

US Supreme Court Limits Extraterritorial Reach of the US Securities Laws; Congress Acts

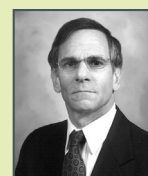
On June 24, 2010, the US Supreme Court for the first time ruled on the extraterritorial reach of the US securities laws in its Opinion of *Morrison v. National Australia Bank*, significantly limiting the application of a key US statute in litigation brought by private parties where “securities are not registered” on US stock exchanges and the “purchases and sales of securities” at issue occur outside the United States. In affirming the US Court of Appeals for the Second Circuit’s dismissal of the case, the US Supreme Court unanimously ruled that a “foreign-cubed” securities transaction—a transaction involving (1) a foreign plaintiff, (2) suing a foreign issuer in a US court for violations of US securities laws based on securities transactions, in (3) foreign countries—was outside the scope of Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act).

Background

Morrison v. National Australia Bank, which has been the subject of previous advisories by Arnold & Porter LLP,¹ involved three Australian investors who filed suit alleging that the respondents, an Australian bank, its wholly-owned US-based subsidiary, and individual officers of the two companies, engaged in securities fraud in violation of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. Section 10(b) is the primary US statute under which private investors may sue to obtain a recovery when securities fraud has occurred, as well as one of the primary statutes under which the US Securities and Exchange Commission (SEC) enforces its anti-fraud authority. The plaintiffs alleged that they were harmed after the US subsidiary provided false accounting figures to the Australian bank and the Australian bank incorporated that false information into its financial reports and other public statements. The plaintiffs, who purchased stock in the Australian bank on Australian stock exchanges, alleged that their stock purchases were at prices that were inflated by the misstatements, causing the price of the plaintiffs’ stock to fall when the misstatements were exposed.

¹ “Supreme Court to Consider Whether ‘Foreign-Cubed’ Securities Fraud Cases May Be Heard in US Courts” available at: http://www.arnoldporter.com/public_document.cfm?id=15565&key=10F1; “US Supreme Court Grants Certiorari to Review Foreign-Cubed Securities Transaction Case Despite Solicitor General’s Opposing View” available at: http://www.arnoldporter.com/public_document.cfm?id=14963&key=23D3; and “Second Circuit Rejects Bar on ‘Foreign-Cubed’ Securities Lawsuits” available at: http://www.arnoldporter.com/public_document.cfm?id=13644&key=26E0.

Contacts



Scott B. Schreiber
+1 202.942.5672



Michael D. Trager
+1 202.942.6976



Stewart D. Aaron
+1 212.715.1114



John A. Freedman
+1 202.942.5316

Both the trial court and the Second Circuit dismissed the case for lack of subject matter jurisdiction. The Second Circuit concluded that the allegedly improper actions and failures to act by the Australian bank were significantly more central to the fraud and more directly responsible for the harm to investors than the purported manipulation of the data in the United States. However, in affirming the lower court's decision, the Second Circuit refused to adopt a bright-line rule that barred all foreign-cubed cases, instead suggesting that such decisions be reached on a case-by-case basis.

The US Supreme Court granted *certiorari* to settle the disagreement among circuit courts regarding whether and under what circumstances Section 10(b) of the Exchange Act should be applied to transnational securities cases in US courts.

The Opinion

In the US Supreme Court's Opinion, written by Justice Scalia, the Court sided with the defendants in holding that Section 10(b) does not provide a cause of action to foreign plaintiffs suing in connection with securities registered and traded on foreign exchanges. The Court relied on the "longstanding principle" that unless a contrary intent is apparent, the legislation of Congress is meant to apply only within the territorial jurisdiction of the United States. Slip Op. at 5. The Court held that, "when a statute gives no clear indication of an extraterritorial application, it has none." *Id.* at 6. The Court reasoned that because Section 10(b) "is silent as to [its] extraterritorial application," Section 10(b) should not be applied extraterritorially. Contrary to the arguments provided by the petitioners at oral argument, the Court noted that "general" and "fleeting" references to securities transactions or commerce abroad in the Exchange Act do not defeat the presumption against extraterritoriality.

In addition, Justice Scalia rejected the Second Circuit's test that extended Section 10(b) to situations where the conduct had some "effect on American securities markets or investors" or there was "significant conduct in the United States." Slip Op. at 8. Although the Second Circuit has a long history of applying the "conduct" and "effects" test and the

test has been adopted by a number of other appellate courts, Justice Scalia expressed skepticism about the results of "judicial-speculation-made-law—divining what Congress would have wanted if it had thought of the situation before the court..." Slip Op. at 12. Justice Scalia stated that, rather than guess as to Congress's intention in each case, the presumption against extraterritoriality should be applied in all cases in order for Congress to be able to legislate with predictable effects.²

As an alternative, the Supreme Court adopted a "transactional test," under which the critical facts in considering whether misconduct is subject to Section 10(b) is the location of the stock exchange where the security is registered and where the purchase or sale of the security occurs. Slip Op. at 20-21. The Court reasoned that Section 10(b) does not punish deceptive conduct. Rather it punishes deceptive conduct in connection with the purchase or sale of "any security registered on a national securities exchange or any security not so registered." Slip Op. at 17-20.

Under the "transactional test," Section 10(b) only reaches to putative misconduct where the plaintiff can show "the purchase or sale [was] of a security listed on an American stock exchange" or "the purchase or sale of any other security [occurred] in the United States." Slip Op. 24. The US Supreme Court concluded that, because this case involved no securities listed on a domestic exchange, and all aspects of the purchases complained of by the petitioners occurred outside of the United States, the petitioners failed to state a claim on which relief could be granted. The US Supreme Court therefore affirmed the dismissal of petitioners' Complaint.

Significance

The US Supreme Court's Opinion in this case will likely have a far-reaching impact on the global securities markets for two reasons. First, the *Morrison* Opinion significantly limits the availability of private investors to sue under Section 10(b)

² In an Opinion concurring in the judgment, Justice Stevens, joined by Justice Ginsburg concluded that the majority Opinion unnecessarily "upend[ed]" the "conduct" and "effects" test, and noted that under the Second Circuit test, the "case has Australia written all over it." Slip. Op. at 13.

where (a) the stock is not registered on a US exchange, and (b) the investor is not able to show that its securities purchases or sales occurred on a US exchange.

Second, because Section 10(b) is also utilized by the SEC as an anti-fraud enforcement mechanism, the Opinion raises significant questions as to the SEC's authority to pursue companies under Section 10(b) that are not registered on US exchanges. Although the *Morrison* Opinion does not discuss the ramifications for governmental enforcement of Section 10(b), the majority failed to address a request by the US Solicitor General, on behalf of the US government, to expressly preserve the SEC's authority to enforce Section 10(b) extraterritorially. See Br. for United States at 13-18 & 21-22. In his concurrence, Justice Stevens specifically noted that he did not believe the majority Opinion "foreclose[d] the [SEC] from bringing enforcement actions in additional circumstances, as no issue concerning the Commission's authority is presented by this case." Slip Op. at 11 n. 12.

Legislative Update

Since the opinion was originally issued, Congress has attempted to clear up this ambiguity. As part of Section 929P(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), Congress provides for US jurisdiction over extraterritorial actions brought by the SEC or the US Department of Justice (DOJ) under the antifraud provisions of the US securities laws by codifying a variant of the "conduct" and "effects" test. The legislation provides that federal courts have jurisdiction over securities cases brought or instituted by the SEC or the DOJ that involve "(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."

Further, Section 929Y of the Act requires the SEC to conduct a study to determine whether federal courts should have jurisdiction over private causes of action involving extraterritorial securities transactions using the same

standard applied to causes of action brought by the United States or the SEC. The study would consider, among other things, the appropriate scope of such private causes of action, including whether it should extend to all private actors or whether it should be limited to just institutional investors; the implications that such private causes of action would have on international comity; the economic costs and benefits of extending private causes of action for transnational securities frauds; and whether a narrower extraterritorial standard should be adopted. The study and recommendations from the study are due 18 months after the date of enactment of the Act. Until Congress takes further action, however, the *Morrison* Opinion will continue to apply and limit the extraterritorial application of the US securities laws with respect to private causes of action.

We hope that you have found this advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

Scott B. Schreiber, Co-Chair
Securities Enforcement and Litigation Practice
 +1 202.942.5672
Scott.Schreiber@aporter.com

Michael D. Trager, Co-Chair
Securities Enforcement and Litigation Practice
 +1 202.942.6976
Michael.Trager@aporter.com

Stewart D. Aaron
 +1 212.715.1114
Stewart.Aaron@aporter.com

John A. Freedman
 +1 202.942.5316
John.Freedman@aporter.com

Lauren R. Bittman
 +1 212.715.1199
Lauren.Bittman@aporter.com

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