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THE IMPLICATIONS OF THE MORRISON JUDGMENT FOR INTERNATIONAL SECURITIES LITIGATION

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ABSTRACT

In *Morrison v National Australia Bank* the Supreme Court of the United States has addressed for the first time in its history the extraterritorial scope of the US securities laws. In its landmark ruling, the Supreme Court has introduced a new standard for securities suits which allege a fraud or deception in the purchase or sale of securities pursuant to Section 10(b) of the Securities Exchange Act of 1934 or SEC Rule 10b-5. The new standard – the *transactional test* – restricts the scope of the anti-fraud provisions to "transactions in securities listed on domestic exchanges and domestic transactions in other securities."

Shortly after the *Morrison* judgment, Congress sought to revoke some of the effects of the transactional test by introducing Section 929P(b) of the Dodd Frank Act. While Section 929P(b) restores the former more permissive standard for jurisdiction, its scope is limited to suits brought by governmental agencies enforcing the anti-fraud provisions and does not extend to private rights of action. Thus, as currently worded the new transactional test is likely to substantially limit the availability of federal courts for both domestic and foreign investors who have purchased or sold stock in a foreign exchange.

Yet, the rigors of the *Morrison* judgment are being partially circumvented as plaintiffs have sought to bring common law fraud claims in state courts, have attempted to plead foreign securities law in federal courts or are seeking redress in foreign jurisdictions, primarily in Canada.

SUMMARY: 1. Introduction. 2. Morrison and the Prior Tests for Extraterritorial. 3. Implications of the new transactional test. 4. Conclusion.

1. Introduction

The judgment of the Supreme Court of the United States in *Morrison v National Australia Bank*[1] has been the most important judgment concerning the extraterritorial scope of the US securities laws in the Court's history. The Court has single-handedly overruled more than forty years of established precedent devising a new standard for securities suits alleging a fraud or deception in the purchase or sale of securities.

The new test devised by the Supreme Court – the transactional test – restricts the scope of the anti-fraud provisions of the Securities Exchange Act of 1934 to "transactions in securities listed

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[1] *Morrison v. National Australia Bank*, 130 S.Ct. 2869 (2010).

on domestic exchanges and domestic transactions in other securities." This standard is likely to substantially limit the availability of federal courts for investors who have purchased or sold stock in a foreign exchange.

The US Congress attempted to fill this sudden lacuna in investor protection law by enacting Section 929P(b) of the Dodd Frank Act.[2] Regrettably, a drafting error in the legislation has effaced much of the advantage which the Congressional pronouncement on the matter could have had. Nevertheless, Section 929P(b) has *de facto* restored an extraterritorial reach for governmental agencies enforcing the anti-fraud provisions, so that only private suits remain thwarted in the *Morrison* aftermath.

2. Morrison and the Prior Tests for Extraterritorial Jurisdiction

The principal anti-fraud provision of the US securities laws is Section 10(b) of the Securities Exchange Act of 1934. The section provides how:

> "It shall be unlawful for any person ... to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." [3]

The Securities and Exchange Commission ("SEC"), the federal agency empowered to regulate the securities industry and capital markets, promulgated SEC Rule 10b-5 when implementing the federal statute. The Rule introduces a private right of action and prohibits:

> "any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) to employ any device, scheme, or artifice to defraud,
> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub.L. 111-203, H.R. 4173, signed into federal law on July 21, 2010.

[3] 15 U.S.C. § 78j(b) (2006).

> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." [4]

Despite having a tenuous basis in the statutory language,[5] Rule 10b-5 has become the preferred cause of action for enforcement agencies and private plaintiffs alleging a fraud or deception in the sale of securities. To better comprehend the significance of the Rule, it is important to understand how US securities laws are premised on a disclosure philosophy requiring prospective and registered issuers to routinely disclose an extensive amount of financial information through quarterly and annual public returns.[6] Yet, the effectiveness of this public disclosure regime has been ensured only through the diligent scrutiny of the securities plaintiffs' bar, which has operated as an additional regulator to ensure compliance with the securities laws.

Prior to the *Morrison* judgment the extraterritorial application of the US securities laws was ambiguously defined. The Second Circuit, (the appellate jurisdiction for federal cases arising from Connecticut, New York and Vermont – New York being the district where traditionally most securities suits are brought) had conceived several different jurisdictional standards to assess whether federal courts had subject matter jurisdiction to hear an extraterritorial 10b suit.

Under the 'effects' test, courts had jurisdiction where the fraud or transaction had a significant impact on US investors or the US capital markets.[7] Under the 'conduct' test instead, federal courts were vested with jurisdiction only if the fraudulent conduct occurred in the US.[8] In cases where the plaintiff was foreign, there was an additional requirement that the alleged domestic

[4] 17 C.F.R. § 240.10b-5 (2010).

[5] In *Blue Chip Stamps v. Manor Drug Stores,* Chief Justice Rehnquist interpreted Rule 10b-5 as a "legislative acorn" from which a "judicial oak" had sprung. 421 U.S. 723, 737 (1975).

[6] "There is no doubt that a major underlying premise of the federal securities laws is that full and prompt disclosure will best serve the purposes of both investors and corporate issuers... we are persuaded that the original assumptions that full disclosure permits investors to make informed and intelligent choices; discourages hanky-panky on the part of corporate management; and operates to reduce suspicion and generate confidence are as valid today as they were forty years ago." Roy Garrett, *The Disclosure Philosophy*, An Address by Roy Garrett, Chairman of the SEC, 20/02/1975; Louis Loss & Joel Seligman, *Securities Regulation*, 3rd edn (1998), 29: "Then, too, there is the recurrent theme throughout of disclosure, again disclosure, and still more disclosure. Substantive regulation has its limits. But ''The truth shall make you free.'''

[7] *Schoenbaum v. Firstbrook*, 268 F.Supp. 385 (1967).

[8] *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326 (1972).

wrongful conduct be more than merely preparatory or indirect.[9] Prior to *Morrison*, the standard to determine whether federal courts were entitled to hear a case applying the antifraud provisions extraterritorially was an intensive factual analysis with only a broad sketch of applicable jurisprudence. The complexity of the case law and the unpredictability in outcomes was a source of heated criticism.[10] While it ensured compliance with the broader policy objectives of the statute (investor protection and deterrence of fraudulent conduct) it exposed foreign and domestic issuers to an uncertain potential liability for their US related conduct.

Thus, when the Supreme Court granted certiorari to hear the case, the financial services industry was eagerly awaiting a clarification of the law. The majority opinion, written by Justice Antonin Scalia, focused upon principles of statutory interpretation (the presumption against extraterritoriality) and conflict of laws (the principle of comity) to substantially narrow the ambit of Section 10(b) and Rule 10b-5. Under the new transactional test, a foreign plaintiff can bring suit in federal courts only if “the purchase or sale is made in the United States, or involves a security listed on a domestic exchange.”[11] Ultimately, the Court clarified how the jurisdictional lens with which prior federal courts had addressed the matter was incorrect: rather than an issue of jurisdiction, the question is one of merits.

In the wake of *Morrison*, judges and litigators were left with a bright-line standard which defined the applicable securities transactions in the abstract but offered little practical assistance. By categorically discarding the conduct and effects test the wealth of subtle analysis accumulated in forty years was jettisoned overnight. Moreover, Congress’ reaction was textually incorrect and therefore unhelpful, insofar as it sought to restore subject matter jurisdiction for actions brought by the SEC or the Department of Justice when the Supreme Court had determined that the question was one of merits rather than subject matter jurisdiction.

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[9] Some courts had chosen to apply an ‘admixture’ of the two tests, and the other federal Circuits differed slightly in their application of the conduct or effect test.

[10] John C. Coffee, Jr., *Foreign Issuers Fear Global Class Actions*, The National Law Journal 1 (June 14, 2007).

[11] *Morrison*, at 2886. The judgment framed the transactional test in three separate formulations:

“Transactions in securities listed on domestic exchanges, and domestic transactions in other Securities;” [cases where] “the purchase or sale is made in the United States, or involves a security listed on a domestic exchange;” and [instances where the plaintiff alleges] “use of a manipulative or deceptive device or contrivance … 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.”

3. Implications of the new transactional test

Almost paradoxically, the earliest cases to deal with the transactional test relied on a purposivist interpretation of the *Morrison* judgment rather than a literal application of its transactional test – the very same form of judicial analysis which the Supreme Court had chastised in the former conduct/effects standard.

A restrictive interpretation of what constitutes a "transaction in domestic securities" dismissed American Depositary Receipts ("ADRs") and equity-based swap agreements referencing foreign shares, as they were categorised as the functional equivalents of foreign transactions.[12] Likewise, a narrow interpretation of what constitutes a transaction in securities "listed on domestic exchanges" rebutted the argument that dually listed securities (namely, securities listed on a foreign and domestic exchange) could benefit from Section 10(b).[13]

Indicative of this trend towards extreme curtailment of Section 10(b) was the *In Re Swiss Insurance* litigation.[14] The plaintiffs' claim that the purchase order was made by brokers in Chicago (and thus sufficient to bring the transaction within the ambit of the first prong of the Morrison test - tranactions made on a domestic exchange) was dismissed by the Southern District of New York, as Judge Koeltl held that if the security was ultimately traded on a foreign exchange the location of the purchase order was irrelevant.

In a recent ruling of the Second Circuit,[15] the appellate court reconsidered the pivotal issue of what constitutes a purchase or sale for the purposes of the transactional test. In particular, the Court stressed that a purchase or sale occurs when the parties become "bound to effectuate the transaction." Such an obligation is found only where irrevocable liability is incurred or where title to the instrument is transferred. This holding solves many of the ambiguities left by the *Morrison* judgment in applying the transactional test to complex financial operations. However, by carefully circumscribing the definition of purchase or sale within two other legal standards, the court has added an ulterior level of legal formalism. To this end, only if legal clarity and predictability in outcomes are the policy goals which inspired the reformulation of the extraterritorial law, can this judgment be correct. If, instead, investor protection remains at the

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[12] *Elliott Assocs. v. Porsche Auto. Holding SE*, 759 F. Supp. 2d 469, 476 (S.D.N.Y. 2010) ; *In re Société Générale Securities Litigation.*, No. 08-2495(RMB), 2010 WL 3910286 (S.D.N.Y. Sept. 29, 2010).

[13] *In re Alstom SA Securities Litigation*, 741 F.Supp.2d 469 (S.D. N.Y. 2010).

[14] *Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.*, 753 F. Supp. 2d 166 (S.D.N.Y. 2010).

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

core of the securities laws, then both the Supreme Court judgment and the recent jurisprudence have been somewhat mistaken.

Undeniably, the harshness of *Morrison's* bright line rule has left meritorious investors "out in the cold."[16] Insofar as foreign securities laws are more restrictive than the federal system in both procedure and doctrine these plaintiffs may have been left without any legal remedy regardless of the blameworthiness of the alleged fraud they suffered. Paradoxically, the rigour with which the transactional test applies to investors which have been harmed by frauds originated in the US but executed on a foreign exchange, may lead to a greater breach of comity than the prior regime. In fact, while the pursuit of international perpetrators of securities frauds is a common objective of regulatory agencies, granting immunity to enact frauds on US territory insofar as it affects only transactions in foreign exchanges clearly undermines the spirit of cooperation and comity.

To bypass the restrictions of the *Morrison* judgment, an ingenious number of alternatives have been pursued. First, plaintiffs have sought to camouflage their Rule 10b-5 claims as common law claims in state courts. Pursuing state law claims for common law fraud or unjust enrichment has been particularly encouraging in New York. On the other hand, resort to state law courts requires the plaintiff to 'survive' motions to dismiss the case based on the unsuitability of the forum (forum non conveniens). Therefore, these state law claims require some genuine link between the alleged fraudulent transactions and the forum chosen.

A particularly creative class of plaintiffs has chosen to pursue foreign law claims in federal court. In this way, the plaintiff would benefit from the favourable procedural rules of the American system while avoiding the jurisdictional limitations of the transactional test.[17]

As a last resort, some plaintiffs have chosen to file suit abroad – primarily in jurisdictions which have developed a comparable class action structure for securities litigation. It is not surprising that Canada has witnessed an unprecedented rise in the number of securities laws class action filings given the contraction of US dockets.[18] Similarly, plaintiffs of a US case dismissed under

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[16] Marco Ventoruzzo, *Like Moths To A Flame? International Securities Litigation After Morrison: Correcting The Supreme Court's "Transactional Test",* 52 Va. J. Int'l L. 405, 438 (2012).

[17] Yet this was not successful in the Toyota Phantom Class Action, *In Re Toyota Motor Corp. Securities Litigation.* Nos. CV 10-0922 DSF (AJWx), (C.D. Cal. July 7, 2011).

[18] Bradley Heys and Mark Berenblut, NERA Economic Consulting, *Trends In Canadian Securities Class Actions: 2011 Update,* 1 February 2012.

Morrison have also brought suits in the Netherlands – another jurisdiction which has developed a sophisticated class action strategy.[19]

4. Conclusion

The *Morrison* judgment has gravely affected private rights of action in securities suits bearing transnational elements. As the Supreme Court chose to focus on predictability of outcome over factual analysis, the consequence of such formalism is to deny relief to an entire class of plaintiffs. As the concurrence in *Morrison* had outlined, the transactional test will harm any US investor which is lured into a fraudulent scheme where the ultimate purchase or sale is executed in a foreign exchange.[20] Given that, in this case, the wrongful conduct occurred domestically, its effects are borne domestically and affect both US investors and the accuracy of US capital markets this offends the spirit of the securities regulations. It is questionable whether such a result is worth the predictability which the bright line rule provides.

[19] *Copeland v. Fortis*, No. 08. Civ. 9060 (DC) (S.D.N.Y. Feb. 18, 2010).

[20] *Morrison*, at 2895.