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Supreme Court Holds that §10(b) of the Exchange Act Applies Only to Domestic Securities Transactions

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On June 24, the Supreme Court held that §10(b) of the Securities Exchange Act of 1934 ("Exchange Act") applies to prohibited conduct only in connection with "the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States." *Morrison v. Nat'l Australia Bank Ltd.*, --- S.Ct. ---, Case No. 08-1191, June 24, 2010, at *24. In this historic decision, the Court addressed, for the first time, the territorial scope of the Exchange Act and whether cases involving foreign purchases or sales of securities may be litigated in United States courts. Abandoning four decades of extensive §10(b) jurisprudence in the Courts of Appeals, the Court rejected the widely applied "conduct" and "effects" tests, which focused on whether wrongful conduct occurred in the United States or whether foreign conduct and had a substantial effect in the United States or upon its citizens. Instead, the Court prescribed a new "transactional" test to determine whether a claim with one or more foreign elements may be asserted under §10(b) in a United States court.

Under the transactional test, the Australian petitioners, who had purchased foreign securities on foreign exchanges, had no §10(b) claim because "no securities were listed on a domestic exchange and all aspects of the purchases . . . occurred outside the United States."

The Complaint

Defendant National Australia Bank Limited ("National") is the largest bank in Australia. Its "ordinary shares," which are the equivalent of American common stock, trade on the Australian Securities Exchange and other foreign stock exchanges. Although National's ordinary shares do not trade on United States exchanges, its American Depository Receipts ("ADRs"), which provide the right to receive a specified number of National's ordinary shares, are listed on the New York Stock Exchange. Although one of the original plaintiffs had purchased National's ADRs, his claim was dismissed on other grounds in the district court and the dismissal was not appealed.

In 2003, several Australian investors sued National in the Southern District of New York, alleging financial fraud by the bank's U.S. subsidiary, HomeSide Lending, Inc. ("HomeSide"), a mortgage servicing company. In particular, the investors alleged that HomeSide overvalued its assets by miscalculating interest rates on mortgages that it was servicing, which caused its parent National to write-down millions of dollars in losses and the prices of National's stock and ADRs to plummet. The complaint alleged that (a) HomeSide, at the direction of its officers, and at least with the acquiescence of National and its officers, "knowingly used unrealistic financial models in order to artificially inflate its [mortgage servicing rights]"; (b) all public statements made by National in both domestic and international press and pertaining to HomeSide's profitability were "consequently false and intentionally misleading"; and (c) the alleged fraud caused the owners of National's securities to suffer significant losses.

On the basis of these allegations, the plaintiffs sought to represent a class of non-U.S. investors who purchased National's ordinary shares prior to the write-down, and asserted that the defendants violated §§10(b) and 20(a) of the Exchange Act.

The Lower Court Decisions

The defendants moved to dismiss the complaint for lack of subject matter jurisdiction pursuant to Federal Rule of Civil Procedure ("Rule") 12(b)(1) and for failure to state a claim on which relief can be granted under Rule 12(b)(6). The District Court granted the defendants' motion on the former ground, finding no jurisdiction where the domestic acts did not "directly cause[] the alleged harm" and were, "at most, a link in the chain of an alleged overall securities fraud scheme that culminated abroad."

In October 2008, the Second Circuit affirmed. *Morrison v. Nat'l Australia Bank Ltd.*, 547 F.3d 167, 177 (2d Cir. 2008). To determine the extraterritorial reach of §10(b), the Court of Appeals applied a combination of the "conduct" and "effects" tests, which inquires whether "the harm was perpetrated [in the United States] or abroad and whether it affected domestic markets and investors." The Second Circuit concluded that National's conduct in Australia was "significantly more central to the fraud and more directly responsible for the harm to investors" than the financial misconduct occurring in Florida. Thus, because the financial statements at issue emanated from National's headquarters in Australia, neither American investors nor American capital markets were affected, and the chain of causation between HomeSide's actions and the public statements that reached investors was too tenuous, the Second Circuit held that it lacked subject matter jurisdiction.

The Supreme Court Decision

Although the Supreme Court unanimously affirmed the dismissal, there were concurring opinions by Justice Breyer and by Justice Stevens, joined by Justice Ginsburg, the latter of which strongly disagreed with the adoption of a standard based solely on the geographic location of the challenged securities transaction. The majority opinion, authored by Justice Scalia, first rejected the Second Circuit's Rule 12(b)(1) analysis leading to the dismissal for lack of subject matter jurisdiction and clarified that the issue of the extraterritorial reach of §10(b) was not jurisdictional, but an issue of the *merits*, i.e., whether a claim for relief had been stated. Justice Scalia's analysis reiterated a primary tenet of American law, that "legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States." According to the Court, this presumption against extraterritoriality stems from the traditional rule of statutory interpretation that "when a statute gives no clear indication of an extraterritorial application, it has none."

The Court criticized the Second Circuit's "conduct" and "effects" tests, which the Court deemed to be a flagrant "disregard of the presumption against extraterritoriality." Under those tests, Courts attempted to "discern", based on the particular facts in each case, whether Congress would have intended or wanted §10(b) to reach beyond the United States in that case. Although federal courts had been using such tests for over forty years, the Court determined that such precedent had no basis in the text of the Act, and produced "judge-made rules" that were difficult to administer and led to inconsistent application and unpredictable results. Rather than allowing courts to guess anew as future transnational securities fraud cases arise, the Court's holding requires application of the presumption against extraterritoriality in *all* cases, "preserving a stable background against which Congress can legislate with predictable effects."

Referring to the text of the Exchange Act, the Court found no affirmative indication that §10(b) applies extraterritorially. The Court then examined the purpose of §10(b) and devised a "transactional" test to define the territorial reach of §10(b). Explaining that §10(b) serves to punish misconduct only "in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered," (emphasis added) the Court found that its application depends upon whether the "purchases and sales of securities" were made specifically in the United States – and "not [necessarily] upon the place where the deception originated." Thus, in *Morrison*, only "transactions in securities listed on domesticexchanges, and domestictransactions in other securities" are within the purview of §10(b), and *where* the securities are purchased is the only factor in this "transactional" test. The Court noted that adoption of this "clear" test would ensure against any conflict or "interference with foreign securities regulation that the application of §10(b) abroad would produce."

Applying the "transactional" test to the facts at hand, the Court concluded that the plaintiffs failed to state a cognizable §10(b) claim because this case "involves no securities listed on a domestic exchange, and all aspects of the purchases complained of by those petitioners who still have live claims occurred outside the United States."

The Practical Effects of the Decision

The *Morrison* decision undoubtedly will have significant impact on securities litigation, eliminating Exchange Act claims based upon foreign securities transactions regardless of the number and substance of domestic contacts and conduct. The ruling signals a sweeping victory for foreign issuers, as they will no longer face securities class actions in the United States for securities sold outside the United States, even if they have expansive operations in the United States and the challenged conduct emanated from those operations. In this regard, *Morrison*'s bright-line test enhances predictability as to the reach of the most potent anti-fraud provision in the federal securities law.

Concomitantly, residents of the United States who make purchases in foreign securities markets will have no legal recourse within the United States under the Exchange Act, even if, as Justice Stevens posited in his concurring opinion, a foreign issuer's domestic affiliate made false and misleading statements in the United States as to the issuer's financial condition upon which United States investors relied.

The Court's opinion in *Morrison* is definitive as to the requirement in private actions that the connected purchase or sale of a security forming the predicate for a claimed violation of Section 10(b) and Rule 10b-5 be made in the United States. As Justice Stevens notes in his concurrence, however, the Court's opinion does not foreclose the SEC from bringing enforcement actions, since no issue concerning the SEC's authority was presented. Justice Stevens goes on to suggest the possibility of a different result because SEC enforcement proceedings differ from private actions "in numerous potentially relevant respects" and they "pose a lesser threat to international comity" based on the notion that the government may exercise more "self-restraint and consideration of foreign governmental sensibilities" than private plaintiffs.

Neither of these observations alters the requirement set forth in the text of both Section 10(b) and Rule 10b-5 that certain activities are unlawful if committed "in connection with the purchase or sale of a security." Although the SEC need not allege and prove reliance, loss causation and damages to sustain a claimed violation of Section 10(b) and Rule 10b-5, the SEC must allege and prove, among other things, that the challenged conduct occurred in connection with the purchase or sale of a security. In view of the Court's holding that such a purchase or sale must be made in the United States, it is difficult to see how the SEC would not be subject to the same rule of law. That the SEC might be more sensitive to the interests of foreign governments than private plaintiffs, even if true, does not suggest that in the absence of an explicit reference in the text of the Securities Exchange Act of 1934, a Congressional intent to permit the SEC to pursue extraterritorial claims may be inferred and the presumption to the contrary overcome. Although §§ 30(a) and (b) create limited exceptions, (which address the potential liability of a broker or dealer, acting in the United States or with the intent to evade the Exchange Act, in connection with transactions on foreign exchanges involving securities of United States issuers) these provisions are dependent upon as yet unpromulgated regulations of the SEC and, as the Court's opinion explains, strongly confirm that the exclusive focus of the Exchange Act is on domestic purchases and sales.

Finally, although not specifically addressed in the opinion, the Court's clarification, that extraterritoriality is a question going to the merits and not to jurisdiction, may have a number of effects. First, it may signal a need for plaintiffs to plead that the alleged fraud occurred "in connection with" a domestic securities transaction. (Query whether US purchases of ADRs, which were not addressed by the Court, will consistently satisfy this element.) Second, it almost certainly will raise new issues in class definitions where a proposed class may include both U.S. and non-U.S. transactions with respect to the same issuer. Third, in cases in which there may be a factual dispute about where the transaction occurred, *Morrison* does not address the procedure to be used to resolve the dispute. The fact that *Morrison* holds that the issue is one to be raised as merits based under Rule 12(b)(6) and not as jurisdiction based under Rule 12(b)(1) may suggest that, to the extent that the transaction test cannot be determined on the face of the pleadings (and any documents incorporated by reference), disputes about the transaction may not be resolved until the summary judgment phase, after full discovery, rather than through a more limited – and early – jurisdictional hearing on a rule 12(b)(i) motion, after limited discovery.

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