Wilson Sonsini Goodrich & Rosati
PROFESSIONAL CORPORATION

WSGR ALERT

JUNE 2010

SUPREME COURT HOLDS THAT SECTION 10(B) OF THE SECURITIES EXCHANGE ACT APPLIES ONLY TO DOMESTIC TRANSACTIONS

On June 24, 2010, the U.S. Supreme Court ended nearly a half century of speculation over the extraterritorial application of the United States securities laws. In *Morrison v. National Australia Bank Ltd.*, the Court held that Section 10(b) of the Securities Exchange Act of 1934, the principal anti-fraud provision of the federal securities laws, applies only to transactions in securities that are listed on domestic exchanges and domestic transactions in other securities. In so holding, the Court affirmed the dismissal of a "foreign-cubed" securities class action, i.e., a private action brought in the United States by foreign purchasers of securities issued by a foreign company traded on a foreign exchange. The Court rejected an analysis widely used by the lower courts that permitted such lawsuits when the transactions had a substantial effect on the U.S. market or significant conduct in the U.S.

Background

In 1998, National Australia Bank, an Australian bank whose ordinary shares (i.e., common stock) traded only in Australia, purchased HomeSide Lending, a mortgage-servicing company headquartered in Florida. In 2001, National wrote down the value of the assets that it received in the HomeSide acquisition, which caused its share price to fall.

Petitioners, who were Australians who purchased National's shares before the write-down, sued National, HomeSide, and officers of both companies in U.S. federal court for violations of Section 10(b) of the Exchange Act and Rule 10b-5. They claimed that HomeSide and its officers had manipulated financial models to make the company's mortgage-servicing assets appear more valuable than they really were, and that National and its chief executive officer were aware of this deception. The defendants moved to dismiss for lack of subject-matter jurisdiction under Federal Rule of Civil Procedure 12(b)(1) and for failure to state a claim under Rule 12(b)(6). The district court granted the motion, finding that it lacked jurisdiction because the only domestic acts alleged were, at most, a link in a securities fraud that was concluded abroad. The Second Circuit Court of Appeals affirmed on similar grounds.

The Decision

In a unanimous ruling (Justice Sotomayor recused herself from the case), the Supreme Court agreed with the Second Circuit that the lawsuit should be dismissed. The Justices split 6-2, however, on the question of whether Section 10(b) has, at least under some circumstances, an extraterritorial reach. The majority opinion was authored by Justice Scalia, while Justice Stevens, joined by Justice Ginsburg, and Justice Breyer filed separate opinions.

The majority opinion found that the Second Circuit was correct in concluding that the lawsuit should be dismissed, but rejected the "conduct and effect" test the Second Circuit applied to reach that conclusion. According to that test, foreign transactions may give rise to Section 10(b) liability if: (1) the wrongful conduct that occurred in the United States is "more than merely preparatory to the fraud," and (2) "the wrongful conduct had a substantial effect in the United States or upon United States citizens." Justice Scalia chastised the Court of Appeals for acknowledging that the Exchange Act is silent on its own extraterritoriality and yet declining to apply the long-standing principle of American law that federal legislation is meant to apply only within the territorial jurisdiction of the United States unless a contrary intent appears in the statute, and applying instead the "conduct and effect" test.

The Court disagreed with the Second Circuit that the issue of extraterritorial reach concerned whether the U.S. courts had the power to hear the case; rather, the Court found that the issue was whether the securities laws permitted relief for such a claim. The Court found no clear evidence that Congress intended Section 10(b) to apply to foreign transactions, and rejected the argument advanced by the petitioners that a general reference to "foreign commerce" in the definition of "interstate commerce" defeated the presumption against extraterritoriality. The reference in the description of the Exchange Act's purposes regarding the dissemination and quotation abroad of the prices of the nationally traded

Continued on page 2...

securities was also deemed too weak to overcome the presumption. So was Section 30(b) of the Exchange Act, which provides for the application of the Exchange Act to transactions abroad under certain limited circumstances.

The second part of the Court's analysis focused on how much and what kind of domestic contacts are sufficient to trigger the application of Section 10(b)—an important issue for the Court because, as it pointed out, "the presumption against extraterritorial application would be a craven watchdog indeed if it retreated to its kennel whenever *some* domestic activity is involved in the case." The Court found that Section 10(b)'s language prohibiting deceit "in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered" focuses not upon the place where the deception originated but on where the "purchase or sale" occurred. The Court concluded that only transactions in securities listed on domestic exchanges, as well as domestic transactions in other securities, were within the scope of Section 10(b). In reaching this conclusion, the Court noted that the reference to "securities not so registered" in Section 10(b) made sense only if the presumption against extraterritoriality applied. Otherwise, Congress simply could have stated that Section 10(b) applied to "all purchases and sales of securities."

Finally, the Court rejected an alternative "significant and material" conduct test that was suggested by the petitioners and the government, which filed an *amicus* brief. The test would have found a violation of Section 10(b) if the transnational securities fraud involved significant conduct in the United States that was material to the fraud's success. The Court found that the proposed test lacked any textual support, and failed to satisfy the "in connection with" requirement of Section 10(b).

The Court expressed concern that opening the doors to private shareholder litigation under Section 10(b) based on foreign securities transactions would present a high probability of conflict with the applicable laws of other countries, as Australia, the United Kingdom, France, and a number of international organizations argued in their *amicus* briefs. Responding to criticism that the Court's ruling would remove from the statute's application transactions that resulted in substantial wrongful conduct in the United States or injured U.S. markets or citizens, Justice Scalia noted that "[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."

In his concurring opinion, Justice Stevens criticized the majority's interpretation of the presumption against extraterritoriality, contending that the majority transformed a "flexible rule of thumb" into a bright-line standard. Justice Stevens stated that Section 10(b) and other provisions of the Exchange Act make clear that Congress contemplated some amount of transnational application. Justice Stevens further pointed out that the majority's take on the presumption against extraterritoriality did little to avoid the real issue of what types and extent of domestic contacts would defeat it—the issue that was properly addressed by the Second Circuit's "conduct and effects" test.

Implications

The Court's new transactional test provides a clear and predictable standard for the application of Section 10(b), even though it may not entirely avoid factual disputes over when a securities transaction is "domestic." The standard replaces the Second Circuit's "conduct and effects" test and its variations followed by other courts, which produced unpredictable and inconsistent applications of Section 10(b) to transnational cases and made it very difficult for foreign companies to predict what types of contacts with the United States might subject them to a risk of securities litigation in the U.S. courts.

The Court's decision will now foreclose foreign-cubed securities class actions that the applicability of potentially conflicting foreign laws and regulations have made notoriously difficult to litigate and prone to nuisance settlements. The decision, however, does not affect foreign companies whose shares are traded on U.S. exchanges or who engage in the purchase or sale of securities in the United States.

The Court's decision leaves open the issue whether the SEC will be foreclosed from bringing enforcement actions in foreign-cubed circumstances since the Court's holding did not concern the SEC's authority to bring enforcement proceedings. The financial reform legislation pending in Congress would provide the federal courts jurisdiction over SEC actions alleging fraud that involved 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 conduct outside the United States that has a foreseeable substantial effect within the United States. The legislation might not resolve the issue of the SEC's powers, however, because, as Justice Scalia pointed out in *Morrison*, the issue of extraterritorial reach of Section 10(b) is not jurisdictional, but substantive. To bring the extraterritorial conduct within the scope of the SEC's powers under Section 10(b), Congress may need to amend Section 10(b) itself.

For more information on *Morrison* or other related issues, please contact any member of Wilson Sonsini Goodrich & Rosati's securities litigation practice.

Continued on page 3...

Continued from page 2...

WSGR

Wilson Sonsini Goodrich & Rosati

PROFESSIONAL CORPORATION

This WSGR Alert was sent to our clients and interested parties via email on June 30, 2010. To receive future WSGR Alerts and newsletters via email, please contact Marketing at wsgr_resource@wsgr.com and ask to be added to our mailing list.

650 Page Mill Road
Palo Alto, CA 94304-1050
Tel: (650) 493-9300 Fax: (650) 493-6811
email: wsgr_resource@wsgr.com

www.wsgr.com