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EXTRATERRITORIALITY FOR SECURITIES FRAUD POST-*MORRISON*

INTRODUCTION

In 2010, the Supreme Court decided *Morrison v. National Australia Bank Ltd.*, which addressed the extraterritorial application of the Securities Exchange Act of 1934. In the late 1960s, the Second Circuit developed a set of tests allowing the extraterritorial enforcement of § 10b. In *Morrison*, the Supreme Court overturned the Second Circuit's precedents and established a new test. This essay will look at the history, current trends, and possible future developments with respect to extraterritoriality of securities enforcement.

I. EXTRATERRITORIALITY IN PRE-*MORRISON* ERA

During the pre-*Morrison* era, *Schoenbaum* and *Leasco*, both Second Circuit decisions, governed extraterritorial application of § 10b.¹ In *Schoenbaum*, the underlying conduct involved a Canadian corporation's sale of treasury shares in Canada. At the time of the sale, the Canadian corporation had publicly traded shares on the American stock market. The Second Circuit concluded that because the sale affected the common shares on the American stock market, the Exchange Act of 1934 had extraterritorial jurisdiction over conduct in Canada in order to "protect American investors."²

In *Leasco*, the underlying conduct involved the purchase of an English corporation's securities in England.³ Unlike *Schoenbaum*, the English corporation had no securities on American markets.⁴ The company that purchased the securities was American and some of the English corporation's fraudulent conduct occurred in the United States.⁵ The Second Circuit concluded that the Exchange Act could be read to have extraterritorial jurisdiction over the transaction in England because Congress had prescriptive

¹ See generally *Leasco Data Processing Corp. v. Maxwell*, 468 F.2d 1326 (2nd Cir. 1972); *Schoenbaum v. Firstbrook*, 405 F.2d 200 (2nd Cir. 1968).

² *Schoenbaum*, *supra* note 1, at 206.

³ *Leasco*, *supra* note 1, at 1330-33.

⁴ *Id.*

⁵ *Id.*

jurisdiction to regulate the underlying conduct.⁶ The court reasoned that if the 1934 Congress had been presented with the facts in *Leasco*, the legislature would have wanted § 10b to apply.⁷

In the thirty years following *Schoenbaum* and *Leasco*, the Second Circuit used the principles of these cases to create a two-part disjunctive test. The first part, the “effects test,” determined “whether the wrongful conduct had substantial effect in the United States or upon United States citizens.”⁸ The second part, the “conduct test,” determined whether the “wrongful conduct occurred in the United States.”⁹ The result was a flexible test, which gave the Exchange Act extraterritorial reach for a § 10b violation that affected American interests. The test allowed the courts to reach fraudulent securities transactions by foreign companies in foreign markets when American investors were harmed.

The approach adopted by the Second Circuit was met with considerable criticism because its test led to an “assumption-driven analysis” due to the lack of any bright line rules.¹⁰ As a result, judges made case-by-case determinations, leaving foreign markets in the dark.¹¹ Other critics, attacking the original reasoning in *Schoenbaum*, claimed that Congress either rejected extraterritorial application or that congressional silence did not give the Second Circuit license to create a judge-made rule.¹² This criticism came primarily from outside the judicial system as the circuit courts tended to accept the “conduct” and “effects” test.

II. *MORRISON* AND ITS PROGENY IN CIVIL CASES

Justice Scalia’s majority opinion in *Morrison* overturned the “conduct” and “effects” tests and replaced them with a “domestic transaction” test.¹³ In

⁶ *Id.* at 1334-37.

⁷ *Id.* at 1337 (“Still we must ask ourselves whether, if Congress had thought about the point, it would not have wished to protect an American investor if a foreigner comes to the United States and fraudulently induces him to purchase foreign securities abroad . . . [W]e think it tips the scales in favor of applicability when substantial misrepresentations were made in the United States.”).

⁸ *SEC v. Berger*, 322 F.3d 187, 192-93 (2nd Cir. 2003).

⁹ *Id.*

¹⁰ Stephen Choi & Linda Silberman, *Transnational Litigation and Global Securities Class-Action Lawsuits*, 2009 WIS. L. REV. 465, 505 (2009).

¹¹ *Id.* at 506.

¹² Margaret v. Sachs, *The International Reach of Rule 10b-5: the Myth of Congressional Silence*, 28 COLUM. J. OF TRANSNAT’L L. 677, 721 (1990).

¹³ *See generally Morrison v. Nat’l Austl. Bank Ltd.*, 130 S.Ct. 2869 (2013).

Morrison, the respondent, Australia National Bank, operated in Australia and had common stock on the Australian Stock Exchange Limited and other foreign exchange markets.¹⁴ The bank had no common stock on American exchange markets.¹⁵ The underlying fraudulent conduct occurred in Australia.¹⁶ The Second Circuit upheld the district court's dismissal of the case.¹⁷ The Second Circuit, applying the "conduct" test concluded that the "heart of the conduct" occurred in Australia.¹⁸ It therefore held that it did not have subject-matter jurisdiction over the fraudulent conduct.¹⁹

The Supreme Court affirmed the dismissal, but in a lengthy opinion, overturned the "conduct" and "effects" tests. Justice Scalia strongly criticized the Second Circuit for disregarding the presumption against extraterritorial jurisdiction without clear congressional intent.²⁰ Looking to the text of the Exchange Act, Justice Scalia did not find any textual support for extraterritorial application.²¹ Drawing analogies to the extraterritorial application of Title VII, in *EEOC v. Arabian American Oil Co.*, the Court held that when an American company hires an American citizen to work abroad, Title VII does not apply because the law focuses on "domestic employment."²² Justice Scalia reasoned that the "focus" of the Exchange Act is on the deceptive conduct in relation to the purchase and sale of domestic securities.²³ Thus, the new test for the jurisdiction of the Exchange Act turns on the location of the transaction involving securities.²⁴ The Exchange Act will have jurisdiction if the transaction occurred in the United States.²⁵ Applying this new test to the facts of *Morrison*, the high court affirmed the dismissal of the case because the transaction for securities occurred in Australia.²⁶

In *Absolute Activist Value Master Fund Ltd. v. Ficeto*, the Second Circuit, applying *Morrison*, developed a definition for when a securities transaction is domestic. In *Absolute Activist*, a foreign company committed the fraudulent

¹⁴ *Id.* at 2875.

¹⁵ *Id.*

¹⁶ *Id.* at 2876.

¹⁷ *Id.*

¹⁸ *Morrison v. Nat'l Austl. Bank Ltd.*, 547 F.3d 167, 175-76 (2nd Cir. 2009).

¹⁹ *Id.* at 176.

²⁰ *Morrison*, *supra* note 13, at 2883.

²¹ *Id.*

²² *EEOC v. Arabian Am. Oil Co.*, 499 U.S. 244, 246, 259 (1991).

²³ *Morrison*, *supra* note 13, at 2884.

²⁴ *Id.* at 2885.

²⁵ *Id.*

²⁶ *Id.*

securities transaction.²⁷ Despite many connections to the United States, including victims' and perpetrators' residency in the United States, the court could not definitively show that the transaction took place on American soil.²⁸ Establishing a definition for domestic transaction, the court held that a "securities transaction is domestic when the parties incur irrevocable liability to carry out the transaction within the United States or when title is passed within the United States."²⁹ Therefore, the court held that the transactions failed to satisfy the "domestic transaction" test established in *Morrison*.³⁰

III. APPLICATION TO CRIMINAL CASES

In *United States v. Vilar*, the Second Circuit applied *Morrison* to criminal prosecutions of securities fraud. The defendants executed a fraudulent securities scheme through a foreign company.³¹ The prosecution sought to establish jurisdiction through the old "conduct" and "effects" tests by limiting *Morrison* to civil cases.³² Following Justice Scalia's reasoning, Circuit Judge Cabranes concluded that the same justification for the presumption against extraterritoriality applied to criminal cases.³³ The fundamental purpose "to protect against unintended clashes between our laws and those of other nations which could result in international discord" is served equally in applying the presumption against extraterritoriality in civil and criminal cases.³⁴ Therefore, the court held that the "transactional" test in *Morrison* applies to criminal prosecutions.³⁵

Nevertheless, in *Vilar*, the Second Circuit established jurisdiction in accordance with *Morrison* using the domestic transaction definition established in *Absolute Activist*. In *Vilar*, in count one, renewal contracts occurred on American soil.³⁶ In count two, the victim prepared and delivered papers executing the transaction on American soil.³⁷ The court concluded that the record evinced facts "concerning the formation of contract" and "exchange of

²⁷ *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 63 (2nd Cir. 2012).

²⁸ *Id.* at 70.

²⁹ *Id.* at 67.

³⁰ *Id.*

³¹ *U. S. v. Vilar*, 729 F.3d 62, 68-69 (2nd Cir. 2013).

³² *Id.* at 72.

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.* at 76.

³⁷ *Id.* at 77.

money[,]” establishing “irrevocable liability” in the United States.³⁸ This led the court to hold that the conduct of the defendants fell within the jurisdiction of § 10b(5) of the Exchange Act, but only because it satisfied the “domestic transaction” test.³⁹

IV. MOVING FORWARD

The Dodd-Frank Wall Street Reform and Consumer Protection Act amended certain provisions of the Exchange Act. In particular, § 78aa(b) provides for District Court’s jurisdiction over:

- 1) Conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside 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.⁴⁰

These provisions did not apply in *Morrison*, *Absolute Activist*, or *Vilar* because of the presumption against retroactivity when legislation establishes jurisdiction.⁴¹ At first glance, § 78aa(b) appears to codify the “conducts” and “effects” test. A closer reading, however, reveals that the provisions only refer to the extraterritorial jurisdiction of the District Courts and not to the substantive provision of § 10(b).⁴²

Foreshadowing this distinction, Justice Scalia specifically referred to § 78aa(b) in his *Morrison* majority opinion.⁴³ As part of his rejection of the pre-*Morrison* regime, he points out that the lower courts mistakenly viewed extraterritorial reach of § 10(b) as a subject-matter jurisdiction question.⁴⁴ “But to ask what conduct § 10(b) reaches is to ask what conduct § 10(b) prohibits, which is a merits question.”⁴⁵ “[S]ubject-matter jurisdiction, by contrast,” he continues, “refers to a tribunal’s power to hear a case.”⁴⁶ Scalia then reads § 78aa(b) as conferring subject-matter jurisdiction to the district courts “to

³⁸ *Id.* at 78.

³⁹ *Id.* at 77-78.

⁴⁰ 15 U.S.C.A. § 78aa(b).

⁴¹ See *Hughes Aircraft Co. v. U.S.*, 520 U.S. 939 (1997).

⁴² *Morrison*, *supra* note 13, at 2877.

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

adjudicate whether § 10(b) applies to a National’s conduct.”⁴⁷ By emphasizing this distinction, Justice Scalia laid the foundation for excluding § 78aa(b) from reestablishing the “conduct” and “effects” test.

Court watchers have identified *SEC v Cañas Maillard* as a possible test case for the government to assert extraterritorial jurisdiction through § 78aa(b).⁴⁸ In *Cañas Maillard*, two Spanish citizens were accused of insider trading in the takeover of a Canadian-based company.⁴⁹ The Canadian company was listed on the New York Stock Exchange.⁵⁰ Also, some of the securities trades occurred on the New York Stock Exchange, but the transaction were executed in foreign countries.⁵¹ Following *Vilar*, the basis for jurisdiction in § 10(b)5 criminal prosecution must rest on domestic transactions. In *Cañas Maillard*, the SEC will have difficulty in establishing “irrevocable liability” in the United States under the “domestic transaction” test.⁵² Therefore, to establish extraterritorial jurisdiction the SEC will likely have to rely on a different theory to establish jurisdiction. In other words, this case will likely determine whether the SEC can use § 78aa(b) to establish extraterritorial jurisdiction over foreign transactions.

CONCLUSION

Assuming that the application of § 78aa(b) does not overturn *Morrison*, what will be the legacy of *Morrison* on enforcement of foreign securities fraud? While overturning the “conducts” and “effects” tests, the subsequent decision by the Second Circuit have effectively limited *Morrison* to the facts of the case; a foreign corporation executing foreign transactions. This effectively eliminates any attempt of resurrecting the “effects” test because any extraterritorial jurisdiction based solely on adverse effects on American markets would be dismissed under *Morrison*. When investing offshore, investors are now acutely aware that they probably do not have a remedy in

⁴⁷ *Id.* § 78aa(b) would not go into effect until July 22, 2010; however, *Morrison* was decided a month earlier.

⁴⁸ Miles Norton, Patrick Smith, Jeffrey Rotenberg & Sarah Zimmer, *United States v. Vilar: New Limits on Extraterritorial Securities Enforcement*, DLAPIPER.COM, <http://www.dlapiper.com/us-v-vilar-new-limits-on-extraterritorial-securities-enforcement/> (last visited Mar. 6, 2014).

⁴⁹ *SEC v. Cañas Maillard*, Civil Action No. 13-CV-5299 (S.D.N.Y. Aug. 1, 2013), available at <http://www.sec.gov/litigation/litreleases/2013/lr22768.htm> (last visited Mar. 6, 2014).

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² Norton, *supra* note 48.

American courts.⁵³ They must therefore “make a legal decision, in addition to a financial decision.”⁵⁴

Has the Second Circuit resurrected a ghost of the “conduct” test through its “irrevocable liability” definition in *Absolute Activist* and *Vilar*? In *Leasco*, the court found extraterritorial jurisdiction based on the fact that a contract for sale of foreign securities had been negotiated and signed in New York.⁵⁵ Using similar language in *Vilar*, the Second Circuit concluded that “the record contains facts ‘concerning the formation of the contracts’ and ‘the exchange of money,’ which are precisely the sort that we indicated may suffice to prove that irrevocable liability was incurred in the United States.”⁵⁶ This description of the record in *Vilar* could very well describe the reasoning behind *Leasco* and the “conduct” test. In other words, the Second Circuit has limited *Morrison* to overturning only the “effects” test while still applying the ghost of the “conduct” test.

ADDENDUM

Since the writing of this essay, Cañas Mailliard settled with the SEC.⁵⁷ The decision to settle followed a district court memorandum opinion and order freezing assets and other equitable relief.⁵⁸ In its memorandum opinion, the court addressed the application of *Morrison* to the facts of the case.⁵⁹ In response to Malliard’s argument that he did not make a domestic transaction, the court wrote,

The Court is unpersuaded by this crabbed reading of *Morrison*. Although Cañas did not himself purchase a security that is listed on an American exchange, the fraudulent scheme as alleged by the SEC involved his purchasing CFDs in Luxembourg, which directly caused Internaxx to purchase securities that were listed on the NYSE.⁶⁰

⁵³ John Filar Atwood, *DC Bar Panel Examines Ongoing Impact of Morrison Decision*, 8 INT’L SEC. & FIN. REPORTING UPDATE (CCH) No. 10 (May 23, 2013).

⁵⁴ *Id.*

⁵⁵ *Leasco*, *supra* note 1, at 1332.

⁵⁶ *Vilar*, *supra* note 31, at 78.

⁵⁷ SEC, *Spanish Trader Agrees to Pay Disgorgement and a Penalty to Settle Insider Trading Case*, Litigation Release No. 23048 (July 22, 2014) available at <http://www.sec.gov/litigation/litreleases/2014/lr23048.htm> (last visited Oct. 5, 2014).

⁵⁸ SEC v. Malliard, No. 13-CV-5299, 2014 WL 1660024, at *1 (S.D.N.Y. Apr. 23, 2014) (Memorandum Opinion and Order Freezing Assets and Other Equitable Relief).

⁵⁹ *Id.* at *2-3.

⁶⁰ *Id.* at *3.

Instead of accepting a bright line rule between transactions domestic and foreign transaction, the court seems to harken back to an “effects test” from *Schoenbaum*. The case against Julio Marin Ugedo, the codefendant in *Mailliard*, continues.⁶¹

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⁶¹ SEC, *supra* note 57.

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