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Comment Letter of Richard W. Painter on Release No. 34-63174; File No. 4-617, Study on Extraterritorial Private Rights of Action

In *Morrison v. National Australia Bank*, the U.S. Supreme Court ruled in June 2010 that securities fraud suits could not be brought under U.S. law against foreign defendants by foreign plaintiffs who bought their securities outside the United States (so called "f-cubed" securities litigation). The Court held that Section 10(b) of the Securities Exchange Act of 1934 does not apply extraterritorially, and that "the focus of the Exchange Act is not upon the place where the deception originated, but upon purchases and sales of securities in the United States." The Court concluded that Section 10(b) reaches only fraud 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." 139 S. Ct. 2869 at 2888 (2010).

Congress responded to *Morrison* with a provision in Section 929P of the Dodd-Frank Act that gives federal courts jurisdiction in certain cases brought by the SEC and the Department of Justice (DOJ) concerning fraud inside the United States affecting securities transactions outside the United States. There is dispute, however, over the meaning of this provision – whether it confers jurisdiction only or changes the substantive reach of the statute. See e.g. Wachtell, Lipton, Rosen & Katz, *Extraterritoriality of the Federal Securities Laws After Dodd-Frank: Partly Because of a Drafting Error, the Status Quo Should Remain Unchanged*, June 21, 2010 (authored by George T. Conway III). Section 929P almost certainly was intended to expand the substantive reach of Section 10(b) in SEC and DOJ suits but Section 929P does not expressly say so. In view of this confusion the SEC should ask Congress to amend the provision to clarify its impact on the extraterritorial reach of Section 10(b). An amendment could also clarify which version of the pre-*Morrison* conduct and effects tests will be applied in SEC and DOJ suits brought pursuant to 929P. In the meantime, the SEC should address this latter issue with a rule clarifying its position as to what version of the conduct and effects tests it intends to use.

Congress also requested an SEC study of whether private rights of action should be reinstated by an act of Congress. For all of the reasons stated in the *amicus* brief I wrote and submitted with other law professors in the *Morrison* case, I believe reinstating such a private right of action would be bad as a matter of public policy. These reasons include substantial differences between United States securities law and laws in most other countries, the fact that class action litigation is viewed less favorably in other countries, the fact that Congress probably never intended Section 10(b) to allow private lawsuits to begin with and Section 10(b) therefore should not be applied expansively in private lawsuits, the fact that Congress never intended to regulate foreign markets and there is no reason to change that stance now, the fact that allowing private plaintiffs and their lawyers to sue foreign persons in U.S. courts would likely be viewed as unilateral action by the United States, and the fact that diplomatic and other disruption caused by f-cubed securities litigation could make it very difficult for the SEC to get cooperation from foreign securities regulators to pursue transnational securities fraud. Furthermore the Dodd-Frank provision in 929P giving the SEC and DOJ authority to pursue actions concerning securities transactions outside the United States makes it even less necessary that private plaintiffs be allowed to sue the same defendants. The SEC and DOJ are far more likely than private plaintiffs' lawyers to consider the totality of circumstances before deciding to bring a suit that goes beyond the domestic scope of Section 10(b) set forth in *Morrison*.

In the past week, the pending NYSE - Deutsche Boerse merger has been the focus of unsubstantiated concerns about loss of American jobs and loss of investor protection. Some commentators suggest that the merger justifies Congressional legislation rolling back *Morrison* and reinstating f-cubed securities litigation. A large volume of securities transactions by American investors will move offshore and Section 10(b) should follow, or so the argument goes. This argument is wrong for several reasons. First, there is little evidence that the merger will result in a substantial number of transactions moving offshore; the NYSE trading platform will remain intact and will probably improve and become more competitive because of the merger. Second, the two markets most often mentioned are London and Frankfurt and both are in countries that have done at least as well as the United States in protecting investors. They may do it differently – with more emphasis on risk management and personal responsibility and less emphasis on private litigation – but the U.K. Germany and many other industrialized countries have as good a track record as the United States (in fact our Securities Act and the Exchange Act are modeled in part on the English Companies Act). Third, Section 10(b) already follows securities transactions abroad because the SEC and DOJ have enforcement authority pursuant to Section 929P of Dodd Frank to enforce Section 10(b) in foreign markets. If foreign regulators and foreign courts do not do their job, the SEC can step in with enforcement actions, including actions for recovery of monetary damages on behalf of injured investors, and the DOJ can step in with criminal prosecution. It is not a question of whether American investors are protected abroad; it's a question of who the lawyers are. Fourth, for the NYSE-Deutsche Boerse merger to go smoothly and for the United States to be competitive in world financial markets, the United States must work with foreign regulators to combat securities fraud. The SEC has experience working with foreign regulators, and the SEC's mission is to protect American investors in an era when our markets are increasingly interdependent with foreign markets. SEC lawyers are paid by the public and work for the public; their objective is not to collect a contingent fee and move on; they care what people in other countries think of our government and our legal system. Turning transnational securities enforcement over to American private plaintiffs' lawyers and their very different incentive structure is a sure way of undermining the credibility of our legal system abroad and assuring that financial services jobs leave our Country because people in other countries will not want to deal with American investors. In sum, the NYSE-Deutsche Boerse merger is a reminder that we are part of a larger world economy and that we prosper when we work with other countries not against them. In *Morrison* the Court recognized that litigation driven unilateralism is not an effective strategy for protecting American investors. The ruling should remain intact. I anticipate that the SEC will receive comment letters from several foreign governments that express similar viewpoints, and their viewpoints ought to be respected.

The remainder of this comment letter addresses my concern that Congress missed an opportunity in Dodd-Frank to clarify important issues in private securities litigation that remain open after *Morrison*. One issue that Congress or the SEC may have to address is the status of securities that are listed on exchanges both in the United States and outside the United States, when a suit is brought over transactions in the securities outside the United States. The district courts thus far have approached such dually listed securities in a manner consistent with the *Morrison* opinion, but the status of dually listed securities likely will continue to be litigated until Congress, the SEC or the Supreme Court clarifies it.

Another perhaps more pressing concern is the status under Section 10(b) of security-based swap agreements in the US that reference foreign traded securities as well as security-based swap agreements in foreign countries that reference U.S. traded securities. It will be difficult for the courts to work through this issue because there is relatively little guidance from *Morrison.* Consequently Congress may need to enact legislation to specify the "location" of security based swap agreements and other derivative contracts, or to specify some other test for determining when Section 10(b) applies. In the meantime the SEC should propose and adopt rules clarifying its view of when a securities based swap agreement takes place inside the United States and when it does not.

I address some of these issues more extensively in my publications, including one article coauthored with Douglas W. Dunham and Ellen P. Quackenbos, another article coauthored with Prof. Dr. Wulf A. Kaal, and a forthcoming article I am publishing in the Harvard Business Law Review. I summarize my own views here. These views are my own and not necessarily the views of my coauthors or of the University of Minnesota. I have not received compensation from any party interested in the views expressed herein.

Dually Listed Securities

Dually listed securities are those that are listed both in the United States and in another country. Many Canadian companies, for example, have one class of common shares that trades on both the Toronto Stock Exchange and the New York Stock Exchange. The proposed merger of the New York Stock Exchange with the Deutsche Boerse may lead to more cross listings. Does Section 10(b) apply to trades in these securities made outside the United States simply because the same securities are listed for trading in New York?

The logic of the *Morrison* opinion strongly suggest the answer to this question is "no" because Section 10(b) should apply only to transactions made in the United States. However, the summary of the *Morrison* opinion states, "[a]nd it is in our view only transactions in securities listed on domestic exchanges, and domestic transactions in other securities, to which § 10(b) applies." At the end of the opinion, there is similar language: "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."[1] Looking at these two sentences alone, it could be argued that a security listed listed on a U.S. exchange is covered by Section 10(b), even if that security is purchased outside the United States. Arguably, Section 10(b) would apply to a purchase of securities in Canada on the Toronto exchange by a Canadian citizen, simply because the shares are of a class that is also listed in New York. Plaintiffs' lawyers are already claiming that as long as any shares are listed

[1] Justice Scalia probably draws this language from the language in Section 10(b) itself: "the purchase or sale of any security registered on a national securities exchange or any security not so registered." 15 U.S.C. § 78j(b) (2006).

on a U.S. exchange, all transactions of the issuer's shares, including on foreign exchanges, are covered by Section 10(b).[1]

The SEC, in a recent insider trading enforcement case involving transactions in Toronto, implied that it could sue under Section 10(b) as to transactions in Canada because the shares are also listed in New York, although the SEC only sought disgorgement with respect to trades inside the United States.[2] Because of the aforementioned Dodd-Frank Section 929P granting federal courts jurisdiction in SEC and DOJ extraterritorial enforcement actions, the SEC in the future will not need to rely upon such a questionable interpretation of the *Morrison* opinion in order to bring suit over insider trading and other fraudulent transactions outside the United States that occur after Dodd-Frank was enacted. Congress presumably had good reasons for expanding the scope of Section 10(b) in SEC and DOJ enforcement actions, and prosecution of persons who trade in foreign markets on the basis of information misappropriated in the United States is a good reason. The SEC need not endorse, and should not endorse, private plaintiffs' theory of Section 10(b) liability for dually listed securities in order for the SEC to do its job.

Most important, as pointed out above the view that Section 10(b) applies to dually listed securities is inconsistent with the basic thrust of the *Morrison* opinion, that focuses on the location of a transaction. The entire point of the opinion is that Section 10(b) does not apply extraterritorially.[3] Just because an issuer had some shares listed in the United States does not mean that all transactions in its shares everywhere are subject to Section 10(b). Furthermore, allowing Section 10(b) suits over dually listed securities traded outside the United States would undermine the strongest policy arguments discussed in the *Morrison* opinion — that applying Section 10(b) to foreign exchanges would interfere with the laws of other countries and turn the United States into a Shangri-La for plaintiffs' lawyers suing on behalf of investors who purchased their shares on foreign exchanges.

Case law on this issue thus far in the Southern District of New York has refused to recognize a cause of action for plaintiffs who purchased securities outside the United States simply because the issuer lists securities of the same class inside the United States.[5] If courts were to reach a

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[1] *See, e.g.*, Plaintiffs' Supplemental Memorandum Concerning the Impact of *Morrison v. National Australian Bank* at 10-16, *In re* Vivendi Universal, S.A. Sec. Litig., No. 02 Civ. 5571 (S.D.N.Y. July 16, 2010).

[2] *See* Complaint, S.E.C. v. MacDonald, No. 09 Civ. 5352 (S.D.N.Y. June 9, 2009), 2009 WL 1683785 at 11. The SEC only sought disgorgement of profits from trades in the United States and did not seek disgorgement of profits from trades in Toronto. *See id.* at 11. It is thus unlikely that a court will rule on this issue in that case.

[3] The Supreme Court knew that NAB had ADRs listed in New York (traders in the ADRs were not parties to the case in *Morrison*, and NAB did not deny that they could sue under Section 10(b)). *Morrison*, 130 S. Ct. 2869 (No. 08-1191) app. at 56. NAB's registration statement under the Exchange Act thus pertained to the "ordinary shares.",The 20-F cover of the Appendix says NAB's ordinary shares were "registered" on the "NYSE". *Morrison*, 130 S. Ct. 2869 (No. 08-1191) app. at 58. *Morrison* held, however, that Section 10(b) did not apply to trades in NAB's ordinary shares in Australia. The holding of the Supreme Court itself thus rejected the theory that Section 10(b) applies to a transaction merely because securities of the same class are registered on a U.S. stock exchange.

[5] *See In re* Royal Bank of Scotland Group PLC Sec. Litig., No. 09 Civ. 300, 2011 WL 167749, at *6-7 (S.D.N.Y. Jan. 11, 2011); In re Alstom SA Sec. Litig., No. 03 Civ. 6595, 2010 WL 3718863, at *2-3 (S.D.N.Y. Sept. 14, 2010) ("[T]he most natural and elementary reading of Morrison" is "[t]hat the transactions themselves must occur on a domestic exchange to trigger application of § 10(b)."); Sgalambo v. McKenzie, No. 09 Civ. 10087, 2010 WL 3119349, at *17 (S.D.N.Y. Aug. 6, 2010) (*Morrison*

contrary conclusion, non-U.S. issuers would be encouraged to delist their securities in the United States to avoid worldwide exposure to Section 10(b). This concern is even more pronounced if foreign exchanges such as the Deutsche Borse are viewed as comparable in other respects with exchanges inside the United States and the U.S. listing is viewed as a dispensable invitation to Section 10(b) liability.

Ideally, Congress would have anticipated this problem and used Dodd-Frank to clarify that the mere listing of a security in the United States does not mean that all of the issuer's securities will be treated as if they were traded in the United States for purposes of Section 10(b). Congress, however, only had weeks to react to the *Morrison* holding and did not address this issue (plaintiffs lawyers at the time were only beginning to raise it). Unless the courts develop a clear and consistent line of cases on the status of dually listed securities, the SEC should adopt a rule that clearly states that, except in SEC and DOJ actions brought under Section 929P of Dodd-Frank, SEC Rule 10b-5 does not apply to transactions in securities outside the United States regardless of where the issuer has listed the securities.

Securities Based Swap Agreements

Another post-*Morrison* issue that Congress could have addressed in Dodd-Frank is the status of securities-based swap agreements and other derivative securities inside the United States that reference securities traded outside the United States. This issue is raised in *Elliott Associates, L.P. v. Porsche Automobil Holding SE,* 10 Civ. 0532, 2010 WL 5463846 (S.D.N.Y. Dec. 30, 2010). In *Elliott Associates*, the plaintiffs were international hedge funds who bet that the value of Volkswagen AG shares would decline by taking short positions in equities-based swap agreements that referenced the common stock of Volkswagen AG, which traded in Germany but not in the United States. The plaintiffs alleged the swap agreements were entered into inside the United States, although they did not identify the location of their counter parties. They sued Porsche alleging that Porsche increased its share ownership in VW through October 2008, while denying its intent to take over VW. When as a result of Porsche's allegedly deceptive conduct the price of VW shares rose, plaintiffs suffered losses from their short positions in VW. Plaintiffs sued Porsche under Section 10(b) even though almost all of the alleged conduct occurred outside the United States. Judge Baer dismissed the complaint. He examined the totality of the circumstances, including the fact that plaintiffs failed to allege that their counterparties were in the United States, that the swap transactions were cleared in the United States or even in U.S. dollars and the fact that the reference security was traded in Germany. For all of these reasons Judge Baer found that the swap transactions had not been entered into in the United States and thus the claims were barred under *Morrison.* Judge Baer observed that "[t]he economic reality is that Plaintiffs' swap agreements are essentially 'transactions conducted upon foreign exchanges and markets,' and not 'domestic transactions' that merit the protection of § 10(b)." Id. at *6.

Judge Baer's decision to dismiss the complaint is a relief for non-U.S. issuers whose securities may be referenced by swap agreements entered into inside the United States. The decision,

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foreclosed claims of plaintiffs who purchased Canadian Superior common stock on a non-U.S. exchange); Anwar v. Fairfield Greenwich Ltd., 728 F. Supp. 2d 372, 404-05 (S.D.N.Y. 2010) (deferring ruling on whether *Morrison* applied subject to further discovery regarding whether the transaction occurred within the United States); Terra Sec. ASA Konkursbo v. Citiqroup, Inc., No. 09 Civ. 7058, 2010 WL 3291579, at *4-5 (S.D.N.Y. Aug. 16, 2010) (dismissing claims for financial instruments sold on foreign exchanges and outside of the United States) ; Cornwell v. Credit Suisse Group, 729 F. Supp. 2d 620 (S.D.N.Y. 2010).

however, will likely be appealed. The district court reached the right result – U.S. plaintiffs placing side bets in swap agreements in the United States over the performance of German stocks should not be permitted to use U.S. law to sue the German issuers of the reference securities or other parties trading in the reference securities outside the Untied States. However, discerning the location of a swap transaction for purposes of *Morrison* will not always be as easy as it was here, and will not always involve looking only to the location of trading for the reference security.

For example, a swap agreement between two German counterparties referencing a NYSE-traded stock probably is not the equivalent to a trade on the NYSE, and probably should not give the German swap parties the right to bring a Section 10(b) suit in the United States against the NYSE-listed company or another party trading in the company's shares in the United States simply because the German swap agreement referenced the NYSE-traded stock (with the NYSE – Deutsche Boerse merger there might be more such swap transactions in Germany and thus more potential plaintiffs if such suits were to be allowed in the United States). Yet one could argue that an "economic reality" test might require that the German swap agreement be located in the United States because the underlying security was traded in the United States. If the swap transaction referencing a NYSE traded stock is the functional equivalent of a NYSE transaction, a court might even believe itself compelled to allow the German swap parties to sue each other under Section 10(b) over alleged misrepresentations made in Germany by one of the swap parties to the other (some misrepresentations might concern the value of the NYSE reference security but others might concern such things as a counterparty's ability to perform pursuant to the terms of the swap or the legality of the swap under German law). Applying Section 10(b) to many of these scenarios is counterintuitive and would not comport with the overall reasoning in *Morrison,* which is that Section 10(b) protects investors who buy and sell securities in the United States, not investors who invest their money – or place bets through security-based swaps – outside the United States.

On the other hand, there would be a much stronger case for applying Section 10(b) to the swaps in the *Porsche* case if the U.S. parties to the swap agreement, instead of suing Porsche or Volkswagen, had sued their counterparties over misrepresentations made by the counterparties inside the United States about their ability to perform under the swap agreement, the legality of the swap agreement under U.S. law or about some other matter relevant to the swap agreement itself rather than about the underlying security. It is not clear that a U.S. court would, or should, dismiss such a case under *Morrison* simply because the reference security was traded in Germany. In that instance the swap participants seeking protection under Section 10(b) would have invested their money and lost it in the United States because of an alleged misrepresentation made to them in the United States. The underlying reasoning in *Morrison* does not appear to foreclose such a claim.

Given the enormous increase in the regulation imposed on swap agreements in the United States under the Dodd-Frank Act, the issue of when a swap agreement is deemed to occur inside the United States for purposes of Section 10(b) should have been addressed in the Act. This question should not have been left up to courts applying *Morrison*, a case which did not involve swaps but rather conventional transactions in a foreign stock on a foreign exchange.

An additional complication arises from the fact that the Dodd-Frank Act requires some swap agreements to be traded on organized exchanges in the United States.[1] At least in those circumstances, it will be difficult to claim that a swap transaction is outside the United States for purposes of *Morrison* simply because the reference security is traded outside the United States.

The Dodd-Frank Act should have explicitly stated when Section 10(b) applies if swap agreements referencing non-U.S. securities are entered into inside the United States and when Section 10(b) does not apply. The Act also should have defined when a swap agreement is deemed to have been entered into inside the United States. The Act furthermore should have addressed whether Section 10(b) applies not only to defendants involved in the U.S. swap agreement but also to defendants issuing or trading in the reference securities outside the United States. Finally, all of these questions should have been answered in the converse situation where a swap agreement is entered into outside the United States with a reference security traded inside the United States.

Once again, unless and until Congress acts, the SEC should clarify some of these points with a rule that defines when a securities based swap agreement will be deemed to be located inside the United States for purposes of Rule 10b-5 and when a securities based swap agreement will be deemed to be located outside the United States.

For example a rule could provide that for purposes of Rule 10b-5 a swap agreement entered into inside the United States that references securities traded outside the United States is deemed to be a transaction inside the United States only where the conduct alleged to have violated Rule 10b-5 was in connection with the swap itself rather than in connection with the reference security. Otherwise the swap agreement would be deemed to be a transaction outside the United States.

Whatever Congress or the SEC decide to do about the status of swap agreements under *Morrison*, Congress or the SEC is likely to do a better job at drawing lines more precisely and more quickly than courts struggling to apply *Morrison* in such a context having little to do with the facts of *Morrison*.

The SEC may be even better positioned to address this issue than Congress. There is a small risk that a court could narrow the scope of a SEC rule if it believes the rule identifies a transaction as being inside the United States when in the court's view the transaction is outside the United States for purposes of Section 10(b). This result, however, is unlikely if the SEC rule is reasonable in scope. Conversely, a court will not hold that a SEC rule is too narrow when it does not apply Rule 10b-5 to a transaction; Congress gave the SEC discretion to narrow the scope of Section 10(b) liability by saying that a violation of Section 10(b) also requires a violation of an SEC rule. See e.g. Rule 10b-5.

Conclusion

For the aforementioned reasons the SEC should not recommend to Congress any expansion outside the United States of the implied private right of action under Section 10(b) of the Exchange Act. The SEC also should give substantial weight to the views of foreign governments in any recommendations that the SEC makes to Congress. The SEC furthermore should request

[1] *See, e.g.*, Dodd-Frank § 171(b)(7)(B)(i), 610, 24 Stat. 1376, 1611-12 (2010).

that Congress clarify the scope of Section 10(b) in SEC and DOJ actions brought pursuant to Section 929P of the Dodd-Frank Act. The SEC should use this extraterritorial enforcement authority in cooperation with securities regulators in foreign countries to the extent cooperation is possible. Finally, the SEC should promulgate rules clarifying its view of the status of security based swap agreements under *Morrison*, and the SEC should be prepared to promulgate rules on the status of dually listed securities if federal courts do not develop a clear body of case law – following the few 2010 and 2011 cases on dually listed securities in the Southern District of New York -- consistent with the underlying reasoning in *Morrison*.

Respectfully,

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