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The Battle to Restore Investor Rights in an Increasingly Global Economy

By Bruce Bernstein

Last year, in *Morrison v. National Australia Bank*, the United States Supreme Court significantly changed the geography of investor rights and protections. In the *Morrison* decision, the Court rejected long standing jurisprudence and greatly limited the ability of the Securities and Exchange Commission (the "SEC") and private litigants to pursue transnational securities fraud claims under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act").

"Transnational securities fraud" refers to fraud in connection with a securities transaction in violation of Section 10(b) of the Exchange Act, where the transaction is consummated through purchases or sales of securities outside of the United States, including on non-U.S. exchanges or trading platforms. Prior to *Morrison*, courts considering whether to exercise jurisdiction over transnational securities frauds focused on "whether the wrongful conduct occurred in the United States," and whether "the wrongful conduct had a substantial effect in the United States or upon U.S. citizens." In *Morrison*, the Supreme Court rejected this "conduct and effects" test as the appropriate standard for determining whether such a claim could be brought under the Exchange Act. Instead, the Court held that Section 10(b) only applies "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."

Shortly after the *Morrison* decision, the United States Congress, through the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), rejected a portion of this new standard and restored transnational enforcement power to the SEC. Specifically, Dodd-Frank authorizes SEC actions under Section 10(b) for alleged transnational frauds involving: "(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside

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Given the Exchange Act's principal objective of protecting investors and the financial markets, investors should have tools similar to those available to the SEC — including a private right of action for certain transnational frauds. Numerous former SEC Chairs have expressly noted that private enforcement plays an important — and complementary — role in the regulation of the financial markets.

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." In short, Dodd-Frank codified for the SEC the pre-*Morrison* conduct and effects test that courts had applied for decades. The test was based upon the well-established principle (developed by U.S. courts) that the federal securities laws were designed to prevent the U.S. from being used as a base for fraudulent securities schemes even when the victims reside outside this country.

Dodd-Frank did not, however, restore investors' ability to bring private claims in response to transnational fraud. Private investors remain relatively limited where significant fraudulent conduct either occurred in the United States or had a substantial effect in the United States or on its citizens, regardless of where the subject securities were traded. Instead, Dodd-Frank directed the SEC to solicit public comment and conduct a study to determine the extent to which private rights of action under the Exchange Act should be extended to cover such matters. By the February 18, 2011 deadline for public comment, the SEC had received more than 50 submissions. Comments were submitted by, among others, private investors (including domestic and foreign pension funds), academics (including a submission filed by 42 law professors), shareholder advocates (e.g., the Council of Institutional Investors), pro-business associations (e.g., the Chamber of Commerce), and foreign governments.

The Global Investor Comment

In light of the significance of this issue for investors worldwide, BLB&G, in coordination with two other U.S. law firms, submitted a twenty-page comment on behalf of more than 65 institutional investors from outside of the United States (the "Global Investor Comment"). Collectively, these investors, which included some of the largest institutional investors from Australia, Denmark, the Netherlands, Norway, Sweden, and the U.K., manage approximately two trillion U.S. dollars in assets. These institutional investors have significant investments in U.S. companies that trade on foreign exchanges, as well as in foreign companies that have a significant presence in the United States.

The Global Investor Comment urged the SEC to find that the antifraud provisions of the Exchange Act should allow investors to bring private actions in cases involving transnational securities fraud, and to recommend to the U.S. Congress that the Exchange Act be amended accordingly. Specifically, the Global Investor Comment proposes that private actions under Section 10(b) should be governed by the same standard Dodd-Frank made applicable to the SEC, which would allow for uniform enforcement of Section 10(b) in transnational fraud actions. Indeed, prior to *Morrison*, long-standing appellate jurisprudence applied the conduct and effects test as a limit on both private and government transnational fraud actions. Such an analysis would take into account, among other things: (i) whether the security was issued by a U.S. company; (ii) whether the security was purchased or sold on a foreign stock exchange, a non-exchange trading platform or other alternative trading system outside the U.S.; (iii) whether the issuer's securities are traded exclusively outside the U.S., (iv) the citizenship of the purchaser; and (v) where substantial fraudulent conduct occurred. This is consistent with pre-*Morrison* case law, which held that the conduct and effects test was satisfied only if either a substantial part of the wrongful conduct occurred in the U.S. or the wrongful conduct substantially affected the U.S., or if some substantial mixture of the two was present.

In light of the Exchange Act's principal objective of protecting investors and the financial markets, investors should have tools similar to those available to the SEC — including a private right of action for certain transnational frauds. Numerous former SEC Chairs have expressly noted that private enforcement plays an important — and complementary — role in the regulation of the financial markets. Similarly, the Supreme Court "has long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions." In light of budgetary and other constraints, it is unrealistic to expect the Department of Justice and SEC to uncover and prosecute all securities fraud. Moreover, the *Morrison* test fails to recognize

the realities of today's modern trading environment, and it punishes investors who often do not know whether their securities transaction was ultimately executed on a U.S or foreign exchange — and therefore whether it is covered by the U.S. securities laws.

In addition, because all nations have significant interests in deterring fraud in today's global economy, restoring private litigants' ability to bring a transnational fraud claim within the parameters of the conduct and effects test would not offend international comity (which is implicated when there is a conflict between the law of two jurisdictions) or undermine international relations. Indeed, as a result of securities frauds seen over the past decade that failed to recognize any national boundaries, and the global financial crisis that caused significant damage to financial markets and investors worldwide, these interests have become even more closely aligned. Accordingly, permitting investors to bring such claims in the appropriate context (i.e., where a material component of the transnational fraud occurred in or substantially affected the U.S.) will benefit international relationships and the overall standing of the United States as a global leader in combating fraud. Moreover, because the proposed restoration of private litigants' rights is consistent in scope with the SEC's restored authority, no unique international comity concerns apply that Congress would not already have weighed when passing Dodd-Frank.

Finally, the Global Investor Comment makes clear that increased investor protection necessarily enhances efficient markets and capital formation. It cites empirical evidence demonstrating that properly functioning financial markets require the protection of investors' rights, a position also espoused by the SEC. It also cites research supporting what courts have long-recognized — that private actions are an essential component of protecting investors and fostering the proper functioning of capital markets.

Additional Comments Supporting Extraterritorial Application of the Exchange Act

As noted above, a number of additional comments were submitted to the SEC, the majority of which supported restoring private investors' ability to bring claims in certain instances of transnational fraud. For example, 42 law professors submitted a comment expressing their belief that the conducts and effects test should be reinstated for private rights of action. Among other things, the professors cited the recent merger between Deutsche Borse and the NYSE and Euronext as a "compelling example" that supports their view. The professors opined that, if the merger is consummated, there is a potential for "most trades" for securities listed on this exchange to be in London, and therefore not covered by the federal securities laws. Even those professors who are "deeply skeptical about extending U.S. securities law to its fullest reach agree that it would make little sense to apply the approach in *Morrison* to preclude application of the securities laws to those trades."

In another comment, the Israel Security Authority (the "ISA"), argued that the Exchange Act should cover claims for those securities that are dually listed on a U.S. and foreign exchange and where the U.S. disclosure requirements apply in both markets (as they do in Israel), "irrespective" of where the security was ultimately purchased. The ISA noted that, "[s]ince [dually listed] issuers have chosen to reap the benefits of dual listing and investors have relied, at least indirectly, on U.S. regulatory standards, any argument that hearing a claim in the U.S. constitutes unreasonable interference with foreign sovereignty ignores both the essence and practical consequences of the dual listing arrangement."

Comments in Opposition to Restoring Investors' Ability to Seek Legal Redress in Certain Instances of Transnational Fraud

The governments of Australia, France, and Germany each submitted comments in opposition to extending the extraterritorial scope of the U.S. securities laws to private actions. Each expressed concerns that returning to a pre-*Morrison* standard would transform the United States into the world's court. Although such concerns are reasonable, years of experience with the pre-*Morrison* standard show that such concerns would not be realized.

The conduct and effects standard precludes the prosecution of Section 10(b) claims unless the case has a significant connection to the United States. To this end, in order to support an SEC enforcement action for transnational fraud, a defendant's U.S. conduct must "constitute[] significant steps in furtherance of the violation," while a fraud's effects must be "foreseeable [and] substantial." In addition, courts have dismissed private actions under the doctrine of *forum non conveniens* where a defendant has successfully shown that an adequate forum is available elsewhere, and that the private and public interests implicated in the case weigh strongly in favor of dismissal or removal to another forum. U.S. courts have also dismissed meritorious claims for lack of subject matter jurisdiction over foreign investors, and, in class actions, at the class certification stage. Accordingly, there are numerous procedural mechanisms that

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ensure cases without sufficient ties to the U.S. will not be prosecuted in its courts.

There is also empirical evidence that should assuage concerns over the U.S. becoming the world's court. The number of securities class actions against foreign issuers is just a small fraction of the number of securities fraud cases litigated under the U.S. federal securities laws. See *Advisen Quarterly Report* — Q3 2010, at 11-12 (Eleven percent of the securities actions filed through the third quarter of 2010 (i.e., prior and subsequent to the *Morrison* decision in June 2010) were against companies domiciled in a foreign country); see also *RiskMetrics Blog*, "*Morrison v. National Australia Bank* — the Dawn of a New Age" (June 25, 2010) ("[O]f the 530+ suits that settled in 2009, approximately 50 of them were against defendants domiciled in a country outside the U.S.[]").

Other comments, including the U.S. Chamber of Commerce's submission, suggest that restoring investors' rights to pre-*Morrison* levels is unnecessary because public enforcement mechanisms, both within and outside of the U.S., are sufficient to protect investors. Such sentiments are belied by previous statements made by both the Supreme Court and SEC, and are also undermined by today's realities. Restoring private litigants' rights to pre-*Morrison* levels simply provides investors the opportunity to assert claims on their own behalf, and does not require them to rely entirely on government enforcement to remedy injuries.

Conclusion

Pursuant to Dodd-Frank, the SEC's report on the extraterritorial private right of action for securities fraud and its corresponding recommendation is due in early 2012. For the reasons discussed above, if the SEC's study results in a recommendation to Congress to allow for such actions, it could open the door to an Exchange Act amendment that would in effect overrule *Morrison*.

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