

US securities fraud jurisdiction over transnational transactions is extensive but uncertain, and may be on the cusp of change | BY LUCINDA O. MCCONATHY

US securities fraud jurisdiction is potentially applicable to many transnational transactions

The financial markets have become increasingly integrated global markets. The flow of capital and investments does not stop at national borders. Companies that issue securities and traders who trade securities may do business anywhere and may engage in transnational securities transactions with other companies and investors in multiple locations scattered around the globe.

A complex transnational securities transaction often will have some connection to the United States because of the size and sophistication of the US markets. Foreign companies may list their stock on foreign exchanges but also issue American Depository Receipts (ADRs) that trade in the US. Foreign companies may be based outside the US but hold substantial assets or conduct significant operations in the US. Foreign companies and foreign traders may deal with investors and counterparties in the US as well as abroad. Contact with the US – whether intentional or unintentional – may create US jurisdiction.

Investors outside the US are seeking access to US courts and invoking US jurisdiction in private litigation with increasing frequency in sometimes surprising circumstances, where the connection to the US is not obvious – as where foreign plaintiff investors sue a foreign issuer for fraud in a transaction that occurred in a foreign market, a situation commonly referred to as a ‘foreign-cubed’ litigation. In these cases foreign investors may seek to recover losses collectively in class actions that might be difficult to bring in their home countries.

US securities fraud law is silent with respect to its reach in the context of transnational transactions. Traditionally, jurisdiction is presumed to exist within the sovereign’s territory, but that presumption offers little guidance in circumstances where the transaction and the participants may have some contacts with the United States but are located outside US territory.

US courts have developed two tests for determining whether securities fraud claims are subject to US jurisdiction. The first test is the so-called ‘effects’ test, and the second is the so-called ‘conduct’ test.

Simply put, under the effects test, jurisdiction exists whenever the alleged fraud has a detrimental effect on US investors or US markets. For example, if foreign persons engage in a stock manipulation that drives up the price of stock traded on a US exchange, jurisdiction will exist in order to protect US markets and US investors even if all the unlawful conduct occurred outside the US.

Under the conduct test, jurisdiction will exist if conduct occurred in the US that was sufficiently linked to the fraud. US courts have articulated in several different ways what will be a sufficient link, making the application of the test to a particular case somewhat unpredictable. But it is clear in all formulations of the conduct test that the connection between the conduct occurring in the US and the alleged fraud must be significant and not incidental. The conduct test grew out of the idea that the US does not want to be a base for fraudulent conduct even if

the only harm is inflicted on others outside its borders. As one court colourfully put it, courts have been “reluctant to conclude that Congress intended to allow the United States to become a ‘Barbary Coast,’ as it were, harboring international securities ‘pirates.’”

Both the effects test and the conduct test are highly dependent on the particular facts of a case. Moreover, even if a case does not clearly qualify for US jurisdiction under one of the tests, several courts have suggested that the two tests can be combined in some fashion to create jurisdiction. For these reasons, and because of the differing judicial articulations of the conduct test, it is difficult to evaluate whether a court will find jurisdiction in a particular case.

Foreign private plaintiffs are seeking to extend US jurisdiction in foreign-cubed litigation

A petition for US Supreme Court review was filed earlier this year in a foreign-cubed case that illustrates the current uncertainty and could change the analytic framework. At the time of this writing, the Court had not decided whether to grant the petition and take the case, but was scheduled to make that determination at the end of November.

The petition involves a lawsuit brought in federal court in New York by Australian plaintiffs who bought stock in the National Australian Bank (NAB) that was offered on the Australian market. The Australian plaintiffs alleged that NAB financial statements created and issued by NAB in Australia contained false and misleading information. No US market was involved. No US person was a party to the transactions. One might have thought that the US securities laws were not relevant.

However, a subsidiary of NAB located in Florida and its senior managers were alleged to have conceived of the fraud in Florida, manipulated certain valuation models, generated fraudulent financial data using those models, and then transmitted the fraudulent data to NAB for inclusion in the parent company’s financials. The plaintiffs argue that this conduct in the US is sufficient to establish US jurisdiction. As further support for jurisdiction, the plaintiffs also note that NAB had issued ADRs that traded on the New York Stock Exchange and that the allegedly fraudulent disclosures were included in NAB filings with the US SEC. However, the plaintiffs do not allege that they purchased ADRs or that they relied on the SEC filings.

In the Australian case, the court below, the Second Circuit Court of Appeals, had concluded that there was no jurisdiction, saying that the causal link between the US conduct and the Australian company’s alleged fraudulent statements was too attenuated to satisfy the conduct test for jurisdiction. Another federal appellate court, however, the Eleventh Circuit, concluded in August 2009 that there was jurisdiction in a foreign-cubed case similar to the Australian case. Allegedly fraudulent financial data created in the United States became part of a foreign corporation’s financial statements, which were issued in the UK. The Eleventh Circuit concluded that there was jurisdiction because the foreign corporation’s CEO and accounting department, who were re- ▶▶

sponsible for verifying the accuracy of the corporation's financial statements, worked out of a Florida office.

The US government is seeking broad jurisdiction for its own enforcement actions

Of particular interest in the pending Supreme Court case is the US government's position. At the invitation of the Court, the United States filed an amicus curiae (friend-of-the-court) brief. The government's brief argues that there is US jurisdiction over "all suits" brought to enforce "any liability" created under the securities laws. According to the government, "the geography of an alleged fraudulent scheme" is irrelevant to subject matter jurisdiction.

The government asserts that the lower courts have mischaracterised the conduct test as a test of jurisdiction. Instead, the government maintains, whether there is a sufficient link between conduct in the US and the alleged fraud in a transnational transaction is a substantive question that arises in private securities fraud actions seeking damages, not a jurisdictional question. The conduct in the US must be sufficiently 'directly' the cause of the private plaintiff's alleged damages in order for the plaintiff to recover.

In taking this position, the US government is apparently trying to preserve the ability of the SEC to bring an enforcement action in circumstances where the link between conduct in the US and the alleged fraud would be too attenuated for a private plaintiff to plead and prove the required elements of its claim for damages – such as reliance and loss

causation. The SEC does not have to prove those elements in order to establish a violation.

If the Supreme Court takes the case, there is a potential for a drastic reworking of the analysis that has been employed by lower US courts for the last 40 years. If it does not grant the petition, it will leave standing the Second Circuit decision finding no US jurisdiction, a holding that would appear to be equally applicable to the private plaintiffs and the US SEC.

Legislation also has been recently proposed that would create broad US jurisdiction. A bill introduced in the House would amend US statutes to grant jurisdiction if there is "conduct in 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".

Global securities market participants should 'stay tuned'

Participants in transnational securities transactions should keep a watchful eye on current developments. Any contact with the United States creates a potential for being sued in US courts, but, depending on the circumstances, a defendant may still have a sound basis for arguing lack of jurisdiction or failure to state a claim in order to obtain early dismissal of any federal securities fraud claims. ■

Lucinda O. McConathy is a partner at Richards, Kibbe & Orbe LLP.

She can be contacted on +1 (202) 261 2992 or by email: lmconathy@rkollp.com



Lucinda O. McConathy

Partner

T: +1 (202) 261 2992

E: lmconathy@rkollp.com

www.rkollp.com

RK&O RICHARDS KIBBE & ORBE LLP

Lucinda O. McConathy joined the firm in 1998, after having served for ten years as a senior appellate lawyer for the SEC. Her practice focuses on securities litigation, regulatory investigations and counseling.

Since joining the firm, she has, among other things:

- Defended foreign nationals sued in the United States for securities fraud in connection with a cash-out merger;
- Represented plaintiff banks, insurance companies and hedge funds bringing federal and state securities fraud actions against promoters, accounting firms, investment banks, and attorneys in connection with securitizations of asset-backed securities;
- Defended brokerage firm employees under investigation by the SEC or FINRA for alleged insider trading, fraudulent representations to investors, improper valuations, market

timing, and other violations;

- Served as legal counsel in connection with an SEC receivership for the purpose of returning disgorged funds to defrauded investors;
- Counseled institutional investors in public companies on their disclosure obligations and guided their compliance efforts;
- Developed policies and procedures for hedge funds on protecting confidential information and avoiding insider trading; and
- Advised clients in determining when they may be restricted from trading.

Ms. McConathy is an experienced appellate litigator. Most recently, she represented a number of prominent economists who filed an amicus curiae brief in the United States Supreme Court concerning the constitutionality of state taxation of municipal bonds.

While at the SEC, Ms. McConathy was responsible for supervising attorneys in the

appellate litigation group in the SEC's Office of General Counsel, and for developing and advocating the Commission's positions on a broad range of securities law, accounting, arbitration and administrative law issues. On behalf of the SEC, she regularly drafted briefs and appeared in federal district courts and appellate courts throughout the nation. She also prepared briefs on behalf of the SEC before the U.S. Supreme Court.

From 1974 to 1987, Ms. McConathy was in private practice, where she developed expertise in antitrust, class actions, appellate litigation, and land claims by Native Americans.

Ms. McConathy is admitted to the bar of the Illinois Supreme Court and the District of Columbia Court of Appeals; the United States Courts of Appeals for the District of Columbia and the Second, Fourth, Fifth, Ninth and Tenth Circuits; and the United States Supreme Court.