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REPORT FROM WASHINGTON

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The Supreme Court Considers the Application of the Antifraud Provisions of the United States Securities Laws in "Foreign-Cubed" Cases

March 30, 2010

The Supreme Court heard oral arguments yesterday in *Morrison v. National Australia Bank*, No. 08-1191, a "foreign-cubed" case in which the Court is expected to address for the first time the extraterritorial application of the antifraud provisions of the United States securities laws.

Federal courts have recently wrestled with the application of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") in these "foreign-cubed" cases where the investors are foreign, the issuers are foreign, and the securities are listed on foreign exchanges. Lower courts currently employ varying interpretations of the "conduct" test to determine whether foreign issuers may be sued for securities violations in the United States.[1] The District of Columbia Circuit requires that the domestic conduct itself constitute a securities violation. The Third, Eighth, and Ninth Circuits require that only some fraudulent activity occur domestically. The Second, Fifth, and Seventh Circuits require that the conduct in the United States be more than preparatory to the fraud and that it be a direct cause of the alleged loss. The Court is poised to provide much-needed guidance on the appropriate standard for determining the application of the antifraud provisions of the United States securities laws in such cases.

BACKGROUND

The *Morrison* appeal relates to alleged misstatements in National Australia Bank ("NAB")'s financial statements based on the figures reported to NAB by its wholly-owned subsidiary, HomeSide Lending, Inc. ("HomeSide"), a mortgage service provider located in Florida. In 2001, NAB announced two write-downs in excess of three billion Australian dollars in the value of its mortgage portfolio. NAB's ordinary shares do not trade on United States exchanges.

In late 2003, plaintiffs, non-US investors who purchased NAB stock, brought suit in the Southern District of New York against NAB, HomeSide, and three of HomeSide's top

[1] In assessing jurisdiction, lower courts may also use the "effects" test or a combination of the "conduct" and "effects" tests. While the circuit split involves varying articulations of the "conduct" test for subject matter jurisdiction in securities fraud cases, the arguments before the Court are framed in terms of the scope of Section 10(b).

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executives.[2] Specifically, plaintiffs alleged that defendants intentionally overvalued HomeSide's portfolio to create an appearance of financial strength and thus violated Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5.

NAB moved to dismiss the complaint, arguing that the district court lacked subject matter jurisdiction over claims brought by foreign plaintiffs or based on transactions conducted on foreign exchanges. The court agreed and dismissed the claims.[3]

On appeal, the United States Court of Appeals for the Second Circuit invited the Securities and Exchange Commission ("SEC") to submit an amicus brief expressing its views on the issue. The SEC recommended that: "[t]he antifraud provisions of the securities laws apply to transnational frauds that result exclusively or principally in overseas losses if the conduct in the United States is material to the fraud's success and forms a substantial component of the fraudulent scheme." 2008 WL 5485243. Applying this standard to the instant case, the SEC concluded that there was support for the application of the U.S. antifraud provisions due to HomeSide's conduct in the United States.

The Second Circuit, however, affirmed the district court's dismissal of claims concerning transactions not occurring on domestic exchanges. The Second Circuit opted to use its own "conduct" test, rather than adopt either the SEC's recommended standard or defendants' suggested bright-line rule against "foreign-cubed" securities fraud actions: "Under the 'conduct' component, subject matter jurisdiction exists if 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." 547 F.3d 167, 171 (2d Cir. 2008). In applying the standard, the court, while acknowledging that HomeSide was the source of the allegedly fraudulent numbers, concluded that dismissal was justified for lack of subject matter jurisdiction because the actions of NAB in Australia were more central to the alleged fraud and more directly responsible for causing the harm to investors than were actions taken in the United States. Though not employing an "effects" test, the court noted that "the striking absence of any allegation that the alleged fraud affected American investors or America's capital markets" weighed against the exercise of subject matter jurisdiction. *Id.* at 176.

On November 30, 2009, the Supreme Court granted plaintiffs' petition for writ of certiorari. In its amicus brief opposing certiorari, the Solicitor General articulated a standard similar to the standard proposed by the SEC: "[A] transnational securities fraud violates Section 10(b) when the fraud involves significant conduct in the United States that is material to the fraud's success." 2010 WL 719337, at * 16. The Solicitor General supported the dismissal of plaintiffs' suit, however, reasoning that: "in a suit alleging transnational securities fraud, the plaintiff should be required to prove that his

[2] An American plaintiff was also included in connection with its purchase of NAB's American Depository Receipts ("ADRs") on the New York Stock Exchange, but the Southern District of New York dismissed this plaintiff's claims for failure to state a claim on the basis that it did not allege that it suffered damages. This dismissal was not appealed.

[3] The court granted plaintiffs leave to substitute a lead domestic plaintiff and to amend their pleadings with respect to ADR purchasers only.

injury was a direct result of the component of the fraud that occurred in the United States." *Id.* at * 7. The SEC joined the Solicitor General's amicus brief.

Justice Sotomayor, who sat on the Second Circuit at the time of the appeal, but was not on the *Morrison* panel, has recused herself from this case.

"[T]his case is Australian plaintiff, Australian defendant, shares purchased in Australia. It has 'Australia' written all over it.'"

JUSTICE GINSBURG

SUMMARY OF THE MARCH 29 ARGUMENT

The Supreme Court heard oral argument yesterday from Plaintiffs-Petitioners, Respondents-Defendants, and the United States. Plaintiffs argued that the scope of the antifraud provisions of the United States securities laws permits foreign investors to sue foreign issuers based on losses sustained from trades on foreign exchanges where alleged material and substantial fraudulent conduct took place on United States soil.

Justice Ginsburg challenged: "this case is Australian plaintiff, Australian defendant, shares purchased in Australia. It has 'Australia' written all over it.'" Plaintiffs countered by responding that American law should apply because the case "has 'Florida' written all over it because Florida is where the numbers were doctored, Florida is where the fraudulent conduct in putting the phony assumptions into the valuation portfolio were done . . . . and the senior management of HomeSide in Florida created those numbers with the expectation and the knowledge that those would go into the financial statement."

Assuming that plaintiffs could not prevail under Australian law in the Australian court system, Justice Alito queried: "what United States interest is there . . . that should override that" result. Justice Scalia similarly noted: "Australia says: Look, it's up to us to decide whether there has been a misrepresentation, point one; and whether it's been relied upon . . . by the plaintiffs, point two. And we should be able to decide that and we don't want it decided by a foreign court." He later observed: "[t]he only misrepresentation to these plaintiffs was made in Australia by an Australian company."

Nevertheless, plaintiffs maintained that interpreting the scope of the statute to apply only to domestic exchanges "takes an eraser to the statute." Plaintiffs' counsel acknowledged the concern of permitting private causes of action, but argued that there are "other legitimate ways of cabining the private cause of action" without misconstruing the statute.

"The only misrepresentation to these plaintiffs was made in Australia by an Australian company."

JUSTICE SCALIA

Defendants argued that the Court should affirm the Second Circuit's decision because plaintiffs cannot overcome the presumption against extraterritoriality. Defendants further argued that the securities laws should not be interpreted to apply to transactions involving securities of foreign issuers on foreign exchanges, but rather should only apply to securities purchased or sold on United States exchanges. Allowing an implied right to claims of purchasers and sellers of securities of foreign issuers on foreign exchanges presents a threat to the sovereign authority of other nations.

Justice Breyer asked defendants whether the securities laws should cover a hypothetical fact pattern involving shares purchased on a foreign exchange but where the "[c]onduct took place in the United States, a terrible fraud . . . . The fraud took place totally here." Defendants maintained their position that such circumstances would not be covered due to the lack of a purchase or sale on a United States exchange.

"[T]here are a lot of moving parts in [the Government's proposed test for determining whether private plaintiffs may bring suit under Section 10(b)]. You know, significant conduct, material, you require it to have a direct causal relationship. Doesn't the complication of that kind of defeat the whole purpose?"

CHIEF JUSTICE ROBERTS

Defendants then argued that Congress included a clear statement regarding foreign exchanges in Section 30 of the Exchange Act, whereas it did not make any such clear statement of extraterritoriality in Section 10. Justice Scalia questioned, "is your point also that you wouldn't need section 30 if . . . 10(b) . . . were read as broadly [as plaintiffs urge]?" Defendants agreed, explaining that plaintiffs' "reading of 10(b) would render section 30 superfluous."

Justice Breyer questioned defendants as to how providing a remedy through United States securities laws to injured foreign investors trading on foreign exchanges would hurt other countries. Defendants responded that using the proposed tests of the Government or the Second Circuit would "allow the application of U.S. law in a manner that would infringe the sovereign authority of other nations." Specifically, the United States would be allowing foreign plaintiffs to avoid "the narrower rules of the liability and the narrower remedies that other nations provide."

The United States argued that the alleged fraud was covered under Section 10(b) because "significant conduct material to the fraud's success occurred in the United States." Though the Government and defendants are at odds on this issue, the Government nonetheless agreed with defendants that the Court should affirm the Second Circuit's affirmation of the dismissal. The Government reasoned that the domestic conduct was not the direct cause of plaintiffs' losses, which is a requirement in private suits.[4] The Government clarified the scope of the causation component of the test, explaining that if the action overseas was simply ministerial such that the conduct in the United States was directly responsible for plaintiff's injury, then the test would be met.

Chief Justice Roberts questioned the practicality of the Government's proposed test: "[T]here are a lot of moving parts in that test. You know, significant conduct, material, you require it to have a direct causal relationship. Doesn't the complication of that kind of defeat the whole purpose?" The Government responded that, "if Section 10b didn't cover that kind of conduct, then that would risk allowing the United States to become a base for orchestrating securities fraud for export." Justice Breyer noted: "[w]hat's bothering me, taking off from what the Chief Justice said, is the feasibility of your test."

On rebuttal, plaintiffs stressed that the actions of NAB in Australia were purely ministerial, and should not preclude application of the United States securities laws to the instant case.

IMPLICATIONS

In deciding this case, the Court is expected to clarify whether and under what circumstances the antifraud provisions of the United States securities laws apply in "foreign-cubed" cases. If the Court were to uphold defendants' proposed bright-line rule, the Court would prevent United States courts from adjudicating "foreign-cubed" disputes. Critics of this approach are concerned with the possibility of creating a safe haven for the exporting of the consequences of domestically-engineered securities fraud.

[4] In contrast to its position against allowing private rights of action in these circumstances, the Government argued in favor of allowing the SEC to bring an enforcement action on these facts. Justice Scalia remarked that it did not seem that the Government's proposed test for SEC actions was "an appropriate test," but then observed that "I guess we don't have to say anything about . . . what the government can do, do we?"

However, if the Court were to adopt a more expansive standard, such as the materiality and substantiality interpretation of the "conduct" test advanced by the SEC, non-U.S. issuers—especially those with a significant presence in the United States—could be increasingly subject to private securities fraud suits and regulatory enforcement actions in the United States, which critics say could discourage foreign investment in the United States.

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