RE-DEFINING THE EXTRATERRITORIAL REACH OF ANTI-FRAUD PROTECTIONS UNDER THE U.S. SECURITIES LAWS

By

Michael D. Mann
&
Morgan G. Macdonald

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1 Mr. Mann is a partner and Mr. Macdonald is an associate in the Washington, D.C., office of Richards Kibbe & Orbe LLP.
I. Introduction

Prior to the Supreme Court’s decision in *Morrison v. National Australia Bank Ltd.*, federal courts liberally applied a multi-faceted “conduct and effects” test to determine whether they had subject matter jurisdiction over securities fraud cases involving foreign parties and foreign transactions. One of the driving forces behind federal courts’ broad exercise of jurisdiction over extraterritorial securities fraud cases was the view, announced by the United States Court of Appeals for the Second Circuit in 1975, that the federal securities laws should be used to “prevent issuers from using U.S. territory as a base of operations for the manufacture and exportation of securities fraud to non-U.S. investors.” Following that mandate, courts regularly exercised jurisdiction over transnational securities fraud cases whether or not they involved transactions that originated in, or came to rest in, the U.S.

The conduct and effects test, as applied before *Morrison*, had two independent prongs. First, under the conduct prong, a federal court would exercise jurisdiction over a dispute concerning an allegedly fraudulent securities transaction if a sufficient amount of conduct related to the transaction occurred in the United States, even if the transaction primarily involved foreign parties or a foreign exchange. Under the effects prong, a federal court would exercise jurisdiction when an otherwise extraterritorial transaction had an effect (usually consisting of some form of injury) on U.S. markets or a U.S. investor. To some degree, the conduct and effects test operated similarly to the “minimum contacts” standard derived from *International Shoe Co. v. Washington*, which courts have used to assert personal jurisdiction over non-resident parties. Like minimum contacts, the conduct and effects test has been quite malleable and has permitted courts to exercise jurisdiction over securities fraud disputes that involve relatively little conduct or effects in the U.S.

Although the conduct and effects test was widely accepted as the proper standard to govern federal court jurisdiction over transnational securities fraud cases, the Court in *Morrison* abruptly reversed course. The Court held that the application of the securities laws to a particular case must be resolved on the merits and does not dictate the subject matter jurisdiction of the federal courts. The Court further ruled that, to be consistent with Congress’ intent when enacting the anti-fraud provisions, a more limited standard should govern the application of the securities fraud laws to extraterritorial transactions. Accordingly, the Court adopted a “transactional test” to replace the conduct and effects standard.

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5 326 U.S. 310 (1945).
Morrison’s transactional test is meant to create a “bright-line” standard that limits the policing powers of federal courts to specific categories of securities transactions that have a close connection to the U.S. In adopting this standard, the Court recognized that international securities markets have changed considerably since the 1970s and in ways that were not contemplated by the Second Circuit’s decisions in Leasco Data Processing Equipment Corp. v. Maxwell⁶ and Bersch v. Drexel Firestone, Inc.,⁷ the decisions that first established the conduct and effects test. Ironically, while Morrison sought to create more uniformity through its new bright line test, legal developments after the decision have caused a lack of uniformity in the law. This outcome can be attributed largely to Congress’ attempt to swiftly overrule the transactional test by statute. Congress inserted a provision in the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) that explicitly grants federal courts the ability to exercise subject matter jurisdiction over securities fraud cases brought by the Securities and Exchange Commission (“SEC”) and the Department of Justice (“DOJ”) so long as those cases involve conduct or effects within the U.S. Congress did not address what test should govern private securities fraud actions, leaving that issue as the topic of an SEC study.

The result of Congress’ action is that government lawsuits are once again governed by the conduct and effects test while private investor suits are governed by Morrison’s more limited transactional test. There is little information about what action, if any, Congress will take to revise the law to enhance protections for private investors. Accordingly, the determinative factor dictating whether the anti-fraud provisions of the securities laws apply to a non-U.S. transaction is whether the case is brought by the government or by a private party. While this sort of limitation on private rights has worked for certain regulatory issues, it is very odd when applied to matters of fraud. It has the effect of leaving some investors defenseless unless the SEC decides to use its powers to protect them and conversely leaves persons who thought they were engaging in foreign transactions in a total quandary about whether the SEC can regulate their conduct.

Notably, neither Congress nor the SEC, which released its study on private rights of action in April of 2012,⁸ chose to take advantage of the unprecedented opportunity created by Morrison to reconsider the manner in which U.S. anti-fraud laws are applied extraterritorially in light of the changes in international securities markets over the past four decades. The question is not simply one of jurisdiction but a chance to position U.S. markets and U.S. investor protection under a framework that encourages and facilitates the growth of a well-functioning interconnected marketplace. The debate surrounding Morrison should not be limited to attempts to reinstate some version of the conduct and effects test. That test may offer strong protection to individual investors, but in a developed securities market such a broad standard also has great potential to overlap with regulatory regimes established in other countries. For that reason, reinstating the conduct and effects test may neither be efficient nor practical for the markets or

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⁶ 468 F.2d 1326 (2d Cir. 1972).
⁷ 519 F.2d 974 (2d Cir. 1975).
⁸ The study was released by the Staff of the SEC. As discussed below, the Commission itself took no position with regard to the options that the Staff presented to Congress.
investors. Now is the time to explore other approaches to see if they are capable of offering an equal level of investor protection while also accounting for the practicalities of modern securities markets.

This article examines the *Morrison* decision and subsequent case law interpreting the transactional test. The article also evaluates the legislative response to *Morrison* and the SEC Staff study regarding private rights of action. The article argues that *Morrison* gives a once-in-a-lifetime opportunity to reevaluate what form of protection U.S. investors should have from fraudulent transnational securities transactions and how broadly U.S. laws should be used to police securities activity throughout the world. Finally, the article sets forth specific proposals that could be used to revise and strengthen U.S. securities laws and markets after *Morrison* and Dodd-Frank.

II. *Morrison v. National Australia Bank* – Overruling the Conduct and Effects Test

The Supreme Court’s decision in *Morrison* rejected the conduct and effects test that courts have used for decades to make subject matter jurisdiction determinations in securities fraud cases. The Court distinguished between the power to exercise jurisdiction over international securities fraud disputes, which the Court found not to be at issue in *Morrison*, and the extraterritorial reach of the anti-fraud provisions of the Securities Exchange Act of 1934 (the “Exchange Act”). As for the latter issue, the Court adopted a “transactional test” to govern the extraterritorial application of the Exchange Act in fraud cases.

A. Background of *Morrison*

*Morrison* was a “foreign-cubed” case, meaning that it involved foreign plaintiffs suing foreign securities issuers for violations of U.S. law based on securities transactions in foreign countries. The defendant in *Morrison* was National Australia Bank Limited (“NAB”), the largest bank in Australia. Shares of NAB were traded on the Australian Stock Exchange and other exchanges throughout the world but were not traded on any exchanges in the United States. However, American Depository Receipts (“ADRs”) for NAB were traded on the New York Stock Exchange.

In 1998, NAB purchased a Florida-based mortgage servicing company named HomeSide Lending, Inc. (“HomeSide”). On July 5, 2001, NAB unexpectedly announced that it was writing down the value of HomeSide’s assets by $450 million and then again by $1.75 billion on September 3. These write-downs caused the ordinary shares of NAB and the associated ADRs to lose value.

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9 *Id.* at 2877.

10 *Id.*

11 *Id.* at 2876.
The plaintiffs in *Morrison* comprised a group of Australian investors\(^\text{12}\) who had purchased NAB shares in 2000 and 2001 prior to the HomeSide write-downs. In response to the write-downs, the plaintiffs brought a putative class action suit against NAB in the United States District Court for the Southern District of New York. The plaintiffs alleged that HomeSide officials had fraudulently manipulated the company’s financial valuation statistics and that NAB and its officers knew about this fraudulent conduct by mid-2000 but did nothing to prevent it.\(^\text{13}\) The plaintiffs claimed that NAB, HomeSide, and their respective officers violated §§ 10(b) and 20(a) of the Exchange Act and Rule 10b-5 thereunder.

NAB filed a motion to dismiss under Federal Rule of Civil Procedure 12(b)(1), arguing that the transactions at issue were “fundamentally foreign in nature” and therefore beyond the subject matter jurisdiction of the court.\(^\text{14}\) The district court, applying the conduct and effects test, agreed with NAB’s argument and dismissed the case.\(^\text{15}\) The plaintiffs then appealed to the United States Court of Appeals for the Second Circuit, which noted that the case required the court to “revisit the vexing question of the extraterritorial application of the securities law” but nevertheless affirmed the district court’s decision.\(^\text{16}\) The Second Circuit focused on the fact that the fraudulent statements at issue came from NAB’s headquarters in Australia, the “complete lack” of any effect in America, and the lengthy causation chain between HomeSide’s actions and the statements that reached investors.\(^\text{17}\) The plaintiffs appealed the Second Circuit’s ruling to the Supreme Court.

### B. The Supreme Court’s Ruling

The Court began its analysis by clarifying that the real issue in dispute was not the jurisdictional authority of the federal courts but whether the anti-fraud provisions of the securities laws were meant to apply to the type of international conduct at issue.\(^\text{18}\) The Court emphasized the “long-standing principle” that Congressional legislation applies only within the territorial boundaries of the United States unless a contrary intent appears in the law.\(^\text{19}\) Without a clear Congressional statement regarding the extraterritorial effect of a law, according to the Court, there is a strong presumption against extraterritorial application.\(^\text{20}\) As for the Exchange

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\(^{12}\) Robert Morrison, an American investor in NAB’s ADRs, also brought suit alongside the Australian plaintiffs, but his claims were dismissed at the district court level for failure to properly allege damages. *See id.* at 2876 n.1.

\(^{13}\) *Id.* at 2876.


\(^{15}\) *Id.* at *6, 8.


\(^{17}\) *Id.* at 177.

\(^{18}\) 130 S.Ct. at 2877.

\(^{19}\) *Id.*
Act, the Court found that “there is no affirmative indication in the Exchange Act that §10(b) applies extraterritorially, and we therefore conclude that it does not.”

With the presumption against extraterritoriality as the back-drop for its ruling, the Court criticized and ultimately overruled the conduct and effects test. The Court found “no more damning indictment of the . . . [conduct and effects] tests than the Second Circuit’s own declaration that the presence or absence of any single factor which was considered significant in other cases . . . is not necessarily dispositive in future cases.” Moreover, the Court rejected the plaintiffs’ argument that the case involved domestic application of §10(b) in light of the actions of HomeSide in Florida. The Court stated, “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] 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.”

To replace the conduct and effects test, the Court adopted a “transactional test.” Under that test, §10(b) applies only to “transactions in securities listed on domestic exchanges, and domestic transactions in other securities.” In *Morrison*, the Court found “no securities listed on a domestic exchange, and [that] all aspects of the purchases complained of . . . occurred outside the United States.” The Court therefore concluded that the plaintiffs’ case should be dismissed on the merits for failure to state a claim upon which relief can be granted.

### III. Legislative Response to *Morrison*

Congress and the SEC had prepared for the need to legislatively adopt the conduct and effects test, which was embodied in an amendment to Dodd-Frank before the Supreme Court’s ruling in *Morrison*. Dodd-Frank contains two provisions that touch upon the “extraterritorial jurisdiction” of U.S. federal courts. First, section 929P amends Section 27 of the Exchange Act by adding the following new subsection under the heading, “extraterritorial jurisdiction”:

“(b) The district courts of the United States and the United States courts of any Territory shall have jurisdiction of an action or proceeding brought or instituted by the Commission or the United States alleging a violation of the antifraud provisions of this title involving –

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20 *Id.* at 2878.
21 *Id.* at 2883.
22 *Id.* at 2879 (quoting *IIT v. Cornfeld*, 619 F.2d 909, 918 (1980)) (internal quotation marks omitted).
23 *Id.* at 2884.
24 *Id.*
25 *Id.* at 2888.
26 *See id.*
(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.”

On its face, the Dodd-Frank language gives federal courts jurisdiction over cases brought by the SEC and DOJ that involve domestic conduct or have domestic effects. While Congress most likely intended Dodd-Frank to overrule Morrison’s transactional test, Morrison was primarily concerned with the extraterritorial reach of the Exchange Act as a merits question. It is, therefore, somewhat difficult to reconcile the Dodd-Frank revisions with the holding in Morrison. However, subsequent to Morrison, many courts and the SEC have taken the position that Dodd-Frank reinstates the conduct and effects test for actions brought by the government.

Second, Congress ordered an SEC study to determine whether private rights of action should fall under the conduct and effects standard to the same extent as actions brought by the SEC and DOJ provision. The Staff of the SEC released its conclusions, entitled the “Study on the Cross-Border Scope of the Private Right of Action Under Section 10(b) of the Securities Exchange Act of 1934,” in April of 2012. The study focuses on two issues: (1) how the conduct and effects test could be modified for private rights of action, and (2) whether a new narrower test could be adopted in such cases.

Notably, the study contains no recommendations or proposals from the Commission itself. Rather, in the study, the SEC Staff sets forth a variety of options for Congress to consider. The primary option discussed in the study is for Congress to adopt a “direct injury” requirement. This direct injury requirement would narrow the conduct test such that a plaintiff would be required to show that his “injury resulted directly from conduct within the United States.” According to the SEC, a direct injury requirement would “further the strong federal


29 Dodd-Frank § 929Y.


31 Notably, the study does not ask Congress to correct the drafting ambiguity in Dodd-Frank relating to government actions.

32 Id. at 61.

33 Id. (emphasis in original).
interest in deterring fraudulent conduct that emanates from the United States . . . [and] could serve as a filter to exclude those claim that have a closer connection to another jurisdiction.”

An alternate proposal by the Staff is a “conduct and effects test available just to U.S. investors,” which would pose a lesser challenge to international comity.

If Congress chooses not to adopt a modified version of the conduct and effects test, the Staff sets forth four narrower ways for Congress to approach private rights of action. Specifically, the Staff suggested that Congress could consider: (1) adopting a cause of action for all investors in a security that is registered with the SEC regardless of the location of the transaction; (2) authorizing private rights of action against securities intermediaries located within the United States when they defraud a client in connection with any securities transaction and against foreign securities intermediaries when they are reaching into the United States to provide services for U.S. clients; (3) permitting investors to pursue a 10(b) claim if they can demonstrate that they were induced while in the United States into a fraudulent transaction regardless of where the transaction occurred; and (4) clarifying the “domestic transactions” prong of the transactional test as it applies to off-exchange transactions.

Although the Commission itself did not endorse or adopt the study, one member of the Commission voiced strong concerns about the Staff’s conclusions. In a “dissenting statement” issued on April 11, 2012, Commissioner Aguilar expressed his “strong disappointment” with the study. According to Commissioner Aguilar, the SEC should have made forceful recommendations and asked Congress to completely throw out the transactional test. He asserts that, as a result of Morrison, “[i]f American investors are defrauded by a company that they have invested in – and that company is listed on a foreign exchange – investors may be unable to have their day in court and seek redress against this company for its lies and misrepresentations. Thus, investors have been stripped of a traditional American right.” In Commissioner Aguilar’s view, the study “falls far short of providing Congress with an informed recommendation and falls far short in fulfilling the Commission’s mission to protect investors.”

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34 Id.
35 Id. at 63.
36 Id. at 64.
37 Id. at 66.
38 Id. at 67.
39 Id. at 68. The Staff acknowledges that some courts have adopted an “irrevocable liability” standard, which is discussed in the next section of this article, but says that standard is unclear and does not further the bright-line rule supported by Morrison.
Regardless of whether one agrees with Commissioner Aguilar’s dissent, there is little doubt that more should be done to give investors more predictability about (1) what protections they have under the anti-fraud provisions of the securities laws, and (2) about what laws will govern securities transactions that have a transnational component to them. The present state of affairs leaves investors in a state of limbo, in which they have a weak legal basis to sue for fraud in connection with transnational securities activity and instead must wait to see if the SEC intends to assert its authority.

It is not clear what steps, if any, Congress will take to fill the void left by Dodd-Frank. Even if Congress chooses to adopt one or more of the Staff’s options, those reforms are essentially a “fix” or a “patch” in response to *Morrison* and represent a shift back towards the conduct and effects test instead of movement forward towards a modernized regulatory solution. *Morrison*, whether one agrees with the decision or not, provides an opportunity to have a broader discussion about what sort of regulatory regime is appropriate today.

**IV. Case Law Developments after Morrison**

Before considering proposals for enhancing investor protection after Dodd-Frank, it is helpful to look at how courts have applied *Morrison*’s transactional test. New legislative proposals should extend these developments in the courts and use them as a jumping off point for more comprehensive regulatory reform. Indeed, as the final section of this article discusses, courts applying the transactional test have developed practical and coherent standards that may be worth codifying as a component of post-*Morrison* regulatory reform.

The transactional test that the Court adopted in *Morrison* is a seemingly straight-forward two-pronged test. Under the test, the anti-fraud provisions of the Exchange Act apply to: (1) transactions in securities listed on domestic exchanges; and (2) domestic transactions in other securities. However, the Court’s decision was limited and did not address the scope of the prongs of the transactional test or whether it applies beyond § 10(b) of the Exchange Act. This section addresses those issues. First, the section covers *Morrison*’s application beyond the Exchange Act. Next, this section discusses the scope and application of the two prongs of the transactional test – the “domestic transactions” and “domestic exchanges” prongs. Finally, this section addresses the application of the transactional test to swap international swap transactions.

**A. The Transactional Test beyond Section 10(b)**

Following the *Morrison* decision, federal courts have analyzed whether the transactional test should apply to a variety of statutes that regulate securities transactions other than the Exchange Act. The law remains unsettled in this area, but certain trends are emerging. It appears that courts are likely to apply the transactional test to the anti-fraud provisions of the Securities Act of 1933 ("Securities Act") given that law’s close historical connection to the Exchange Act. For other securities laws, such as the Investment Advisers Act of 1940 ("Advisers Act") and the Commodity Exchange Act ("CEA"), courts are likely to follow *Morrison*’s approach and carefully analyze the language and purpose of the statute to determine whether Congress intended the law to apply to extraterritorial conduct and, further, whether it would be appropriate to apply a transactional test similar to that adopted in *Morrison*.
1. The Application of *Morrison* to the Securities Act

The applicability of *Morrison* to the Securities Act was examined by the United States District Court for the Southern District of New York in *SEC v. Goldman Sachs & Co.* ("Goldman"). In that decision, the court found that *Morrison’s* transactional test applies to the anti-fraud provisions of the Securities Act just as it does to the anti-fraud provisions of the Exchange Act, including to the “offer” of securities under §17(a) of the Securities Act.

The principal actor in *Goldman* was Fabrice Tourre, a vice-president in the structured products correlation trading desk at the New York City office of the investment bank, Goldman Sachs & Co. The SEC alleged that Tourre, acting on behalf of Goldman Sachs, sent term sheets and offering memoranda to a German bank for a collateralized debt obligation ("CDO") that was tied to the performance of subprime residential mortgage-backed securities. Tourre then purportedly engaged in negotiations with the bank, leading the bank to purchase approximately $150 million of the CDO notes. The SEC alleged that Goldman and Tourre’s conduct was fraudulent because they failed to disclose to the German bank and other parties involved in the transaction that a prominent hedge fund manager, who had helped to select the residential mortgage-backed securities underlying the CDO, held a short position against those securities.

On a motion to dismiss, the court in *Goldman* agreed with Tourre that the transactional test applies to the anti-fraud provisions of the Securities Act but disagreed that the SEC’s 17(a) claim should be dismissed. The court held that to the extent Section 17(a) applies to the “sale” of securities, it does not apply to such sales if they occur outside the United States. With regard to the “offer” of securities, a term that is not used in § 10(b) of the Exchange Act, the court stated, “for an offer to be domestic, a person or entity must: (1) attempt or offer, in the United States, to dispose of securities or security-based swaps or (2) solicit in the United States, an offer to buy securities or security-based swaps.” The court in *Goldman* found that the SEC had adequately pled its case in conformity with this standard.

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41 790 F. Supp. 2d 147 (S.D.N.Y. 2011). As with many of the district court opinions discussed in this article, the *Goldman* case was filed prior to the *Morrison* decision and, therefore, was not pled with the transactional test in mind.

42 790 F. Supp. 2d at 150.

43 Id. at 153.

44 Id. at 164; see also *In re Vivendi Universal, S.A., Sec. Litig.*, No. 02 Civ. 5571 (S.D.N.Y. Feb. 1, 2012) ("The Court determines that *Morrison’s* underlying logic counsels extending its holding to cover the Securities Act.").

45 Id.

46 Id.

47 Id. (citing *Morrison*, 130 S.Ct. at 2886) (internal quotation marks omitted).
The *Goldman* decision shows that courts are likely to extend the *Morrison* rationale to the anti-fraud provisions of the Securities Act. As discussed below, courts are split as to whether *Morrison* should apply to other securities statutes.

2. **The Application of *Morrison* to the Investment Advisers Act**

At least one federal court has applied the *Morrison* test to a case involving alleged violations of the Advisers Act. In *SEC v. Gruss*, the court considered whether *Morrison* blocks the SEC’s ability to sue Perry Gruss (“Gruss”), the CFO of a domestic investment adviser, under the Advisers Act for allegedly misappropriating money held in an offshore fund for the use of an onshore fund that Gruss also managed. Gruss argued that the SEC’s case should be dismissed under *Morrison*, because, as with the Exchange Act, the Advisers Act contains no clear Congressional statement in favor of the extraterritorial application of the statute.

The court rejected Gruss’ argument. First, the court emphasized that the case was brought by the SEC against an employee of a domestic investment adviser who allegedly perpetrated his wrongful conduct from the United States. Although the case involved an offshore fund and offshore plaintiffs, the court viewed the case as the type of lawsuit that falls squarely within the purpose of the Advisers Act, which is to regulate and prevent fraud by investment advisers. Indeed, according to the court, the entire focus of the Advisers Act, as demonstrated by a lack of a private right of action, shows that it is the adviser, and not the clients of the adviser, that is the sole focus of the statute. Finally, the court noted that, even if *Morrison* applied to the Advisers Act, the Dodd-Frank amendments arguably restore the SEC’s ability to bring extraterritorial enforcement actions and, therefore, *Morrison* would not preclude the SEC’s suit.

3. **The Application of *Morrison* to the Commodity Exchange Act**

In *Starshinova v. Batratchenko*, a suit brought by Russian plaintiffs against various funds managed by an American citizen living in Moscow, the court held that *Morrison’s* analysis applies with equal weight to the CEA. The court acknowledged that no case law directly addresses this issue but found persuasive *Morrison’s* emphasis on the requirement that a statute should have a “clearly expressed . . . affirmative intent” in order for it to apply extraterritorially. According to the court, pre-*Morrison* case law holds that the CEA has no

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49 Id. at 661.
50 Id. at 662.
51 Id. at 663.
52 Id. at 664.
54 Id. at * 11.
extraterritorial application. The court also found that certain provisions of the CEA specifically limit the application of the statute to the United States, which the court viewed as a strong indication that Congress did not intend for the statute to apply extraterritorially. Thus, the court held that *Morrison* and, by extension, the transactional test, applies to the CEA.\(^55\)

Although it remains unclear how broadly *Morrison*’s analysis will extend beyond the Exchange Act, courts have made considerable progress defining the parameters for the application of *Morrison*’s two-pronged transactional test. The following two sections address legal developments concerning the transactional test.

**B. The “Domestic Exchanges” Prong of the Transactional Test**

The first prong of the transactional test applies to “transactions in securities listed on domestic exchanges.” The application of this prong has proven to be relatively straightforward. There have been two primary developments. First, courts have held that that the anti-fraud provisions of the securities laws will not apply merely because a security is “cross-listed” on a domestic exchange if the securities transaction at issue occurs elsewhere. Second, U.S. laws will not apply simply because a given security may have associated ADRs registered in the U.S.

1. **Cross-Listing of a Security Is Insufficient under *Morrison***

   The court in *In re Alstom SA Securities Litigation* addressed whether a cross-listed security constitutes a security listed on a domestic exchange.\(^56\) The case involved a group of plaintiffs who purchased securities on the Premier Marche of Euronext Paris, a foreign stock exchange. The plaintiffs made two arguments as to why their transactions satisfied the *Morrison* test. First, they asserted that the purchases were domestic because they were “initiated” in the United States. The court rejected this argument outright as a reformulation of the “conduct” test that the Supreme Court overruled in *Morrison*.\(^57\) Second, the plaintiffs contended that, because the securities were registered and listed on the New York Stock Exchange, though they were purchased on a European exchange, the transactions fell within *Morrison*’s requirement for transactions in securities “listed on a domestic exchange.”\(^58\)

   The court rejected the plaintiffs’ second argument as “selective and hyper-technical” and out of accord with the basic premise of *Morrison*.\(^59\) The court noted that “isolated clauses of the [*Morrison*] opinion may be read as requiring only that a security be ‘listed’ on a domestic exchange for its purchase anywhere in the world to be cognizable under the federal securities

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\(^{55}\) *Id.* at *12-13.*

\(^{56}\) 741 F. Supp. 2d 469 (S.D.N.Y. 2010).

\(^{57}\) *Id.* at 472.

\(^{58}\) *Id.*

\(^{59}\) *Id.*
laws," but when read in context those same excerpts lead to the opposite conclusion. The anti-fraud provisions of the securities laws, according to the court, are meant to regulate transactions. Under the clear intent of the *Morrison* holding, those transactions “must occur on a domestic exchange.”

The cross-listing issue also arose in *In re UBS Securities Litigation*. The plaintiffs in that case, foreign and domestic institutional investors, claimed that UBS AG, a Swiss bank, made false and misleading statements concerning the bank’s exposure to mortgage-backed securities and other high risk assets. Both sets of plaintiffs – domestic and foreign – purchased UBS stock on foreign exchanges. UBS argued that the court should dismiss the plaintiffs’ claims under *Morrison*. In approaching this issue, the court analytically separated the claims of the foreign plaintiffs who purchased UBS stock on a foreign exchange (traditional “foreign cubed” claims) from the claims of domestic plaintiffs who purchased UBS stock on a foreign exchange (the court labeled these claims as “foreign-squared” cases).

The “foreign cubed” plaintiffs argued that their case was distinct from the plaintiffs in *Morrison* because the securities they purchased on foreign exchanges were also cross-listed on the New York Stock Exchange. According to these plaintiffs, all that *Morrison* requires is that the securities in question be “registered with a U.S. exchange, regardless of whether the purchase or sale occurred in the United States or abroad.” The court rejected this argument. Similar to the decision in *In re Alstom*, the court emphasized that the plaintiffs were quoting selectively and that their approach could not be “harmonized with the *Morrison* court’s clear intention to limit the extraterritorial reach of §10(b).”

The court also rejected the argument from the “foreign squared” plaintiffs that a domestic investor who purchases shares of a foreign corporation on a foreign exchange but from within the United States falls within the *Morrison* transactional test. The court found nothing in *Morrison* to suggest that the location of an investor placing a buy order should be determinative.

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60 *Id.*

61 *Id.* at 473.


63 *Id.* at *1.

64 *Id.* at *2.

65 *Id.* at *4.

66 *Id.* at *5.

67 *Id.* at *7.
Moreover, the court found the plaintiffs’ argument, which was premised on harm to domestic investors to be an unconvincing reformulation of the “effects test” rejected in *Morrison*. 68

2. Domestic ADRs Associated with a Security Are Not Sufficient to Meet *Morrison’s* Domestic Exchange Prong

A second argument made by the plaintiffs in *In re Alstom* was that their transactions fall within *Morrison’s* domestic exchange prong because ADRs associated with the securities they purchased were traded on the New York Stock Exchange. 69 While the court in *In re Alstom* does not explicitly address this argument, it appears to implicitly reject it by granting the defendants’ motion to dismiss. The ADR argument was also addressed in *In re Vivendi Universal S.A. Securities Litigation*. 70 There, the court found the argument to be a “technical one that is contrary to the spirit of *Morrison*. 71 Notably, *In re Alstom* and *In re Vivendi Universal* have support in *Morrison* itself. The defendant in *Morrison*, NAB, had ADRs that traded on a U.S. exchange, but that fact did not alter the Court’s ultimate conclusion. 72

C. The “Domestic Transactions” Prong of the Transactional Test

Under *Morrison’s* second prong, the Court held that Section 10(b) applies to “domestic transactions” in securities even if those securities do not necessarily trade on a U.S. exchange. The Court did not explain what it meant by “domestic transaction” nor did it provide a test for lower courts to apply. As explained below, courts applying this prong have found that a domestic transaction occurs when “irrevocable liability” attaches or “title passes” within the U.S.

1. *Absolute Activist* and the Irrevocable Liability Standard

The United States Court of Appeals for the Second Circuit set forth the most authoritative pronouncement to date on the meaning of “domestic transaction.” In *Absolute Activist Value Master Fund Ltd. v. Ficeto*, the Second Circuit held that “transactions involving securities that

68 Id. at *8; see also Cornelius v. Credit Suisse Group, 729 F. Supp. 2d 620, 624 (S.D.N.Y. 2010) (rejecting plaintiffs’ argument that *Morrison’s* transactional test excludes “transactions in securities traded only on exchanges abroad if the purchase or sale involves American parties, or if some aspects or contracts of such foreign transactions occur in the United States” as simply a reformulation of the “core element[s]” of the conduct and effects test).

69 See 741 F. Supp.2d at 471.


71 Id. at 530. The court in *In re Vivendi Universal* did not find this to be a clear cut issue, however. The court stated, “when a foreign issuer decides to access U.S. capital markets by listing and trading ADRs, it subjects itself to SEC reporting requirements, and it would not be illogical to subject that company to the antifraud provisions of the Exchange Act at least where there is a sufficient nexus to the United States.” Id. at 529. Nevertheless, the court rejected the argument that merely registering ADRs with a U.S. exchange equates to “listing” them on the exchange for the purposes of *Morrison*.

72 See 130 S. Ct. at 2876.
are not traded on a domestic exchange are domestic if irrevocable liability is incurred or title passes within the United States.”

Under the Second Circuit test, a plaintiff in a securities fraud case must allege facts showing that “that the purchaser incurred irrevocable liability within the United States to take and pay for a security, or that the seller incurred irrevocable liability within the United States to deliver a security.” By making such an allegation, the court said that a plaintiff could show “facts concerning the formation of . . . contracts, the placement of purchase orders, the passing of title, or the exchange of money.” Alternatively, a plaintiff can allege that “title [to shares] transferred in the United States.” Without facts to prove either allegation, a plaintiff cannot sustain a securities fraud action under the domestic transactions prong of Morrison’s transactional test.

Notably, the court in Absolute Activist explicitly rejected other tests put forth by the plaintiffs, including: (1) the location of a broker-dealer; (2) the identity of the securities and whether they have been issued by a domestic company; (3) the fact that the securities are registered with the SEC; (4) the nationality and identity of the buyer and seller; and (5) whether each individual involved engaged in some conduct within the United States.

Thus, the Second Circuit’s decision gives helpful guidance about which factors should not be considered when analyzing irrevocable liability.

In the short period since the Absolute Activist decision, there has been relatively little opportunity for development of the irrevocable liability test. However, there are a handful of cases, some of which precede Absolute Activist, that help to clarify the meaning of that standard.

2. Irrevocable Liability Case Law Prior to Absolute Activist

The Second Circuit in Absolute Activist relied on two decisions from the United States District Court for the Southern District of New York – Goldman (which is discussed in the prior

73 Absolute Activist Value Master Fund Ltd. v. Ficeto, 677 F. 3d 60 (2d Cir. 2012).

74 Id. at 67-68.

75 Id. .

76 Id at 68-69. For this aspect of the test, the court looked to the Eleventh Circuit’s decision in Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada. 645 F.3d 1307 (11th Cir. 2011). In that case, Quail Cruises Ship Ltd (“Quail”) claimed that the defendants induced Quail to purchase shares in a company whose primary asset was a vessel by misrepresenting to Quail the quality of the vessel. Id. at 1309. Quail brought claims for securities fraud against the defendants as a result. Applying the Morrison transactional test, the court found persuasive Quail’s allegation that the transaction closed in the United States because the parties submitted the stock transfer documents by express courier in Florida. Id. at 1310. The court emphasized that it was not until the domestic closing that title to the shares transferred to Quail. Id. Thus, the court found that Quail had made sufficient allegations to survive the defendants’ motion to dismiss based on Morrison.

77 See Absolute Activist, 677 F.3d at 68-69.
section) and *Plumbers’ Union Local No. 12 Pension Fund v. Swiss Reinsurance.*

In *Goldman*, the court applied the irrevocable liability standard as the basis for rejecting the SEC’s assertion that the court should consider the “entire selling process” relating to the CDO transaction at issue. Instead of following the SEC’s position, the court looked solely to whether irrevocable liability attached in the U.S. The court held that, “[i]n view of the fact that none of the conduct or activities alleged by the SEC, including the closing, constitute facts that demonstrate where any party to the [relevant] note purchases incurred,” there was no basis to draw a “reasonable inference” that the transactions occurred in the United States.

The ruling in *Goldman* is noteworthy because it shows the contrast between the transactional test and the conduct and effects test. Under the transactional test, the court in *Goldman* refused to consider the “selling process” of the CDO as a whole. By contrast, a court applying the conduct and effects test would likely have considered whether any aspect of the selling process could constitute domestic conduct. Thus, while the German bank in *Goldman* had little protection under the transactional test, the opposite may have been true had the court applied the conduct and effects test.

A second case applying the irrevocable liability standard is *Plumbers’ Union*. There, the plaintiffs were a group of investors who bought Swiss Reinsurance Company’s (“Swiss Re”) stock through purchase orders placed electronically in Chicago, Illinois. Despite the place of submission for the purchase orders, the shares were ultimately purchased on a foreign exchange. The plaintiffs later sued the company for alleged violations of § 10(b) arising from false and misleading disclosures concerning sub-prime residential mortgage-backed security exposure.

The plaintiffs in *Plumbers’ Union* argued that “a purchase occurs when and where an investor places a buy order.” The court, however, found this proposed test to be at odds with *Morrison* because it suggested that §10(b) applies to “every security traded on a foreign exchange . . . whenever an investor located in the Unites States placed an electronic order.” Instead, the court ruled that, “as a general matter, a purchase order in the United States for a security that is sold on a foreign exchange is insufficient to subject the purchase to the coverage of section 10(b) of the Exchange Act.” The court stated that there could be rare circumstances

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78 753 F. Supp. 2d 166, 177 (S.D.N.Y. 2010).
79 790 F. Supp. 2d at 158.
80 Id. at 159.
81 753 F. Supp. 2d at 172.
82 Id.
83 Id. at 177.
84 Id.
85 Id. at 178.
in which this rule may not apply, but only if irrevocable liability to purchase attaches in the United States.\textsuperscript{86}

3. Irrevocable Liability Case Law after \textit{Absolute Activist}

Since \textit{Absolute Activist}, there have been several decisions that have helped to define the parameters of the irrevocable liability test. One such decision arose out of the \textit{Goldman} case, discuss above. Prior to \textit{Absolute Activist}, the court had dismissed the SEC’s claim against Fabrice Tourre that involved certain note purchases by a German Bank named IKB. On a motion for reconsideration, the SEC argued under \textit{Absolute Activist} that the claims against Tourre should be reinstated because the SEC had pled that title to the notes transferred to Goldman in the U.S., which was the first step in a series of transactions related to the alleged fraud. The SEC specifically argued that the U.S. transfer of title satisfied the irrevocable liability test and was sufficiently “in connection with” the foreign IKB transaction such that the entire transaction should be subject to § 10(b) of the Exchange Act.\textsuperscript{87}

The court disagreed with the SEC’s attempt to rely on the irrevocable liability standard to reinstate its claims against Tourre. The court held that the SEC’s argument distorted the “in connection with” language of Rule 10b-5 by making it the determinative factor as to whether the Exchange Act applied to the conduct at issue.\textsuperscript{88} In that regard, the court wrote, “the in connection with language modified how close the fraud and the offending domestic transaction must be—not whether the domestic transaction can sit between the fraud and a purely foreign transaction, thereby itself providing the connection.”\textsuperscript{89} Accordingly, the court denied the SEC’s request for consideration.

The \textit{Goldman} case illustrates irrevocable liability is a key component of the transactional test, but it does not supplant the other requirements of § 10(b) and Rule 10b-5 thereunder. In other words, the mere fact that irrevocable liability for some part of a transaction may have occurred in the U.S. does not necessarily mean that U.S. law will apply to the transaction as a whole if the U.S. component is too attenuated from a wholly foreign transaction.

A second post-\textit{Absolute Activist} decision illustrates that traditional rules for determining the time and location of contractual acceptance may apply to the irrevocable liability test. In \textit{SEC v. Benger},\textsuperscript{90} the SEC claimed that the defendants engaged in a fraudulent scheme involving the sale of penny stocks to foreign purchasers. The only contact that the defendants had with the United States was a mailbox in Baltimore, Maryland.\textsuperscript{91} The SEC argued that the “mailbox rule,”

\textsuperscript{86} See id.
\textsuperscript{87} Id. at *3.
\textsuperscript{88} Id. at *4.
\textsuperscript{89} Id. (internal quotation marks omitted).
\textsuperscript{90} No. 09 C 676, 2013 WL 593952, at *1 (Feb. 15, 2013).
\textsuperscript{91} Id. at *3.
which holds that the acceptance of an offer occurs upon the mailing of a countersigned copy of the contract, should inform the application of the Absolute Activist irrevocable liability standard. In Benger, escrow agents in the U.S. mailed the contract and, therefore, the SEC argued that U.S. law should apply. The court criticized and ultimately rejected the SEC’s application of the mailbox rule to the facts in Benger because the court found that the involvement of the escrow agents, who were not parties to the agreement, was too attenuated to serve as the basis for the application of U.S. law. However, the court did not completely rule out the mailbox rule as one possible method of determining when irrevocable liability occurs in the context of a securities transaction.

These decisions demonstrate that, although further development in the law is necessary, the irrevocable liability standard is likely to lead to predictable outcomes regarding when a transaction falls under domestic securities laws. The potential for courts to rely on well-developed areas of law, such as rules governing contract formation, increases the likelihood that this test will lead to predictable outcomes. As a result, this standard gives parties to a securities transaction clarity about the steps they can take—such as inserting clear language in contracts about the location where parties must bind themselves to the agreement—to increase the likelihood that U.S. law will, or will not, reach their securities transactions.

D. Swap Agreements under Morrison May Be Governed by the Law of the Exchange Where the Reference Security Is Traded

Finally, Morrison’s transactional test has also been applied in the context of swap transactions. This issue arose in Elliott Associates v. Porsche Automobil Holding SE (“Porsche Automobil”). There, a group of hedge funds brought suit against Porsche Automotive Holding SE, a German company, arising from securities-based swap transactions that referenced the share price of Volkswagen, a German car company. The hedge fund plaintiffs allegedly suffered significant losses from the swap transaction when Porsche caused the Volkswagen share price to rise dramatically by buying nearly all available shares of Volkswagen. The hedge funds claimed that Porsche falsely denied its intent to take over Volkswagen and took other manipulative steps to hide the extent to which it controlled the company.

Eighteen of the 35 hedge fund plaintiffs in Porsche Automobil were organized under the laws of foreign jurisdictions, but the investment managers for all the funds were located in New York. The swap agreements were private contractual agreements that were not traded on any

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92 Id. at *10.
94 Id.
95 Id.
96 Id. at 471.
exchange but the value of which fluctuated with the price of Volkswagen shares. The swap agreements also contained a choice of law provision designating New York law as the governing law. Shares of both Porsche and Volkswagen traded on a German exchange.

Porsche filed a motion to dismiss, which the court granted, framing the issue as “whether there is any distinction . . . between a domestic ‘buy order’ for securities traded abroad [for which § 10(b) would not apply] and one party’s execution in the U.S. of a swap agreement that references foreign securities.” The plaintiffs argued that, because the swap agreements were executed in the U.S., they should qualify as “domestic transactions in other securities” under Morrison. The court rejected this argument, writing, “[s]ince the economic value of securities-based swap agreements is intrinsically tied to the value of the reference security, the nature of the reference securities must play a role in determining whether a transnational swap agreement may be afforded the protection of § 10(b).” Accordingly, the court found that the swap agreements were the “functional equivalent” of trading Volkswagen shares on a German exchange and therefore fell outside of the Morrison transactional test.

The Porsche Automobil ruling is noteworthy because the court’s holding implies that swap agreements that have reference securities traded on a U.S. exchange would be the functional equivalent of trading on a U.S. exchange. By extension, fraud relating to such transactions may be subject to regulation under U.S. law.

However, a subsequent ruling casts doubt on the analysis in Porsche Automobil. In Phelps v. Stomber, a group of investors who “purchased or otherwise acquired Class B shares or Restricted Depository Shares (“RDS”) of CCC,” an investment fund formed under the laws of Guernsey but managed by Carlyle Investment Management in Washington D.C., brought a securities fraud case against various defendants including John Stomber, the CEO of CCC. The defendants relied on Porsche Automobil for the argument that the transactions at issue were the equivalent of foreign transactions outside the scope of the Exchange Act. The court found this argument unpersuasive, stating that the “‘functional equivalent’ gloss” developed by Porsche Automobil was “inconsistent with the bright line test set forth by the Supreme Court in Morrison, which focus[ed] specifically and exclusively on where the plaintiff’s purchase

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97 Id.
98 Id.
99 Id. at 475.
100 Id. at 475.
101 Id. at 476.
102 Id.
104 Id. at 194-95.
occurred.” Furthermore, in examining the transactions that occurred in Phelps, the court held that the transactions could not be considered the “functional equivalent” of foreign transactions because United States investors purchased their securities from registered U.S. broker-dealers regardless of the fact that the investors were investing in a Guernsey entity.

Although there are important factual differences between Porsche Automobil and Phelps, the two rulings show that the law is not settled in this area. It is unclear whether the “functional equivalent” standard will apply in future cases or whether courts are now likely to look to the irrevocable liability from Absolute Activist as the relevant standard for determining whether U.S. anti-fraud laws reach transnational swap agreements.

E. Summary of Legal Developments

Post-Morrison case law shows that courts have been relatively successful in applying the transactional test in a uniform and predictable manner. While some areas of the law remain unsettled, courts appear to have quickly set parameters for when a transaction can be said to have taken place on a “domestic exchange” and have similarly developed a workable irrevocable liability test to analyze when a securities transaction is “domestic” for the purposes of Morrison. The irrevocable liability test is a practical standard that is premised on the fundamental question of where a party to a contract agreed to be bound or acquired legal title. The answer to that inquiry is not always evident, but it is likely to be based on long-standing legal precedent pertaining to the formation of contracts and, therefore, gives parties a predictable way to evaluate whether U.S. law will apply to their transnational securities transactions.

V. A Proposal for Moving Beyond Dodd-Frank

We are now at an inflection point. Many, including the SEC Staff, take the position that we should return to a regime centered on the pre-Morrison conduct and effects test. That view is premised on the argument that the way to protect investors is through a jurisdictional test and not through a substantive definition of the boundaries of U.S. oversight. The proposals from the SEC Staff are grounded in old-line jurisdictional analysis that largely ignores the fact that an investor may have knowingly subjected himself to foreign jurisdiction or, on the other hand, may want to “contract” for a particular type of legal protection. In redrawing the lines, regulators and Congress should first look at the nature of transactions in today’s marketplace and then come to a view about the breadth of appropriate protection. The court decisions discussed above are helpful in drawing these lines.

Today, average investors are able to conduct transactions involving foreign securities and foreign exchanges with increasing ease, and sophisticated investors are developing complex financial deals that affect numerous securities markets as part of a single transaction. In such an interconnected market, investors need protection, but they also want predictability concerning which laws will govern their conduct. Sometimes investors seek the protection of U.S. law but,

105 Id. at 208-09.
106 Id. at 209.
in other instances, it is beneficial for them to have confidence that another country’s protections
will govern their conduct and that there will be no conflict with U.S. law. This is particularly
true for sophisticated investors who can more readily evaluate the regulatory protections offered
by other markets and make a determination about whether they wish to subject themselves to the
oversight of non-U.S. regulators. While historically the concept of allowing an investor to
“waive” the protection of US law would have been considered heresy, in today’s markets, where
investors regularly and knowingly chose to operate outside the market, this bedrock principle
may need to evolve.

As markets have become internationalized, regulatory regimes have also evolved and
become more uniform. Many jurisdictions are adopting uniform accounting standards and
signing onto international standards for securities regulation. For example, there are now more
than 100 members of the International Organization of Securities Commissions (“IOSCO”),
which comprises securities regulators throughout the world. IOSCO members seek to implement
consistent standards for market regulation and to share information across jurisdictions. It is a
fact that the U.S. is no longer the single dominant market or regulator in the world today. It is
also a fact that investors, even some who are located in the U.S., avail themselves of foreign
markets, purchasing foreign listed securities pursuant to local laws. It is critical that U.S. law
respond effectively to these facts in defining and providing appropriate and predictable investor
protection.

As a first step in this analysis, we propose that regulators consider two different
approaches to protect investors. First, regulators should consider and implement the irrevocable
liability standard from *Absolute Activist*. Second, regulators should consider stronger disclosure
obligations for market intermediaries that investors use to conduct transactions in foreign
securities or on a foreign exchange. These proposals, as discussed below, would respond to the
challenges posed by *Morrison* and provide new bright-line tests for investor protection.

A. Adopting the Irrevocable Liability Standard Would Lead to Uniformity and
Predictability

The irrevocable liability standard adopted by the Second Circuit in *Absolute Activist* has
proven to be a useful means of determining when a transaction is “domestic” under *Morrison’s*
transactional test. Irrevocable liability focuses on the location where title passes or the location
where a party becomes bound to a contract. Those are knowable factors that parties to
international securities transactions can rely upon to give them guidance regarding whether a
transaction will, or will not, be covered by U.S. law. For example, parties could put language in
offering documents or prospectuses that make clear their intent about where a transaction closes
or where parties to a transaction intend to finalize applicable contracts.

Accordingly, it would be a step in the right direction for Congress and the SEC to make
explicit, and to define with particularity, that irrevocable liability is the standard that should be
used to determine when the anti-fraud provisions of the securities laws apply to securities
transactions that are not effectuated on a domestic exchange (which would automatically subject
them to U.S. law under *Morrison*). In addition, it would be worthwhile for regulators to set forth
specific examples of circumstances in which irrevocable liability attaches to a particular
transaction. While this standard may be of little use to average investors, it would be particularly helpful for sophisticated investors who are engaged in complex international transactions and seek to operate under the regulatory regimes of markets outside the U.S.

It may be the case that the irrevocable liability test will be uniformly adopted by U.S. courts in which case a regulatory enactment could be viewed as unnecessary. However, codifying the irrevocable liability and providing specific examples of when irrevocable liability attaches would help to address the wide variety of circumstances when investors may confront this standard. Indeed, codification would turn the irrevocable liability into a bright-line standard that would greatly increase predictability for investors.

B. Adopting Disclosure Obligations for Market Intermediaries Would Enhance Investor Protection

1. U.S.-Based Brokerage Accounts

The irrevocable liability standard would be particularly helpful for sophisticated parties but would likely offer little assurance to average retail investors concerning when they can rely upon U.S. legal protections when engaging in foreign securities transactions. For this less sophisticated group of investors, whose ability to bring private actions has been limited as a result of *Morrison*, further protection is needed. We recognize that investors of all stripes choose to venture abroad for all kinds of goods, services, and investments. The question is whether in today’s internationalized and borderless marketplace those investors should expect the protection of U.S. law and how those protections should attach. We have little question that investors need to know when and where they will receive U.S. protection. But, rather than extend that protection to transactions beyond U.S. borders, we believe it is more appropriate to draw clear and transparent lines regarding the extent of the protection and the risks investors will encounter if they venture outside the U.S.

In considering the appropriate standard, we note that virtually no transaction by investors in the market, be they in the U.S. or abroad, can take place in the absence of a market intermediary – generally, a stockbroker. As an intermediary, the broker knows when a transaction is “on a U.S. exchange” or when it will occur outside the U.S. A broker is, therefore, best positioned to inform investors about the risks associated with a transaction and whether U.S. legal protections are likely to apply to fraud that may occur in connection with the transaction. Rather than creating a special standard to bring foreign transactions into the scope of U.S. laws, regulators should consider adopting and implementing robust disclosure regulations for broker-dealers who conduct transactions in foreign securities on behalf of U.S. investors that ensures investors are fully aware when they are conducting transactions outside the purview of U.S. law.

Placing disclosure requirements on market intermediaries is not a novel approach for enhancing investor protection. A similar standard has been adopted in the recent Jumpstart Our Business Startups Act (“JOBS Act”) and has been successfully applied for many years in the context of chaperoning international brokers. Specifically, the JOBS Act, which President Barack Obama signed into law in April of 2012, provides certain exceptions and revisions to the securities laws for the purpose of allowing increased equity funding for startups in the form of
small-investment “crowdfunding.” To facilitate the new crowdfunding rules, and to provide some level of oversight and investor protection, crowdfunding fundraising must be done through an SEC-registered crowdfunding intermediary. These crowdfunding intermediaries have obligations under the JOBS Act to provide information to investors to reduce the risk of fraud. According to a FAQ issued by the SEC, the obligations of crowdfunding intermediaries include: (1) providing disclosures that the SEC determines appropriate by rule, including regarding the risks of the transaction and investor education materials; (2) ensuring that the investor positively affirms that the investor understands that the investor is risking the loss of the entire investment, and that the investor could bear such a loss; and (3) answering questions that demonstrate that the investors understand the level of risk generally applicable to investments in startups, emerging business, and small issuers and the risk of illiquidity.\(^\text{107}\)

More established market intermediary requirements have been used in connection with requirements for chaperoning foreign broker-dealers. Under SEC Rule 15a-6 of the Exchange Act, foreign broker-dealers must be “chaperoned” if they want to transact in U.S. markets. Specifically, foreign broker-dealers may effect “unsolicited” transactions with U.S. customers but, in order to “solicit” orders from U.S. customers, they must be chaperoned by a U.S. broker-dealer under Rule 15a-6. The rule provides an exception to the solicitation prohibition in the context of institutional investors if the foreign broker-dealer enters into a relationship with an SEC registered broker-dealer and the domestic broker-dealer fulfills certain requirements, including: (1) effecting all transactions between the customer and the non-U.S. broker-dealer; (2) issuing transaction confirmations; (3) maintaining books and records; and (4) protecting customer assets by fulfilling the requirements of the customer protection rule.\(^\text{108}\)

The above are examples of ways in which obligations have been imposed on intermediaries to ensure that investors receive appropriate information in light of the risks involved in a transaction. The examples provide a point of comparison for similar market intermediary requirements in connection with investors who seek to engage in foreign securities transactions.

Using market intermediaries would not be unduly burdensome and would not interfere with established principles governing whether U.S. courts have jurisdiction over foreign parties. Rather, the use of intermediaries is a straightforward approach that would serve to alert investors about the risks of their international market activity and the possibility that engaging in such activity puts them outside the reach of U.S. securities laws. In short, inserting intermediaries is a way of creating a gatekeeper for the unsuspecting. It recognizes that in today’s marketplace, people can easily engage in transactions outside the U.S. for all kinds of goods and that this international activity extends to transactions in securities. By using a standard that warns people – “you are outside the protection of U.S. law” – this approach allows for appropriate


\(^{108}\) 17 C.F.R. § 240.15a-6.
expectations for those who engage in such transactions about the market and legal environment in which they are trading.

More specifically, we propose that the SEC should consider modifying account opening requirements such that U.S. investors have accounts for U.S. transactions and accounts for “non-U.S.” transactions involving foreign securities. The non-U.S. accounts would come with explicit warnings. The warnings could include statements, such as: (1) U.S. law may not apply to the transactions; (2) investors may not be able to sue for any related fraud in U.S. courts; (3) investors may be subjecting themselves to the jurisdiction of foreign countries; and (4) if investors are harmed as a result of fraud in connection with their investments, they may have no means to seek recovery. These types of disclosures would ensure that U.S. investors are made aware of the risks associated with transacting in foreign securities and the fundamental point that U.S. law may not govern any matters relating to the transaction, including fraud.

2. Foreign-Based Brokerage Accounts

We recognize that not all transactions happen through U.S.-based broker-dealers and a broker disclosure requirement will therefore not work in cases where U.S. investors reach out to foreign broker-dealers to conduct transactions directly on a foreign exchange. In such cases, where the U.S. person has not been fraudulently induced to venture outside the U.S., the question of whether the investor should be able to rely upon U.S. law is one worthy of debate. Nonetheless, as a matter of policy, it may make sense to develop a standard that promotes warnings to investors about the risks associated with their market activity. To ensure that outcome, one approach would be to consider adoption of a safe harbor that insulates foreign broker-dealers from transaction liability under U.S. law if they give a set of disclosures similar to those set forth above for domestic broker-dealers. Under such a safe harbor, where a foreign broker-dealer informed a U.S. investor that U.S. laws and, in particular, U.S. anti-fraud protections, may not apply to a transaction on a foreign exchange (and followed procedures similar to those discussed earlier in the article), the broker-dealer would not be subject to U.S. law. While this measure may only be a first step in allowing these risks, we think it is one worthy of debate.

VI. Conclusion – Further Debate and Reform Is Necessary

Morrison has created an extraordinary opportunity to have a broader debate about: (1) under what circumstances U.S. law should apply to international transactions; and (2) how best to address and meet market participants’ expectations with respect to what law will apply to a transaction. As this article proposes, the result of this discussion would be to shape and clarify the aspirations for an internationalized U.S. market.

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109 Although Congress may adopt legislation directing the SEC to implement disclosure requirements for broker-dealers, the SEC would likely have the responsibility of developing the details of any such requirements. Thus, the remainder of this discussion focuses on proposals for the SEC’s consideration.
A debate over the extent of the protection afforded by the U.S. securities laws should not be seen as an effort to limit or expand jurisdiction. Rather, it is an exercise in defining the appropriate expectations for all market participants over when conduct will be covered and receive the attendant protection of US law and, conversely, when it will receive the protection of foreign law. In crafting the new standard, it is appropriate to reconsider the degree to which investors can choose what law applies to an international transaction.

The overriding point is that the debate about the transactional test has been overly rigid and retrospective. *Morrison* presents an opportunity to have a broader debate about the extraterritorial extension of U.S. anti-fraud laws in modern securities markets. Instead of a discussion confined to consideration of slight variations in the conduct and effects test, Congress and the SEC, which now have the benefit of the SEC Staff’s *Morrison* study and lower court interpretations of the transactional test, should take this opportunity to consider a more comprehensive set of proposals. The proposals set forth in this article are only one part of the solution. Further thought must be given to how to implement regulatory reform and what other protections are needed in a post-*Morrison* environment.