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NEW YORK JUNE 25, 2010

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U.S. Supreme Court Limits Section 10(b) of the Securities Exchange Act to Security Transactions Made on Domestic Exchanges or in the United States

On June 24, 2010, the United States Supreme Court issued an important decision addressing the extraterritorial application of the U.S. securities laws, rejecting the nearly four-decade old "conduct" and "effects" tests widely applied by the Courts of Appeals and holding that § 10(b) of the Securities Exchange Act of 1934 (the "Act") gives rise to liability only for securities transactions on a U.S. exchange or otherwise occurring in the United States.

In *Morrison v. National Australia Bank*, the Court held that § 10(b) did not provide a cause of action for Australian plaintiffs who purchased securities on foreign exchanges because the securities were listed *only* on foreign exchanges and "all aspects of the purchases . . . occurred outside of the United States." Absent a transaction on a domestic exchange or a purchase or sale in the United States, the Court held, a plaintiff cannot state a cognizable § 10(b) claim. Accordingly, the *National Australia Bank* significantly reduces many issuers' likelihood of facing federal securities class action liability in the United States.

I. Background

National Australia Bank arose out of a class action lawsuit filed by a group of plaintiffs against National Australia Bank ("NAB"), an Australian entity. The plaintiffs alleged that NAB's public disclosure contained fraudulent information relating to NAB's U.S. subsidiary, HomeSide Lending Inc. Three of the four named plaintiffs sought to represent a class of investors who purchased NAB shares on foreign exchanges. The Second Circuit's decision from which petitioners sought certiorari related only to the claims asserted on behalf of foreign exchange purchasers.[1]

The plaintiffs alleged that NAB's annual reports and press releases contained false and misleading information relating to HomeSide, a mortgage servicer headquartered in

[1] The claims of the fourth plaintiff, who had purchased American Depository Receipts, were dismissed for failure to allege damages. The dismissal of these claims was not appealed and thus not before the Supreme Court.

Florida, which NAB had acquired in 1998. According to the plaintiffs, HomeSide knowingly furnished fraudulent accounting information to NAB, and NAB subsequently included the information in its annual reports and press releases issued from Australia. Subsequently, NAB announced substantial writedowns due to a recalculation of HomeSide's information, causing NAB's share price to fall significantly.

The plaintiffs filed suit in the United States District Court for the Southern District of New York, asserting that the actions of NAB and HomeSide violated § 10(b) and § 20(a) of the U.S. Securities Exchange Act of 1934, and Rule 10b-5 thereunder (all of which generally prohibit making fraudulent statements in connection with the purchase and sale of securities). The plaintiffs argued that it was appropriate for the suit to be brought in the United States because the fraud was caused by the conduct of HomeSide in producing false accounting information, which occurred in the United States. Prior to the Supreme Court's decision here, U.S. courts had accepted jurisdiction over securities fraud actions where the fraudulent activity produced substantial "effects" in the United States (the "effects test"), or where the fraud resulted from significant "conduct" that took place in the United States (the "conduct test"). The plaintiffs argued under the conduct test.

On October 25, 2006, the District Court dismissed the case for lack of jurisdiction because the alleged conduct in the United States was "at most, a link in the chain of an alleged overall securities fraud scheme that culminated abroad." On October 23, 2008, the Second Circuit affirmed, holding that the conduct test applied but that the particular facts did not warrant accepting jurisdiction. On December 1, 2009, the Supreme Court granted the plaintiffs' petition for writ of certiorari.

II. The Supreme Court's Decision

Voting 8-0,[2] the Supreme Court held that § 10(b) provides a cause of action only for fraud "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," thereby disposing of the conduct and effects tests.

Writing for the Court, Justice Scalia, joined by Chief Justice Roberts and Justices Kennedy, Thomas, and Alito, first found that the extraterritorial reach of § 10(b) does not raise a question of subject-matter jurisdiction (whether the court has power to hear the case), as the District Court and Court of Appeals had analyzed. Rather, the Court held, extraterritorial reach of the statute is a merits question (whether a plaintiff's allegations entitle it to relief). The Court refused, however, to remand the case for this reason because "nothing in the analysis of the courts below turned on the mistake," and thus "a remand would only require a new . . . label for the same . . . conclusion."

[2] Justice Sotomayor took no part in consideration or decision of the case.

Turning to the merits, the Court began by reciting the long-standing presumption against extraterritorial application of U.S. law: "[w]hen a statute gives no clear indication of an extraterritorial application, it has none." Applying the presumption, the Court rejected the almost four-decade old conduct and effects tests developed by the Second Circuit (and adopted by other Courts of Appeals), finding that they had no basis in the text of the Act. The Court also found the tests were difficult to administer and led to unpredictable results.

The Court next turned to the text of the Act and found that because no language affirmatively indicated that § 10(b) should apply extraterritorially, it does not. The Court also examined the specific text and aim of § 10(b). Because § 10(b) punishes deceptive conduct "in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered," the Court observed, application of § 10(b) turns "not upon the place where the deception originated, *but upon the purchases and sales of securities in the United States*" (emphasis added). In other words, since "[t]hose purchase-and-sale [securities] transactions are the objects of the statute's solicitude," then § 10(b) applies only to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities." In support of this bright-line transaction-based rule, and citing *amicus* briefs filed by foreign governments and business associations, the Court noted the inevitable interference with regulatory regimes of foreign countries that would arise should § 10(b) apply to securities transactions abroad.

The Court also rejected the Solicitor General's proposed "significant and material conduct test" – that "[a] transnational securities fraud violates [§] 10(b) when the fraud involves significant conduct in the United States that is material to the fraud's success" – for lack of any support in the Act's text or case law. Further, the Court was dissuaded by the likely adverse consequences from this proposed test, which could continue to allow the United States to be "the Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets."

The Court concluded by applying the transactional test to the facts at issue and found that because the case involved no securities listed on a domestic exchange and "all aspects of the purchases complained of . . . occurred outside the United States," petitioners failed to state a claim upon which relief could be granted.

Justices Breyer, Stevens, and Ginsburg did not join Justice Scalia's majority opinion. Justice Breyer issued a brief concurring opinion, in which he determined that the text of § 10(b) did not apply because the purchased securities were registered only on foreign exchanges and "the relevant purchases of theses unregistered securities took place entirely in Australia and *involved only Australian investors*" (emphasis added.) Presumably, Justice Breyer would have found that § 10(b) applied if a sub-class of U.S. investors remained.

Justice Stevens, joined by Justice Ginsburg, concurred in the judgment only, agreeing that the plaintiffs failed to state a claim under the conduct and effects tests. Although Justice Stevens agreed that this particular transaction "has Australia written all

over it," he rejected the majority's new "transactional test" and argued that the Second Circuit's approach "has done the best job of discerning what sorts of transnational frauds Congress meant in 1934—and still means today—to regulate." Justice Stevens feared that the new bright-line transactional rule would allow certain transnational frauds that adversely impact American investors or markets to operate without redress. Justice Stevens also maintained that the plaintiffs' allegations, if true, could potentially render NAB accountable in an enforcement proceeding brought by the Securities and Exchange Commission even though they did not state a cognizable private claim.

The *National Australia Bank* decision follows other recent Supreme Court decisions interpreting the private right of action under § 10(b), in which the Court has clarified (or, in some observers' eyes, restricted) the reach of the private right of action.

III. Implications of the Decision

The *National Australia Bank* decision will provide companies that offer securities abroad with significant protection from U.S. securities class action litigation, so long as their securities are not purchased or sold in the United States or on U.S. exchanges. Although the case was a private shareholder action, the Court did not tether its territorial limit on § 10(b) to that fact. As such, it is possible that the Securities and Exchange Commission's enforcement power under § 10(b) may be similarly limited.

Finally, we note that the decision provides little guidance as to what constitutes the sale or purchase of a non-listed security "in the United States" under § 10(b). For example, is the sale of a non-listed security to a U.S. citizen living abroad a sale "in the United States"? What if the sales pitch was delivered in New York, but the transaction was completed overseas? Or what if the sale was simply billed to the United States or paid from a United States checking account or credit card? The lower courts are left to answer these questions and to ultimately define the boundaries of what constitutes a sale "in the United States" in our ever-expanding global world.

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Cleary Gottlieb Steen & Hamilton LLP represented the Securities Industry and Financial Markets Association, the Association for Financial Markets in Europe, the Chamber of Commerce of the United States of America, the United States Council for International Business, the Association Française des Entreprises Privées, and GC100, which were *amici curiae* in support of NAB.

For further information about the *National Australia Bank* decision or any of the issues discussed above, please do not hesitate to contact any of your regular contacts at the firm or any of our partners and counsel listed under Litigation and Arbitration in the "Practices" section of our website (www.clearygottlieb.com).

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