

ClientAlert

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Supreme Court Limits Federal Securities Fraud Claims to Securities Traded, Purchased or Sold Domestically

On June 24, 2010, the United States Supreme Court in *Morrison v. National Australia Bank Ltd.*, No. 08-1191, overturned a substantial body of lower-court jurisprudence by holding that Rule 10b-5 federal securities fraud claims are available only where the securities in question were traded on a U.S. securities exchange or were otherwise purchased or sold in the United States.

In its ruling, the Supreme Court rejected the so-called “conduct” and “effects” tests that had been used for such claims by lower courts, under which the claims would be allowed if the particular facts of the case showed that the relevant conduct took place in the United States or had sufficient effects upon the United States or its citizens. The Supreme Court instead adopted a new bright-line rule, citing the principle that acts of Congress are presumed not to apply beyond the territorial jurisdiction of the United States absent express indication from Congress. The Court’s ruling not only curtailed a specific kind of federal securities fraud claim, but may also in the future have the effect of limiting far-reaching extraterritorial applications of U.S. law outside the securities area.

The *Morrison* Plaintiffs’ Claims

The plaintiffs in *Morrison* were Australian purchasers of the shares of National Australia Bank (“NAB”), a company whose “ordinary shares” traded on the Australian Stock Exchange and other foreign stock exchanges, but did not trade directly on any U.S. exchange. The plaintiffs alleged that in 2000 and 2001, NAB’s financial statements overstated the value of certain home mortgage servicing rights held by a Florida-based U.S. subsidiary of NAB, and that as a result, the plaintiffs suffered injury when they purchased NAB shares in 2000 and 2001. The plaintiffs accordingly asserted securities fraud claims under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

The Second Circuit’s Decision

The trial court dismissed the plaintiffs’ claims and on appeal the United States Circuit Court of Appeals for the Second Circuit affirmed. (See C&P Client Alert [“Foreign-Cubed” Securities Actions — by Foreign Plaintiffs Against Foreign Issuers Based on Foreign Stock Purchases — Can Fall Within Subject Matter Jurisdiction of U.S. Courts Under Appropriate Facts](#)” (Oct. 29, 2008).

While the Second Circuit upheld the District Court’s dismissal of the plaintiffs’ claims, it did so by applying its longstanding “conduct” and “effects” tests. Under those tests, extraterritorial § 10(b) liability may exist either where “activities in this country were more than merely preparatory to a fraud and culpable acts or omissions occurring here directly caused losses to investors abroad,” or where “the wrongful conduct had a substantial effect in the United States or upon United States citizens.”

The Second Circuit held that neither of these tests were satisfied. It held that the “effects” test was not satisfied because the allegedly injured investors were located overseas. It held that the “conduct” test likewise was not satisfied because the alleged acts of wrongdoing at NAB’s Florida-based subsidiary were, at best, a highly indirect and secondary cause of the plaintiffs’ injuries, which were, in the Second Circuit’s analysis, primarily caused by alleged actions and statements of NAB in Australia.

The Supreme Court’s Analysis

The Supreme Court affirmed the Second Circuit’s dismissal of the *Morrison* plaintiffs’ claims, but rejected the “conduct” and “effects” tests that the Second Circuit had used in its analysis. The Supreme Court replaced those tests with a bright-line rule focused on the location of the exchanges where securities trade, or the location where securities in question were purchased or sold.

The Court began its analysis with the “longstanding principle” that unless Congress “clearly express[es]” its “affirmative intention” to give a statute extraterritorial scope, courts must presume that the statute applies “only within the territorial jurisdiction of the United States.” “Silence,” the Court wrote, “means no extraterritorial application.” This “presumption against extraterritoriality,” the Court concluded, is inconsistent with using the “conduct” and “effects” tests to determine whether an extraterritorial securities fraud claim should be allowed to proceed.

The Court held that the nothing in the text or context of the Exchange Act demonstrates that Congress intended § 10(b) to have extraterritorial effect, noting that § 10(b) lacks a “clear statement of extraterritorial effect.” The Court also considered and rejected plaintiffs’ arguments that other provisions of the Exchange Act — including the Act’s definition of “interstate commerce” to include foreign trade, and a limited authorization permitting the SEC to promulgate extraterritorial regulations in order to prevent “evasion” of the Act — demonstrated that Congress meant § 10(b) to have extraterritorial scope. The Court also rejected plaintiff’s argument that a “fleeting reference” in the Exchange Act to the possibility that prices quoted on U.S. exchanges would be disseminated around the world provided a basis to apply the Exchange Act outside of the United States.

The Court’s New Standard

Having thus rejected the “conduct” and “effects” tests, the Court held that 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.” The Court articulated a bright-line rule that § 10(b) applies only to transactions in securities listed on U.S. exchanges and, with regard to securities not listed on a U.S. exchange, only to transactions occurring in the United States. In reaching this holding, the Court pointed to the “primacy of the domestic exchange” as the principal subject of regulation under the Exchange Act, and the absence of evidence that Congress meant to regulate foreign securities exchanges under the Act.

In support of its decision to use this approach, the Court reviewed the history of the “conduct” and “effects” tests and concluded that they amounted to “vague formulations” that have proved difficult to administer in practice, leading to “unpredictable” and “inconsistent” results. The Court additionally criticized the “conduct” and “effects” approach as involving an excessive amount of fact-intensive judicial balancing of a multitude of considerations, concluding that “[t]he results of judicial-speculation-made-law — divining what Congress would have wanted if it had thought about the situation before the Court — demonstrate the wisdom of the presumption against extraterritoriality.”

The Court also identified some prudential justifications for its approach. It noted that other countries regulate securities transactions and securities exchanges within their territories, and that foreign law may differ from U.S. law as to a number of issues, such as the “what constitutes fraud, what disclosures must be made, what damages are recoverable, what discovery is available, what attorneys’ fees are recoverable, and many other matters.” The likelihood of inconsistencies between an extraterritorially-applied § 10(b) and the laws of other countries was “so obvious,” said the Court, that if Congress had meant § 10(b) to apply outside of the United States, it would have expressly addressed “the subject of conflicts with foreign laws and procedures.”

The Court also noted that the governments of the United Kingdom, Australia and France, as well as numerous international organizations, had filed *amicus* briefs complaining of the interference with foreign securities laws that would be produced by the extraterritorial application of § 10(b), especially in the absence of a “clear test” determining when § 10(b) did and did not apply. The Court wrote that its approach provides just such a “clear test.”

The Court discounted fears that its narrow rule would permit securities fraud to flourish, while raising concern that the existing permissive approach to extraterritorial securities fraud claims has helped to facilitate abusive class action litigation, commenting that “[w]hile there is no reason to believe that the United States has become the Barbary Coast for those perpetrating frauds on foreign securities markets, some fear that it has become the Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets.”

Implications of *Morrison*

Because *Morrison* now precludes securities fraud plaintiffs from pursuing such claims in the federal courts where the securities at issue were not traded on a U.S. exchange and were not purchased by plaintiffs in the United States, its practical impact (unless Congress enacts legislation providing for extraterritorial jurisdiction over some or all § 10(b) claims)¹ is most likely to be to substantially curtail the ability of foreign plaintiffs to pursue securities fraud claims under U.S. law when U.S. securities are not involved. The decision may also have significant implications in putative securities class actions where many, or most, of the putative class members purchased the relevant securities outside of the United States. Moreover, the decision will limit the ability of U.S. investors who purchased securities directly on overseas exchanges to pursue securities fraud claims under U.S. law. The proportion of pending U.S. securities claims that will be impacted by the *Morrison* rule is unclear at present.

Even with its bright-line rule, *Morrison* still may leave room for debate on whether a particular securities fraud claim should be regarded as impermissibly extraterritorial or not. When securities are not traded on a U.S. exchange, for example, the courts will need to determine what it means for securities to be “purchased in the United States,” a question that may raise complex issues when only some but not all aspects of the purchase occurred in the United States.

¹ The proposed “Dodd-Frank” financial regulatory legislation (H.R. 4173), in the form recently approved by a House-Senate conference, would provide the SEC, but not private plaintiffs, with jurisdiction to pursue extraterritorial securities fraud claims based upon a version of the “conduct” and “effects” tests. The proposed legislation would also direct the SEC to study the merits of restoring the “conduct” and “effects” tests with respect to private § 10(b) suits.

More broadly speaking, the Court's opinion also serves as a vigorous reaffirmation of the presumption against extraterritorial application of U.S. law. While the Court noted but did not disturb existing extraterritoriality precedent in certain other specific contexts, such as under the federal antitrust laws, the skeptical attitude towards extraterritoriality it demonstrated in *Morrison* may in the future come to affect the extraterritorial application of certain other federal statutes outside the securities area. *Morrison* also illustrates the substantial weight the Court gives to concerns that application of U.S. law to acts and transactions occurring overseas might interfere with the legal systems and norms of other countries, a consideration that may take on increasing importance in an ever more globalizing world economy.

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