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Client Alert

Securities Litigation Practice Group

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Developments Regarding Extraterritorial Effect of U.S. Securities Fraud Statutes

In June 2010, the Supreme Court overturned years of federal jurisprudence by holding that the U.S. securities fraud laws do not apply extraterritorially in the case *Morrison v. National Australia Bank Ltd*, 561 U.S. _, 130 S. Ct. 2869 (2010). Within a month of the holding, Congress partially reversed *Morrison* with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") by granting the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ) authority to bring enforcement actions under the historical jurisprudence. At the same time, Congress asked the SEC to solicit public comment and conduct a study on whether *Morrison* should be reversed as to private rights of action as well.

Earlier this year, the SEC released its study on international securities fraud cases since *Morrison* and explained its stance that the Supreme Court's holding should be reversed for private rights of action. That same day, an SEC Commissioner issued a statement dissenting from the SEC's study, finding that it fell short of providing an informed recommendation to Congress because the study did not provide a strong enough case to fully repeal *Morrison*. Needless to say, the holding in *Morrison* is under intense scrutiny.

I. *Morrison*

Before *Morrison*, most U.S. courts found that jurisdiction existed over a securities fraud claim under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") if it satisfied either the "effects" test or the "conduct" test. The effects test examined whether the wrongful conduct had a substantial effect in the U.S. or upon U.S. citizens. The conduct test examined whether the wrongful conduct occurred in the United States. Under the effects test or the conduct test, a plaintiff need not demonstrate that the security was listed on a U.S. exchange.

Justice Scalia abolished these tests in *Morrison*, writing that "there is no affirmative indication in the Exchange Act that § 10(b) applies extraterritorially." And "unless a contrary intent appears," legislation of Congress "is meant to apply only within the territorial jurisdiction of the United States." Consequently, the Court adopted what it referred to as a transactional test:

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> 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.

The *Morrison* holding raised many questions. One such question was whether the SEC and the DOJ were also limited to the transactional test. This was promptly addressed by section 929P of the Dodd-Frank Act, which allows the SEC and the DOJ to bring actions alleging securities violations under close iterations of the effects or conduct tests. According to a Congressional Report on the Dodd-Frank Act, Congress clarified that the presumption of extraterritoriality discussed in *Morrison* was rebutted by a statute "clearly indicating that Congress intends extraterritorial application in cases brought by the SEC or the Justice Department."

Another question raised by *Morrison's* transactional test was when a U.S.-based investor's purchase or sale of a foreign-listed security qualifies as "a domestic transaction in other securities." The Second Circuit Court of Appeals in *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 2012 WL 1232700, at *5 (April 13, 2012), recently addressed this question and found that "transactions involving securities that are not traded on a domestic exchange are domestic transactions if irrevocable liability is incurred or title passes within the United States." Irrevocable liability is incurred in the United States if either the buyer or the seller was physically in the United States at the moment the parties became obligated to purchase or sell the securities. The *Ficeto* court found that plaintiffs did not plead sufficient facts regarding the location of the purchase or sale of the security at issue to make a determination on where irrevocable liability was incurred. Consequently, many questions still exist regarding what constitutes a "domestic transaction"—such as whether a U.S. investor that purchases foreign-issued shares on his computer in the U.S. qualifies under *Morrison*.

Various other issues have also arisen, such as whether American depository receipts qualify as securities listed on an American stock exchange under the first prong of the transactional test, and how the test applies to derivatives or when the fraudulent conduct is not engaged in by the issuer of the security, but rather intermediaries like investment advisors or broker-dealers.

II. SEC Report

Although Congress quickly clarified that *Morrison* did not apply to actions brought by the SEC or DOJ with Section 929P of the Dodd-Frank Act, it did not do so for private rights of action. Instead, Congress mandated the SEC to solicit public comments and conduct a study on the issue in Section 929Y of Dodd Frank. Specifically, the SEC was tasked to investigate whether:

(1) the scope of such a private right of action, including whether it should extend to all private actors or whether it should be more limited to extend just to institutional investors or otherwise;
(2) what implications such a private right of action would have on international comity;
(3) the economic costs and benefits of extending a private right of action for transnational securities frauds; and
(4) whether a narrower extraterritorial standard should be adopted.

On April 11, 2012, the SEC issued its 106-page study. It discussed post-*Morrison* case law (including an in-depth review of the questions raised by *Morrison*), the responses to the request for public comments, and various options for a Congressional solution, namely either to (i) enact some form of the conduct and effects tests; (ii) supplement the Supreme Court's transactional test; or (iii) take no action at all. The SEC favored the first option, but by how much was unclear due to the favorable discussion of the second and third options. It appears that the SEC did not want the same test for private rights of action that was used for SEC and DOJ actions since that "would involve policy trade-offs that could carry significant implications in many areas, including . . . international comity," which was emphasized a number of times throughout the study.

III. Commissioner's Response

The same day the SEC released its study, Commissioner Louis A. Aguilar released a strong statement against it. He believes that the test for SEC and DOJ actions should be the same for private litigants. Commissioner Aguilar concluded that the SEC study was woefully incomplete and watered down for four primary reasons:

- It failed to adequately explain how private rights of action are a vital complement to SEC actions and essential to investor protection;
- It overstated the international comity concerns associated with restoring investors' rights to assert private claims under Section 10(b);
- It did not accurately portray investor harm resulting from *Morrison* and failed to convey a sense of urgency as to the harm being suffered; and
- It provided as an option that Congress take no action at all despite the continuing harm to investors.

It is clear that Commissioner Aguilar believes that investors are being harmed because of *Morrison's* and the Dodd-Frank Act's exclusion of private rights of action. He emphasized that private litigants are essential to combating securities fraud. As he put it: "The truth of the matter is that the SEC, does not and will not, ever have enough resources to investigate all of the fraud cases that exist. The SEC will never be able to seek justice in all of the potential transnational securities fraud matters." Moreover, he went on to explain that *Morrison* weakens all private investors trading outside the U.S. because, even if the securities at issue were registered and listed on a U.S. exchange, a particular investor would not be able to recover for fraud unless he or she could establish that his or her particular shares were registered and listed on a U.S. exchange, providing yet another hurdle. The bottom line for Commissioner Aguilar is that "the *Morrison* test disadvantages investors and [thus] is at odds with the very purpose of the securities laws."

IV. Conclusion

Morrison rendered a fatal blow to long-standing tests for applying the U.S. securities laws to foreign-listed securities. While Congress has revived these tests for government actions, *Morrison* remains in effect for private-based lawsuits. Although it is unlikely that the current Congress will do anything that encourages private litigation, the debate is nonetheless complicated as shown by the conflicting positions between the SEC and one of it's own Commissioners.

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