. Securities Laws 2009: Strategies for the Changing Regulatory Environment 1243, 1253–54 (May 2009).

201. *Id.*

202. Buxbaum, *supra* note 5, at 62.

203. *Id.*

204. NERA, *supra* note 197, at 19.

205. *See* Comment on Study on Extraterritorial Private Rights of Action from Vivendi, *supra* note 176.

206. NERA, *supra* note 197, at 14.

207. *Id.* (author's calculations).

skyrocketing cost of discovery and the potential for massive awards and years of attorneys' fees if the defendants go to trial.

Indeed, the specter of bet-the-company litigation appears to have been a recent deterrent to foreign listings in the United States. For years, the SEC maintained what was known as a "Hotel California" rule, under which a foreign company listed in the United States had to maintain registration with the SEC as long as it had 300 shareholders in the United States—a very difficult threshold to meet.[208] But in June 2007, the SEC loosened the rule, allowing such deregistration if a firm's average U.S. trading volume is five percent or less of its global trading volume during a given one year period.[209] Since then, many foreign companies have in fact delisted from U.S. exchanges. Of foreign companies who were registered in the United States at the end of 2005, the following had delisted by the end of 2008: fifteen of twenty-seven French companies; nineteen of forty-four U.K. companies; seven of twenty German companies, six of eleven Italian companies; and fifteen of twenty-four Australian companies.[210] The Committee on Capital Markets Regulation, in a 2007 report on the competitiveness of U.S. public equity markets, also presented data showing that net foreign delistings (i.e., delistings less new listings) in the United States spiked in 2007.[211] Further, a 2007 survey conducted by the Financial Services Forum found that senior executives from nine of ten foreign companies who delisted from the United States between 2003 and 2007 said that litigation risk was a factor in their delisting.[212]

These data are not intended to show that foreign issuers should be exempted from *all* Sec. 10(b) liability, but rather that the pre-*Morrison* class action landscape was overly broad and unpredictable for foreign issuers, with deleterious effects. The challenge is to narrow the scope of Sec. 10(b) class actions against foreign issuers to well-defined situations where U.S. regulatory interests are clearly implicated. A reliance requirement for Sec. 10(b) liability arising from foreign transactions would supply this kind of limitation. Allowing for class actions arising solely from transactions on U.S. exchanges would subject foreign issuers to class action litigation only when they had affirmatively opted into the U.S. securities law regime—a fairer, more predictable arrangement. Because foreign issuers would be better able

208. Nuno Fernandes et al., *Escape from New York: The Market Impact of SEC Rule 12h-6* (Bd. of Governors of the Fed. Reserve Sys., International Finance Discussion Paper No. 945, 2008), *available at* http://www.federalreserve.gov/Pubs/Ifdp/2008/945/IFDP945.pdf.

209. Dominic Jones, *Foreign Firms Check Out of SEC's 'Hotel California'*, Investor Relations Web Report, May 30, 2007, *available at* http://irwebreport.com/20070530/foreign-firms-check-out-of-secs-hotel-california/.

210. *See* S.E.C., International Registered and Reporting Companies (June 11, 2009), *available at* http://www.sec.gov/divisions/corpfin/internatl/companies.shtml.

211. *See* Comm. on Capital Mkts. Regulation, The Competitive Position of the U.S. Public Equity Market 21 (2007), *available at* http://www.capmktsreg.org/pdfs/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf.

212. Fin. Servs. Forum, 2007 Global Capital Markets Survey 8 (2007).

to measure and account for the risk of liability under this system, they would be more willing to avail themselves of U.S. capital markets.[213] In any event, these delisting data demonstrate that foreign companies are genuinely concerned by the reach and impact of U.S. class actions, which should be an important policy question for U.S. officials when determining the proper extraterritorial scope of Sec. 10(b).

B. *The need for conducts-effects as a baseline standard*

By foreclosing any Sec. 10(b) claims arising from foreign transactions, the *Morrison* Court certainly addressed the concern of extraterritorial class actions under Sec. 10(b). But it did so in an unnecessarily overbroad manner, as the earlier analysis of post-*Morrison* case law revealed, and as will be discussed further below. The predictability and judicial economy benefits of the transactional test are offset, at least in part, by the efficiency losses borne by U.S. investors. And any benefits of the test appear to be limited to *Morrison*'s first prong, exchange traded securities; courts dealing with the second prong, OTC transactions, continue to confront detailed, case-by-case determinations a full year after *Morrison* was decided. Finally, the transactional test creates troubling fairness concerns and enforcement gaps that did not exist under conducts-effects.

The transactional test's logic creates several risks of arbitrary Sec. 10(b) application. Specifically, it may allow for certain cases with attenuated U.S. connections to proceed while barring certain cases with substantial U.S. involvement. Its disparate treatment of F-squared cases illustrates this phenomenon. There are three potential types of F-squared actions: a) foreign investors suing foreign issuers for fraud arising from a U.S. transaction; b) U.S. investors suing foreign issuers for fraud arising from a foreign transaction; and c) foreign investors suing U.S. issuers for fraud arising from a foreign transaction. By *Morrison*'s plain terms, only the first kind of F-squared claim could proceed under Sec. 10(b), even though the claim could have no more connection to the United States than a foreign investor's broker buying a multi-listed issuer's stock on an electronic U.S. exchange platform.

As securities trading has moved predominantly to electronic platforms, the geographic location of the actual exchange has become something of a virtual formality. Indeed, major exchanges have been merging across national borders, as noted earlier with respect to the pending NYSE Euronext-Deutsche Boerse merger.[214] If the merger goes through, there is the poten-

213. It is true that this greater certainty may lead some issuers to conclude that the risk of liability outweighs the benefits of a U.S. listing. But to the extent that murky and over-extensive class action risks simply impede foreign issuers from recognizing that a U.S. listing is not in their best interests, there is no defensible efficiency or fairness rationale for the broader application of Sec. 10(b) aggregate litigation.

214. *See supra* note 97 and accompanying text.

tial that many trades between U.S. parties would be executed overseas, depending on how the merged entity decides to structure its electronic systems. This creates the unsettling possibility that Sec. 10(b) may soon not cover the majority of U.S. buyers and sellers on the NYSE—the quintessentially American securities marketplace.

In the OTC context, issuers were unable to disclaim Sec. 10(b) liability by contract before *Morrison*. But they may be able to do so now, should courts follow the formalistic *Quail Cruises* decision and provide that the transaction "location" is outside the United States. Clearly, there are important predictability benefits to this arrangement, yet those are offset at least in part by the potential for foreign issuers with substantial U.S. involvement to exempt themselves from anti-fraud liability through a contractual formality. And should courts instead adopt the SDNY's "irrevocable liability" standard for assessing the location of OTC transactions under *Morrison*, the variance and complexity of such transactions would present administrability challenges similar to conducts-effects, thus vitiating a key purported advantage of the "transactional" approach.

From a fairness standpoint, it may be reasonable to expect institutional and sophisticated investors to know the transactional rule and structure their securities purchases and sales accordingly. However, such expectations seem unrealistic in the context of retail investors. And even sophisticated investors may find structuring their orders and sales in accordance with the test to be inefficient. Currently, large U.S. investors such as hedge funds, pension funds, and other institutional entities trade freely on both U.S. and foreign exchanges. A natural incentive of *Morrison* is that such parties will be more averse to conducting transactions abroad (or induced to shift more purchases to the United States) so as to preserve a Sec. 10(b) right of action. This could diminish liquidity in foreign markets, given the substantial volume of U.S. investor capital at play.

Moreover, *Morrison* may harm U.S. investors by creating a higher barrier to geographical portfolio diversity. As the largest public pension fund in the United States, the California Public Employees Retirement System ("CalPERS"), has argued, the ability to buy foreign securities is essential to meeting its diversification mandate.[215] Even if ADRs were fully covered by Sec. 10(b), the limited number of issuers who have U.S. ADRs, combined with the higher cost of trading them, would make it impractical for CalPERS to shift its $63.3 billion in international equity investments (twenty-eight percent of its total portfolio) to ADRs. Although such funds could pursue fraud actions abroad, the higher potential cost of doing so would necessarily be factored into purchasing decisions ex ante, thus raising the price of geographical diversification. This may especially impact invest-

215. Comment on Study on Extraterritorial Private Rights of Action from CalPERS, *supra* note 176, at 3.

ment in firms based in emerging economies with less robust securities enforcement regimes. Restoring conducts-effects (with a foreign fraud-on-the-market limitation) would allow U.S. funds to transact abroad with confidence that if they actually relied on a defendant's misrepresentation, a Sec. 10(b) remedy would be available.

As argued in the previous section, subjecting foreign issuers to Sec. 10(b) class actions arising from non-U.S. transactions raises fairness and efficiency concerns that clearly outweigh any positive impact. Beyond that, though, the more flexible liability standard of conducts-effects may actually generate more benefits than costs for foreign issuers who list in the United States. This is because opting into the onerous U.S. securities regulation and enforcement system yields a premium to foreign firms in terms of lower capital costs, as investors perceive them as less likely to commit fraudulent acts.[216] Under this "bonding" hypothesis, a foreign firm's decision to list in the United States shows not only an intention to comply with SEC registration and disclosure requirements, but also an acknowledgement that they are fully subject to the "private and public enforcement systems that are unique to the United States."[217]

Finally, failing to restore conducts-effects for private plaintiffs would leave an unacceptable enforcement void regarding the anti-fraud provisions of the U.S. securities laws.[218] Professor Genevieve Beyea has pointed out, for instance, that shareholder activism in other countries has revealed the need for systematic reforms in order to fully protect investors from securities fraud.[219] Statements by SEC officials over the years also lend credence to this position. SEC chairmen, including Richard Breeden, Arthur Levitt, and Mary Shapiro, have stressed that the agency's resources are simply too thin to fulfill all of its enforcement mandates in the absence of private litigation.[220] Certainly, there remain many persuasive reasons why public enforcement of extraterritorial securities frauds is preferable to private actions, as discussed earlier—including more attention to judicial resources and inter-

216. Stephen R. Foerster & G. Andrew Karolyi, *The Effects of Market Segmentation and Investor Recognition on Asset Prices: Evidence from Foreign Stocks Listing in the United States*, 54 J. FIN. 981 (1999).

217. John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 230 n.2 (2007). One recent working paper has found that home country stock prices of cross-listed foreign issuers after *Morrison* did not fluctuate as bonding theory would predict. *See* Amir Licht, Xi Li, Jordan Siegel, *What Makes the Bonding Stick? A Natural Experiment Involving the Supreme Court and Cross-Listed Firms* (Harvard Business School Working Paper No. 11-072, Feb. 18, 2011), *available at* http://www.sec.gov/comments/4-617/4617-41.pdf. It remains to be seen whether this critique is simply an outlier or will be corroborated in future studies. For the time being, bonding remains a viable, well-developed theory with prominent advocates. *See generally* Craig Doidge et al., *Why Do Foreign Firms Leave U.S. Equity Markets?*, 4 J. FIN. 1507 (2010); Luzi Hail & Christian Leuz, *Cost of Capital Effects in Growth Expectations around U.S. Cross Listings*, 93 J. FIN. ECON. 428 (2009).

218. *See* Comment on Study on Extraterritorial Private Rights of Action from seventy international pension funds, *supra* note 176, at 4.

219. Beyea, *supra* note 26, at 556–57.

220. *See* Comment on Study on Extraterritorial Private Rights of Action from CalPERS, *supra* note 176, at 4.

national comity, among other factors. But even accepting those arguments as true, one must still ask whether the SEC, especially as it takes on additional duties under the Dodd-Frank Act during a period of federal budget austerity, can adequately fill that enforcement void.

Assuming further that the SEC can successfully prosecute the most serious securities frauds that *Morrison* would bar private plaintiffs from pursuing, but must abandon pursuit of lesser potential violations due to resource constraints, there would still be a deleterious effect on deterrence, especially for relatively minor misrepresentations. Chairman Levitt touched directly on the matter of deterrence in his Senate testimony, averring that "private actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws."[221] Restoring conducts-effects as a baseline standard (with a foreign transaction reliance requirement) would help remedy this concern by providing a broader, yet appropriately limited, scope for private actions.

C. *Comparison with the Solicitor General's proposal*

Imposing a reliance-based limitation on the extraterritorial application of Sec. 10(b) would result in a standard quite similar to what then-Solicitor General Elena Kagan proposed in her *Morrison* amicus brief.[222] The Solicitor General advocated extraterritorial application of Sec. 10(b) where the fraud involved "significant conduct" in the United States that was "material" to the fraud's success, and the fraud directly caused the plaintiff's injury.[223] In retrospect, the Supreme Court ought to have embraced the Solicitor General's compelling proposal, which would have struck a balance between the prevailing conducts-effects test and the transactional test the Court ultimately adopted. As Professor Elizabeth Cosenza has pointed out, the Solicitor General's proposal addressed the troublesome overbreadth of the traditional conducts-effects test while retaining sufficient flexibility to encompass the variety of frauds that may implicate core U.S. regulatory interests.[224] And in arguing for the reliance requirement, the Solicitor General's brief expressly recognized the comity concerns posed by extraterritorial application of fraud-on-the-market theories and U.S. class actions.[225]

The Solicitor General was also correct in formulating the conducts test in a way that does not discriminate between U.S. and foreign investors. By

221. S. Rep. No. 104-98, at 38 (1995) (statement of SEC Chairman Arthur Levitt).

222. Professor Jonathan Macey also advocated a reliance-based standard in a *Morrison* amicus brief, as discussed earlier. *See supra* note 181 and accompanying text. Likewise, George Conway of Wachtell Lipton has made a similar proposal in an SEC comment letter. *See supra* note 179 and accompanying text.

223. *Morrison* Solicitor General Brief, *supra* note 10, at *13, *25; *see also* Elizabeth Cosenza, *Paradise Lost: § 10(b) after Morrison v National Australia Bank*, 11 Chi. J. Int'l L. 343, 386–98 (2011) (arguing in favor of the Solicitor General's standard).

224. Cosenza, *supra* note 223, at 387.

225. *Morrison* Solicitor General Brief, *supra* note 10, at *26.

comparison, some commentators have argued that conducts-based claims arising from foreign transactions should be limited to U.S. plaintiffs.[226] They generally note that the "Good Neighbor" policy rationale for such claims that was set forth by Judge Friendly in *Vencap* has a relatively attenuated connection to the core U.S. investor and market protection goals of the securities fraud laws, especially when the plaintiff is foreign.[227] Although this argument has merit, several other considerations support a non-discriminatory conduct test on balance. First, limiting the application of provisions of U.S. securities laws by the plaintiff's nationality would run afoul of widely held norms codified in the Restatement of Foreign Relations Law.[228] Second, barring fraud-on-the-market claims that arise from foreign transactions eliminates much of the regulatory overreach problem of the pre-*Morrison* conducts test, which was focused on class actions. There seems to be relatively little comity concern in applying Sec. 10(b) if a foreign plaintiff can show actual reliance on fraudulent statements made by a defendant in the United States, even while making the purchase abroad. When applying the "significant, material" conduct standard in such cases, however, courts should ensure that, at the very least, the defendant actually made the fraudulent communication from the United States.

However, by omitting the effects test, the Solicitor General's standard is arguably under-inclusive. As other scholars have argued, the effects test conforms closely with U.S. market and investor purposes of the antifraud laws, rarely raising comity concerns when used.[229] Consequently, the Solicitor General's standard could create an enforcement gap in cases where U.S. investors are induced by fraudulent foreign sales efforts to buy securities abroad. Given the electronic nature of many communications and securities trading mechanisms, a seller could well have a substantial, adverse effect on U.S. investors or markets through formally "foreign" means.

To be sure, the scope of this "effects" test must be narrowly defined. As Professor William Dodge has pointed out, the notion of effects in Sec. 10(b) jurisprudence has been construed in vastly differing ways.[230] At one extreme is the Second Circuit's holding in *Schoenbaum*, where a foreign exchange-based transaction's effect on U.S. share prices was sufficient to invoke Sec.

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226. *See* Comment on Study on Extraterritorial Private Rights of Action from Professor Hannah Buxbaum, *supra* note 176, at 3; *see also* Courtney Haraguchi, *Extraterritorial Application of the U.S. Securities Laws and the F-Cubed Plaintiff Problem*, HARVARD LAW SCHOOL PROGRAM ON INTERNATIONAL FINANCIAL SYSTEMS 52 (Mar. 18, 2008), *available at* http://www.law.harvard.edu/programs/about/pifs/llm/select-papers-from-the-seminar-in-international-finance/llm-papers-2008_2009/haraguchi.pdf.

227. *See* Comment on Study on Extraterritorial Private Rights of Action from Professor Hannah Buxbaum, *supra* note 176, at 3; Haraguchi, *supra* note 226.

228. *See* Comment by Forty-Two Law Professors on Study on Extraterritorial Private Rights of Action, *supra* note 176, at 10 (citing RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 416 (1987)).

229. *See* Comment on Study on Extraterritorial Private Rights of Action from Professor Hannah Buxbaum, *supra* note 176, at 3; *see also* William S. Dodge, *Understanding the Presumption Against Extraterritoriality*, 16 BERKELEY J. INT'L L. 85, 124 (1998).

230. Dodge, *supra* note 170, at 692.

10(b).[231] On the other extreme is the transactional test, which confines the effects test to a single United States based target: the transaction.[232] Here, the effects nexus should generally be tailored to the defendant's fraudulent inducements. That is, if investors can show that they were in the United States when they relied on a foreign seller's misrepresentations, they should be afforded a Sec. 10(b) remedy even if they bought the securities abroad, whether on exchange or OTC.

IV. Conclusion

This Article has demonstrated that post-*Morrison* case law has largely validated the arguments of Professor Jonathan Macey and former Solicitor General Kagan, whose reliance-based proposals regarding Sec. 10(b)'s extraterritorial reach were rejected by the Court in *Morrison*. In its study, the SEC ought to recommend that Congress reinstate the conducts-effects test, while imposing a reliance requirement on foreign transactions that is closely tailored to the alleged conduct or effect nexus. But however Congress ultimately decides to proceed with private rights after receiving the SEC's study, it must not lose sight of the broader implications of *Morrison* before moving from the issue altogether.

Even if Congress does decide to maintain the transactional test, it should authorize the SEC to analyze how lower courts have been defining "transaction" in specific factual circumstances and empower the SEC to provide guidance in difficult areas, particularly OTC purchases and sales. Beyond the securities regime, Congress should also conduct an ad-hoc inquiry as to laws it may also wish to insulate from *Morrison*, such as RICO.

While *Morrison* and Dodd-Frank have created an unprecedented moment of turmoil in this area of law, they have allowed for—by way of the DFA Section 929Y study—a prime opportunity to carefully analyze the tradeoffs and implications of each reform option. As international securities markets continue to integrate at a rapid pace, it is essential that Congress undertake a comprehensive, thoughtful, and nuanced consideration before it finally gives statutory shape to the question of extraterritorial private rights under Sec. 10(b).

231. *See id.*; *see also supra* note 28 and accompanying text.
232. *See* Dodge, *supra* note 170, at 692.