Study on the Cross-Border Scope of the Private Right of Action Under Section 10(b) of the Securities Exchange Act of 1934

As Required by Section 929Y of the Dodd-Frank Wall Street Reform and Consumer Protection Act

Study by the Staff of the
U.S. Securities and Exchange Commission

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This study has been prepared by the Staff of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings, or conclusions contained herein.

Executive Summary

Introduction

This study stems from two significant legal developments in the Summer of 2010 regarding the application of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") to transnational securities frauds. Section 10(b) is an antifraud provision designed to combat a wide variety of manipulative and deceptive activities that can occur in connection with the purchase or sale of a security. The Securities and Exchange Commission ("Commission") has civil enforcement authority under Section 10(b) and the Department of Justice ("DOJ") has criminal enforcement authority. Further, injured investors can pursue a private right of action under Section 10(b); meritorious private actions have long been recognized as an important supplement to civil and criminal law-enforcement actions.

On June 24, 2010, the Supreme Court in *Morrison v. National Australia Bank* concluded that there is no "affirmative indication" in the Exchange Act that Section 10(b) applies extraterritorially. Finding no affirmative indication of an extraterritorial reach, the Supreme Court adopted a new transactional test under which:

> Section 10(b) reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States.

Congress promptly responded to the *Morrison* decision by adding Section 929P(b)(2) of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"). Section 929P(b)(2) provided the necessary affirmative indication of extraterritoriality for Section 10(b) actions involving transnational securities frauds brought by the Commission and DOJ. Specifically, Section 929P(b)(2) provides the district courts of the United States with jurisdiction over Commission and DOJ enforcement actions if the fraud involves:

(1) conduct within the United States that constitutes a significant step 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.

With respect to private actions under Section 10(b), Section 929Y of the Dodd-Frank Act directed the Commission to solicit public comment and then conduct a study to consider the extension of the cross-border scope of private actions in a similar fashion, or in some narrower manner. Additionally, Section 929Y provided that the study shall consider and analyze the potential implications on international comity and the potential economic costs and benefits of extending the cross-border scope of private actions.

Background

Conduct and Effects Tests. Prior to the Supreme Court's *Morrison* decision, the lower federal courts had applied two tests to determine the cross-border reach of Section 10(b): the conduct test and the effects test.

Under the conduct test, Section 10(b) applied if a sufficient level of conduct comprising the transnational fraud occurred in the United States, even if the victims or the purchases and sales were overseas. Although the courts had adopted a range of approaches to defining when the level of domestic conduct was sufficient, courts generally found the conduct test satisfied where: (1) the mastermind of the fraud operated from the United States in a scheme to sell shares in a foreign entity to overseas investors; (2) much of the important efforts such as the underwriting, drafting of prospectuses, and accounting work that led to the fraudulent offering of a U.S. issuer's securities to overseas investors occurred in the United States; or (3) the United States was used as a base of operations for meetings, phone calls, and bank accounts to receive overseas investors' funds.

Under the effects test, Section 10(b) applied to transnational securities frauds when conduct occurring in foreign countries caused foreseeable and substantial harm to U.S. interests. Among other situations, the effects test applied where either overseas fraudulent conduct or a predominantly foreign transaction resulted in a direct injury to: (1) investors resident in the United States (even if the U.S. investors are relatively small in number); (2) securities traded on a U.S. exchange or otherwise issued by a U.S. entity; or (3) U.S. domestic markets, at least where a reasonably particularized harm occurred.

Morrison Litigation. *Morrison* involved a so-called "foreign-cubed" class action – a class action on behalf of foreign investors who had acquired the common stock of a foreign corporation through purchases effected on foreign securities exchanges. The plaintiffs alleged that the foreign corporation made false and misleading statements outside the United States to the plaintiff-investors that were based on false financial figures that had been generated in the United States by a wholly-owned U.S. subsidiary. The federal district court dismissed the case, holding that the conduct test had not been satisfied. The court of appeals affirmed the dismissal.

At the Supreme Court, many of the arguments raised by the parties and the various *amici curiae* (*i.e.*, non-parties who voluntarily submitted their views and analysis to assist the Court) centered on policy arguments supporting or opposing the conduct and effects tests in comparison to a bright-line test that would restrict the cross-border reach of Section 10(b).

The plaintiffs and their supporting *amici* argued, among other things, that: (1) there is an inherent U.S. interest in ensuring that even foreign purchasers of globally traded securities are not defrauded, because the prices that they pay for their securities will ultimately impact the prices at which the securities are sold in the United States; (2) foreign issuers that cross-list in the United States benefit from the prestige and increased investor confidence that results from a U.S. listing, and thus it is reasonable to hold these foreign issuers to the full force of the U.S. securities laws regardless of where the particular transaction occurs; (3) without the cross-border application of Section 10(b) afforded by the conduct and effects tests, there generally would be no legal options for redress open to the foreign victims of frauds committed by persons residing in the United States; and (4) eliminating the conduct and effects tests could be a significant factor weighing against further or continued foreign investment in the United States.

The defendants and their supporting *amici* (excluding foreign governments) argued, among other things, that: (1) the uncertainty and lack of predictability resulting from the conduct and effects tests discourage investment in the United States and capital raising in the United States, which would not occur with a bright-line test limiting Section 10(b) only to transactions within the United States; (2) application of Section 10(b) private liability to frauds resulting in transactions on foreign exchanges would result in wasteful and abusive litigation, cause the United States to become a leading venue for global securities class actions, and subject foreign issuers to the burdens and uncertainty of extensive U.S. discovery, pre-trial litigation, and perhaps trial before plaintiffs' claims can be dismissed under the conduct and effects tests; and (3) different nations have reached different conclusions about what constitutes fraud, how to deter it, and when to prosecute it, and the cross-border application of U.S. securities law would interfere with those sovereign policy choices.

The U.S. Solicitor General, joined by the Commission, recommended to the Supreme Court a standard that would permit a private plaintiff who suffered a loss overseas as part of a transnational securities fraud to pursue redress under Section 10(b) if the U.S. component of the fraud directly caused the plaintiff's injury. Although the Solicitor General acknowledged the potential for private securities actions brought under U.S. law to conflict with the procedures and remedies afforded by foreign nations, the Solicitor General opposed a transactional test that would permit a Section 10(b) private action only if the securities transaction occurred in the United States. A transactional test, the Solicitor General explained, would produce arbitrary outcomes, including denying a Section 10(b) private action even when the fraud was hatched and executed entirely in the United States and the injured investors were in the United States if the transactions induced by the fraud were executed abroad.

The British, French, and Australian Governments opposed to varying degrees the cross-border scope of private rights of action under Section 10(b). Each argued that it had made different policy choices about the prevention of fraud and enforcement of antifraud rules based on its own sovereign interests, and asserted that each choice deserved respect. The British and French Governments expressly supported a bright-line test.

Morrison Decision. As noted above, the Supreme Court adopted a new transactional test under which Section 10(b) applies only to frauds in connection with the "the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States." In rejecting the conduct and effects tests, the Court expressly identified the potential threat of regulatory conflict and international discord that private securities class actions can pose in the context of transnational securities frauds. Justice Stevens filed a concurrence in which he argued in favor of the conduct and effects tests, and criticized the transactional test as unduly excluding from private redress under Section 10(b) frauds that transpire in the United States or directly target U.S. citizens.

Post-*Morrison* Legal Developments

Following the *Morrison* decision, the lower federal courts have addressed a number of questions regarding the interpretation and application of the transactional test. To date, the courts have issued decisions holding that:

1) Although the Supreme Court stated in *Morrison* that Section 10(b) applies to the "purchase or sale of a security listed on an American stock exchange," an investor in a U.S. and foreign cross-listed security cannot maintain a Section 10(b) private action if he or she acquired the security on the foreign stock exchange.

2) An investor who acquires an exchange-traded American depositary receipt (ADR), which is a type of security that represents an ownership interest in a specified amount of a foreign security, can maintain a Section 10(b) private action.

3) The purchase or sale of a security on a foreign exchange by a U.S. investor is not within the reach of Section 10(b) even if the transaction was initiated in the United States (*e.g.*, the purchase or sale order was placed with a U.S. broker-dealer by a U.S. investor).

4) A Section 10(b) private action is not available for a U.S. counter-party to a security-based swap that references a foreign security, at least to the extent that the counter-party is suing a third party (i.e., a non-party to the swap) for fraudulent conduct related to the foreign-referenced security.

5) Section 10(b) applies where a defendant engages in insider trading overseas with respect to a U.S. exchange-traded corporation by acquiring contracts for difference, which are a type of security in which the purchaser acquires the future movement of the underlying company's common stock without taking formal ownership of the company's shares.

6) A Section 10(b) private action is not available against a securities intermediary such as a broker-dealer, investment adviser, or underwriter if the transaction for which the investor suffered a loss occurred on a foreign exchange or otherwise outside the United States, even if (i) the intermediary resided in the United States and primarily engaged in the fraudulent conduct here, or (ii) the intermediary traveled to the United States frequently to meet with the U.S. investor-client.

7) Investors who purchase shares of an off-shore feeder fund that holds itself out as investing exclusively or predominantly in a U.S. fund cannot maintain a Section 10(b) private action unless the purchase of the feeder fund's shares occurred in the United States.

Courts are divided on the issue of how to determine whether a purchase or sale of securities not listed on a U.S. or foreign exchange takes place in the United States, setting forth a number of competing approaches that include looking to: (a) whether *either* the offer *or* the acceptance of the off-exchange transaction occurred in the United States; (b) whether the event resulting in "irrevocable liability" occurred in the United States; or (c) whether the issuance of the securities occurred in the United States.

Responses to Request for Public Comment

In response to the Commission's request for public comments, as of January 1, 2012 the Commission received 72 comment letters (excluding duplicate and follow-up letters) – 30 from institutional investors; 19 from law firms and accounting firms; 8 from foreign governments; 7 from public companies and associations representing them; 7 from academics; and 1 from an individual investor. Of these, 44 supported enactment of the conduct and effects tests or some modified version of the tests, while 23 supported retention of the *Morrison* transactional test.

Arguments in Favor of the Transactional Test. The comment letters in support of the transactional test asserted that cross-border extension of Section 10(b) private actions would create significant conflicts with other nations' laws, interfere with the important and legitimate policy choices that these nations have made, and result in wasteful and abusive litigation involving transactions that occur on foreign securities exchanges. Those comment letters argue that, by contrast, retention of the transactional test would foster market growth because the test provides a bright-line standard for issuers to reasonably predict their liability exposure in private Section 10(b) actions.

Arguments Against the Transactional Test. The comment letters opposed to the transactional test argued, among other things, that: whether an exchange-traded securities transaction executed through a broker-dealer occurs in the United States or overseas may not be either apparent to U.S. investors or within their control; the transactional test impairs the ability of U.S. investment funds to achieve a diversified portfolio that includes foreign securities because the funds will have to either trade in the less liquid and potentially more costly ADR market in the United States or, alternatively, forgo Section 10(b) private remedies to trade overseas or pursue foreign litigation; and the transactional test fails to provide a private action in situations where U.S. investors are induced within the United States to purchase securities overseas.

Arguments in Favor of the Conducts and Effects Tests. The comment letters supporting enactment of the conduct and effects tests argued that doing so would promote investor protection because private actions would be available to supplement Commission enforcement actions involving transnational securities frauds. These comment letters also argued that the conduct and effects tests reflect the economic reality that although a company's shares may trade on a foreign exchange and the company may be incorporated overseas, the entity may have an extensive U.S. presence justifying application of U.S. securities laws. Further, comment letters also argued that the conduct and effects tests ensure that fraudsters operating in the United States or targeting investors in the United States cannot easily avoid the reach of Section 10(b) private liability, and facilitates international comity by balancing the interests of the United States and foreign jurisdictions.

Arguments Against the Conduct and Effects Tests. The arguments against the conduct and effects tests largely mirrored those set forth above in favor of the transactional test. In addition, these comment letters argued that: investor protection and deterrence of fraud are sufficiently achieved in the context of transnational securities fraud by Congress having enacted the conduct and effects tests for cases brought by the Commission and DOJ; small U.S. investors do not need the heightened protection of the conduct and effects tests because they generally do not directly invest overseas; the conduct and effects tests' fact-specific analysis bears little relationship to investors' expectations about whether they are protected by U.S. securities laws; and foreign legal regimes already provide sufficient remedies for investors who engage in transactions abroad.

Alternative Approaches that Commenters Proposed. Several comment letters argued in support of conduct and effects tests limited to U.S. resident investors. According to these comment letters, such an approach would minimize many of the international comity concerns associated with the conduct and effects tests because foreign nations recognize that the United States has a strong interest in protecting its own citizens.

Another option that the comment letters suggested was a fraud-in-the-inducement standard under which an investor could maintain a Section 10(b) private action if the investor was induced to purchase or sell the security in reliance on materially false or misleading material provided to the investor in the United States. Comment letters supporting this alternative argued that it would be consistent with investors' expectations, because investors generally believe that they will be protected by the legal regime that applies in the locations where they are subjected to fraudulent information or conduct.

Options Regarding the Cross-Border Reach of Section 10(b) Private Actions

The Staff advances the following options for consideration:

Options Regarding the Conduct and Effects Tests. Enactment of conduct and effects tests for Section 10(b) private actions similar to the test enacted for Commission and DOJ enforcement actions is one potential option. Consideration might also be given to alternative approaches focusing on narrowing the conduct test's scope to ameliorate those concerns that have been voiced about the negative consequences of a broad conduct test. One such approach (which the Solicitor General and the Commission recommended in the *Morrison* litigation) would be to require the plaintiff to demonstrate that the plaintiff's injury resulted *directly* from conduct within the United States. Among other things, requiring private plaintiffs to establish that their losses were a direct result of conduct in the United States could mitigate the risk of potential conflict with foreign nations' laws by limiting the availability of a Section 10(b) private remedy to situations in which the domestic conduct is closely linked to the overseas injury. The Commission has not altered its view in support of this standard.

Another option is to enact conduct and effects tests only for U.S. resident investors. Such an approach could limit the potential conflict between U.S. and foreign law, while still potentially furthering two of the principal regulatory interests of the U.S. securities laws – *i.e.*, protection of U.S. investors and U.S. markets.

Options to Supplement and Clarify the Transactional Test. In addition to possible enactment of some form of conduct and effects tests, the Study sets forth four options for consideration to supplement and clarify the transactional test. One option is to permit investors to pursue a Section 10(b) private action for the purchase or sale of any security that is of the same class of securities registered in the United States, irrespective of the actual location of the transaction. A second option, which is not exclusive of other options, is to authorize Section 10(b) private actions against securities intermediaries such as broker-dealers and investment advisers that engage in securities fraud while purchasing or selling securities overseas for U.S. investors or providing other services related to overseas securities transactions to U.S. investors. A third option is to permit investors to pursue a Section 10(b) private action if they can demonstrate that they were fraudulently induced while in the United States to engage in the transaction, irrespective of where the actual transaction takes place. A final option is to clarify that an off-exchange transaction takes place in the United States if either party made the offer to sell or purchase, or accepted the offer to sell or purchase, while in the United States.

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I. Introduction

A. Study's Genesis

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"). Section 929Y of Title IX of the Dodd-Frank Act ("Dodd-Frank Section 929Y") requires the Securities and Exchange Commission to conduct a study regarding whether and to what extent the private right of action under Section 10(b) of the Exchange Act should be extended to transnational securities frauds involving the purchase and sale of a security that occurs outside the United States ("Study").[1] (The Study refers to this interchangeably as the "extraterritorial extension" or "cross-border extension" of the Section 10(b) private right of action). It has long been recognized that meritorious private litigation under the federal securities laws is an important tool to combat securities fraud, particularly given the limited resources available to the Commission.[2]

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1 Section 10(b) of the Exchange Act 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 –
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> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b).

2 *See, e.g.*, *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007) (meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions); *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964) (private rights of action under the securities laws are a "necessary supplement" to Commission actions). *But see Tellab*s, 551 U.S. at 313 (cautioning that private securities fraud actions, if not adequately contained, can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law); *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 80 (2006) (observing that the Court had previously noted that private Section 10(b) litigation presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general).

Congress commissioned this Study in response to the Supreme Court's decision in *Morrison v. National Australia Bank, Ltd.*,[3] in which the Court significantly limited the cross-border scope of Section 10(b) of the Exchange Act. *Morrison* held that:

> Section 10(b) reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States.[4]

The *Morrison* decision rejected four decades of federal court of appeals' precedents that had allowed Section 10(b) actions involving transnational securities frauds either when the fraud involved significant conduct within the United States causing injury to overseas investors, or substantial foreseeable effects occurring to investors or markets within the United States.

B. Study's Mandate

In Section 929P(b)(2) of the Dodd-Frank Act, Congress restored the ability of the Securities and Exchange Commission ("Commission") and the Department of Justice ("DOJ") to bring enforcement actions under Section 10(b) in cases involving transnational securities fraud.[5]

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3 130 S. Ct. 2869 (2010).

4 *Id.* at 2888. *See also id.* at 2884 ("[I]t is in our view only transactions in securities listed on domestic exchanges, and domestic transactions in other securities, to which §10(b) applies.").

5 With respect to Commission and DOJ actions under Section 10(b), Dodd-Frank Act Section 929P(b)(2) codified the pre-*Morrison* view that the extraterritoriality inquiry is one of subject matter jurisdiction by adding the following provision to Section 27 of the Exchange Act:

> (b) EXTRATERRITORIAL JURISDICTION. – The district courts of the United States and the United States courts of any Territory shall have jurisdiction of an action or proceeding brought or instituted by the Commission or the United States alleging a violation of the antifraud provisions of this title involving –
>
> (1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or
>
> (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

See 156 Cong. Rec. H5237 (daily ed. June 30, 2010) (statement of Rep. Kanjorski, author of Section 929P(b)) ("In the case of *Morrison v. National Australia Bank*, the Supreme Court last week held that section 10(b) of the Exchange Act applies only to transactions in securities listed

Section 929Y(a) of the Dodd-Frank Act directs the Commission to conduct a study to determine whether private rights of action under Section 10(b) should be similarly extended. Specifically, the Commission is directed to solicit public comment and then undertake a study considering whether private actions under Section 10(b) should be extended to reach:

(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.

Section 929Y(b) provides that the Study shall consider and analyze, among other things:

- the scope of such a private right of action, including whether it should extend to all private actors or whether it should be more limited to extend just to institutional investors or otherwise;

- what implications such a private right of action would have on international comity;[6]

- the economic costs and benefits of extending a private right of action for transnational securities frauds; and

- whether a narrower extraterritorial standard [than was enacted for the Commission and the DOJ] should be adopted [for private actions].

These considerations are addressed below. Section 929Y(c) requires that the Study be submitted to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives.

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on United States exchanges and transactions in other securities that occur in the United States. In this case, the Court also said that it was applying a presumption against extraterritoriality. This bill's provisions concerning extraterritoriality, however, are intended to rebut that presumption by clearly indicating that Congress intends extraterritorial application in cases brought by the SEC or the Justice Department. Thus, the purpose of the language of section 929P(b) of the bill is to make clear that in actions and proceedings brought by the SEC or the Justice Department, the specified provisions of the Securities Act, the Exchange Act and the Investment Advisers Act may have extraterritorial application, and that extraterritorial application is appropriate, irrespective of whether the securities are traded on a domestic exchange or the transactions occur in the United States, when the conduct within the United States is significant or when conduct outside the United States has a foreseeable substantial effect within the United States."). *See also* 156 Cong. Rec. S5915-16 (daily ed. July 15, 2010) (statement of Senator Reed).

[6] *See* discussion in Section II.A, *infra*.

C. Study's Scope

Given the multitude of issues to be considered, a cross-Divisional staff working group ("Staff") was formed to undertake the Study. Staff participants included representatives from the:

Office of the General Counsel;
Office of International Affairs;
Division of Corporation Finance;
Division of Enforcement; and
Division of Risk, Strategy, and Financial Innovation.

The Staff also consulted during the course of the Study with staff from the Office of Investor Education and Advocacy, the Division of Investment Management, and the Division of Trading and Markets.

On October 25, 2010, the Commission issued a release that was subsequently published in the *Federal Register* inviting public comment on the four statutory issues identified above. The release also encouraged commenters to discuss, among other things:

- the circumstances, if any, in which a private plaintiff should be allowed to pursue claims even though the plaintiff purchased or sold the security outside the United States, and whether it makes a difference if: (a) the security was issued by a U.S. company or a non-U.S. company; (b) the security was purchased or sold on a foreign stock exchange, or purchased or sold on a non-exchange trading platform; or (c) the company's securities are traded exclusively outside the United States;

- the degree to which investors know, at the time that they place a securities purchase or sale order, whether the order will take place on a foreign stock exchange or on a non-exchange trading platform or other alternative trading system outside of the United States;

- any cases that have been dismissed as a result of *Morrison* or pending cases in which a challenge based on *Morrison* has been filed;

- remedies available outside the United States to U.S. investors who purchase or sell shares on a foreign stock exchange, or on a non-exchange trading platform or other alternative trading system outside of the United States; and

- the potential impact of the extraterritorial application of the private right of action on: (a) investor protection; (b) the maintenance of fair, orderly, and efficient markets; and (c) the facilitation of capital formation.

The Commission received 72 public comment letters as of January 1, 2012, including letters from investors and investor organizations, business associations, foreign government authorities, law firms, accounting firms, and academics. The Staff has carefully considered the views of these commenters and has incorporated them in the Study.

To help further inform the Study, when requested by outside parties, the Staff met with interested parties representing a variety of perspectives beginning in the Spring of 2011. These included meetings with representatives from investor protection associations, business associations, foreign institutional investors, and U.S. public pension funds. In addition, members of the Staff participated in a conference on the extraterritorial application of the federal securities laws that was hosted by the American Law Institute in Washington, D.C.[7] Conference participants included federal and state judges, lawyers from the plaintiff and defense bar, representatives from foreign governments, and academics.

II. Background

A. International Comity

Because much of the discussion concerning the cross-border scope of the Section 10(b) private right of action implicates considerations of international comity, a brief overview of the concept is appropriate.[8]

International comity is a customary international-law principle involving respect for the validity and effect of nations' executive, legislative, and judicial determinations.[9] The United States has recognized the principle of international comity as part of U.S. law.[10] Consistent with international comity, U.S. courts and government agencies often attempt, where possible, to balance the public and private interests of the United States with the competing policies of foreign jurisdictions when a conflict arises between U.S. and foreign law.[11]

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[7] A video of the American Law Institute conference is available at the following internet address: http://www.ali.org/index.cfm?fuseaction=meetings.videos&video=1.

[8] A number of the *amicus* briefs and comment letters described in the Study raised arguments related to international comity. *See* Section II.C.2 and Section IV.B, *infra*.

[9] *See Hilton v. Guyot*, 159 U.S. 113, 143 (1895) (explaining that international comity is "the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws"). *See generally* EXTRATERRITORIAL JURISDICTION IN THEORY AND PRACTICE (Karl M. Meessen ed., 1996).

[10] *Hilton*, 159 U.S. at 143.

[11] *See generally* Joel R. Paul, *The Transformation of International Comity*, 71 LAW & CONTEMP. PROBS. 19 (2008).

International comity is frequently implicated in the context of transnational securities frauds, particularly given that issuers and investors may be located in multiple jurisdictions, and various parts of their securities transactions may occur in each of these jurisdictions.[12] In these situations, it is often the case that each of the jurisdictions may have an interest in applying its legal regime to the fraudulent conduct. International comity requires each jurisdiction to recognize the laws and interests of the other jurisdictions with respect to persons and activities outside its territory, and thus helps ameliorate potential conflicts among the jurisdictions.[13]

B. Conduct and Effects Tests

Prior to the adoption of Section 929P(b)(2) of the Dodd-Frank Act,[14] the Exchange Act did not explicitly define the circumstances under which Section 10(b) applied to securities frauds that took place in whole or in part outside the United States.[15] In the absence of clear Congressional guidance, the courts faced with transnational fraud issues had attempted "[t]o discern 'whether Congress would have wished the precious resources of the United States courts and law enforcement agencies to be devoted'" to transnational securities frauds.[16] The courts acknowledged that the inquiry was largely guided by "policy considerations and the court's best judgment."[17]

The consensus view among the courts that considered the issue was that Congress would not have wanted wrongdoers offshore to be free to cause harm in the United States, or for the United States to be used as a base for fraudulent schemes directed at foreigners, even if the actual transaction affected by the fraud took place overseas. Consequently, the courts applied two tests to determine the reach of the antifraud provisions: the conduct test and the effects test.[18] These tests were based on generally recognized principles of international law.[19]

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12 *See generally* Kellye Y. Testy, *Comity and Cooperation: Securities Regulation in a Global Marketplace*, 45 ALA. L. REV. 927 (1994).

13 RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES (1987) (hereinafter "RESTATEMENT OF FOREIGN RELATIONS") Part IV, Chapter 1, Subchapter A, Introduction ("International law has long recognized limitations on the authority of states to exercise jurisdiction to prescribe in circumstances affecting the interests of other states.").

14 *See supra* note 4.

15 *See Itoba Ltd. v. LEP Group PLC*, 54 F.3d 118, 121 (2d Cir. 1995).

16 *Europe and Overseas Commodity Traders, S.A. v. Banque Paribas London*, 147 F.3d 118, 125 (2d Cir. 1998) (quoting *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 985 (2d Cir. 1975)).

17 *Kauthar SDN BHD v. Sternberg*, 149 F.3d 659, 664 (7th Cir. 1998).

18 *See, e.g.*, *Alfadda v. Fenn*, 935 F.2d 475, 478 (2d Cir. 1991); *Itoba Ltd.*, 54 F.3d at 121-22. Courts also applied an admixture of the two tests. *See generally* Dennis R. Dumas, *United*

The conduct test focused "on the nature of [the] conduct within the United States as it relates to carrying out the alleged fraudulent scheme,"[20] on the theory that "Congress would not want the United States to become a base for fraudulent activity harming foreign investors."[21] This test held that sufficient conduct in the United States violated Section 10(b) even if the victims or the purchases and sales were overseas.

The courts had adopted a range of approaches to defining when the level of domestic conduct was sufficient. On one end of the spectrum, the D.C. Circuit Court of Appeals required that the domestic conduct at issue must itself constitute a securities violation.[22] On the other end of the spectrum, three courts of appeals required only "some activity" in the United States that was "significant" to the furtherance of the fraudulent scheme.[23] Although it was difficult to know what differences in phraseology meant in practice, three other courts of appeals defined the test in terms that seemed to rest somewhere between the two extremes, not requiring that all of the violative conduct occur in the United States as under the D.C. Circuit standard, but requiring more U.S. conduct that had a larger role in the scheme than the courts requiring only "some activity" that was "significant" to the scheme. For example, the Seventh Circuit Court of Appeals explained that this intermediate standard permitted a Section 10(b) action to proceed when the conduct "forms a substantial part of the alleged fraud and is material to its success."[24]

States Antifraud Jurisdiction Over Transnational Securities Transactions: Merger of the Conduct and Effects Tests, 16 U. PA. J. INT'L BUS. L. 721 (1995).

[19] *See generally* RESTATEMENT OF FOREIGN RELATIONS § 402, *supra* note 13 (stating that the United States has authority to prescribe law with respect to, among other things, (i) "conduct that, wholly or in substantial part, takes place within its territory," and (ii) "conduct outside its territory that has or is intended to have substantial effect within its territory").

[20] *Psimenos v. E.F. Hutton & Co.*, 722 F.2d 1041, 1045 (2d Cir. 1983).

[21] *Banque Paribas*, 147 F.3d at 125.

[22] *See Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 31 (D.C. Cir. 1987) ("[J]urisdiction will lie in American courts where the domestic conduct comprises all the elements of a defendant's conduct necessary to establish [a violation of the antifraud provisions].").

[23] *See, e.g.*, *Grunenthal GmbH v. Hotz*, 712 F.2d 421, 425 (9th Cir. 1983); *Continental Grain (Australia) Pty. Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409, 421 (8th Cir. 1979); *SEC v. Kasser*, 548 F.2d 109 (3d Cir. 1977).

[24] *Kauthar*, 149 F.3d at 667. *See also, e.g., Robinson v. TCI/US West Communications Inc.*, 117 F.3d 900, 905 & n.10 (5th Cir. 1997) (domestic conduct must be "material" and "substantial"); *Psimenos*, 722 F.2d at 1045 (2d Cir.) (domestic conduct must be "material" and "substantial").

Notwithstanding the competing formulations, the conduct test as applied had a broad reach that led to the application of Section 10(b) to a variety of transnational securities fraud schemes with roots in the United States – many of which did not involve domestic transactions. These included securities frauds where: (1) the mastermind of the fraud operated from the United States in a scheme to sell shares in a foreign entity to overseas investors;[25] (2) much of the important efforts such as the underwriting, drafting of prospectuses, and accounting work that led to the fraudulent offering of a U.S. issuer's securities to overseas investors occurred in the United States;[26] or (3) the United States was used as a base of operations for meetings, phone calls, and bank accounts to receive overseas investors' funds.[27]

Under the effects test, Section 10(b) applied to transnational securities frauds when conduct occurring in foreign countries "caused foreseeable and substantial harm to interests in the United States."[28] This approach was generally consistent with the principle that acts done outside a jurisdiction, but that are either intended to produce, threaten to produce, or foreseeably do produce detrimental effects within its jurisdiction, justify a state in punishing the harm as if the actor had been present in the jurisdiction.[29] Among other situations, the effects test applied when either overseas fraudulent conduct or a predominately foreign transaction resulted in harm to: (1) investors resident in the United States (even if the U.S. investors were relatively small in

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25 *See SEC v. Berger*, 322 F.3d 187 (2d Cir. 2003) (applying Section 10(b) to a U.S. resident who operated an investment company organized under the laws of the British Virgin Islands that was held almost entirely by foreigners).

26 *See IIT v. Cornfeld*, 619 F.2d 909 (2d Cir. 1980) (applying Section 10(b) where overseas offering was in essence an offering of securities of an American issuer that was closely coordinated with a United States offering of securities in the same issuer, and where much of the critical efforts in making the offering occurred in the United States, and little of importance happened overseas).

27 *Kauthar*, 149 F.3d at 667.

28 *Mak v. Wocom Commodities Ltd.*, 112 F.3d 287, 289 (7th Cir. 1997) (quoting *Tamari v. Bache & Co. (Lebanon) S.A.L.*, 730 F.2d 1103, 1108 (7th Cir. 1984)). *See also Banque Paribas London*, 147 F.3d at 125. *See also Interbrew S.A. v. Edperbrascan Corp.*, 23 F. Supp. 2d 425, 430 (S.D.N.Y. 1998).

29 *See Schoenbaum*, 405 F.2d at 206. Presumably because it focused on domestic injuries for which the United States has long been viewed as having a strong sovereign interest in redressing, the effects test appears to have been relatively uncontroversial. *See generally Strassheim v. Daily*, 221 U.S. 280, 285 (1911) ("Acts done outside a jurisdiction, but intended to produce and producing detrimental effects within it, justify a State punishing the cause of the harm as if he had been present at the effect ….").

number);[30] (2) securities either traded on a U.S. exchange or issued by a U.S. entity;[31] or (3) U.S. domestic markets, at least where a reasonably particularized harm occurred.[32]

C. *Morrison* Litigation

1. Lower Court Litigation

Morrison v. National Australia Bank involved a so-called "foreign-cubed" class action – foreign plaintiffs suing a foreign issuer concerning securities transactions that occurred on a foreign exchange.[33] Specifically, the case was a putative class action on behalf of persons who had acquired National Australia Bank's (NAB) common stock on foreign securities exchanges during a two-year period beginning in mid-1999. Plaintiffs alleged that NAB – a large Australian bank whose stock principally trades on the Australian Securities Exchange[34] – made

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[30] *See, e.g.*, *Consolidated Gold Fields PLC v. Minorco, S.A.*, 871 F.2d 252, 262-63 (2d Cir.), *amended on other grounds*, 890 F.2d 569 (2d Cir. 1989); *Bersch*, 519 F.2d at 991; *E.ON AG v. Acciona, S.A.*, 468 F. Supp. 2d 537, 546-48 (S.D.N.Y. 2006). *Cf. Banque Paribas*, 147 F.3d at 128 n.12 ("U.S. residence of individual investors – not American nationality – must be the focus of the effects test.").

[31] *See, e.g.*, *Des Brisay v. Goldfield Corp.*, 549 F.2d 133, 134-36 (9th Cir. 1977). *See also Schoenbaum v. Firstbrook*, 405 F.2d 200, 206 (2d Cir. 1968), *modified on other grounds*, 405 F.2d 215 (1968) (*en banc*) ("protect[s] the domestic securities market from the effects of improper foreign transactions in American securities").

[32] *Cf. Mak v. Wocom Commodities Ltd.*, 112 F.3d 287, 290 (7th Cir. 1997).

[33] Generally speaking, foreign-cubed class actions were perhaps one of the most controversial Section 10(b) private actions pursued under the conduct and effects tests because, to many courts and commentators, the cases seemed to have relatively little connection to the United States. *See generally* John C. Coffee, Jr., *Foreign Issuers Fear Global Class Actions*, NAT'L L.J. (June 14, 2007). *But see generally* Peter M. Saparoff & Katharine C. Beattie, *The Benefits of Including Foreign Investors in U.S. Securities Class Action Suits*, SN084 A.L.I.-A.B.A. 669 (2008) (arguing that "U.S. courts should include [foreign-cubed plaintiffs] in class actions for three overarching reasons: (1) the U.S. class action is the superior method for resolving global securities fraud cases; (2) including foreign investors will promote securities fraud settlements and deter future fraud; and (3) including foreign purchasers will encourage cooperation on the global regulatory front").

[34] A small percentage of NAB's equity traded on the New York Stock Exchange in the form of American Depositary Receipts (ADRs), but none of the remaining class members involved in the suit on appeal had purchased these instruments. *See generally* discussion of ADRs in Appendix A, *infra*.

NAB first listed its ADRs on the New York Stock Exchange ("NYSE") on June 24, 1988, at the same time registering its securities with the Commission (which, as discussed in Appendix false and misleading statements overseas to the class members concerning the profitability of a wholly-owned U.S. subsidiary. NAB's overseas public statements were allegedly based on false financial figures that the subsidiary's executives knowingly generated in the United States in order to inflate the subsidiary's value, and then sent to Australia for incorporation in NAB's consolidated financials. When the fraud was revealed, the price of NAB's shares dropped significantly, causing losses to the class members. Plaintiffs filed suit in a U.S. district court against NAB, its subsidiary, and certain senior officials, alleging violations of Section 10(b) of the Exchange Act and Rule 10b-5.[35]

A, the Commission requires in order to list ADRs on a U.S. stock exchange). At that time, shares of NAB also traded on the Australian Stock Exchange, London Stock Exchange, Tokyo Stock Exchange, and New Zealand Stock Exchange. Over the next several years, NAB made regular filings and submissions of its annual report and additional reports on Form 6-K (report of information that the foreign issuer (i) makes or is required to make public pursuant to the law of the jurisdiction of its domicile or in which it is incorporated or organized, or (ii) files or is required to file with a stock exchange on which its securities are traded and which was made public by that exchange, or (iii) distributes or is required to distribute to its security holders). From time to time, NAB registered equity and debt securities for sale under the Securities Act in connection with capital raising transactions and employee benefit plans. NAB delisted its ADRs from the NYSE on June 18, 2007, and NAB filed a Form 15F to terminate its registration and reporting obligations under the Exchange Act on June 21, 2007. NAB's ADRs continue to trade in the United States over-the-counter.

[35] Rule 10b-5, which the Commission promulgated pursuant to its rulemaking authority under Section 10(b) of the Exchange Act, prohibits any act or omission resulting in fraud or deceit in connection with the purchase or sale of any security. The rule provides that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5.

The district court dismissed the case, holding that the foreign plaintiffs' claims did not satisfy the conduct test.[36] In analyzing the allegations under the conduct test, the district court determined that "a significant, if not predominant, amount of the material conduct in this case occurred a half-world away."[37] As the district court saw it, the U.S. subsidiary's conduct "amounts to, at most, a link in the chain of an alleged overall securities fraud scheme that culminated abroad," and, thus, "[o]n balance, it is the foreign acts – not any domestic ones – that 'directly caused' the alleged harm here."[38]

The Second Circuit Court of Appeals affirmed the dismissal. The court found that the conduct and effects tests were not satisfied given "the fact that the fraudulent statements at issue emanated from NAB's corporate headquarters in Australia, the complete lack of any effect on America or Americans, and the lengthy chain of causation between [the subsidiary's] actions and the statements that reached investors."[39]

Notwithstanding its holding in favor of NAB, the court declined NAB's broader invitation to "jettison[] [the] conduct and effects tests" in favor of a "bright-line" standard.[40] *First*, the court did not agree with NAB that a bright-line standard was necessary to reduce potential conflicts between U.S. antifraud laws and those of foreign nations, explaining that "[i]f our anti-fraud laws are stricter than [a foreign state's], that country will surely not be offended by their application."[41] *Second*, the court expressed concern that a bright-line standard "would conflict with the goal of preventing the export of fraud from America" and ensuring that the United States is not "seen as a safe haven for securities cheaters."[42] *Third*, the court stated that it is "leery of rigid bright-line rules because [it] cannot 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."[43] Lastly, the court reasoned that the conduct and effects tests adequately ensure that U.S. courts are not converted to "the world's court" for securities fraud, or that U.S.

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36 *In re National Australia Bank Securities Litig.*, No. 03-6537, 2006 WL 3844465, at *2-8 (S.D.N.Y. Oct. 25, 2006).

37 *Id.* at *7.

38 *Id.* at *8.

39 547 F.3d 167, 177 (2d Cir. 2008).

40 *Id.* at 175.

41 *Id.* (quoting *IIT v. Cornfeld*, 619 F.2d 909, 921 (2d Cir. 1980) (Friendly, J.) (internal quotation marks omitted)).

42 *Id.*

43 *Id.*

judicial resources are expended "resolving cases that do not affect Americans or involve fraud emanating from America."[44]

2. Supreme Court Briefing

a. The Parties' Arguments

In their merits briefs before the Supreme Court, the plaintiffs argued that Section 10(b) affords a private action for victims of transnational securities frauds if the conduct in the United States both is material to the fraud's success and forms a substantial component of the fraudulent scheme.[45] According to plaintiffs,

> The materiality inquiry would ensure that the domestic conduct was an integral link in the chain of events in the transnational fraud leading to the foreign investors' losses. The substantiality showing would generally be satisfied by demonstrating that a sufficient quantum of conduct occurred in the United States reasonably to warrant application of the Exchange Act.[46]

Plaintiffs asserted that this standard would not cause significant conflicts with other nations' laws because the potential for such conflict is much less where enforcement of the antifraud sections of the securities laws is concerned.[47] Moreover, the material-and-substantial standard would "permit the courts to make flexible case-by-case determinations of the extraterritorial applicability of the antifraud provisions of the Exchange Act, insuring that the interests of comity will be furthered and not offended by each application."[48]

The defendants argued that the conduct and effects tests should be rejected as contravening the presumption that a statute only applies domestically unless there is a clear indication that Congress intended otherwise.[49] The defendants argued instead for a bright-line bar on private actions under Section 10(b) for frauds in connection with a transaction on a foreign securities exchange.[50] In support, they asserted that the extension of the Section 10(b)

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[44] *Id.*

[45] Brief for Petitioners, at 31 (Jan. 19, 2010) (available at 2010 WL 265632). The formulation offered by the plaintiffs largely reflected the intermediate version of the conduct test as set forth by the Courts of Appeals for the Second, Fifth, and Seventh Circuits. *See generally* cases cited in footnote 24, *supra*.

[46] *Id.* at 32.

[47] *Id.* at 35-38.

[48] *Id.* at 40.

[49] Brief for Respondents, at 32-39 (Feb. 19, 2010) (available at 2010 WL 665167).

[50] *Id.* at 43-44.

private right of action to securities transactions outside the United States would create significant conflicts with other nations' laws, cataloguing dozens of potential conflicts, and argued that the United States should not interfere with other nations' sovereign policy choices on these issues. [51]

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[51] See *id.* at 47-48. The defendants identified the following potential conflicts:

> What are the duties of disclosure? What information is material? Should forward-looking statements be allowed, and, if so, with what restrictions or protections? How is fraud to be redressed? Should public enforcement be supplemented with private lawsuits at all? If so, what are the elements of a claim? What state of mind is required to establish liability? Must a plaintiff show reliance? If so, how? Should a "fraud-on-the-market" presumption of reliance be recognized? … Should there be issuer liability for secondary trading at all – that is, should an issuer, and by extension its current shareholders, pay damages for losses suffered by shareholders who did not buy their shares from the company, but from other shareholders on the open market? What is the test for causation? How are damages measured? Should there be a cap on class damages? Should there be a "lookback" limit on recoverable losses, limiting damages on the basis of an upswing in a security's price after it drops? Who can be sued? Control persons? Secondary actors? Should class actions be allowed? Opt-out? Or opt-in? Should losers pay the winners' attorneys' fees? Should contingency fees be allowed?

b. Views Expressed in *Amicus Curiae* Briefs Supporting Plaintiffs

The *amicus curiae* briefs submitted in support of the plaintiffs identified a number of concerns with a rule that would reject the conduct and effects tests in favor of defendants' proposed transactional test.[52] One set of concerns related to securities that are listed on both U.S. and foreign exchanges. Certain of the plaintiffs' *amici* asserted that it "makes little sense to apply a rule that artificially seeks to sever purchases abroad from purchases within the territorial United States."[53] As they explained, securities prices are set by information and trading that "transcends national boundaries," and thus "there is an inherent American interest in ensuring that even foreign purchasers are not defrauded, because the prices they pay for their securities will ultimately impact the prices at which securities are sold in America."[54]

Relatedly, plaintiffs' *amici* argued that foreign issuers that cross-list in the United States benefit from the prestige and increased investor confidence that results from the U.S. listing, and thus it is reasonable to hold these foreign issuers to the full force of the U.S. securities laws regardless of where the particular transaction occurs.[55] "By voluntarily listing its securities on an American exchange and filing reports with the SEC, a foreign issuer signals to global investors its willingness to comply with – and be bound by – the U.S. law's disclosure and liability provisions. That willingness translates into greater liquidity and higher prices for [the foreign issuer's] shares, whether they be the U.S.-listed [American Depositary Receipts[56]] or common stock traded on [a] non-U.S. exchange."[57]

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52 An *amicus curiae* is a non-party to a legal proceeding who volunteers to offer information, analysis or views – often in the form of a legal brief – to assist a court in deciding an issue before it. The phrase "*amicus curiae*" means "friend of the court."

53 Brief for Alecta Pensionsförsäkring, Ömsesidigt, AmpegaGerling Investment GmbH, APG Algemene Pensioen Groep N.V., *et al.*, at 25 (Jan. 26, 2010) (available at 2010 WL 342027).

54 *Id.* at 23.

55 *See generally* discussion of "bonding hypothesis" in Appendix B, *infra*.

56 *See generally* discussion in Appendix A, *infra.*

57 Brief for MN Services Vermogensbeheer B.V., Scottish Widows Investment Partnership Limited, and North Yorkshire Pension Fund, at 9 (Jan. 26, 2010) (available at 2010 WL 342029). *See also* Brief for the Australian Shareholders' Association and the Australian Council of Super Investors, at 9 (Jan. 26, 2010) (available at 2010 WL 342028) (hereinafter Brief for the Australian Shareholders, *et al.*") ("[W]hen the economy is global, and truly 'international' companies trade their stock over securities exchanges throughout the world, it is essential for the optimal functioning of national and international securities markets that foreign investors are afforded the protection of laws such as the anti-fraud provisions of the *Securities Exchange Act of 1934*.") (emphasis in original).

Beyond situations involving cross-listing, plaintiffs' *amici* argued that the existence of substantial fraudulent conduct in the United States that is targeted overseas should be sufficient to allow foreign investors to sue under Section 10(b). They argued that, without the extraterritorial application of Section 10(b) afforded by the conduct and effects tests, there would generally be no legal options for redress open to the foreign victims of frauds committed by persons residing in the United States.[58] As a result, "perpetrators of securities fraud within the United States [would be] able to 'export' the consequences of their misdeeds with little or no risk of being held responsible."[59] Plaintiffs' *amici* argued that this would "do considerable damage to the standing of the United States in investors' minds,"[60] and could "lead to United States citizens lacking similar protections for their own foreign investments."[61] They warned that eliminating the conduct and effects tests could also become "a significant factor weighing against further or continued foreign investment in the United States."[62] According to plaintiffs' *amici*, "[i]f foreign investors believe that they cannot trust the securities issued by corporations with a substantial American presence – because the American portion of the business may not be subject to stringent antifraud regulation – those investors will hesitate to risk their capital on such securities."[63]

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[58] Brief for the Australian Shareholders, *et al.*, at 6 ("Where the party committing a fraud resides in the United States, there are generally few or no legal options open to the foreign victims of that fraud to seek redress other than those provided under the United States legal system."). In advancing this argument, plaintiffs' *amici* did not specify whether the lack of a legal option for redress would result from the difficulty of a foreign court obtaining jurisdiction over the U.S. person who committed the fraud, from limitations on private redress under foreign law, or from other factors.

[59] *Id.* at 5.

[60] *Id.* at 7.

[61] *Id*. at 8.

[62] *Id*. at 11

[63] Brief for Alecta Pensionsförsäkring, Ömsesidigt, AmpegaGerling Investment GmbH, APG Algemene Pensioen Groep N.V., *et al.*, at 34-35. *But see generally* economic analysis set forth in Appendix B, *infra*.

c. Views Expressed in *Amicus Curiae* Briefs Supporting Defendants (Excluding Foreign Governments' Briefs)

Defendants' *amici* generally argued in favor of a bright-line standard that, at a minimum, would eliminate Section 10(b) private actions for foreign-cubed class actions.[64]

A principal argument advanced in support of such an approach concerned the importance of predictability in encouraging domestic investment and raising capital.[65] "The absence of a clear standard leaves open the risk for non-U.S. entities that engaging in investment activity in the United States – be it direct investment, such as acquiring a U.S. subsidiary, or raising capital in U.S. markets – will give rise to liability for claims under an expansive Section 10(b) implied right of action as applied to securities issued abroad under other regulatory regimes."[66] By

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[64] As an alternative, one *amicus curiae* brief proposed a "bright-line rule restricting the fraud-on-the-market doctrine to domestic exchanges." Brief for Professors and Students of the Yale Law School Capital Markets and Financial Investments Clinic, at 3 (Feb. 26, 2010) (available at 2010 WL 748251). Under the fraud-on-the-market doctrine, an investor need not establish individualized reliance on a defendant's misrepresentations or omissions, but instead may rely on a presumption that "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." *Basic Inc. v. Levinson*, 485 U.S. 224, 246 (1988). The *amicus* brief argued that application of the fraud-on-the-market theory to foreign exchanges poses international comity concerns because: (1) "almost all other jurisdictions *reject* that doctrine," and (2) it would require an assessment of a foreign nation's regulatory regime as part of the overall determination of whether the stocks traded in an efficient market. Brief for Professors and Students of the Yale Law School Capital Markets and Financial Investments Clinic, at 8 & 12-13 (emphasis in original).

[65] *Cf.* Brief for NYSE Euronext, at 11 (Feb. 26, 2010) (available at 2010 WL 723008) (asserting that a bright-line rule that excludes transactions by foreign investors on foreign exchanges from private redress under Section 10(b) would also be consistent with the reasonable expectations of these investors because investors "make investment decisions based on the laws and regulations in the countries where they purchase securities").

[66] Brief for the Securities Industry and Financial Markets Association, the Association for Financial Markets in Europe, the Chamber of Commerce of the United States of America, the United States Council for International Business, the Association Française des Entreprises Privées, and GC100, at 8-9 (Feb. 26, 2010) (available at 2010 WL 723005) (hereinafter "Brief for SIFMA *et al.*"). *See also* Brief for Washington Legal Foundation, at 19 (Feb. 26, 2010) (available at 2010 WL 723011) ("Subjecting a company to a United States securities class action, even where it sells no securities in the United States, on the basis of conduct at a United States subsidiary or division, would increase the risk of investing in the subsidiary or division in the first place."); Brief for Infineon Technologies AG at 27 (Feb. 26, 2010) (available at 2010 WL 723007) (stating that foreign issuers may be discouraged from listing a portion of their securities on a U.S. exchange because the financial risk of "global class actions by foreign investors who have no connection with the United States often vastly exceeds the value of such listings").

contrast, a bright-line standard that eliminated private liability under Section 10(b) for transactions in foreign securities that occur on foreign exchanges would "foster[] capital-raising activities" because a foreign issuer "would be able to reasonably predict the scope of potential liability in the U.S. as a result of its listing" some fraction of its shares in the United States – *i.e.*, "liability would be limited to the universe of investors who chose to purchase the issuer's securities on the U.S. exchange."[67] According to defendants' *amici*, this would allow the issuer to "adjust[] the size of its issuance in proportion to its choice of risk."[68]

As an additional policy basis supporting a bright-line standard, defendants' *amici* argued that extending Section 10(b) private liability to frauds in connection with transactions on foreign exchanges would result in wasteful and abusive litigation. They warned that the United States could become a venue for global securities class actions, which would "burden[] the already overtaxed district courts and divert[] precious judicial resources to redress harms having nothing to do with United States markets or United States investors."[69] This, they explained, is in part because global securities class actions "present challenges" in both "managing discovery where a substantial part of the evidence and parties reside outside the United States" and administering the class (including providing notice to class members) "when most of the class members reside in other countries."[70] From the foreign issuers' perspective, this means they would "often be subjected to the burdens and uncertainty of intensive U.S. discovery, pre-trial litigation, and perhaps trial before plaintiffs' claims can be ruled out-of-bounds as improperly extraterritorial and by that time much harm to the foreign issuer will have been done."[71]

Finally, echoing the defendants' brief, defendants' *amici* argued that "different nations have reached different conclusions about what constitutes fraud and how to deter and prosecute it," and the "[e]xtraterritorial application of U.S. securities law necessarily risks interfering with the authority of other sovereign nations to make these policy choices."[72] The threats to

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67 Brief for NYSE Euronext, at 5-6.

68 *Id.* at 5-6.

69 Brief for Washington Legal Foundation, at 17. *See also* Brief for Law Professors, at 28 (Feb. 26, 2010) (available at 2010 WL 740747).

70 Brief for Washington Legal Foundation, at 19.

71 Brief for the Institute of International Bankers, European Banking Federation, and the Australian Bankers' Association, at 28 (Feb. 26, 2010) (available at 2010 WL 723004) (hereinafter "Brief for International Bankers, *et al*."). *See also* Brief for the International Chamber of Commerce, the Swiss Bankers Association, Economiesuisse, the Federation of German Industries and the French Business Confederation, at 7 (Feb. 26, 2010) (available at 2010 WL 719334).

72 Brief for International Bankers, *et al*., at 18-19. *See, e.g.*, Brief for SIFMA *et al.* at 26 ("conflict with the careful policy judgments made by other nations"); Brief for the European Aeronautic Defence & Space Co. N.V., Alstom SA, Lagardère Groupe SCA, Thales SA, Technip

international comity may be particularly severe where a global class action under Section 10(b) might threaten the solvency of a foreign nation's major corporation, thereby risking direct adverse impacts on that nation's economic interests.[73]

d. United States Government's View

The U.S. Solicitor General, joined by the Commission, submitted an *amicus curiae* brief on behalf of the United States that recommended a standard that would permit a private plaintiff who suffered a loss outside the United States as part of a transnational securities fraud to pursue redress under Section 10(b) if the U.S. component of the fraud directly caused the plaintiff's injury.[74] This direct-injury standard was more restrictive than that which the Solicitor General advocated for Commission and DOJ enforcement actions,[75] but a broader standard than the domestic-transactions standard urged by the defendants. As the Solicitor General explained, the plaintiffs would have lost under the direct-injury standard.

In explaining the basis for this more restrictive standard for private actions than for public enforcement actions, the Solicitor General stated that "SEC enforcement actions are unlikely to produce conflict with foreign nations because the Commission routinely works with its overseas

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SA, and Vivendi SA, at 6 (Feb. 26, 2010) (available at 2010 WL 719336) (hereinafter "Brief for Aeronautic Defense *et al.*") ("Superimposing U.S. anti-fraud regulation – via U.S.-based class action litigation – on the[] carefully considered and sophisticated European regulatory regimes would effectively override important policy decisions that the EU and its member states have sought to implement."). *See also* Brief for NYSE Euronext, at 12 (stating that "an imposition of U.S. law over foreign transactions is directly at odds with the years of effort that the U.S. has devoted to promoting cooperation with foreign governments in the regulation of securities trading"); Brief for SIFMA, *et al.*, at 26 ("hamper efforts of international coordination for regulating global markets"); Brief for Aeronautic Defence, *et al.*, at 24 ("At least fifteen foreign countries – including France, the Netherlands, Germany, Great Britain, Italy, and Belgium – have enacted blocking legislation in an effort to ensure that their sovereign policy choices regarding the conduct of civil litigation are not overridden by U.S. courts.").

[73] Brief for the Organization for International Investment, at 9 (Feb. 25, 2010) (available at 2010 WL 719335).

[74] *See* Brief for the United States, at 27 (Feb. 26, 2010) (available at 2010 WL 719337).

[75] The Solicitor General argued that the Commission and DOJ should be able to maintain an enforcement action under Section 10(b) if significant conduct material to the fraud's success occurs in the United States. *See* Brief for the United States Government, at 16. This standard reflected the broad version of the conduct test that had been adopted by the Courts of Appeals for the Third, Eighth, and Ninth Circuits. See *supra* discussion at page 11 and cases cited in footnote 23. As discussed above, Congress has now codified a similarly broad standard for Commission and DOJ enforcement actions. *See* Dodd-Frank Act § 929P(b)(2).

counterparts to develop coordinated approaches to enforcement."[76] By contrast, private securities actions "present a significant risk of conflict with foreign nations because the United States affords private plaintiffs litigation procedures and remedies that other countries often do not provide."[77] As examples, the Solicitor General stated that, "unlike many other countries, the United States permits securities class actions and use of the fraud-on-the-market theory to establish reliance in those actions."[78] The direct injury standard, by requiring private plaintiffs to establish that their losses were a direct result of conduct in the United States, would "mitigate[] that risk by limiting the availability of United States remedies to situations in which domestic conduct is closely linked to the plaintiff's grievance."[79]

The Solicitor General opposed the defendants' transactional test, expressing concern that, under such an approach, "Section 10(b) would not apply to a fraud that was hatched and executed entirely in the United States and that injured domestic investors if the transactions induced by the fraud were executed abroad."[80] Yet, "Section 10(b) would apply to a fraud even if its only connection to the United States was that the injured foreign investor happened to be here when the fraudulent transaction was consummated."[81] Such "arbitrary" outcomes, the Solicitor General stated, would not comport with the Congressional purposes behind Section 10(b), which include ensuring honest securities markets, promoting investor confidence, and preventing the exportation of securities fraud to other nations.[82]

e. Views Expressed by Foreign Governments

The British, French, and Australian Governments filed briefs in the *Morrison* case opposing to various degrees the cross-border extension of a private right of action under Section 10(b).[83] Each emphasized that other nations' approaches to securities regulation and litigation

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[76] *Id.* at 26.

[77] *Id.* at 27.

[78] *Id.*

[79] *Id.* Further, the Solicitor General explained that a direct-injury requirement would alleviate the danger that the resources of U.S. courts would be diverted to redress securities-related harms suffered outside the United States having only an attenuated connection to this country. *Id.* at 28.

[80] *Id.* at 21.

[81] *Id.* at 22.

[82] *Id.* at 21-22.

[83] The Swiss Government submitted a diplomatic note that, although not proposing a specific standard, expressed the view that "[t]he United States should not purport to provide civil remedies for alleged securities law violations committed by non-U.S. corporations against non-

differ in important respects from the U.S. approach,[84] and "those differences represent legitimate policy choices and sovereign interests that ought to be respected by the United States."[85]

- The British Government argued that the Section 10(b) private action should not be available to purchasers of securities on a foreign exchange who are injured by misleading statements or omissions made outside of the United States by the foreign issuer.[86] Such a bright-line standard

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U.S. persons on non-U.S. securities exchanges." Swiss Embassy Note No. 17/2010, at 1-2 (attached as Appendix A to Brief for International Bankers *et al*. (available at 2010 WL 723004)). The Swiss Government asserted that "international mutual assistance is the most effective mechanism for combating instances of genuinely transnational securities fraud schemes." *Id*. at 3.

[84] In addition to identifying a number of substantive and procedural differences between U.S. and foreign law with respect to private securities actions, the British Government identified a more fundamental disagreement "as to the desirability and appropriateness of even having a private right of action against an issuer for securities fraud." Brief for the United Kingdom of Great Britain and Northern Ireland, at 18 (Feb. 25, 2010) (available at 2010 WL 723009) (hereinafter "Brief for U.K."). "Unlike a claim against an individual wrongdoer that would be paid from personal assets, a claim against a public company by former shareholders, if successful, imposes the costs of compensation for losses on current shareholders." *Id*. The British Government asserted that "the result can be a mere transfer of wealth from one group of innocent investors to another, with large transaction costs in the form of legal fees and expenses." *Id.*

[85] Brief for U.K., at 5-6. *See also, e.g.*, Brief for the Republic of France, at 20, 22 (Feb. 26, 2010) (available at 2010 WL 723010) (hereinafter "Brief for France") (stating the United States does not have a "valid interest" in applying its "chosen method of remedying securities fraud" – *i.e.*, "privately initiated class actions instituted by plaintiffs' attorneys working on a contingency-fee basis" – "to foreign securities transactions"); Brief for the Government of the Commonwealth of Australia, at 22-23 (Feb. 26, 2010) (available at 2010 WL 723006) (hereinafter "Brief for Australia") (stating that "[a]dopting appropriate legal processes is a basic sovereign function on which reasonable sovereigns can differ" and requesting "respect [for] Australia's sovereign judgments on civil procedures, especially when the litigation concerns Australian citizens suing an Australian corporation over conduct that occurred in Australia"); Swiss Embassy Note No. 17/2010, at 2 (asserting that permitting private rights of action under Section 10(b) for foreign citizens who trade securities of foreign issuers on foreign exchanges "would interfere with the sovereignty of foreign nations, which have the right to regulate securities-related activities within their own territory without interference from U.S. civil lawsuits").

[86] Brief for U.K., at 3 & n.7. The British Government did state that an "SEC enforcement action (unlike a private suit) permits the opportunity for cooperative dialogue with foreign regulators" and that "[s]uch dialogue and cooperation limit the risks of conflict with regulation by another state and of duplicative foreign litigation." *Id.* at 38-39.

"would allow issuers to plan their global affairs and assess their potential legal exposure with greater confidence and provide investors with a clearer understanding of where they can seek relief for alleged securities fraud."[87]

- The French Government supported a bright-line standard under which the Section 10(b) private action would not extend to frauds involving foreign plaintiffs suing a foreign company for losses suffered in connection with the purchase or sale of securities on a foreign exchange.[88]

- The Australian Government suggested that the conduct test should be abandoned in favor of a standard that would require a tight factual nexus between the U.S. conduct and the alleged injury.[89]

3. The Supreme Court's Decision in *Morrison*

The Supreme Court's *Morrision* decision rejected the conduct and effects tests in favor of a transactional test.[90] In rejecting the conduct and effects tests, the Court explained that the tests lacked textual support in the Exchange Act and contravened the presumption that a statute only applies domestically unless there is a clear indication that Congress intended otherwise.[91] The

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87 *Id.* at 30. *See also id.* at 27 ("Inherent in [investors'] investment decisions – and in the global flow of capital – is a choice of varying [regulatory and legal] safeguards. The market will align incentives appropriately if issuers are held responsible by the jurisdiction in which they have issued their securities and if investors know they can seek redress for harms in the jurisdiction in which they purchased or traded securities.").

88 Brief for France, at 18. The French Government expressed concern that allowing foreign investors to sue foreign companies for losses resulting from transactions on foreign exchanges would promote "international forum shopping" by "foreign plaintiffs who believe they can obtain a better result in the U.S." *Id.* at 29-30. The French Government explained that this could, in turn, cause greater difficulties for foreign regulatory authorities and courts that are attempting to resolve such disputes because the injured investors will know that they have "the option of bypassing the [foreign] regulatory system altogether by filing a lawsuit in the U.S." *Id.* at 30.

89 Brief for Australia, at 31-32.

90 *See Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869, 2888 (2010).

91 *Id.* at 2878. For a historical discussion of the Supreme Court's application of the presumption against extraterritoriality that includes the *Morrison* decision, see generally John H. Knox, *The Unpredictable Presumption Against Extraterritoriality*, 40 S.W. L. REV. 635, 636-49 (2011).

Court was critical of the ad-hoc balancing approaches that the conduct and effects tests employed, stating that "[t]here is no more damning indictment of the 'conduct' and 'effects' test[s] than the Second Circuit's own declaration that 'the presence or absence of any single factor which was considered significant in other cases … is not necessarily dispositive in future cases.'"[92]

The Court instructed that, under the transactional test, "Section 10(b) reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States."[93] In adopting the transactional test, the Court was mindful of the concerns of foreign governments and other foreign entities that urged adoption of a bright-line standard that would limit Section 10(b)'s interference with foreign securities regulation, stating that the transactional test "meets that requirement."[94] The Court explained that the "probability of incompatibility" with other nations' securities laws is "obvious,"[95] stating:

> Like the United States, foreign countries regulate their domestic securities exchanges and securities transactions occurring within their territorial jurisdiction. And the regulation of other countries often differs from ours as to what constitutes fraud, what disclosures must be made, what damages are recoverable, what discovery is available in litigation, what individual actions may be joined in a single suit, what attorney's fees are recoverable, and many other matters.[96]

Further, the Court seemed to believe that the risk that the United States might export securities frauds overseas to the detriment of foreign investors was outweighed by the potential threat of regulatory conflict and international discord that private securities class actions can pose in the context of transnational securities frauds. As the Court viewed it, "[w]hile there is no reason to believe that the United States has become the Barbary Coast for those perpetrating frauds on foreign securities markets, some fear that it has become the Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets."[97]

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92 *Id.* at 2879 (quoting *IIT v. Cornfeld*, 619 F.2d 909, 918 (2d Cir. 1980)).

93 *Id.* at 2888. *See also id*. at 2884 ("[I]t is in our view only transactions in securities listed on domestic exchanges, and domestic transactions in other securities, to which §10(b) applies.").

94 *Id.* at 2885.

95 *Id*. at 2886.

96 *Id*.

97 *Id.* To the extent that the *Morrison* decision can be understood to suggest that the perpetration of securities frauds from the United States on investors in other countries is not a significant problem, this view is not supported by the following recent Commission enforcement actions:

Justice Stevens filed a concurrence, joined by Justice Ginsburg, in which he expressed support for the conduct and effects tests.[98] He explained that the conduct and effects tests "strike[] a reasonable balance between the goals of preventing the export of fraud from America, protecting shareholders, enhancing investor confidence, and deterring corporate misconduct, on the one hand, and conserving United States resources and limiting conflict with foreign law, on the other."[99] Justice Stevens also criticized the transactional test as unduly excluding from

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- *In the Matter of Aurelio Rodriquez*, No. 3-14678, and *In the Matter of Investment Placement Group*, *et al.*, No. 3-14677 (S.E.C. Administrative Proceedings filed Dec. 23, 2011) (orders instituting Administrative Proceedings available at: http://www.sec.gov/litigation/admin/2011/33-9289.pdf and http://www.sec.gov/litigation/admin/2011/34-66055.pdf) (California-based brokerage firm acted in concert with a Mexican investment adviser to unnecessarily insert a separate broker-dealer as a middleman into securities transactions in order to generate millions of dollars of fraudulent additional fees, causing investors to pay approximately $65 million more than they would have without the middleman);

- *SEC v. Seisma Oil Research, LLC, et al.*, No. 5:10-CV-95 (N.D. Texas filed June 16, 2010) (litigation release available at: http://www.sec.gov/litigation/litreleases/2010/lr21562.htm) (a Florida resident and three affiliated companies allegedly fraudulently sold investments in Texas oil and gas projects to more than 400 non-U.S. investors, raising at least $25 million);

- *SEC v. Peter C. Son, et al.*, No. CV-09-2554 MMC (N.D. Cal. filed June 9, 2009) (litigation release available at: http://sec.gov/litigation/litreleases/2009/lr20881.htm) (two California residents and two companies they controlled allegedly conducted an $80 million Ponzi scheme that targeted approximately 500 investors in the United States, South Korea, and Taiwan); and

- *SEC v. Stefan H. Benger, et al.*, No. 09-CV-00676 (N.D. Ill. filed Feb. 3, 2009) (litigation release available at: http://sec.gov/litigation/litreleases/2009/lr20881.htm) (massive and ongoing international boiler room scheme that allegedly sold shares of U.S. penny stock raising at least $44.2 million from 1,400 investors in Europe).

98 *See id.* at 2888-95 (Stevens, J., concurring in the judgment). Although generally supporting the conduct and effects tests, Justice Stevens did suggest that a bar on foreign-cubed actions would be appropriate. *Id.* at 2894-95 n.11 ("In recognition of the Exchange Act's focus on American investors and the novelty of foreign-cubed lawsuits, and in the interest of promoting clarity, it might have been appropriate to incorporate one bright line into the Second Circuit's test, by categorically excluding such lawsuits from §10(b)'s ambit.").

99 *Id.* at 2893-94 (Stevens, J., concurring in the judgment) (footnote and internal citations omitted).

private redress under Section 10(b)'s reach "frauds that transpire on American soil or harm American citizens."[100] He posed the following situation:

> Imagine, for example, an American investor who buys shares in a company listed only on an overseas exchange. That company has a major American subsidiary with executives based in New York City; and it was in New York City that the executives masterminded and implemented a massive deception which artificially inflated the stock price – and which will, upon its disclosure, cause the price to plummet. Or, imagine that those same executives go knocking on doors in Manhattan and convince an unsophisticated retiree, on the basis of material misrepresentations, to invest her life savings in the company's doomed securities. Both of these investors would, under the Court's new test, be barred from seeking relief under §10(b).[101]

III. Application of the Transactional Test: Issues Addressed in Post-*Morrison* Decisions

Since the *Morrison* decision, the lower federal courts have addressed a number of questions regarding the interpretation and application of the transactional test. The discussion below highlights the eight principal issues that the federal courts have addressed through January 1, 2012.

For purposes of this discussion, prong 1 of the transactional test refers to a "purchase or sale of a security listed on an American stock exchange," and prong 2 of the test refers to "the purchase or sale of any other security in the United States."[102] Subsections A through C discuss issues involving the application of prong 1 of the transactional test; Subsection D addresses issues involving the application of prong 2 of the transactional test; and Subsections E through H address application of the test to transnational securities frauds involving a security-based swap, fraud by an intermediary, insider trading, and an off-shore feeder fund.

At the outset, it should be observed that there appears to be no dispute that *foreign investors* who purchase securities either through a U.S. exchange or otherwise in the United States fall within the transactional test.[103]

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[100] *Id.* at 2895 (Stevens, J., concurring in the judgment).

[101] *Id.* (Stevens, J., concurring in the judgment).

[102] *Morrison*, 130 S. Ct. at 2888.

[103] *See, e.g.*, *Foley v. Transocean Ltd.*, 272 F.R.D. 126, 133-34 (S.D.N.Y. 2011) (stating *Morrison* provides no support for the "notion that foreign investors are not adequate plaintiffs in the United States courts when the securities at issue were purchased on a United States exchange"); *Lapiner v. Camtek, Ltd.*, No. 08-01327, 2011 WL 445849, at *2 (N.D. Cal. Feb. 2, 2011); *Hufnagle v. Rino Int'l Corp.*, No. 10-8695, 2011 WL 710704, at *8 (C.D. Cal. Feb. 14, 2011), *adopted by* 2011 WL 710676 *1 (C.D. Cal. Feb. 16, 2011). *Cf. generally* Hannah L. Buxbaum, *Remedies for Foreign Investors Under U.S. Federal Securities Law*, 75 LAW &

A. Is the "Purchase or Sale of a Security Listed on an American Exchange" Prong of the Transactional Test Satisfied if a Transaction Involves a Security that Is "Listed" on a U.S. Securities Exchange, or Must the Actual Transaction that Resulted in the Investor's Loss Have Occurred on the U.S. Exchange?

District courts that have considered the issue have consistently held that, under prong 1 of the transactional test, the transactions at issue must occur on a domestic exchange to trigger application of Section 10(b)'s private right of action.[104] Thus, an investor in a cross-listed security cannot maintain a Section 10(b) cause of action if he or she purchased or sold the security on the foreign exchange.[105] As one court explained, "[t]hough isolated clauses of the [*Morrison*] opinion may be read as requiring only that a security be 'listed' on a domestic exchange for its purchase anywhere in the world to be cognizable under the federal securities laws, those excerpts read in total context compel the opposite result."[106] As another court explained, the "clear … concern [in *Morrison*] is on the true territorial location where the purchase and sale was executed and the particular securities exchange laws that governed the transaction."[107] "The idea that a foreign company is subject to U.S. securities laws everywhere it conducts foreign transactions merely because it has 'listed' some securities in the United States is simply contrary to the spirit of *Morrison*."[108]

CONTEMP. PROBS. 101, 113-23 (2011) (discussing the potential for foreign investors to seek recovery in U.S. courts for claims arising under foreign securities law).

104 *See, e.g.*, *In re UBS Sec. Litig.*, No. 07-11225, 2011 WL 4059356, at *4-6 (S.D.N.Y. Sept. 13, 2011); *In re Vivendi Universal, S.A. Sec. Litig.* ("*Vivendi*"), 765 F. Supp. 2d 512, 531 (S.D.N.Y. 2011); *In re Royal Bank of Scotland Group PLC Sec. Litig.* ("*Royal Bank of Scotland*"), 765 F. Supp. 2d 327, 336 (S.D.N.Y. 2011); *In re Alstom SA Sec. Litig.* ("*Alstom*"), 741 F. Supp. 2d 469, 473 (S.D.N.Y. 2010); *In re Celestica Inc. Sec. Litig.*, No. 07-312, 2010 WL 4159587, at *1 n.1 (S.D.N.Y. Oct. 14, 2010); *Sgalambo v. McKenzie*, 739 F. Supp. 2d 453, 487 & n.216 (S.D.N.Y. 2010).

105 It should be noted that, as it is being applied by the lower federal courts, the transactional test focuses on whether the private party bringing the Section 10(b) claim engaged in a domestic transaction, not whether the alleged wrongdoer did so. *See SEC v. Compania Internacional Financiera S.A.*, No. 11-4904, 2011 WL 3251813, at *6 (S.D.N.Y. July 29, 2011) (explaining that *Morrison* "never states that a defendant must itself trade in securities listed on domestic exchanges or engage in other domestic transactions").

106 *Alstom*, 741 F. Supp. 2d at 472.

107 *Royal Bank of Scotland*, 765 F. Supp. 2d at 336.

108 *Id*. One district court did acknowledge, however, that the alternative view does have supporting policy rationales. *Vivendi*, 765 F. Supp. 2d at 528-29. As this court explained, "[w]hen a foreign issuer decides to access U.S. capital markets by listing and trading ADRs [*see* discussion in Appendix A, *infra*], it subjects itself to SEC reporting requirements, and it would

B. Are Purchases and Sales of American Depositary Receipts Covered by Section 10(b)?

The courts that have considered the issue have concluded that a transaction involving ADRs[109] on a domestic *securities exchange* falls within the scope of prong 1 of the transactional test.[110]

However, one district court has held that transactions in ADRs that trade in the United States on the over-the-counter-market (and thus not on an exchange) [111] do not qualify as domestic transactions under the transactional test, *at least* for purposes of a Section 10(b) private

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not be illogical to subject that company to the antifraud provisions of the Exchange Act at least where there is a sufficient nexus to the United States." *Id.* at 529. *But see In re UBS Sec. Litig.*, 2011 WL 4059356, at *6 (rejecting a "listing theory" under which a defendant would be subject to Section 10(b) private actions "by cross-listing securities on multiple exchanges" and thus "consent[ing] to 'regulation in the multiple jurisdictions in which the ordinary shares are registered,'" and explaining that "the issue here is not whether Defendants, by listing shares of stock on the NYSE, consented to regulation by the United States government …, but whether Congress intended a private right of action to apply extraterritorially such that it reaches transactions that are executed on foreign exchanges").

109 "An ADR is a receipt that is issued by a depositary bank that represents a specified amount of a foreign security that has been deposited with a foreign branch or agent of the depositary, known as the custodian." *Pinker v. Roche Holdings Ltd.*, 292 F.3d 361, 367 (3d Cir. 2002). "The holder of an ADR is not the title owner of the underlying shares; the title owner of the underlying shares is either the depositary, the custodian, or their agent." *Id.* ADRs trade "in the same manner as any other registered American security, may be listed on any of the major exchanges in the United States or traded over the counter, and are subject to the [federal securities laws]." *Id.* "This makes trading an ADR simpler and more secure for American investors than trading in the underlying security in the foreign market." *Id.* *See generally* discussion of ADRs in Appendix A, *infra.*

110 *See, e.g.*, *Vivendi*, 765 F. Supp. 2d at 527; *Stackhouse v. Toyota Motor Co.*, No. 10-CV-0922, 2010 WL 3377409, at *1-2 (C.D. Cal. July 16, 2010); *In re Elan Corp. Sec. Litig.*, No. 08-Civ.-8761, 2011 WL 1442328, at *1 (S.D.N.Y. Mar. 18, 2011).

111 All trades not executed on an exchange are considered "over-the-counter." This includes not only bilateral transactions between parties, but also trades executed on alternative trading systems ("ATSs") and other electronic trading platforms. ATSs typically are electronic trading systems that automatically match buy and sell orders of securities at specified prices using established, non-discretionary methods. ATSs carry out many of the same functions as exchanges, but, unlike exchanges, do not set rules governing the conduct of their subscribers (other than the conduct of such subscribers' trading on the system) or discipline subscribers other than by exclusion from trading. *See* Regulation ATS, 17 C.F.R. §§ 242.300 and following.

action against the issuer of the underlying foreign securities.[112] Although the court's analysis was somewhat ambiguous, it appears that the court reasoned that purchasing ADRs over-the-counter is a "predominantly foreign securities transaction" because the transaction occurs "in a less formal" market with lower exposure to U.S.-resident buyers than a formal securities exchange.[113]

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[112] *In re Société Générale Sec. Litig.* ("*Société Générale*"), No. 08-2495, 2010 WL 3910286, at *6-7 (S.D.N.Y. Sept. 29, 2010).

[113] *Id.* at *6. One commentator has suggested that the *Société Générale* decision may be based on the fact that ADRs traded over-the-counter are frequently unsponsored, meaning that the issuer of the underlying foreign security was not responsible for the ADRs' creation, while exchange-traded ADRs are always sponsored by the foreign issuer. *See* James Wilson, *One Year Later: The Reach of U.S. Securities Laws After* Morrison, LEXIS-NEXIS EMERGING ISSUES ANALYSIS, May 25, 2011, available at LEXIS, 2011 Emerging Issues 5668. *See also* Hannah L. Buxbaum, *Remedies for Foreign Investors Under U.S. Federal Securities Law*, 75 LAW & CONTEMP. PROBS. 107 (2011) ("The holding in *Société Générale* is difficult to square with the *Morrison* test …. If a foreign issuer has chosen to establish an ADR program in the United States, and is then charged with perpetrating a fraud in order to inflate the value of the U.S.-traded securities, it would be reasonable to apply U.S. antifraud law to resulting claims." (footnote omitted)). *See generally* discussion of ADRs in Appendix A, *infra*.

C. How Does the Transactional Test Apply to "Foreign-Squared" Cases – *i.e.*, U.S. Investors Purchasing Foreign Securities on a Foreign Exchange?

Courts have thus far held that the purchase or sale of a security by a U.S. investor on a foreign exchange is not within the reach of Section 10(b.)[114] These courts have consistently held that prong 1 of the transactional test makes clear that a transaction on a foreign exchange is not actionable in a Section 10(b) private action.[115] Further, these courts have rejected arguments by U.S. investors that, because the transaction on the foreign exchange was initiated in the United States[116] or involved a U.S. investor,[117] prong 2 of the transactional test should apply.

In reaching this conclusion, courts have explained that it would amount to a "restoration" of the core elements of the conduct and effects tests to "exclude from operation of the [*Morrison*] test transactions in securities traded only on exchanges abroad if the purchase or sale involves American parties, or if some aspects or contacts of such foreign transactions occur in the United States."[118] The courts addressing this issue have further explained that any exception that would

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114 *See, e.g.*, *Vivendi*, 765 F. Supp. 2d at 531; *Royal Bank of Scotland*, 765 F. Supp. 2d at 337; *Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co. ("Plumber's Union*"), 753 F. Supp. 2d 166, 178-79 (S.D.N.Y. 2010); *Société Générale*, 2010 WL 3910286, at *5-6; *Alstom*, 741 F. Supp. 2d at 472-73; *Cornwell v. Credit Suisse Group*, 729 F. Supp. 2d 620, 625-26 (S.D.N.Y. 2010).

115 *See, e.g.*, *Stackhouse*, 2010 WL 3377409, at *1.

116 *Plumbers' Union*, 753 F. Supp. 2d at 179 ("For the purposes of determining whether a securities transaction is a 'domestic' transaction under *Morrison*, the country in which an investor happened to be located at the time that it placed its purchase order is immaterial"). *See also In re UBS Sec. Litig.*, 2011 WL 4059356, at *7-8.

117 *Plumbers' Union*, 753 F. Supp. 2d at 178 ("A purchaser's citizenship or residency does not affect where a transaction occurs; a foreign resident can make a purchase within the United States, and a United States resident can make a purchase outside the United States."); *Vivendi*, 765 F. Supp. 2d at 533 (stating that "the American citizenship of a person who purchase[s] a foreign company's shares on a foreign exchange does not render that a 'domestic transaction'").

118 *Cornwell*, 729 F. Supp. 2d at 624. *See also Société Générale*, 2010 WL 3910286, at *6 ("By asking the Court to look at the location of the act of placing a buy order …, Plaintiffs are asking the Court to apply the conduct test specifically rejected in *Morrison*.") (internal quotation marks omitted); *Royal Bank of Scotland*, 765 F. Supp. 2d at 337 ("Plaintiffs' approach – that it is enough to allege that Plaintiffs are U.S. residents who were in the country when they decided to buy [foreign exchange traded] shares – is exactly the type of analysis that *Morrison* seeks to prevent."); *Cascade Fund LLP v. Absolute Capital Management Holdings Ltd.*, No. 08-01381, 2011 WL 1211511, at *5-7 (D. Colo. Mar. 31, 2001) (explaining that the transactional test applies irrespective of whether the investors were U.S. residents and to do otherwise would "simply [be] a restatement of the … discredited 'effects test'").

allow private Section 10(b) actions for foreign exchange purchases directed from the United States would conflict with the transactional test's goal of avoiding interference with foreign securities regulation given that foreign countries regulate their domestic securities exchanges and the transactions on those exchanges.[119] As one court characterized it, "because the actual transaction takes place on the foreign exchange, the purchaser or seller has figuratively traveled to that foreign exchange – presumably via a foreign broker – to complete the transaction."[120]

D. When Does a Purchase or Sale of Securities not Listed on a U.S. or Foreign Exchange Take Place in the United States?

When a transaction constitutes a domestic transaction under prong 2 of the transactional test is perhaps one of the most difficult issues that the courts have been dealing with in the wake of *Morrison*.[121] This is so in significant part because the Supreme Court was silent as to when an off-exchange transaction occurs in the United States. All that can conclusively be said thus far is that the lower federal courts' opinions suggest that the "bright-line" standard that the

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[119] *Royal Bank of Scotland*, 765 F. Supp. 2d at 337. *See also Plumbers' Union*, 753 F. Supp. 2d at 178 (explaining that to allow U.S. residents to sue under Section 10(b) for purchases on foreign exchanges would "produce the regulatory multiplicity that the Supreme Court has directed courts to avoid"); *Cornwell*, 729 F. Supp. 2d at 624-25 (stating that "substantial concern" underlying the transactional test was that U.S. courts "would be called upon to enforce American laws regulating transactions in securities that are also governed by the laws of the foreign country and exchanges where those securities were actually purchased or sold").

[120] *Stackhouse*, 2010 WL 3377409, at *1.

[121] *See, e.g.*, *Basis Yield Alpha Fund (Master) v. Goldman Sachs Group, Inc.* ("*Basis Yield*"), 798 F. Supp. 2d 533, 537 (S.D.N.Y. 2011); *United States v. Coffman*, 771 F. Supp. 2d 735, 737-38 & n.1 (E.D. Ky. 2011). *See generally* Hannah L. Buxbaum, *Remedies for Foreign Investors Under U.S. Federal Securities Law*, 75 LAW & CONTEMP. PROBS. 101, 107-08 (2011) ("Determining the location of non-exchange-based transactions has proved quite complicated. Not surprisingly, many investment transactions involve touches with multiple countries or are executed by electronic or other means to which it is difficult to assign a location."); *id.* at 113 (explaining that "in extending a bright-line test to all forms of investment transactions, the [Supreme Court in *Morrison*] ignored the substantial variability of such transactions"). A related question that one district court has addressed so far is how market manipulation of the U.S. over-the-counter market should be analyzed under the transactional test. *See SEC v. Ficeto*, No. CV 11-1637, 2011 U.S. Dist. LEXIS (C.D. Cal. Dec. 20, 2011) ("Market manipulation of domestic over-the-counter securities simply does not implicate the extraterritorial application of our securities laws. Accordingly, *Morrison* does not bar the application of § 10(b) to the facts presented in this case: foreign and domestic Defendants who allegedly engaged in manipulative trading tactics on the domestic over-the-counter securities market.").

Supreme Court hoped to set forth in *Morrison* has proven to be a fact-intensive question in the context of off-exchange transactions.[122]

Courts have set forth a number of potentially competing approaches for determining whether an off-exchange transaction occurs in the United States. One approach presupposes that securities transactions may take place across more than one jurisdiction. Therefore, courts must examine the entire transaction process to determine if any of the critical steps occurred domestically.[123] When "an offer is made in one state and accepted in another," the transaction is deemed to have taken place in *both* jurisdictions because both nations have an interest in regulating the transaction.[124]

Another approach that some courts have followed is to examine the transaction closely to determine precisely when in the course of the purchase or sale "the parties incurred 'irrevocable liability' to complete the transaction."[125] If the event resulting in irrevocable liability occurred in the United States, then a Section 10(b) private remedy would be available; if that event occurred elsewhere, a Section 10(b) private remedy would not be available.[126]

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122 *See, e.g.*, *id.* at 737-38; *Anwar v. Fairfield Greenwich Ltd.*, 728 F. Supp. 2d 372, 405 (S.D.N.Y. 2010); *SEC v. Goldman Sachs & Co.* ("*Goldman Sachs & Co.*"), 790 F. Supp. 2d 147, 157-63 (S.D.N.Y. 2011); *Basis Yield*, 789 F. Supp. 2d at 537 (stating "courts dealing with securities not traded on any exchange … have had to define *when* a purchase or sale occurs so that it can determine *where* the transaction took place") (emphasis in original); *Quail Cruises Ship Mgmt. v. Agencia de Viagens CVC Tur Limitada*, 732 F. Supp. 2d 1345, 1349-50 (S.D. Fla. 2010), *rev'd*, 645 F.3d 1307 (11th Cir. 2011).

123 *Cf. In re Nat'l Century Fin. Enters.* (*"Nat'l Century"*), 755 F. Supp. 2d 857, 879-88 (S.D. Ohio 2010) (relying on *Morrison*'s transactional test to construe the extraterritorial reach of the Ohio Securities Act).

124 *Nat'l Century*, 755 F. Supp. 2d at 880 (citing *A.S. Goldman & Co. v. N.J. Bureau of Securities*, 163 F.3d 780, 787 (3d Cir. 1999)). *But see Goldman Sachs & Co.*, 790 F. Supp. 2d at 158 (rejecting a standard that would look to "the entire selling process" to determine if the transaction occurred in the United States). *But see generally In re Merkin*, __ F. Supp. 2d __, __, No. 08-10922, 2011 WL 4435873 (S.D.N.Y. Sept. 23 2011) (rejecting argument that U.S. residents' purchase or sale of off-exchange securities does not, standing alone, create a presumption that the transactions occurred in the United States for purposes of the transactional test).

125 *See, e.g.*, *Basis Yield*, 798 F. Supp. 2d at 537 (citing *Goldman Sachs*, 2011 WL 2305988, at *8).

126 *See, e.g.*, *Basis Yield*, 798 F. Supp. 2d at 537; *Anwar*, 728 F. Supp. 2d at 405. One court has held that an investor's transfer of the payment money for the purchase of securities to a U.S. bank is not sufficient to satisfy the transactional test where the payment of the funds was "one step" in a sales process in which the seller, by the terms of the parties' subscription agreement, still retained the right to accept or reject the transaction. *See Cascade Fund*, 2011 WL 1211511,

Still other courts have suggested that either the issuance of the securities in the United States[127] or "transfer of title to the shares in the United States"[128] may satisfy the transactional test for purposes of a private action under Section 10(b).[129] The Court of Appeals for the Second Circuit has endorsed both the "irrevocable liability" standard and the "transfer of title" standard, holding that "to sufficiently allege a domestic securities transaction in securities not listed on a domestic exchange," a plaintiff "must allege facts suggesting that irrevocable liability was incurred or title was transferred within the United States."[130]

E. How Does the Transactional Test Apply When the Fraudulent Conduct Is not Engaged in by the Issuer of the Security, but Rather by Intermediaries such as Investment Advisers, Broker-Dealers, or Underwriters?

Although *Morrison* itself involved allegations of fraud by the foreign issuer, district courts have also applied the transactional test to cases involving fraud by intermediaries such as investment advisers, broker-dealers, and underwriters. In doing so, these courts have determined that Section 10(b) does not apply if the transaction for which the investor suffered a loss occurred either on a foreign exchange or otherwise outside the United States, even if (1) the intermediary resided in the United States and primarily engaged in the fraudulent conduct

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at *7. One scholar has warned that the location-of-irrevocable-liability standard is subject to manipulation by a contracting party and "can be non-transparent to the other party" because "the seller of securities can simply situate itself outside the United States when formally engaging in an act of acceptance, and thereby avoid the application of U.S. law." Hannah L. Buxbaum, *Remedies for Foreign Investors Under U.S. Federal Securities Law*, 75 LAW & CONTEMP. PROBS. 101, 113 (2011).

127 *See In re Optimal U.S. Litig.*, 813 F. Supp. 2d 351, 73 (S.D.N.Y. 2011).

128 *Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada*, 645 F.3d at 1310-11.

129 *See generally United States v. Mandell*, No. 09-Cr-0662, 2011 WL 924891, at *4 (S.D.N.Y. March 16, 2011) (stating that Section 10(b) private actions reach a fraudulent scheme involving the private placement of equity in the United States of securities traded on a foreign exchange).

130 *Absolute Activist Value Master Fund Ltd. v. Ficeto*, __ F.3d __, __, 2012 WL 661771, at *6 (2d Cir. March 1, 2012) (hereinafter "*Ficeto*"). *See also id.* at *8 ("Absent factual allegations suggesting that the [plaintiffs] became irrevocably bound within the United States or that title was transferred within the United States, including, but not limited to, facts concerning the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money, the mere assertion that transactions 'took place in the United States' is insufficient to adequately plead the existence of domestic transactions.").

here,[131] or (2) the intermediary traveled to the United States frequently to meet with the U.S. investor-client.[132]

While such cases may well have survived under the conducts and effects tests, the dispositive consideration now, according to the courts that have addressed the issue, is whether the transaction causing the investor's loss occurred on a domestic exchange or was otherwise a purchase or sale in the United States.

F. How Does the Transactional Test Apply to a Security-Based Swap Transaction that References a Security Traded on a Foreign Exchange?

Section 10(b) of the Exchange Act also covers fraud in connection with the purchase or sale of a security-based swap.[133] Securities fraud in connection with a security-based swap transaction could take a number of forms – for example, the fraudster could be a counterparty to the swap or a third party unrelated to the swap transaction such as the issuer of the referenced security; and the fraudulent statements or omissions could directly concern the referenced security or relate exclusively to the security-based swap agreement.

Thus far, only one court has applied the transactional test to securities fraud involving a security-based swap. The court held that, *at least* to the extent that a counterparty to the swap is suing a third-party unrelated to the swap transaction for fraudulent conduct in connection with the referenced security, the transactional test does not afford a cause of action under Section 10(b) for transactions in security-based swaps that reference a security traded on a foreign exchange.[134] In reaching this holding, the court examined the "economic reality" of the swap transactions and concluded that the swap transactions were the "functional equivalent" of engaging in a short sale of the reference security on the foreign exchange because the gains and losses of the swap agreements were directly tied to the fluctuations in the foreign shares' trading

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131 *See Absolute Activist Value Master Fund Ltd. v. Homm*, No. 09-CV-8862, 2010 WL 5415885, at *5 (S.D.N.Y. Dec. 22, 2010), *rev'd sub nom Ficeto*, __ F.3d __, 2012 WL 661771.

132 *Horvath v. Banco Comercial Portugues, S.A.*, No. 10-Civ.-4697, 2011 WL 666410, at *2-3 (S.D.N.Y. Feb. 15, 2011), *aff'd* 2012 WL 497276 (2d Cir. Feb. 16, 2012).

133 Security-based swaps are defined in Section 3(a)(68) of the Exchange Act, 15 U.S.C. § 78c(a)(68), and generally include swaps on single securities and narrow-based security indexes. Security-based swaps are in the definition of security under Section 3(a)(10) of the Exchange Act, 15 U.S.C. § 78c(a)(10). Section 10(b) of the Exchange Act also covers fraud in connection with the purchase and sale of security-based swap agreements, which are defined in Section 3(a)(78) of the Exchange Act, 15 U.S.C. § 78c(a)(78), and include securities-related swaps that are not security-based swaps (*e.g.*, swaps on broad-based security indexes).

134 *Elliott Assocs. v. Porsche Automobil Holding SE*, 759 F. Supp. 2d 469, 473-76 (S.D.N.Y. 2010).

price.[135] The court thus concluded that these swap transactions should be deemed to have taken place on the foreign exchange under the transactional test irrespective of whether transactions in the security-based swaps themselves were entered into in the United States.[136]

The district court appeared particularly concerned that application of Section 10(b) to transactions in security-based swaps that reference a foreign security could create conflicts with foreign governments' efforts to regulate their securities exchanges: "In light of *Morrison*'s strong pronouncement that U.S. courts ought not interfere with foreign securities regulation without a clear Congressional mandate, I am loathe to create a rule that would make foreign issuers with little relationship to the U.S. subject to suits here simply because a private party in this country entered into a derivatives contract that references the foreign issuer's stock."[137]

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[135] *Id.* at 476. In *Valentini v. Citigroup, Inc.*, the district court relied on the "economic reality" standard to hold that "a transaction in securities that may, under certain circumstances, convert into domestically-traded stock qualif[ies] as a 'transaction involving securities based on a domestic exchange'' under prong 1 of the transactional test. No. 11-Civ.-1355, 2011 WL 6780915, at *13-14 (S.D.N.Y. Dec. 27, 2011). The securities at issue were equity linked notes, which the court explained "are complex debt instruments that differ from standard securities in that their value upon maturity is tied to the value of a third-party equity, such as stock, a basket of stocks or an equity index." *Id.* at *1. All of the equity linked notes were linked to the value of ADRs or the common stock traded on U.S. securities exchanges. *Id.* Applying the "economic reality" standard in light of the facts that "the value of the notes rose and fell as the price of the [U.S.-exchange-traded] shares to which they were linked rose and fell" and "some of the notes were also convertible into those securities," the court concluded that when the purchases acquired "these convertible notes, they were in effect purchasing a put option on those [U.S.-exchange-traded] stocks." *Id.* at *14. Then relying on precedent that "held the purchase of an option … is equivalent, for purposes of §10(b) liability, with a purchase of that security," *id.* (citing *Caiola v. Citibank, N.A.*, 295 F.3d 312, 327 (2d Cir. 2002)), the district court held that "[u]nder the 'economic reality' approach," the equity linked notes transactions that "involved convertible securities" "constitute 'transactions involving securities on domestic exchanges' and thereby satisfy *Morrison*'s [first] prong." *Valentini*, 2011 WL 6780915, at 14.

[136] *Id. See also id.* ("Although *Morrison* permits a cause of action by a plaintiff who has concluded a 'domestic transaction in other securities,' this appears to mean 'purchases and sales of securities explicitly solicited by the issuer in the U.S.,' rather than transactions in foreign-traded securities – or swap agreements that reference them – where only the purchaser is located in the United States.") (citing *Stackhouse*, 2010 WL 3377409, at *1).

[137] *Elliott Assocs*, 759 F. Supp. 2d at 476. *See generally* Wulf A. Kaal & Richard W. Painter, *The Aftermath of* Morrison v. National Australia Bank *and* Elliott Associates v. Porsche, 8 EUR. COMPANY & FIN. L. REV. 77, 91 (2011) (recommending that a focus "on the totality of the circumstances could help establish appropriate parameters to determine where a privately negotiated derivative transaction takes place").

G. How Does the Transactional Test Apply When an Individual Engages in Insider Trading with Respect to a U.S. Listed Company by Purchasing Derivatives *Overseas* that Reference the U.S. Security?

One district court has held that Section 10(b) applies where a defendant engages in insider trading overseas with respect to a U.S. listed company by acquiring contracts for difference ("CFD")[138] that reference the company's U.S. exchange-listed security.[139] The court determined that the defendants' purchase of the overseas CFDs fell squarely within the language of Section 10(b) because it was a manipulative or deceptive device or contrivance "in connection with" the U.S. exchange-traded stock. Further, the court rejected the defendants' argument that the *Morrison* transactional test foreclosed the suit because the defendants' purchase of the CFDs occurred overseas. The court explained that *Morrison* does not state "that a defendant must itself trade in securities listed on domestic exchanges or engage in other domestic transactions" for Section 10(b) to apply.[140]

H. How Is the Purchase of Shares in an Off-Shore Feeder Fund that Itself Invests in a U.S. Fund Treated Under the Transactional Test?

Investors who purchase shares of an off-shore feeder fund that holds itself out as investing exclusively or predominantly in a U.S. fund may have to demonstrate that their purchases of the off-shore fund's shares occurred in the United States in order to maintain a

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[138] A contract for difference constitutes a security as defined by the federal securities laws. "CFD purchasers acquire the future price movement of the underlying company's common stock (positive or negative) without taking formal ownership of the underlying shares." *SEC v. Compania Internacional Financier*, No. 11-4904, 2011 WL 3251813, at *3 (S.D.N.Y. July 29, 2011) (quoting *Freudenberg v. E*Trade Financial Corp.*, No. 07-Civ.-0538, 2008 WL 2876373, at *7 (S.D.N.Y. July 16, 2008)). The prices for CFDs are identical to the prices quoted for shares of the company's stock, and in advance of pricing a CFD, the broker purchases matching shares of the stock on the U.S. exchange. *See id.* ("Because identical matched transactions occur in shares of the actual common stock immediately before the purchase or sale of the CFDs, any influence on the public market price of the underlying securities is also reflected in the price of the CFDs.") (quoting *Freudenberg*, 2008 WL 2876373, at *7). One purported advantage of CFDs is that they allow foreign investors to access U.S. exchange-listed securities without the need to open a U.S. brokerage account. *See id.*

[139] *SEC v. Compania Internacional Financiera*, No. 11-4904, 2011 WL 3251813 (S.D.N.Y. July 29, 2011).

[140] *Id.* at 6-7 (stating that this "interpretation of *Morrison* would create a dramatically narrower view of § 10(b) liability, not only limiting its extraterritorial application, but also precluding actions against persons who themselves did not trade in securities").

Section 10(b) action for losses experienced as a result of the purchases.[141] Although only one court has expressly addressed the issue, that court was unwilling to give foreign investors in these situations the benefit of a "pass through effect" under the *Morrison* test that might otherwise allow the investors to treat their purchases of the off-shore fund's shares as the functional equivalent of purchasing shares in the United States.[142] It explained that such an approach would effectively involve "examining a foreign investors' intent to own United States securities," which is an "unpredictable and subjective criterion" that would "eliminate the doctrinal clarity that the Supreme Court provided in *Morrison*."[143]

IV. Response to Request for Public Comment

A. Overview

The Commission received 72 comment letters (excluding duplicate and follow-up letters).[144] Of these letters, 30 were from institutional investors or organizations representing them; 19 were from law firms and accounting firms; 8 were from foreign governments; 7 were from public companies or associations representing them; 7 were from academics; and 1 letter was from an individual investor. Further, 44 of the comment letters supported enactment of the conduct and effects tests or some modified version of the tests; 23 supported keeping the *Morrison* transactional test; and the remaining 4 either supported alternative approaches or simply provided additional information.

The comment letters submitted by investors and organizations representing investors uniformly supported enactment of the conduct and effects tests, or some modified version thereof. By contrast, comment letters submitted by issuers and organizations affiliated with

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141 *Cf. Optimal,* 813 F. Supp. 2d at 371-73; *Anwar*, 728 F. Supp. 2d at __; *In re Banco Santander Securities-Optimal Litig.* ("*Banco Santander*"), 732 F. Supp. 2d 1305, 1316-18 (S.D. Fla. 2010).

142 *Banco Santander,* 732 F. Supp. 2d at 1317-18.

143 *Id*. at 1317-18.

144 Copies of comment letters that the Commission received are available on the Commission's website at http://www.sec.gov/comments/4-617/4-617.shtml. The comment letter submitted by Pomerantz, Haudek, Grossman and Gross, LLP ("Pomerantz") included nine separate comment letters from pension funds. Each attached letter was considered as a separate comment letter for purposes of this section. Additionally, the letters submitted by Devon County Council Pension Fund, Lancashire County Pension Fund, Hampshire Pension Fund, and Cumbria Local Government Pension Scheme all incorporated and supported the letter submitted by Strathclyde Pension fund ("Strathclyde"). For purposes of this section, references to Strathclyde should be viewed as also representing the views of Devon County Council Pension Fund, Lancashire County Pension Fund, Hampshire Pension Fund, and Cumbria Local Government Pension Scheme.

issuers uniformly supported the transactional test. With one exception, the comment letters from foreign national governmental authorities also favored the transactional test.[145] The Israeli Securities Authority was the one exception, expressing the view that investors should be permitted to pursue a Section 10(b) private action against any issuer that has cross-listed its shares in the United States and Israel irrespective of whether they purchased the securities on a U.S. or Israeli exchange.[146] The viewpoints expressed by academics and law firms varied – some supporting adoption of the conduct and effects tests, and others supporting retention of the transactional test.

Finally, only a few comment letters addressed whether the conduct and effects tests should be extended just to institutional investors; these letters uniformly opposed any different treatment between institutional and non-institutional investors (*e.g.*, retail investors). That said, comment letters did voice differing opinions on whether foreign investors should be treated differently than U.S. investors if some form of the conduct and effects tests are extended to private rights of action.

B. Comments Concerning the *Morrison* Transactional Test

1. Arguments in Favor of the Transactional Test

The comment letters that favored retaining the transactional test in large measure restated the arguments that the *Morrison* defendants and their *amici* advanced at the Supreme Court, and which are discussed above in Sections II.C.2.c and II.C.2.e.[147]

One argument asserted by a range of commenters – including foreign governmental authorities, issuers, law firms, and accounting firms – is that the extension of the conduct and effects tests to Section 10(b) private actions would create significant conflicts with other nations'

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145 The foreign national governmental authorities that supported the *Morrison* transactional test included: HM Treasury, U.K. Government ("U.K. Government"); Government of the Federal Republic of Germany; Government of France; Australian Government; European Commission; Government of Switzerland; and Autorité des Marchés Financiers (the French securities regulator). The Israel Securities Authority outlined situations where the transactional standard should not apply.

146 *See* letter from ISA, at 1. Under Israeli law, "an issuer that has listed its securities on certain U.S. exchanges and is therefore subject to SEC disclosure requirements may carry out a secondary listing on [the Tel Aviv Stock Exchange]." *Id.* at 2. Given that Israeli law has expressly "recognized the adequacy of U.S. disclosure for its own domestic regulatory requirements," the Israeli Securities Authority expressed the view that the "right to bring a private action before the U.S. courts does not undermine international comity." *Id.* at 3.

147 Of the 22 comment letters submitted in support of retaining the transactional test, 7 were from foreign government authorities; 7 were from issuers or professional associations representing issuers; 5 were from law firms or professional lawyers' associations; 2 were from academics; and 1 was from a group of accounting firms.

laws, interfering with the important and legitimate policy choices that these nations have made.[148] For example, the European Commission's comment letter, which "strongly urge[d] … against" a cross-border extension of Section 10(b), stated that an "extraterritorial application of the antifraud provisions of the United States' securities laws … where the nexus is stronger with a foreign jurisdiction[] is liable to violate the E.U.'s and its Member States' sovereignty, and to impede the proper development of [the] E.U.'s securities regulation."[149]

Some comment letters supporting the transactional test also argued that the extension of the conduct and effects tests to private actions would result in what they believe to be costly and abusive litigation involving transactions that occur on foreign securities exchanges.[150] One comment letter, for example, highlighted several procedural aspects of U.S. securities class actions that the letter asserts result in significant costs, also citing to a recent statement from the European Commission characterizing U.S. class actions as "creating incentives for abusive litigation."[151] Similarly, the U.K. Government comment letter highlighted, among other things, the "irrecoverable" high costs a U.K. company must incur when litigating in U.S. courts.[152]

Some of these comment letters argued that, by contrast, retention of the transactional test would foster market growth because the test provides a bright-line standard for issuers to

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148 *See, e.g.*, letters from U.K. Government; Government of the Federal Republic of Germany; Government of France; Australian Government; European Commission; Government of Switzerland; Autorité des Marchés Financiers (France); Law Society of England & Wales and the City of London Law Society; Vivendi; U.S. Chamber of Commerce; BDO International Limited; Deloitte Touche Tohmatsu Limited, Ernst & Young Global Limited, Grant Thornton International Ltd, KPMG International, PricewaterhouseCoopers International Limited, RSM International Limited ("BDO, *et al*.").

149 Letter from European Commission, at 1. A number of comment letters supported this point by noting that other jurisdictions provide investor protection that is comparable to the level of investor protection provided by the U.S. securities laws. *See, e.g.*, letters from Government of France; Australian Government; Government of Switzerland; Canadian Bar Association.

150 *See, e.g.*, letters from U.S. Chamber of Commerce; U.K. Government; Government of France; Australian Government; Government of Switzerland; Autorité des Marchés Financiers (France); City of London Law Society; Vivendi. *See also, e.g.*, Government of the Federal Republic of Germany; Embassy of Switzerland; Mouvement des Entreprises de France; the Federation of German Industries, Economiesuisse; the European Banking Federation; the Swiss Bankers Association, and the Institute of International Bankers ("Medef"); Deutsches Aktieninstitut; Securities Industry and Financial Markets Association and the Association for Financial Markets in Europe ("SIFMA").

151 Letter from U.S. Chamber of Commerce, at 15. *See also* letters from Australian Government; Medef; City of London Law Society; White & Case.

152 *See* letter from U.K. Government, at 5.

reasonably predict their liability exposure in Section 10(b) private actions.[153] These comment letters also asserted that the transactional test appropriately respects international comity and sovereign interests. The European Commission, for example, stated that "in relation to private rights of action, we believe that the 'transactional' test … is in accordance with the principles of comity and international law, and helps to avoid unreasonable interference with sovereign authority of other nations."[154]

2. Arguments Against the Transactional Test

As discussed below, comment letters raised a series of concerns with the transactional test.

a. Whether an Exchange-Traded Securities Transaction Occurs in the United States or Overseas May Not Be Apparent to Investors.

A joint comment letter submitted by sixty-nine foreign pension funds argued that "the *Morrison* test fails to recognize the realities of today's modern trading environment, and is punitive to investors who often do not know whether their respective securities transaction was ultimately executed on a U.S. or foreign exchange."[155] As a result, application of the

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[153] *See, e.g.*, letters from Skadden, Arps, Slate, Meagher & Flom, LLP ("Skadden"); U.S. Chamber of Commerce; White and Case; Vivendi; GC100 Group, the Association of General Counsel and Company Secretaries of the U.K. FTSE 100 ("GC100"); SIFMA; White and Case; EuropeanIssuers; Canadian Bar Association.

[154] Letter from European Commission, at 3. *See also* letters from Government of the Federal Republic of Germany; U.K. Government; Government of Switzerland.

[155] Letter from AGEST Superannuation Fund; Alecta Pensionsförsäkring, Ömsesidigt; AMF Fonder AB; AMF Pensionsförsäkring AB; APG Algemene Pensioen Groep N.V.; ASSETSuper Superannuation Fund; ATP - Arbejdsmarkedets Tillægspension; AUST (Q) Superannuation Fund; Australian Catholic Superannuation & Retirement Fund; Australian Institute of Superannuation Trustees; Australian Reward Investment Alliance; Australian Superannuation Fund; Australia's Unclaimed Super Fund; AustSafe Superannuation Fund; AVSuper Superannuation Fund; Catholic Superannuation Fund; Construction & Building Industry Superannuation Fund; Danica Pension; Danske Invest Management A/S; Electricity Supply Industry Superannuation Fund; Emergency Services & State Superannuation Fund; Energy Industries Superannuation Scheme; FIL Investments International; FirstSuper Superannuation Fund; Folksam; Forsta AP-Founden; GMB Trade Union; Health Employees Superannuation Trust Australia; Health Superannuation Fund; HOSTPLUS Superannuation Fund; Industriens Pension; KLP Kapitalforvaltning; Labour Union Co-operative Retirement Fund; Legalsuper Superannuation Fund; Local Government Superannuation Scheme; Local Super (SA-NT) Superannuation Fund; Maritime Superannuation Fund; Media Superannuation Fund; Merseyside Pension Fund; Motor Trades Association of Australia Superannuation Fund; Non-Government Schools Superannuation Fund; Nordea Fondbolag Finland AB; Nordea Fondene Norge AS; Nordea Fonder AB; Nordea Investment Funds Company I S.A.; OMERS Administration

transactional test may deny U.S. investors a private right of action under Section 10(b) without the investors having made any decision to forego such a remedy or even having an awareness that a loss of remedy has occurred.

According to some comment letters, the uncertainty about where a transaction occurs may result because broker-dealers under certain circumstances may be obligated to execute a trade on a non-U.S. exchange, even if the particular security is listed on a U.S. exchange.[156] As one comment letter explained, "the United States ha[s] adopted legislation requiring brokers to establish a best execution policy to ensure that orders for securities are executed to the best benefit of the client.[157] In order to achieve 'best execution,' in the case of a [cross]-listed

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Corporation; PFA Pension; PGGM Vermogensbeheer B.V. (PGGM Investments); Raiffiesien Capital Management; Retail Employees Superannuation Trust; Royal Mail Pension Plan; Sampension KP Livsforsikring A/S; SKAGEN A/S; Skandinaviska Enskilda Banken AB; SPEC Superannuation Fund; State Superannuation Scheme // SAS Trustee Corporation; Statewide Superannuation Fund; Sunsuper Superannuation Fund; Swedbank Robur Fonder AB; Syntrus Achmea; Tasplan Superannuation Fund; Telstra Superannuation Fund; The Australian Council of Superannuation Investors; TWUSUPER Superannuation Fund; UniSuper Superannuation Fund; Universities Superannuation Scheme; Varma Mutual Pension Insurance Company; VicSuper Superannuation Fund; VisionSuper Superannuation Fund ("AGEST *et al.*"). *See also* letters from Strathclyde; California Public Employees' Retirement System ("CalPERS"); Scott + Scott, LLP ("Scott + Scott"); Forty-two Law Professors.

[156] *See, e.g.*, letters from AGEST, *et al.*; CalPERS; National Association of Shareholder and Consumer Attorneys ("NASCAT"); Leandro Perucchi; California State Teachers' Retirement System (CalSTRS), Colorado Public Employees' Retirement System, Delaware Public Employees' Retirement System, State Board of Administration of Florida, North Carolina Department of State Treasurer, Connecticut Treasurer's Office, Maryland State Retirement and Pension System, Pennsylvania Public School Employees' Retirement System, Rhode Island General Treasurer, Pennsylvania State Employees' Retirement System, New York City Employees' Retirement System, New York City Police Pension Fund, Teachers' Retirement System of the City of New York, New York Fire Department Pension Fund, Board of Education Retirement System of the City of New York, Pension Reserves Investment Management Board Commonwealth of Massachusetts ("CalSTRS, *et al.*").

[157] U.S. brokers have a legal responsibility to seek to obtain the "best execution" reasonably available for their customers' orders. *See, e.g., Newton v. Merrill, Lynch, Pierce, Fenner & Smith*, 135 F.3d 266, 269-70, 274 (3d Cir. 1998) (finding Merrill Lynch may have failed to maximize the economic benefit to its customers by failing to take advantage of prices better than the NBBO); *In re Herzog, Heine, Geduld, LLC*, Exchange Act Release No. 54148 (July 14, 2006) 2006 WL 1982741, at *5; *In re Certain Market Making Activities on Nasdaq*, Exchange Act Release No. 40900 (Jan. 11, 1999), 1998 WL 919673, at *5. Best execution means that the broker must seek to obtain for its customers the most favorable terms reasonably available under the circumstances, taking into account price, order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market, as well as the potential for price improvement. *See Newton*, 135 F.3d at 270, n.2.

security, the broker will execute the transaction on the exchange that provides the greatest [financial] advantage to the client, which could be a U.S. or a foreign exchange, depending on circumstances."[158] Under the transactional test, achieving best execution could result in transactions that fall outside the protection of the U.S. securities laws, even if the transactions are carried out by U.S. brokers on behalf of U.S. clients.

Another comment letter provided an additional potential explanation for why investors may not know the location of the transaction, explaining that at least one major U.S. securities broker-dealer has a policy that "'if the securities are listed on more than one financial instruments exchange … we will place the order on the exchange which is selected … as the primary exchange[[159]] at the time of the execution.'"[160] Thus, according to the comment letter, "[i]f purchasers of shares only have a [Section 10(b) private] cause of action if the trade occurs on a U.S. exchange, the purchaser has no idea at the time of purchase whether U.S. law will protect them, and investor protection becomes a random event."[161]

Comment letters also asserted that the potential merger of domestic securities exchanges with foreign exchanges may complicate the question of where a transaction occurs.[162] As one comment letter explained,

> [I]t is not going to be entirely clear very much longer to American investors if they are transacting on a foreign or domestic exchanges. When one purchases on the new *Börse-NYSE* or the *NYSE-Börse* … where will that transaction take place?[[163]] Where the buyer is located? Where the seller is located? In the country where the exchange itself determines to plant its network servers? In the country where the exchange is headquartered?"[164]

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[158] Letter from AGEST, *et al.*, at 9.

[159] The term "primary exchange" has often been used to refer to the market on which a security experiences the greatest trading volume.

[160] Letter from CalSTRS, *et al.*, at 11.

[161] *Id.*

[162] *See, e.g.*, letters from NASCAT; Leandro Perucchi; Forty-Two Law Professors.

[163] The proposed merger between NYSE Euronext (United States) and Deutsche Börse (German) that the commenter refers to has subsequently been terminated.

[164] Letter from Scott + Scott, at 2 (emphasis in original). *See also* letter from Forty-Two Law Professors.

Finally, several comment letters expressed concern that, following the *Morrison* decision, it may be unclear whether purchasing ADRs in the United States constitutes a domestic transaction under the transactional test.[165]

b. Transactional Test Impairs the Ability of U.S. Investment Funds to Achieve a Diversified Investment Portfolio.

Comment letters also discussed ways in which the transactional test complicates the efforts of many investment advisers to achieve a diversified portfolio for their clients.[166] To achieve a fully diversified portfolio, investment advisers generally seek to include foreign securities holdings in their clients' portfolios. Commenters asserted that acquiring ADRs on U.S. exchanges often may not be a viable option to achieve this diversification, and instead advisers must acquire the desired foreign securities directly through transactions on a foreign exchange:

> Public pension funds such as CalPERS diversify their assets in order to protect their beneficiaries.… Given the enormous size of this investment and the limited number of foreign issuers whose securities trade in the U.S. in the form of ADRs, most of CalPERS international equity investments cannot be purchased as ADRs ….[167]

Even when ADRs are available for particular foreign securities, comment letters identified several reasons why these are not an adequate means to achieve diversification. *First*, because ADRs are often less liquid than the underlying foreign securities, it may be impractical for large funds to purchase or sell the desired volume of ADRs within a time frame that is consistent with the funds' needs or investment objectives.[168]

Second, U.S. institutional investors may be disadvantaged in achieving the best price because they are unable to immediately trade when material information is disclosed about the

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165 *See, e.g.*, letter from Hannah L. Buxbaum, at 3 ("But surely the United States' regulatory interest in protecting its markets is triggered by fraud relating to *any* securities trading in those markets; and surely an investor who purchases [ADRs] on a U.S. securities exchange, or in the over-the-counter market in the United States, is entitled to the protection of U.S. antifraud law just as it would be had it purchased different securities in those markets."). *See also* discussion at Section III.B, *supra*.

166 *See, e.g.*, letter from CalPERS. Under the conduct and effects tests, investment advisers did not have to worry that the singular act of acquiring foreign securities on a foreign exchange could foreclose a Section 10(b) private remedy for their clients.

167 Letter from CalPERS, at 4.

168 *See, e.g.*, letters from CalPERS and G.A. Karolyi.

foreign security in the local market, forcing U.S. institutional investors instead to wait until the U.S. markets open to trade in the security's ADRs. This gives rise to a dilemma that one commenter described as follows:

> Why should American investors – including American pension funds – be relegated to waiting five or six hours for NY-based exchanges to open to transact in the securities of companies like BP and Shell – when the stock is trading on then current information throughout the trading day in different time zones in London and across Europe and Asia. Simply stated, the U.S. markets open later in the trading day and thus American investors are being put to the Hobson's choice of transacting on foreign exchanges without the protections of the antifraud provisions of the U.S. securities laws, or waiting to trade until the U.S. markets open, potentially under adverse financial conditions where information disclosed during the overseas trading day has already been impacted into the price.[169]

Third, comment letters argued that trading in ADRs instead of the underlying foreign security could impose significant additional costs on institutional investors such as pension funds and mutual funds.[170] Indeed, one comment letter from an investment fund identified specific additional costs that would result if, in an attempt to achieve diversification while still attaining the protections of the U.S. securities laws, it were to acquire ADRs rather than the underlying foreign securities:

> ADR issuers announce and disclose, in their 20-F filings[171] with the Commission, what charges are incident to a purchase of the ADRs. Among those

169 Letter from Scott + Scott, at 2.

170 *See, e.g.*, letters from CalPERS; Scott + Scott; Consolidated Retirement Fund. Providing empirical support for this position, G.A. Karolyi, an economist, noted a finding in one of his articles where he examined "a sample of 506 United States cross-listed stocks from 35 different companies and examine[d] arbitrage opportunities by the comparison of intraday pricing, between ADR markets and the 'local' market on a currency adjusted basis." According to Karolyi, "the price of a single ADR, with all other factors controlled for, effectively cost 32 basis points more than the equity equivalent on the 'local' market."

171 A foreign private issuer of securities is required to file with the Commission Form 20-F, 17 C.F.R. § 249.220f. Form 20-F is the combined registration statement and annual report form for foreign private issuers under the Exchange Act. It also sets forth disclosure requirements for registration statements filed by foreign private issuers under the Securities Act of 1933.

A foreign private issuer is a non-government foreign issuer, except for a company that (1) has more than 50% of its outstanding voting securities owned by U.S. residents, and (2) has either a majority of its officers and directors residing in or being citizens of the United States, a majority of its assets located in the United States, or its business principally administered in the United States. *See* Exchange Act Rule 3b-4(c), 17 C.F.R. § 240.3b-4(c).

costs are the cost charged by depositary institutions for a purchase or a sale under the theory that this is a reasonable charge to create, assemble, or "issue", and to cancel or "withdraw" the ADR from the stock held by the depositary. … We have reviewed the 20-Fs of a sample for twenty large ADR issuers by size of capitalization. Practically all of those indicate that the depositary charge is $5.00 per 100 ADRs, although some of the language suggests that it might be less than that. We believe the market power and size of a fund in order to negotiate that must be substantial, so for purposes of this analysis we have assumed that the $5.00 per 100 ADR "purchase" or "sale" is the prevailing price. On the other hand, we have not tried to incorporate into the additional pricing for ADRs what are obviously substantial incidental costs, namely the fee for keeping an account at a depositary (oftentimes $2.00 per ADR per year) or the additional charges for the processing of dividends which presumably occurs with some frequency, particularly with large capitalization stocks …. [I]f we look at international equity investments reflected for *all funds* described in Thomson's, the amount of those assets are $819 billion and the amount to maintain that investment in ADRs, given their increased pricing, would amount to an *additional "tax" for the use of American law of $2.2 billion*. To impose this additional tax solely so Americans can utilize the laws that Congress has passed for their benefit is fundamentally unfair and puts funds and their fiduciaries in a fundamentally unfair position having to choose to pay increased costs for ADRs or to purchase international securities on foreign exchanges. [172]

Further, one comment letter from an institutional investor stated that, when U.S. institutional investors acquire securities overseas, the transactional test will mean that they may need to "either become involved in foreign litigation to effectuate loss recovery or to forego its claims, potentially raising fiduciary concerns."[173]

c. Transactional Test Forecloses Private Actions Involving Foreign Transactions in U.S. Listed Securities.

Comment letters also argued that a Section 10(b) private right of action should exist for purchasers who acquire overseas securities cross-listed on U.S. and foreign exchanges.[174]

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172 Letter from Consolidated Retirement Fund, at 3, 5 (emphasis in original).

173 *See, e.g.*, letter from CalSTRS.

174 *See, e.g.*, letters from Leandro Perucchi; Forty-Two Law Professors; Israel Securities Authority. A comment letter from the Israel Securities Authority explicitly supported enforcing actions in U.S. court for securities that are cross-listed in Israel and the U.S. As the only government regulator that expressed such an opinion, the Israeli authority noted that, "[i]n our opinion, claimants who believe they have a valid claim under section 10(b) of the Securities Exchange Act against an issuer that has cross-listed its shares and the US regulation applies in the non-US market, should have a private right of action in the US irrespective of whether they

According to a comment letter submitted by a group of law professors, "a compelling reason why [foreign] issuers … list securities on a U.S. exchange, and voluntarily subject themselves to filing periodic reports with the Commission, is that they increase the value of their securities globally by doing so. Issuers benefit by signaling their intention to comply with, and be subject to, U.S. securities laws."[175] This comment letter went on to conclude that, because these foreign issuers benefit from being listed in the United States, they should be held accountable to U.S. securities law standards – including Section 10(b) private rights of action – regardless of where a specific transaction occurs.

Further, some comment letters noted that the transactional test could arbitrarily disadvantage U.S. investors relative to foreign investors in situations where a fraud has occurred involving a U.S. and foreign cross-listed security.[176] Specifically, if U.S. investors acquired their shares overseas but foreign investors acquired the same securities in the United States, the foreign investors could seek private redress under Section 10(b) while the U.S. investors would be denied similar recourse.

d. Transactional Test Fails to Account for Situations When U.S. Investors Are Induced to Purchase Securities Overseas.

A number of comment letters criticized the transactional test because it fails to protect U.S. investors who, *while in the United States*, are actively induced to enter into overseas securities transactions.[177] Indeed, to press the point, one commenter discussed Justice Stevens' example from his *Morrison* concurrence concerning the foreign company that actively encourages "an unsophisticated retiree, on the basis of material misrepresentations, to invest her life savings in the company's doomed securities," but is "barred from seeking relief" as a result

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purchased the relevant securities on the US domestic exchange or on the non-US exchange." Israel Securities Authority, at 1.

175 Letter from Forty-Two Law Professors, at 9.

176 *See, e.g.*, letters from CalPERS; Strathclyde; and NASCAT.

177 *See, e.g.*, letters from New York State Comptroller; The London Pensions Fund Authority; Wirral MBC on Behalf of the Merseyside Pension Fund; Mn Services Vermogensbeheer B.V.; The Council of the Borough of South Tyneside Acting in Its Capacity as the Administering Authority of the Tyne and Wear Pension Fund; City of Bradford Metropolitan District Council as the Administering Authority for the West Yorkshire Pension Fund; Wolverhampton City Council, Administering Authority for the West Midlands Metropolitan Authorities Pension Fund ("London Pensions Fund *et al.*"); Maryland State Retirement and Pension System; Consolidated Retirement Fund; American Bar Association, Business Law Section ("ABA").

of the transactional test.[178] These comment letters generally argued that such a result is both unfair and inconsistent with the investor protection objective of the U.S. securities laws.

C. Comments Concerning the Conduct and Effects Tests

1. Arguments in Favor of the Conduct and Effects Tests

In addition to asserting problematic aspects of the transactional test, many comment letters advanced a number of arguments in favor of the conduct and effects tests.[179]

a. Conduct and Effects Tests Better Serve Investor Protection and Improves Investor Confidence in the U.S. Securities Market.

A common argument advanced by the comment letters that supported enactment of the conduct and effects tests for Section 10(b) private actions is that doing so would promote investor protection through more vigorous enforcement of the federal securities laws.[180] As one comment letter explained:

> No one disputes that the limited resources available to the Commission renders the private enforcement of the federal securities laws a necessary tool to combat the scourge of securities fraud. Allowing only the Commission to bring actions in instances where the "conduct and effects test" is satisfied but the new restrictive "transactional" standard is not will cause, perversely, a disproportionate amount of Commission funds being diverted to address one of the most expensive species of securities fraud to investigate and prosecute – those cases that involve multiple nations with wide-flung witnesses and highly complex facts and issues.[181]

Several comment letters stated that affording private litigants the ability to bring Section 10(b) private actions under the conduct and effects tests would signal strong investor protection, thereby bolstering investor confidence in U.S. markets. These comment letters argued that this

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178 Letter from CalPERS, at 2 (quoting *Morrison v. National Australia Bank*, 130 S. Ct. 2869, 2895) (Stevens, J., concurring in the judgment)); *see also* letter from NASCAT, at 16.

179 Of the 39 comment letters supporting enactment of the conduct and effects test, 27 were from institutional investors, 7 were from law firms, 2 each were from investor organizations and academics, and 1 was from an individual investor.

180 *See*, *e.g.*, letter from DRRT, at 3 (stating that "only a fraction of the damages are recovered by the SEC while contemporaneous or subsequent [private] civil enforcement actions return much bigger financial compensation to investors").

181 Letter from London Pensions Fund, *et al.*, at 2. *See also* Consolidated Retirement Fund.

would in turn draw more investment to the United States and, thus, ensure that the benefits of reinstating the conduct and effects tests would outweigh the costs of doing so.[182]

b. Conduct and Effects Tests Reflect the Realities of Modern Global Business Organizations and Finance.

Many comment letters expressed the view that the conduct and effects tests better reflect the economic reality that a foreign company may have an extensive U.S. presence making it reasonable to subject the company to Section 10(b) private actions even though its shares may trade on a foreign exchange and the company may be incorporated overseas.[183] Several comment letters observed that the U.S. presence may be so extensive – including in many cases wholly-owned U.S. subsidiaries that standing alone could be considered major U.S. corporations – that the foreign company may generally be perceived by U.S. investors as a *de facto* U.S. corporation.[184] The comment letters expressed the view that it is particularly appropriate in these situations for the U.S. securities laws to afford investors a remedy when the conduct and effects tests are satisfied.[185] According to one comment letter, where this is the case, the U.S. "securities laws should not be diminished simply because the stock purchase occurred on a foreign exchange."[186]

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182 *See, e.g.*, Letter from Leandro Perucchi, at 8.

183 Letter from Consolidated Retirement Fund, at 9 ("[m]ultinationals who earn billions of dollars from Americans should not be insulated from fraud whether or not it is exported from our shores. Does one reasonably think that if you have billions of dollars of assets in the United States and receive billions of dollars of revenue from the United States and the fraud had a substantial connection to conduct in the United States, and it hurts a foreigner, will that foreigner think that America's involvement is irrelevant?").

184 In meetings with the Staff, representatives from pension funds discussed the issue of corporate structures and the perception of certain companies as *de facto* U.S. corporations. Memoranda regarding staff meetings with representatives from pension funds are included in the comment files referenced in footnote 44.

185 *See, e.g.*, letter from New York State Comptroller (discussing on-going private securities litigation against BP, plc, which is incorporated in the U.K., but is the largest oil and gas producer in the United States, has 40% of its assets and workers in North America, and has 40% of its ordinary common shares owned by U.S. individuals and institutions).

186 *Id*. at 2-3.

c. Conduct and Effects Tests Ensure that Fraudsters Either Operating in the United States or Targeting the United States Cannot Avoid the Reach of the U.S. Securities Laws Simply by Arranging for the Securities Transaction to Occur Overseas.

A number of comment letters suggested that the advantage of the conduct and effects tests are that these tests look to the overall nexus of the fraud with the United States in determining whether a Section 10(b) private action exists.[187] As a result, those who would commit transnational securities frauds either executed from the United States or targeted at the United States can reasonably anticipate that they may face liability in a Section 10(b) action brought by the injured investors.

This advantage stands in marked contrast to the transactional test which, according to the comment letters, provides a clear roadmap for a fraudster seeking to escape private liability under Section 10(b) – *i.e.*, structure the fraud so that even if its genesis, orchestration, and effects occur domestically, the securities transaction occurs outside the United States. One comment letter explained this view as follows:

> *Morrison* tossed aside 40 years of time-tested jurisprudence relating to the "conduct and effects test" in favor of a "transactional" standard that looks solely at the locus of the transaction in question. Alarmingly, under *Morrison* it matters not whether the fraud committed is domestic or what the fraud's domestic impact is, but instead depends upon a hyper-technical inquiry that elevates – above all else – the sole fact of where the transaction took place. By ignoring the fraud's genesis or effect and focusing instead on the technical transaction, *Morrison* creates not just an easy escape for foreign fraudsters, but an open invitation: Come to the United States to commit securities fraud and feel free to negatively impact the United States with that fraud – so long as you don't list your securities on an American exchange, you may never have to repay any of the investors you victimized. Through *Morrison*, the Supreme Court has strayed from the securities laws' underpinnings of investor protection and largely denied investors – both domestic and foreign – the protections of the federal securities laws.[188]

Several comment letters identified pre-*Morrison* cases that, they explain, might not have survived in whole or in part under the transactional test, including *In re Royal Dutch/Shell Transp. Sec. Litig.*, Civ. No. 04-374 (D.N.J.) (U.S. plaintiffs who purchased on both foreign and U.S. exchanges settled securities claims for in excess of $130 million), and *In re Royal Ahold N.V. Sec. & ERISA Litig.*, No. Civ. 1:03-MD-01539 (D.

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[187] *See, e.g.*, letters from Sunil Taparia and NASCAT.

[188] Letter from London Pensions Fund, *et al.*, at 3; *see also* letter from DRRT.

Md.) (U.S and European investors who purchased stocks both on foreign and U.S. exchanges settled securities fraud claims for $1.1 billion).[189]

d. Conduct and Effects Tests Do Not Harm International Comity.

In contrast with the views generally expressed by the foreign governmental authorities in their *Morrison* briefs and comment letters to the Commission,[190] some comment letters stated that enactment of the conduct and effects tests for Section 10(b) private actions would not harm international comity.[191] Indeed, one comment letter asserted that application of the conduct and effects tests would, in fact, enhance international comity:

> While some may contend that extension of a private right of action under the Exchange Act to transnational securities frauds would harm international relations based on comity, such an argument fails to credit substantive jurisprudential history and data and that counsels otherwise. … Neither we nor our counsel has uncovered a single instance where private securities fraud litigation on behalf of non-U.S. purchasers of non-U.S. securities on non-U.S. exchanges ha[s] ever been found to interfere with a non-U.S. sovereign's ability to independently regulate its own securities markets. … Indeed, the policy of the Exchange Act – to protect investors, the integrity of capital markets, and the ability to raise capital in public

189 Letter from AGEST, *et al.*, at 18-19 & n. 33. *See also* letter from NASCAT, at 31-32 (listing cases that might have been resolved differently had the transactional test been applied, including: *In re Paramalat Sec. Litig.,* MDL 1539 ($50 million settlement on behalf of a global class of shareholders); *In re SCOR Holding (Switzerland) AG Litig.*, 04-CV-7897 (S.D.N.Y.) ($84.6 million settlement on behalf of purchasers of ADR purchasers anywhere in the world and ordinary share purchasers who resided in or were citizens of the United States); *In re Bayer Secs. Litig.,* 03-1546 (S.D.N.Y.) ($18.5 million settlement on behalf of all purchasers on U.S. exchanges and U.S. purchasers on foreign exchanges); *Wagner v. Barrick Gold Corp.*, 1:03-cv-4302 (S.D.N.Y.) ($24 million settlement on behalf of common stock purchasers on both the New York and Toronto stock exchanges)).

190 As discussed in the text accompanying footnote 146, *supra*, unlike other foreign national governmental authorities, the Israeli Securities Authority expressed the view that investors should be permitted to pursue a Section 10(b) private action against any issuer that has cross-listed its shares in the United States and Israel irrespective of whether they purchased the securities on a U.S. or Israeli exchange. *See* letter from ISA, at 1.

191 *See, e.g.*, letters from CalSTRS, *et al.*; NASCAT; Leandro Perucchi; AGEST, *et al.*; Strathclyde.

> markets – is identical with and parallel to the policies of market regulators worldwide ….[192]

The comment letter further explained that:

> Under the conduct and effects test, the federal securities laws protect non-U.S. investors harmed by a securities fraud exported from the United States, even where the issuer is a non-U.S. issuer and the stock transactions are executed on a non-U.S. exchange. As such the conduct and effects test is designed to prevent the United States from being used as a manufacturing base for the export of fraud and deceit. ... It is entirely appropriate for the federal securities laws to have extraterritorial application in situations demonstrating the export of fraud or deceit from the U.S. in the global securities markets, where there is substantial fraudulent conduct by top directors or executives in or throughout the United States, the direct effect of which caused harm to investors both in the U.S. and abroad. …[193]

2. Arguments Against the Conduct and Effects Tests

The comment letters that opposed enacting the conduct and effects tests incorporated the policy arguments that were raised in the *Morrison* briefs before the Supreme Court, discussed above in Sections II.C.2.c. and II.C.2.e. These arguments included concerns about impaired U.S. relations with other nations due to the cross-border extension of U.S. law, reduced foreign direct investment in the U.S. market, increased litigation costs, and diverted U.S. judicial resources.

In articulating their concerns with the conduct and effects tests, a number of comment letters asserted that the tests are unpredictable. The U.K. Government's comment letter, for example, stated that application of the conduct and effects tests can "degenerate into an unpredictable collection of incompatible decisions and theories."[194] Another comment letter asserted that, as a consequence of this unpredictability, the "[pre-*Morrison*] U.S. litigation environment was having the predictable effect of depressing foreign willingness to invest in the United States."[195] Similarly, a comment letter stated that "extraterritorial application of the U.S. securities laws could have a chilling effect on foreign direct investment in the United

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192 Letter from Strathclyde, at 4-6 (citing Makoto Ikeya and Satoru Kishitani, *Trends in Securities Litigation in Japan: 1998-2008*, NERA ECONOMIC CONSULTING REPORT (July 15, 2009)).

193 *Id.*

194 Letter from U.K. Government, at 4. *See also* letters from George T. Conway; SIFMA; U.S. Chamber of Commerce; Law Society of London.

195 Letter from U.S. Chamber of Commerce, at 34. *See also* letter from Skadden, Arps, Slate, Meagher & Flom LLP ("Skadden Arps").

States as well as capital formation in U.S. markets" because foreign issuers "fear that their investment could expose them to costly, distracting and potentially meritless U.S. securities fraud class actions based on securities transactions that occur outside the United States."[196]

Additionally, a number of comment letters argued that investor protection and deterrence are sufficiently achieved in the context of transnational frauds by Congress having enacted the conduct and effects tests for Commission and DOJ enforcement actions.[197] The comment letters also explained that different considerations underlying Section 10(b) private actions relative to Commission enforcement actions warrant retention of the transactional test for private actions.[198] For example, the U.S. Chamber of Commerce stated that, "[i]n the past, the Commission has evinced an acute awareness of the dangers of intruding on foreign nations' enforcement jurisdiction." Private litigants, however, are primarily interested in obtaining a financial recovery and are more prone to pursue litigation in "circumstances that the government deems inappropriate or unjustified (because, for example, the law of the foreign nation provides a sufficient remedy)."[199]

Comment letters suggested a series of additional reasons why the conduct and effects tests are inappropriate for Section 10(b) private actions. *First*, one comment letter argued that it is unnecessary to enact the conduct and effects tests to protect small U.S. investors because they generally do not invest overseas.[200] *Second*, a letter asserted that the conduct tests are particularly inappropriate because these tests involve an arduous, fact-specific analysis that bears little relationship to investor expectations about whether they are protected by U.S. securities laws.[201] *Finally*, a number of comment letters – including several from foreign national governmental authorities – argued that the conduct and effects tests are unnecessary for Section

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196 Letter from Medef, at 3. *See also* letters from Skadden Arps; U.K. Government; Government of France; Australian Government; Vivendi.

197 *See, e.g.*, letters from Government of France; U.S. Chamber of Commerce; Skadden; European Issuers. *See also* letter from Medef (explaining that transnational securities frauds are better pursued by the Commission rather than private litigants because the Commission has a greater understanding of international comity concerns).

198 Letter from U.S. Chamber of Commerce, at 29-33. *See also* letter from Medef, at 13-15.

199 Letter from U.S. Chamber of Commerce, at 30-31, 33. *See also* letter from Richard W. Painter.

200 *See* Letter from U.S. Chamber of Commerce. Retail investors tend to purchase ADRs domestically whereas U.S. institutional investors, which tend to purchase larger blocks of securities, generally do so in the local markets where the underlying foreign securities principally trade.

201 *See* Letter from EuropeanIssuers.

10(b) private actions because many foreign legal regimes already provide sufficient remedies for investors.[202]

D. Alternative Approaches Proposed by Commenters

Several comment letters proposed alternatives to the pre-*Morrison* conduct and effects tests and the transactional test.[203]

1. Adoption of a Conduct and Effects Tests that Are Limited to U.S. Resident Investors

Although many comment letters argued that the pre-*Morrison* conduct and effects tests should be available to both foreign and domestic investors,[204] a number of comment letters supported enacting a modified version of the conduct and effects tests that would afford a Section 10(b) private action *only for U.S. investors*.[205] These comment letters generally argued that limiting the conduct and effects tests to U.S. investors would help to minimize some of the comity concerns.[206] One letter supporting such an approach explained that "there is the strongest of connections" between the United States and its own citizens, which "the federal securities laws are designed to protect."[207] According to these comment letters, international comity

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202 *See, e.g.*, letters from the Government of Australia; Government of France; Law Society of England & Wales and the City of London Law Society; Government of Federal Republic of Germany; HM Treasury, U.K. Government; European Commission; Government of Switzerland. *But see, e.g.*, NASCAT (arguing that remedies available in other nations are deficient).

203 Several comment letters recognized the difficulty of identifying where a transaction takes place and suggested that a clarification through Commission rulemaking would bring much needed predictability. *See* letter from James B. Heaton, III and Hannah L. Buxbaum. Alternatively, one comment letter stated that the Commission could require that investors be provided with more disclosure about the implication of purchasing securities overseas. The letter suggested that the Commission "explore the need, if any, for a disclosure standard to ensure that investors making securities purchases and sale orders in the U.S. are made aware that non-U.S. law will govern those transactions executed abroad." Letter from Atlantic Legal Foundation comment letter, at 11.

204 *See, e.g.*, letters from Strathclyde; AGEST, *et al.*; Global Pension Fund.

205 *See e.g.*, letters from NASCAT, Maryland State Retirement and Pension System, New York State, and Consolidated Retirement Fund.

206 *See, e.g.*, letter from CalSTRS, *et al.*, at 13. ("Allowing U.S. investors to bring Section 10(b) claims [using the conduct and effects test] against foreign issuers will not offend principles of international comity."). *See also* letter from NASCAT, Maryland State Retirement and Pension System, New York State, and Consolidated Retirement Fund.

207 *Id.* at 14.

recognizes that, just as foreign nations have a significant interest in determining what level of redress their own residents should receive, the United States has a significant and legitimate interest in making that determination for its citizens in the context of transnational securities, regardless of where the actual securities transaction occurred.[208]

Another comment letter argued that, because the conduct and effects tests require a nexus between the fraud and the United States, further restricting the tests' applicability to U.S. investors should significantly alleviate any international comity concerns:

> Where there is a material domestic component to the fraud, it is clear that providing a remedy to U.S. investors will not raise concerns about extraterritoriality or create a conflict between American and foreign law, even when the transaction took place on a foreign exchange. In most cases involving a U.S. investor, that material domestic component will exist since investment decisions will have been made in the U.S., fraudulent statements will have been received in the U.S., securities purchases and sales will have been initiated in the U.S., and harm will occur to entities resident in the U.S.[209]

But several comment letters from foreign pension funds argued that it would be unfair to differentiate between U.S. investors and foreign investors in enacting the conduct and effects tests:

> The conduct and effects test inquiry focuses on whether the alleged wrongful conduct occurred in the U.S. or affects the U.S., not on who asserts the claim. The conduct and effects language is thereby consistent with the public policy that the law should be

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208 One comment letter from a law professor explained that the two relatively unique features of U.S. law that foreign governments often identify – (1) the 'opt-out' system of U.S. class actions, and (2) the fraud-on-the-market theory in Section 10(b) private suits – make it problematic from an international comity perspective to enact a broad conduct test that would apply to foreign investors. *See* letter from Hannah L. Buxbaum, at 3-4. However, this comment letter further explained that enactment of the effects test would not present these concerns:

> In my view, [the effects test] should be reinstated with respect to private actions …. Recognizing effects as a basis for the application of U.S. law is consistent with *Morrison*'s holding that U.S. law may be applied to fraud that affects a transaction taking place within the United States. Moreover, effects-based cases implicate the central regulatory interest of the United States: protecting U.S. markets and those who transact on them. They are therefore relatively unproblematic with respect to international comity.

209 Letter from CalSTRS, *et al.*, at 13 (internal citations omitted). *See also* letters from NASCAT; Leandro Perucchi; AGEST, *et al*.

> equally applied to all and, as such, extending the extraterritorial cause of action to all investors comports with traditional notions of fairness.[210]

2. Adoption of a Fraud-in-the-Inducement Test

Several comment letters suggested a "fraud in inducement" test that would afford a Section 10(b) private remedy when fraudsters "reach into" the United States to induce a fraudulent domestic or foreign securities transaction.[211] As one comment letter explained, this test would focus on "the location of the investor at the time the investor is induced to purchase or sell securities in reliance on a materially false or misleading statement or pursuant to a manipulative act."[212] The letter further explained that this proposed test is consistent with the expectation of investors, because "[i]nvestors would expect to be protected by the laws of the place they are present at the time they are subjected to false or misleading statements or manipulative conduct."[213]

Relatedly, a comment letter from the lead counsel for the *Morrison* defendants, George T. Conway, proposed amendments to Section 10(b) that would afford a private action if both: (i) the misconduct has a nexus with the United States similar to the nexus required by the conduct and effects tests; and (ii) the "defendant solicited the transaction or directed manipulative or deceptive conduct specifically at the plaintiff" and the plaintiff *actually relied* on the misconduct.[214] According to the letter, the proposal recognizes that "some extraterritorial

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[210] Letter from Strathclyde, at 3. As noted at footnote 144, a number of funds incorporated Strathclyde's position by reference.

[211] *See e.g.*, letters from Forty-Two Law Professors; ABA; London Pension Funds.

[212] Letter from ABA, at 3. *See also* letter from Forty-Two Law Professors, at 7 (highlighting the scenario where "a person in the U.S. is approached by brokers in the U.S. and is led to execute a trade on a foreign exchange" based on fraudulent information).

[213] Letter from ABA, at 3. During a meeting with the Staff, a group of foreign institutional investors advised that foreign and domestic issuers have trade fairs and road shows in the United States in which these issuers provide information to funds and managers in the hopes of obtaining investments from these large investors. *See* July 12, 2011 Meeting with Representatives of European Pension Funds. Under a fraud in the inducement test, institutional investors (whether foreign or domestic) that make investments in reliance on fraudulent information provided at these events would presumably be able to pursue Section 10(b) private actions.

[214] *See* letter from George T. Conway, at 4. The letter suggested adding the following legislative language at the end of Section 10(b):

> Subsection (b) of this section, and rules promulgated under subsection (b) of this section, shall apply to domestic or extraterritorial conduct involving manipulative or deceptive

application should be permitted, but should be … specifically restricted to circumstances in which the United States' interest in redressing fraudulent conduct is the strongest."[215] Further, the letter explained that the proposal seeks to alleviate the international comity concerns that arise from application of the fraud-on-the-market presumption of reliance for securities fraud actions involving transactions occurring outside the United States.[216]

V. Options to Extend the Section 10(b) Private Action Extraterritorially

The Staff has carefully considered the views expressed in the comment letters that were submitted in response to the Commission's request for public comment, as well as the views that were expressed in meetings that the Staff had with interested parties, in the Supreme Court briefs that were filed during the *Morrison* litigation, and in relevant scholarly literature. The Staff has also considered the pre- and post-*Morrison* case law.

The Staff offers a series of options for possible consideration. In Section A, the Staff discusses the conduct and effects tests. In Section B, the Staff discusses four other options that Congress might wish to consider.[217] In addition, a final option would be for Congress to take no

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> devices or contrivances in connection with any extraterritorial purchase or sale of any security, where either
>
> (1) conduct within the United States that constitutes substantial acts in furtherance of a manipulative or deceptive device or contrivance, or
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> (2) conduct outside the United States that has a substantial and reasonably foreseeable effect within the United States,
>
> has occurred in connection with the purchase or sale; provided, however, that, in any private action arising under subsection (b) of this section, where the plaintiff seeks recovery of losses arising from any extraterritorial purchase or sale, the plaintiff shall be required to prove that the defendant solicited the purchase or sale or engaged in manipulative or deceptive conduct directed specifically at the plaintiff, and that either
>
> (i) the plaintiff, while within the United States, actually relied upon manipulative or deceptive conduct of the defendant, or
>
> (ii) the plaintiff, while outside the United States, actually relied upon manipulative or deceptive conduct of the defendant occurring inside the United States.

215 *Id.* at 3.

216 *See id.* at 5.

217 Section 929Y(b) of the Dodd-Frank Act discusses as one possible option extending private rights of action extraterritorially under Section 10(b) "just to institutional investors" such as pension funds and mutual funds, leaving other investors (including retail investors) with only

action on this subject. Under that approach, the lower courts would continue to interpret and refine the Supreme Court's holding in *Morrison*.

Further, the Staff believes that each of the specific options identified below is consistent with the recognized principles of prescriptive jurisdiction – *i.e.*, legislative authority – as set forth in the *Restatement (Third) of Foreign Relations Law of the United States*.[218] According to the *Restatement of Foreign Relations Law*, the United States has authority to prescribe law with respect to:

> (1) (a) conduct that, wholly or in substantial part, takes place within its territory;
>
> (b) the status of persons, or interests in things, present within its territory;
>
> (c) conduct outside its territory that has or is intended to have substantial effect within its territory;
>
> (2) the activities, interests, status, or relations of its nationals outside as well as within its territory; and
>
> (3) certain conduct outside its territory by persons not its nationals that is directed against the security of the state or against a limited class of other state interests.[219]

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the transactional test. The Staff found no support for such an approach either in the comment letters or during meetings with investors, including institutional investors.

[218] RESTATEMENT OF FOREIGN RELATIONS LAW, *supra note* 13. The *Restatement of Foreign Relations Law* is one of the leading secondary authorities on international and foreign-relations law, and is also generally viewed as a persuasive authority on questions of international comity such as those implicated by the potential extraterritorial extension of a Section 10(b) private cause of action. The principles of prescriptive jurisdiction set forth in the *Restatement of Foreign Relations Law* seek to balance the competing interests of the United States and other jurisdictions in a manner that is consistent with international comity.

[219] *Id.* § 402. Notwithstanding the foregoing, the *Restatement of Foreign Relations Law* recognizes limitations to ensure that the exercise of jurisdiction over a person or activity is reasonable. *Id.* § 403. Relevant factors include, among others, the "extent to which the activity takes place within the territory, or has substantial, direct, and foreseeable effect upon or in the territory," *id.* § 403(2)(a), "the connections, such as nationality, residence, or economic activity, between the regulating state and the person principally responsible for the activity to be regulated, or between that state and those whom the regulation is designed to protect," *id.* § 403(2)(b), "the character of the activity to be regulated, the importance of regulation to the regulating state, the extent to which other states regulate such activities, and the degree to which the desirability of such regulation is generally accepted," *id.* § 403(2)(c), "the extent to which

In addition, the *Restatement of Foreign Relations Law* specifically provides that the United States may exercise authority to regulate activities related to securities if the securities transaction itself or the conduct related to the transaction occurs in the United States or, if such transaction or conduct takes place outside of the United States, if it has "a substantial effect on a securities market in the United States for securities of the same issuer or on holdings in such securities by United States nationals or residents."[220]

A. Options Regarding the Conduct and Effects Tests

Much of this Study has been dedicated to identifying the various implications of extending to Section 10(b) private actions the conduct and effects tests that Congress enacted for Commission and DOJ enforcement actions – *i.e.*, a *conduct test* that would extend Section 10(b) private actions to transnational securities frauds that involve "conduct within the United States that constitutes a significant step in furtherance of the [fraud], even if the securities transaction occurs outside the United States and involves only foreign investors"; and an *effects test* that would extend Section 10(b) private actions to transnational securities frauds that involve "conduct occurring outside the United States that has a foreseeable substantial effect within the United States."[221]

Having identified the various implications of extending Section 10(b) private actions under these standards, the Staff is of the view that enactment of the Commission and DOJ conduct and effects tests for Section 10(b) private actions would involve policy trade-offs that could carry significant implications in many areas, including investor protection and international comity. [222] However, the Staff offers several alternative approaches that might

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another state may have an interest in regulating the activity," *id.* § 403(2)(g), and "the likelihood of conflict with regulation by another state," *id.* § 403(2)(h).

[220] *Id.* § 416(2)(a).

[221] Section 929Y(a) of the Dodd-Frank Act.

[222] The *Federal Securities Code*, which was a proposal by the American Law Institute to revise the federal securities laws, provides one potential model for codification of the conduct and effects tests. *See* AMERICAN LAW INSTITUTE, FEDERAL SECURITIES CODE (1980). Section 1905(a)(1)(D)(ii) would apply United States law if some or all elements of an otherwise actionable conduct occur outside the United States but cause a "substantial effect" in this country "as a direct and reasonably foreseeable result." Section 1905(a)(1)(D)(i) would apply United States law to actionable conduct that occurs "to a significant (but not necessarily predominant) extent within the United States." Further, section 1905(c) would provide for a flexible administration of the extraterritorial scope of the securities laws by authorizing the Commission to make rules narrowing or broadening the scope of these provisions. *See generally* Louis Loss, *Extraterritoriality in the Federal Securities Code*, 20 HARV. INT'L L. J. 305, 308 (1979) (Code represents "blending" of judicial expertise in international law with the Commission's expertise in rulemaking).

alleviate certain of the potential negative consequences previously discussed that could result from enacting the broad conduct test set forth in Section 929Y. The Staff offers these alternatives particularly in light of the investor interest expressed in extending some form of a conduct and effects tests for Section 10(b) private actions.

One alternative approach is to adopt the conduct and effects tests, but to narrow the conduct test so that a private plaintiff seeking to base a Section 10(b) private action on it must demonstrate that the plaintiff's injury resulted *directly* from conduct within the United States.[223] This is the formulation of the conduct test that the Solicitor General, joined by the Commission, recommended in the *Morrison* litigation in the Supreme Court.[224] The Commission has not altered its view in support of this standard.

Significantly, a conduct test with a direct injury requirement would further the strong federal interest in deterring fraudulent conduct that emanates from the United States.[225] When fraudsters are masterminding and executing a securities fraud from within the United States, there seems little doubt that the resulting injuries that occur to investors outside the United States would be a direct result of the U.S. conduct.

Correspondingly, a direct injury requirement could serve as a filter to exclude those claims that have a closer connection to another jurisdiction and, thus, are more appropriately pursued elsewhere.[226] Indeed, the facts of the *Morrison* litigation demonstrate this. As the

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[223] The effects test – both as formulated in Section 929Y(a)(2) of the Dodd-Frank Act and as developed by the lower federal courts prior to the *Morrison* decision – includes the proximate causation concept of foreseeability, which ensures an element of reasonableness in the effects test's application. This may explain in part why the effects test was relatively uncontroversial. *See generally* John H. Knox, *The Unpredictable Presumption Against Extraterritoriality*, 40 S.W. L. REV. 635, 640 (2011) ("The circuit courts saw less disagreement over the effects test, perhaps due to the simplicity of its application, or because the importance of extending securities laws abroad to protect against substantial effects in the United States seemed particularly compelling.").

[224] *See* Brief for the United States, at 26 (Feb. 26, 2010) (available at 2010 WL 719337) ("[T]his Court should require a private plaintiff to establish not simply that his loss resulted from the fraudulent scheme as a whole, but that the loss resulted directly from the component of the fraud that occurred in the United States.").

[225] *See generally* discussion in footnote 97, *supra*, addressing the statement in *Morrison*, 130 S. Ct. at 2886, that the United States in not being used as a "Barbary Coast" to perpetrate frauds on foreign securities markets.

[226] It should be noted that early court of appeals' decisions invoking the conduct test stated that Section 10(b) would not apply "to losses from sales of securities to foreigners outside the United States unless the acts (or culpable failures to act) within the United States *directly cause*[*d*] such losses." *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 993 (2d Cir. 1975)

Solicitor General explained, significant conduct in furtherance of the defendants' fraud was alleged to have occurred in the United States – *i.e.*, the fraudulent scheme was conceived in the United States and the false information that the Australian parent corporation ultimately released to the Australian public was generated here.[227] This alleged domestic conduct would be sufficient to support a Commission or DOJ enforcement action under the conduct test enacted by Congress in Section 929P(b)(2) of the Dodd-Frank Act. However, the alleged fraudulent conduct in the United States was not a direct cause of the Australian investors' injuries because, as the Solicitor General explained, there were a number of "significant intermediate events outside this country" between the generation of the false information here and the distribution of that information by the Australian parent corporation to Australian investors.[228] As a result, the indirectness of the link between the alleged U.S. misconduct and the plaintiffs' injury would preclude a Section 10(b) claim in this and similar circumstances under the "direct injury" version of the conduct test.[229]

Imposing a direct-injury requirement on private plaintiffs seeking to use the conduct test could have additional benefits identified by the Solicitor General during the *Morrison* litigation:

First, in contrast to Commission enforcement actions, which are unlikely to produce conflict with foreign nations,[230] private actions under Section 10(b) "present a significant risk of conflict with foreign nations because the United States affords private plaintiffs litigation procedures and remedies that other countries often do not provide."[231] "Requiring private

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(Friendly, J.) (emphasis added). However, subsequent decisions generally appear not to have included a rigorous application of the direct cause standard. *See, e.g.*, *In re Alstom SA Securities Litig.*, 406 F. Supp. 2d 346, 373 (S.D.N.Y. 2005) (noting the "shift in emphasis from a test of strict causation").

[227] Brief for the United States, at 30-31.

[228] *Id.* at 31 (describing the intermediate events in Australia as review by various personnel of the parent corporation in Australia and distribution of the information by Australian personnel of the parent corporation who were "not acting under the direction and control" of individuals in the United States, "but rather were exercising independent judgment as officers" of the parent).

[229] Importantly, the direct injury requirement should not be confused with an actual reliance requirement that would preclude use of the fraud-on-the-market theory to demonstrate reliance. Rather, the direct injury requirement would require that a plaintiff demonstrate a tight causal connection between the U.S. conduct and the foreign investors' losses to maintain a Section 10(b) private action. That tight causal connection could be satisfied in situations where the fraudulent statements emanating from the United States impact the price of a security trading on a foreign exchange, irrespective of whether the foreign investors bringing suit actually relied on the fraudulent statements.

[230] *See* discussion at Section II.C.2.d, *supra*.

[231] Brief for the United States, at 26-27.

plaintiffs to establish that their losses were a direct result of conduct in the United States mitigates that risk by limiting the availability of United States remedies to situations in which domestic conduct is closely linked to [their] grievance."[232]

Second, a direct-injury requirement could reduce the risk that "the resources of United States courts will be diverted to redress securities-related harms having only an attenuated connection to this country."[233] In contrast to the Commission, which "can be expected to take account of national interests when it determines whether particular enforcement suits represents sound uses of its resources and the resources of the federal courts," private plaintiffs "have little incentive to consider whether resolution of their securities-related grievances represent a wise use of federal judicial resources" because their "overarching concern … is redressing their own injuries."[234]

Notwithstanding the addition of a direct-injury requirement, extending Section 10(b) private actions under the conduct test could pose many of the same issues – albeit it to a reduced degree – that commenters and others have voiced with respect to the broader conduct test. There would still be some number of cases even with the direct causation requirement for which foreign investors receive remedies that their governments have determined not to provide, and this could pose challenges to international comity. These comity challenges could be particularly acute when the Section 10(b) private actions are brought by foreign investors against foreign issuers based on purchases or sales on a foreign exchange.

Finally, the direct-injury version of the conduct test could still require a fact-intensive inquiry involving burdensome discovery and other significant litigation efforts to determine if the alleged U.S. conduct constituted a direct cause of the overseas injury, which could impose increased costs on both U.S. courts and foreign corporations.

An additional option is to enact conduct and effects tests available just to U.S. investors.[235] This approach may pose less of a challenge to international comity than conduct and effects tests available to all investors because international law generally recognizes that nations have a strong and legitimate sovereign interest in protecting their residents from frauds directed at them.[236]

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232 *Id.* at 27.

233 *Id.* at 28.

234 *Id.*

235 *See* discussion in Section IV.D.1, *supra.*

236 *See generally* RESTATEMENT OF FOREIGN RELATIONS LAW, *supra* note 13, §§ 402, 416.

Conduct and effects tests limited to U.S. investors would have the additional benefit of possibly fitting more closely with two of the principal regulatory interests of the U.S. securities laws – *i.e.*, protection of U.S. investors and U.S. markets – than the transactional test.[237] For example, considering Justice Stevens' example of the foreign issuer that goes door to door fraudulently inducing U.S. investors to purchase the issuer's stock on a foreign exchange, conduct and effects tests available for U.S. investors would provide these U.S. investors a remedy in the event securities fraud occurred. As another example, a Section 10(b) private action would be available for U.S. investors who are defrauded in connection with overseas securities transactions by their securities intermediaries – *i.e.*, broker-dealers and investment advisers.[238]

But conduct and effects tests limited to U.S. investors would not be without potential drawbacks. Significant among these are the potential for (i) costly discovery and ad-hoc factual analysis before any determination as to whether Section 10(b) reaches the conduct, and (ii) application of Section 10(b) to securities transactions that occur on foreign securities exchanges, which a number of foreign governmental authorities have opposed.

B. Options to Supplement and Clarify the Transactional Test

In addition to considering whether the conduct and effects tests should be applied to Section 10(b) private actions, the Study is to consider whether "a narrower extraterritorial standard" than the conduct and effects tests might be appropriate. Accordingly, the Staff offers the following options that Congress may wish to consider.

1. Permit Investors to Pursue a Section 10(b) Private Action for the Purchase or Sale of any Security that Is of the Same Class of Securities Registered in the United States, Irrespective of the Actual Location of the Transaction

Investors could be expressly permitted to bring a private action whenever there is a violation of Section 10(b) involving a security that is of the same class of securities registered in the United States without regard to the location of the actual transaction.[239]

When any issuer – domestic or foreign – registers a class of securities with the Commission, that issuer agrees to the obligations and conditions imposed by the federal securities laws, including the antifraud obligations of Section 10(b). By affording a cause of

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[237] Letter from Hannah L. Buxbaum.

[238] In addition, these scenarios could also be addressed by reinstating the effects test.

[239] As discussed in Section III.A, *supra*, there is disagreement regarding prong 1 of the transactional test – *i.e.*, is it sufficient that a plaintiff engaged in a transaction involving a security that is listed on a U.S. exchange, irrespective of where the actual transaction occurs, or must the plaintiff in fact have traded the security on the U.S. exchange.

action for all investors in that class of securities – and not just those who may have purchased or sold in the United States – the potential deterrent effect that results from the private liability might be enhanced, which in turn could reduce the overall incidence of Section 10(b) violations.

As a further benefit of permitting private actions for all investors in a security, the class of which was registered in the United States, U.S. institutional investors might be able to diversify their securities holdings with respect to cross-listed securities without, as discussed above, having to decide between the potential additional costs and burdens of acquiring exchange-traded ADRs in the United States, on the one hand, or foregoing a Section 10(b) private action by purchasing the underlying reference securities on an overseas exchange.[240] In addition, a standard based on U.S. registration would provide a bright line that would permit any issuer considering U.S. registration to estimate the potential liability exposure and to proceed accordingly.

Additionally, registration of a class of securities for trading on an exchange could be seen as an appropriate trigger to determine the availability of a Section 10(b) private action. A company that has registered its class of securities has developed a significant connection to the U.S. securities markets. It has either listed its securities on a U.S. exchange or has both more than five hundred shareholders of record (and at least three hundred shareholders in the United States)[241] and ten million dollars in total assets.[242] Focusing on registration would ensure that investors will retain the ability to pursue Section 10(b) claims against those companies that have sought to access the public U.S. securities markets and are meeting the reporting and disclosure requirements of U.S. securities law.[243]

But private liability based solely on registration could be perceived as disruptive to international comity. This is particularly so because this approach could result in a return to U.S. courts of so-called "foreign-cubed" class actions – *i.e.*, private class actions brought by foreign investors suing foreign issuers involving transactions on foreign exchanges. Indeed, under a

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240 As discussed in Appendix A, *infra*, when ADRs are listed on a national securities exchange, the foreign issuer must register the class of underlying securities under the Exchange Act.

241 *See* Exchange Act Rule 12g3-2, 17 C.F.R. § 240.12g3-2.

242 *See* Exchange Act Rule 12g-1, 17 C.F.R. § 240.12g-1.

243 The registration standard may not sufficiently protect the interests of U.S. investors in all situations where foreign issuers avail themselves of the U.S. markets to raise money from U.S. investors. For example, foreign issuers could raise a significant amount of capital from U.S. investors in transactions that are exempt from the registration requirements of the Securities Act involving securities that are not of a class registered under the Exchange Act. If the Congress were to enact the registration standard, the Commission should be given rulemaking authority to deal with other situations where foreign issuers avail themselves of the U.S. markets to raise money from U.S. investors.

U.S.-registration standard, the *Morrison* litigation itself would have been decided differently because, as discussed below in Appendix B, defendant National Australia Bank's stock was registered in the United States.

In addition, there is a risk that a U.S.-registration standard could discourage foreign issuers from registering securities in the United States because doing so could expose foreign issuers to so-called global securities class actions – *i.e.*, class actions that comprise investors from all nations that purchased the company's securities on any securities exchange. This could negatively impact the competitiveness of the United States capital markets. Relatedly, this could impair U.S. investors' ability to directly acquire foreign securities domestically – particularly U.S. retail investors' ability to acquire ADRs – if a significant number of foreign issuers avoided the U.S. securities market. Although the probability of this occurring is unclear, the Staff notes that foreign issuers actively pursued U.S. registration for forty years notwithstanding the potential Section 10(b) private liability, which could indicate that foreign issuers would generally continue to do so under a U.S.-registration standard.

2. Authorize Section 10(b) Private Actions Against Securities Intermediaries that Engage in Securities Fraud While Purchasing or Selling Securities Overseas for U.S. Investors

As discussed above, several federal district court cases have held that a securities intermediary – *e.g.*, a broker-dealer[244] or investment adviser – that defrauds a customer or client in connection with a foreign securities transaction may avoid Section 10(b) private liability under the transactional test, even if the intermediary is physically operating in the United States or actively providing services to U.S. investors. If this application of the transactional test stands, it would create a void in the Section 10(b) private liability regime that unscrupulous securities intermediaries could abuse.[245]

To prevent this risk, Congress may wish to consider affording a Section 10(b) private action against: (i) securities intermediaries located within the United States when they defraud a client in connection with any securities transaction (*i.e.*, foreign or domestic); and (ii) foreign securities intermediaries when they are reaching into the United States to provide securities

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[244] Customers of a U.S.-registered broker-dealer may still be able to pursue other claims through FINRA arbitration proceedings. *See generally* http://www.finra.org/ArbitrationMediation/Parties/Overview/.

[245] To illustrate this point, consider the example of a U.S. broker-dealer that seeks to defraud its U.S. and foreign customers. The broker-dealer could advise its customer to purchase or sell a U.S. security, and then steal the customers' money rather than execute the transactions. Under this scheme, the broker-dealer would be subject to Section 10(b) private liability because the fraud was in connection with a domestic securities transaction. *See generally SEC v. Zandford*, 535 U.S. 813 (2002). However, if the U.S. broker-dealer modifies the scheme slightly to instead advise its customer to purchase securities on a foreign exchange, and then steals the money, the transactional test may preclude private liability under Section 10(b).

investment services for a U.S. client and commit fraud against that client in connection with any securities transaction.[246]

Such an approach would likely not offend principles of international comity given the significant U.S. interest in ensuring that securities intermediaries either physically operating here or reaching into the United States market to provide services for U.S. clients do not engage in fraud. Indeed, where a U.S.-based securities intermediary commits fraud against a U.S. client in connection with an overseas securities transaction, it is arguably the case that only the United States would have a sovereign interest implicated by the fraud.

3. Permit Investors to Pursue a Section 10(b) Private Action if They Can Demonstrate that They Were Induced While in the United States to Engage in the Transaction, Irrespective of Where the Actual Transaction Occurred

Congress may also wish to consider a "fraud in the inducement" test similar to that suggested by a number of comment letters.[247] Under such a test, an investor could purse a Section 10(b) private action if the investor is in the United States "at the time the investor is induced [by the fraudster] to purchase or sell securities in reliance on a materially false or misleading statement or pursuant to a manipulative act."[248] A benefit of this approach is that it could help deter both domestic and foreign parties from targeting persons in the United States with deceptive or manipulative actions while those persons are present here (a limitation that Justice Stevens's concurrence identified with the transactional test's scope), lest they face a potential Section 10(b) private action. [249]

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[246] This standard could be tailored to apply to only those broker-dealers and investment advisers that are required to register with the Commission, or it could also include those intermediaries that are exempt from registration. *See generally* Exchange Act Rule 15a-6, 17 C.F.R. § 240.15a-6.

[247] *See* discussion in Section IV.D.2, *supra*.

[248] Letter from ABA, at 3.

[249] *See* discussion in Part II.C.3, *supra*. It seems fair to observe that Justice Stevens's concern is already being realized. For example, in *In re Royal Bank of Scotland Group plc Securities Litigation*, plaintiffs were U.S. investors that claimed that one of the fraudulent transactions affected by defendant Royal Bank of Scotland involved securities sold to them in a rights offer. 765 F. Supp. 2d 327, 336 (S.D.N.Y. 2011). A rights offer is a capital raising undertaken by an issuer in which the issuer extends to its existing security holders the opportunity to purchase additional securities from the issuer. Plaintiffs claimed that the offering document prepared by the defendant bank specifically for the rights offer was subject to liability under Section 10(b). The court, however, found otherwise, stating that "*Morrison* is dispositive as to the Rights Issue claims as … [it] did not involve a domestic securities transaction." *Id.* at 339. Thus, at least one court has found that a *direct* offer and sale by a foreign issuer to U.S.

A fraud-in-the-inducement standard likely would not raise significant international comity concerns. *First*, as discussed above, the United States has a strong and well-recognized interest in ensuring that fraudulent conduct is not directed at investors in the United States. *Second*, a fraud-in-the-inducement standard would require a showing that the investor was actually induced in the United States by the deceptive communications or devices. By definition, therefore, the standard would require a demonstration of actual reliance when it is invoked to support a Section 10(b) private action, precluding use of the "fraud on the market" theory that has been a source of criticism from foreign government authorities when it is applied to transnational securities frauds involving overseas transactions.

4. Clarify that an Off-Exchange Transaction Takes Place in the United States if Either Party Made the Offer to Sell or Purchase, or Accepted the Offer to Sell or Purchase, While in the United States

As discussed above, the Supreme Court's *Morrison* decision did not specify when an off-exchange transaction takes place in the United States, and as a result the lower federal courts have been struggling to determine when an off-exchange transaction occurs here. One approach that at least two court decisions have applied involves a fact-intensive inquiry that looks to whether the moment of irrevocable liability occurred in the United States.[250] Yet, an "irrevocable liability" or similar narrow standard would cut against the bright-line purposes underlying the transactional test, and it could also serve as a roadmap for overseas fraudsters to structure transactions to avoid Section 10(b) private liability. As an example of the latter, consider a U.S.-based issuer that solicits off-exchange securities transactions by sending U.S. investors a sales subscription agreement and, in an attempt to escape Section 10(b) private liability, directs the U.S. investors to fax back the signed agreement to the issuer's off-shore agent, who then signs the sales agreement outside the United States on behalf of the U.S. issuer.

For these reasons, if Congress determines to legislate in this area, a statutory clarification of the transactional test's application to off-exchange transactions would be useful. Specifically, Congress might clarify that, in the case of off-exchange transactions, a domestic securities transaction occurs if a party to the transaction is in the United States either at the time that party made the offer to sell or purchase, or accepted the offer to sell or purchase.[251] This clarification would be consistent with the *Morrison* decision's intention to establish a bright-line standard because this clarification would provide a readily apparent answer as to whether the parties can

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investors is not subject to Section 10(b) private liability, the scenario contemplated by Justice Stevens.

[250] *See* discussion in Section III.H, *supra*.

[251] This is essentially the standard employed in the Uniform Securities Act. *See* Uniform Securities Act § 610 (as amended in 2002) (available at http://apps.americanbar.org/buslaw/newsletter/0009/materials/uniformsecure.pdf).

resort to a Section 10(b) private action. This clarification would have the following additional benefits: it would reduce the risk that fraudsters will attempt to structure off-exchange transactions so that the moment of irrevocable liability occurs outside the United States; it is consistent with modern contract theory which recognizes that a contractual arrangement such as a sales or purchase transaction can occur in both of the jurisdictions where the parties are located at the time of contracting;[252] and it reflects investor expectations because investors generally appear to expect that the law of the jurisdiction where they are located when they enter an off-exchange securities transaction will protect them.

Finally, this clarification for off-exchange transactions should not present international comity concerns because the United States has a strong and well-recognized interest in redressing fraud that occurs in transnational securities transactions that involve U.S. parties.

VI. Conclusion

In *Morrison v. National Australia Bank*, the Supreme Court eliminated the availability of Section 10(b) private actions for victims of transnational securities frauds that relate to overseas transactions. Congress responded both by adding Section 929P(b)(2) to codify the conduct and effects tests for Commission and DOJ actions involving transnational securities fraud and by directing that the Commission seek public comment and issue this Study to consider similarly extending the cross-border scope of Section 10(b) private rights of action. This Study has attempted to identify the relevant policy considerations that Congress might want to consider as part of a process for determining whether to enact legislation regarding the cross-border scope of Section 10(b) private actions.

Whether the cross-border scope of Section 10(b) private actions is ultimately addressed through legislation, further judicial developments, or both, this area will be subject to further

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252 As the Third Circuit Court of Appeals has explained:

> At one time, it was fashionable to conceive of contracts between diverse parties as being rooted in a single geographical location, such as the place the offer was accepted. Under this traditional approach, it was believed that when a contract offer made in New Jersey was accepted in New York, the contract was "made" in New York, and thus implicated New York's sovereignty. The contrasting modern approach is to recognize that contracts formed between citizens in different states implicate the regulatory interests of both states. Thus, when an offer is made in one state and accepted in another, we now recognize that elements of the transaction have occurred in each state, and that both states have an interest in regulating the terms and performance of the contract.

A.S. Goldmen & Co., Inc. v. New Jersey Bureau of Securities, 163 F.3d 780, 787 (3d Cir. 1999) (internal citations omitted). *See also Lintz v. Carey Manor Ltd.*, 613 F. Supp. 543, 550 (W.D. Va. 1985) ("[S]o long as there is some territorial nexus to a particular transaction, the laws of two or more states may simultaneously apply.").

legal development in the years ahead. Absent legislation, lower federal courts in particular will likely be called upon to resolve myriad novel and difficult issues regarding the application of the new transactional test.

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APPENDIX A

Regulatory Framework for American Depositary Receipts

U.S. investors often hold equity securities of foreign issuers (other than Canadian issuers) in the form of American depositary receipts ("ADRs"). An ADR[1] is a negotiable security that represents an ownership interest in a specified number of foreign securities that have been placed with a depositary financial institution by the holders of such securities. An ADR is in essence a substitute trading mechanism for foreign securities – the holder can transfer title to the underlying foreign securities by delivery of the ADR. The securities that are deposited with the depositary ("deposited securities") typically are equity securities, although debt securities have been deposited securities on rare occasions. The depositary is typically a U.S. bank or trust company, and it usually appoints a custodian to hold the deposited securities in the home market of the foreign issuer. The custodian is often a bank, and may be a subsidiary or branch of the depositary or a third-party institution with which the depositary has a contractual custodian relationship.

The ADR mechanism was developed in the early part of the twentieth century to overcome or mitigate certain legal, technical and practical problems confronting U.S. investors that wanted to effect transactions in foreign securities. The use of ADRs obviated the need to record transfers of ownership of foreign securities on share registers maintained outside the United States, and it also made it easier to handle equity securities in bearer form, which were common outside the United States. An ADR may represent one security of a foreign issuer or fractions or multiples of a security of a foreign issuer.[2]

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[1] The Commission's regulations distinguish between ADRs and American depositary shares ("ADSs"). Under these regulations, an ADR is the physical certificate that evidences ADSs (in much the same way a stock certificate evidences shares of stock), and an ADS is the security that represents an ownership interest in the deposited securities (in much the same way a share of stock represents an ownership interest in a corporation). It appears, however, that ADR market participants largely do not differentiate between ADRs and ADSs. As a result, the term "ADS" is not used in this Study, and the term "ADR" may, depending on its context, refer to either the physical certificate or the security evidenced by such certificate.

[2] The ratio of such securities represented by one ADR (referred to by market participants as the "multiple") compensates for differences between traditional pricing levels in the United States and those of foreign markets. When creating an ADR facility, the depositary and the issuer determine the ratio of securities represented by one ADR to establish a price per ADR that would be attractive to U.S. investors. For example, for ADRs representing securities that traditionally trade in a foreign market at low per share prices as compared with the U.S. market, one ADR may represent two, five or more underlying shares of the foreign issuer to arrive at a price per ADR that falls within the expected trading range for securities trading on a specified U.S. market. Conversely, for ADRs representing securities that traditionally trade in a foreign market at high per share prices as compared with the U.S. market, one ADR may represent one-half, one-fifth or smaller fraction of the underlying shares of the foreign issuer to arrive at a price

The ADR arrangement provides U.S. investors[3] with several attributes that are absent in direct ownership of foreign securities. The depositary (or the custodian) monitors the declaration of dividends, collects them and converts them to U.S. dollars for distribution. In addition, the clearance and settlement process for ADRs generally is the same as for other domestic securities that are traded in the U.S. markets. Thus, investors can own an interest in securities of foreign issuers while holding securities that trade, clear and settle within automated U.S. systems and within U.S. timeframes. In essence, ADRs have many characteristics of a domestic equity security.

Sponsored and Unsponsored ADR Facilities

ADR facilities may be established as either "sponsored" or "unsponsored." While ADRs issued under these two types of facilities are similar in some respects, there are distinctions between them relating to the rights and obligations of ADR holders and the practices of market participants.[4] Although the terms of deposit for sponsored and unsponsored ADR facilities differ, sponsorship in and of itself does not result in different reporting or registration requirements with the Commission.

Unsponsored Facilities

"Unsponsored" ADR facilities generally are created in response to interest on the part of some investors, a broker-dealer and a depositary. A depositary may establish an unsponsored facility without participation by (or even the acquiescence of) the issuer of the deposited securities. Once a registration statement registering the ADRs has been filed with the Commission and has become effective, the depositary may begin to accept deposits of the foreign securities and to issue ADRs against such deposits.

Holders of unsponsored ADRs generally bear all the costs of such facilities. The depositary usually charges fees upon the deposit and withdrawal of deposited securities, the conversion of dividends into U.S. dollars, the disposition of a non-cash distribution, and the performance of other services. The depositary of an unsponsored facility frequently is under no obligation to distribute shareholder communications received from the issuer of the deposited securities or to pass through voting rights to ADR holders in respect of the deposited securities.

Unsponsored ADR facilities are usually duplicated; that is, after one depositary has established a facility for a particular issuer's securities, other depositaries often establish their

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per ADR that falls within the expected trading range for securities trading on a specified U.S. market.

3 Although originally developed for U.S. investors, foreign investors may also hold ADRs.

4 Some of these differences are inherent to the two different ADR types, *i.e.*, they are a function of the different levels of issuer involvement. Other differences are attributable largely to industry custom and practice.

own facilities for the same class of that issuer's securities. Such duplication can occur without the approval of either the foreign issuer or the original depositary. Duplicate unsponsored ADRs generally are considered fungible with each other and trade without regard to the identity of the depositary.

Sponsored Facilities

A "sponsored" ADR facility is established jointly by an issuer and a depositary.[5] Sponsored ADR facilities are created in generally the same manner as unsponsored facilities, except that the foreign issuer of the deposited securities enters into a deposit agreement with the depositary and signs the registration statement under the Securities Act. The deposit agreement sets out the rights and responsibilities of the issuer, the depositary and the ADR holders. Each ADR holder becomes a party to such agreement through its holding of the ADR.

With sponsored facilities, the issuer of the deposited securities generally agrees contractually to bear some of the costs relating to the facility, such as costs associated with the distribution of dividends, although ADR holders continue to pay other costs, such as deposit and withdrawal fees. Under the terms of some sponsored arrangements, depositaries agree to distribute notice of shareholder meetings and voting instructions, thereby facilitating the ability of ADR holders to exercise voting rights. In addition, the depositary may agree to distribute shareholder communications and other information to the ADR holders at the request and cost of the foreign issuer of the deposited securities.

The ADR Market

ADRs are traded in the United States in substantially the same manner as the equity securities of domestic issuers. Some foreign issuers choose to list their ADRs on a U.S. stock exchange, such as the New York Stock Exchange, NYSE-Amex, or Nasdaq Stock Market. Other foreign issuers choose to have trading in their ADRs conducted in the U.S. over-the-counter market.

Regulatory Treatment

Securities Act Registration. The definition of "security" in the Securities Act states that the term "security" means "any … stock, … certificate of deposit for a security, … or, in general

[5] Market participants describe sponsored facilities in terms of three categories, based on the extent to which the issuer of the deposited securities has accessed the U.S. securities market. A "Level 1 facility" is a sponsored ADR facility the ADRs of which trade in the U.S. over-the-counter market and the foreign issuer is not registered with or reporting to the Commission under Section 12 or 15 of the Exchange Act. "Level 2" refers to sponsored ADRs that are listed on a U.S. stock exchange (and thus the foreign issuer has registered under Section 12 of the Exchange Act) but the foreign issuer has not sold ADRs in the United States in order to raise capital or effect an acquisition. "Level 3" denotes sponsored ADRs that are listed on a U.S. stock exchange where the foreign issuer has sold ADRs in the United States in a registered public offering.

any interest or instrument commonly known as a security, … [or any] receipt for … any of the foregoing." As a result, for purposes of the Securities Act, ADRs and the deposited securities are considered as separate securities, each subject to the registration requirements under the Securities Act. When a foreign issuer is making a public offering of its securities in the United States, the securities generally must be registered with the Commission under the Securities Act. While the issuer may choose to sell such securities in ADR form, the use of ADRs to facilitate a public offering does not supplant the need for the foreign issuer to register its securities – both the ADRs and the deposited securities must be registered.

Beyond circumstances where the foreign issuer is engaged in a public offering of the deposited securities, registration of the foreign issuer's securities generally is not required. For example, a person who purchased securities of a foreign issuer on a foreign stock exchange in an ordinary secondary market transaction would generally be able to resell those securities in the United States without registration in reliance on an exemption.[6] The fact that this person may decide to deposit the securities into an ADR facility, create ADRs and then resell the ADRs in the United States would not alter the applicability of the exemption to the resale of the underlying securities in the form of ADRs. However, the issuance of ADRs upon such a deposit would involve a public offering of the ADRs and that transaction must be registered.

The Commission has adopted a special registration scheme specifically for the registration of ADRs under the Securities Act – Form F-6. This form elicits disclosure of the terms of deposit relating to the ADRs, such as: the number or fraction of underlying securities represented by an ADR; procedures for dividend collection and distribution; procedures for voting, transmission of shareholder notices, lending arrangements, fees and charges relating to the ADRs; and any restrictions upon the right to withdraw and deposit underlying securities. The form does not elicit any information about the foreign issuer itself, such as its financial statements or a description of its business.

Exchange Act Registration and Reporting. In general, there is no *direct* reporting requirement on the part of the foreign issuer of the deposited securities that results solely from the establishment of a sponsored ADR facility or a depositary's establishment of an unsponsored ADR facility. When ADRs are listed on a national securities exchange, however, the foreign issuer must register the class of underlying securities under the Exchange Act and, in so doing, becomes subject to the Exchange Act's reporting requirements.[7]

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6 *See, e.g.,* Section 4(1) of the Securities Act, 15 U.S.C. 77d(1) (providing an exemption from registration for transactions by persons other than the issuer, underwriters and dealers); Section 4(3) of the Securities Act, 15 U.S.C. 77d(3) (providing an exemption from registration for certain transactions by dealers following a distribution).

7 Under Exchange Act Rule 12a-8, the ADRs themselves are exempt from registration under the Exchange Act. *See* 17 C.F.R. § 240.12a-8.

APPENDIX B

Economic Research on the Costs and Benefits of Extending a Private Right of Action for Transnational Securities Frauds

I. Introduction

This Appendix describes the economic consequences of a cross-border extension of a Section 10(b) private right of action in transnational securities. To understand the costs and benefits of a cross-border extension, we both reviewed the findings from existing economic research and empirically analyzed the stock price reactions of U.S. cross-listed companies to news of the U.S. Supreme Court's June 24, 2010 decision in *Morrison v. National Australia Bank Ltd.*[1] Our empirical analysis does not show a statistically significant stock price reaction to the decision. Considering both the existing economic research and the results of our analysis, we are unable to document evidence of either economic costs or economic benefits that could be clearly and directly linked to extending a private right of action.[2]

II. Expected Economic Effects

A. Effects on the Number of Eligible Investors and the Size of a Class

For purposes of this analysis, we assume that if Congress were to extend a cross-border private right of action for transnational securities frauds, the extension would expand the number of investors who would be eligible to participate in a class action for transnational securities frauds. Expanding the pool of eligible investors would, in turn, increase the number of investors who would choose to participate in private class action lawsuits against companies whose shares are listed on non-U.S. exchanges, particularly among those investors who purchased their shares in non-U.S. markets.[3]

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1 130 S. Ct. 2869 (2010).

2 There are two other recent empirical studies on the *Morrison* decision available in the public comment file http://www.sec.gov/comments/4-617/4-617.shtml. Licht, Poliquin, Siegel and Li (2011) provided a preliminary study with evidence that *Morrison* positively affected stock prices of foreign firms, which would be evidence against the benefits of a cross-border extension. The results provided in Gagnon and Karolyi (2011) suggest that investors moved trading from the home market to the US to obtain class-action protections, evidence in favor of benefits of a cross-border extension.

3 The overall effect of increase in the size of a class may be less than one-to-one because the transaction costs of communicating with investors who had purchased in non-U.S. markets may be greater than the costs of communicating with investors who purchased in the U.S. market.

B. Effects on Settlement Amounts and Filing Rates for Private Class Actions

A direct effect of a cross-border extension would be to increase the expected size of the class by increasing the number of eligible shareholders. As long as shareholders that purchase shares overseas have some positive likelihood of filing a claim, adding these investors to a class would cause an increase in the amount actually paid in a settlement.[4] Therefore, by increasing the number of eligible investors, holding all else equal, a cross-border extension would increase both the estimated aggregate damages and the amount actually paid in settlement for litigation against companies that are listed both on U.S. exchanges and abroad.[5]

It is also significant that the payoffs for plaintiff's attorneys for settled cases are usually directly related to the amount of the settlement.[6] As a result, increasing the size of the eligible class and therefore the potential settlement would likely increase the incentives for plaintiff's attorneys to bring a lawsuit. Consequently, there could be an increase in the number of lawsuits as well.[7] Consistent with this expectation, economists have found that the likelihood of a class action lawsuit, and particularly the likelihood of a class action lawsuit against foreign firms, is positively related to the number of affected shares.[8]

As regards the incentives of corporations that may be the targets of class action suits, the increase in settlement sizes might lead them to exert greater effort to avoid being the subject of a class action. For example, by increasing the expected settlement amount for a given lawsuit, a cross-border extension could benefit investors by providing a deterrent effect on managerial

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4 *See, e.g.*, Crew, N., *et al.*, *Securities Act Violations: Estimation of Damages,* LITIGATION SERVICES HANDBOOK: THE ROLE OF THE FINANCIAL EXPERT, ch.17 (3rd ed.) (Weil *et al*. eds.). Although actual claimed losses may be uncorrelated with estimated losses based on proportional trading models (*see* Fischel, Ross, and Keable (2006)), an increase in the size of the class would be expected to have a direct effect on the number of filed claims.

5 Consistent with this position, two papers have noted that the *Morrison* decision reduced the legal protections for shareholders of foreign companies. *E.g.*, Buckberg and Gulker (2011) ("We conclude that, following *Morrison*, foreign companies' expected litigation costs should fall, because investors who purchased their shares on overseas exchanges will be excluded from classes, driving down damages and settlements."); Licht, Poliquin, Siegel and Li (2011) (stating that, post-*Morrison*, "U.S.-listed foreign private issuers ("FPIs") (also referred to in the literature simply as cross-listed firms) thus were suddenly shielded from civil claims by investors who purchased their shares on their home markets.").

6 *See, e.g.*, Eisenberg and Miller (2010).

7 *See* Buckberg and Gulker (2011) (stating that "by driving down the entire distribution of expected settlement sizes and expected fee awards, *Morrison* may also reduce the aggressiveness with which the plaintiffs' bar pursues foreign issuer complaints, further driving down foreign issuer settlements").

8 Field, Lowry, and Shu (2005); Gande and Miller (2011).

behavior.[9] Improving deterrence would limit managerial expropriation which, in turn, would be expected to reduce the number of violations. The cross-border extension, therefore, could improve shareholder welfare by increasing the cost of managerial misbehavior. This may indicate fewer lawsuits in the aggregate.

C. Effects on Weak or Meritless Lawsuits

There is a risk that an increase in the ability of shareholders to bring a Section 10(b) class action in securities fraud under the cross-border extension, and the potential for larger resulting awards or settlements, could lead investors and others to pursue weaker or even unmeritorious cases in the hope of settling with corporations that are risk-averse and have much to lose from negative publicity. The effect of these class action lawsuits could be both a transfer of capital and a deadweight cost. The transfer is from current shareholders of the defendant corporation to a particular subset of shareholders who effected certain transactions on a particular day. The transfer is accompanied by a deadweight cost because the attorney representing the class is expected to get a significant fraction of the settlement amount.[10] To the extent that this type of weak or meritless lawsuit gets filed and settled more frequently, one economic effect of the cross-border extension is an increased frequency of such transfers and deadweight costs on current shareholders.

It is unclear whether the increase in the size of the class, potential settlements and the probability of lawsuit would be outweighed by the deterrent effect on managers.[11] There are legitimate arguments in both directions.

D. Effects on Trading Volume

The cross-border extension may also affect the incentives of investors to trade on non-U.S. exchanges rather than U.S. exchanges. A cross-sectional study by Halling *et al*. (2007) indicates that for cross-listed firms, trading volume on U.S. exchanges is higher for companies from countries with poor investor protections.[12] To the extent that the *Morrison* decision reduced the scope of protection available to investors who trade outside the U.S., all else equal, investors may have a stronger incentive to execute trades within the United States. As a result,

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9 Since the penalties in securities class action lawsuits are borne (mostly) by shareholders rather than managers, whether they achieve an optimal level of managerial deterrence for their costs is controversial. *See, e.g.*, Fox (2011); Coffee (2006). The question of deterrence is discussed further as the "bonding hypothesis" in the following section on the valuation effect of cross-listings.

10 *See, e.g.*, Eisenberg and Miller (2010).

11 Some threshold evidence on the effect of limiting the extraterritorial reach of private class action lawsuits was provided by Buckberg and Gulker (2011), who reported that "filings against foreign companies have not decreased since the *Morrison* decision in June 2010."

12 Similar results are reported in a study of institutional investors' holdings of American Depositary Receipts ("ADRs") by Aggarwal *et al.* (2007).

Morrison could have a positive effect on U.S. trading volume. Consistent with this expectation, Buckberg and Gulker (2011)—citing Halling *et al*. (2007), claim that, post-*Morrison*, "at least some institutional investors are likely to request that their trades in cross-listed stocks be executed in the U.S." The implication of these studies is that a cross-border extension of a Section 10(b) private right of action might cause an expected decline in U.S. trading volume, though this has not yet been empirically tested.

It is important to note that a private right of action is only one of many factors that affect trading volume on U.S. and non-U.S. exchanges for cross-listed securities. Because of the complexity of factors affecting trading volume and execution decisions, the practical significance of the impact on trading volume on U.S. exchange of a cross-border extension is not clear.

III. Empirical Evidence: Research on U.S. Cross-Listings

Another question raised by the proposed cross-border extension is whether greater exposure to U.S. securities laws and regulations would cause an increase in firm value. The primary focus on whether a firm can increase value through bonding to U.S. securities laws has been on studies of cross-listings. Many of these studies have concluded that there is a valuation premium associated with cross-listing a foreign firm on a U.S. exchange (for reviews of the research, see Karolyi, 2011 and Karolyi, 2006).[13]

In addition to a possible valuation premium, evidence of bonding includes improved corporate governance for firms that cross-list on U.S. exchanges. Specifically, economists have found evidence of a reduced cost of capital (*see, e.g.*, Hail and Leuz, 2009), higher-valued excess cash holdings (*see* Fresard and Salva, 2010), and even CEO terminations in poorly-performing firms (*see* Lel and Miller, 2008).

Notwithstanding the evidence of potential benefits to a foreign issuer from listing in the United States, because private rights of actions are just one component of the U.S. securities regulations, we do not have sufficient evidence to conclude that the existence and effects of a cross-border extension would have a net beneficial effect on firm value. Simply put, cross-listing on a U.S. exchange entails many other economic effects, and may be motivated for many reasons beyond simply exposing the firm to U.S. securities law and regulation.

A. Evidence of the Valuation Benefits of U.S. Cross-Listings

Several studies have identified a valuation premium associated with a U.S. listing. At least three different methods have been used. The first method is an event study, which is a statistical technique used to assess the effects of an economic event on the value of firms.[14] Some of the early studies use the event studies method to analyze stock price reactions to the announcement of depositary receipt programs (*see, e.g.*, Foerster and Karolyi, 1999, and Miller,

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13 This Appendix is not comprehensive in its coverage of the existing research.

14 *See, e.g.*, MacKinlay (1997).

1999). One such study (Miller, 1999) found a statistically significant positive announcement effect of 1.27% for firms cross-listing on over-the-counter markets ("OTC"), and a larger effect of 2.63% for firms cross-listing on the NYSE or NASDAQ.

The second method compares Tobin's *q* for cross-listed and non-cross-listed foreign companies. Tobin's *q* is the ratio of the market value of a firm's assets to the replacement value of those assets. A higher value of Tobin's *q* is interpreted as an indicator of superior managerial performance and better growth opportunities.[15] Using this approach, Doidge, Karolyi, and Stulz (2004) found that Tobin's *q* for U.S. cross-listed foreign companies were 16.5% higher than Tobin's *q* of non-cross-listed peers. [16] In light of all the factors affecting company valuations at the time of a cross-listing, however, they concluded that their analysis "does not provide an estimate of the fraction of the cross-listing premium that can be attributed directly to listing."

A third approach assesses the valuation benefits of a U.S. cross-listing. Hail and Leuz (2009) analyzed the implied cost of capital for firms that cross-list to U.S. exchanges and the OTC by comparing them to the implied costs for non-cross-listed peers. A lower relative implied cost of capital for U.S. cross-listed firms is a valid measure of the valuation premium for the U.S. listing. They found that the estimated benefits ranged from a 70 to 120 basis point reduction in the cost of capital for firms cross-listing onto an exchange, and from 30 to 70 basis points for firms that are cross-listed in the OTC markets. In addition, they found that there were no similar results indicating a reduction in the cost of capital for firms cross-listing on the London Stock Exchange. The reduction in the cost of capital supports the hypothesis that there is a valuation increase associated with the cross-listing event.

Additional recent research indicates that the valuation premium associated with a U.S. cross-listing may not be unique to the United States. Sarkissian and Schill (2011) studied 2,838 listings from 69 home markets that list abroad in 32 host markets. They found that a foreign issuer's valuation premium associated with cross-listing in the U.S. was comparable with the valuation premium associated with cross-listing to a market in Japan, France, or Switzerland. Further, they found that U.S. firms that cross-list onto non-U.S. exchanges in Germany, Japan, and other markets (except Canada), experience a statistically significant valuation premium. These results suggest that the valuation benefits associated with a U.S. cross-listing may not be caused by the U.S. legal and regulatory environment.

In summary, although the results from these analytical approaches provide evidence of a cross-listing valuation premium, the Sarkissian and Schill analysis suggests that the cross-listing premium is not unique to the United States. More importantly, none of these studies indicates that the cross-listing valuation premium is attributable to the U.S. securities-law private rights of action specifically. As a result, these studies have not yet provided direct evidence regarding the cross-border extension of the private right of action.

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[15] Ross, Westerfield, and Jaffe (2005), p. 41; Grinblatt and Titman (1998), p. 684.

[16] Doidge *et al.* measured Tobin's *q* as the total book value of assets minus book equity plus market value of equity, all divided by the total book value of assets. They considered only firms with total book value of assets greater than $100 million.

B. Evidence of Improved Corporate Governance from a U.S. Cross-Listing

There are several different reasons why stock prices might be expected to increase with the announcement of a U.S. cross-listing.[17] One reason, which has been labeled the "bonding hypothesis," is that, by exposing the firm to legal protections for shareholders, disclosure requirements,[18] and increased monitoring from analysts and bankers,[19] a cross-listing enables managers to credibly commit that they will not expropriate the firm's resources or defraud minority investors.

Several economists have found evidence consistent with the bonding hypothesis. For instance, Lel and Miller (2008) found that firms from weak investor protection regimes that are cross-listed on a U.S. exchange are more likely to terminate a poorly performing CEO. Their results are consistent with the theory that U.S. cross-listed foreign firms are more committed to disciplining senior management than their non-cross-listed foreign peers.[20] They also found that prior to cross-listing, there was no significant relationship between CEO turnover and CEO performance.

Providing further evidence of a link between U.S. cross-listing and corporate governance, Fresard and Salva (2010) found that excess cash balances on foreign company balance sheets had a higher valuation for U.S. cross-listed firms than for their non-cross-listed foreign peers. These results are consistent with the theory that cash balances created a larger increase in shareholder value for cross-listed firms, suggesting stronger corporate governance. In another study,

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[17] Coffee (2002) provides a detailed description and analysis.

[18] Although there is extensive research on the economic costs and benefits of U.S. disclosure requirements, the net economic impact of these requirements is not clear. *See, e.g.*, Leuz and Wysocki (2008); Beyer *et al*. (2010)).

[19] At least two studies have reported an increase in analyst coverage associated with a U.S. cross-listing. For instance, Lang, Lins, and Miller (2003) found that, after controlling for firm size, country, and industry, firms that cross list in the United States and reconcile to U.S. GAAP have an average of two to three more analysts covering the firm, and the average analyst earnings forecast is more accurate than non-U.S. firms that are not cross-listed. Furthermore, they find that analyst coverage and higher forecast accuracy are associated with a higher Tobin's *q* ratio. Baker, Nofsinger, and Weaver (2002) also found evidence of an increase in analyst coverage.

[20] Lel and Miller do not find that cross-listing to the U.S. OTC provides any improvement in the likelihood of terminating a poorly performing CEO. However, companies cross-listed on OTC markets, which face reduced disclosure requirements relative to exchange-listed firms, could be sued in a shareholder class action during the period of their study (1992-2003), subject to the limitations of the conduct and effects tests. Therefore, their results do not provide evidence that private class action protections for shareholders produce improved corporate governance.

economists found that, when controlling shareholders have high levels of control, their firms are less likely to be cross-listed to a U.S. exchange (Doidge, Karolyi, Lins, Miller and Stulz, 2009). This suggests that foreign companies with greater opportunities for controlling shareholders to expropriate firm assets are less likely to cross-list, consistent with the theory that a U.S. cross-listing tends to impose limitations on opportunities for expropriation.

However, an improvement in corporate governance is just one among many economic factors that might cause a U.S. cross-listing premium. Economists have also found evidence that firms with U.S. cross-listings obtain: (a) better access to larger capital markets ("segmentation hypothesis"), (b) increased liquidity for shareholders, (c) increased visibility ("recognition hypothesis"), and (d) an improvement in price discovery ("information channel").[21] In addition, many economists have suggested that the observed valuation premium could actually motivate firms to cross-list, or that an unobserved factor might cause both the valuation premium and the cross-listing. This has been described by economists as a 'selection bias' issue, which affects nearly all studies on the valuation and corporate governance effects of cross-listings.[22]

One recent study takes a unique approach to examine companies that would have been unaffected by the selection bias associated with the firm's decision to cross-list, by studying a group of firms that reflect an alternative selection bias. The authors study firms that were selected by a depositary bank for Level 1 ADR's,[23] causing an involuntary cross-listing onto OTC markets (Iliev, Miller, and Roth, 2011). They found that firms experience a significant decrease in Tobin's q after being involuntarily cross-listed.[24] Although the involuntary cross-listing would not cause the firms to be subject to U.S. disclosure requirements, it might increase the firm's U.S. class action litigation risk. The authors found that, with the involuntary cross-listing, audit fees for these companies increased by nine percent and the firm value declined by six percent. For these firms, it appears that the increased litigation risk associated with an involuntary U.S. listing might have a net negative, rather than a positive, effect on valuations.[25]

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21 For a review of some of these studies, *see* Karolyi and Gagnon, 2010. *See also* Foucault and Gehrig (2008); Fernandes and Ferreira (2008); Foucault and Fresard (2011).

22 *See generally* Bailey *et al.* (2006) (noting that "larger, more leveraged, faster growing firms are more likely to list"). *See also, e.g.*, Karolyi (2011); Doidge, Karolyi, and Stulz (2004); Sarkissian and Schill (2011).

23 *See* discussion of ADRs in Appendix A, *supra*.

24 The authors found that depositary banks selected large, profitable, high valuation firms from countries with better protections for minority investors and stronger disclosure requirements.

25 One interpretation consistent with these results is that firms are heterogeneous in terms of the potential benefits that they face in cross-listing, with the possibility that some firms could end up incurring more costs than benefits. Therefore, firms that do choose to cross-list in the U.S. may reap a cross-listing premium but those that are involuntarily listed – who rationally did not themselves choose to list – may actually experience a decrease in their firm values.

Regardless, even if there were a consensus in the literature that U.S. cross-listed firms improve their corporate governance as a direct result of the cross-listing, more research would be required to conclusively determine if the improvement to corporate governance would be a sufficient basis for extraterritorially extending the Section 10(b) private right of action. The reasons for the improvement in corporate governance and the potential contribution of a U.S. private right of action would remain unclear as this hypothesis has not been directly tested by the prior literature. Indeed, even if there were a clear improvement in corporate governance that was directly caused by a U.S. listing, the available evidence does not rule out the possibility that the Section 10(b) private right of action might have a negative effect on company value (albeit a negative effect that is netted out by the countervailing positive effects of the U.S. dual-listing).

IV. Potential Shareholder Wealth Effects of a Cross-border Extension: Evidence from the Time Period Surrounding the *Morrison* Oral Argument and Decision

As discussed above, although there are many economic studies that analyze the economic impact of cross-listing, the evidence that they provide on the economic costs and benefits of extraterritorially extending a private right of action for transnational securities frauds is indirect and inconclusive. However, *Morrison* itself provides an opportunity to test for a market impact of restricting private rights of action for securities fraud.[26]

Specifically, we assess the economic consequences of the decision by analyzing the net-of-market stock price reactions of U.S.-listed foreign firms on March 29, 2010, the date of the oral arguments in *Morrison*, and on June 24, 2010, the date of the decision.[27] In doing so, we test the hypothesis that, by excluding transactions on non-U.S. exchanges from participation in private class actions, *Morrison* had an effect on the value of U.S.-listed foreign companies.

As discussed below, we do not find a statistically significant stock price reaction in response to either the decision or the oral arguments in *Morrison*. Our analysis of the data provides no evidence that the *Morrison* decision resulted in statistically significant costs or

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[26] This analysis follows the approach of Licht, Poliquin, Siegel and Li (2011), which was submitted during the public comment period. Our analysis stems from their insight and approach, although our conclusions are different. Karolyi and Gagnon (2011) study the effects of the *Morrison* decision by analyzing the spread between ADR and home market securities prices.

[27] We look in particular at the oral arguments because, according to some observers, the Supreme Court effectively communicated the direction of the ultimate decision. *See, e.g.*, Goldhaber, Michael, "Out of Gas; During Its Four-Year Pursuit of Volkswagen, Little Porsche Outmaneuvered the Giant Carmaker – But then Sputtered at the Finish. Were Porsche's Lawyers to Blame?" AMERICAN LAWYER (May 1, 2010) ("The U.S. Court of Appeals for the Second Circuit adopted a relatively narrow rule on F-cubed jurisdiction in *Morrison v. National Australia Bank*, and most observers expect that rule to narrow further after the U.S. Supreme Court decides that case this term.").

benefits on shareholders of foreign companies that were listed on U.S. and non-U.S. securities exchanges.

A. Data

We test the hypothesis that the trading price of a company that is simultaneously listed on both U.S. and non-U.S. exchanges is affected by news of either the oral argument or the decision. Because there are multiple different ways to identify foreign firms, we take four different approaches:[28]

- Set 1 uses 966 companies that were identified by the Commission as international registered and reporting companies as of December 31, 2009. We removed from this list the following: one duplicate, six companies that are identified as NYSE-Debt and NYSE-Preferred, 32 companies due to lack of daily returns data,[29] and 284 companies that the SEC identifies as "OTC", leaving a total of 643 companies.

- Set 2 includes these 643 companies and adds 90 companies that are identified as either ADRs or companies incorporated outside the U.S. by CRSP as of March 29, 2010, producing a list of 733 companies.[30]

- Set 3 begins with the list of 643 companies from the SEC list, and removes 51 companies that are not listed on an exchange outside the U.S., producing a set of 592 companies.[31]

- Set 4 begins with the 592 companies and removes 179 companies for which the only non-U.S. exchange listing is in Germany, but the company is not incorporated in Germany,[32] which leaves 413 companies.

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[28] We have posted the names and tickers for the companies included in each of the four sets. They may be obtained from the public comment file for this study. http://www.sec.gov/comments/4-617/4-617.shtml

[29] Specifically, we require that the daily stock file from the Center for Research in Securities Prices ("CRSP") must include a daily return on at least one of the event dates and it must include at least 60 days of daily returns between 3/29/2008 and 3/26/2010.

[30] We identify a company as a foreign issuer when the CRSP share type code has a first digit equal to "3" or a share type code equal to "12". Of our sample of 643 original companies, 623 were identified as foreign issuers by CRSP. The remaining 20 companies were identified as international registered and reporting companies by the SEC. We eliminated five companies that were identified as foreign issuers by CRSP, because Standard and Poor's Compustat identified these companies as U.S.-based.

[31] We used Datastream as well as the October 2011, Citigroup ADR list to identify foreign listings.

Table 1: Number of Non-U.S. Companies, by Country

This table shows the distribution of the sample datasets across 50 countries. Companies are assigned to countries based on the Commission's list of International Registered and Reporting Companies ("SEC List") or, where this information is not available, based on Standard and Poor's Compustat.

	Set #1	**Set #2**	**Set #3**	**Set #4**
Country	**SEC List subject to data availability, excluding OTC**	**Set #1 *plus* companies with ADRs or non-U.S. incorporation**	**Set #1 *excluding* companies not listed outside U.S.**	**Set #3 *excluding* companies with low trading volume outside the U.S.**
Antigua	1	1	1	0
Argentina	13	13	13	13
Australia	9	9	9	9
Bahamas	1	2	1	0
Belgium	2	2	2	2
Bermuda	21	53	20	7
Brazil	15	15	15	15
British Virgin Islands	25	26	22	0
Canada	173	177	152	141
Cayman Islands	78	87	71	1
Chile	11	12	11	11
China	11	11	11	11
Colombia	1	1	1	1
Denmark	2	2	2	2
Finland	1	1	1	1
France	9	9	9	7
Germany	7	7	7	7
Greece	3	3	3	3
Hong Kong	5	5	5	4
Hungary	1	1	1	1
India	13	13	13	11
Indonesia	2	2	2	2
Ireland	8	18	7	6
Israel	60	61	55	37
Italy	5	5	5	3
Japan	21	21	21	21
Korea	10	10	10	9
Liberia	2	3	1	0
Luxembourg	5	6	5	3
Marshall Islands	25	28	21	1
Mexico	18	21	17	17
Netherlands	15	18	13	9
Netherlands Antilles	1	3	1	1
New Zealand	1	1	1	1
Norway	1	1	1	1
Panama	2	3	2	0
Papua New Guinea	1	1	0	0
Peru	1	1	1	1
Philippines	1	1	1	1
Portugal	1	1	1	1
Russia	3	4	3	3
Singapore	1	4	1	0

[32] We exclude the non-German companies that are listed on a German exchange because we are concerned that low trading volume for these firms could bias our test against finding an effect.

South Africa	6	6	6	6
Spain	5	5	5	4
Sweden	1	1	1	1
Switzerland	6	15	5	5
Taiwan	6	6	5	5
Turkey	1	1	1	1
United Kingdom	32	36	30	27
Totals	**643**	**733**	**592**	**413**

The distribution of the four datasets by country is provided in Table 1. The differences across the datasets are primarily due to companies incorporated in the Cayman Islands, Bermuda, Canada, the Marshall Islands, the British Virgin Islands, Israel, Ireland, and Switzerland.

B. Results

We consider the U.S. stock exchange returns for each of the four sets of non-U.S. companies on March 29, 2010, the date of the oral arguments for *Morrison*, and June 24, 2010, the date of the decision. To test the significance of the returns on those dates, after adjusting for market movements, we utilize a "portfolio method" event study to calculate abnormal returns for each of the four sets of foreign companies.[33] To adjust for the cross-sectional correlation in abnormal returns induced by the simultaneous effect on all of the companies in the sample, we form an equally-weighted portfolio of the companies in each dataset, and estimate the abnormal returns by running a regression of the portfolio returns on a proxy for returns on the market (the S&P 500 index). We used a two year estimation period immediately preceding the date of the oral arguments, from March 29, 2008 to March 26, 2010. The regression results are provided in Table 2, Panel A, and are strongly consistent across the different data sets. The estimated betas are very close to one, and the R-squared statistic shows that approximately 80% of the variability in the portfolios is explained by the market proxy.[34] These portfolios are highly correlated with the S&P 500 index.

As a point of reference, we compared the results of these regressions to regression results for the S&P 500 over the same estimation period on four different international stock indices: the Vanguard FTSE All-World ex-US Index (VFWIX), the Vanguard Total World Stock Index ETF (VT), the iShares MSCI EAFE Index (EFA), and the iShares MSCI All Country World Index (ACWI). The results for these indices, provided in Table 3, were similar, with betas closer to one, and slightly higher R-squared statistics.[35] The comparison suggests that the strong

33 The "portfolio method" is similar to a Fama-MacBeth regression, and is described in detail by Sefcik and Thompson (1986).

34 For each of these regressions, the root mean squared error ("RMSE") is approximately 1%, so, as a rough estimate, the absolute value of an estimated abnormal return would need to be approximately 2% to be statistically significant. This threshold far exceeds the estimated abnormal returns on the event study dates.

35 The RMSE for the regressions on these indices ranges from 0.67% to 0.93%, indicating that the threshold for statistical significance is that the absolute value of abnormal returns would exceed 1.3% to 1.8%.

correlation with the S&P 500 is not induced by a cross-listing effect, but instead reflects correlation across economic factors driving broad portfolio returns.

Table 2, Panel B, shows the abnormal returns for each portfolio and date, defined as the difference between the portfolio actual returns and the predicted returns based on the market model.[36] On March 29, 2010, we find abnormal returns ranging from 0.27% to 0.28% that are not statistically significant.[37] On June 24, 2010, we find abnormal returns ranging from 0.00% to 0.08% that are not statistically significant. As a reasonableness check on the statistical results, Chart 1 shows the daily abnormal returns data for 2010 using the portfolio method. The portfolio used in this chart is the one identified as Set #4, the SEC list of international registered and reporting companies as of December 31, 2009, after excluding OTC firms and other companies that are not listed on non-U.S. exchanges, as described above. The chart provides a visual confirmation that the abnormal returns on the dates of the oral arguments and the decision are not unusual. In fact, the abnormal returns on March 29, 2010, are in the 74th percentile and the results on June 24, 2010, are in the 42nd percentile. The chart and the percentile calculations support the validity of the statistical results.

In addition to using the portfolio method to test for statistical significance, we estimate abnormal returns using a Brown and Warner (1985) approach and obtain similar results, also shown in Table 2. The Brown and Warner results are based on running a market model regression for each company in each dataset during the same two year estimation period. The same market proxy is used, but an additional restriction is applied to reduce the effects of outlier returns: all returns that have an absolute value in excess of 25% are excluded from the estimation period. The Brown and Warner abnormal returns are slightly larger than the abnormal returns calculated using the portfolio method, and are also not statistically significant.

Because March 29, 2010, falls on a Monday, the one-day returns on March 29th actually represent the return between the close of trading on Friday March 26th and the close of trading on Monday March 29th. As a result, any firm-specific or portfolio-specific weekend news would presumably have affected the abnormal returns. Because the oral arguments did not begin until 11:07 a.m. on March 29th, we believe that abnormal returns that took place between the close of trading on March 26th and 11:00 a.m. on March 29th should not be attributed to the *Morrison* case.

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[36] Although several newswires ran articles describing the oral arguments on March 29th, 2010, neither the *Wall Street Journal* nor the *New York Times* carried an article that mentioned the *Morrison* case on March 30th. When the decision was announced on June 24th, 2010, there was a similar lack of newspaper coverage on the following day. In contrast, when the Supreme Court decision in the *Janus Capital* case was announced on June 13, 2011, the Wall Street Journal, New York Times, and Washington Post published articles the following day describing the decision. *See Janus Capital Group v. First Derivative Traders*, 131 S. Ct. 2296 (2011). Although newspaper coverage is not always associated with stock price movement, this apparent lack of attention in the newspapers to the *Morrison* decision is consistent with our finding of statistically insignificant returns to the stock portfolio.

[37] The preliminary study submitted to the public comment file by Licht, Li, and Siegel (2011) found different results.

We perform two checks to confirm that our results are not caused by the effects of returns that preceded the oral arguments. First, to eliminate the effect of the weekend and pre-market returns, we measure the abnormal return of the stocks using returns from the opening price to the closing price of each day. We find that the results were unaffected by this change. For instance, the abnormal return for Set #4 declined from 0.28% to 0.17%, and the t-statistic dropped from 0.27 to 0.21, but the results are substantially the same: a small abnormal return that is not close to statistical significance.

We also examine intraday transactions data from the New York Stock Exchange for indications of a reaction to the information released in the oral arguments. These charts do not provide any indication of a timely stock price drop in reaction to the news. Chart #2 provides the intraday chart for Set #4. The chart indicates that when markets opened on 3/29/2010, the cumulative return for the portfolio was higher than the previous close, and higher than the return for the market over the same time period. In addition, the cumulative return for the portfolio rose, relative to the market, between 10:30 a.m. and 11 a.m., *prior to the start of the oral argument*. Most importantly, the cumulative returns do not rise significantly between 11 a.m. and the close of trading. This pattern of cumulative returns during the day is inconsistent with a hypothesis that the oral arguments in *Morrison* had a statistically significant impact on the returns to this portfolio.

IV. Conclusion

Overall, the conflicting evidence in the academic literature and the results of our event study on the *Morrison* decision are inconclusive as to the net benefits or costs of a cross-border extension of private rights of action.

Table 2: Event Study Results: Portfolio Method and Brown-Warner Method

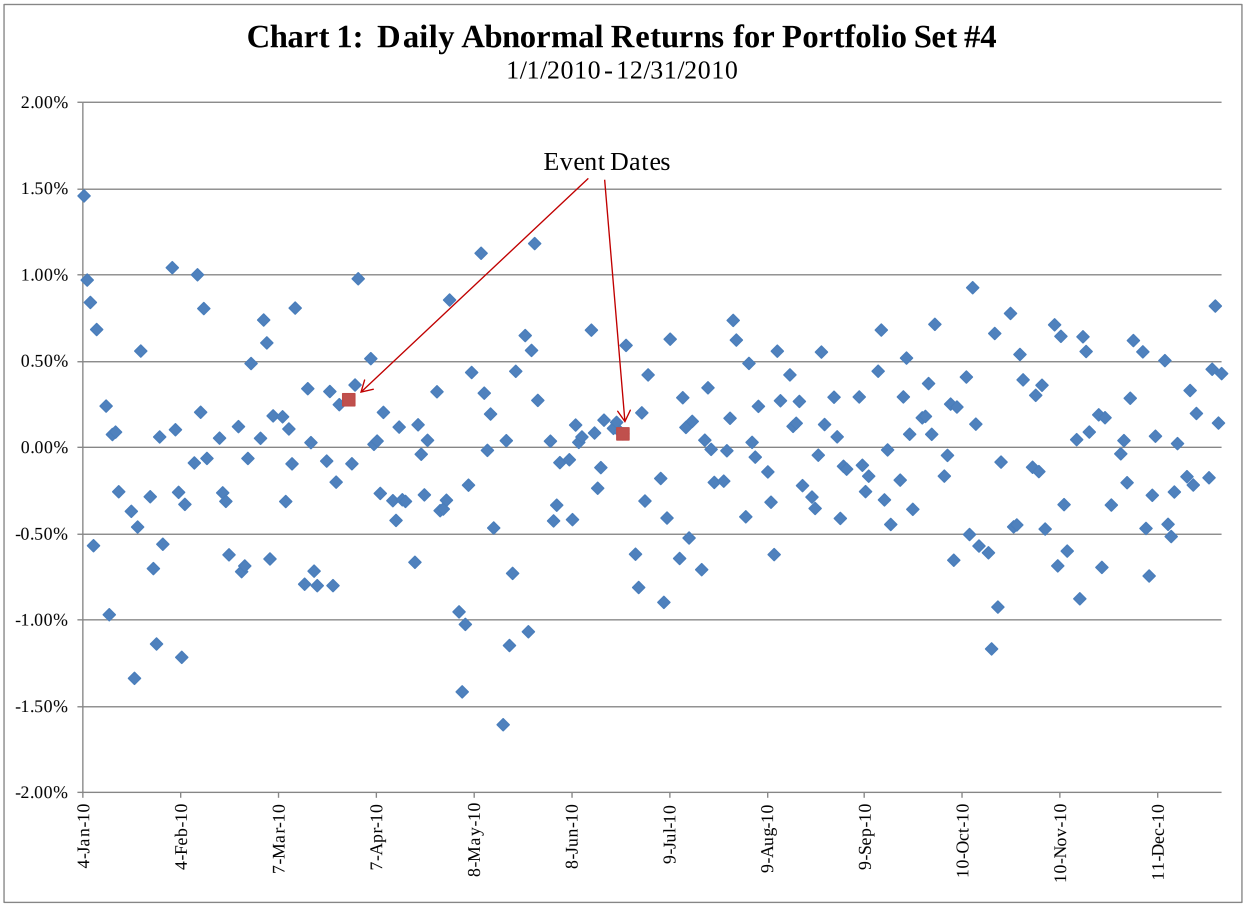
This table presents regression results from a market model as well as event study results for the dates of the oral argument and the publicized decision in *Morrison*. For Set #1, the portfolio of returns includes 643 firms that are included in the Commission's list of International Registered and Reporting Companies as of 12/31/09, after eliminating OTC firms. Set #2 adds companies identified as incorporated outside the United States and ADRs, based on data from the Center for Research in Securities Prices. Set #3 begins with Set #1 and removes companies that are not listed on an exchange outside the U.S. Set #4 begins with Set #3, and also excludes companies for which the only non-U.S. listing is in Germany, and the company is not German, because many of these companies have low trading volume in Germany. Panel A shows the results for the market model across the different portfolios. The portfolio method and the Brown-Warner methods for calculating abnormal returns, along with corresponding t-statistics, are presented together in Panel B for each data set.

	Set #1		**Set #2**		**Set #3**		**Set #4**	
	SEC List subject to data availability, excluding OTC		**Set #1 *plus* companies with ADRs or non-U.S. incorporation**		**Set #1 *excluding* companies not listed outside U.S.**		**Set #3 *excluding* companies with low trading volume outside the U.S.**	
Panel A: Portfolio Regression Results								
Intercept	0.001		0.001		0.001		0.001	
t-statistic	*(1.76)*		*(1.83)*		*(1.85)*		*(1.79)*	
Beta (S&P 500)	0.939		0.965		0.959		0.974	
t-statistic	*(43.38)*		*(47.46)*		*(44.71)*		*(44.65)*	
R-squared	0.790		0.818		0.800		0.799	
Panel B: Abnormal Returns								
Results - March 29, 2010	**Portfolio Method**	**Brown-Warner**	**Portfolio Method**	**Brown-Warner**	**Portfolio Method**	**Brown-Warner**	**Portfolio Method**	**Brown-Warner**
Raw return	0.89%	0.89%	0.89%	0.90%	0.90%	0.90%	0.92%	0.92%
Abnormal return	**0.28%**	**0.38%**	**0.27%**	**0.37%**	**0.27%**	**0.36%**	**0.28%**	**0.35%**
t-statistic	*(0.26)*	*-(0.23)*	*(0.26)*	*(0.79)*	*(0.26)*	*(0.72)*	*(0.27)*	*(0.69)*
Number of observations		643		733		592		413
Results - June 24, 2010	**Portfolio Method**	**Brown-Warner**	**Portfolio Method**	**Brown-Warner**	**Portfolio Method**	**Brown-Warner**	**Portfolio Method**	**Brown-Warner**
Raw return	-1.50%	-1.45%	-1.50%	-1.52%	-1.51%	-1.45%	-1.47%	-1.39%
Abnormal return	**0.00%**	**0.07%**	**0.00%**	**0.04%**	**0.02%**	**0.10%**	**0.08%**	**0.19%**
t-statistic	*-(0.00)*	*(0.15)*	*(0.00)*	*(0.10)*	*(0.02)*	*(0.19)*	*(0.08)*	*(0.37)*
Number of observations		634		722		587		408

Table 3: Comparison Market Model Results: International Indices

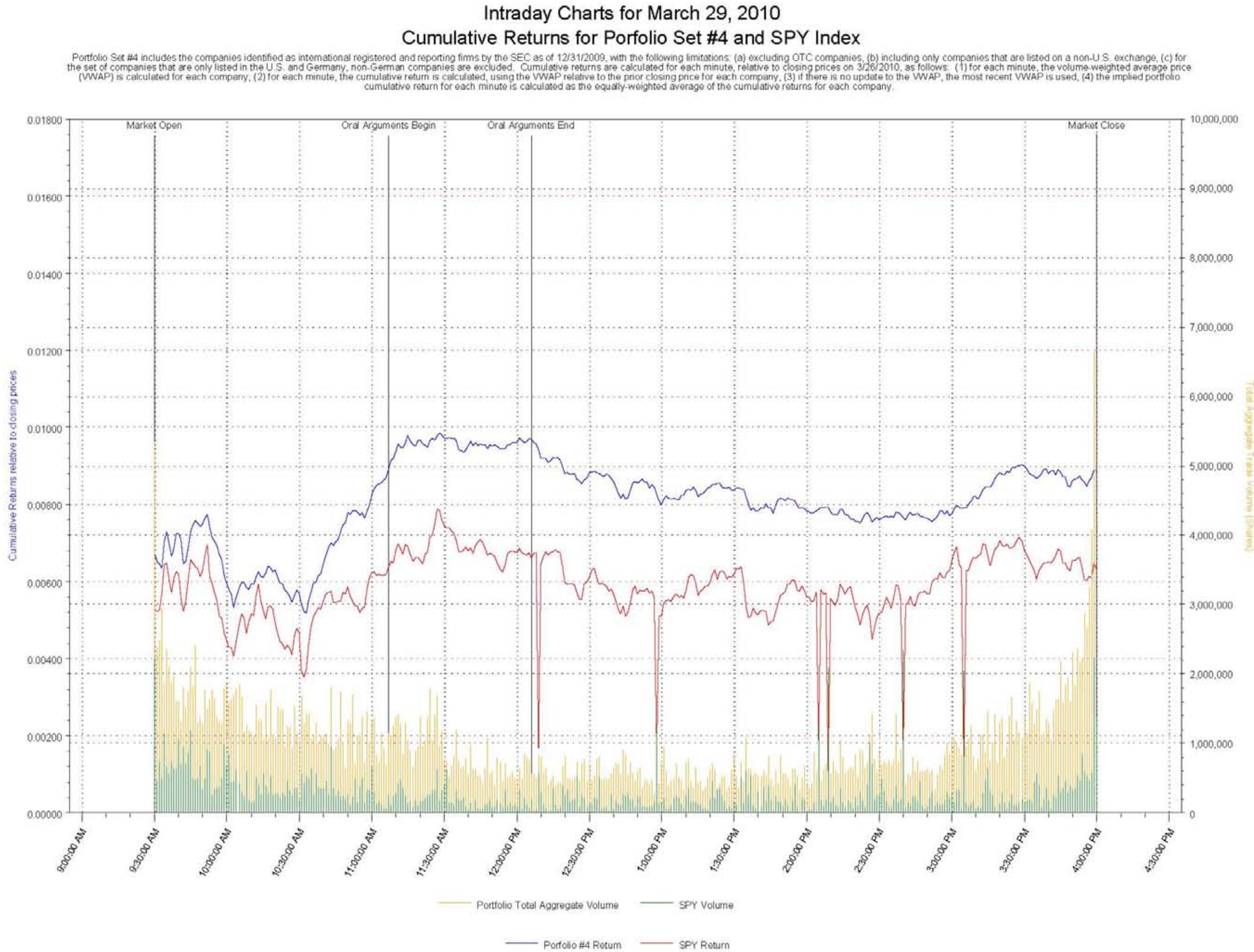
As a point of comparison for the results in Table 2, this table presents regression results from a market model. Instead of the constructed portfolios of cross-listed firms that would be expected to be affected by the *Morrison* decision, these portfolios are indices of international firms, many of which would be unaffected by the *Morrison* decision. The results for both the market model and the event studies are similar to the results for the four different test portfolios provided in Table 2. The t-statistics are reported in parentheses below the coefficient estimates.

	Vanguard Total World Stock Index ETF (VT)	**iShares MSCI EAFE Index (EFA)**	**iShares MSCI All Country World Index (ACWI)**	**Vanguard FTSE All-World ex-US Index Inv (VFWIX)**
Regression Parameters				
Intercept	0.000	0.000	0.000	0.000
t-statistic	*(0.10)*	*-(0.17)*	*(0.02)*	*-(0.30)*
Beta (S&P 500)	1.007	1.094	1.003	1.019
t-statistic	*(51.47)*	*(61.23)*	*(72.78)*	*(59.64)*
R-squared	0.858	0.882	0.914	0.877
Number of observations	440	503	503	503



This chart shows the daily abnormal returns for Portfolio Set #4. It includes the companies identified as international registered and reporting firms by the SEC as of 12/31/2009, except that it: (a) excludes OTC companies, (b) includes only companies that are listed on a non-U.S. exchange, and (c) excludes non-German companies for the set of companies that are only listed in the U.S. and Germany. Each point on the chart is the abnormal return for each trading day between January 1, 2010 and December 31, 2010. The abnormal returns on the date of the oral arguments and the decision in Morrison are highlighted in red, and are shown as a square rather than a diamond.

Chart 2



Intraday Charts for March 29, 2010
Cumulative Returns for Porfolio Set #4 and SPY Index
Portfolio Set #4 includes the companies identified as international registered and reporting firms by the SEC as of 12/31/2009, with the following limitations: (a) excluding OTC companies, (b) including only companies that are listed on a non-U.S. exchange, (c) for the set of companies that are only listed in the U.S. and Germany, non-German companies are excluded. Cumulative returns are calculated for each minute, relative to closing prices on 3/26/2010, as follows: (1) for each minute, the volume-weighted average price (VWAP) is calculated for each company, (2) for each minute, the cumulative return is calculated, using the VWAP relative to the prior closing price for each company, (3) if there is no update to the VWAP, the most recent VWAP is used, (4) the implied portfolio cumulative return for each minute is calculated as the equally-weighted average of the cumulative returns for each company.
Market Open
Oral Arguments Begin
Oral Arguments End
Market Close
Cumulative Returns relative to closing prices
0.01800
0.01600
0.01400
0.01200
0.01000
0.00800
0.00600
0.00400
0.00200
0.00000
Total Aggregate Trade Volume (Shares)
10,000,000
9,000,000
8,000,000
7,000,000
6,000,000
5,000,000
4,000,000
3,000,000
2,000,000
1,000,000
0
9:00:00 AM
9:30:00 AM
10:00:00 AM
10:30:00 AM
11:00:00 AM
11:30:00 AM
12:00:00 PM
12:30:00 PM
1:00:00 PM
1:30:00 PM
2:00:00 PM
2:30:00 PM
3:00:00 PM
3:30:00 PM
4:00:00 PM
4:30:00 PM
Portfolio Total Aggregate Volume
SPY Volume
Porfolio #4 Return
SPY Return

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