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REPORT FROM WASHINGTON

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The Supreme Court Limits the Extraterritorial Application of the Antifraud Provisions of the U.S. Securities Laws

June 25, 2010

Yesterday, in its much-anticipated decision in *Morrison v. National Australia Bank Ltd.*, No. 08-1191, the Supreme Court held that Section 10(b) of the Securities Exchange Act of 1934 applies only to fraud that is alleged to have arisen in connection with purchases and sales of securities listed on a domestic exchange or domestic transactions in other securities. In setting forth this bright-line, transaction-based rule, the Court held that "foreign-cubed" cases—in which the investors are foreign, the issuers are foreign, and the securities are listed on foreign exchanges—are not covered by the antifraud provisions of the U.S. securities laws absent a domestic purchase or sale.

BACKGROUND

The *Morrison* case related to alleged misstatements in National Australia Bank Ltd. ("NAB")'s financial statements based on the figures reported to NAB by its 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.

In late 2003, non-U.S. investors who had purchased NAB stock brought suit in federal court in the Southern District of New York against NAB, HomeSide, and three of HomeSide's top executives, alleging 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.

On appeal, the United States Court of Appeals for the Second Circuit invited the Securities and Exchange Commission 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 Report From Washington is published by the Washington, D.C. office of Simpson Thacher & Bartlett LLP.

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 the "conduct" test adopted by a number of Circuits, rather than either the SEC's recommended "materiality" 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. Justice Sotomayor, who sat on the Second Circuit at the time of the appeal, but was not on the *Morrison* panel, recused herself from this case.

The Supreme Court heard from the parties and the United States at oral argument on March 29. The plaintiffs argued that the scope of the antifraud provisions of the U.S. 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 U.S. soil. NAB, on the other hand, argued that the Court should affirm the Second Circuit's decision because the plaintiffs cannot overcome the presumption against extraterritoriality and that the securities laws should only apply to securities purchased or sold on U.S. exchanges, not to transactions involving securities of foreign issuers on foreign exchanges. Finally, advocating for a standard similar to that proposed by the SEC, the Government 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," but that the plaintiffs did not have a private right of action because the alleged conduct was not a direct cause of their alleged injuries.

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OPINION OF THE COURT

SUMMARY OF THE DECISION

In its opinion, written by Justice Scalia and joined by Chief Justice Roberts and Justices Kennedy, Thomas, and Alito, the Supreme Court held: "Section 10(b) reaches the use of a manipulative or deceptive device or contrivance 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."

The Court first corrected a threshold error in the Second Circuit's analysis. Although the Second Circuit had considered the question presented as one of subject-matter jurisdiction, the Court disagreed, explaining that the issue was one that goes to the merits, not one relating to the court's power to hear the case. The Court concluded that the district court had subject matter jurisdiction, and proceeded to address the question of whether the plaintiffs' allegations state a claim.

The Court stated: "It is a 'longstanding principle 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.'" Despite this canon of construction, the Court observed that "the Second Circuit believed that, because the Exchange Act is silent as to the extraterritorial application of §10(b), it was left to the court to 'discern' whether Congress would have wanted the statute to apply." Discussing the Second Circuit's decisions in *Schoenbaum v. Firstbrook*, 405 F. 2d 200, *modified on other grounds en banc*, 205 F. 2d 215 (2d Cir. 1968), and *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F. 2d 1326 (2d Cir. 1972), the Court described how the Second Circuit had created a "conduct" test and "effects" test to evaluate the extraterritorial application of Section 10(b). However, the Court concluded, "[t]he Second Circuit never put forward a textual or even extratextual basis for these tests." The Court also observed the difficulty of district courts in applying these "vague formations," and that commentators criticized the inconsistent treatment of Section 10(b) to transnational cases. "The criticisms seem to us justified," the Court concluded, and therefore, "[r]ather than guess anew in each case, we apply the presumption [against extraterritorial application] in all cases . . . ."

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The Court next rejected the plaintiffs' and Government's arguments in support of extraterritorial application of Section 10(b). First, the Court concluded: "The general reference to foreign commerce in the definition of 'interstate commerce' [used in the Exchange Act] does not defeat the presumption against extraterritoriality." Second, the Court found: "The fleeting reference to the dissemination and quotation abroad of the prices of securities traded in domestic exchanges and markets [in Congress's description of the purposes of the Exchange Act] cannot overcome the presumption against extraterritoriality." And, finally, the Court was "not convinced" that the presence of an exception to the extraterritorial application in Section 30(b) of the Exchange Act supported a finding of the Act's extraterritorial application more generally. "In short, there is no affirmative indication in the Exchange Act that §10(b) applies extraterritoriality, and we therefore conclude that it does not."

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The Court then analyzed the extent to which domestic conduct falls within the scope of Section 10(b). The Court concluded: "[W]e think 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 based its determination on the text of the statute, and observed that applying U.S. antifraud provisions to other transactions would interfere with foreign securities regulation. As a result, the Court set forth a new bright-line test governing the scope of Section 10(b) and Rule 10b-5: "it is in our view only transactions in securities listed on domestic exchanges, and domestic transactions in other securities, to which §10(b) applies."

Finally, the Court rejected the "significant and material conduct" test the Government had proposed, and which the plaintiffs had supported. First, neither the Government nor the plaintiffs provided any textual support for the test. Second, the Court was concerned by the "adverse consequences" of the test, in particular that "some fear that [the U.S.] has become the Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets." Third, the Court found the Government's support for its position unpersuasive because, in the case cited by the Government, unlike here, the fraud was complete once executed within the U.S. Fourth, the fact that the proposed test is consistent with prevailing notions of international comity "in no way tends to

prove that that is what Congress has done." And, finally, the Court found that no deference was warranted to the SEC's interpretation that is similar to the "significant and material conduct" test because the SEC's interpretation is based upon cases the Court disapproved of for ignoring or discarding the presumption of extraterritoriality.

"The federal courts have been construing §10(b) in a different manner for a long time, and the Court's textual analysis is not nearly so compelling . . . as to warrant the abandonment of their doctrine."

JUSTICE STEVENS, concurring

Justice Stevens authored an opinion joined by Justice Ginsburg that concurred in the judgment, but disagreed with the Court's new bright-line rule as to the scope of Section 10(b). According to Justice Stevens, "the federal courts have been construing §10(b) in a different manner for a long time, and the Court's textual analysis is not nearly so compelling . . . as to warrant the abandonment of their doctrine." Justice Stevens stated that the Court has consistently recognized that courts may need to "flesh out" portions of the law in applying Section 10(b) and Rule 10b-5, noting that "[t]he Second Circuit refined its test over several decades and dozens of cases, with the tacit approval of Congress and the Commission and with the general assent of its sister Circuits."

Justice Stevens also took issue with the Court's application of the presumption against extraterritoriality. According to Justice Stevens, "the Court seeks to transform the presumption from a flexible rule of thumb into something more like a clear statement rule." Furthermore, he said, "the Court errs in suggesting that the presumption against extraterritoriality is fatal to the Second Circuit's test" because "the real question in this case is how much, and what kinds of, *domestic* contacts are sufficient to trigger application of §10(b)." Accordingly, Justice Stevens would have adopted the Second Circuit's standard of applying Section 10(b) extraterritorially only when: (1) "substantial acts in furtherance of the fraud were committed within the United States"; or (2) "when the fraud was 'intended to produce' and did produce 'detrimental effects within' the United States."

Justice Breyer authored a brief opinion concurring in part and concurring in the judgment. According to Justice Breyer, Section 10(b) is inapplicable because: (1) "the purchased securities are listed only on a few foreign exchanges . . ."; and (2) "the relevant purchases of these unregistered securities took place entirely in Australia and involved only Australian investors." Echoing his apparent concern at oral argument about exporting frauds from the U.S., he noted that state law or other federal fraud statutes, such as for mail fraud and wire fraud, may apply to the fraudulent conduct alleged to have occurred in the U.S.

IMPLICATIONS

The Supreme Court's decision in *Morrison* establishes a bright-line, transaction-based rule under which Section 10(b) and Rule 10b-5 apply only to alleged fraud arising in connection with the purchase or sale of securities made in the U.S., or involving a security listed on a domestic exchange. This is consistent with the scope of the Securities Act of 1933, which the SEC has interpreted as not reaching sales outside the U.S. In setting forth this rule, the Court altered the legal landscape by rejecting both the "effects" test and "conduct" test that have been used by courts for decades in evaluating the extraterritorial application of the federal securities fraud provisions. Many lower courts found the prior tests difficult to apply. The new rule should lead to more consistent and predictable outcomes, although exactly when transactions in securities not listed on domestic exchanges should be treated as "domestic transactions" covered by the statute may not always be easy for lower courts to discern.

Furthermore, although Justice Stevens states in a footnote in his concurrence that the Court's decision does not foreclose enforcement actions in such cases by the SEC, *Morrison*'s holding regarding the proper substantive scope of Section 10(b) would appear to suggest that there is certain U.S.-based conduct related to foreign securities transactions that U.S. criminal prosecutors can reach under mail fraud and wire fraud statutes, but that the SEC cannot reach under the securities laws.

Finally, *Morrison*'s explicit reaffirmation of the "presumption against extraterritoriality" may also have an impact on how courts in the future think about the extraterritorial application of other federal statutes in private actions, including civil RICO.

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